THE LAW OF CONTRACTS

SUPPLEMENTAL READINGS

Class 05

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CHAPTER 14 Incapacity

§14.1 THE SCOPE AND FOCUS OF THE DOCTRINES DISCUSSED IN THIS CHAPTER

The law generally assumes that all persons have the capacity to enter contracts. The two exceptions to this rule are minors and mentally incompetent adults. A minor’s lack of contractual capacity is relatively easy to establish because it is largely based on the objective criterion of age. The determination that an adult lacks contractual capacity is more complex because it requires proof of mental illness or disturbance sufficiently serious to render the person incompetent. Although mental incapacity is necessarily based on the party’s subjective state of mind, her mental condition is proved by objective evidence of her behavior observed by others, and by expert psychiatric evidence.

There are connections between incapacity and the doctrines discussed in Chapter 13, but there are also notable differences. The underlying rationale for permitting the avoidance of a contract entered into by a person who lacks mental capacity is the protection of the incapacitated person. This suggests analogies both to improper bargaining and public policy. However, there are important distinctions.

Although improper bargaining may sometimes be present in an incapacity case, especially where the other party has exploited the lack of capacity, there is no requirement that any improper bargaining be proved. Where the other party has taken advantage of the incapacitated party, this obviously has an influence on the court's decision on whether to permit avoidance of the contract on grounds of incapacity. However, the fundamental basis of incapacity is the legal status of the incapacitated party. This means that incapacity can be invoked even where there was no deception or illegitimate pressure in the formation of the contract and it is on fair terms.

Incapacity is based on the public policy of protecting an incapacitated person from assuming contractual duties to which she was not capable of assenting. However, incapacity usually does not create tension between the contract policy of freedom of contract and the more general policy, external to contract law, of protecting mentally incapacitated people. Rather, the policies pull in the same direction because the incapacitated party's lack of mental competence means that her apparent assent to the contract is illusory. The policy of freedom of contract is not served by holding a person incapable of assent to a false manifestation of it.

Like improper bargaining, incapacity renders the contract voidable, not void. Usually, avoidance of the contract in its entirety is the only appropriate form of relief. Severance is not a proper solution because the incapacity affects the whole contract, not just a term of it. Because there has been no breach of a contract, damages are not called for unless the conduct of the other party gives rise to some other cause of action. As in other situations of avoidance, rescission of the contract is accompanied by restitution of any benefit conferred under the contract. However, in the case of a minor, there are exceptions to this.

§14.2 MINORITY

§14.2.1 The Basis and Nature of a Minor's Contractual Incapacity

a. The Minor's Right to Disaffirm

A person attains majority at the age of 18 in most states. Before that time, the minor[1] does not have the legal capacity to be bound in contract, and the contract is voidable at the minor's instance.[2] As explained in section 13.3. a voidable contract is not absolutely void, but may be avoided at the instance of the party entitled to make that election. In the context of minor's contracts, it is the minor who has this power of avoidance, commonly referred to as the minor's right to disaffirm the contract. This means that the minor may disaffirm it at any time before reaching the age of majority, or within a reasonable time thereafter. Because a minor has no capacity to contract, it follows that she does not have the capacity to ratify (affirm) the contract while still a minor. This is why the right to make the election to disaffirm extends for a reasonable time past the attainment of majority. Nothing that the minor does before attaining majority, including full performance of the contract, constitutes a waiver of her right to disaffirm upon reaching majority. If the minor decides to disaffirm the contract, she must disaffirm it in its entirety. She cannot keep parts of it in force and seek to disaffirm others. For example, in *A.V. v. Iparadigms, L.L.C.*, 544 F. Supp. 2d 473 (E.D. Va. 2008), a school required its students to submit their class papers to a website that checked them for plagiarism. To use the website, students had to register on it. On registering, the students (who were minors) signified assent to a clickwrap agreement. One of its terms authorized the website to archive their work. The students later challenged terms of this agreement on several grounds[3] and also sought to disaffirm the contract as minors. The court refused disaffirmance because the minors did not entirely abandon the contract and still sought to retain the benefit of the services provided by the website. Similarly, in *E.K.D. v. Facebook, Inc.*, 885 F. Supp. 2d 894 (S.D. Ill. 2012), the minor continued to use Facebook's networking website while seeking to avoid a forum selection clause in Facebook's standard terms. The court held that the minor could not disaffirm only that part of the contract that does not suit him, while continuing to receive the benefit of performance under the contract.

b. Ratification

If the minor has not disaffirmed the contract by the time that she reaches the age of majority, she may ratify it as a major. Ratification can be express, or it could be by conduct if the minor takes a benefit under the contract after majority, or it could be implied if the minor fails to disaffirm the contract within a reasonable time after becoming a major. For example, in *In re The Score Board, Inc.*, 238 B.R. 585 (D.N.J. 1999), Kobe Bryant, the professional basketball player, entered into a contract at the age of 17 under which he granted rights to the use of his name and image on products. He turned 18 six weeks later. Shortly after his birthday, he deposited a check of $10,000, an initial payment under the contract, in his bank account. He continued to perform under the contract for the subsequent year and a half, and then became dissatisfied with the contract and sought to disaffirm it on the grounds that he was a minor when it was made. The court refused disaffirmance because he ratified the contract by affirmative conduct when he deposited the check. (For another case that illustrates implied ratification by conduct, *see State v. Bishop*, 240 P.3d 614 (Kan. App. 2010), described in section 14.2.2c.) Note, however, that some states may not treat conduct as implied ratification and may require an express or even a written ratification. For example, in *Foss v. Circuit City*, 477 F. Supp. 2d 230 (D. Me. 2007), the court refused to recognize ratification by conduct because a state statute required written ratification.

c. The Objective Nature of Minors' Incapacity

The legal incapacity of minors is based on the assumption that minors lack the maturity to make reasoned judgments in the conduct of their affairs and are vulnerable to exploitation. Of course, some minors, especially those close to majority, may in fact be mature and sophisticated enough to enter a contract, and the other party may not have taken advantage of the minor's youth and inexperience. Nevertheless, the law places the risk of contracting with a minor on the other party, so the minor's physical appearance and apparent or actual competence does not matter. The test for a minor's contractual capacity is purely objective, and the other party cannot prevent avoidance by showing that the minor was sufficiently mature or that the contract was on fair terms. The purely objective test of incapacity, based on age, has the advantage of certainty and simplicity, but it has the disadvantage of inflexibility and does not take into account that some minors do have both the maturity and the need to enter into contracts. It insulates a minor from responsibility for transactions, even where the adult party has not tried to take advantage of her, and the minor did in fact have enough maturity to make a reasoned judgment about entering the contract. This is particularly true of adolescents who are not far short of the age of capacity. As a result, some courts and commentators have criticized this test as paternalistic and rigid. This bright-line test has become even more questionable in the age of the Internet because minors are now so fully engaged in electronic commerce, and in some instances, are a dominant presence in the marketplace.

d. Parental Consent

A minor might be represented by a parent in entering into a contract, or might enter the contract with express parental permission. In some situations, the parent's involvement in the contract may make it binding on the minor, but this is not the general rule, and a minor usually does not lose the power to disaffirm merely because she was represented by or had the consent of a parent. For example, in *Berg v. Traylor*, 148 Cal. App. 4th 809 (2007), the court allowed a minor, a ten-year-old child actor, to disaffirm a representation agreement with an agent, even though the minor's mother represented him in entering the agreement. Although the court recognized that there are some situations recognized in the state by statute or caselaw in which a parent can bind a minor contractually (for example, a contract for medical services or a release of liability relating to participation in school activities), this was not such a situation.[4]

§14.2.2 Situations in Which a Minor May Incur Legal Liability

There are some limited situations in which a minor can incur legal liability as a result of having entered a contract. However, this liability may not be equal to the minor's full contractual commitment and may be confined to restitution for benefits received.

a. Necessaries

The most common situation in which a minor can incur liability is if the contract is for necessaries. A necessary is not the same as a necessity, and it has a broader meaning. It includes not only the bare necessities of life but whatever goods or services are needed for the minor’s livelihood or appropriate to her standard of living and position. However, it does not include luxuries. The question of what constitutes a necessary is factual and based on all the circumstances. As you may expect, what one court accepts as a necessary another could see as a luxury. For example, a court may or may not see a car as a necessary if it is used by the minor to drive to work or school. If the minor lives at home or is supported by her parents, even goods or services that would otherwise be required for subsistence are not likely to qualify as necessaries. For example, in *Webster St. Partnership v. Sheridan*, 368 N.W.2d 439 (Neb. 1985), the court held that an apartment leased by a minor was not a necessary. Although shelter is normally vital to an acceptable standard of living, the minor could have moved back to his parents’ home whenever he wanted.

The concept of emancipation is important to the minor’s liability for necessaries. *Webster St. Partnership* took the approach that unless a minor is emancipated, he has no liability for necessaries at all because his parents have a duty to support him. Other courts do not follow such a firm rule, even though they are more likely to classify goods or services as necessaries where the minor is emancipated. The exact meaning of “emancipated” is not entirely clear. Some courts define it narrowly to include only marriage or military enlistment. Other courts adopt a broader test, and find emancipation if the minor has established her own home and is independent of her parents and not supported by them.

There is also a difference of view on the enforcement of a claim for necessaries. Some courts see a contract for necessaries as an exception to the rule that the minor can avoid the contract. They therefore simply enforce it as if it was a major’s contract. Other courts avoid the contract even though it involved necessaries but hold the minor liable for restitution on the theory of unjust enrichment. This means that if the market value of the goods or services is less than the contract price, the minor is only liable for that lower value.

b. Misrepresentation of Age

The minor’s ability to escape liability under a contract is weakened if she deliberately misrepresented her age and the other party, acting reasonably, was misled by the misrepresentation and gave value to the minor or otherwise suffered a detriment in reasonable reliance on it. A court may fully enforce the contract by estopping the minor from asserting minority. (*See* section 8.4 for an explanation of estoppel.) Alternatively, the court may deny enforcement of the contract but hold the minor liable for the tort of fraud. (Accountability for tortious conduct typically begins at an earlier age than contractual capacity.) The remedy in tort is different from that in contract and aims at restoring the other party's loss rather than giving him the benefit of his bargain. To allow grounds for relief for misrepresentation, the fact misrepresented must be the minor's age. In *Foss v. Circuit City*, cited in section 14.2.1, the minor represented that he had parental consent to enter the contract by forging his mother's signature on the written agreement. The court held that this was not enough to estop the minor from asserting minority.

c. Statutory Exceptions

Apart from any recognition of liability under these principles of common law, a state or federal statute may confer contractual capacity on a minor of a specified minimum age with regard to certain types of contract. For example, minors are usually able to enter into insurance contracts or banking transactions, and a state may validate a minor's employment contract provided that it complies with the state's regulation of child labor.

Sometimes a statute expressly lowers the age of capacity for a particular type of contract. However, the statute may not always be that clear, so the legislature's intent to lower the age of capacity for particular types of transactions has to be determined by statutory interpretation. This issue can sometimes come up in a situation outside of the ordinary commercial context of contract law, as illustrated by *State v. Bishop*, 240 P.3d 614 (Kan. App. 2010). Bishop, a 16-year-old minor, entered into a diversion agreement with the state in 2002 to avoid prosecution for the offense of driving under the influence of alcohol. Under state law, a person who avoids prosecution by entering a diversion agreement is deemed to have been convicted of the offense. Bishop became a major in 2003. She was again caught driving under the influence of alcohol in 2004 and 2007. In her sentencing for the third offense, her previous diversion agreement was treated as a prior conviction. In an attempt to avoid the more severe penalty for a third conviction, Bishop sought to avoid the diversion agreement on the grounds that she was a minor without contractual capacity when she entered it. The court acknowledged that a diversion agreement is a contract, and that a minor would normally be able to disaffirm a contract entered into during minority. Although the statute governing diversion agreements did not specifically accord minors the contractual capacity to enter such agreements, the court concluded that the overall purpose of the statute made the contract binding. A minor who is old enough to get a driver's license is subject to the same standards and has the same responsibilities as an adult driver. All persons, regardless of age, are prohibited from driving under the influence of alcohol or drugs, and the statute was silent as to any age requirements. The court also found that, even if the agreement could have been disaffirmed by Bishop, she did not seek to disaffirm for several years after becoming a major, and this would have constituted a ratification of the agreement.

§14.2.3 Restitution or Other Relief Following Disaffirmation

If the contract is purely executory—that is, neither party has performed—disaffirmance simply terminates it. However, if either party had given value to the other before disaffirmance, the effect of disaffirmance is more complicated. Where a contract between parties of full contractual capacity is avoided, each party must restore whatever she has received from the other under the avoided contract. When the avoidance concerns a minor's contract, this general rule is not as firmly followed. The major party must always restore in full the value of anything that he has received from the minor. However, the minor is generally only liable to return to the major party whatever she still has left of the major's contract performance at the time of avoidance. As part of the goal of protecting the minor from an improvident contract, the minor is shielded from liability beyond the duty to return the present and existing economic advantage that she retains at the time of avoidance. She does not have to pay the major the value of services or of property that has been consumed or lost. For example, say that the minor bought a car for $10,000. The minor paid $2,000 down and agreed to pay the balance in installments. Six months later, the car was stolen, and the minor had not bought theft insurance for it. The minor may disaffirm the contract and is entitled to restitution of the $2,000 down payment as well as the installments that she paid during the six months. As she no longer has the car, she has no obligation to restore the value of the car to the seller. She is also not obliged to compensate the seller for the value of her six months' use of the car. Similarly, if the car was not stolen but damaged in an accident, the minor's only obligation on disaffirmance is to return the damaged car to the seller. In *I.B. ex rel. Fife v. Facebook, Inc.*, 905 F. Supp. 2d 989 (N.D. Cal. 2012), a minor used his mother's credit card to purchase Facebook Credits, which were used to play a game called "Ninja Saga." The mother had authorized an initial purchase of $20 worth of credits, but Facebook stored the credit card information, so the minor was able to continue to make in-game purchases that ultimately amounted to several hundred dollars. Upon discovering this, the mother brought a class action against Facebook to disaffirm the contract on behalf of her own son and similarly situated minors. Facebook moved to dismiss the suit on several grounds, including that the minor could not disaffirm the contract because he had already received the benefit of the Facebook Credits. The court denied the motion to dismiss, holding that the minor was entitled to disaffirm and to recover all consideration paid to Facebook, without any obligation to restore to Facebook the value of the Facebook Credits used up in the game. The court also held that it did not matter that the payments made to Facebook came from the mother's credit card account and were not the minor's own money.

Some courts apply the rule restricting the minor's restitution absolutely, but others are concerned that it is too generous to the minor. A few courts do require the minor to restore the value of what she has received, whether or not she still has it. Others courts are willing, in limited circumstances, to impose some liability on a minor beyond the bare return of what she still has. For example, if the contract was fair and did not exploit the minor, and the major was not aware of the minority, a court may allow the major party to offset (deduct) the value received by the minor against what he is obliged to refund to the minor. (That is, if the minor has paid the major party, the restitution of that payment by the major party is reduced by the value of the benefit to the minor.) Some courts limit the value of the benefit to an offset against the major's restitution, but others have granted a judgment against the minor beyond the amount of the offset. *Dodson v. Schrader*, 824 S.W.2d 545 (Tenn. 1992), is an example of the former approach. The minor had paid cash for a truck and had then caused severe damage to its engine by neglect. The court permitted the minor to avoid the contract and to recover the cash paid for the truck, but it allowed the major party to offset against his restitutionary payment the value of the minor’s use of the truck and its depreciation. By contrast, in *Valencia v. White*, 654 P.2d 287 (Ariz. 1982), the court imposed liability on a minor, beyond an offset against restitution, for the cost of repairing a truck that the minor had used in his trucking business. Instead of granting restitutionary relief to the major for the value of its performance, a court may allow the major to recover in tort where the minor’s fault caused the deterioration in the property. (For example, if the car accident mentioned above was caused by the minor’s negligence, the court may not allow the major to recover the value of the undamaged car or the value of the minor’s use, but may hold the minor liable in tort for the damage to the car.)

§14.2.4 Minors’ Internet Contracts

It is safe to assume that minors frequently enter into contracts for goods or services on the Internet, so one might have expected a flood of disaffirmance suits, such as the two cases against Facebook cited in sections 14.2.1 and 14.2.3, following the advent of transacting on the Internet. However, the number of such cases is quite modest in relation to the high volume of Internet commerce. It is not clear why this is so. It could be that Internet retailers tend to handle claims for disaffirmance informally by allowing cancellation of the contracts upon request or that the pervasive use of standard arbitration clauses preclude suits in courts, or that the value of many such transactions is too small to justify legal action (unless suitable for filing a class action). Whatever the reason, unless there is a state statute binding minors to the Internet transaction in question, minors’ Internet contracts are subject to the rules that cover minors’ contract generally.

§14.3 MENTAL INCAPACITY

§14.3.1 The Basis and Nature of Avoidance Due to Mental Incapacity

The common law has long recognized mental incapacity as a basis for avoiding a contract. Mental incompetence is determined at the time of contracting. If it can be proved to have existed at that time, it is a basis for avoidance even if the condition causing the incapacity was temporary or was not present before or after the transaction. In contrast to the objective incapacity of a minor, based on the fact of age alone irrespective of the minor's actual state of mind, the mental incapacity of a major is measured subjectively. It is based purely on the actual state of his mind. The law presumes that adults are competent to contract and an adult bound, under the objective test, to his manifestation of assent. A party seeking to avoid a contract on grounds of mental incapacity must rebut this presumption by proving that he suffers from a mental disability severe enough to preclude him from forming rational contractual intent. This is usually established by expert psychiatric testimony, corroborated by lay testimony of people who observed his conduct during the period that he entered the contract.

The purpose of permitting avoidance is the protection of the disabled person and his estate, but the benign motive of protection carries a risk of paternalism and intrusion. It could mean that a person diagnosed with or suspected of having a mental disease is deprived of his freedom to contract because others will not risk dealing with him. Even if that problem was overcome and a contract was made, a finding of incapacity might still undermine the party's autonomy. In many cases, it is not the contracting party himself who desires to escape the contract, but a family member (sometimes with a personal stake in having the contract avoided) who seeks to have him declared incompetent so that the contract can be avoided. In situations like this, a court has to be particularly careful that it is truly serving his best interests and not unduly interfering with his contractual liberty.

§14.3.2 The Test for Mental Incapacity: Cognitive and Motivational Disorders

The older-established test for mental incapacity is strict. The contract can only be avoided if, at the time of contracting, the party was unable to understand the nature and consequences of the transaction. This standard, called the cognitive test, confines avoidance to cases in which the party was so profoundly disabled that he did not know what he was doing. As knowledge of the effects of various kinds of mental illness grew over the twentieth century, courts came to accept that the cognitive test was too narrow and that there are many forms of mental incapacity that fall short of cognitive disability but that nevertheless so affect a person's judgment, self-control, and motivation that he is incapable of genuine assent. This led to a broader test that recognizes not only cognitive disorders but also an illness or defect that impairs the party's ability to transact in a reasonable manner. This test is commonly called the motivational test (also known as the affective, or volitional, test). Restatement, Second, §15(1) recognizes both the cognitive and motivational tests. Section 15(1)(a) sets out the cognitive test. It allows a party to avoid a contract if he "is unable to understand in a reasonable manner the nature and consequences of the transaction." Section 15(1)(b) sets out the motivational test, under which a party may avoid the contract if "he is unable to act in a reasonable manner in relation to the transaction and the other party has reason to know of his condition."

The "reason to know" requirement is included in the motivational test in §15(1)(b) but not in the cognitive test in §15(1)(a). This is because cognitive disorders are severe and profoundly disabling and also because cognitive incapacity is more likely to be apparent to the other party, at least where the parties had personal interaction. This reduces the likelihood that the other party did not reasonably rely on the genuineness of manifested intent and it strengthens the equities in favor of avoidance. However, because motivational disorders may be more subtle and less apparent to the other party, §15(1)(b) gives greater weight to the reliance interest of the other party, and only permits avoidance if the other had reason to know of the condition.

Davis v. Davis, 89 P.3d 1206 (Or. App. 2004), is a good illustration of the difference in approach and result between the cognitive and motivational tests. The parties entered into a divorce settlement in which the wife gave the husband full ownership of jointly owned stock options and their interest in a software company. About a month later, the wife moved to avoid the settlement on the grounds that she was not mentally competent when she made it. The couple had been married for about 17 years. The husband had physically abused the wife on numerous occasions during the marriage. A social worker who treated the wife after the dissolution testified that the wife loved and feared the husband enormously. The wife was diagnosed as suffering from depression, post-traumatic stress syndrome, and battered woman's syndrome. When the parties met to negotiate the settlement, the wife was emotionally distraught and also had hopes of reconciliation. When she expressed her desire to reconcile, the husband made it clear that he was not interested, and he also verbally abused her at one point during the course of the meeting. Near the end of this meeting, the wife told her attorney that she did not want to fight anymore and wanted to get the meeting over with. Contrary to her attorney's advice, she did not press for a half share in the stock options and interest in the software company but insisted on signing the agreement that gave the husband full ownership. The majority of the court of appeals upheld the trial court's dismissal of the wife's motion to set aside the agreement. Both courts considered themselves bound by the cognitive test, which had been adopted by the state supreme court. A concurring judge regretfully accepted this legal conclusion but expressed the view that the motivational test is more in accord with psychological theory and reflects a better understanding of human behavior.

This description of the case shows two things. First, it demonstrates the truth of the concurring judge's view that there are many situations in which a strict cognitive test disregards what could be a real and serious impairment of the capacity to make a rational and voluntary decision. Second, it suggests the hazard of the broader test. If mental incapacity is wide enough to encompass severe emotional disturbance short of cognitive disability, the test becomes less predictable and harder to apply. At the borderline, it may be difficult to distinguish incapacity that merits avoidance from eccentric, strangely motivated, ill-advised, or irrational decisionmaking that affects many transactions in the marketplace. A court that accepts the broader motivational test as a basis for avoidance can mitigate this risk by requiring persuasive expert testimony to establish a clinically recognized illness, and by adopting the qualification of Restatement, Second, §15(1)(b), which requires a showing of the other party's knowledge or reason to know of the mental condition.

It must be stressed that the basis of avoiding a contract for mental incompetence is lack of capacity, not harshness in the terms of the contract. Therefore, the party seeking avoidance need not show that the terms of the contract are unfair. Even a contract with perfectly reasonable terms can be avoided if mental incompetence is established. This does not mean that the existence of unfair or one-sided terms is irrelevant in cases of mental incompetence. As explained below, the decision to avoid the contract involves some degree of equitable balancing, and unfair terms or advantage-taking may influence the court in deciding to allow avoidance.

§14.3.3 Proving Mental Incapacity

Because adults are presumed to have contractual capacity, the party alleging incapacity has the burden of proving it. It is relatively easy to discharge this burden if the patient has been declared incompetent by a court and a guardian has been appointed to administer his affairs and property. However, sustaining the burden of proof is harder if there has been no adjudication of incapacity prior to the contract. To prove incapacity, the party must demonstrate both that the condition existed, and that it was in nature and extent severe enough to preclude an adequate degree of assent. This is usually shown by both expert psychiatric evidence and testimony by people who observed the behavior of the party at the time of the transaction. In *Sparrow v. Demonico*, 960 N.E.2d 296 (Mass. 2012), the court held that psychiatric diagnosis is indispensable because a lay witness is not qualified to give an opinion on mental condition.

In *Gaddy v. Douglass*, 597 S.E.2d 12 (S.C. App. 2004), the dementia of the mentally incapacitated party, an elderly woman with advanced Alzheimer's disease, was convincingly established by the testimony of three neurologists who examined her and three lay people who observed her conduct and attested to her gradual mental deterioration, confusion, and forgetfulness. As a result of this testimony, the court avoided a power of attorney that the incapacitated woman had executed in favor of some grasping relatives who induced her to sign it after they knew that she was suffering from the disease. In some cases, the evidence relating to mental incompetence can be complex and difficult to evaluate. For example, in *In re Jack*, 390 B.R. 307 (Bankr. S.D. Tex. 2008), the bankruptcy court had to determine whether an agreement to settle a personal injury claim, executed ten years before the case by Samuel Jack, the debtor's late husband, was voidable because of his mental incapacity at that time. Prior to entering the contract, Samuel had sustained a serious head injury while working as a longshoreman. In addition to this injury, which damaged his brain, Samuel suffered from alcoholism and had a preexisting mental disorder, known as schizoaffective disorder, which affected his judgment and reasoning ability. Around the time of entering the agreement, he was hospitalized several times, and some medical reports indicated that his thought processes were disordered and impaired. However, other expert opinion indicated that his thought processes were intact. To glean Samuel's mental capacity at the time of the contract, the court had to weigh and assess the credibility of considerable conflicting and complex evidence of medical diagnoses and observations of Samuel's conduct. It also had to take into account the nature of the contract and the degree to which a person of diminished mental capacity might be able to comprehend its purpose and effect. It ultimately determined that Samuel's wife (the debtor in bankruptcy) had not sustained the burden of proving that, at the time of contracting, Samuel was incapable of appreciating the effect of what he was doing or of understanding the nature of the transaction and the consequences of his actions.

§14.3.4 Distinguishing Actionable Mental Incapacity from Nonactionable Incompetence or Infirmity

As noted in section 14.3.3, avoidance for mental incapacity is confined to psychiatrically diagnosed mental illness or incompetence. Incompetence or infirmity that falls short of psychiatrically recognized mental incapacity does not give grounds to avoid the contract. This distinction is illustrated by *In re Seminole Walls and Ceilings Corp.*, 366 B.R. 206 (Bankr. M.D. Fla. 2007),[5] and *Sparrow v. Demonico*, cited above. In *Seminole Walls*, a bankruptcy court had to decide on the validity of a settlement agreement executed between a bankruptcy trustee and a photographer who claimed ownership of a collection of his photographs in the possession of the estate. The photographs were of Hollywood celebrities, including Marilyn Monroe, that had been taken by the claimant many years before and had later been acquired by the bankrupt company. The settlement agreement resolved the question of their ownership. One of the grounds raised by the claimant for avoiding the settlement agreement was that he was mentally incompetent when it was made. At the time of entering the agreement, the claimant was 87 years old and had had a mini-stroke. He was declared mentally incompetent a few months after entering the agreement. The court found that notwithstanding some degree of feebleness and considerable eccentricity at the time of contracting and the subsequent declaration of incompetence, there was insufficient evidence to show that he was incapable of entering into the settlement agreement at the time of contracting.

Sparrow involved a settlement agreement reached during mediation to resolve a family dispute over the ownership of real property. Frances Sparrow sought to enforce the settlement against her sister, Susan Demonico, and Susan's husband. The Demonicos claimed that the settlement was unenforceable because Susan had experienced a mental breakdown during the mediation and therefore lacked capacity to contract. The trial court denied enforcement of the contract on the basis of the Demonicos' testimony that Susan was very distraught and distressed at the time of the mediation. She cried most of the day, became less coherent and less in control during the course of the day, and was generally in a bad emotional state. The Supreme Court reversed. It held that the Demonicos had not sufficiently demonstrated that Susan lacked mental capacity at the time that she entered the settlement agreement. It recognized that incapacity could be present at the time of contracting, even where the party did not suffer from a permanent mental illness. However, mental incapacity cannot simply be established by lay observation of the party's emotional state but must be proved by expert psychiatric testimony that explains the nature of the party's mental incompetence and the manner in which it affected her ability to act rationally in relation to the transaction.

§14.3.5 Avoidance and Its Consequences

Like a minor's contract, the contract of a mentally incompetent person is voidable, not void. Unlike minority, however, mental disability does not disappear on a set and certain date, after which the fact of disaffirmance or ratification can be settled. The fate of a contract by a mentally incapacitated person may therefore hang in the balance until either it is disaffirmed or the incapacity abates, and the formerly incompetent party affirms it. (Or a guardian is ultimately appointed and does so.) In the interim, there may be performance or the other party may have otherwise changed his position in reliance on the contract. If that party had not taken unfair advantage of the other's mental incapacity—that is, he contracted on fair terms without awareness of the incapacity—Restatement, Second, §15(2) acknowledges his interests. It provides for termination of the power of avoidance to the extent that the contract has been so performed, or circumstances have so changed that avoidance would be unjust.

If the contract is avoided, the parties must be restored to the status quo ante. Both must return money or property received under the contract, or the value of property consumed or dissipated, or of services rendered. However, if the other party knew of and took advantage of the incompetence, the disabled party may be excused from paying to the extent that benefits received did not ultimately enrich him.

§14.3.6 Incapacity Induced by Alcohol or Drug Abuse

Courts recognize that if intoxication is severe enough, its impairing effect can be just as profound as mental illness. Therefore, a party is usually permitted to avoid a contract entered into under the influence of drugs or alcohol if the level of intoxication is sufficient to deprive him of understanding the transaction (cognitive disability) or of the ability to act rationally in relation to the transaction (motivational disability). In the latter case, as with motivational mental illness, the other party must have had reason to know of this. Restatement, Second, §16 follows this approach. The case for relief is even stronger if the terms of the resulting contract are unfair or unduly favorable to the other party.

Examples

1. Hardy Culturalist, age 19, was about to leave his hometown to attend college. Up to that time, he had operated a very successful part-time yard maintenance business on weekends. As he would no longer be able to service his customers, he wished to dispose of his lawnmower, trimmer, edger, and other garden tools. Laughan Mower, a 16-year-old high-school junior, who lived with his parents next door to Hardy, was interested in filling the gap that would be left by Hardy's departure. He wanted to buy the equipment and try to take over Hardy's customers. Hardy and Laughan began negotiations and eventually reached agreement on the sale of all the equipment for $800. This is a fair price, somewhat below its market value. Laughan did not have that much money in his savings account, so he paid $300 to Hardy and undertook to pay the balance in installments of $50 per month, which he expected would be generated from his yard work. Laughan had just taken a business law course in high school, so he knew that a sale of goods over $500 had to be recorded in writing and signed. He therefore drew up a simple document reflecting their agreement, and they both signed it. Under the state law applicable to this transaction, a person acquires contractual capacity at the age of 18.
   a. After taking delivery of the equipment and paying Hardy the $300, Laughan began work. He successfully groomed about five yards in the first week but did not enjoy the hard labor very much and began to regret having undertaken this new venture. In the second week, he had

a disaster. He lost control of the lawnmower, which ran over the trimmer, completely mangling it, and then plunged off a steep embankment and exploded. This experience convinced Laughan that yard work was not for him. He wishes to cancel the sale, get his $300 back, and return all the surviving equipment to Hardy. May he do this?

b. Say that at the time he made the contract with Hardy, Laughan was 17 years old and just two weeks short of his eighteenth birthday. Laughan took delivery of the equipment and paid Hardy the $300. He used the garden equipment for five weeks and then decided that he no longer wished to do landscaping work. (The calamity involving the runaway lawnmower did not occur, and Laughan was able to return the equipment to Hardy in much the same condition as when he bought it.) Laughan would like to avoid the contract, return the equipment to Hardy, and get his money back. Does this change in the facts affect Laughan's ability to disaffirm the contract?

2. Bonna Petite is a precocious 17-year-old with an appetite for *haute cuisine*. For a while she had been dying to eat lunch at Trés Cher, the most elegant and expensive restaurant in town. One day she put on her mother's best business suit and groomed herself meticulously, succeeding in making herself look like a young executive of around 25 years of age. She set off for the restaurant, where she was seated and served a magnificent lunch. At the end of the meal she announced to the waiter that she was a minor. She disaffirmed the contract and refused to pay for the lunch. The age of majority in Bonna's state is 18. Can she get away with this?

3. Price Slasher, a man of 82, had lived in his house for 45 years. During the last ten years of that period, following the death of his wife, he had lived alone. As he got older, it had become increasingly burdensome for him to maintain the house and to take care of domestic chores. He therefore decided that the time had come for him to sell it and to move to an assisted living complex. Price had always been a stubborn, impatient, and difficult man, and this had become worse as he aged. He hated asking anyone for help, and he rarely sought or listened to advice. His insistence on self-reliance had become quite worrisome to his daughter, because he did not seem to manage his affairs very well. He

was constantly losing things, could not keep his bank account balanced, forgot to pay some bills, and double-paid others without realizing it.

When he told his daughter that he planned to sell the house, she offered to help him, but he declined her assistance. She then begged him to get it appraised and to list it with a reputable real estate agent. He refused, insisting that he was fully aware of the market, knew exactly how much the house was worth, and was perfectly capable of negotiating the sale himself. In this he was quite wrong. His information about the market was years out of date, and he had never been much of a negotiator.

Price advertised the house for sale at a figure that was about 25 percent lower than its true market value. Lowe Ball saw the advertisement and came to see the house. It did not take him long to make an offer at the full asking price, which Price accepted. Lowe's contact with Price during the transaction was quite minimal. The parties had a short conversation when Lowe inspected the house, and another when the written offer was submitted and accepted. Lowe did not attempt to negotiate the price because he realized that Price's price was good (although he did not realize that it was so far below the market value of the house). His only impression about Price was that he was an elderly man of few words who seemed to know exactly what he wanted.

After the contract of sale had been signed, Price told his daughter about it. She was appalled because she knew that he had let the house go for a patently inadequate price. A long family meeting took place that evening, at which his daughter and other relatives finally convinced Price that he had sold too cheaply. He now wishes to rescind the sale. Does he have grounds to do so?

4. Clark Rapp, age 30, suffers from bipolar disorder, a psychiatric condition that causes extreme swings in mood, ranging from high (manic) periods to depressive periods. During the high periods, a patient with this disorder becomes excitable and hyperactive and experiences lack of self-control and impaired judgment. During a manic episode, Clark visited the website of an exclusive resort and booked an exorbitantly expensive and luxurious vacation. To complete and submit his online booking, Clark signified his agreement to the resort's standard terms by clicking on an "I agree" button on the website. Clark did not read the standard terms before clicking the button. One of the terms

stated, “I understand that upon submission of my booking, my credit card will be debited with the full cost of the accommodation booked. This booking cannot be changed and if I cancel it I will not be entitled to a refund of this charge.” A few days after booking the vacation, Clark’s manic episode ended. He regretted booking the expensive vacation. When the resort refused to cancel the booking and refund his payment, Clark sued to avoid the contract and recover his payment. What are his prospects of success?

5. Change the facts of Example 4 to the following extent: Clark is not an adult suffering from bipolar disorder or any other psychiatric condition, but is a minor, age 17. Clark is intellectually gifted. He graduated from high school at the age of 16 and is a college student. He has his own credit card, which he used to book the vacation. (Under a state statute, a minor may validly contract for a credit card from the age of 16.) May Clark avoid the contract and recover his payment?

Explanations

1. a. This is a sale of goods, but apart from the statute of frauds issue, which Laughan has cleverly satisfied, there are no special rules applicable in this case. UCC Article 2 does not deal with minors’ contracts, which are therefore governed in sales transactions by general principles of common law.

   Because Laughan is a minor, he may disaffirm the contract. It does not matter that he may have been smart and sophisticated enough to understand exactly what he was doing, that he was knowledgeable about the statute of frauds, or that he planned to use the equipment for a moneymaking venture. The protection from contractual commitment afforded a minor is based on the objective fact of age and does not take account of the subjective attributes of the minor. The objective criterion of minority also makes it irrelevant that Hardy was little over the age of minority himself, that the contract was on fair terms, or that Hardy did not exploit or take advantage of Laughan. Laughan’s right to disaffirm does not depend on a showing of substantive unfairness or bargaining impropriety.

   When the minor elects to disaffirm the contract, each party must restore what was received from the other. However, if the minor has lost, consumed, or damaged property obtained under the contract, the established rule is that he is responsible to restore only what he has at the time of disaffirmance and need not compensate the major for any shortfall. Under this rule, Laughan is entitled to his $300 back and must return the surviving equipment to Hardy. Some courts have recognized that a rigid rule to this effect may not be fair in every case, and have been willing, in proper circumstances, to hold the minor liable for more than the mere return of existing enrichment. The basis for liability could be tort where the minor has caused the loss negligently. (Liability for tort arises at a younger age than contractual capacity.) If Laughan was negligent in losing control of the mower, this approach would make Laughan responsible to reimburse Hardy for the value of the lost mower and trimmer, in addition to returning the other equipment. As an alternative to tort liability, some courts require the minor to restore the value of any benefit received from the use of the property. Some courts confine recovery to an offset against any restitution due to the minor, but others are willing to grant a money judgment against the minor, imposing liability on him greater than any offset against restitution. Laughan earned money by using the equipment for a week. He may therefore be responsible, in addition to restoring the remaining tools to Hardy, for payment of the rental value of all the equipment for a week.

If the court does not apply either of the above principles to compensate Hardy for the loss, he may try the argument that the mower and trimmer were necessaries, because Laughan used them to earn money. This is not a strong argument because Laughan was still in school and living with his parents. He did the yard work on a part-time basis, and not as a means of earning his livelihood. If the goods were to be classified as necessaries, some courts would treat the contract as fully enforceable, so that Laughan would have no right of avoidance. Other courts would allow avoidance but would require the minor to make restitution for the value of what he received. On this basis, if the goods were held to be necessaries, Laughan would, in addition to returning the other (undamaged) equipment, be liable to pay for the mower and trimmer, based on the lesser rate of the contract value or fair market value at the time of sale.[6] In this case, fair value was apparently above the contract price, so the contract price of the destroyed mower and trimmer would be the proper measure of recovery.

b. The fact that Laughan was almost 18, rather than 16, at the time of contracting does not affect Laughan's right to avoid the contract. Minority is measured objectively, and the only question is whether or not Laughan was a minor at the time of contracting, even if he was almost a major. However, once a minor reaches the age of majority, he may ratify the contract, thereby fully validating it and terminating the power to avoid it. Ratification may be express, or it could be implied where the minor fails to disaffirm the contract within a reasonable time of reaching majority or otherwise acts in a way that signifies an intent to ratify. (As noted in section 14.2.1, an argument of implied ratification would not work in a state that requires a written ratification.)

The measurement of a reasonable time for disaffirmance is a factual question, based on all the circumstances of the case. About three weeks have passed since Laughan's eighteenth birthday and he has not yet disaffirmed. His failure to act for three weeks may in itself constitute a ratification. Even if this passive delay in disaffirming is not, in itself, enough to constitute ratification, Laughan continued to use the equipment during the three-week period. This action is inconsistent with an intent to disaffirm, and likely constitutes conduct evidencing an intent to ratify.

2. A minor may disaffirm her contract at any time before or within a reasonable time after attaining majority. The general rule is that she must restore any benefits that she still retains at the time of disaffirmance, but is not accountable for the value of property that has been consumed or dissipated. (In a sense, she does still have Trés Cher's property and will retain it until the process of digestion is complete, but Trés Cher would probably not be too interested in the disgorgement of this benefit.)

The general rule places the burden on Trés Cher to inquire about the age of its youthful-looking customers, and it bears the risk of failing to do so, even if Bonna looked older than she was. On the other hand, Bonna has behaved very badly, and the law should not encourage our young citizens to do this kind of thing. There are a few possibilities for holding Bonna accountable for her conduct.

Trés Cher could argue that the meal was a necessary. Food required for sustenance could qualify as a necessary, but it is harder to so classify a sumptuous meal at a fancy restaurant, especially where the minor lives with her parents and has food available at home. Alternatively, Trés Cher could argue that Bonna should be held liable in tort for deliberately misrepresenting her age. Because responsibility for tort arises at an earlier age than contractual capacity, a finding of fraud could make Bonna liable for the loss caused by her misrepresentation. The difficulty with this argument is that courts usually require that the minor makes an affirmative lie about her age. Dressing up is probably not enough to constitute a deliberate misrepresentation of age.

In the absence of a finding of liability for a necessary or in tort, the established rule is that a minor is responsible to restore only the existing benefit received under the contract. Some courts have moved away from that absolute rule and do permit restitution of the value of a consumed benefit provided that the contract was fair and the major party was unaware of the minority. There is a stronger incentive for adopting this approach where, as here, the minor was willful in causing the major party's loss. The court may limit the minor's obligation to restore the value of his benefit to an offset against the major party's restitutionary obligation to the minor. If the court adopts this limitation in the present case and so confines the major party's recovery against the minor, Trés Cher would receive nothing because Bonna gave nothing to the restaurant and there is no restitution owed to her against which her obligation could be offset.

As a matter of policy, a rule that confines the major party's recovery to the minor's existing benefit most strongly advances the goal of protecting the minor against improvident conduct that creates liability. However, a rule that makes a minor fully accountable for the value of the benefit, even if consumed or lost, allows the court to sanction the minor's irresponsible or antisocial conduct. A rule that makes the minor accountable for a consumed or lost benefit, but only to the extent of an offset against the major party's restitutionary obligation, is a compromise solution that tries to accommodate both these goals.[7]

3. The facts concerning Price's mental capacity are deliberately vague but suggestive. It appears that he has certain character traits, such as stubbornness, resistance to advice, weak negotiating skills, and

impatience, that are likely to place him at risk of entering into a disadvantageous contract. These flaws in his nature may indicate that he probably lacks skill in contracting, but do not, on their own, constitute the kind of mental incompetence that would give rise to a claim for avoidance. However, there are indications that the effect of these shortcomings have been aggravated by mental infirmity, manifested in symptoms such as loss of memory and confusion. His family has noticed a deterioration in his mental capacity, but this is not necessarily something that was obvious to Lowe.

A person is presumed to be competent to contract. If Price seeks to avoid the contract on the basis of incapacity, he must prove that he was mentally incompetent at the time of entering the contract. The degree of incompetence to be established depends on whether the jurisdiction recognizes only the older cognitive test—that he could not understand the nature and consequences of the transaction; or has extended the test to include the looser motivational standard—that his mental defect impaired his ability to transact in a reasonable manner. The motivational test is satisfied by a much less serious degree of infirmity, but for that reason it more strongly protects the reasonable reliance interest of the other party and is not a basis for avoidance unless Lowe had reason to know of Price's inability to conduct the transaction rationally.

Evidence of Price's behavior during the transaction is directly relevant to his mental state at the time. However, evidence of his conduct immediately before and after the transaction is also a pertinent indicator of his state of mind at the time of contracting. Price's daughter can testify about his confused and disoriented behavior during the period surrounding the transaction, but Lowe was the only person who observed Price during the transaction, and he claims to have found nothing amiss. Both of them could be telling the truth, because Price's condition seems to have manifested itself in lapses. The anecdotal evidence may therefore be quite inconclusive, and it may not be possible for Price to make a case for avoidance unless he can offer expert testimony by a psychiatrist who has examined him, diagnosed his condition, and can convince the factfinder that it is serious enough to have impaired his ability to contract under the applicable test.

Although evidence of Price's mental state is the most directly relevant to the decision on whether to permit avoidance on grounds of incapacity, courts are concerned with balancing the protection of the incapacitated party against the need to treat the other party fairly and to foster the security of transactions. Therefore, testimony about the transacting environment is often of great relevance, particularly when the mental incapacity falls short of a palpable cognitive disorder. Such factors as the adequacy of consideration given to the incompetent party, the fairness of the contract terms, any abuse of trust or confidence by the other party, and any other bargaining impropriety could influence the outcome of the case. In the present case, if Lowe is believed, he was guilty of no deliberate underhand dealing and had no reason to notice anything peculiar in Price's demeanor that may have alerted him to a problem. He offered what was asked for the property, and his only sin was that he made an attractive bargain. However, a 25 percent shortfall from the market price is quite extreme, and (even though Lowe may not have known how good a price it was) this could in itself be regarded as an indication to a reasonable buyer that something was wrong with Price. A person who makes a particularly favorable exchange with one who suffers from a mental disability is not in a particularly strong position.

In *Heights Realty Ltd. v. Phillips*, 749 P.2d 77 (N.M. 1988), an 84-year-old woman entered into an exclusive listing agreement with a real estate agent, and then refused to sell the property when the agent found a willing and able buyer. Although there was nothing unfair or extraordinary about the contract terms, and the agent testified that the seller was "sharp as a tack" during their negotiations, the seller had been in a gradual and subtle mental decline for some years. Her deteriorating mental condition was described by a number of family members, who had noticed erratic and confused behavior, memory lapses, and mismanagement of her affairs. A psychiatrist testified that although it could not be stated conclusively that she was mentally incompetent, this could be asserted as a matter of medical probability. He believed that she probably realized that she was contracting for the purpose of selling her property but could not have understood the detailed terms of her contract. During the course of the suit, she was in fact adjudged incompetent and was represented by a conservator. The court, applying the stricter cognitive test followed in the jurisdiction, found that the combination of psychiatric and anecdotal evidence was sufficient to satisfy the seller's burden of establishing mental incompetence under that standard.

4. In the absence of a mental condition that impairs Clark's contractual capacity, Clark would not be able to escape this contract. He signified his assent to the standard terms by clicking the "I agree" button. As explained in section 5.3, courts commonly uphold such a manifestation of assent to standard clickwrap terms. It is unlikely that any of the policing doctrines discussed in Chapter 13 would provide grounds for avoidance. The facts do not suggest any basis for claiming fraud or duress. The facts also do not support a claim of unconscionability. There were no unfair bargaining tactics and the standard terms seem to be clear and accessible, so there does not appear any basis for claiming procedural unconscionability. There is also no persuasive argument for substantive unconscionability. Although the term precluding cancellation of the booking and refund is disadvantageous to the customer, nonrefundable bookings are common and such a term is therefore not likely to be unfairly surprising or unduly harsh and one-sided.

   Clark's only basis for avoidance is mental incapacity. He suffers from a well-recognized mental disorder that might have deprived him of the capacity to enter into this contract. Clark must establish the existence, symptoms, and effects of the disorder by expert psychiatric testimony, possibly bolstered by evidence of friends or family who observed his behavior during the manic phase of the disorder. Let's assume that he can produce this testimony. It will not be enough to allow avoidance in a jurisdiction that recognizes only the stricter cognitive test of mental incapacity. Although the illness impaired his judgment, motivation, and self-control, it did not disable him from understanding and appreciating the nature and consequences of his acts when entering the transaction. In *Proctor v. Classic Automotive, Inc.*, 20 So. 3d 1281 (Ala. Civ. App. 2009), the court refused to allow avoidance of a contract to lease a car, even though the lessee suffered from bipolar disorder and had behaved impulsively and irrationally when she entered the lease transaction. (She seemed to be confused about the difference between a lease and a purchase, she had gone on a spending spree just before entering the transaction, she did not test-drive the car, and she could not afford the lease payments.) The court held that despite this, the illness failed to meet the cognitive test of incapacity, because she had enough understanding and perception to realize that she was entering into an automobile lease agreement.

A court that accepts the looser motivational test of Restatement, Second, §15(1)(b) would allow Clark to avoid the booking if he can show that a mental illness or defect affected his ability to act in a reasonable manner in the transaction and that the other party had reason to know of his condition. Although bipolar disorder likely does affect his ability to approach the transaction rationally, Clark cannot satisfy the second element of the test because there is no basis for arguing that the resort knew or had reason to know of his mental condition. This aspect of the test is particularly difficult to satisfy in an Internet transaction in which the resort had no opportunity to observe behavior that may alert it to the possibility that Clark was not approaching the transaction rationally.

5. The simpler objective test applicable to minor's contracts makes this Example much easier to answer. Clark is a minor, and he can avoid the contract. It does not matter that he is brilliant and advanced for his age. The exception relating to necessaries cannot apply here—a luxurious vacation surely cannot qualify as a necessary for a college student. Although the state has carved out a statutory exception to allow a minor to make a valid contract for a credit card, it would be a stretch, in the absence of clear statutory language, to interpret the legislation to extend to transactions in which the credit card is used. The traditional justification of the objective test for minority is that the other party should be placed on inquiry by the youthful appearance of the minor and assumes the risk of avoidance when contracting with someone who looks young. This rationale is not pertinent in an Internet transaction, in which the parties do not meet face to face. Nevertheless, in the absence of means of having a customer certify majority, the operator of a website takes the risk that a person buying goods or services on the site could be a minor. For some web-based traders, the risk that some transactions will be avoidable may be of minimal significance.

1. The word "infant" is sometimes used in legal texts to refer to a person below the age of majority. The word sounds odd in contemporary usage, because we now take it to mean a baby.

2. As explained in section 14.2.2c, states have created some exceptions to this general rule by enacting statutes that give minors over a stated age the capacity to enter into binding contracts in relation to specific transactions.

3. One of the grounds was that they had not assented to the clickwrap term. This aspect of the case is discussed in section 5.3.

4. The adult party also argued that the contract was enforceable on the grounds that the provision of representation for a child actor was a necessary, but the court rejected that argument. Contracts for necessaries are explained in section 14.2.2.

5. The case was affirmed in part and reversed in part by the district court in relation to matters unconnected to the capacity issue: 388 B.R. 38 (M.D. Fla. 2008) and 412 B.R. 878 (M.D. Fla. 2008).

6. Note that if the contract is for a necessary and the court requires the minor to restore the value of what was received instead of paying the contract price, the measure of restitution should be the value of the goods themselves, not their rental value. This is the more appropriate measure of restitution because the basis of restitution in a contract for necessaries is the value of the goods (the mower and trimmer) themselves.

7. Because responsibility for criminal conduct arises at an earlier age than contractual capacity, a minor who obtains goods or services under false pretenses may also face criminal prosecution. The criminal law may therefore provide a disincentive to antisocial behavior, even if contract law does not.

CHAPTER 15

Mistake, Impracticability, and Frustration of Purpose

§15.1 THE COMMON THEMES AND THE DIFFERENCES BETWEEN MISTAKE, IMPRACTICABILITY, AND FRUSTRATION OF PURPOSE

The three doctrines considered in this chapter have common themes that make it useful to consider them together. They are each concerned with a situation in which the exchange between the parties turns out to be very different from what was expected. In the case of mistake, this is caused by a serious factual error made by one or both parties at the time of contracting, so that the contract is premised on incorrect information. By contrast, impracticability and frustration arise when there is no false premise at the time of contracting, but events change drastically enough after formation to belie the original expectations of the parties. Mistake is grounds for avoidance of the contract, whereas impracticability or frustration are raised as a defense to a claim of breach.

Each doctrine poses two central questions that will be constant themes in our discussion:

1. *Materiality: How fundamental is the discrepancy between the expected and the actual exchange?* This question is concerned with the impact of the mistake or altered circumstances on the bargain reasonably anticipated by the parties. Relief is only available when the impact is so material that it changes the very basis of their bargain.
2. *Risk: Which party should be made to bear the consequences of this defeat of the original expectations?* The fact that original expectations have been fundamentally upset only justifies relief if the party seeking it does not bear the risk of this upset. The allocation of risk may be clear from the terms of the contract, or it may have to be established by interpretation from the circumstances of the transaction. The determination of risk allocation is a crucial aspect of the judicial inquiry in all these cases.

Having identified common themes, it is important to stress the difference between mistake, on the one hand, and impracticability and frustration on the other. As noted earlier, the doctrine of mistake applies when the contract is based on an error relating to facts at the time of contracting. The error causes one or both parties to manifest assent that would not have been given had the true facts been known. When the error is later discovered the mistaken party—or one of them, if the parties shared the mistake—may have grounds to avoid (or in a special case, to claim adjustment of) the contract. The basis of mistake is that the manifestation of assent is not genuine because it was induced by error. Although one party's error may sometimes be induced by the deception of the other, improper conduct is not an element of mistake and does not have to be shown. (Of course, if there was deception, this fact strengthens the grounds for avoidance and may give rise to an alternative claim of fraud or unconscionability.) In contrast to mistake, impracticability and frustration are concerned with the impact of supervening events on the transaction. These doctrines are not based on any defect in assent at the time of contracting, but aim to provide relief when the basis of a fully consensual transaction is profoundly altered by some external event that occurs afterward. Chronology is therefore a helpful means of deciding whether a case raises an issue of impracticality or frustration rather than mistake. Impracticability and frustration should always be concerned with supervening events.

UCC Article 2 does not deal with the doctrine of mistake, so a mistake in a contract for the sale of goods is governed by principles of common law. As discussed in section 15.7.3, Article 2 does have a provision that deals with impracticability, written broadly enough to encompass frustration of purpose as well.

§15.2 THE MEANING OF MISTAKE AND THE DISTINCTION BETWEEN MUTUAL AND UNILATERAL MISTAKE

§15.2.1 The Legal Meaning of Mistake: An Error of Fact

In lay terms, "mistake" has quite a wide range of meaning. It could refer to a factual error, but it might also include a bad judgment, a rash decision, or simply a situation that did not work out well. For example, it may have been a real mistake to buy that ugly chair, to invest in your cousin's harebrained enterprise, or to drive to town instead of taking the bus. The legal meaning of "mistake" is much narrower. It is confined to errors of fact—that is, to errors about some thing or event that actually occurred or existed and can be ascertained by objective evidence. This leads to a number of important observations on the scope of mistake doctrine.

a. An Error in Judgment Does Not Qualify as a Mistake

A party cannot escape a disadvantageous or regrettable contract resulting from poor judgment. Say, for example, that a buyer of a plot of land purchases it in the belief that it is worth more than the asking price but then finds that this is untrue. Or a buyer of stock believes wrongly that the company is undervalued and the stock is considerably more valuable than its price. If these parties were to be allowed to avoid their obligations simply because they had judged wrongly, no transaction could be secure. Although this distinction can be drawn in principle, it is not always a simple matter to distinguish an error in judgment from a mistake of fact. Judgments are usually based on fact, and less obvious cases could require some unraveling.

A famous old case and a more modern one illustrate the subtle distinction between a mistake of fact and one of judgment. In *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887), a cattle breeder, believing a highly pedigreed cow to be infertile, sold it as a beef cow for a fraction of its value. Before delivery, the seller discovered the cow to be pregnant and he refused to deliver it to the buyer. The buyer sued to compel delivery but the court allowed the seller to avoid the contract for mistake. The majority and dissenting opinions differ on whether the belief that the cow was infertile should be treated as a mistake. The majority thought that it was, but the dissent felt that the cow's ability to breed was really a question of judgment. In the dissent's view, neither party knew for sure that the cow was infertile. The seller gambled that it was, and the buyer that it was not. The buyer's judgment was right and he should not be deprived of the fruits of his successful speculation.

Firestone & Parson, Inc. v. Union League of Philadelphia, 672 F. Supp. 819 (E.D. Pa. 1987), involved the sale of a painting attributed to Albert Bierstadt, the celebrated nineteenth-century landscape painter. At the time of the sale, art experts regarded the painting as Bierstadt's and the parties had no reason to believe otherwise. As a result, it was sold for $500,000. Several years after the sale, scholarly research revealed that the painting was not by Bierstadt. As a result, it was worth only a tenth of what was paid for it. The buyer sued for avoidance of the contract. The suit was dismissed because the statute of limitations had run. However, the court discussed the claim of mistake and suggested that even had the buyer sued in time, the contract would not have been avoidable. The value and authorship of a work of art, based on expert opinion, is more a matter of judgment than of fact.

b. An Incorrect Prediction of Future Events Is Not a Mistake

A future event may one day become a fact, but it is not a fact until it has happened. Therefore, as a rule, it is generally accurate to say that the mistake must relate to a fact in existence at the time of contracting. A party cannot claim relief for an erroneous prediction. This is often closely related to point *a* above, because most predictions at the time of contract are speculations concerning the future value of the transaction and are therefore in the nature of judgments. For example, if a buyer of oranges purchases them in the belief that the market will rise, he cannot complain if it later turns out that he was wrong. This is not a mistake in the legal sense, but simply an erroneous prediction (or misjudgment) of profitability. *Paramount Petroleum Corporation v. Superior Court*, 227 Cal. App. 4th 226 (2014), illustrates the distinction between an error of fact and an erroneous prediction—a judgment of what will happen in the future. Paramount had entered into a multiyear requirements contract with GAF, a roof tile manufacturer, to supply all GAF's requirements of asphalt used in the fabrication of the tile. The price to be paid for the asphalt was based on an index keyed to the price of crude oil in a specific market. (Asphalt is derived from crude oil.) Because of an unexpected glut of crude oil as a result of significant quantities of oil from fracking entering the market selected in the contract, there was a dramatic reduction in the price of crude oil in that market. This caused the pricing formula in the contract to become unrealistically low. After failing to get GAF to agree to a different pricing formula, Paramount terminated the contract and GAF sued it for breach. Paramount raised the defense of mistake, but the court held that the selection of the pricing formula was not a mistake but an error in judgment—Paramount made the erroneous judgment that the pricing formula would work for the period of the contract.

As noted earlier, although the distinction between fact and prediction is easy to draw in some cases, there are situations in which a contractual assumption may have both factual and speculative elements. When that happens, it can be difficult to decide if the error should be treated as a mistake.

c. Mistake of Fact Must Be Distinguished from Mistake as to Meaning (Misunderstanding)

When the parties dispute the meaning of a contract term, this could be characterized as a type of mistake—one of the parties is mistaken as to the intention of the other. Mistake doctrine is not concerned with this type of error, which is not a mistake as to some external fact, but rather a mistake as to the meaning of a manifestation of assent. It is resolved by the process of interpretation, governed by the principles set out in Chapter 10. That is, the correct meaning of a manifestation is decided by determining the reasonable meaning of the words or conduct in context. For example, the manager of a supermarket intends to order 100 frozen pizzas. She fills out an order form in which she mistakenly writes an extra zero in the quantity ordered, so that the form shows an order of 1,000 pizzas. This is not a mistake as to an external fact but an error in communication. Under the objective test, the supermarket is held to the supplier's reasonable understanding of its manifestation of intent and is bound by the clear meaning of that manifested intent to order 1,000 pizzas.

d. A Mistake of Law Could Qualify as a Fact

Courts differ in their approach to errors of law. Some courts are willing to treat the legal rules applicable to a transaction as facts—to see those legal rules as constituting an existing state of affairs that can be objectively ascertained. On this approach, a mistake of law could be the basis for relief. For example, in *Mattson v. Rachetto*, 591 N.W.2d 814 (S.D. 1999), the court held that a party to a sale of land could rescind the contract on grounds of mistake where both parties operated under the mistaken belief that a leaseback right provided for in the contract (that is, a provision in the contract that the buyer would lease the property to the seller following the sale) was lawful. The parties did not know that a state statute invalidated such leasebacks. Other courts, motivated by the rationale that parties are expected to know the law (embodied in the well-known maxim, "ignorance of the law is no excuse"), have refused to treat a mistake as to the law as a basis for relief under the doctrine of mistake. For example, the court adopted this approach in *Burggraff v. Baum*, 720 A.2d 1167 (Me. 1998), which involved a sale of seafront property. The buyers and seller both believed, based on the buyers' research of the applicable zoning ordinance, that the buyers would be able to build a cabin on the property 75 feet from the water. The buyers had erred in their research. After the sale, they discovered that they had overlooked another statute that required a 250-foot setback from the water. Upon discovering the error, the buyers sought rescission. The court refused relief on the grounds that the mistake related to law, not fact, and the parties are presumed to know the law.[1] *See also Janusz v. Gilliam*, 947 A.2d 560 (Md. App. 2008), in which the court refused to allow avoidance of a divorce settlement agreement on the ground of mistake where the spouses had entered the agreement in the erroneous belief that federal regulations entitled the wife to a survivor's annuity under the husband's pension plan.

Even if a court does treat an error of law as a mistake of fact, the maxim “ignorance of the law is no excuse” could still have an impact on the right of avoidance. The court might deny avoidance because the party claiming avoidance should have known the law and therefore bore the risk of mistake. (Risk allocation is discussed in sections 15.3 and 15.4.)

e. Situations That Appear to Call for the Application of Mistake Doctrine May Be More Properly Treated as a Breach of a Contractual Commitment

This is not so much a new point as a reinforcement of two prior observations that merit strong emphasis: It has already been noted that many mistakes in the lay sense do not constitute mistakes in the legal sense, and that risk allocation is a crucial consideration in deciding whether a mistake should be grounds for relief. A party’s responsibility for her own judgments and the parties’ understanding about risk allocation may mean that a mistake does not call for application of mistake doctrine, but should be treated as the breach of a contractual promise (that is, a warranty) or as a misrepresentation.

For example, a buyer purchases a painting for $500 million, based on the seller’s claim that it is a genuine Van Gogh. It turns out to be a forgery. Only by carefully examining the facts of the transaction and weighing the closely related issues of judgment and risk allocation can we decide which party must be assigned responsibility for the problem. Some of the questions to consider would be: Did the seller knowingly or unwittingly give false information to the buyer or conceal facts? If so, there may be a misrepresentation. Did the seller promise that this was a genuine Van Gogh? If so, there may be a breach of warranty. Was this an uncertain fact on which both parties gambled? If so, the buyer may be stuck with the bad judgment. Was the genuineness assumed without question by the parties, so that it was a basic premise of the contract? If so, maybe an actionable mistake was made. The characterization is important, because the remedies are very different, ranging from no remedy at all to rescission for mistake or innocent misrepresentation, to expectation damages for breach of warranty, to expectation damages plus possible punitive damages for fraud.

§15.2.2 Mutual and Unilateral Mistake

Established doctrine draws a distinction between mutual mistake, in which the error is shared by both parties, and the unilateral mistake of only one of the parties. This sounds like a simple distinction, but it can be quite subtle and elusive. This is because a mistake is only mutual if it relates to a factual assumption shared by the parties. That is, it is a joint premise of their bargain. A mistake is unilateral, not only in the obvious case where one party knows the true facts and the other does not but also where both parties may be unaware of the truth, yet the fact in issue affects the decision of only one of the parties—although neither realizes the error, the incorrect fact is a basic assumption of only one of the parties because the other does not use it as a basis for deciding to enter the contract. This means that the distinction between mutual and unilateral mistake is not necessarily merely a matter of deciding whether one or both parties had been misinformed. The contract must be interpreted in context to decide if it was built around the mutual assumption that a particular fact was true.

The distinction between mutual and unilateral mistake is best illustrated by bidding errors, which are commonly treated as unilateral mistakes. For example, the owner of a plot of land entered into a contract with an excavator to excavate the land in preparation for a building. In determining the price charged under the contract, the excavator made an arithmetical error in calculating the number of hours required to perform the excavation and accordingly submitted a bid 25 percent lower than its actual cost of doing the work. The owner, not realizing the error, accepted the excavator's figure. This may sound like a mutual erroneous assumption that the excavator's calculations are correct. However, it is better treated as a unilateral error of the excavator because the determination of the price that he will charge for his work is the responsibility of the excavator, not the owner. The owner does not know how the builder decided on the price, played no role in determining the price, and merely accedes to it if he finds it acceptable. *Bert Allen Toyota, Inc. v. Grasz,* 909 So. 2d 763 (Miss. App. 2005), is another example of a unilateral mistake relating to pricing. A car dealer's computer miscalculated the price of the car, resulting in a sale price $2,000 lower than it should have been. The dealer argued that this was a mutual mistake because both parties relied on the erroneous price calculated by the computer. The court disagreed. The buyer was interested only in the bottom line and the miscalculation that led to the final price was the dealer's unilateral mistake. These examples provide some insight into the determination of whether a mistake is mutual or unilateral. However, they are not meant to enunciate a firm rule for making this distinction, which is a question of interpreting the contract to decide on the relationship of the mistaken fact to the basis of the contract.

Although it may be tricky to distinguish mutual from unilateral mistake, an incorrect classification will often not have an impact on the outcome of the case because both forms of mistake have essentially the same elements and involve the same basic inquiry: Which party should suffer the consequences of the error, in light of the factual indications of contractual intent and the surrounding equities? The principal difference between their elements is that unilateral mistake calls for a stronger focus on the reliance interest of the nonmistaken party so that the party who made the unilateral mistake must demonstrate that the unfairness of enforcing the contract outweighs the need to protect the reasonable reliance of the other party.

§15.3 THE ELEMENTS OF MUTUAL MISTAKE

According to Restatement, Second, §152 (read with §§151 and 154), a mutual mistake is avoidable by the adversely affected party if the following prerequisites are satisfied:

1. *At the time of contracting, the parties must have shared an error of fact.* As noted already, to allow for avoidance, the mistake must be an error relating to a fact. The error must be made at the time of contracting and it must relate to a state of affairs existing at the time, rather than one predicted to occur in the future.
2. *The erroneous fact was a basic assumption on which the contract was made.* The mistaken fact must be so fundamental to the shared intent and purpose of both parties that it is reasonable to conclude that they would not have made the contract at all or on the present terms had they known the truth. For example, the seller sold a lakefront lot to the buyer for $500,000. The price was that high because this is a prime waterfront location surrounded by expensive homes in a popular vacation area. The seller knew that the buyer intended to build a luxury home on the lot and both parties believed that the lot was suitable for building. Neither party knew at the time of contracting that the lot is on porous and unstable land and it cannot

support a building. Given the parties’ shared understanding of the purpose of the sale, the mistake is the basis of the bargain.

3. *The mistake must have a material effect on the agreed exchange of performances.* This sounds like a repetition of the prior element, because it would seem to follow that an erroneous basic assumption of the contract will inevitably have a material effect on the exchange. This is often true, but the focus of these elements is different. The test of basic assumption examines the aggrieved party’s motivation, as shared with the other party, but materiality calls for an assessment of the mistake’s impact on the balance of the exchange to see if it substantially deprived the adversely affected party of the value expected. Restatement, Second, §152, Comment *c*, suggests that the test is whether the error creates an overall imbalance between the parties by making the exchange less desirable to the adversely affected party and more advantageous to the other. This element thus contains a component of equitable balancing, in which the court examines the effect of the mistake on both the parties to decide the fairness of enforcing the contract despite the mistake.

   Sometimes, the materiality of the effect on the exchange is obvious. For example, if the land in the above illustration is worth only $25,000 because it cannot support a building, the contract price of $500,000 reflects the contrary erroneous belief. The mistake not only forms the basis of the bargain but also has a material effect on the exchange. However, the interaction between the basis of the bargain and materiality could be more subtle. Say that the lakefront location is so desirable that the land can most likely be resold to a campground operator for $500,000 despite its unsuitability for building. The evaluation of materiality is more difficult, and it could lead to a different conclusion. Although the mistake still forms the basis of the bargain, the mistake might not have a material effect on the exchange because it did not affect the market value of the property. This is not to say that the effect of the mistake is unquestionably immaterial. After all, the buyer is deprived of the benefit of using the property as contemplated. However, this illustration shows that the considerations taken into account to decide materiality are different from those relating to the parties’ basic assumption and could lead to a different conclusion.

4. *The adversely affected party must not have borne the risk of the mistake.* Although this question is commonly phrased so as to focus on the assumption of risk by the adversely affected party, the issue is to allocate the risk of error to one party or the other. There is no such thing as a neutral decision on risk because a determination that one party did not bear the risk inevitably means that the other did. The allocation of risk is often the dispositive element in mistake cases. Despite everything that has been said up to now, and no matter how serious the error, if the adversely affected party bore the risk of mistake, there can be no avoidance of the contract.

   How can one tell who assumed the risk of the mistake? The first place to turn for an answer to this question is the contract itself. The resolution is clearest if the contract expressly addresses the risk. In the example involving the sale of the lakefront property, allocation of risk would be clear if the contract for the sale of the lakeside lot states, "While the seller believes that the lot is suitable for building, he neither represents nor warrants that this belief is correct. The buyer may not terminate this contract if this belief proves to be wrong." In *Gibbs v. Gilleland*, 2016 WL 792418 (Tenn. App. 2016), the buyers of land sought to avoid the contract on grounds of mistake after they discovered that the property was below the county's base flood elevation. The buyers argued that the parties entered into the contract under the mutual mistake that the land was suitable for construction of a house. The court denied relief because the contract allocated the risk of unsuitability of the property for building by stating that the buyers waived inspection and bought the property in its condition at the time of closing.

   Even if the contract is not that clear, risk allocation may be inferred from the contract terms in context by the usual process of interpretation or construction. As always, factual interpretation is attempted first, but if no evidence of actual agreement can be found, the court must assign the risk in the way most reasonable under the circumstances, based on general expectations and practices in the market or community. That is, the court must resolve the question by construction, determining how the parties would reasonably have allocated the risk, had they thought of the issue.

   Many different factors may come into play in the process of construing risk allocation. If a pertinent commercial practice exists, it is a strong indicator of the parties' reasonable expectation of risk. For example, it would be useful to know if buyers of land normally investigate its suitability for building. If so, this buyer's failure to investigate would be an assumption of the risk of error. Similarly, if loss or liability can be insured against in transactions of this type, it would be helpful to know which party normally takes out the policy. In some cases, there may be a legal rule that dictates or suggests risk allocation in the absence of contrary agreement. For example, the rule of *caveat emptor* (buyer beware) usually applies to a sale of real estate, so the buyer bears the risk of any defect in the property in the absence of an express warranty by the seller. The relative responsibility of the parties to ascertain the true state of affairs is also a consideration. If one of the parties had greater responsibility for investigating the facts, that party's negligence or lack of diligence in ascertaining the facts will likely influence the allocation of risk to that party.

§15.4 THE ELEMENTS OF UNILATERAL MISTAKE

The elements of unilateral mistake are set out in Restatement, Second, §153. Relief for unilateral mistake has basically the same prerequisites as mutual mistake, with some variations to take account of the fact that the parties do not share the erroneous basic assumption. In addition, because the error affected the assent of only one of the parties, the protection of the reliance interest of the other party is emphasized more strongly. Therefore, unilateral mistake is grounds for relief only if the equities favoring release of the mistaken party outweigh the need to uphold the reasonable expectations of the nonmistaken party. (The presence of this element in unilateral mistake does not distinguish it from mutual mistake as significantly as one may think because the elements of mutual mistake also take into account the reliance interests of the party against whom avoidance is sought. Therefore, this express requirement of the balancing of the equities in unilateral mistake is a matter of stronger emphasis, rather than an element completely absent from mutual mistake.)

The elements for unilateral mistake are:

1. *The error concerns a fact.* This requirement is no different from mutual mistake.
2. *The fact is a basic assumption on which the mistaken party made the contract.* Of course, we are concerned here not with a shared assumption, but with the individual motive of only one of the parties, which has not necessarily been communicated to the other. Nevertheless, the subjectivity of this requirement is not a threat to the reliance interest of the other party, which is taken care of by the other elements.
3. *The mistake has a material effect on the exchange, adverse to the mistaken party.* As with mutual mistake, this element concerns the mistake's objectively determinable impact on the exchange of values.
4. *The mistaken party must not bear the risk of the mistake.* The allocation of risk involves issues of interpretation and construction the same as those in mutual mistake, but any negligence of the mistaken party in causing the mistake plays an even stronger role in risk allocation because the mistaken party is most likely the party who had the responsibility to ascertain the correct facts. This does not mean that negligence invariably precludes relief if the other elements are satisfied, but the presence and degree of the mistaken party's negligence are highly relevant to the decision on whether to grant relief. For example, in *Bert Allen Toyota, Inc. v. Grasz*, cited in section 15.2.2, the court refused the dealer's claim for avoidance of the contract where its computer miscalculated the price. The court found that the dealer failed to exercise reasonable care when it did not check the computer's calculations, especially because it was aware that the computer had made errors before. The more serious the degree of negligence—such as gross negligence, recklessness, or dereliction of a duty owed to the other party—the greater the likelihood that the court will find that the risk of mistake should be borne by the party who could have avoided the error by taking greater care. Quite apart from its role in the element of risk allocation, the carelessness of the mistaken party could have an impact on the balance of the equities discussed below. That is, even if there has not been enough sloppiness or serious negligence to dispose of the case

on the question of risk allocation, the mistaken party's fault could tip the balance in favor of the other party.

5. *The equities must favor relief for the mistake.* While equitable balancing takes into account factors beyond the first four elements, it obviously cannot be performed in isolation from them. In other words, the degree to which the first four elements are satisfied forms a vital component in the overall balance. Beyond this, the court also balances the impact of avoidance on the parties. It weighs the hardship that enforcement would have on the mistaken party against the hardship of avoidance on the other party. These equitable considerations are therefore quite far ranging. They take into account not only relative innocence and fault but also the economic consequences of avoidance on each of the parties.

   Therefore, the balance weighs most heavily in favor of the nonmistaken party when the mistake involved a degree of negligence by the other, the nonmistaken party had no reason to realize the mistake, and took action in reliance on the contract. In such a situation, her good faith reliance on the apparent assent of the mistaken party has led her to incur some commitment or expense, so that avoidance would go beyond depriving her of the good bargain but would actually cause her loss. The protection of good faith reliance is the central issue, but the principle may be articulated in different ways—for example, it is sometimes expressed as a rule to the effect that a contract cannot be avoided for unilateral mistake unless the innocent nonmistaken party can be restored to the status quo. It is sometimes stated that relief should be denied unless the mistaken party promptly notifies the other upon becoming aware of the error. This rule is aimed at ameliorating any prejudicial reliance on the mistake, and it also reflects another factor in the balance—the degree of diligence exercised by the mistaken party. At the other end of the scale, if the nonmistaken party caused the error or realized the error and kept quiet in order to jump at the bargain, her reliance interest is at its weakest. (In fact, a party who knows that the other party has made a unilateral mistake and takes advantage of it could violate the duty of good faith and fair dealing, thereby committing fraud by nondisclosure.)[2] Between these extremes, there are countless variations in relative fault and hardship, so that the balance may be harder to find.

To make this more concrete, refer to *Drennan v. Star Paving*, 333 P.2d 757 (Cal. 1958), discussed in section 8.11 in relation to the application of promissory estoppel to validate and option. In *Drennan*, a subcontractor made an error in its bid to the prime contractor; the prime contractor then used that bid in calculating its own bid to the owner. After the owner accepted the prime contractor's bid, and the prime contractor was committed to the owner, the subcontractor discovered the error and attempted to revoke its own bid. The court applied the doctrine of promissory estoppel to make the subcontractor's bid irrevocable even though it did not qualify as option with consideration and the prime contractor had not accepted it before attempted revocation. Because the bid was irrevocable, acceptance by the prime contractor within a reasonable time created a contract with the subcontractor. Viewed in the present context, you can see that this situation also presents an issue of unilateral mistake, which was raised as an alternative argument by the subcontractor in *Drennan*. The subcontractor argued that even if a contract was created by the process of offer and acceptance, it should be able to avoid the contract on the grounds that it made an error in compiling the bid. The court rejected this argument and refused relief to the subcontractor for unilateral mistake. The error was caused by the subcontractor's negligence, and because there was a considerable variation in bids for the work, the prime contractor had no reason to suspect that the subcontractor's low bid was a result of error. The prime contractor had committed itself to the owner on the strength of the bid, and the equities favored leaving the loss with the subcontractor. In *Drennan*, the balance of the relative hardship on the parties was about even. However, the result could have been different if, say, the prime contractor had such a good profit margin in its contract with the owner that the extra cost of the subcontract could have been absorbed without making the prime contract unprofitable, but the subcontractor was in such perilous financial circumstances that the loss on this job might have put it out of business.

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§15.5 RELIEF FOR MISTAKE

§15.5.1 Avoidance and Restitution

The principal remedy for mistake is avoidance of the contract. If the mistake is unilateral, avoidance will be sought by the party who made the mistake. If the mistake is mutual, both parties made the mistake. The party seeking avoidance will be the one who is adversely affected by the mistake. Avoidance brings the contract to an end and both parties must restore any benefit (or its value) resulting from performance that was rendered prior to termination. Value is normally based on the market worth of the property or services (of which the contract value may be probative evidence). However, the court has some discretion in determining the basis of valuation, and it may use some other measure appropriate under the circumstances. For example, if the party who conferred the benefit was more to blame for the mistake, the value of consumed goods or services could be confined to the actual ultimate economic benefit enjoyed by the other party.

§15.5.2 Other Relief, Including Reformation

Although avoidance and mutual restitution is the standard and common remedy for mistake, the equitable derivation of mistake doctrine gives the court some flexibility in remedy, so that it could provide relief other than avoidance and restitution if the equities so dictate. For example, avoidance on the grounds of unilateral mistake could be ordered subject to the payment of reliance expenses designed to restore the nonmistaken party to the status quo.

In relatively rare cases, the court may keep the contract in force with an adjustment to its terms to counter the effect of the mistake. In the context of mistake, this remedy is known as reformation—that is, the court reforms the agreement to negate the effect of the mistake. As explained in section 15.6, reformation is more commonly used where the parties have not made a mistake of fact, but have made an error in recording the terms of their agreement. However, it is sometimes an appropriate exercise of the court's equitable discretion to use this remedy to alter the terms of the agreement so as to counteract a mistake of fact. Reformation is not a common remedy for mistake, and courts use it sparingly. It is not an appropriate remedy if the mistake is so fundamental that reformation would alter the entire character of the transaction or would defeat the contract's basic purpose. It is also seldom the best solution if the contract is entirely executory, and neither party performed or otherwise relied on it before the mistake was discovered. However, in some cases, if avoidance would be disruptive and the error relates to an aspect of the contract that can be adjusted (say to a price calculation), an alteration of terms may be a fair remedy. For example, the court did reform the contract's price term in *Aluminum Company of America v. Essex Group, Inc.*, 499 F. Supp. 53 (W.D. Pa. 1980).[3] The parties had made a mutual mistake in adopting a particular pricing formula, believing it to be an accurate predictor of Alcoa's costs. It turned out not to be, and the price payable under the formula fell far short of Alcoa's cost of performance. The court felt that it would be unfair to allow Alcoa to avoid the contract as a whole because this would completely deprive Essex of its bargain and would give Alcoa the windfall of full release from its contractual commitment. It therefore adjusted the price term to give Alcoa a profit that accorded with the parties' reasonable expectations.

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§15.6 MISTAKE IN TRANSCRIPTION

§15.6.1 Reformation to Correct Mistakes in Transcription

A mistake may relate not to a factual premise of the agreement but to the way in which the agreement is expressed in writing. For example, a memorandum of agreement reflects the price of a piece of land as $280,000. The buyer contends that the parties had orally agreed to a price of $250,000, and that the written price is a typographical error not noticed by the parties when signing the document. If the parties later recognize that an error occurred in transcription and they act honestly, the problem can be disposed of simply by amending the writing by agreement. However, the party who benefits from the error may claim (whether genuinely or disingenuously) that the writing is correct. If so, the other party can seek the equity-based remedy of reformation to have the court correct the writing so that it accurately reflects what was agreed. This remedy involves both a declaration by the court that the contract is on terms other than reflected in the writing, and enforcement on those terms.

A mistake in transcription is completely different in nature from a mistake of fact, discussed in the prior sections. The "fact" that is wrong did not motivate the transaction but is in the written record of the transaction. The problem is not that the manifestation is based on a faulty premise but that it incorrectly records the parties' agreement. Nevertheless, an error in expression has one thing in common with a mistake of underlying fact: In both cases one of the parties seeks to avoid the apparent meaning of a manifestation of assent by showing that it was induced by error. In the case of mistake as to an underlying fact, the goal is to negate assent and avoid the contract. When the mistake is in transcription, the desired relief is to have the writing changed to reflect what was actually agreed. It must be stressed that the goal of reformation in this situation is to correct the contract so that it reflects what was actually agreed, not to adjust or rewrite its terms. For example, in *Sikora v. Vanderploeg*, 212 S.W.3d 277 (Tenn. App. 2006), Sikora bought a chiropractic practice from Vanderploeg. Prior to the sale, the seller had a detailed financial report prepared, which included a disclosure of the earnings of the practice in the seven months prior to the sale. The buyer was given a copy of this financial report. The agreement of sale warranted the accuracy of the earnings stated in the report. However, in preparing the agreement of sale, the buyer's attorney made an error in drafting the warranty, which stated that the earnings were for a six-month period, not for seven months. After the buyer took over the practice, it deteriorated and its earnings declined. The buyer sued the seller, claiming that the contract misstated the presale earnings. The court held that since both parties intended the agreement to reflect the earnings in the report, and both had overlooked the error in the agreement, there was a mutual mistake in expression. The court therefore reformed the agreement, defeating the buyer's claim that the agreement falsely recited presale earnings.

A court will not reform a contract unless it is clear that both parties erroneously believed that the memorial of agreement embodied what they actually agreed. For example, in *Silsbe v. Houston Levee Industrial Park, LLC*, 165 S.W.3d 260 (Tenn. App. 2005), the last day for exercising an option turned out to be a public holiday. As a result, the option holder could not exercise it on that day, and the grantor refused to accept the exercise of the option on the following day. The option holder sought reformation of the contract on the grounds that the parties had mistakenly selected a public holiday as the deadline for exercising the option. The court refused reformation. Although the parties may not have realized that the deadline fell on a public holiday, this was the date that they intended. The option therefore correctly reflected the parties' intent and reformation would have changed the contract rather than corrected an error in expression.

Because a signed writing is usually regarded as the most reliable evidence of what was agreed, a party seeking reformation has a difficult burden. He must convincingly show that an error was indeed made in recording the terms agreed, and must also plausibly explain why the error was made and why he failed to notice it when signing the document. Because the right to reformation cannot be shown except by recourse to evidence extrinsic to the writing, the parol evidence rule does not bar the introduction of evidence for the purpose of showing a mistake in transcription. If it did, the remedy of reformation could never be used.

§15.6.2 Reformation to Rectify the Unintended Legal Effect of Language

A question of reformation could also be presented when the parties chose words in their writing that do not have the legal effect intended. For example, a written contract for the sale of a car states that it is sold "as is." This is a legal term of art that means that it is sold without any warranties. However, the buyer contends that the parties were unaware of that meaning and did not intend it at all. The seller had added a number of accessories to the car, and the words "as is" were used merely to reflect their agreement that these accessories were to be included. This kind of error in recording the agreement is more complicated than a simple error in transcription, such as the incorrect recording of the price in the illustration in section 15.6.1, because the exact nature of the problem is less clear: If the dispute centers around what the parties meant by the term "as is," the determination of its meaning is a matter of interpretation, but if the evidence establishes that the parties had agreed on what the term meant but that they just used the wrong words to record that agreement, reformation is the more appropriate course. Also, it is difficult to distinguish this kind of erroneous expression of agreement from a mutual mistake of law. By wrongly using the phrase "as is" the parties do, in a sense, make a legal error—but that error relates not to what the law is, but to the legal meaning of the word-symbol used in the writing.

§15.7 IMPRACTICABILITY OF PERFORMANCE

§15.7.1 The Nature of Impracticability Doctrine, Contrasted with Mistake

Mistake concerns an error of fact in existence at the time of contracting, so fundamental to the premise of the contract that it precludes the formation of true assent. Impracticability applies when events following contract formation are so different from the assumptions on which the contract was based, that it would be unfair to hold the adversely affected party to its commitments. Although there are close affinities between mistake and impracticability, as you will see when comparing their elements, they have an important difference in scope and purpose. A mistake causes a defect in contract formation, permitting a party to be excused from accountability for a manifestation of assent. Impracticability has nothing to do with any problem in formation and presupposes that a binding contract was made. Rather, it is concerned with whether a post-formation change of circumstances has such a serious effect on the reasonable expectations of the parties that it should be allowed to excuse performance.

An example will illustrate this difference: The owner of a beachfront cabin makes a contract to sell it. The parties execute the contract at the owner's place of business in an inland city, many miles from the cabin. Unknown to both parties at the time of contracting, a tidal wave swept the cabin into the sea just a few hours before the contract was executed. They are mutually mistaken that the cabin exists. However, if the tidal wave hits after the contract was made, but before the seller transfers and delivers the cabin to the buyer, there was no error about its existence at the time of contracting. Instead, the issue is whether this supervening event should permit the seller to escape liability for failure to deliver the cabin as promised in the otherwise valid and enforceable contract.

Although it is usually easy to distinguish mistake from impracticability, sometimes the facts are ambiguous enough to make this unclear. The case could be resolved either on grounds of mistake or impracticability, depending on the court's perspective. For example, in *Aluminum Company of America*, cited in section 15.5.2, the parties entered into a long-term contract under which Alcoa would smelt alumina for Essex. The period of the contract was 16 years, with a five-year renewal option. The parties based their pricing formula on the Wholesale Price Index-Industrial Commodities (WPI). They used the WPI because it had reliably corresponded to Alcoa's costs of production in prior years and they assumed that it would continue to do so. However, a few years after the contract had been executed, electricity prices increased steeply because of the OPEC oil embargo and the higher cost of producing electricity in compliance with pollution regulations. As a result, the WPI ceased to be an accurate predictor of Alcoa's costs, which escalated to such an extent that its costs exceeded the contract price under the formula. Had Alcoa been obliged to perform the contract on its original terms, it would have lost about $60 million over the term of the contract. The court treated this as a case of mistake because it held that the parties erroneously assumed at the time of the contract that the WPI index was an appropriate standard for achieving the goal of measuring Alcoa's future costs. However, the court discussed impracticability as an alternative basis for relief because it recognized that the case fitted equally well into that doctrine—the oil embargo and tougher environmental regulations were supervening events that overturned a basic assumption of the contract.

The issue in an impracticability case is not whether the party can be forced to perform. Clearly, in the above example of the cabin, the seller cannot deliver it because it is flotsam on the ocean. The issue is whether, by failing to perform, he has breached the contract. If failure to perform is excused on grounds of impracticability, the seller of the cabin is not in breach and is therefore not liable to pay damages for breach of contract to the buyer. On the facts of this example, impracticability would completely excuse the seller's performance. It follows, of course, that the buyer would not be required to perform either, so the effect of impracticability is to terminate the contract.[4]

The fact that impracticability is a defense to a claim of breach of contract, thereby precluding liability for damages for breach of contract, does not mean that there is no remedy where a contract is found to be impracticable. If either party has partly performed before this (say, for example, that the buyer made a down payment), the benefit of that performance must be restored under principles of unjust enrichment. This is illustrated by *Petrozzi v. City of Ocean City*, 433 N.J. Super. 290 (2013). The city planned to perform a beach restoration project and had to get easements from beachfront property owners to access the privately owned beach area in front of their properties. It obtained the easements under contracts with the owners in which it paid no monetary compensation for the easements, but instead undertook that it would create and maintain the dunes at a stated maximum height so as not to interfere with the owner's view of the sea. After the contracts were executed and the restoration was completed at the height required by the contracts, natural accretion caused the dunes to grow in height and width. The contract obliged the city to reduce the height of the dunes. However, its ability to do this was restricted by regulations, promulgated by the state after the contracts were executed, that required the city to obtain a state-issued permit to work on the dunes. The city applied for the permit, which was denied. The court held that the state's permit requirement and its denial of the permit were supervening events that met the required elements of impracticability (discussed below) and excused the city from performing its obligation to maintain the dunes at the height specified in the contracts. The owners therefore could not sue the city for breach of contract. However, the court recognized that because the city was excused from performing its part of the bargain, it had been unjustly enriched by not paying any compensation for the grant of the easements. The court therefore held that the owners were entitled to restitution based on what the city would have had to pay for the easements had the contracts provided for money compensation rather than maintenance of dune height.

§15.7.2 The Early Form of the Doctrine: Impossibility of Performance

In older common law, once a contract had been made, the parties were absolutely bound and remained committed even if a change in circumstances made it extremely difficult or even impossible for one of them to perform. (As just noted, the party was not expected to work a miracle by performing the impossible, but the failure to perform was not excused by the supervening event and was a breach giving rise to a damages claim.) By the mid-nineteenth century, the harshness of this rule was ameliorated by judicial recognition of the doctrine of impossibility of performance. In its original form, as articulated by the English case of *Taylor v. Caldwell*, 122 Eng. Rep. 309 (Queens Bench, 1863), the doctrine was quite narrow: If, when making the contract, the parties reasonably contemplated that its performance was dependent on the continued existence of a person or thing, the post-formation death of the person or destruction of the thing, not caused by the fault of the party seeking relief, would excuse performance by that party, and hence, also the return performance, resulting in termination of the contract without liability for breach.

In *Taylor*, the contract was for the hire of a music hall that burned down after the contract was made and before the time for performance. Although the obligation to provide the hall was not qualified by any express term of the contract, the court found the continuing existence of the hall to have been a basic assumption of the contract. This led to the legal implication of a term that the destruction of the hall excused performance. As originally formulated, the defense of impossibility was confined to situations in which the change of circumstances made the contract objectively impossible to perform. That is, the event must have completely defeated the ability to deliver the performance, not only by this party but by a reasonable person in his position. Say, for example, that the fire merely damaged the music hall. If a reasonable owner could have restored it sufficiently in time for the performance, this owner could not claim the defense of impossibility merely because he did not have the resources or inclination to do so.

§15.7.3 The Contemporary Doctrine of Impracticability of Performance

During the course of the twentieth century, the doctrine of impossibility came to be perceived as too restricted. There are situations in which events do not make performance absolutely impossible, yet they place such a great and unexpected burden on the party that fairness demands relief. As a result, the scope of the doctrine has broadened and has been renamed “impracticability” to reflect this change. As in so many other areas of contract law, a strong impetus for change in the doctrine came from the UCC. Section 2.615 enacted the broader concept of impracticability as the standard for sales of goods, and this has been influential in reinforcing change in common law doctrine too. By embracing a formulation based on the UCC, Restatement, Second, §§261 to 272 reinforce the common law’s movement away from the stricter impossibility standard. There are a number of differences between UCC §2.615 and the provisions of the Restatement, Second, but the basic concepts are the same. This discussion focuses on general principles applicable to both.

If all of its elements are established, the excuse of impracticability is available to the party who is adversely affected by the change in circumstances. (In a sale of goods, UCC §2.615 assumes that it will always be the seller who claims impracticability, but this need not necessarily be so, and courts have recognized that a buyer can use the excuse in appropriate circumstances.) Although the following discussion identifies and discusses these elements separately, the defense of impracticability is better understood if one recognizes that they are very much interwoven and that the facts affecting one are often relevant to the others. All the elements must be satisfied for the defense to be available. As in mistake, risk allocation is usually the predominant and pervasive consideration. We now examine each of the elements:

a. After the Contract Was Made, an Event Occurred, the Nonoccurrence of Which Was a Basic Assumption of the Contract

This concept is very much like its equivalent element in mistake doctrine, except that the basic assumption relates not to an existing but to a future state of affairs. The idea here is that when the parties entered the contract they expressly or impliedly made assumptions about the future course of events and these assumptions were a central motivation of the contract. Whether or not a basic assumption is articulated, it must be patent enough from the circumstances and the apparent purpose of the contract that it is reasonable to conclude that the parties must have shared it.

Having entered the contract on this basic assumption, the parties are then faced with an event so contrary to the assumption that it changes the very basis of the exchange. Comment 1 to UCC §2.615 describes this occurrence as an "unforeseen supervening circumstance not within the contemplation of the parties at the time of contracting." This suggests that the event must be so unexpected that the parties did not think of it at the time of contracting, or if they did, that they did not consider it to be a realistic likelihood.

The comment uses the word "unforeseen," which must be distinguished from "unforeseeable." An event is unforeseen by the parties if they themselves did not contemplate it as a real likelihood. That is, although it could be imagined, the parties did not expect it to happen and contracted on the assumption that it would not. It may be a possibility, but is not treated by the parties as a probability. An event is unforeseeable if it could not have been conceived of by a reasonable person. To require unforeseeability would impose too stringent a test, making the defense of impracticability available only when the supervening event is beyond human experience. For example, it is unforeseeable that a music hall could be demolished by a rampaging dinosaur, a monstrous robot, or a fleet of alien space ships,[5] but its destruction by fire is certainly within the range of possibility. Therefore, fire was foreseeable at the time of contracting, but it was not foreseen by the parties if, under all the circumstances, it is shown that they did not think of it at all or, even if one or both may have realized the possibility, it was not considered a strong enough likelihood to be raised and dealt with as a contingency. Of course, the fact that the event was unforeseen does not, on its own, mean that the defense of impracticability will succeed. This is only the first of the elements that must be satisfied. Often, even though the nonoccurrence of the event was a basic assumption of the contract, the risk of the occurrence may have been impliedly assumed by the party claiming impracticality. That is, if the parties foresaw the likelihood of the event, they probably allocated the risk of its happening (expressly or impliedly) in the contract. However, even if they did not foresee it, commercial practice or other surrounding circumstances may give rise to an implication of risk assumption.

Impracticability arises from the occurrence of an event, so we must identify what types of happening might constitute an event. Again, there is an analogy to mistake, in that an event is a factual situation, albeit one that arises after the contract. Most occurrences external to the contract qualify as events: war, a natural disaster, a strike, and so on. A change in the law or government regulation is also an event. Therefore, if the law changes to prohibit a performance that was lawful at the time of contracting, the change in the law defeats a basic assumption of the contract. UCC §2.615(a) and Restatement, Second, §264 expressly recognize this by providing that good faith compliance with governmental regulation excuses performance, even if the regulation is later found to be invalid. Say, for example, that the music hall did not burn down, but shortly after the contract was made, the city council strengthened its public safety regulations so that the hall no longer satisfied them and cannot be lawfully let for public performances. If the council's action was unexpected and was not publicized prior to formation of the contract, this would be an unforeseen contingency that defeats the basic assumption that the hall could be used lawfully for the purpose of the contract. This example highlights the development of the law from impossibility to impracticability. Although it would still be possible for the lessor to make the hall available and for the buyer to pay the rent, the contract is made impracticable because its basic assumption that the performance would be lawful has been overturned.[6]

A change in market conditions is generally not regarded as a contingency beyond the contemplation of the parties because the very purpose of setting a price or committing to a future delivery of goods or services is based on the possibility that prices or demand may change. Therefore, the basic assumption of most contracts is not that the market will remain constant, but that it might change. For example, in *Ferguson v. Ferguson*, 54 So. 3d 553 (Fla. App. 2011), the parties entered into a divorce settlement agreement under which the husband kept the marital home. In exchange, he agreed to refinance it and to pay the wife $185,000. Until that payment was made, the wife and child had the right to reside in the house. Shortly after the agreement was executed, home prices in Florida plunged. The husband claimed that because of this downturn in the market, he had not been able to refinance the house, and it had therefore become impracticable to make payment to the wife. He sought to evict the wife, sell the house, and give her half the net sale proceeds. The court held that the impracticability doctrine did not excuse the husband from performing the settlement agreement as promised by paying the wife $185,000. The Florida real estate market is subject to periodic downward adjustment, and a market decline is not an unanticipated circumstance in a market-based economy.

This does not mean that a market disruption could never be grounds for claiming impracticability. The basic assumption of any particular contract is a factual question. It is therefore possible that a constant market was assumed in a contract, or even if not, that the market variation results from a disruption which causes changes way beyond reasonable expectations. This is particularly so if some unexpected calamity, such as a sudden war, embargo, or natural disaster is the cause of the market changes. This has happened a number of times, and there are cases arising from events such as the Suez crisis of the 1950s (when Egypt blocked the canal, making it impracticable for shipping companies to use it), the Vietnam War, and the OPEC oil embargo of the 1970s, in which the supplier of a commodity or service has claimed impracticability based on greatly added expense or burdens on performance caused by the crisis. In some of the cases, the international disturbance was found to render performance impracticable, but in others, the defense did not succeed, either because the disruption was foreseen by the parties or because one of the other elements of the defense (such as extreme hardship or risk allocation) was not satisfied.

Aluminum Company of America, discussed in sections 15.5.2 and 15.7.1, is an example of a case in which the court did recognize that severe market disruption made a contract impracticable. As stated in section 15.7.1, the parties entered into a long-term contract under which Alcoa smelted alumina for Essex. After the contract had been executed, the contract price to be paid to Alcoa for processing the alumina, calculated under the contract's WPI-based pricing formula, fell significantly below Alcoa's costs as a result of escalating electricity costs caused by the OPEC oil embargo and stricter government regulations. Although the court resolved the case in favor of Alcoa on the basis of mistake, it discussed impracticability as an alternative basis for relief. It concluded that the increase in electricity costs and the scale of the resulting loss were of such dramatic proportions that they were not foreseen by the parties and went beyond the level of risk that Alcoa had assumed. *Paramount Petroleum Corporation*, another mistake case (cited in section 15.2.1), illustrates a contrary conclusion. Recall that Paramount had devised a pricing formula in a multiyear requirements contract with GAF, a roof tile manufacturer, to supply all GAF's requirements of asphalt. The formula was keyed to the price of crude oil in a specified market, but the formula became unrealistically low as a result of a glut of crude oil on that market. Paramount terminated the contract, GAF sued it for breach, and Paramount raised the defense that the parties were mistaken in selecting the pricing formula. The court held that the selection of the pricing formula was not a mistake but an erroneous judgment that the pricing formula would work. The case could have been analyzed on the basis of impracticability as well, in that the glut of crude oil was a supervening event. However, this would not likely have changed the result because the facts of the case suggest that Paramount would have foreseen the possibility that the market would change and would therefore have assumed that risk.

Restatement, Second §262 states that where the existence of a particular person is necessary for the performance of a duty (that is, where the contract contemplates the personal performance of a particular person), the death or incapacity of that person is to be treated as an event, the nonoccurrence of which was a basic assumption of the contract. Comment *a* to the section states that the death or incapacity of that person is a case of objective impracticability and that although the language or circumstances of the contract may indicate a contrary conclusion, it would be rare for a party to undertake to render a personal service despite his death or incapacity. Of course, it is important to remember that the issue in impracticability is not whether the party can be compelled to perform the impossible but whether the contract contemplated that the party or his estate would be liable in damages for breach of contract if his death or incapacity rendered him incapable of performing. The possibility of death or incapacity of the party is certainly foreseeable, and the crucial question in such a case will be which party assumed the risk of the death or incapacity.

b. The Effect of the Event Is to Render the Party's Performance "Impracticable"—That Is, Unduly Burdensome

A loss in certainty is the price paid for the law's movement away from the more discernible standard of impossibility, toward the vaguer and more relative concept of impracticability. Once a party no longer has to establish that performance is objectively incapable of being rendered, we are left with the task of deciding how extensively the performance must have changed to qualify as impracticable. If impracticability merely required a showing of inconvenience, lack of profitability, or the loss of a better opportunity, it would be too easy for a party to escape a contract that turns out to be disadvantageous because of a change in the market or commercial environment. Therefore, relief is only appropriate if the change is extreme or very burdensome. In a sense, this requirement is similar to the element of materiality in mistake. The event must have such a severe impact on the performance that it cannot be rendered without great loss, risk, or other hardship. Unfortunately, this is as vague as it sounds, but it necessarily must be so, because impracticality is relative and must be assessed on all the facts of the case.

In the easiest case, an event that creates objective impossibility also renders the performance impracticable, because the wider doctrine includes cases that would have satisfied the narrower standard. Therefore, if the parties contemplated the rental of a specific music hall, the destruction of the hall makes performance impossible and hence also impracticable. However, as the facts move beyond this clearer case, the determination becomes more difficult. Say that the music hall did not burn down, but after the contract was made, the premium payable by the lessor for liability insurance increased tenfold because of a large number of theater fires in the region over the last year. As a result, if the lessor is to permit use of the premises by the public, he must pay a huge insurance premium that will exceed the earnings he will make from renting the hall. Both parties can still perform—the lessor can make the hall available and the lessee can pay the rent—but the increase in insurance rates has imposed a financial burden (or a massive risk of liability, if the policy is not renewed) on the lessor that may make its performance impracticable.

Consider another example: The hall does burn down, but there is another hall in the same block owned by a competitor of the lessor. The hall is about the same size, is equally suitable for the performance, and it is available for the night of the concert. The lessee contends that the lessor's performance is therefore still possible, because there is nothing in the contract that makes the exact identity of the hall material, and the lessor can still provide appropriate premises by hiring the second hall and making it available to the lessee as a substitute for the destroyed hall. The problem is that the owner of the surviving hall demands a rental from the lessor far higher than that which the lessor is to be paid by the lessee under the contract, so the lessor will lose money by doing this (or by paying the rental difference to the lessee as damages if he refuses). If the lessee's contention is correct and the identity of the hall was not a central term of the contract, the lessor's performance is not impossible, so the question becomes whether the loss to be incurred in finding a substitute renders it sufficiently burdensome to constitute impracticability.

There is no definitive answer to the question in these cases. However, they point to the focus of the inquiry—the economic impact of the unforeseen supervening event. A prospective loss that is not negligible could satisfy this element. The magnitude and effect of the loss are obviously of crucial significance, and a huge loss that threatens the lessee's financial survival is more likely to be seen as making the performance impracticable than a manageable smaller loss. This may make it sound as if the defense of impracticability can be easily invoked whenever a serious prospective loss is shown. But remember that this element is only one of several that must be satisfied, and proof of the most devastating loss is not enough to assure relief if the other elements are not also present.

c. The Party Seeking Relief Was Not at Fault in Causing the Occurrence

A person should not be able to take advantage of his own wrongful or negligent act, and a party who disables himself from performing, or makes performance more difficult, cannot expect to be excused from liability. Thus, the lessor of the music hall cannot claim impracticability if he deliberately set the fire. Similarly, a person cannot be excused from liability just because it turns out that he is incompetent and cannot perform as promised. However, the issue of fault could be more subtle. Should the lessor be denied relief if the fire was caused by an antiquated and improperly maintained electrical system in the music hall? In less obvious cases, the degree to which the party was in some way responsible for his troubles, or could have surmounted them with reasonable effort, is a relevant factor to be taken into account.

In *CNA International Reinsurance Co. v. Phoenix*, 678 So. 2d 378 (1996), the actor River Phoenix died from a massive overdose of illegal drugs during the filming of two movies in which he was acting. The question was whether his estate was relieved from paying damages arising out of his failure to complete the movies. His estate argued that it was not liable for breach of contract because his death rendered the contracts impracticable, but the plaintiff responded that Phoenix was at fault in creating the impracticability in causing his own death by the overdose of illegal drugs. The court rejected the plaintiff's argument, stating that it would be too difficult to determine fault in such a case, and that it preferred the simpler rule of Restatement, Second, §262 that treated the death of a party to a personal services contract as objectively impracticable. The court is no doubt correct in having qualms about evaluating fault in such circumstances. However, the question of fault goes directly to the crucial issue of risk allocation, and by refusing to take it into account, the court placed the risk of Phoenix's death on the movie's producers, which may not be the right place to allocate it.

d. The Party Seeking Relief Must Not Have Borne the Risk of the Event Occurring

As with mistake, risk allocation is often the dispositive issue in impracticability cases. In many ways, the other elements foreshadow the question of risk allocation and seem to be no more than components of it. (In fact, as you may have sensed, the issue of risk allocation was constantly lurking in the discussion of the other elements and had to be restrained from jumping out.) The analysis of risk allocation is basically the same as for mistake: If the party adversely affected by the event had expressly or impliedly assumed the risk of its occurrence, the nonperformance cannot be excused even though all the other elements are satisfied.

The first place to look in determining risk allocation is the contract itself. If the parties realized that a particular future event could affect performance, the contract may have an express and specific term assigning risk. For example, a consignor of goods and a shipping company may contemplate the possibility that a war may break out along the route, requiring a diversion of the ship. If so, they may specifically state in the contract which party will bear the loss and expense of the diversion. Even if the parties do not have a particular contingency in mind, the contract may have a more general provision allocating the risk of disruptions or calamities. This is known as a force majeure clause. It may provide, for example, that the shipping company will not be responsible for any delay (or will have the right to charge for the cost of any diversion or delay) of the ship resulting from war, revolution, national disasters, governmental action, and so on.

Even in the absence of these more direct types of risk allocation clauses, the contract may impliedly place risk on a party by means of a provision such as a warranty, an undertaking to obtain insurance, or some other commitment from which the assumption of risk may be inferred. In fact, a term expressly allocating the risk of certain events to one party may give rise to the inference that the other assumed the risk of events not enumerated. For example, a clause states that the shipping company will not be responsible for delay caused by war, revolution, and governmental action. If the ship is seized by pirates and held hostage for ransom, this disruption is not apparently covered by the contract, so it could be inferred that the shipping company assumed this risk. It is good planning for the parties to consider potential risks and to provide for them clearly in the contract. This reduces the possibility of later disputes and litigation. Of course, as the last example suggests, no risk allocation provision is foolproof. It may fail to contemplate the actual event that occurs.

If the contract terms do not settle the issue, its context, including normal commercial practices and expectations, must be examined to decide where the risk should lie. For example, the facts in *Taylor v. Caldwell* satisfy all the other elements of impracticality. However, if we consider risk allocation, we could conclude that the case might come out differently if decided under the elements of impracticability. Under contemporary practice, the owner of property is the person who customarily insures it against fire and other damage. This suggests that in the absence of a contract term providing otherwise, risk of loss of the property should be borne by the owner, and not by the person who hires the premises for an event. Conversely, if the music hall did not burn down, but a sudden and unexpected recession resulted in abnormally small ticket sales, the lessee of the music hall would not likely be able to claim impracticability on this ground. Unless the contract provides otherwise, commercial practice in the entertainment industry probably places this risk on the promoter of the concert and will not allow him to foist it on the lessor of the hall by canceling the booking if sales are weak.

§15.7.4 Relief for Impracticability

When impracticability fully defeats the feasibility of performance by a party, it is a complete defense to that party's failure to perform, relieving him of the duty of performance and liability for damages. Release of that party's performance obligation also discharges the contractual duties of the other. If any performance had been rendered by either party under the contract prior to the finding of impracticability, the benefit or its value must be returned, measured in accordance with the same restitutionary principles applicable to mistake. This is illustrated by the *Petrozzi* case, discussed in section 15.7.1.

If impracticability does not go to the entire basis of the contract, the court has the discretion to award relief short of fully excusing performance. This is recognized in general terms by Comments 6 and 7 to UCC §2.615, and in more detail by Restatement, Second, §§269 and 270. It may be more appropriate to adjust the terms of the contract, to excuse a portion of the performance (with any appropriate reciprocal reduction in counterperformance), or simply to permit a delay if this would enable the difficulties to be surmounted.

§15.8 FRUSTRATION OF PURPOSE

The doctrine of frustration of purpose developed as an extension of the original doctrine of impossibility. It was designed to provide relief when a party could not show that an unexpected supervening event rendered his performance impossible, yet it so destroyed the value of the transaction for him that the contract's underlying purpose was frustrated. The case responsible for this extension of the impossibility doctrine was *Krell v. Henry*, 2 K.B. 740 (1903). Krell owned a flat on the route to be taken by the coronation procession of Edward VII. Krell placed a sign in the window stating that the flat was available to be let for viewing the procession. Henry responded to the sign and contracted to hire the flat on the two days of the coronation celebrations. The King became ill before the coronation, and it was postponed, so Henry was left with no need for the premises on the days in question, and he did not use them. Krell sued him for the balance of the agreed rental. (Henry had made a down payment but apparently did not pursue a counterclaim for a refund of the deposit.) The court resolved the case by using an adaptation of the impossibility defense of *Taylor v. Caldwell*. Although the contract did not expressly state the purpose of the rental of the flat, both parties understood that Henry's sole purpose in making the contract was to view the coronation procession. This purpose was the very foundation of the contract. The postponement of the coronation was a supervening event that had not reasonably been contemplated by the parties at the time of contracting. Although it did not make either party's performance impossible (Henry could still pay the agreed rent and Krell could give him possession of the flat), it so defeated the purpose of the contract that it should excuse Henry's performance.

Because impracticability no longer requires objective impossibility, most cases of frustration could probably be resolved by using impracticability doctrine. This lessens the need for a separate doctrine of frustration of purpose, but these closely linked defenses continue to coexist and are treated by courts (and by Restatement, Second, §265)[7] as separate but allied. It is therefore necessary to understand what distinguishes them from each other. The only difference between them lies in the sometimes subtle distinction between an event that makes a party's performance unduly burdensome, and one that makes it pointless. Beyond that, the elements of the two doctrines are identical, involve the same issues, and would lead to the same result.

Like impracticability, frustration is concerned with a post-formation event, the nonoccurrence of which was a basic assumption on which the contract was made. This event must not have been caused by the fault of the party whose purpose is frustrated, and that party must not have borne the risk of its occurrence. The essential difference lies in the effect of the event. It does not directly affect the performance of the adversely affected party by making it unduly burdensome. Rather, its impact is on the benefit reasonably expected by that party in exchange for the performance. The event so seriously affects the value or usefulness of that benefit that it frustrates the contract's central purpose for that party. This cannot be a secret or obscure purpose, because a party's private motivation is not relevant to the contract and cannot be the basis of disappointing the other party's reliance. Therefore, the purpose must be so patent and obvious to the other party that it can reasonably be regarded as the shared basis of the contract. *Krell v. Henry* remains one of the best illustrations of the elements of frustration. Note, however, that the court did not pay much attention to the crucial question of risk allocation. This was raised in a concurring opinion that queried whether Henry, the lessee, may have been the more appropriate party to bear the risk of the coronation's postponement. This is a fair question, and it reinforces the point that when the contract does not itself provide for risk allocation, it is not always easy to know who should suffer the loss caused by the frustration. It is by no means self-evident that the court was right in imposing it on the lessor rather than the lessee.

The purpose of most commercial contracts is to make a profit. However, although it could be said that profit is the underlying purpose of a contract, this does not mean that a party can invoke the doctrine of frustration of purpose merely because the contract is no longer profitable to him as a result of events after contract formation. A party cannot so easily escape the performance of a contract that turns out to have been a bad deal. This distinction was made in *Karl Wendt Farm Equipment Co. v. International Harvester Co.*, 931 F.2d 1112 (6th Cir. 1991). Following losses resulting from a bad downturn in the farm equipment market, I.H. sold its farm equipment division and terminated a number of dealerships. The plaintiff, one of the terminated dealers, sued I.H. for breach of contract. I.H. raised the defense of frustration of purpose on the grounds that the loss of profit from adverse economic conditions frustrated the purpose of the contract. The court rejected the defense of frustration of purpose. It said the primary purpose of the contract was to sell farm equipment. This purpose could still be achieved, even if the desired goal of profitability could not be.[8]

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§15.9 A TRANSNATIONAL PERSPECTIVE ON MISTAKE,

IMPRACTICABILITY, AND FRUSTRATION

The CISG does not deal with mistake. (As noted in section 13.14, Article 4 of the CISG states that it is not concerned with the validity of a contract.) Any question of mistake would therefore be resolved under domestic law in an international sale of goods. Articles 3.4 and 3.5 of the UNIDROIT Principles cover mistake. Articles 3.17 and 3.8 are general provisions that deal with the effect of avoidance on any grounds, including mistake. Although the concepts are phrased slightly differently from the common law, the basic tenor of the doctrine is largely comparable to the common law. Article 3.4 defines a mistake as an "erroneous assumption relating to facts or to law existing when the contract was concluded." Article 3.5 sets out the elements of mistake. Unlike the common law, it does not specifically distinguish mutual and unilateral mistake. Article 3.5(1)(a) generally permits avoidance if the mistake was objectively material and the other party made the same mistake or caused the mistake, or knew or should have known of the mistake. Article 3.5(1)(b) provides an alternative basis for avoiding the contract for mistake: if the mistake was objectively material and the other party has not yet acted in reliance on the contract. Article 3.5(2) precludes avoidance if the party bore the risk of the mistake or was grossly negligent in making the mistake. Under Article 3.17, mutual restitution is available upon avoidance of mistake. However, Article 3.18 allows for the possibility of a claim of compensatory damages if the nonmistaken party knew or had reason to know of the mistake.

Article 79(1) of the CISG contains a principle equivalent to impracticability, under which a party is not liable for a failure to perform obligations under a contract if it proves that the failure was due to an "impediment" that the party could not reasonably have been expected to take into account at the time of contracting, that was beyond its control, and that the party could not reasonably be expected to overcome or avoid. Article 7.1.7 of the UNIDROIT Principles excuses performance of a party as a result of "force majeure." (This term should be familiar, because it is used in common law to describe a general risk-allocation clause in a contract. *See* section 15.7.3d.) The concept of force majeure is similar to that used in Article 79(1) of the CISG: an "impediment" beyond the control of the party, which could not reasonably have been taken into account by the party at the time of contracting, and which the party could not have avoided or overcome. (In a sense, force majeure is equivalent to what we would think of as objective impossibility under common law.) Apart from this, Article 6.2 recognizes a broader concept that is more akin to the doctrine of impracticability, but more restricted in its relief. It allows excuse for “hardship,” which is not as severe as force majeure but makes performance more onerous for the party. Hardship occurs where supervening events “fundamentally alter the equilibrium of the contract,” the events could not reasonably have been taken into account by the “disadvantaged party” at the time of contracting, they are beyond its control, and the disadvantaged party did not assume the risk of the events. Hardship does not necessarily result in complete excuse. It allows the disadvantaged party to request renegotiation of the contract, provided that it acts without undue delay. If the parties cannot settle the problem by negotiation, either party may ask the court to terminate or to adapt the contract to restore its equilibrium.

Examples

1. Tiffany De Canter owned an ornate silver jug. She inherited it from her grandmother who had told her that it was very valuable because it was made by Maestro Da Silva, an important nineteenth-century silversmith. Since she acquired it, Tiffany has had it examined by several experts. Although some of them thought that it might have been made by Da Silva, the prevailing view among them is that it was the product of one of his pupils. It has therefore been appraised at $10,000. Had it been authenticated as the work of Da Silva, it would be worth $1 million.

   Tiffany decided to sell the jug. She offered it to Sterling Silverman, an art collector, for $12,000. Sterling was familiar with Da Silva’s work. He had a hunch that the experts may have been wrong in concluding that the jug was not made by Da Silva. He accepted Tiffany’s offer to sell the jug for $12,000. The parties executed a simple written contract that set out the physical description of the jug and stated the price and delivery obligation. A few months after the sale was completed, a scholar unearthed some previously unknown notebooks and sketches by Da Silva that conclusively proved that he had made the jug.

   Can Tiffany avoid the sale to Sterling?

2. Manny Lisa recently became wealthy through the exercise of his stock

options. All his newfound rich friends owned portraits of themselves painted by the celebrated society portraitist Leonardo De Fancy. Although he is clueless about art, Manny decided to get hold of the divine Leonardo and commission a portrait. He searched on the Internet for the name "De Fancy" and found the website of "Leonardo De Fancy, Portraitist." He called the number on the website and spoke to Leonardo, who agreed to paint his portrait for $250. Manny was astounded at how reasonable this was, and he accepted. The parties arranged a date for a sitting at the end of the week.

A couple of days later, Manny discovered from a more worldly friend that the person whose website he visited is not *the* Leonardo but his father, Leonardo De Fancy the Elder, a talentless hack who ekes out a meager living by painting the children of middle-class suburbanites. Being unschooled in the ways of the art world, Manny had not known that a famous celebrity portraitist like Leonardo, the Younger, would not deign to have a website and only accepts commissions on referral. Furthermore, his charge for a portrait would be about 40 times what Manny had agreed to pay Leonardo the Elder.

Understandably, Manny no longer desires the portrait for which he contracted. Can he avoid the contract?

3. Reliabuild Contractors, Inc., was invited by the owner of property to submit a bid for the erection of a new building. Reliabuild planned to do all the work itself except for the excavation of the land. It needed to know the cost of excavation before it could complete its bid, so it sent the building plans to Bill Dozer, an earthmover whom it had used with satisfactory results on several prior projects. Bill studied the plans and calculated his own cost. Because Bill was very busy and distracted, he did not pay careful enough attention to this task and he miscalculated his cost as $500,000 instead of $800,000. He then added a 10 percent profit of $50,000 and submitted a written bid of $550,000 to Reliabuild. Reliabuild calculated its own bid on the basis of this figure and submitted it to the owner. Reliabuild's bid was about $400,000 less than the lowest competing bid, so the owner accepted it. Reliabuild then accepted Bill's bid.

   A few days before Bill was to begin his performance, he reviewed his bid and discovered his miscalculation. The error not only would deprive him of his expected profit but would result in a loss of $250,000.

He could not absorb such a loss, which would put him out of business. Bill called Reliabuild immediately, explained the error, and withdrew from the contract. Reliabuild told Bill that it regarded this as a repudiation and would hold him liable for damages. Reliabuild then sought other bids and accepted the lowest one of $900,000. As a result, Reliabuild had to pay $350,000 more than it originally expected and lost about 40 percent of the profit it had anticipated on the project.

Reliabuild claims the $350,000 from Bill as damages for breach of contract. Does Bill have a defense?

4. Change the facts of Example 3 as follows: Assume that when Bill explained the mistake, Reliabuild did not wish to drive him out of business by pressing its claim for damages. It therefore took pity on him and agreed to release him from his obligation. Reliabuild does not itself wish to assume the extra cost of employing a more expensive subcontractor, so it in turn seeks to withdraw from its contract with the owner. The owner is not so kind and threatens suit if Reliabuild does not perform as agreed. Can Reliabuild escape its contract with the owner?

5. Merlin Magnifico, Master of the Impossible, is a magician. On July 1 he entered into a contract with Showstopper Promotions, Inc., under which he agreed, for a fee of $10,000, to perform a magical extravaganza at the Pyro Palace Theater on August 30. This contract forms the basis of the separate and distinct factual variations set out in the following questions.
    a. On July 20, Merlin tried to perform the most daring escape trick ever attempted. He jumped out of a plane all trussed up like a turkey, allowing himself two minutes to free himself and pull his parachute cord. He succeeded in loosening his bonds, but in his feverish unraveling, also mistakenly untied his parachute harness. Is the estate of the late Merlin Magnifico liable to Showstopper for the substantial profits it lost as a result of having to cancel the show and refund the price of tickets sold?
    b. The sad event described in question (a) had an impact (no, I would not be so callous as to intend a pun) on a transaction between two other parties: By July 15, all the tickets to Merlin's show had been sold, and people were clamoring to buy tickets from those who had been lucky enough to get them. Buck Fast had managed to buy a ticket for $50 when they first went on sale. His friend Fanny De

Voted adored Merlin and desperately wanted to see the show. She nagged Buck to sell the ticket to her, offering an increasingly higher price each time he refused. Eventually he gave in and sold it to her when her offer reached $150. When Merlin was killed, Showstopper canceled the show and announced that ticketholders should return their tickets for a refund. Naturally, Showstopper will only refund the face value of the ticket, so Fanny demands that Buck repay her the excess of $100. Buck refuses. Is Fanny entitled to the return of her money?

c. Change the facts of (a) so that Merlin did succeed in accomplishing the parachute trick. As a result, he became an instant worldwide sensation. He is now able to command a fee of $500,000 for a booking. He does not wish to perform for Showstopper at the measly rate of $10,000. Can he escape the contract?

d. Merlin survived his parachute prank, only to be apprehended by grim-faced Federal Aviation Administration (FAA) officials for failing to obtain the permits needed for exiting an aircraft in a state of physical restraint. To avoid prosecution and stern punishment, Merlin entered into a consent decree with the FAA in which he undertook never again to perform magic tricks on land or sea, or in the air. When Merlin told Showstopper that he could no longer perform on August 30, Showstopper sued him for breach of contract. Does he have a defense?

e. The trick of July 20 did not happen. (In fact, Merlin is terrified of heights and can only undertake air travel under deep sedation with his seatbelt firmly fastened.) Merlin was therefore willing and able to give his show at the end of August. On August 15 the Pyro Palace burned down. Showstopper had sold almost all the tickets to the extravaganza and did not wish to cancel or postpone it. There is another theater in town that was available on August 30 and is suitable for staging the show. Showstopper proposed to change the show’s venue to the other theater. Merlin refused to perform at the other theater. He argued that the parties intended the show to be performed at the Pyro Palace, and its destruction made the contract impracticable. Should Merlin be able to terminate the contract on this ground?

f. None of the above catastrophes happened. However, ticket sales for the show were appalling. Despite intensive promotion, Showstopper had filled only 30 percent of the house by August 20. It is clear that Showstopper will incur a substantial loss if the show goes on. Showstopper takes the position that, known to Merlin, its obvious purpose in entering the contract was to make a profit. The supervening lack of interest on the part of the public has frustrated this purpose, and Showstopper is therefore entitled to cancel the contract with Merlin. Is this a good argument?

6. Professor Goldbrick hates grading exams. One day he saw an advertisement by Slacker Software, Inc., in which it claimed that it could design computer programs to meet any educational need. Goldbrick contacted Slacker and asked if they could devise a program that could grade essay exams. Slacker took full details of what Goldbrick would need and said it would consider the matter and get back to him. A few weeks later, Slacker sent him a written proposal in which it undertook to create a program of the kind he required. It was based on a complex system of identifying key words and phrases in electronically written essay answers. Because the program was so innovative, Slacker wanted the obscene price of $100,000 for producing it. Goldbrick hated grading so much that he decided it was worth it, even though it meant that he would have to sell all his assets to come up with the money. The parties entered a contract under which Slacker undertook to deliver the program within six months.

   Slacker set to work on the program immediately. After struggling with it for four frustrating months, Slacker concluded that its original concept would not work. The program required considerable further research and refinement that would push Slacker's development costs to $150,000, which exceeds the contract price by $50,000. It therefore told Goldbrick that it could not produce the program and canceled the contract. Goldbrick is deeply disappointed. He would like to contract with another programmer and hold Slacker liable for any difference in price. Would Slacker be liable?

7. Crystal Springer owns land on which a pristine spring is located. The sweet water emerges from the earth in a completely pure state. Crystal bottles her water and sells it to health food shops. Because Crystal's water is so exquisite, it is regarded as the champagne of bottled water.

Although it is more expensive than other brands, it is whisked away by customers as soon as stores place it on the shelf. Holy Foods, a preeminent organic grocery store, entered into a contract with Crystal under which it bought 20,000 bottles of her water a year for five years, to be specially bottled for Holy Foods under its own “Holy Water” label. The contract provides a stated price for the water, to be adjusted at the beginning of each year in accordance with the Consumer Price Index. The contract makes no provision for changing the quantity of water supplied or terminating the contract.

The contract was performed satisfactorily for two years. Just before the third year, Crystal’s spring dried up. A hydrologist has determined that this was caused by an unusual phenomenon. A subterranean tremor had blocked the channel to the surface of the land and prevents the stream from reaching it. The problem can be rectified by an expensive excavation. Crystal can obtain a mortgage on the land to pay for the excavation, but the payments under the mortgage would be so high that Crystal could not expect to make a profit from sales of her bottled water for the next 15 years. Crystal therefore decided not to do the excavation. She notified her customers, including Holy Foods, that she would not deliver the water promised for the remaining years of their contracts.

Holy Foods can obtain water of a quality equivalent to Crystal’s but it has to import it from the foothills of the Himalayas at a much higher cost. Assume that Holy Foods can prove a loss of profits as a result of Crystal’s failure to complete her performance under the contract. Is Crystal liable to Holy Foods for this loss?

8. Fast Fryers, a new fast-food chicken restaurant, ordered 1,000 chickens from Fairest Fowls, Inc., a poultry supplier. When the chickens were delivered, Fast Fryers found them to be tough and unusable for frying. Unknown to Fast Fryers (who is new to the chicken industry and unfamiliar with its customs) there is a well-established usage in the industry that the word “chicken” refers only to old, tough birds, suitable only for stewing or soup. A frying chicken is known in the industry as a “poulet.” Can Fast Fryers avoid the contract on the basis of its mistake as to the meaning of “chicken”?

Explanations

1. This is a sale of goods, but mistake is not specifically dealt with in UCC Article 2, so it is governed by common law rules. Tiffany is a sophisticated seller who made her judgment without any reliance on a representation by Sterling or under any pressure from him. In the absence of deception or other improper bargaining, the only possible basis for avoidance is mistake. (It may be tempting to find unconscionability in the grossly inadequate price. Although there is some recognition that a gross disparity in exchange could, on its own, be grounds for unconscionability, the generally accepted view is that this substantive unfairness must have resulted from wrongful bargaining conduct or at least from an environment that would allow advantage to be taken of a vulnerable party. Therefore, Tiffany is most unlikely to succeed in arguing that the contract was unconscionable. This is discussed in section 13.11.)

   The error in this case does not concern the actual identity of the jug itself, but of its maker. The identity of its maker is a fact, and the low price reflects an erroneous shared basic assumption (that is, a mutual mistake) about it. However, both parties were aware of the possibility of incorrect attribution, and if they were wrong, this is more a question of incorrect judgment. Tiffany gambled that she was correct in believing it to be a work of Da Silva's pupil, in which case, she obtained a good price, somewhat above its true market value. Sterling speculated that the experts might be wrong, in which case he would make a killing. When parties deal with each other in an arm's-length market transaction, their respective reliance interests are entitled to protection. One of them cannot be deprived of his bargain because it later turns out that the other made a poor judgment.

   Thus, the case can be disposed of quickly by treating it as a misjudgment on Tiffany's part and not an error of fact at all. However, even if, as an initial matter, it was to be conceded that there was a mistake of fact, the analysis of risk allocation leads to the same result: Tiffany must be held responsible for her own judgment. The written contract simply describes the jug without making any representation of authorship, and there is no other term that expressly allocates the risk of error. In the absence of guidance in the contract itself, risk must be allocated to the party who should most appropriately bear it under all the circumstances of the transaction. When the parties knowingly enter a contract for the sale of a work of art of uncertain attribution, the risk must lie with the party whose judgment proves to be wrong. This is the resolution suggested in *Firestone & Parson, Inc.* and the dissent in *Sherwood v. Walker* discussed in section 15.2.1.

2. There are two possible arguments that Manny could make for avoidance, but both would be difficult to establish on these facts. He could claim that Leonardo the Elder made a fraudulent misrepresentation by creating a website under the name shared with his celebrated son and failed to make it clear on the website that he was not *the* Leonardo. This argument seems tenuous. Although there is some chance of confusion, and maybe a possibility that Leonardo was consciously taking advantage of his son's name recognition, the two painters operate in different spheres. Leonardo the Elder has not misrepresented his name and he made no claim to be a society painter. In addition, the modesty of his fee suggests that he may not even have imagined that there would be any reasonable confusion. (If the website included photographs of his work, that would probably have made it even clearer to someone who was not as clueless as Manny that this was not the work of the famous son.) Furthermore, any duty that he may have had to alert potential customers to the fact that he was not *the* Leonardo seems to be outweighed by Manny's carelessness in not making proper enquiries to obtain easily ascertainable information, especially in light of the low price.

   Manny's other possible argument is that the contract was induced by unilateral mistake. A mistake as to the identity of the other party is treated as a factual error. The mistake did relate to Manny's basic assumption in entering the contract. It is harder to say whether the error materially affected the exchange of values. Manny got what he paid for, but there could still be a material impact on the exchange because this was not the portrait that Manny bargained for. Because there is probably not much of a market for hack-painted portraits of the nouveau riche, Manny does not have much chance of recouping the price by selling the painting.

   However, even if these elements are satisfied, Manny is likely to lose on the allocation of risk and the equities. Manny may have been untutored in the ways of the art world, but he had ready access to information and advice and should have proceeded more carefully before committing himself to ordering a painting from the wrong artist.

There do not seem to be strong equities for shifting the risk to Leonardo. There is nothing to suggest that Leonardo had reason to suspect an error and exploited it, and he has a legitimate reliance interest worthy of protection.

3. This Example does not implicate the promissory estoppel issue in *Drennan v. Star Paving*, discussed in sections 8.11 and 15.4, because the offer was accepted before Bill tried to revoke it. We can therefore focus purely on the mistake analysis presented by these facts.

   This mistake is not mutual, but unilateral on Bill's part. In a sense, Reliabuild has also been in error over the correct price for the earthmoving, but this does not make the mistake mutual. The calculation of Bill's price is solely within his realm and forms his individual basic assumption. Reliabuild was not involved in the determination of Bill's price. It simply reacts to the end result of Bill's calculations, which it will accept or reject. Are the requirements of unilateral mistake satisfied? Bill should not have much trouble with the first three: His cost in doing the work is a fact. It was a basic assumption on which he entered the contract. It materially affects the exchange, in that it causes him to undercharge so badly that his expected profit becomes an unbearable loss.

   He is not likely to do as well with the issues of risk allocation and equitable balancing. His miscalculation is not simply a matter of conscientious error, but results from sloppy inattention to his work. Although negligence is not an absolute bar to relief for mistake, it is a factor that is taken into account in deciding whether a party assumed the risk of the error. Even if this does not dispose of the matter, the cause and nature of the mistake will weigh against him in the balance of the equities. On the other side of the balance is the hardship he will suffer if the contract is enforced. The damages may put him out of business, but shifting the loss to Reliabuild will apparently have a less devastating effect because it has a bigger profit margin and may be able to better absorb it. When the potential impact of the mistake is so severe to the mistaken party as to threaten his livelihood, and only reduces the gains of the other party, a court may be swayed by the balance of hardship.

   Nevertheless, the relative economic impact on the parties, while a relevant consideration, may not be weighty enough to be the overriding factor in the decision to foist the loss onto one of them. Relative blame and innocence must be considered as well. In this case, Bill’s carelessness must be weighed against Reliabuild’s justifiable reliance on his contractual commitment. It could be that Reliabuild, as an experienced prime contractor, should have realized that the bid was too low. If this was so, Reliabuild would have no legitimate reliance interest, and in fact may even have been guilty of fraudulent nondisclosure in keeping silent and seizing on Bill’s erroneous bid. We do not have enough information to reach a conclusion on whether Reliabuild acted in bad faith in accepting a bid that it knew or should have known was incorrectly calculated. If Reliabuild had no reason to have suspected the mistake, it made its own commitment to the owner in reasonable reliance on Bill’s manifestation of assent. Bill cannot be released from his obligation without subjecting Reliabuild to the substantial harm of either reneging on its obligation to the owner, with the probability of ensuing litigation, loss of reputation and loss of profit, or of having to pay the additional cost of a substitute. In other words, Reliabuild cannot be restored to the status quo if Bill is allowed to escape liability under their contract.

4. If Reliabuild releases Bill from his subcontract, the question becomes whether Reliabuild itself could use mistake as the basis for seeking relief under the prime contract. That is, Reliabuild could seek relief for unilateral mistake by arguing that it made an error in its own cost calculations, based on having been given incorrect information by Bill. Reliabuild should not have much trouble establishing two of the elements of unilateral mistake: Bill’s charges are a fact forming Reliabuild’s basic assumption in entering the prime contract, and the mistake has a material effect in the exchange of values. However, Reliabuild may have greater difficulty with risk allocation and the balance of the equities. There are no facts to suggest that the owner realized or should have realized that Reliabuild’s bid was too low to be correct (and if Reliabuild itself did not notice Bill’s error, it seems even less likely that the owner would have been aware that Reliabuild’s bid was too low). The owner therefore has a strong reliance interest. Although enforcement of the bid would severely diminish Reliabuild’s profits, nonenforcement would deprive the owner of its bargain to the same extent. In addition, it is more appropriate to allocate the risk of this error to Reliabuild than to the owner. Reliabuild, not the owner, selected

and dealt with Bill as its subcontractor, and the owner had no direct contact with Bill, had no means of evaluating his bid, and had no role in releasing him.

The error in this example is in the bid at the time of contracting, so it is best characterized as an issue of mistake. However, it could conceivably be treated under the doctrine of impracticability. Bill's withdrawal after formation of the contract could be seen as an unforeseen supervening event, the nonoccurrence of which was a basic assumption of the contract between Reliabuild and the owner. As a result, Reliabuild's performance becomes unduly burdensome. However, even if the case is analyzed under impracticability, the result should not change, because fault and risk allocation are again the dispositive considerations and they should be resolved in the same way.

5. All the factual variations in this example involve supervening events—occurrences after contract formation that may be grounds for a claim of impracticability or frustration of purpose.
   a. Even under the original doctrine of impossibility, performance was excused by the death of a party whose continued existence was necessary for the performance. Restatement, Second, §262 adopts this rule for impracticability as well. It may seem ridiculously obvious that the death of the party who has to perform the service would render the performance objectively impossible, but remember that, as the question indicates, the issue is not whether Merlin's corpse can be made to do magic tricks but whether his estate is liable for damages. The initial two elements of impracticability are satisfied: As the contract was for Merlin's personal services, it was clearly dependent on his continued vitality. His death is a supervening event contrary to the contract's basic assumption.

      The more difficult question concerns who bore the risk of his death. The contract itself does not assign the risk, so the allocation must be made in light of the parties' reasonable expectations, determined from all the circumstances surrounding the transaction. These circumstances may include a particular practice in the entertainment industry that may help determine the normal incidence of risk when an artist dies before a show. (For example, promoters may regularly insure the lives of performers who have been booked.) If not, general community expectations must be determined and any pertinent considerations of public policy must be taken into account. It is difficult to be sure what result would be reached. Many contracts do not terminate as a result of the death of a party, so that performance or damages becomes an obligation of his estate. As noted above, this may not be the reasonable expectation when the contract is for personal services. In this case, however, the risk allocation is also influenced by the circumstances of Merlin's death. Impossibility or impracticability cannot be used as a defense by a party who is at fault in causing the supervening event, and it could be argued that Merlin recklessly caused his own death. This may, in itself, be grounds for withholding relief from his estate. If not, it may tip the balance in the determination of risk.

b. Fanny's demand for refund of the $100 is, in effect, a claim of restitution based on the implicit contention that the cancellation of the magic show frustrated the purpose of her contract with Buck. (The facts here differ from *Krell v. Henry*, but the situation is analogous.) These facts show how difficult it can be to distinguish impracticality and frustration. The latter seems more appropriate here because the contractual performance—the exchange of a ticket for $150—has not been altered by the supervening event. Rather, the goal and purpose of the exchange have been defeated. (However, it could just as plausibly be argued that the supervening event so devalued the exchange for Fanny that her performance was rendered unduly burdensome, and impracticality doctrine is applicable.)

    The first three elements of frustration are clearly satisfied: Merlin's death and the ensuing cancellation of the show were supervening events that defeated a shared basic assumption of the parties entering the contract, and neither was at fault in causing the event. Therefore, once again, risk allocation becomes the determinative issue.

    In the absence of any assignment of risk in the contract itself, the risk of the show's cancellation must be placed where the parties reasonably would have expected it. It is not clear what this reasonable expectation might be, but in the absence of some established practice to the contrary, the usual expectation in a sale transaction (in the absence of any express term to the contrary) is that the buyer assumes the risk that the item or service purchased will be worth less than its price, and the seller assumes the countervailing risk that it will be worth more. On this basis, Fanny would bear the risk of cancellation and partial refund, and would not be entitled to recover the $100 from Buck. This is contrary to the result in *Krell v. Henry*, but the concurring opinion in that case questioned the issue of risk allocation.

c. The only basis on which Merlin could escape the contract is to contend that his new-found fame is a supervening event that defeats the basic assumption on which the parties contracted for his services at the relatively modest sum of $10,000. As a result, his loss of the opportunity to earn 50 times that amount is such a burden as to make his performance impracticable. He should not get away with this because he does not show either that performance has become unduly burdensome or that Showstopper bears the risk of the change in circumstances. Impracticability should not be permitted as an excuse when the change in market conditions merely has the effect of making the performance more valuable than anticipated, especially when the harm to Merlin is nothing more than the loss of an opportunity to sell his services at greater advantage. In addition, the argument made in Explanation 5(b) is applicable here too: Each party made a judgment in assenting to the price of $10,000, and neither can complain if that judgment turns out to have been wrong.

d. Compliance with a change in the law or government regulation or with a judicial or administrative order is generally regarded as a basis for excusing performance on grounds of impracticability. The FAA's prohibition on Merlin's further career as a magician could fall into this category, but because the bar on his performance resulted from his violation of the law, he should be denied relief. Even had he not entered a consent decree, the event precluding his performance arises from his own fault, and he must be held to have assumed the risk of its occurrence. This resolution is made more compelling by the fact that the FAA may not unilaterally have imposed the prohibition, and Merlin acquiesced in it by entering a consent decree to avoid other punishment.

These are sufficient grounds to defeat a claim of impracticability, but one further issue should be noted: We do not have to be concerned about whether the FAA had the legal authority to enter the consent decree. Even if it did not, and the order was invalid, this would not in itself prevent a claim of impracticability, provided that compliance with the order is in good faith.

e. At last, we get to the fiery destruction of the Pyro Palace, but with a twist on *Taylor v. Caldwell*: It is not Showstopper, the party who is obliged to supply the hall, that raises the excuse of impracticability. Rather, Showstopper tenders a substitute performance, but it is Merlin who claims impracticability on the basis of the destruction of the hall. This may therefore not be a proper case for invoking the doctrine of impracticability, which is intended to provide a defense to the party who cannot perform as promised as a result of the supervening event. The language of Restatement, Second, §261 contemplates this by stating that where a party's performance has become impracticable, his duty to render the performance is discharged. On the facts of this Example, it is not Merlin's performance that has become impracticable but Showstopper's. It is conceivable that Merlin could argue that the destruction of the hall renders his performance impracticable as well. He could show that there was some special reason why that venue was a basic assumption of his performance—for example, that the Pyro Palace had special facilities or characteristics essential to his performance that were not available in the new venue. However, the facts do not suggest that he is making this claim. Therefore, unless he can show that the substitute venue defeats a basic assumption of the contract, rendering his performance unduly burdensome, Merlin cannot use the change in venue as a basis for discharging the contract.

f. Most commercial contracts are motivated by the prospect of profit, so if Showstopper's argument was taken seriously, no party could ever be held to a contract once it becomes apparent that its expectation of profit will be disappointed. Therefore, although profitmaking may, in a sense, be the purpose of a contract, the doctrine of frustration does not simply focus on this underlying "bottom line" purpose, but calls for a more penetrating examination of the parties' mutual objective in entering the contract. This shared objective must be determined in light of the contract's allocation of risk. The facts do not make it clear who bore the risk of poor sales. However, if the contract did not specifically allocate this risk to Merlin, and there is no usage to the contrary, the reasonable inference from the structure of the contract is that Showstopper assumed this risk. Merlin agreed to perform for a fixed fee, and Showstopper would keep whatever proceeds were generated from ticket sales. If Showstopper bore the risk of poor ticket sales, it follows that it was not the common purpose of the contract that Showstopper would make a profit. Rather, the common purpose was to stage a public entertainment. The prospect of making a profit may have strongly motivated Showstopper to undertake the venture, but that was its purpose, not Merlin's. Viewed this way, we can see that the purpose of staging the show has not been frustrated.

Showstopper based its argument on frustration of purpose. It could equally have argued that the supervening event of poor ticket sales rendered the contract impracticable. (A similar alternative argument was made and rejected in *Karl Wendt Equipment,* discussed in section 15.8.) Because the defenses of frustration of purpose and impracticability are so closely related, we should get the same answer, whichever one is used. Again, the key to resolving an impracticability defense is to determine who bore the risk of poor ticket sales. If Showstopper bore that risk, it cannot escape the contract on grounds of impracticability.

6. This is one of those ambiguous situations that sounds like a case of impracticability, but is better characterized as a unilateral mistake. Slacker's post-contractual realization that it underestimated the complexity and cost of production is not a supervening event, but a discovery that it had underbid its price. However, because risk allocation is the key element here and it is common to both mistake and impracticability, mischaracterization should not affect the result.

   Let us consider mistake first. Slacker, the expert, was approached by Goldbrick, a lay customer who desired an end product and had no idea about what may be involved in creating it. Slacker made its own evaluation of what would need to be done to create the product and then made an unqualified promise to deliver the program in six months. We may simply describe this as an error in judgment, or we could say that Slacker assumed the risk that it could not perform for the price quoted. However phrased, the point is that Goldbrick had no way of knowing that Slacker had misjudged the complexity of the project, and Slacker was foolishly overconfident in giving him an absolute promise. Because Slacker was creating an innovative custom-made product—a prototype

—it would have been wiser to draw the contract so as to identify the experimental nature of the project and provide for a price increase, a delay in delivery, or a right to terminate if production difficulties are encountered. By not doing this, Slacker assumed the risk of unforeseen problems. It is therefore liable for Goldbrick's expectation damages measured as the difference between the contract price and the higher price charged by the other programmer.

It was noted earlier that this is not properly viewed as an impracticability case, but that even if it was analyzed as such, the same result would apply because Slacker assumed the risk of post-contractual difficulties in production.

7. Crystal has breached the contract and is liable for Holy Foods' damages unless she has the defense of impracticability. Bottled water satisfies the definition of "goods" under UCC article 2, so the issue of impracticability must be resolved under UCC §2.615. The analysis of impracticability under §2.615 is substantially the same as under contemporary common law.

The blockage that diverted the stream was a supervening event. Section 2.615 requires that it must have been an event "the nonoccurrence of which was a basic assumption on which the contract was made." Comment 1 to §2.615 paraphrases this by stating that the contract must have become impracticable because of unforeseen supervening circumstances not within the parties contemplation at the time of contracting. The blockage is described as an unusual phenomenon. This suggests that the parties probably did not contemplate it as a possibility. There is no indication that they discussed or provided for it in the agreement.

The supply of water is not objectively impossible because there is a means of restoring the stream. However, §2.615 (like the common law) does not require impossibility, but impracticability. Mere increase in cost, lack of profit, or even some degree of loss, is not enough to make a performance impracticable. The scale of the problem must be large enough that it makes the performance so burdensome that it cannot be rendered without devastating loss, great risk, or serious hardship. The facts here have a good chance of meeting this standard. The high cost of curing the problem is disproportionate to the value of the water. It would take Crystal 15 years of sales to pay off the cost of the work. Although the excavation may pay for itself in the very long term, it would impose a significant burden on Crystal. She would not derive any income from her business for 15 years, even if we assume that the market for her water remains strong.

Crystal was not in any way at fault in causing the occurrence, so she is doing well so far in establishing the elements of impracticability. This leaves risk allocation as the crucial factor in deciding if she should be excused from performance. The contract makes no provision for reductions in quantity for any reason, so the parties' intent must be determined from interpretation of the contract as a whole in context. If no factual indicators of intent are available, the court must construe the parties' reasonable intent. We have no evidence of express terms or pertinent usage or custom, so are left with nothing more than the bare terms of the contract to decide if Crystal assumed this risk. The contract establishes a formula for fixing the price of the water over the five-year period. Where parties fix the price in the contract, the seller is usually assumed to undertake the risk of any increases in cost. In addition, the seller of goods assumes the risk that she may not be able to make or obtain the goods promised in the contract. However, the cost increase here was so unforeseen and so great that a court could conclude that it goes well beyond the normal level of risk assumed in a fixed price contract. If so, Crystal can escape the contract on grounds of impracticability.

It is worth making a final observation about this contract. Where parties enter into a long-term relationship, they run a greater risk of unforeseen future contingencies. Although it may be difficult to imagine all the things that could go wrong to make the contract unexpectedly burdensome to one of the parties, a generally worded clause, excusing performance in case of a force majeure could help a party like Crystal in establishing grounds for excusing performance.

8. If this Example reminds you of *Frigaliment Importing*, the cherished chicken case in section 10.1.3, that should give you a clue to its answer. Your immediate reaction may be to resolve the case on the basis of unilateral mistake because the trade usage is, after all, a fact external to the contract. However, as discussed in section 10.1.3, a trade usage, although extrinsic to the written contract, is not treated as a fact external to the contract itself, but is part of the context used to give meaning to

the terms used by the parties. Unless specifically included, a usage is an implied term of the contract. Therefore, this issue is properly resolved, not as a question of mistake, but as a question of interpretation: If the usage is proved to exist, the question is whether Fast Fryers, as a new entrant to the industry, had reason to know of it. If so, as a matter of interpretation, the word "chicken" means stewing chicken and Fast Fryers is bound to a contract for the purchase of 1,000 tough old birds.

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1. The opinion made an interesting distinction. The court suggested that had the parties not known that any regulation existed, this ignorance might have been a mistake of fact. But once they knew that the setback was regulated and they erred as to the law's provisions, this was a mistake of law. This suggests that the court may have treated complete ignorance of the law as grounds for mistake, but not an error in legal research.

2. *See* section 13.6.3c.

3. In the *Alcoa* case, the facts were ambiguous enough to be treated either under mistake or impracticability doctrine. This is explained in section 15.7.1, which contains a fuller account of the facts of the case. It is also discussed in section 15.7.3a.

4. In the example of the cabin, its destruction materially affected the seller's performance and therefore results in complete termination of the contract. However, it could happen that a supervening event has a less fundamental effect so that performance can still be rendered, but not on the exact terms agreed. In such a case, impracticability might excuse the shortfall in performance but might not result in complete termination of the contract.

5. Of course, the fact that I (and several talented movie creators) have contemplated these possibilities may mean that they are indeed foreseeable.

6. In anticipation of the discussion in section 15.8, it is also worth pointing out that these facts would support an argument that the purpose of the contract has been frustrated: Although the lessor can still deliver possession of the hall and the lessee can still pay the rent, the purpose of the hiring—the use of the hall for a public concert—has been negated by the new regulations. This illustrates the observation in section 15.8 that impracticality is broad enough to cover most, if not all, situations that would have required a separate doctrine of frustration in earlier law.

7. UCC Article 2 has no doctrine of frustration of purpose, so cases of frustration in sales of goods must be dealt with either by resolving them as impracticability cases under §2.615 (which is broad enough to encompass frustration of purpose as well) or by applying the common law doctrine of frustration of purpose.

8. I.H. also raised the defense of impracticability, which the court also rejected. It held that the poor market conditions were not so severe as to pass beyond the range of the normal risk that I.H. bore, and the impact of the market downturn was not grave enough to constitute undue hardship to I.H. The fact that the circumstances of the case gave rise to alternative arguments of impracticability and frustration of purpose, and that both failed, shows the close connection between the doctrines.

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CHAPTER 13
MISCELLANEOUS DEFENSES: ILLEGALITY, DURESS, MISREPRESENTATION, UNCONSCIONABILITY, AND LACK OF CAPACITY MISCELLANEOUS DEFENSES

*ChapterScope*____________________

This chapter discusses miscellaneous defenses that may be asserted by a party being sued for breach of contract. Key defenses:

- **Illegality:** A contract is ***illegal*** if the subject matter is unlawful, whether it is barred by statute or found to be against public policy. (*Examples:* gambling contracts, usurious contracts, unreasonably broad covenants to compete.)
  - **Neither party may enforce:** As a general rule, neither party to an illegal contract may enforce it — the court will leave the parties to the contract where it finds them.
- **Duress:** A party may assert the defense of ***"duress,"*** i.e., that he entered into or modified a contract because of unfair coercion arising from the other party's wrongful act or threat. The act or threat must be great enough to overcome the free will of the party asserting the defense.
- **Misrepresentation:** An aggrieved party may sue for rescission or breach or defend in a suit when the other party to the contract makes an intentional or even innocent ***misrepresentation.*** The aggrieved party must have ***justifiably relied*** on a misrepresentation of ***fact*** (not opinion).
  - **Concealment and disclosure:** There are some instances in which a party may rescind or recover on account of the other party's mere ***failure to disclose*** information (as opposed to that other party's making of an affirmative misrepresentation).
- **Unconscionability:** The ***unconscionability*** defense is available to consumers who enter into contracts that are so one-sided that they are considered ***shockingly unfair***.
- **Capacity:** A party who does not possess the ***capacity to contract*** may generally avoid the contact. (The option to avoid the contract belongs solely to the party lacking capacity, not to the other party.)

- □ **Infants.** Until a person has reached his ***majority*** (usually age 18), most contracts which he enters into are voidable at his option.
- □ **Mental incompetents.** Persons who are ***mentally incompetent*** (the insane, mentally ill, retarded and intoxicated) may sometimes avoid contracts they sign.

I. ILLEGALITY

A. Kinds of illegal contracts: There are many kinds of illegal contracts, ranging from those that are explicitly barred by statute, to those that are rendered illegal only by judicial decisions that they are "against public policy." See Rest. 2d, § 178. (The Restatement does not use the term "illegal," but refers to such contracts as unenforceable on grounds of public policy. See Ch. 8, Topic 1, Introductory Note.) Because the ***effects*** of illegality on contractual recovery are more important to the contracts student than a cataloging of the various kinds of illegal contracts, we summarize here only a few classes of illegal contracts:

1. Gambling contracts: Contracts involving ***wagering*** are generally held illegal, and thus unenforceable. The most common types of unenforceable gambling contracts are: (1) a ***bet*** between the plaintiff and the defendant (that is, the court will not allow the winner to sue the loser to collect on the bet); and (2) contracts involving the ***lending of money*** which the lender knows will be used for gambling (e.g., a casino that gives credit to one of its customers may ordinarily not recover against the customer, absent special legislation allowing casinos to do so — but such legislation exists in the few states that have legalized casino gambling).

a. Legality of underlying wager: The legality of a particular wagering contract will generally depend on whether the underlying wager is made a ***crime***. For example, in a state where lotteries are run by the government, an agreement between two people that they will share ownership of what turns out to be a winning ticket will normally be enforced, whereas an agreement by two people to share ownership of an entry in an illegal numbers game would presumably not be upheld because the underlying wager itself is illegal.

2. **Contract to buy an illegal business:** Contracts relating to the ownership or operations of a ***business*** that both parties know or should know is principally engaged in ***illegal operations*** generally will not be enforced. For instance, a contract to purchase a business which the buyer knows to be a ***criminal enterprise*** typically will not be enforced against either party.

   Example: D agrees to purchase from P a corporation that is mainly in the business of manufacturing drug paraphernalia, such as bongs and roach clips. D signs promissory notes as part of the purchase price, then fails to pay on them. P bring suit on the notes.

   Held, for D, on grounds of illegality. There is a strong public policy against manufacturing paraphernalia that facilitates the use of an illegal drug. "Refusal to enforce the instant contract will further that public policy not only in the present circumstances but by serving notice on manufacturers of drug paraphernalia that they may not resort to the judicial system to protect or advance their business interests." *Bovard v. Amer. Horse Enterprises, Inc.*, 247 Cal.Rptr. 340 (Cal. App. 1988).

3. **Usurious contracts:** Every state has its own ***usury*** statute, under which the legal rate of interest for particular kinds of loans is limited to a specified figure. A contract calling for interest to be paid above the legal rate is generally unenforceable (and the creditor cannot recover even a lower, legal, interest rate).

   a. **Limits:** But the usury laws of most states apply only to loans made to ***individuals***, not to those made to ***corporations***. Furthermore, most statutes do not apply to ***purchase money mortgages***, whereby the seller of real property gives the buyer credit, and retains a security interest in the property. In many but not all states, the usury statutes apply to retail installment credit sales, i.e., purchases made "on time."

4. **Covenants not to compete:** There are two main situations in which a person can promise ***not to compete*** with another person: as part of a ***sale of his business*** to that other person, and as part of his ***employment*** by that person. Since our economy is supposedly based on free competition, such covenants not to compete are carefully scrutinized; if they are ***unreasonably broad***, they will be held to be illegal and not enforced. See Rest. 2d, § 188.

   a. **Sale of business:** If the seller of a business is selling its "good will" as well as its physical assets, her ancillary promise that she will not compete in the same business as the purchaser will be upheld, provided that it is ***not unreasonably broad either geographically or in duration.***

i. **Geographical overbreadth:** If the geographical area specified is substantially greater than that within which the seller and the buyer are now doing business, and even beyond the buyer's area of probable expansion, the covenant will probably be held to be unduly far-reaching.

Example: D sells P a liquor store, whose customers almost all come from no more than 3 miles away. D has no plans to open new stores. As part of the sale, D agrees that for 3 years, D won't operate or work in any liquor store within a 200-mile radius of the store that's being sold. One year later, D opens a store 190 miles away. P seeks an injunction. A court is likely to hold that the restriction is unreasonably broad, geographically, in which case the court will deny the injunction.

ii. **Length of time:** Similarly, if the non-compete is for a length of time longer than the seller's goodwill is likely to continue, it will also be invalid. See C&P, p. 634.

Example: Same facts as above Example, except the non-compete is drafted to last for 15 years. Fourteen years later, D opens a competing store near the original store. A court is likely to hold that all the goodwill that D had at the time of sale has long-since been either lost, or transferred to P. Therefore, the court will probably deny the injunction.

b. As part of employment contract: An employee will often be required, as part of his employment contract, to sign an agreement in which he promises not to compete with his employer if he leaves the latter's employ. Such covenants are usually more closely scrutinized than those mentioned above regarding sales of businesses. Courts will generally permit the employment covenant to stand only if it is designed to accomplish one of the following two purposes:

[1] **Trade secrets:** To prevent the employee from ***disclosing or using confidential information*** or ***trade secrets*** gained from the employer; or

[2] **Taking of good will:** To prevent the employee from taking advantage of his contacts with the employer's ***customers*** by

approaching them and trying to ***steal them*** from the employer.

i. **Standards:** Even where an employee non-compete *does* merely prevent the employee from disclosing confidential information or soliciting the employer's customers, the non-compete will not necessarily be found "reasonable," and thus not necessarily enforced by the court. A good summary of most courts' approach is that "a restraint is reasonable only if it (1) is ***no greater than is required*** for the protection of the employer, (2) does not impose ***undue hardship*** on the employee, and (3) is ***not injurious to the public***." (73 Harv. L. Rev. 648-49, quoted approvingly in *Hopper v. All Pet Animal Clinic, infra*.) Courts pay close attention to whether the non-compete is reasonable as to the ***type of conduct*** proscribed, the ***geographical reach*** of the prohibition, and the ***length of time*** for which it applies.

Example: D, who has recently completed her education as a veterinarian, goes to work for P, a pet clinic in Laramie, Wyoming. A few months after D starts to work for P, D and P sign an employment/non-compete agreement that provides that: (1) either party may terminate the employment on 30 days notice to the other; and (2) upon termination, D "will not practice small animal medicine for a period of three years from the date of termination within 5 miles of the corporate limits of the City of Laramie." Two years later, D begins negotiating to buy a competing practice, P fires her because of this, D buys the practice and starts competing, and P sues on the non-compete.

Held, the non-compete here is partially enforceable. When D first moved to Laramie and began work for P, D had no significant professional contact with the Laramie community. The introduction that P gave to D of P's "clients, client files, pricing policies, and practice development techniques provided information which exceeded the skills [D] brought to her employment." This exposure to clients and knowledge "had a monetary value for which [P is] entitled to reasonable protection from irreparable harm." The fact that P proved at trial that D successfully recruited 187 of P's clients to D's new practice shows that P suffered actual harm from D's unfair competition.

The subject-matter scope of the non-compete here was reasonable: the limitation of the non-compete to "small animal medicine" meant that while D could not care for domesticated dogs and cats and other household pets, she could still care for large animals, a significant area of practice in Wyoming. Nor was the five-mile radius unreasonable, since it allowed D to set up a practice in other parts of the county. However, the three-year duration was unreasonable as a matter of law, and should be replaced by a one-year limit. *Hopper v. All Pet Animal Clinic*, 861 P.2d 531 (Wy. 1993).

c. Divisibility: If the covenant not to compete, as written, is overly broad, most modern courts will enforce it up to reasonable limits. See Rest. 2d, § 183, Comment a and § 184, Comment b.

i. **Traditional rule:** Some courts still follow the more traditional rule that an unreasonably broad contract should not be enforced at all.

ii. **"Blue pencil" rule:** Other courts follow the ***"blue pencil"*** rule. Under this rule, the unreasonably broad contract will be enforced only if a hypothetical "blue pencil" could be ***drawn through certain portions*** of the agreement, leaving other portions intact to be enforced.

Example: To see how this blue-pencil rule would work, suppose the covenant in *Hopper, supra,* had said that D would not care for "cats, dogs, horses or cows." If the court decided that the limitation as to cats and dogs was reasonable but that the limit as to horses and cows was not, under the blue-pencil rule the court would be permitted to draw a metaphorical line through the words "horses or cows," leaving the prohibition in place as to cats and dogs. On the other hand, the court would not have been permitted to change the three-year duration to one year, because this would require replacement of words, not mere deletion of them.

(1) **Pros and cons:** As you can see from the above Example, the blue-pencil rule is quite stilted and artificial. However, it does have the virtue of ***discouraging*** the draftsman of the contract from writing the most ***overreaching*** contract he can conceive of. See C&P, pp. 639-40.

iii. **Modern "reasonable" rule:** Most courts today do not follow the blue-pencil rule. Instead, they tend to enforce an overly-broad noncompete ***up to reasonable limits***, even if those limits cannot be spelled out by use of the "blue pencil." This is the approach of the Second Restatement; see Rest. 2d, § 184(2), Comment b and Illustr. 2 thereto.

Example: At the time the Ds come to work for P (a collection agency), they sign non-competes prohibiting them, for a two-year period after they leave P's employ, from maintaining any relationship with any past customer of P anywhere in the United States. Under substantive state law, a non-compete must involve time and territorial limits no greater than is necessary to protect the business interests of the employer.

Held, this non-compete is overly broad, but the court will grant it limited enforcement. The court will do so by means of the "rule of reasonableness" rather than the "blue pencil" rule. That is, the court will enforce a one-year limitation rather than the stated two-year limit, will enforce it only as to customers who were clients of P at approximately the time the Ds left P's employ, and will enforce it only in the narrow geographical area where the Ds worked while they were in P's employ. *Central Adjustment Bureau, Inc. v. Ingram*, 678 S.W.2d 8 (Tenn. 1984). (But a dissent argued that the majority's approach "will permit an employer to insert oppressive and unnecessary restrictions into [non-compete] covenants, knowing that the courts will modify and enforce the covenants on reasonable terms.")

5. **Commercial bribery:** Nearly all states have statutes preventing the ***bribery of an employee*** to induce her to give the briber the employer's business, or to take other official action. See, e.g., N.Y. Penal Law § 180.00. Where a supplier procures a contract with a business by bribing the latter's employee, he will almost certainly not be able to recover on the contract, even if he has delivered the goods.

   a. **Bribe paid to third party:** If the plaintiff has paid a bribe not to the defendant's agent, but to some ***third party***, the court is less likely to refuse to enforce the transaction than if payment had been made to the defendant's employee. But such a refusal to enforce may nonetheless occur if the court finds that the public policy behind the bribery statute is sufficiently compelling. See, e.g., *McConnell v. Commonwealth Pictures Corp.*, 166 N.E.2d 94 (N.Y. 1960).

6. **Exculpatory contracts:** There are a number of situations in which one party may contract to ***indemnify*** or hold harmless another from tort or contract liability. The legality of such contracts depends upon who the victim is, and on the kind of tort or contractual liability involved. See Rest. 2d, § 195.

   a. **Release by potential defendant:** If *A* promises *B* that *A* will not hold *B* liable for any ***torts*** which *B* may in the future commit against *A*, the agreement will be held to be ***illegal*** with respect to intentional torts. Such an agreement will normally be allowed, however, insofar as it applies to negligent torts.

   b. **Indemnification for torts and crime:** If *A* promises to indemnify *B* from any consequences that may occur in performing a ***crime,*** the contract will be unenforceable unless *B* acts in good faith and without knowledge of the illegality. But a contract by *A* to indemnify *B* against the consequences of *B*'s own negligence, where a third person is the victim, is normally not illegal.

7. **Licensing requirements:** Where a statute prohibits a person from engaging in a specified business or occupation without a ***license*** or ***permit***, a contract for the performance of such services by an unlicensed person will be illegal "if the [statute] has a ***regulatory purpose*** and the interest in the enforcement of the promise is clearly ***outweighed by the public policy*** behind the [statute]." Rest. 2d, § 181.

   Example: A person who performs highly-regulated services such as those provided by stockbrokers, doctors, lawyers, etc., without having the necessary license or permit, will not be allowed to recover for those services, either on the contract or in quasi-contract.

8. **Impairment of family relations:** One area in which the courts have traditionally struck down parties' attempts to contract is the area of ***family relations***, especially marriage. When parties attempt by contract to vary the legal treatment of such relationships as marriage, cohabitation, reproduction, and the like, courts often refuse to enforce the contract on grounds of public policy.

   a. **Prenuptial agreements:** The ***"prenuptial agreement"*** is a dramatic example of courts' historical hesitation to enforce agreements that modify the rules governing family relationships. (A prenuptial agreement is one in which the "non-moneyed" spouse, typically the wife, agrees that in the event of divorce or separation, that spouse will receive lesser alimony, or a smaller property-division, than the standard legal rules of the jurisdiction would impose.)

      i. **Traditional view:** Traditionally, courts have either entirely refused to enforce such agreements, or subjected them to much tighter scrutiny than other types of contracts, on the grounds that society has a strong interest in ensuring that men support their ex-wives. For instance, many courts traditionally declined to enforce a prenuptial agreement if the court concluded that the agreement did not make "reasonable provision" for the wife's financial needs. And frequently, the court phrased the issue as being whether the agreement was reasonable as viewed ***as of the time of the divorce***, not merely reasonable as of the time it was signed. Therefore, in cases where the man was merely affluent at the time the agreement was signed and then became wealthy, there was a good chance that the court would conclude that the husband's increased fortune made the agreement no longer reasonable, and thus one which ought not to be enforced.

ii. **Modern approach:** But more and more courts are willing to ***enforce*** prenuptial agreements now, especially where basic conditions of procedural fairness are observed before signing. For instance, about half the states have enacted the ***Uniform Premarital Agreement Act***, under which voluntarily-signed prenuptial agreements are enforceable if *either*: (1) the agreement was ***not unconscionable*** when signed; or (2) even though the agreement *was* unconscionable when signed, the signer was either ***provided a fair and reasonable disclosure*** of the other party's financial condition, ***knew or reasonably could have known*** of that financial condition, or voluntarily and expressly ***waived*** in writing any right to such disclosure.

So in a state that has adopted the UPAA, if the wife receives fair disclosure of the husband's financial condition before signing, or voluntarily signs an agreement in which she waives the right to get that information, the court will enforce the agreement ***without ever even entertaining the question of whether the agreement was "fair" or "conscionable"*** at the time it was made (and will certainly not look at whether ***post-signing events*** have made the agreement unfair). See UPAA § 6.

b. Agreements regarding cohabitation: Suppose two unrelated adults ***cohabit*** without getting married. Suppose further that one of them alleges (probably after the relationship breaks up), that both orally agreed early in the relationship on some ***financial arrangement***, such as a sharing of assets obtained during the relationship. In theory, such an agreement regarding finances should be enforceable like any other oral agreement — it seems not to fall within any Statute of Frauds provision (see *supra*, p. 276), and should be enforced if the court is convinced that the alleged oral meeting of the minds in fact occurred.

i. **Traditional view:** But courts traditionally have ***refused to enforce*** such ***"living together"*** agreements, on the grounds that they amount to payment for sex, and are thus illegal. See, e.g., *Hewitt v. Hewitt*, 394 N.E.2d 1204 (Ill. 1979) ("enhancing the attractiveness of a private arrangement over marriage…contravenes the…policy of strengthening and preserving the integrity of marriage").

ii. **Emerging trend to enforcing:** But a strong emerging minority of courts is now willing to ***enforce*** such living together arrangements, at least where they do not explicitly trade sex for money. See, e.g., *Marvin v. Marvin*, 557 P.2d 106 (Cal. 1976).

B. Effects of illegality on contractual recovery: As a general rule, ***neither party to an illegal contract may enforce it***. This is the case even where only one party's performance is illegal. Thus if *X* promises to do something legal in return for *Y*'s promise to do something illegal, neither *X* nor *Y* can sue for either specific performance or damages. C&P, p. 820. However, there are some exceptions to this general rule, which are explored below.

1. Enforceability of contracts that are wholly executory: If neither party to an illegal contract has rendered any performance, there are only a few situations in which the court will allow one party to recover damages for breach:

a. Ignorance of facts: If one of the parties to an illegal bargain is justifiably unaware of the facts which make the contract illegal, and the other is not, the former will usually be allowed to recover damages for breach. Rest. 2d, § 180.

Example: Contractor hires Electrician to perform the electrical work on a project being built by Contractor. Contractor does not find out that Electrician lacks the required license until after the contract is formed, but before Electrician has done the work. Contractor may cancel the contract, and sue Electrician for damages for breach, if Contractor had no reason to know of Electrician's lack of a license.

b. One party has wrongful purpose: Some contracts are illegal solely because one of the parties has a ***wrongful purpose***. For instance, a contract to sell goods to one who plans to smuggle them into another country is illegal, but if the person without the illegal purpose ***does not facilitate the crime***, and the crime is not one involving "serious moral turpitude," the innocent party may recover for breach even though at the time of contracting he knew of the unlawful purpose. Rest. 2d, § 182.

> **Example:** *A* agrees to sell goods to *B*, knowing that *B* plans to smuggle them into the country. Since the crime is not one involving serious moral turpitude, A can recover for breach of contract. But if he ***facilitates*** the smuggling (as by packing the goods in such a way as to conceal them from customs inspectors), he will ***not*** be able to recover for breach. C&P, p. 823.

c. **Statute directed at one party:** Some statutes are designed to ***protect one party,*** and make only the other one's conduct criminal. "Blue sky" laws, designed to protect investors from unscrupulous promoters, are an example. Where such a statute is involved, ***the person for whose protection the statute is designed may enforce the contract***, or sue for its breach. Thus a person who agrees to buy stock in a transaction that would be prohibited by a blue sky law may nonetheless obtain specific performance of the contract, or sue for its breach. C&P, p. 824.

2. **Partially or fully performed illegal contracts:** If one or both parties have ***partially or fully performed*** an illegal contract, the courts are somewhat more willing to partially enforce it, or at least grant a quasi-contractual remedy. While the general rule is still that the court will leave the parties to the illegal contract where it finds them, there are a number of situations in which some remedy will be afforded. In addition to the circumstances described above, in which even before partial performance a party may have a remedy, courts will grant relief in the following contexts:

a. ***Malum prohibitum:*** There are many statutes which render illegal conduct which cannot be said to involve moral turpitude. The illegal act in such a case is sometimes said to be ***"malum prohibitum"*** rather than *"malum in se."* Where the illegality is of this non-serious sort, the courts will sometimes allow the party who has partially performed to recover at least the ***restitutionary value*** of his services.

> **Example:** Bank loans Borrower money at 10% interest, in a jurisdiction where the legal limit on interest is 8%. Because violation of the usury laws is usually held to be *malum prohibitum* rather than *malum in se*, Bank will probably be able to recover the principal, and perhaps the legal interest. It will not be able to recover the excess interest, and might be subject to either a penalty or to forfeiture of the entire interest.

i. **Licensing statutes:** Thus many ***licensing statutes*** are held to be mere revenue-raising laws, and their violation is *malum prohibitum*. One who performs services without having the necessary license is allowed to recover the value of his services. This might be the case for a person who lacks a building contractor's license, where it is clear that the licensing fee is a disguised occupancy tax. But where the license is required to ***protect the public,*** such as a license to practice law, lack of it is usually deemed so serious that a person performing services is generally denied all recovery. C&P, pp. 826-27.

b. ***Pari delicto:*** In addition to the *"malum prohibitum"* situation just discussed, a party who has performed an illegal contract may recover the value of his performance if he meets two requirements: (1) he was not guilty of serious moral turpitude; and (2) although he knew of the illegality and was blameworthy, he was ***less guilty*** than the other party. If these two requirements are met, the partially performing plaintiff is said not to be in ***"pari delicto"*** (i.e., not equally culpable).

Example: P, a Jew who is desperate to escape from Hitler-occupied France, gives $28,000 worth of jewelry to D, in return for D's promise to use the jewelry to bribe the Portuguese consul in France so that a visa will be issued to P. Instead of using the jewelry for this purpose, D absconds with it. P escapes by some other means, and happens across D in New York City. P sues for return of the jewelry.

Held, P is not in *pari delicto*, since he is less blameworthy than D, and since his offense (attempted bribery) is not, considering the circumstances, morally repugnant. Therefore, he may obtain restitution of the jewelry or its value. *Liebman v. Rosenthal*, 57 N.Y.S.2d 875 (N.Y. Sup. Ct. 1945).

i. **Deterrent effect:** In deciding whether to apply the *pari delicto* doctrine, the court will mainly consider whether barring the plaintiff from recovery will ***encourage***, rather than deter, the illegal conduct in the future. If the court thinks that barring the plaintiff will encourage the wrongdoer to engage in the same kind of wrongdoing in the future, it will stretch towards a finding that the parties are ***not*** in pari delicto.

3. **Divisibility:** A key way in which courts avoid the unfairness that may result from total refusal to enforce an illegal contract, is by use of the

doctrine of ***divisibility***. Recall that a party in breach may nonetheless recover on a portion of the contract if that portion was "divisible" and he substantially performed his side of that portion. (See *supra*, p. 221.) A similar doctrine is often applied in the case of an illegal contract: if a divisible part of the contract could be performed on both sides without violating public policy, the court will ***enforce that divisible portion.*** Rest. 2d, § 183.

> **Example:** P, an unlicensed plumber, makes an agreement with D to do certain plumbing work for D for an agreed price. P completes the work by supplying both labor and materials. A local ordinance requires a plumber to be licensed in order to furnish plumbing services. P will be able to recover that portion of the contract price fairly representing the charge for materials, even though he may not recover the portion representing services.

a. Three requirements: There are three requirements which must be satisfied before the doctrine of divisibility will be applied in the illegal contract situation:

i. **Divisibility:** First, the contract itself must indeed be ***divisible***, just as in other situations where divisibility is to be applied. That is, it must be possible to apportion the parties' performances into "***corresponding pairs*** of part performances." Farnsworth, p. 354. Also, it must be fair to "regard the parts of each pair as ***agreed equivalents***." *Id.*

ii. **Not affect entire agreement:** A second requirement is that the illegality ***must not affect the entire agreement***. Farnsworth, p. 355. "If the entire agreement is part of an integrated scheme to contravene public policy, none of it will be enforced." Rest. 2d, § 183, Comment b.

iii. **Serious misconduct:** Finally, the party seeking performance "must not have engaged in ***serious misconduct***." *Id.* For instance, suppose that P, a lawyer, promises to pay certain sums to D, a private investigator; some of the money is for D's services in finding a missing witness, W, and the rest is for D's persuading W to give false testimony. If D fully "performed," a court would probably deny him any recovery, even for his services in locating the witness, since his subornation of perjury was a serious offense.

Note: In all of the situations which have been treated thus far, the illegality existed both at the time the contract was made, and at the time it was to be performed. If a contract is legal at the time it is entered into, but due to subsequent legislative action ***becomes*** illegal before its performance, the problem is treated as one involving impossibility. See *supra*, p. 441. In such a situation, both parties are generally discharged, with restitution awarded to return them as nearly as possible to the positions they occupied prior to contracting. See *supra*, p. 453.

Quiz Yourself on ILLEGALITY

125. Hy Nickin sells Bud Wizer his small beverage store in New York City for $25,000. As part of the deal, Hy promises that for the rest of his life (he's 32), he will never compete in the retail beverage business anywhere within 20 miles of the shop being sold. Eight years later, Nickin opens a beverage store of his own, six miles from Wizer's. Can Wizer enforce the covenant not to compete?

126. The U.S. has a ban on trade with Iraq. The Snakeoil Pharmaceuticals Company gets an unsolicited order for $100,000 worth of medicine from Abdul Hussein. It ships the medicine on credit to Hussein in New Jersey, knowing Hussein intends to smuggle it into Iraq. Hussein doesn't pay. Can Snakeoil recover the $100,000 due under the contract?

Answers

125. Probably not, but it depends on the court's precise approach to non-competes that are unduly broad as drafted. A person's promise not to compete, entered into as part of that person's sale of a business, will be enforceable if (but only if) the non-compete is ***not unreasonably broad*** as to either: (1) the type of activity constrained, (2) the non-compete's duration, and (3) the non-compete's geographic reach. Here, requirement (1) is no problem: the business being sold and the activity proscribed are in the same industry (retail beverage sales). But requirement (2) is probably a problem: Hy has an estimated remaining working life of over 30 years, which is longer than Bud's store's goodwill is likely to last, so a court will probably conclude that the lifetime duration is unreasonable. Requirement (3) is probably also a problem: it's unlikely that a small beverage store in a populous place like N.Y.C. has a 20-mile radius within which it competes with other similar stores; therefore, the 20-mile radius provision is probably unduly broad.

However, a court might enforce the non-compete up to reasonable limits. That is, if the court believes that an 8-year non-compete, applicable to, say, a 6-mile radius, would have been reasonable (which the court might well conclude), the court might choose to bar Hy even though the non-compete as written is way too broad. But not all courts will perform this task of "editing the contract down to reasonable limits." Some won't enforce an unduly-broad-as-written non-compete *at all.* Others will do so only if a hypothetical "blue pencil" could remove the offending provision and leave something left to enforce; since no amount of excision — as opposed to rewriting — can turn a lifetime limit into an 8-year limit, or a 20-mile radius into a 6-mile radius, a court following the blue-pencil rule would refuse to enforce this agreement no matter how reasonable it thought an 8-year or 6-mile-radius limit would be.

126. Yes, probably. Normally, neither party to an illegal contract may recover. But where only one of the parties has an illegal purpose, the other party may be able to enforce the contract, under the "pari delicto" doctrine. Under that doctrine, the "innocent" party can recover, even if it knew about the other party's illegal purpose, as long as: (1) the innocent party is not guilty of moral turpitude; and (2) the innocent party is less blameworthy than the party with the illegal purpose. That's probably the case here: Snakeoil's behavior probably isn't deeply blameworthy (since it involves medicine), and Snakeoil is clearly less blameworthy than Hussein, who's the one who's doing the smuggling.

II. DURESS

A. Duress generally: The defense of duress is available if the defendant can show that he was ***unfairly coerced*** into entering into the contract, or into modifying it. It is much more broadly available today than prior to this century, when it could be used only if a party's person or property was put in actual danger. Today, the essential rule is that duress consists of "any wrongful act or threat which ***overcomes the free will*** of a party."

C&P, p. 309. See also Rest. 2d, § 175.

1. **Subjective standard:** A ***subjective standard*** is used to determine whether the party's free will has been overcome. That is, regardless of whether the will of a person of "ordinary firmness" would have been overborne, if the party can show that he was unusually timid, and was in fact coerced, he may use the defense. But the fact that the hypothetical "person of ordinary firmness" would or would not have been overborne has evidentiary value in ascertaining whether the party's own decision was coerced. C&P, p. 309.

B. **Ways of committing duress:** Facts which constitute duress seem to fall mostly into four categories: (1) ***Violence*** or threats of it; (2) ***Imprisonment*** or threats of it; (3) Wrongful ***taking*** or ***keeping*** of a party's property, or threats to do so; and (4) Threats to ***breach*** a contract or to commit other wrongful acts (e.g., threats to exercise legal rights in oppressive ways). See C&P, p. 311-12.

1. **General rule:** A detailed examination of these various categories is outside the scope of this outline, except for threats to breach a contract, discussed below. However, one important general principle may be stated: If one party threatens another with a certain act, it is ***irrelevant*** that he would have the ***legal right*** to perform that act, if the threat, or the ensuing bargain, are ***abusive or oppressive.***

> Example: P works for D under an at-will arrangement, by which the employment may be terminated at any time at the option of either party. D threatens to fire P unless he agrees to sell shares of stock in D back to the company. This would probably be found to constitute duress, even though D theoretically has the right to fire P for no reason. Therefore, if P sold (or agreed to sell) the shares to D under these circumstances, a court would probably void the transaction.

C. **Threat to breach contract:** Perhaps the most frequently alleged form of duress in contract litigation occurs where one party ***threatens to breach the contract*** unless it is modified in his favor, or a new one drawn up. The modern rule seems to be that there will be duress in this situation if the threatened breach would, if it were carried out, result in ***irreparable injury*** that could not be avoided by a lawsuit or other means, and the threat is made in "breach of the duty of good faith and fair dealing." See Rest. 2d, § 176; see also C&P, p. 318.

> **Example:** D has a government contract to produce $6 million worth of radar sets

for the navy. D sub-contracts with P for production of certain components of the sets. After P has begun delivery of these parts, D gets a second contract for more sets. P tells D that unless it receives a sub-contract for an even greater portion of this new work than it had under the first contract, and an increased price under the first contract, P will stop making deliveries under that contract. It then does indeed stop deliveries. D checks with all the sub-contractors on its approved list, but none can make deliveries under the first contract in time to meet the requirements of D's contract with the Navy. In desperation, therefore, D agrees to P's demands. After the last of the deliveries under both contracts, D stops making any more payments, and says that it will sue to get back the excess amounts paid. P sues first (for the balance due), and D counter-claims for these excesses.

Held, D agreed to the modification and the second contract only under "economic duress," and is therefore entitled to damages. To prove such duress, D needed to show that it could not have gotten the goods elsewhere, but this showing was made here. *Austin Instrument, Inc. v. Loral Corp.*, 272 N.E.2d 533 (N.Y. 1971).

1. **Remedy:** Usually, the remedy for duress is ***restitutionary*** in nature. That is, the party claiming it is allowed to recover an amount sufficient to undo the ***unjust enrichment*** that the other party has obtained. Thus in *Austin Instrument*, D might have been able to recover the increased price in the first contract, and everything beyond a fair and reasonable price on the second contract (less, of course, the amount owed on that contract).

III. MISREPRESENTATION

A. Misrepresentation generally: A claim of ***misrepresentation*** can be used either as a defense against enforcement in a suit brought by the misrepresenting party, or as a grounds for rescission or damages by the misrepresented-to party suing as plaintiff. The contract law of misrepresentation is somewhat similar to misrepresentation in tort law; for a full discussion of the latter, see Emanuel on *Torts*. However, courts have generally made misrepresentation claims easier to establish in contract cases (particularly suits for rescission of contracts) than in tort cases. See Rest. 2d, Ch. 7, Topic 1, Introductory Note.

B. Elements of proof required: In order for a person to rely on misrepresentation for purposes of rescinding a contract, defending against a claim of breach of contract, or suing for breach, the person claiming misrepresentation (we'll call her "P") must show the following elements:

□ D ***misstated*** a ***material fact*** (though the misstatement does ***not*** have to have been ***intentional*** or even ***negligent***);

- □ P ***in fact relied*** on the misstatement;
- □ P's reliance was ***justifiable***; and
- □ P was damaged in a ***pecuniary way*** from the misstatement.

1. **Other party's state of mind:** It is ***not*** usually necessary for the claimant to prove that the misrepresentation was ***intentionally*** made; a ***negligent***, or even ***innocent, misrepresentation*** is generally sufficient to avoid the contract if it goes to a material fact. See Rest. 2d, § 164. (This is an important respect in which the contract law of misrepresentation is more liberal than the usually-applied tort principles.)

2. **Justifiable reliance:** The party asserting misrepresentation must show that he ***justifiably relied*** on the misstatement. This requires him to show not only that he ***in fact*** relied, but also that his reliance was ***justifiable.***

   a. **Gullible people sometimes protected:** However, the latter requirement, that the reliance be justifiable, has not been rigorously enforced in recent years. This is particularly true where the misrepresentation is ***intentional***.

   > **Example:** P buys a house from D, in reliance on D's assurance that the house is suitable for multi-family rental use. D knows that his representation is misleading in that such a use would violate local zoning laws. P believes the misrepresentation without checking the public records, which would have disclosed the zoning problem.
   >
   > *Held*, P may recover for misrepresentation despite his failure to exercise due diligence in checking the zoning laws. This is so in part because D knew that it was making misleading statements. *Kannavos v. Annino*, 247 N.E.2d 708 (Mass. 1969).

3. **Must be misrepresentation of fact:** The misrepresentation must be one of ***fact***, rather than of ***opinion***. If a new car dealer tells a potential customer, "This is a great little car," the buyer probably can't sue on a misrepresentation theory, even if he can prove that not only is the car not "great," but that the dealer had reason to know that it wasn't. This expression of opinion is likely to be termed "mere puffing" or "trade talk," and thus not actionable. See Rest. 2d, §§ 168 and 169.

   a. **Thin line between opinion and fact:** But courts are increasingly willing to find that a statement has crossed over the thin line between opinion and fact. For instance, if a used car is represented to be “mechanically perfect,” this may constitute a statement of fact. See C&P, p. 330.

b. Special circumstances making opinion actionable: Furthermore, the relationship between the parties may be such that even what is obviously an opinion is actionable. For instance, if there is a ***fiduciary relationship*** between the parties (e.g., a corporation and its shareholders), or the person making the statement ***holds himself out as an expert*** (e.g., a jeweler stating that his stone is, in his opinion, worth at least $1,000), the other party may claim that the opinion was a misrepresentation.

> **Example:** P, a 51-year-old widow, becomes a student at D’s dance school (an Arthur Murray franchise). During the space of 16 months, she is sold 14 “dance courses,” totaling 2300 hours of dance lessons, for a total of cash price of over $31,000 (in 1968 dollars!). P does so in part because D repeatedly assures her that in D’s opinion P has “excellent potential” for dance, and that she is developing into a “beautiful dancer.” In reality, P has no dance aptitude whatsoever, and can barely hear the musical beat. P sues to have the contracts rescinded for fraudulent misrepresentation. D moves to dismiss on the grounds that he merely expressed his opinion about P’s abilities, and that statements of opinion cannot be the basis for a misrepresentation suit.
>
> *Held*, for P. It’s true that as a general rule, a misrepresentation is actionable only if it is one of fact rather than opinion. But there are important exceptions, such as “where there is a fiduciary relationship between the parties, ... or where the representee does not have equal opportunity to become apprised of the truth or falsity of the fact represented.” Here, D had ***“superior knowledge”*** about whether P had dance potential, so P’s complaint falls within the exception, and states a cause of action. *Vokes v. Arthur Murray, Inc.*, 212 So.2d 906 (Fla. Dist. Ct. App. 1968).

c. Statement of law: It used to be generally held that a ***“statement of law”*** could not constitute a misrepresentation. Some courts said that this was because a statement about law was necessarily merely an opinion; others said that it was because “[e]veryone is presumed to know the law.” C&P, p. 333.

i. **More liberal modern rule:** But today, this rule is breaking down. Some courts have simply abolished the rule, and hold that a statement as to law may be the basis for a misrepresentation claim under the same circumstances as an opinion could be (e.g., when made by a person presumed to be an expert, such as a lawyer). Others hold that where a statement involving the law is really a statement about facts (e.g., "this house conforms to all building and zoning requirements"), it is actionable the same way any other statement of fact is actionable.

C. Concealment and nondisclosure: Most misrepresentations are affirmative statements (e.g., "This car has less than 50,000 miles on it."). If, however, a party has simply ***failed to disclose*** information, it has traditionally been much harder to make a case for misrepresentation. See Rest. 2d, § 161.

> **Example:** P buys a house from D. At the time of sale, D knows that the house is infested with termites, but says nothing to P. After discovering the termites, P sues to recover the money he spent on repairs.
>
> *Held*, P has no cause of action. There is no liability for "bare nondisclosure." "If this defendant is liable on this declaration every seller is liable who fails to disclose any nonapparent defect known to him in the subject of the sale which materially reduces its value and which the buyer fails to discover." The law has not reached the stage of imposing such a requirement. *Swinton v. Whitinsville Sav. Bank*, 42 N.E.2d 808 (Mass. 1942).

1. More liberal present rule: Today, courts are substantially more willing to allow a recovery based on a failure to give information. While it is still true that in a bargaining situation, there is ***no general duty*** to disclose information to the other party, there are a number of ***special situations*** in which this rule does not prevail:

a. Half truths: If ***part of the truth*** is told, but another portion is not, so as to create an overall misleading impression, this may constitute misrepresentation. See Rest. 2d, § 159, Comment b.

b. Positive concealment: If the party has taken ***positive action*** to conceal the truth, this will be actionable even though it is not verbal. See Rest. 2d, § 160. Thus if the defendant in *Swinton* had carefully swept up the evidence of termites and repainted the affected area just before the sale, this would probably be held to be actionable.

c. Failure to correct past statement: If the party knows that disclosure of a fact is needed to prevent some ***previous assertion*** from being ***misleading***, and doesn't disclose it, this will be actionable. See Rest. 2d, § 161(a), Comment c.

> **Example:** At the start of negotiations on January 1 for a house sale, Seller truthfully states, in response to a question by Buyer, that his house has no termites. But by the time the contract for sale is about to be signed in April, Seller knows that he now has termites. Seller's failure to disclose that fact will constitute a misrepresentation. (And that's true even if Buyer doesn't repeat the question — Seller has an affirmative duty to step forward and volunteer any information needed to prevent his previous statement from being misleading.)

d. Fiduciary relationship: If the parties have some kind of ***fiduciary relationship***, so that one believes the other is looking out for his interests, there will be a duty to disclose material facts. See Rest. 2d, § 303(d).

e. Failure to correct a mistake: If one party knows that the other is ***making a mistake*** as to a ***basic assumption***, the former's failure to correct that misunderstanding will constitute a misrepresentation if the non-disclosure amounts to a "failure to act in ***good faith***" or to act "in accordance with reasonable standards of ***fair dealing***." Rest. 2d, § 161(b).

> **Example:** Jeweler offers a stone for sale without stating what kind of stone it is. Consumer looks at it and says, "Oh, what a beautiful emerald." Probably Jeweler's failure to correct this basic misunderstanding would constitute bad faith, especially in view of Jeweler's superior knowledge. If so, Jeweler's silence would constitute misrepresentation.

f. Easier standard for rescission: Finally, some courts have held that even where one party's silence does not justify the other in suing for damages, the court may grant the ***equitable*** relief of ***rescinding*** the contract.

Quiz Yourself on
DURESS AND MISREPRESENTATION

127. Wicked Witch corners Dorothy and her little dog, Toto, behind the stacks in the public library. Witch snatches Toto and says to Dorothy, "Sign this contract promising to sell me the ruby slippers for $100, or you'll never see Toto alive again." Witch's fingers close ominously around Toto's throat as she says this. Toto whimpers. Dorothy signs.

(A) Dorothy reneges, and Witch sues to enforce the contract. What result?

(B) Before Dorothy hands over the slippers, Witch changes her mind, says, “Forget it,” and hands Toto back to Dorothy. Dorothy would actually rather have the $100 than the slippers. Will a court enforce the contract on her behalf? (Ignore the issue of whether the appropriate remedy is an order of specific performance or a damages award.)

128. Kermit takes his livestock to the county fair in hopes of selling it. Fozzie Bear shows a particular interest in one of Kermit’s sows, “Miss Piggy.” Kermit says the pig will cost Fozzie $10,000 because it is a special dancing pig. Fozzie asks for a demonstration, and he sees what he thinks is Miss Piggy dancing. In fact, Kermit has her pen electrified, and a few well-timed shocks are what create the appearance of “dancing.” Fozzie buys Miss Piggy, and subsequently finds out she can’t dance. He seeks his money back on grounds of misrepresentation. Assume that a person of ordinary credulity attending the fair would not have believed that Miss Piggy was dancing, but that Fozzie did believe that she was. May Kermit have the contract rescinded?

129. Gail Ible meets with her long-time stockbroker, Bully Bear, for some investment advice. Bully advises Gail to invest $2,000 in a local biotechnology company. Bully knows, but carelessly fails to mention, that the president of the company was just indicted on fraud charges and that no successor has yet been picked. (The news is not yet public — Bully knows the info through his contacts at the company.) Gail signs a contract to buy the stock through Bully’s firm. After the news becomes public, the stock price falls by 50%. Gail sues Bully for contract damages based on misrepresentation.

(A) Will the fact that Bully’s misstatement was negligent rather than intentional make a difference in the outcome?

(B) If you’re representing Bully’s firm, what defense will represent your best shot at getting him off?

(C) Will the defense you asserted in part (B) work?

Answers

127. **(A) Dorothy can avoid the contract due to duress.** The defense of duress is available whenever the other party makes a threat or wrongful act that overcomes the free will of the defendant. When the defense is available, the party asserting it is discharged from the contract.

(B) Yes. A contract entered into under duress is voidable only at the option of the *wronged* party, not at the option of the wrongdoer.

128. **Yes, probably.** Courts have traditionally said that a party may recover for contractual misrepresentation only if the party's reliance on the misrepresentation was "reasonable." However, the modern trend is to hold that if the misrepresentation was intentional, and the party asserting misrepresentation honestly believed the misrepresentation, the fact that the reliance was "unreasonable" will not bar recovery. Therefore, a court following the majority approach will find in favor of Fozzie, and allow rescission.

129. **(A) No** A contract action for misrepresentation can be based on a negligent (or even non-negligent but incorrect) misrepresentation of a matter of material fact — unlike a tort action for fraud or deceit, there is no particular mental-state element in a contract misrepresentation action.

(B) That Bully never made any affirmative misrepresentation; he merely failed to make a disclosure. (C) Probably not. It's true that as a *general* rule, a party's failure to make a disclosure won't be treated as equivalent of an affirmative misstatement, and therefore won't serve as the basis for a misrepresentation action. But there are a number of exceptions to this general rule. On of those exceptions is that if there is a relation of ***"trust and confidence"*** between the plaintiff and the defendant, the defendant's failure to make disclosure will be treated as the equivalent of an assertion. Since the facts tell us that Gail has used Bully for a long time, and has come to him for advice, a court would probably hold that the requisite relation of trust and confidence existed between them.

IV. UNCONSCIONABILITY AND ADHESION CONTRACTS

A. Weapons against unfair contracts: A party is normally bound to the terms of a contract which he signs. The parol evidence rule, discussed in a previous chapter, is one indication of courts' unwillingness to tamper with the terms of a writing. But if the provisions of a contract are so grossly unfair as to shock the conscience of the court, the judge may decline to enforce the offending terms, or the entire contract. The two principal tools at his disposal for doing this are the special rules on adhesion contracts, and the related doctrine of unconscionability.

B. Adhesion contracts: Most business contracts in use today are probably "***standardized***"; that is, they consist of a large number of non-negotiated pre-drafted terms put together by one party, with room for negotiation as to only a few aspects of the deal (e.g., price and quantity). It is often the case that the party for whom the standard contract was drafted has substantially greater bargaining power than the other party to the transaction. It is also frequently the case that the standardized terms are complicated, unclear, exceptionally favorable to the drafter, and printed in small type. Such contracts are commonly called "***adhesion contracts***."

1. Refusal to enforce: Courts have always been reluctant to enforce such adhesion contracts; despite the objective theory of contracts (see *supra*, p. 6) they have generally relied on the theory that the non-drafter has ***not really assented*** to the bargain. This has led a number of courts to refuse to give effect to all or part of such contracts.

2. Steps for avoiding contract: A litigant who wants to avoid enforcement of a contractual term on the grounds that it is part of an adhesion contract usually has to make two showings:

[1] that the contract itself is an ***adhesion contract***; and

[2] that the contract (or the clause complained of) either (i) violates his ***reasonable expectations*** or (ii) is ***unconscionable***.

a. What is an adhesion contract: In determining whether a contract is an "adhesion contract," courts look at several factors. The most important two factors (both of which must usually be satisfied) seem to be:

i. **Standardized form:** That the contract was a ***standardized form*** (as opposed to one whose terms were individually negotiated). Thus an adhesion contract is generally offered to the other party on a ***"take it or leave it"*** basis — the offering party refuses to modify any terms.

ii. **Gross disparity in bargaining power:** That the complaining party had ***grossly less bargaining power*** than the party who drafted the standardized agreement. Thus if market conditions or the special circumstances of the case meant that the plaintiff had no other suppliers to choose from (or all the other available suppliers imposed the same terms), the requisite "gross disparity in bargaining power" is likely to be met. In general, ***consumers*** (especially ones who are poor and/or uneducated) are much more likely to be found to have been at a gross bargaining disadvantage than are ***businesses***.

b. Proof as to reasonable expectations or unconscionability: Once the plaintiff has shown that the contract was a contract of adhesion, she must still show that her ***reasonable expectations were thwarted*** by the actual provisions of the contract, or that the contract is ***unconscionable***:

i. **Reasonable expectations:** When the court decides whether the plaintiff's ***"reasonable expectations"*** were thwarted, this determination is based mostly upon whether a ***reasonable person in P's position*** would have ***expected*** that the clause in question was ***present in the contract***. So a very ***unusual and burdensome clause*** stuck into the ***fine print*** on the back of a standard form contract might flunk this "reasonable expectations" test, and entitle the plaintiff to avoid the contract.

Example: Suppose P (a consumer) rents a car from D (a rental agency). D's standard form contract contains, buried in the fine print on the back of the form, a clause stating that "If the car is damaged in any way, whether due to the renter's negligence or not, the renter agrees to pay an additional rental fee equal to five times the actual out-of-pocket cost to the agency of repairing the damage." A reasonable renter in P's position would be unlikely to expect to find this kind of punitive no-fault provision in a car-rental contract. Therefore, a court would probably conclude not only that this agreement was an adhesion contract, but also that the clause in question fails the "reasonable expectations" test. If so, a court would decline to enforce the clause without ever reaching the issue of whether the clause was unconscionable.

ii. **Unconscionable:** Even if the contract or a disputed clause is not at variance with the plaintiff's "reasonable expectations" (e.g., the plaintiff knew exactly what the contract said), plaintiff can still get the contract or clause knocked out on the grounds that it is ***"unconscionable."*** Essentially, a contract or clause will be found unconscionable when it is so ***shockingly unfair*** that the court decides that it should not be enforced. The issue of unconscionability is discussed extensively beginning *infra*, p. 478.

3. Tickets stubs and other "pseudo-contracts": Most adhesion-contract cases involve plaintiffs who knew that they were entering a contract, and the only question was whether the court should decline to enforce the contract or a particular clause because it is unfair or because the plaintiff didn't understand its details. A related but different question arises where the non-draftsman does not even necessarily ***realize that he is entering a contract at all***. For instance, when a person parks his car, and is handed a ***ticket stub*** with a number on it, he is likely to assume that this stub is merely a kind of receipt, to identify his car and enable him to get it back. If the stub includes a lot of fine print on it, in which the parking lot owner disclaims all liability for negligence, intentional torts, etc., the court is likely to hold that the customer had no idea he was making a contract at all, and that all the fine print is completely ineffective.

a. Restatement view: The Second Restatement attempts to deal with this problem of the contract that does not necessarily appear to be a contract. Under Rest. 2d, § 211, a document binds a party only if she "signs or otherwise ***manifests assent***" to it, and furthermore "***has reason to believe that like writings are regularly used to embody terms of agreements of the same type***. . . ." Thus the parking lot owner would have to prove that the customer first of all gave some sign of being aware that there were contractual provisions on the ticket (e.g., testimony that the customer read the ticket), and further that an ordinary person in the customer's position would ***expect to find terms similar to those which the ticket actually contained.*** These would probably be difficult things for the parking lot to establish.

i. **Which terms apply:** Once the party who drafted the document proves these things, the document is to be interpreted, if possible, by "treating alike all those similarly situated, without regard to their knowledge or understanding of the … terms. …" (§ 211(2)). This seems to apply a sort of "common denominator" standard, by which even if the customer were a lawyer who read the ticket in full, he would only be held to an interpretation which the average layman would make of the document.

ii. **Terms that eliminate the transaction's purpose:** As a corollary, Rest. 2d, § 211(3), provides that if the drafting party has "reason to believe that the party manifesting … assent would not do so if he knew that the writing contained a particular term, ***the term is not part of the agreement***." Comment f to that section explains that the drafting party might have reason to believe that the term would not be assented to if "it ***eviscerates the non-standard terms*** explicitly agreed to, or … it ***eliminates the dominant purpose*** of the transaction."

Example: Suppose D sells P a generator under a contract that lists "1136 kilowatts" as part of the typewritten specifications, but that also includes a printed disclaimer of warranty. The disclaimer will not prevent D from being held to warrant that the generator will produce 1136 kilowatts. Otherwise, the non-standard term, 1136 kilowatts, would be "eviscerated." See Rest. 2d, § 237, Illustr. 8.

C. Unconscionability generally: The other principal judicial weapon against unfair contracts is the doctrine of ***unconscionability***. The idea that a contract may be unenforceable because it is shockingly unfair dates back hundreds of years. See W&S, pp. 83-84. Today, courts tend to turn away from time-honored methods of avoiding enforcement of unfair contracts (e.g., by holding that even completely clear, but unfair, language is ambiguous and therefore to be construed against the draftsman) and towards flat holdings that a contract, or part of it, is shocking and unconscionable.

1. **Restatement treatment:** Thus Rest. 2d, § 208, allows a court to decline to enforce all or part of an unconscionable contract. That provision is almost word for word the same as UCC § 2-302(1), discussed below.

2. **Dependence on UCC cases:** Most of the important unconscionability cases in recent years have involved sales of goods, and have therefore

involved the UCC. Accordingly, non-sales cases (e.g., contracts to provide services) have generally looked to the Code, and to cases decided under it. Our discussion of unconscionability will therefore focus on the Code.

D. The Code view generally: UCC § 2-302(1) provides that "If the court as a matter of law finds the contract or any clause 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 clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."

1. **No definition of unconscionability:** The statutory language of the Code itself does not define the word "unconscionable." Comment 1 to § 2-302 attempts to do so; it states that the test for unconscionability is "whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so ***one-sided*** as to be unconscionable under the circumstances existing at the time of the making of the contract." The Comment goes on to say that "the principle is one of the ***prevention of oppression*** and ***unfair surprise*** … and ***not of disturbance of allocation of risks because of superior bargaining power.***"

   a. **Look at contract as of signing:** The contract must be judged ***as of the facts existing at the time of signing it***. The fact that one of the parties (usually the seller) acted in bad faith after the contract was signed (e.g., by delivering shoddy merchandise) has no effect on whether the contract itself was unconscionable. (But these post-contract actions may constitute a violation of the party's duty to perform in good faith, imposed by § 1-203.)

2. **Used mostly by consumers:** Virtually the only successful use of unconscionability under the Code has been made by ***consumers***. See W&S, pp. 138-39. The courts usually presume that where a contract is between two ***businesspeople***, each is capable of protecting his own interests, and should not receive the benefit of judicial assistance via the unconscionability doctrine.

3. **Decision made by judge:** Observe that by the language of § 2-302(1), the decision as to whether a contract is unconscionable is to

be made by the ***judge***, not the jury.

E. Varieties of unconscionability: Elements which render a clause or entire contract unconscionable may be divided (as do W&S, pp. 135-149) into two main categories: (1) "***procedural*** unconscionability" and (2) "***substantive*** unconscionability." In those contracts found to be unconscionable, often there will be elements of *both* categories present.

1. Procedural unconscionability: "***Procedural*** unconscionability" refers to the fact that one party was induced to enter the contract without having any ***meaningful choice***. Thus oppressive clauses tucked away in the ***boilerplate***, ***high-pressure salespeople*** misleading ***illiterate consumers***, ***oligopolistic industries*** in which all sellers offer the same unfair "adhesion contracts" so that no bargaining is possible, are all indications of a lack of real assent.

Example: P sells a freezer to D on credit. D speaks very little English, and the provisions of the installment contract which he signs are written in English. P's salesman neither translates nor explains the contract, and also tells D that the freezer will cost him nothing, because he will be paid a bonus of $25 for each sale which he later makes to his friends.

Held, the contract is unconscionable, and P may not recover the contract price. (In addition to the misleading sales practice, the court was influenced by the fact that the total time-price was over $1,100, in contrast to a wholesale cost to P of $348 and a cash sales price of $900.) See *Frostifresh Corp. v. Reynoso*, 274 N.Y.S.2d 757 (1966), rev'd in part 281 N.Y.S.2d 964 (so that P could recover a reasonable profit, service and finance charges in addition to its own cost of $348).

a. Clues to procedural unconscionability: Rest. 2d, § 208, Comment d, lists several factors indicating that the bargaining process was unconscionable. These include:

[1] "belief by the stronger party that there is ***no reasonable probability*** that the weaker party will ***fully perform*** the contract";

[2] "knowledge of the stronger party that the weaker will be ***unable to receive substantial benefits*** from the contract"; and

[3] "knowledge of the stronger party that the weaker party is ***unable reasonably to protect his interests*** by reason of ***physical or mental infirmities, ignorance, illiteracy*** or ***inability to understand the language of the agreement***...."

The facts of *Frostifresh, supra*, are given as Illustr. 3 to § 208.

2. **Substantive unconscionability:** A clause is ***"substantively unconscionable"*** if it is unduly unfair and one-sided. Most of the cases involving substantive unconscionability involve either an ***excessive price***, or an unfair ***modification of either the seller's or buyer's remedies***. W&S, p. 140.

F. Excessive price: An important type of substantively-unconscionable provision is one where the ***price is excessive***. For instance, ***credit installment sales*** in which the total price over the length of the contract is two or three times the standard cash market price of the item are often held unconscionable. The *Frostifresh* case, cited in the above example, is one such case. Another is described in the following example.

> **Example:** The Ps, who are on welfare, contract to buy a home freezer for $900 from D, through its door-to-door salesperson. The various credit-related charges (interest, credit life insurance, etc.) add another several hundred dollars to the price. The Ps pay over $600 toward the purchase price, yet the evidence indicates that the freezer had a maximum retail value of about $300.
>
> *Held*, the contract is unconscionable. This is principally due to the disparity between the $300 reasonable retail value and the $900 (before credit charges) price. Another factor is the "very limited financial resources of the purchaser, known to [D] at the time of sale.…" Therefore, since the Ps have already paid more than $600, they may keep the freezer without further charge. *Jones v. Star Credit Corp.*, 198 N.Y.S.2d 264 Sup. Ct. Nassau Co. 1969).

1. **What constitutes excessive price:** The courts have not agreed on any well-defined test for determining whether a particular price is so excessive as to be unconscionable. However, almost all of the cases that have held a price to be unconscionably excessive involved prices that were ***two to three times*** the approximate "market price" at which similar goods were sold in the same areas. W&S, p. 143.

G. Remedy-meddling: The other main category of substantively unfair terms that has been recognized in courts is what has been called ***"remedy-meddling."*** W&S, pp. 144-45. The term refers to a variety of tactics by which creditor-sellers try to enlarge their rights upon default by the buyer, and to diminish their own liability for breach if sued by the buyer.

1. **Varieties of remedy-meddling:** There are a whole host of terms which a creditor-seller might insert into his form contract which under certain circumstances may be unconscionable remedy-meddlers.

These might include a liquidated damages clause for when the buyer refuses to accept the goods, a clause limiting the seller's liability for consequential damages, a limitation of the seller's warranty liability, a clause allowing a secured creditor-seller to repossess the goods when he "deems" himself "insecure," etc. Some of these clauses are discussed explicitly or implicitly at various places in the Code:

a. Liquidated damages: UCC § 2-718(1) provides that "a term fixing unreasonably large liquidated damages is void as a penalty." Presumably the same considerations used in unconscionability cases would be used in determining whether liquidated damages were "unreasonably large."

i. **Sum set too low:** A liquidated damages clause setting an unreasonably ***low*** amount might also be held to be unconscionable, either on general principles governing liquidated damage clauses (see *supra*, p. 357) or on grounds of unconscionability.

b. Warranty disclaimer: § 2-719(3) provides that "consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for ***injury to the person*** in the case of ***consumer goods*** is *prima facie* ***unconscionable*** but limitation of damages where the ***loss is commercial*** is ***not***." Disclaimers of liability are discussed in greater detail in the chapter on Warranties.

c. Limitation on remedies: A seller may, rather than disclaiming warranties, try to ***limit*** the buyer's ***remedies*** for breaches of warranty that do occur. He might do this, for instance, by limiting the remedy to ***repair or replacement*** of the defective part or item. UCC § 2-719(2) provides that "where circumstances cause an exclusive or limited remedy to ***fail of its essential purpose***," the other Code-provided remedies (e.g., suit for damages) may be used. Comment 1 to this section indicates that the section applies where the modification or limitation of remedy operates "in an unconscionable manner."

Example: Consumer buys a new car from Dealer. The purchase contract does not disclaim any warranties (such as the implied warranty of merchantability). But the

> contract does say that Consumer's sole remedy for any breach of any warranty, express or implied, shall be the right to have Dealer attempt to repair any defect, but only if the defect is called to Dealer's attention during the first 30 days of ownership. Three months after purchase, the transmission entirely breaks, due to a fundamental fault in it that Consumer could not reasonably have discovered by inspection during his first 30 days of ownership.
>
> It is quite likely that a court would conclude that enforcement of the clause limiting remedies to attempted repair of defects discovered within 30 days would cause all of Consumer's remedies here to "fail of their essential purpose," since the defect couldn't have been caught earlier. If so, the court would find that the limitation of remedy was unconscionable and should be discarded. In that event, Consumer would be allowed to recover damages for the car's failure to be merchantable.

2. **Arbitration clauses:** The remedy-meddling clauses that have triggered the largest number of unconscionability claims are so-called ***"mandatory arbitration"*** clauses. By such a clause, both parties to the contract agree that any dispute between them ***must be subject to arbitration rather than resolved by a lawsuit.***

   a. **Nature of arbitration:** In an arbitration, a private person (usually a lawyer) is appointed to hear and decide the dispute. Arbitration is sometimes thought of as "litigation lite" — it usually includes ***limited discovery***, ***abbreviated presentation*** of ***evidence***, and a written decision by the arbitrator that frequently does not include any ***statement of reasoning***. Typically, the arbitration agreement prevents either party from ***appealing*** either the legal or factual conclusions made by the arbitrator.

   b. **Arbitration in employment contracts:** Arbitration clauses in ***employment agreements*** — in which the ***employee agrees to mandatory arbitration for any claim against the employer*** — have sometimes been found to be unconscionable. The California courts have been the leader in this area. While the California courts have not broadly found mandatory-arbitration clauses in employment contracts to be unconscionable, they have found such clauses unconscionable if the clause's design ***is procedurally one-sided.***

      i. **"Modicum of bilaterality" required:** For instance, the California Supreme Court has held that arbitration agreements must have a ***"modicum of bilaterality,"*** and that a clause providing that ***only claims by employees,*** not those by employers, must be arbitrated is unconscionable for lack of bilaterality. *Armendariz v. Foundation Health Psychcare Services, Inc.*, 6 P.3d 669 (Cal. 2000).

c. **Class-action waivers combined with arbitration clauses:** A claim that a mandatory-arbitration clause is unconscionable is especially powerful when the clause ***combines*** a mandatory arbitration provision and a ***waiver*** of the ***right to bring a "class" arbitration.***

i. **Rationale:** A large corporation typically wants to be able to adjudicate each dispute separately. That's because the corporation typically wants to ***avoid*** in advance the possibility that the corporation's counter-parties in the contract (e.g., individual consumers or employees) will ***join together*** somehow, and make the corporation take the risk of being hit with a single large "bet the company" verdict. Putting a mandatory arbitration provision into each contract partially achieves this goal, because it ***prevents the filing of a class action lawsuit*** by hundreds or thousands of similarly-situated plaintiffs.

ii. **"Class arbitration" would defeat:** But if all the large corporation does is to insert a generic mandatory-arbitration clause — without specifying ***the procedures*** to be used in the arbitration — a lawyer specializing in bringing plaintiffs' class actions will typically be free to bring a "class arbitration." That is, hundreds or thousands of plaintiffs who signed the same contract could band together in a single class-based arbitration proceeding, in which the same type of cripplingly-large money judgment and attorney award might result as in a class-action lawsuit.

iii. **Ban on class arbitration:** Therefore, in recent years large corporations have tended to specify, in the mandatory-arbitration clause, that any arbitration must be ***"one on one" (or "bilateral")***, i.e., must involve ***only a single plaintiff***. That way, at least where each contract tends to be for a small amount, no lawyer is likely to find it worthwhile to take the case on contingent fee, since only a small recovery, and thus a small attorney fee award, is likely.

iv. **Struck down by state courts:** State courts have often been ***sympathetic*** to the claims of plaintiffs — especially consumers — that a combined mandatory-arbitration and no-class-arbitrations clause is unconscionable because it tends to leave plaintiffs in small-dollar-amount contract cases ***without an effective remedy.*** The case in the following example is a good illustration of a successful unconscionability claim.

Example: The Ps sign service contracts with D, a cellular telephone company. The contracts state that each P waives the right to sue in court for breach; instead, each agrees that any dispute under the contract shall be subject to mandatory arbitration, and that the arbitration shall involve only one claimant. The Ps later conclude that D is overcharging each of its customers about $40 each month. The Ps bring a class action lawsuit against D on behalf of all customers who were overcharged. D argues that the arbitration clause should be enforced as written, thereby requiring each individual plaintiff to bring a separate arbitration. The Ps argue that the arbitration provision, insofar as it bans any kind of collective proceeding, is unconscionable and thus unenforceable.

Held, for the Ps: the combined arbitration / class action waiver provision here is substantively unconscionable. First, forbidding class actions and class arbitrations would reduce the public's ability to enforce the state's consumer protection laws. Second, forbidding these class-oriented procedures would, as a practical matter, exculpate D from any liability for small harms it inflicts on customers, because in cases like those it will never make economic sense for the Ps to arbitrate with D individually; the stakes for each P are too small. Only a class action lawsuit makes it feasible to press small claims. *Scott v. Cingular Wireless*, 161 P.3d 1000 (Wash. 2007).

d. The U.S. Supreme Court steps in (the *AT&T Mobility* case): But in a dramatic 2011 development, the U.S. Supreme Court ***took away*** a large portion of the right of courts to find that mandatory-arbitration clauses — including ones that prohibit class arbitrations — are unconscionable under state law. In ***AT&T Mobility v. Concepcion***, 131 S.Ct. 1740 (2011), the Court held that a federal statute intended to encourage arbitration pre-empted the right of the trial court to strike down on state-law unconscionability grounds a mandatory-arbitration clause that forbade class arbitrations and class actions.

i. **The FAA statute:** The federal statute at issue in AT&T Mobility, the ***Federal Arbitration Act (FAA)***, essentially

compels both state and federal courts to ***enforce as drafted any arbitration*** clause that is part of any transaction "involving commerce," which today includes virtually all arbitration clauses.

(1) **The "savings clause":** However, the FAA contains a so-called ***"savings"*** clause. That savings clause says that the FAA does ***not*** prevent either party to an arbitration clause from asserting any general state-law grounds allowing "for the ***revocation*** of any contract." Thus any general ***defense*** that state law would recognize as sufficient to allow a party to ***avoid a "contract"*** — defenses like lack of consideration, mistake, duress, fraud, and (of particular importance) ***"unconscionability"*** — may in theory be used by the plaintiff to avoid a bilateral-arbitration clause that would otherwise be enforceable under the FAA's main provision.

(2) **Narrow view:** But as we'll see shortly below, the Supreme Court in *AT&T Mobility* took a ***narrow view*** of when the state-law defense of unconscionability may be used by a plaintiff to avoid an agreement to arbitrate.

ii. **Facts:** In *Concepcion*, the Ps (a couple named Concepcion) purchased a cell-phone service plan from D (AT&T), which advertised free phones as part of the plan. The Ps were not charged for the phones, but were charged $30.22 in sales tax based on the phones' retail value. Although the cellphone plan contained a mandatory bilateral-arbitration clause, the Ps nonetheless brought a conventional suit against D in federal district court for the Southern District of California. Their suit was later consolidated into a putative class action alleging various acts of fraud by D in cellphone marketing. D then moved to have the Concepcions' part of the case dismissed, and replaced by one-on-one arbitration as required under the Concepcions' original contract with D.

iii. **D's motion for arbitration denied below:** But the federal district court ***denied*** D's motion, on the grounds that: (1) the

California courts would regard this particular mandatory-bilateral-arbitration clause as being unconscionable; and therefore (2) the FAA's "savings" clause applied, in a way that prevented the FAA from pre-empting the states' use of unconscionability doctrine to strike the arbitration clause.

iv. **FAA pre-empts state doctrine of unconscionability:** But by a 5-4 vote, the Supreme Court decided that Congress, in enacting the FAA, had never intended to allow the use of state-law doctrines treating bilateral arbitration as unconscionable.

(1) **Rationale:** The majority in *Concepcion* reasoned that Congress' "principal purpose" in enacting the FAA was to "***ensur[e]*** that ***private arbitration agreements are enforced according to their terms."*** California was subjecting class arbitration to a stricter unconscionability review than that to which it subjected individual arbitration. By so doing, the state's use of unconscionability was fundamentally altering the parties' agreement about arbitration, by ***letting consumers force corporate defendants into the much-less attractive (for the defendant) format of class arbitration.*** And because forcing defendants to use the class- rather than individual-arbitration format rendered arbitration less attractive, California's approach was pre-empted by the pro-arbitration purposes of the FAA.

(2) **Status:** It's not yet clear just how far state courts' powers to strike arbitration clauses for unconscionability are impeded by *Concepcion*. "Most courts apply *Concepcion* more or less mechanically, typically finding that state law is preempted if it makes class litigation unconscionable [merely because] there is ***no other effective remedy***." FSCB&G, p. 548.

Example based on *Scott*: For instance, it seems pretty clear that *Scott*, *supra*, p. 483, would have to be decided differently after *Concepcion*. The court in *Scott* concluded that a clause banning both class actions and class arbitrations was automatically unconscionable merely by virtue of the fact that it would leave any consumer who had only a small-dollar claim with no effective remedy. *Concepcion* almost certainly means that it takes ***more*** than a showing of "lack of effective remedy" to avoid pre-emption by the FAA of the court's power to strike that individual-arbitration clause as unconscionable under state law.

(3) **So one-sided as to still be unconscionable:** On the other hand, a defendant might come up with an arbitration clause that was ***so one-sided and unfair*** that even under *Concepcion*, a state court's use of unconscionability to strike the clause down would not be found to be pre-empted by the FAA.

Example: Suppose D, a powerful corporation with a near-monopoly over a particular consumer market, inserts into each consumer contract a clause providing that (1) not only must all disputes be subjected to individual (not class) arbitration, but (2) unless the consumer completely prevails in the arbitration, the arbitrator must make the consumer reimburse D for its actual legal fees, with no cap, and (3) even if the consumer *does* completely prevail, he may not recover *any* attorneys fees from D. It's doubtful that *Concepcion* would be interpreted to mean that the FAA preempts the state's ability to strike such a one-sided and substantively unfair clause as unconscionable.

3. Other examples: Two last types of remedy-meddling that courts have sometimes held unconscionable involve: (1) a clause whereby the buyer ***waives all defenses*** in a suit against him by the seller's assignee; and (2) a ***"cross-collateralization"*** clause by which a secured seller who has sold multiple items to a buyer on credit has the right to repossess all items until the last penny on the total debt to the seller has been paid.

Example 1 (waiver of defenses): Buyer signs a contract to buy 140 record albums and a stereo from Seller, the price to be paid over a period of several years. Buyer also signs a separate promissory note for the purchase price. The contract contains a clause in which Buyer agrees that if he is sued for the contract price by any assignee of Seller, Buyer will not raise any defense related to Seller's defective performance. Immediately after the signing, Seller assigns the contract and the note to Finance Co., a company formed exclusively for the purpose of financing Seller's retail sales contracts. Seller delivers a few of the albums, but then fails to deliver the rest. Finance Co. sues Buyer for the contract price, and argues that the waiver-of-defense clause prevents Buyer from asserting Seller's default as a defense.

Held, the waiver-of-defense clause is unconscionable, particularly since the beneficiary of the clause, Finance Co., is closely associated with the seller. *Unico v. Owen*, 232 A. 2d 405 (N.J. 1967).

Note: After *Unico* was decided, ***federal law*** was changed to make such waiver-of-defenses clauses in consumer credit agreements illegal. See 16 CFR 433.2. So today, the buyer in *Unico* would be permitted by federal law to defend by showing Seller didn't deliver.

Example 2 (cross-collateralization): D, a welfare mother with seven children, has made a number of purchases from P on credit. Each purchase was made under an installment contract containing a complicated cross-collateral agreement, by which any payment made by D is credited pro-rata against all purchases ever made by D. The effect of this is to give P a continuing right to repossess all the purchases until D has reduced her total balance to $0. D's last purchase is a stereo set for $515, bringing her total purchase from P to $1,800. After paying back over $1,400 of this amount, D falls into default, and P seeks to repossess not only the stereo but all other goods that she has bought from him.

Held (by the Court of Appeals), the case must be remanded to the trial court, because the cross-collateral clause may well be unconscionable. "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.… In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power." *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965).

H. Remedies for unconscionability: Once the court has found a particular clause or contract to be unconscionable, it has a number of options. It may merely ***excise*** the unconscionable clause, and then proceed to enforce the contract in the normal manner. Or, it may ***"reform"*** the contract by ***modifying*** the offending term, particularly where an excessively high price is involved. Finally, it may simply refuse to allow the plaintiff to ***recover at all*** on the contract. See § 2-302(1).

V. CAPACITY

A. Capacity generally: Certain classes of persons have only a limited power to contract. The most important of these classes are ***infants*** and the ***mentally infirm***. In most instances, these persons can in effect "have their cake and eat it, too." That is, if they enter a contract they can enforce it against the other party. But if they wish to escape from the contract, they may do so. In other words, the contact is voidable at their option (but not at the option of the other party).

B. Infants: Until a person reaches her majority, any contract which he enters into is ***voidable*** at her option. That is, the minor has the power to ***"avoid"*** or ***"disaffirm"*** the contract before, or soon after, reaching majority. The age of majority is a matter of statute, and in most states is now 18. See Rest. 2d, § 14.

Example: *A*, a minor, agrees to sell Greenacre to *B*. *A* later changes his mind and refuses to go through with the sale. *B* may not enforce the agreement against *A*. But *A*, if he wishes, may enforce it against *B* (e.g., sue *B* for damages for failure to make the purchase).

1. Effect on third person: A minor's right to avoid, or disaffirm, a contract is sometimes effective even against ***third persons***. Thus if, in the above example, *A* had gone ahead with the conveyance to *B*, and *B* had conveyed to *C*, A could still disaffirm the contract, and in effect regain title from *C*. This would be so even if *C* had no knowledge of A's infancy.

a. **But UCC has different view:** But under the UCC, the rights of a third person cannot be disturbed by the infant's disaffirmance. UCC § 2-403 provides that "a person with voidable title has ***power to transfer a good title*** to a ***good faith purchaser for value***." Thus if *A* had sold goods to *B*, who had then sold them to *C*, and *C* did not know of *A*'s infancy, *A* would not be able to avoid the contract and recover the goods from *C*. (But *A* would probably still be able to demand return of the goods from *B*, and recover damages from *B* if *B* could not return them.)

2. **Unavoidable transactions:** Statutes or case law may prevent an infant from avoiding certain kinds of contractual obligations. Obligations that are held to be unavoidable in many jurisdictions include an agreement by the infant to support his illegitimate child, a bail bond taken out to secure his bail, and a promise by a minor employee not to use his employer's secret customer lists. C&P, pp. 282-83. See Rest. 2d, § 14, Comment b.

3. **Sales by guardian:** Since people who know of a minor's right to disaffirm contracts will generally be reluctant to deal with him, statutes often allow the infant's ***guardian*** to contract on his behalf. Such sales must often be made with court approval, but have the advantage (from the other party's viewpoint) of not being disaffirmable. The Uniform Gifts to Minors Act, for instance, allows the guardian of an infant to whom securities have been given to sell the securities and to reinvest the proceeds for the infant's benefit. C&P, p. 283.

4. **Disaffirmance:** In every state except Michigan, an infant may avoid (or disaffirm), the contract ***even before he reaches majority***. C&P, p. 283. He may do so orally, by his conduct (e.g., a manifest unwillingness to go through with the deal), by the entry of a defense of infancy when sued by the other party on the contract, or in any

other way that brings home the fact that the infant does not wish to proceed.

a. **Conveyances of land:** Where the contract is for a conveyance of land, however, most states do not allow the infant to disaffirm the contract until he has reached majority. This rule seems to be part of the general traditional judicial policy of treating land contracts more seriously; the theory seems to be that the infant is not mature enough to know whether the contract is in his interest or not until he has reached adulthood. C&P, p. 284.

b. **"Necessaries":** Where the contract is for the provision of ***"necessaries"*** to the infant, (e.g., food, clothing or shelter), the contract may not be disaffirmed if the services have been rendered. See *infra*, p. 488.

5. **Ratification:** Because a contract made by an infant is not void, but merely voidable at his option, he can choose to enforce it if he wishes. If he so chooses, he is said to have ***ratified*** the contract. ***He may not ratify it until he has reached adulthood***, since otherwise the whole purpose of the rule allowing disaffirmance would be thwarted. Ratification may occur in three separate ways:

   [1] **Failure to make a timely disaffirmance:** The infant may be held to have ratified the contract by inaction, if she ***fails to disaffirm it within a reasonable time*** after reaching her majority. There is no definitive test for determining what is a reasonable time; if the infant has received benefits under the contract both before and after she has attained her majority, a "reasonable period" will be shorter than if the contract remains completely executory. C&P, p. 284.

   [2] **Express ratification:** The contract may be ratified by ***words***, either written or (in most states) oral. The more fully the contract has been performed, the less specific the words of ratification must be.

   [3] **Ratification by conduct:** If the former infant ***actively induces the other party to perform***, this conduct may constitute a ratification. This will be the case, for instance, if both parties begin to exchange performances under the contract at a time

after the infant's majority. But part payment or performance by the former infant, without express words or benefits received from the other party, is probably not a ratification. C&P, p. 287.

6. **Economic adjustment after disaffirmance:** When an infant disaffirms, courts have to deal with whether and how an ***economic adjustment*** should be made after disaffirmance. Because many courts have treated cases in which the infant is a plaintiff differently from that in which he is a defendant, we consider these two situations separately.

   a. **Where infant is defendant:** Frequently the issue of infancy and disaffirmance arises only when a suit is brought ***against*** the infant (or disaffirming ex-infant) because he has not gone through with the contract. In this situation, the non-infant will not be allowed to recover the profits he would have made under the contract, or any other kind of contract damages. But he will have a ***limited right of restitution***, i.e., the right to require the defendant infant to ***return the goods*** or other value ***if he still has them***. But if the infant has ***disposed*** of the goods or destroyed them, he has ***no obligation*** to pay for their reasonable value, although some courts may require him to return any goods which he received in exchange for them.

      Example: Infant buys a car from P on credit. The contract price is $4,000. If P sues and Infant disaffirms the contract, P will not be able to recover any contract damages (e.g., the profits he would have made on the deal). But if Infant still has the car, he will have to return it to P. If Infant has wrecked the car, or sold it for cash which he has then spent, he will not have to make any kind of restitution. If he has traded it for another car, or received money for it which he still has on hand, he will probably be required to give the new car or the proceeds to P (but only up to the value of the original car). C&P, p. 288.

   b. **Where infant is plaintiff:** If it is the ***infant*** who is suing to recover money already paid by her, most courts treat her less leniently than where she is the defendant. Not only must she return whatever consideration she received from the sale that she still has on hand, but any other value which she received and has ***dissipated*** will be ***subtracted from her recovery.*** In other words, the court will attempt to prevent the infant plaintiff from becoming unjustly enriched.

      Example: P, an infant, buys a car from D, a dealer. Three months later (two months after she reaches majority), she returns the car to D, and sues to get her money back. P may get her money back, but D may recover on a counterclaim for the difference between the value of the car when it was bought and the value when it was returned.

c. Necessaries: Virtually all jurisdictions allow a person who supplies ***"necessaries"*** to an infant to recover in ***quasi-contract*** (not on the contract) for the ***reasonable value*** of those necessaries. The minor cannot use disaffirmance to avoid such a recovery. What constitutes "necessaries" varies from state to state, but needed ***food, clothing, shelter, medical care*** and ***legal services*** are among the items that are likely to be covered. Farnsworth, § 4.5.

Example: Minor shows up at the emergency room of Hospital with appendicitis. Minor agrees to pay the bill. Hospital treats him. Hospital will be entitled to recover the reasonable value of the services directly from Minor — since the services were "necessaries," Minor does not have the right to disaffirm the contract.

7. False representations as to age: If the infant willfully lies about his age, to induce the other party to contract with him, courts differ as to the effect of such misrepresentation.

a. Greater restitution required: Some courts place a greater burden of restitution on the infant than if he had not made the misrepresentation. Thus an infant defendant who had procured goods on credit by lying about his age might be required to pay the reasonable value of the goods, even if he no longer possessed them. But most courts nonetheless give the lying infant the right to disaffirm the contract, so that he can at least escape its executory portions and avoid having to pay expectation damages. C&P, p. 291.

b. Court action: Some states allow the party who has been lied to to bring an independent action in tort for misrepresentation against the infant, even though the contract itself may still be disaffirmed by the latter. Other courts, however, view such a tort action as merely a contractual action in disguise, and do not allow it. C&P, p. 291.

c. Avoidance by other party: Virtually all jurisdictions allow the party who has been lied to by the infant to ***avoid the contract*** on the grounds of fraud. This is in distinction to the usual rule, which is that the infant may, if she chooses, enforce the contract even if the other party is unwilling. C&P, p. 292.

C. Mental incompetents: Mental incompetents, like infants, are treated as having limited contractual capacity. This category includes not only the insane, but also those who are mentally ill, senile, mentally retarded, or drunk. In general, the rules applied to the mentally incompetent are similar to those that apply to infants.

1. Definition of mental incompetence: A broader class of persons would probably be found to be incompetent to contract today than several decades ago, where something bordering on lunacy was usually required. Rest. 2d, § 15(1), provides that a person lacks capacity because of mental illness or defect if either: (1) "He is unable to ***understand*** in a reasonable manner the nature and consequences of the transaction"; or (2) "He is unable to ***act in a reasonable manner*** in relation to the transaction and the other party has reason to ***know*** of his condition." That is, he lacks capacity if he doesn't understand the contract, or if he understands it, but acts irrationally, and the other person knows he is acting irrationally.

a. Total lack of understanding: Where the first branch of the Restatement test applies — the person is completely unable to ***understand*** the contract — the contract is voidable even where its substantive terms are ***completely fair***, and even where the other party has ***no reason to know*** of the mental impairment.

b. Understands, but cannot act reasonably: Where the second branch of the Restatement test is relied on — that the person has some understanding of the transaction, but is "***unable to act*** in a ***reasonable manner*** in relation to the transaction" — the transaction is less likely to be set aside. Here, the transaction will be set aside only if the person opposing it shows that: (1) the other person ***knew*** of the mental condition; and (2) the transaction is ***not one which a reasonably competent person might have made***. See Rest. Rest. 2d, § 15, Comment b.

Example: P, a teacher in the D school system, has during her forty years of work built up a $70,000 credit in the system's retirement plan. She leaves work due to "involutional psychosis." (She has also been diagnosed as having cerebral arteriosclerosis, a life-threatening condition.) P has previously elected to receive a lower monthly retirement benefit so that her husband will receive benefits if she dies first. But after the onset of her psychosis, she revokes this election, borrows money from the plan, and elects to receive an extra $75 per month, in exchange for which her husband loses his right to benefits if she dies first. Two months after this change of election, she dies of cerebral arteriosclerosis. Her husband sues to avoid her change of election.

Held, P's husband should get a chance to prove that she was psychotic at the time of election; if he can do so, the election can be voided. D knew, or should have known, of P's mental illness, since she was on leave because of it. In view of P's arteriosclerosis and thus her reduced life expectancy at the moment she made her decision, that decision was foolhardy, and can only be explained on the theory that when P made the decision, she was unable to contemplate the possibility that she would die before her husband. Furthermore, while substantial performance, or reliance, by the other party (here, the retirement plan) might sometimes make it unfair to allow avoidance, in this case there were "no significant changes of position by the [retirement plan] other than those that flow from the barest actuarial consequences of benefit selection." *Ortelere v. Teachers' Retirement Board*, 250 N.E.2d 460 (N.Y. 1969). (See also Rest. 2d, § 15, Illustr. 1, based on *Ortelere*.)

c. **Right of avoidance terminates:** Assuming that the right of avoidance exists because of a party's mental incompetence, ***how long*** into the contract does that right of avoidance last? Where the contract is not on fair terms, or the other party has knowledge of the mental illness or defect, the rule seems to be that the contract can be disaffirmed ***at any time*** until it is completed. But where the contract is made on fair terms *and* the other party has no knowledge of the mental illness or defect, then the power of avoidance "***terminates*** to the extent that the contract has been ***so performed in whole or in part*** or the circumstances have so ***changed*** that avoidance would be ***unjust***. In such a case, a court may grant relief as justice requires." Rest. 2d, § 15(2).

2. **Intoxication:** Intoxication will give a party the power of avoidance only if: (1) she is so intoxicated that she can't ***understand*** the nature of her transaction; and (2) the other party has ***reason to know*** that this is the case. Rest. 2d, § 16. Most (but not all) states agree with this Restatement approach. (A few states don't recognize the intoxication defense at all.)

Example 1: Steve and Bill go out drinking. After Steve has had so many drinks that Bill knows (or should know) that Steve is very intoxicated, Steve says to Bill, "I'll sell my house to you for $100,000." Bill accepts. The fair market value of Steve's house is in fact $100,000. Steve will be able to avoid the transaction, because it was or should have been apparent to Bill that Steve did not truly understand the consequences of what he was saying, due to his extreme intoxication.

Example 2: Steve writes a letter to Bill one day saying, “I will sell you my house for $100,000.” Completely unbeknownst to Bill, at the time Steve wrote the letter he was utterly intoxicated. The fair market value of the house is $100,000. Steve will not be able to avoid the contract, even though he was so intoxicated as to not understand the nature or consequences of the proposed deal. This is because Bill had no way of knowing that Steve was intoxicated, and the objective theory of contracts (*supra*, p. 6) applies.

3. **Voidability:** Contracts made by an incompetent, like those made by an infant, are voidable, not void. Thus if the maker regains his mental capacity, or has a guardian appointed for him, the contract may be ratified. The other party never has the power of avoidance.

4. **Restitution:** No clear rule exists to determine what obligation of restitution a mental incompetent has to the other party to the contract. The general considerations are similar to those applied in the case of infants. Thus if the contract is wholly executory, the incompetent will have no obligation of restitution. Another factor considered by the courts is the ***apparent mental state*** of the incompetent at the time of contracting, if the incompetent seemed to be capable of intelligently contracting, the other party is more likely to be able to obtain restitution than if it should have been obvious that the incompetent was not in his right mind. C&P, p. 299.

5. **Exploitation:** In many situations, a party’s mental state may be less than alert, yet not so diminished as to allow him to avoid the contract under the above incompetency rules. The contracting party may, for instance, be slightly intoxicated, dull-but-not-retarded, slightly senile, etc. In such a situation, if the other party ***took advantage*** of the slight infirmity, the court may allow avoidance either on grounds of infirmity or fraud.

Example: P is injured by D’s railway train. He is in the hospital suffering from great pain and is under some anesthesia, but is not so narcotized that he is unaware of what he is doing. One of D’s claims adjusters, knowing that P is in pain, procures a release from him in return for a $500 check. P’s out-of-pocket expenses are much more than $500, as the adjuster knows. A court would probably void the release because of D’s exploitation of P. See C&P, p. 303, n. 5.

Quiz Yourself on

UNCONSCIONABILITY AND ADHESION CONTRACTS; CAPACITY

130. The Krullen Heartless Appliance Store is located in a poor neighborhood. Sam Shyster is the sales manager. He puts a sign in the window reading, “New Dishwashers — only $19.” Fred Farkus, fourth-grade dropout, sees the sign and asks, “Is it really $19?” Sam says, “Yeah — take a look at this contract. See? $19!” What Sam doesn’t point out is that it’s $19 a month for ten years, chargeable to a credit card. This is in small print buried toward the bottom of a 10-page contract. Sam tells Fred to sign, and he does, although he doesn’t really understand the contract since it’s all words and no pictures. The actual cost of the dishwasher under the contract, expressed as a present value, is $1,900; the same model is on sale nearby at an all-cash price of $600. Fred soon goes into default, and Sam not only seeks to repossess the dishwasher but also to collect the balance owed.

(A) If you represent Fred, what defense should you assert on his behalf?

(B) Will the defense you assert in (A) be successful.

131. Krullen Heartless, the same appliance store featured in the prior question, offers the same “$19/month for 10 years” deal, on the same dishwasher, to Pete, owner of Pete’s Tavern. (Pete’s tired of having to wash glasses in his bar by hand all night.) Sam Shyster, Krullen’s sales manager, doesn’t make any factual statements about the provisions of the contract — he just hands it to Pete and says, “Look, you can buy for no money down.” Pete glances at the contract, doesn’t realize that he’ll be paying triple the cash price, signs, and then soon goes into default. Krullen sues on the contract. If Pete defends on grounds of unconscionability, what result?

132. Roger Thornhill, teetotaler, is at a party one night. He’s delighted that there’s a big punch bowl full of fruit punch. He drinks a lot of it, not realizing that it’s *Electric Kool Aid*, a very potent brew indeed. He gets completely intoxicated, and in a drunken state calls Windshear Airlines and puts a plane ticket to South Dakota on a credit card. (The ticket agent thinks Roger sounds a bit weird, but doesn’t realize he’s dead drunk.) The ticket is not refundable. Before Roger’s due to leave, he sobers up and wants to get out of the purchase. Can he disaffirm the purchase?

133. Zeus, an adult, sells his chariot to Apollo, aged 17, for $50 down and $50 a month until the $2,000 purchase price is paid off. Apollo, while still 17, rides the chariot much too fast one day, and crashes it into a wall. It bursts into flames and is destroyed; Apollo jumps free, unhurt. He then disaffirms the contract with Zeus, and returns the remnants of the chariot in a shoebox.

(A) Can Zeus recover the remainder of the purchase price?

(B) Say instead that Apollo immediately sells the chariot to an acquaintance, Mars, for $1,000. (Mars thinks Apollo's 18, which is the age of majority in the jurisdiction.) Apollo then disaffirms the contract with Zeus, at a time when he still owes Zeus $1,950. Can Zeus recover any of the unpaid balance from (i) Apollo or (ii) Mars? If recovery from either is possible, how much will Zeus recover?

(C) Now assume that Apollo pays $2,000 cash for the chariot, and totally wrecks it so that it has no value. He then disaffirms the contract, and sues Zeus to get back the $2,000. How much, if anything, may Apollo recover?

(D) Now assume that, after the agreement for an all-cash sale is signed, but before Apollo has received possession or title to the car, Zeus realizes he can get more for it by selling it to someone else and tries to get out of the contract. Assume that Zeus realized, at the time of the agreement, that Apollo was a minor. Can Zeus escape the contract?

(E) Same facts as Part D, except now assume that before the contract is signed, Zeus is worried that Apollo may be underage. He asks Apollo his age, and Apollo falsely replies, "18." After the contract is signed, and before delivery, Zeus learns that Apollo has lied about his age; Zeus also realizes that he can get more money for the chariot from someone else. He therefore purports to rescind the contract on account of Apollo's underage status. If Apollo sues to have the contract enforced, will he prevail?

134. Lizzie Borden axe murders her parents when she is sixteen years old. She is acquitted of the crime on a technicality. While still a minor, she contracts with Shyster & Shyster Publishers to write her memoirs for $500,000. When she turns eighteen, she writes to Shyster & Shyster, reaffirming her acceptance of the contract terms. Shortly thereafter, Lizzie gets religious and decides she doesn't want to relive the horror of her past. Can she avoid the contract on the grounds that she was a minor when she made it?

Answers

130. (A) That the contract is unconscionable.

(B) Yes. A consumer contract will be held void for unconscionability under UCC § 2-302 if it is unduly one-sided under the circumstances existing at the time of signing. The fact that the party opposing a finding of unconscionability concealed the true nature of the contract from the other party will strongly militate towards a finding of unconscionability. So will the weaker party's lack of sophistication or education, as will the extreme substantive unfairness of the terms. Here, all of these factors work in favor of a finding of unconscionability, so that's what the court will probably do. As a remedy, the court will then probably either order the contract rescinded (in which case Fred would give back the used dishwasher and be relieved of the need to make further payments), or will "rewrite" the contract so that the payments due will approximate the dishwasher's fair value.

131. Pete will probably lose. Where the buyer is a business or a businessperson, it's exceptionally rare for the court to find the contract unconscionable. Here, where there's been no affirmative misstatement of the contract's terms — and the only unfairness is the substantive one of an excessive price — the court is unlikely to depart from this general refusal to use unconscionablity in commercial disputes.

132. No. A party seeking to avoid a contract that he entered into when drunk must show *both* (1) that he was so intoxicated that he couldn't understand the nature of his transaction, and (2) that the other party knew, or had reason to know, that this was the case. Here, the airline had no reason to know that Roger was drunk, so the second requirement isn't met.

133. (A) No. Apollo, as a minor, has a right to disaffirm the contract. An infant who disaffirms a contract and still has the consideration in his possession must return it. If the goods have been disposed of or destroyed, the infant has no obligation to pay for them. Since Apollo destroyed the chariot, he doesn't owe Zeus anything.

(B) Probably, but just the $1,000, and just from Apollo. When a minor doesn't have the item in question anymore because he *sold* it, the UCC doesn't let the original seller recover from the good-faith third-party purchaser for value; UCC § 2-403. However, a court will probably require the minor in such a situation to return to the original seller whatever the minor received (and still has) for selling the item. So here, Apollo will probably have to fork over the $1,000 in sale proceeds, if he still has it.

(C) Nothing. When the disaffirming infant is the plaintiff, most modern courts will cut his recovery by the diminution in value of the item. Since the chariot is worthless, what would otherwise be a $2,000 recovery will be reduced by the full $2,000 in diminished value, leaving Apollo with a $0 recovery.

(D) No. Contracts that infants enter into are voidable at *their* option *only* — the other party does not have the option of voiding the contract.

(E) No. Virtually all jurisdictions hold that where the infant lies about his age to induce the transaction, the other party may avoid the transaction. So the usual rule — that only the infant may disaffirm — does not apply to the fraud-by-the-infant scenario.

134. No. Lizzie's initial promise was voidable at her option due to her infant status. However, once she reached the age of majority, she had the right to reaffirm the contract. Once she exercised that right of reaffirmation, the contract became fully enforceable as if she had been an adult at the time the contract was made.

EXAM TIPS ON MISCELLANEOUS DEFENSES

☛ The defenses in this chapter don't appear as frequently on exams as do those that are covered in the previous chapter. Basically focus your efforts on capacity, illegality and unconscionability.

Capacity

☛ **Who may disaffirm:** Pay attention to who's attempting to disaffirm. ***Only the minor may disaffirm***, not the other party.

> **Example:** Myner, a minor, and Deal, a motorcycle dealer, enter into a written agreement for the sale of a new motorcycle to Myner for $1,000, to be paid on delivery within two weeks. One week later, Deal notifies Myner that the motorcycle is ready for delivery, but that Deal will not deliver it unless Myner shows proof of majority or brings an adult as a co-purchaser. If Myner sues Deal for breach of contract, Myner will be successful because Deal is obligated to perform — only Myner can disaffirm the contract.

☛ **Offset:** If the minor is suing for rescission or restitution, her recovery is ***offset by the reasonable value of the benefit*** which she has received.

> **Example:** Mine, a minor, purchases a used car from Carman for $3,000. After two months, the steering fails, and Mine decides that the car is unsafe to drive. Therefore, she returns it to Carman and demands her money back. If the reasonable rental value of the car is $300 a month, Mine is entitled to $2,400 (purchase price less 2 months' rental value) when she returns the car.

Illegality

☛ Make sure ***both parties are aware of the purpose*** of the contract (though not necessarily aware of the illegality of that purpose). If only one party is aware, that party won't be able to claim illegality.

> **Example:** Tenn enters into a 2-year lease for premises from Land. Tenn intends to use the premises for an illegal bookmaking operation. At the time of the lease, Land has no idea that this is Tenn's purpose. Tenn will not be able to have the agreement declared void for illegality, because Land did not know of the illegal purpose; however, Land will probably be able to void the agreement.

- ☞ **Severable:** Look for a contract whose primary purpose isn't illegal, but which contains an illegal provision. Argue that the illegal provision should be ***severed*** and the remaining provisions enforced if these condition are all met:
  - □ the contract is ***divisible*** (i.e. there are corresponding pairs of part performances),

□ the illegality doesn't affect the ***entire agreement***, and

□ the party seeking performance ***hasn't engaged in serious misconduct***.

Example: A premarital agreement is signed by Wilma, a pregnant woman, and Alan, the man with whom she lives. The agreement provides, among other things, that in case of divorce, Alan will not be responsible for payment of child support for the unborn child, in return for the Alan's advance relinquishment of custody and visitation rights. A state statute says that mothers may not agree to waive the right to child support.

The "no child support" provision is arguably severable, since: (1) the child support and custody provision are arguably a "corresponding pair of part performances; (2) other aspects of the agreement (e.g., division of property) are not affected by the illegal provision; and (3) signing the clause does not constitute serious misconduct by either party. If the court agrees, either Wilma or Alan may enforce the contract, except that the court will not enforce the child-support provision (or, probably, the custody/visitation waiver, since that was part of the illegal trade).

Unconscionability

☛ Look for a contract involving a ***consumer***. The unconscionability defense is rarely applied to a contract between businesspeople.

☞ Consider applying the doctrine in any non-UCC context involving a consumer contract, where the party seeking to use the doctrine has ***substantially weaker bargaining power*** and the contract or clause seems substantively or procedurally "unfair" to you.

Example: Same facts as the above example (the premarital agreement between Wilma and Alan). Now, assume that Wilma has been living with Alan for 15 years, and that in the agreement she has agreed to waive not only her rights to child support but also her rights to alimony and to her share of any earnings by Alan during the forthcoming marriage. Alan is a wealthy businessman, and Wilma is unemployed as well as pregnant. Assume further than Alan told Wilma that if she didn't sign the agreement as drafted, he wouldn't marry her.

On these facts, you should argue that Wilma should be given the benefit of the unconscionability doctrine as to the entire agreement, since it is substantively unfair, and the product of the parties' very unequal bargaining positions.

☛ Gauge for unconscionability ***at the time the contract was made,*** not later on.

☛ In order for a ***price*** to be unconscionable, it must be very excessive (e.g., two to three times the market price), not just substantially higher than the prevailing market price.

<u>Capacity</u>

- ☛ Where one party was under 18 at the time of the contract, remember that the minor has the power to "***disaffirm***" (avoid) the contract, whether before or shortly after reaching 18.
  - ☞ But if the non-minor supplied ***"necessaries"*** to the minor (e.g., badly-needed food, shelter or medical care), then the supplier can recover in ***quasi-contract*** for the fair value of the supplies, even if the minor disaffirms the actual contract.

CHAPTER 5
MISTAKE

*ChapterScope*___________________

This chapter deals with situations in which a contract exists and a party attempts to rescind it because one or both parties acted on a ***mistaken belief about an existing fact.*** The chapter discusses two categories of mistake: mutual (made by both parties) and unilateral (made by one party).

- **Mutual mistake:** Where ***both parties*** have acted on the same mistaken belief (***"mutual mistake"***), the party seeking rescission must show three things:
  - ☐ **Basic assumption:** that the mistake concerns a ***"basic assumption"*** on which the contract was made.
  - ☐ **Material effect:** that the mistake had a ***major effect*** on the fairness of the deal.
  - ☐ **Allocation of risk:** that the ***risk*** of this type of mistake was not ***allocated*** to the party who is trying to rescind. An allocation of risk can occur either by intent of the parties, or by the court's own decision about what is reasonable. (*Example:* The seller of a parcel of realty bears the risk that valuable minerals will later be discovered on it, because it's commonly understood that the seller bears this risk.)
- **Unilateral mistake:** Where only ***one party*** has acted on the mistaken belief (***"unilateral mistake"***), it is harder for her to get rescission than in the mutual-mistake situation.
  - ☐ **Additional requirement:** In addition to the three requirements discussed above for mutual mistake, the mistaken party must shown that either: (1) enforcement of the contract would be ***unconscionable***; or (2) the other party had reason to ***know*** of the mistake or actually ***caused*** it.

I. NATURE OF MISTAKE GENERALLY

A. Difficulty of analysis: The Second Restatement defines "mistake" as "a ***belief that is not in accord with the facts.***" Rest. 2d, § 151. "Mistakes," so defined, can crop up in numerous contexts during the formation and performance of a contract. This chapter attempts to analyze some of the situations in which one or both parties holds "a belief that is not in accord with the facts," and acts on that belief.

B. Confusion in case-law: The decisions in cases involving "mistake" are often confused, and many courts seem to make a visceral determination of what the just result is and then work backward, looking for a rationalization for this result.

1. **Unilateral vs. mutual mistake:** One distinction which courts frequently seize upon to justify their conclusion is that between ***"unilateral"*** and ***"mutual"*** mistake. Where the mistake is "unilateral" (i.e., made by only one party), courts often hold that no relief can be granted to that party. Where, on the other hand, the mistake is shared by both parties, it is often held that no contract was formed at all, or that the contract should be subject to either rescission (i.e., cancellation) or reformation (i.e., re-writing by the court).

2. **Distinction not always applied:** However, there are numerous situations in which relief has been granted for what is apparently a "unilateral" mistake, and also many situations in which relief for supposedly "mutual" mistakes is denied. The distinction remains of significance, however, and we use the two terms here.

3. **Material not covered here:** Not all types of "mistake" are covered in this chapter. Here, we deal only with those situations where a contract exists, and one party attempts to ***avoid*** the contract by claiming that she (or both parties) was mistaken on some essential aspect. We do not cover the type of mistake which occurs where the parties have a fundamental misunderstanding about the terms of their deal, such that there is no "meeting of the minds" and thus no contract. (This type of mistake is discussed under the heading "misunderstanding," in the chapter on offer and acceptance, *supra*, p. 73.) Nor do we cover here the situation in which a contract exists, the parties have differing understandings of what it means (but not so different as to prevent a "meeting of the minds"), neither party is trying to avoid the contract, and the dispute is simply about whose interpretation should prevail. (This topic is discussed generally in the materials on interpretation, beginning *infra*, p. 188.)

II. GENERAL RULE ON MISTAKE

A. Restatement position: The modern treatment of mistake is exemplified by the Second Restatement. Under the Restatement's approach, before one can determine whether a party may avoid the contract on the grounds of mistake, one must first determine whether the mistake was made by ***both parties*** (traditionally called "mutual mistake") or by only the one party seeking avoidance (traditionally called "unilateral" mistake). Traditionally, only mutual mistake could serve as grounds for avoidance. But the Restatement allows avoidance based on unilateral mistake as well; however, the conditions for such avoidance are significantly more stringent than in the mutual situation. We consider the mutual and unilateral contexts separately, below.

B. Definition of "mistake": Before we begin, it is important to understand that not every erroneous idea is a "mistake" as we use the term here. A "mistake" refers only to a mistaken belief about an ***existing*** fact, ***not*** an erroneous belief about ***what will happen in the future***. (Erroneous beliefs about the future are handled by the doctrines of impossibility, impracticability and frustration of purpose, discussed in Chap. 12.)

> **Example:** Seller agrees to sell to Buyer all Buyer's requirements for oil for the next five years. Their contract sets a price of $20 per barrel. Both parties believe (reasonably) that the price of oil will increase no more than 10% per year over the life of the contract. Instead, the market price of oil quadruples during the first four years of the contract. If Seller wants to avoid the contract because of this erroneous assumption regarding market prices, he will not be able to use the doctrine of "mistake" discussed in this chapter, since the parties were not mistaken about the facts as they existed at the time the contract was made. Since the error was one concerning the future, Seller will have to rely upon the doctrine of impracticability (discussed *infra*, p. 442).

1. Mistake of law: One or both parties may be mistaken about a ***legal principle***, as embodied in a statute, regulation, court decision, etc. The traditional rule was sometimes stated as being that such a "mistake of law" could ***not*** furnish grounds for avoidance of the contract; courts stating this rule analogized to the comparable principle in criminal law that "ignorance of the law is no excuse."

a. Modern view: However, the modern view, as exemplified by the Second Restatement, ***does*** allow a mistake of law to serve as the basis for avoiding a contract, if the other requirements for the mistake doctrine are satisfied. That is, the modern approach "treat[s] the law in existence at the time of the making of the contract as part of the total state of facts at that time." Rest. 2d, § 151, Comment b.

III. MUTUAL MISTAKE

A. Restatement position: We now turn to detailed consideration of the circumstances under which a party may avoid the contract based upon a mistake by ***both parties*** (the "***mutual*** mistake" situation).

B. Restatement's three requirements: The modern approach is illustrated by the Second Restatement. In § 152, the Restatement imposes ***three requirements*** which must be satisfied before the adversely-affected party may avoid the contract on account of mutual mistake:

[1] The mistake must concern a ***basic assumption*** on which the contract was made;

[2] The mistake must have a ***material effect*** on the "agreed exchange of performances"; and

[3] The adversely-affected party (the one seeking avoidance) must ***not bear the risk*** of the mistake.

Let's consider each requirement in turn.

C. Meaning of "basic assumption": The requirement that the mistake be as to a ***"basic assumption"*** on which the contract is founded is not simple to apply. The problem lies with the inescapable vagueness of the word "basic." The underlying concept is clear enough: If the assumption is a central part of the bargain, it is "basic," but if the assumption relates merely to a collateral or peripheral aspect of the contract, it is not.

1. General test: In determining whether an assumption is "basic" to the underlying bargain, a good method has been suggested: "[O]ne must search the facts for ***unexpected, unbargained-for gain*** on the one hand and unexpected, unbargained-for loss on the other." C&P, p. 350.

Example: P is an elderly collector of (but not dealer in) rare violins. D is a famous violinist and violin collector. D buys two violins from P's collection. Both parties believe that one violin is a rare Stradivarius and the other a rare Guarnerius. The contract sets a price of $8,000 for the two violins. It turns out that both violins are mere imitations, not rare and valuable originals. D sues for rescission, and presents evidence that each violin is worth at most $300.

Held, D is excused from paying the $6,000 he still owes on the $8,000 contract price. (The court applied a warranty theory rather than mistake doctrine, but modern mistake analysis would support the same result.) *Smith v. Zimbalist*, 38 P.2d 170 (Cal. Dist. Ct. App. 1934).

2. **Market conditions and financial ability:** Rest. 2d, § 152, Comment b mentions two types of assumptions which will generally ***not*** be "basic" ones: mistakes as to ***market conditions*** and ones concerning ***financial ability***.

   a. **Market conditions:** Thus if Seller agrees to sell Blackacre to Buyer, and both parties believe that comparable land is then worth $5,000 per acre, neither party will be able to avoid the contract if it turns out that comparable land is in fact worth much more, or much less, than this amount.

   b. **Financial ability:** Similarly, if Seller sells land to Buyer on credit, Buyer's ability to pay the purchase price is a collateral, not basic matter, and Seller's later discovery that Buyer is insolvent will not allow him to avoid the contract for mistake. (But a showing that Buyer lied about his financial condition might support an action for fraud.)

3. **Existence of subject matter:** The ***existence*** of the subject matter of the contract will usually be a "basic" assumption.

Example 1: In a contract to sell land whose value depends mostly on how much timber is on it, a mistaken belief by both parties that the land is covered with timber will be grounds for the buyer to avoid the contract, if it turns out that at the time of the contract the timber had already been destroyed by fire. Rest. 2d, § 152, Illustr. 1.

Example 2: If *A* buys from *B* an annuity on *C*'s life, it is a basic assumption of the contract that *C* is alive. Therefore, *A* may rescind the contract and obtain a refund if it turns out that *C* was already dead at the time the contract was signed. (But the fact that *C* was in bad health at the time the contract was signed, and died shortly thereafter, will *not* entitle *A* to rescind — a court would almost certainly find that the risk of an early demise should be allocated to *A*, just as the risk of a late demise is allocated to *B*, by the very nature of annuity contracts.)

4. **Quality of subject matter:** A major mistake as to the ***quality*** of the contract's subject matter is often viewed as a mistake on a "basic assumption," allowing the disadvantaged party to avoid the contract. The origin (and therefore quality) of the violins in *Smith v. Zimbalist*,

supra, p. 158, is one example of this principle. Another illustration occurs in one of the most famous mistake case in all of Contracts, *Sherwood v. Walker*, recounted in the following example.

> **Example:** Seller agrees to sell Buyer a cow (Rose 2d of Aberlone), which both parties believe to be barren. The contract price is approximately $80. Prior to delivery of the cow, Seller realizes that she is pregnant, and refuses to deliver her. Her value as a breeding cow is at least $750.
>
> *Held*, Seller may rescind the contract. A party may avoid a contract if "the thing actually delivered or received is different in substance from the thing bargained for, and intended to be sold.…" Here, the mistake went "to the very nature of the thing. A barren cow is substantially a different creature than a breeding one." *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887).

a. Contrary view: But the cases involving mistake as to the quality or value of the contract's subject matter are not consistent. For instance, consider *Wood v. Boynton*, 25 N.W. 42 (Wis. 1885), a case universally contrasted to *Sherwood*. In *Wood*, Seller sold a small stone to Buyer for $1. Both parties believed the stone to be a topaz, though neither was sure. The stone turned out to be an uncut diamond worth about $700. The court denied rescission to Seller, reasoning that (at least in the absence of fraud), this was not a mistake as to the "identity" of the thing sold, and that mere "adequacy of price," no matter how extreme, could not by itself be grounds for rescission.

b. Difficulty of distinguishing: On their face, the *Wood* and *Sherwood* cases are extremely hard to distinguish. For instance, the *Sherwood* Court's statement that a barren cow is "substantially a different creature" than a breeding one could be made equally (or more) plausibly about the difference between a topaz and a diamond.

c. Restatement approach: The modern approach, embodied in the Restatement, at least has the merit of not involving vague, manipulable distinctions like that between an object's "mere quality" and its "very nature" (terms used by the *Sherwood* court). Under the Restatement approach, in both *Sherwood* and *Wood* the question would be whether the characteristic on which the parties were mistaken was a ***"basic assumption."*** Phrased in this way, both *Sherwood* and *Wood* seem to have involved such a mistaken "basic assumption." See Farnsworth, pp. 627-28.

i. **Risk of loss:** However, a plausible argument can be made that the cases are distinguishable based on differences in the way they ***allocated the risk of mistake*** (a factor discussed *infra*, p. 160). Under the doctrine of "conscious ignorance" (see *infra*, p. 161), a party who ***knows*** that his knowledge of the facts is limited will be held to bear the risk of an unfavorable mistake. In *Sherwood*, both parties were quite confident that the cow was barren. In *Wood*, however, the parties both ***knew that they did not know*** the identity of the stone (though they suspected it to be a topaz).

(1) **Rightly decided:** Therefore, the two cases can be distinguished on the grounds that only in one (*Wood*) did the adversely-affected party bear the risk of mistake. So under this view, each case was correctly decided on allocation-of-risk grounds. See C&P, pp. 350-51.

5. Releases: A party may agree to ***release*** another party from all claims arising out of a certain transaction; this usually occurs as part of a negotiated settlement. If the party doing the releasing is materially mistaken about the facts surrounding the transaction, may he rescind the release for mistake? As in other contexts, an important factor is whether the mistake involves a "basic assumption" of the parties. The courts are somewhat less inclined to set aside the release for mistake in commercial transactions than in those involving personal injuries.

a. Commercial setting: If the release occurs in a ***commercial*** setting, such as the termination of a contractual dispute, the court will generally be reluctant to set aside the settlement for mistake, in view of the strong policy in favor of encouraging settlement of claims.

b. Personal injury claims: But if a release is signed by an individual who has suffered ***personal injuries***, in favor of an insurance company or person who has allegedly caused the injuries, the courts are much more willing to void the release when the injuries turn out to be ***different from***, or much more ***serious than***, the releasor had suspected when he executed the release. **??**

D. Material effect on agreed exchange: In addition to showing that the mistake was on a "basic assumption" shared by the parties, the person seeking to avoid the contract for mistake must also show that the mistake has a "***material effect*** on the ***agreed exchange of performances***." Rest. 2d, § 152(1). This showing is not made merely by proof that the party would not have made the contract had it not been for the mistake. The party must show "that the resulting imbalance in the agreed exchange is so ***severe*** that he ***cannot fairly be required to carry it out***." Rest. 2d, § 152, Comment c.

1. Advantage to other party: The courts are more likely to find this showing to have been made where the mistake not only disadvantages the party seeking avoidance but also ***advantages*** the other party, than where the other party's position is ***not improved*** by the mistake.

> **Example:** Observe that in *Sherwood v. Walker, supra,* p. 158 (the "Rose of Aberlone" case), the buyer was enriched by the mistake to precisely the same extent as the seller was disadvantaged. This fact, coupled with the large discrepancy between the sale price and the cow's value to the seller, satisfied the requirement that there be a "material effect on the agreed exchange of performances."

2. Significance of other relief: In determining whether the mistake has a "material effect on the agreed exchange of performances," the fact that ***other types of relief*** apart from rescission are available will make it less likely that rescission will be allowed. For instance, the court's ability to ***reform*** the contract, or to order a restitutionary payment, may be enough to undo the effect of the mistake, thereby rendering avoidance unnecessary.

> **Example:** A land sale contract contains a price per acre, and also contains a mistake about the number of acres. The court will order a pro rata adjustment of the purchase price, rather than allowing the party who is disadvantaged by the mistake to escape the contract entirely. See Rest. 2d, § 152, Illustr. 11.

E. Allocation of risk: Even if the mistake is as to a "basic assumption," and the mistake "materially alters the agreed exchange of performances," the disadvantaged party will still not be able to avoid the contract if the risk of that mistake is ***allocated to him***. Rest. 2d, § 154 lists three different ways in which the risk of loss will be allocated to a party:

[1] the risk is allocated to that party ***by agreement of the parties***;

[2] 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

[3] the risk is allocated to him "***by the court*** on the ground that it is ***reasonable in the circumstances*** to do so."

Let's consider each of these in turn.

1. **Agreement of the parties:** If the parties themselves allocate their risk of a mistake, this allocation will, not surprisingly, be binding. For instance, if a contract for sale of land calls for the seller to convey only such title as he possesses (i.e., a "quitclaim deed"), and the seller makes no representations as to his title, the buyer may not obtain relief even if it turns out that the seller has no title at all in the property. Rest. 2d, § 154, Illustr. 1.

2. **Conscious ignorance:** The situation described in Sub-paragraph [2] above is sometimes called that of ***"conscious ignorance."*** The basic idea is that a party who knows that his knowledge is incomplete, but who elects to proceed anyway, must bear the risk that "what he doesn't know will hurt him."

   > **Example:** Recall that in *Wood v. Boynton, supra*, p. 159, both the seller and buyer of the stone were unsure about what kind of stone it was (though both believed it to be a topaz). Since the seller proceeded in "conscious ignorance" of the nature of the stone, he was held to bear the risk of an unfavorable mistake stemming from that ignorance.

3. **Allocation by court:** Probably the most common way in which the risk will be allocated to a particular party is when the ***court*** makes the allocation, "on the ground that it is ***reasonable*** [under] the circumstances to do so." Rest. 2d, § 154. There is no more specific standard for deciding when risk-allocation is "reasonable." However, several fairly common situations in which the court will make such an allocation can give an idea of how courts proceed:

   a. **Minerals in land:** Suppose that Seller contracts to sell land to Buyer, with both parties assuming that the land is suitable only for farming. If before the closing, or shortly thereafter, ***oil, gas*** or other valuable minerals are found under the land, may Seller avoid the contract? The universal answer is ***"no."*** Under the Restatement scheme, the reason for this is that the court will allocate the risk of a mistake about minerals to the seller. See Rest. 2d, § 154, Comments a and d. This allocation is reasonable because a contrary rule would ***disturb*** the ***valuable finality*** of real estate transactions See Farnsworth, p. 629.

b. Building conditions: Suppose Builder contracts to construct a building on land owned by Owner. Both parties assume that sub-soil conditions are normal. It turns out, however, that because the land contains large quantities of rock, or because of some other unexpected condition, ***construction is much more expensive*** than either had expected. A court will not relieve Builder of his construction obligation, since allocating the risk of this kind of mistake to Builder is reasonable, in view of Builder's actual or presumed greater expertise in judging sub-soil conditions. See *Watkins & Son v. Carrig*, 21 A.2d 591 (N.H. 1941); see also Rest. 2d, § 154, Illustr. 5, and Farnsworth, p. 629.

c. Used paintings and other collectibles: Suppose the owner of a painting or other ***used "collectible"*** sells it in a private sale, and the object turns out to be of a fundamentally different — and more valuable — nature than either side believed. Courts generally have allocated this risk to the ***owner/seller***, on the theory that he had the opportunity to ascertain the true value and can't complain if he fails to learn what could have been learned.

Example: Appraiser is hired by Estate (a decedent's estate) to assess the value of various property in Estate. Appraiser disclaims any knowledge of fine art, and says that she sees none in Estate's collection. Acting on Appraiser's recommendations, Estate sells two oil paintings together for $60. Buyer assumes the paintings are not originals but likes their appearance. Buyer later learns that the paintings are indeed the original work of a well-known artist and are worth over a million dollars. Estate sues Buyer to rescind the contract of sale, claiming it was invalidated by mutual mistake: neither side thought the paintings were valuable. (Estate also sues Appraiser, but Appraiser has few assets and that case is settled for a small amount.)

Held, the contract cannot be rescinded. The parties may both have been mistaken about the value of the paintings, but the risk of that mistake is properly allocated to Estate. Estate had a full opportunity to research the paintings. It knowingly chose an appraiser who was not competent to identify and appraise fine art. Estate thus assumed the risk that such art might exist among its holdings without its value being noticed. *Nelson v. Rice*, 12 P.3d 238 (Ariz. App. 2000).

F. Relation to breach of warranty: Where a buyer and seller are both mistaken about the nature or quality of goods, in a way that makes the goods less valuable than expected, the buyer may also have a claim against the seller for ***breach of warranty***. (See *infra*, p. 497). The two types of claims are not mutually exclusive — the fact that there is a breach of warranty claim does not mean that the buyer cannot instead decide to rely on a claim for rescission based on mutual mistake.

G. Misunderstanding: One topic closely related to "mistake" is handled in the chapter on offer and acceptance, *supra*, p. 73, rather than in the present chapter. This is the topic of ***"misunderstanding,"*** in which the parties have different subjective understandings about the meaning of a material term in the contract, usually because the term is ambiguous. The general rule is that if neither party knows or has reason to know of the misunderstanding, there is no meeting of the minds and therefore ***no contract*** at all (assuming that the term is a material one).

1. **Consequence:** Functionally, there will often not be much difference between a finding that there was no contract (the typical result in the "misunderstanding" situation) and a finding that a mistaken party may rescind, i.e., avoid the contract (the usual remedy for the types of mistakes discussed in this chapter).

Quiz Yourself on
MUTUAL MISTAKE

39. Jack agrees to sell Giant a goose for $20. Both parties think the goose is a regular goose, which Giant wants for breeding.

(A) Before the goose is transferred or the $20 paid, the goose begins laying golden eggs, which makes her priceless. Jack refuses to uphold the agreement, and Giant sues to enforce the contract. Will a court force Jack to sell for $20?

(B) Assume instead that before the goose is transferred or the $20 paid, both Jack and Giant witness the goose laying eggs that are gold in color. Giant says, "Wow, that's bizarre. What do you suppose those eggs are made of?" Jack replies, "I don't know, but I think it's some alteration of the albumin content. Anyway, you can still have her for $20 if you want her." Giant, who believes Jack's assessment, agrees to go through with the deal. Shortly thereafter, Jack finds out the eggs are actually made of gold and refuses to consummate the sale. Will a court enforce the agreement?

40. After doing some spring cleaning in his wine cellar, Gatsby decides to sell several bottles of wine from the Magenta region of France. He enters into a contract with Daisy to sell the wine for $250. Both believe this to be the fair market value of the wine at the time. In actuality, wines from the Magenta region have gone up in value recently and the collection is really worth $500. Gatsby learns of this just before the sale is completed, and he seeks to avoid the sale. Can Daisy enforce the contract?

Answers

39. (A) No, due to the parties' mutual mistake. A mistake by both parties, which goes to a ***"basic assumption"*** on which the contract was made, will generally be grounds for avoidance. Here, this standard is satisfied: the parties thought they were bargaining for a regular goose when in fact they were bargaining for a vastly more-valuable goose that lays golden eggs. Were the court to enforce this contract, Giant would wind up with a tremendous windfall and Jack would suffer a significant loss. Although the court will not allow rescission if it's proper to allocate the risk of the mistake to the party seeking avoidance, nothing in these facts makes it appropriate to allocate the risk of this mistake to Jack. Therefore, the court will allow Jack to rescind.

(B) Yes, under these facts, the court *would* enforce the contract. Even where a mistake is mutual, a court will not allow a party to avoid the contract if the risk of the mistake is properly allocated to that party. One of the ways such allocation will occur is if a party is aware that he has only ***limited information*** regarding some aspect of the deal, but treats his limited information as sufficient. (This is sometimes called "conscious ignorance.") Here, Jack knew that there was an issue as to whether the eggs were different from the usual goose eggs, but chose to rely on what he knew was his own imperfect (and wrong, as it turned out) assessment. Having made that choice, he's stuck. (But the result would be otherwise if Giant *knew* that the eggs were gold; this would be a unilateral mistake, of which the non-mistaken party was aware — see the treatment of unilateral mistake later in this chapter.)

40. Yes. Even a mutual mistake will not be grounds for rescission if the mistake is one the risk of which is properly allocated to the party now seeking rescission. A mistake about the general state of market conditions will almost certainly fall into this category, since a contrary rule would give parties an incentive to remain ignorant of something they could easily check. Therefore, Daisy can enforce the contract as it is written.

IV. UNILATERAL MISTAKE

A. The problem generally: We turn now to the type of mistake traditionally called ***"unilateral."*** This is a mistake which is made by ***only one party***.

B. Traditional rule: Traditionally, courts have been ***much less willing to allow rescission*** for unilateral mistake than for mutual mistake. In the unilateral situation, "avoidance of the contract will more clearly disappoint the expectations of the other party than if he too was mistaken." Rest. 2d, § 153, Comment c. Therefore, the traditional rule has been that avoidance for unilateral mistake would be allowed only where the non-mistaken party knew or had reason to know of the mistake at the time the contract was made. C&P, p. 354.

C. Modern view: The modern view, exemplified by the Second Restatement, is more willing to allow rescission in unilateral mistake situations. But even the Restatement makes such rescission ***more difficult to obtain*** than in the mutual mistake context.

1. Requirements: Under Rest. 2d, § 153, the following requirements must be met in order for a party to avoid a contract based on a mistake by him alone:

a. Three basic requirements: First, the same three basic requirements must be satisfied as in the bilateral situation (i.e., the mistake must be as to a "basic assumption" on which the contract was made, the mistake must have a "material effect on the agreed exchange of performances," and the party seeking relief must not "bear the risk of the mistake").

b. Additional requirement: Additionally, ***either*** of two things must be the case:

[1] the mistake is such that enforcement of the contract would be ***"unconscionable"***; or

[2] the other party had ***reason to know of the mistake***, or his ***fault caused*** the mistake.

2. An offer "too good to be true": As we just indicated in Par. 1(b) above, a person who wants to avoid a contract on account of unilateral mistake will often try to show that the ***other party had reason to know of the mistake.*** In the case of a mistake reflected in an ***offer*** that the offeree accepted, and that the offeror now wants to rescind on grounds of offeror's mistake, the offeror will try to show that ***offeree knew or should have known*** that the offer (with the mistake embedded in it) was ***"too good to be true."***

a. "Snapping up" the offer: If the offeror can make this "too good to be true" showing, she will have a good chance of meeting all the elements for rescission on grounds of unilateral mistake. As the idea is usually put, "[a]n offeree ***may not snap up an offer*** that is on its face ***manifestly too good to be true.***" *Lange v. U.S.*, 120 F.2d 886 (4th Cir. 1941).

b. Mechanical errors and "mental blunders": A common source of "offers too good to be true" is where the party now seeking avoidance for unilateral mistake made a written offer, and the offer was the product of a ***"mechanical error"*** or a ***"mental blunder."*** FSCB&G, p. 848. So, for instance, if an offeror makes a ***clerical error*** in ***computing the price*** at which he is proposing to buy or sell, and it should be evident to the offeree that this price is "too good" (from the offeree's perspective) to be anything but the result of a mistake, an offeree who tries to "snap up" the offer — i.e., to immediately accept it without further discussion — is likely to find that the court will permit the mistaken party to avoid the contract.

Example: Several Ps bring a products liability action against D and X. At trial, the Ps are awarded a total of $1.3 million among them, a portion of which (36% as to some Ps, and 48% as to other Ps) is assessed against D, the rest against X. After trial, since the verdict is to be adjusted to account for pre-judgment interest and other factors, the two sets of lawyers (Maywhort and Gray for the Ps, and

Thomasch and Brooks for Ds), exchange various computations about the final amount D owes. During the course of this process, on Nov. 2 Brooks, on behalf of D, emails some further computations and back-up charts to Gray; the text of the email suggests that D owes the Ps $2.7 million, and says to Gray, "Let's discuss." This $2.7 million is in fact a clerical error — it reflects the overall amount that D and X would *together* owe the Ps, rather than the 36% and 48% share allocated by the jury to be paid by D alone.

Gray and/or Maywhort immediately recognize that this $2.7 million number is $500,000 higher than their own computations show to be due from D. But instead of either lawyer's calling Brooks to discuss the discrepancy, Maywhort phones and faxes Thomasch (without copying Brooks) saying that the Ps thereby "accept" D's "offer" of $2.7 million. D refuses to recognize a contract. It argues that even if the Nov. 2 email was an offer (which D disputes), under the rules for avoiding unilateral mistakes, D should be granted rescission and required to pay only the correctly-computed $2.2 million.

Held, for D. First, the Nov. 2 email was not even an offer, and therefore could not be accepted.[1] But even if a contract *did* come into force by Maywhort's phone call and fax, that contract is ***avoidable*** by D on grounds of unilateral mistake. On the key issue of whether the Ps "knew or had reason to know" that the "offer" by the Ds was "too good to be true," the answer is clearly ***yes***: Ds' lawyers' prior statements during the negotiations show that they knew D was responsible for (depending on the P) only 36% and 48% of the total jury award, and intended to submit computations reflecting this fact. Therefore, when the Ps' lawyers received that email with the supposed "offer" of $2.7 million on behalf of D, that offer contained "obvious inconsistencies" that put the Ps on notice that the $2.7 million was probably a clerical mistake.

On the related issue of whether D's case for rescission satisfies the requirement that the party seeking avoidance ***must not "bear the risk of the mistake"*** (see *supra*, p. 160), Comment f to Rest. 2d § 153 states that "It is, of course, unusual for a party to ***bear the risk of a mistake that the other party had reason to know of[.]***" Since the Ps had reason to know of D's mistake, that fact alone demonstrates that the parties did not intend to place the risk of such a mistake on D. Therefore, the court grants D relief from the mistake, by denying the Ps the right to recover anything beyond the already-correctly-paid $2.2 million. *Sumerel v. Goodyear Tire & Rubber Co.*, 232 P.3d 128 (Col. Ct. of App. 2009).

3. **Construction bids:** The most common type of unilateral mistake occurs where a ***contractor*** or ***sub-contractor*** makes an error on a ***bid*** for a construction job.

   a. **Unconscionability:** Assuming that the party receiving the mistaken bid did not cause or have reason to know of the mistake, the bidder must show that enforcement of the contract would be ***unconscionable***. This will normally require her to show not only that she herself will be severely harmed if forced to perform, but also that the other party ***has not relied*** on the bid.

Example: Contractor solicits sub-contracts for the electrical work on a project. Sub-contractor makes a bid of $50,000. Contractor relies on this bid in preparing his own master bid for the entire project. Contractor is awarded the contract, and then enters into the sub-contract with Sub-contractor. Sub-contractor then discovers that its original bid was $25,000 lower than it should have been, due to a mistake in computation. Because Contractor has already relied on the sub-contract bid (by using that price in preparing his own master bid) Sub-contractor will not be able to make the requisite showing that enforcement of the contract would be "unconscionable." See Farnsworth, p. 633. Cf. *Drennan v. Star Paving Co.*, 333 P.2d 757 (Cal. 1958) (also discussed *supra*, pp. 59) and Rest. 2d, § 153, Illustr. 7 (based on *Drennan*).

i. **Relevance of profit:** To make the requisite showing of unconscionability, the contractor will normally have to show that the mistake represents a ***significant portion*** of the overall bid. (He would have to make this showing anyway, in order to satisfy the basic requirement that the mistake have a "material effect on the agreed exchange.") He will also usually have to show that the mistake deprives him of all or most of his ***profit***.

b. Clerical errors: As in non-bid situations (such as *Sumerel*, *supra*), the most common kind of mistake in bidding (and the one for which courts are most likely to give relief) is a ***clerical error*** in ***computing the amount*** of the bid. Other types of clerical errors will also qualify for relief (e.g., the bidder's failure to read closely the job specifications).

i. **Judgment:** Courts are much less willing to allow rescission where the error is a mistake in ***"business judgment"*** rather than a clerical error. For instance, if the bidder makes a mistake in estimating the ***amount of labor required to do the work***, he will not be entitled to avoid the contract; the court will hold that the risk of a mistake on this item should reasonably be allocated to him, rather than to the recipient of the bid. See Rest. 2d, § 154, Illustr. 6.

c. "Snapping up" of offer: Recall that if the other party ***knows*** or has ***reason to know*** of the error, the requirement of "unconscionability" will not apply (*supra*, p. 165). This means that the recipient of the bid cannot "snap up" a bid that he should know was too low to have been intended. This will be true even where the recipient of the bid has relied upon it (since reliance simply goes to whether enforcement would be unconscionable).

Quiz Yourself on
UNILATERAL MISTAKE

41. Mike Angelo, newly arrived in the United States from Italy, develops an immediate fascination with baseball. He visits “Leo’s Locker,” a baseball memorabilia store, to check out some baseball cards. The owner, Leo diVinci, has a slogan, “I love to dicker” — so he doesn’t put a price tag on anything. Mike spots an old card with a famous name on it, and offers Leo $5,000 for it. Leo realizes that Mike has mistaken the player on the card — Babe Root, of the 1929 New York Spankies (an amateur team) — for Babe Ruth, whose card *would* be worth $5,000. Leo quickly accepts Mike’s offer, knowing the card is worth about fifty cents. Leo writes up a contract that they both sign, and Mike goes to the bank to get the $5,000. When he tells the bank teller about his find, the teller laughs hysterically, telling him of his mistake. Mike reneges on the deal. Leo sues. Mike defends on grounds of mistake. Who wins?

42. Shah Jihan is building himself a monument and needs a rock-cutting machine. He sees Mimzeh’s ad in the Bargain Trader Newspaper for a rock-cutting machine for $10,000. Shah goes to Mimzeh’s house and inspects the machine. Mimzeh accurately answers all questions Shah asks. Shah offers Mimzeh $10,000 for the machine, which she accepts. Before the transaction takes place, Shah finds out the rock cutter will not cut marble, which, unbeknownst to Mimzeh, is the type of stone Shah uses. Can Shah avoid the contract due to his mistake?

43. James Beardless, Army chef, solicits bids for a custom-built food processor with a work bowl large enough to hold 500 lbs. of chipped beef.

(A) For this part, assume that Beardless receives bids on the project of $90, $600, $700, and $800. The $90 bid was from the Come-N-Get-It Food Supply House. Come-N-Get-It intended to bid $900, but made a careless clerical error in its bid. Beardless is impressed by Come-N-Get-It’s very low bid. Beardless thinks that Come-N-Get-It must be a very efficient producer; he doesn’t suspect that the bid’s lowness may be due to clerical error, and he therefore doesn't re-confirm the price (though a reasonable person in Beardless' position would have done so). Soon after Beardless accepts, Come-N-Get-It tells Beardless that it made an error, and that its bid should have been for $900. Can Beardless enforce the $90 bid price?

(B) Say instead that the bids were for $500, $600, $700 and $800, with Come-N-Get-It's bid coming in at $500. Come-N-Get-It actually meant to bid $650, but made an error when adding up the figure for its estimate. Beard has no suspicion that there may have been an error (and a reasonable person would not have had such a suspicion). Beardless accepts the offer of $500 and now Come-N-Get-It wants out. Can Beardless enforce the $500 bid price?

Answers

41. Mike. The issue here is the effect of a unilateral mistake. In addition to the requirements necessary in a mutual mistake situation (mainly that the mistake must relate to a "basic assumption" and the risk must not be one properly allocated to the party seeking to avoid it), a party who wants to avoid a contract based on unilateral mistake must also prove that *either:* (1) enforcement of the contract would be unconscionable, *or* (2) the other party ***knew*** or ***should have known*** of the mistake or somehow was ***at fault*** for creating the mistake. Here, Leo was aware from the get-go that Mike was mistaken about the value of the card, but failed to correct Mike. Mike is therefore able to satisfy requirement (2), and can avoid the contract.

42. No. Again, the issue here is whether Shah's unilateral mistake is grounds for avoiding the contract. Remember that to avoid a contract based upon unilateral mistake, the rules for avoiding a contract based on mutual mistake must first be satisfied. That is not the case here: Shah knew that he needed a machine for cutting marble, yet he failed to adequately inspect and investigate to see if Mimzeh's machine was suitable for this purpose before entering into the contract. Shah's "conscious ignorance" of this fact will therefore bind him to the agreement as made.

43. (A) No. A person receiving bids may not "snap up" an unduly low bid — that is, if the recipient either knows or has reason to know that the bid is likely to be an error, the bidder will be able to use the unilateral-mistake doctrine (assuming the other requirements for the doctrine, such as a mistake as to a "basic assumption," are met). So neither the fact that the mistake in bid was due to Come-N-Get-It's own negligence, nor the fact that Beardless didn't actually suspect error, will block Come-N-Get-It from using the doctrine.

(B) Yes. Under these facts, the bid presented is not so out of whack with the others that it should have alerted Beardless to the problem. Therefore, Come-N-Get-It's only chance to avoid for mistake will be to show that enforcing the contract under the mistaken terms would be *unconscionable*. To do this, Come-N-Get-It would probably have to show that it would be severely harmed by enforcement of the contract; it's very unlikely that Come-N-Get-It will be able to do this.

V. DEFENSES AND REMEDIES

A. Negligence usually not a defense: Where a party seeks to avoid the contract because of his own (or both parties') mistake, the fact that the mistake was due to his ***negligence*** will ordinarily ***not prevent relief***. (If the rule were otherwise, the entire doctrine of relief for mistake, at least in unilateral-mistake cases, would be almost irrelevant.) See Rest. 2d, § 157.

> **Example:** Sub-contractor is solicited to prepare a bid for the electrical work on a building. He submits a bid of $100,000 to Contractor. After he is awarded the sub-contract, he discovers that his bid failed to include $50,000 for one part of the job, due to an error in addition. Even if the error is due to Sub-contractor's clear negligence in preparing the bid, he will not be precluded from obtaining rescission of the contract (assuming that the other requirements for relief from unilateral mistake are satisfied). See Rest. 2d, § 157, Illustr. 1.

1. Failure to act in good faith: But the party's fault may be so great that it ***does*** preclude her from avoiding the contract. Traditionally, the type of negligence for which relief will be denied has been described a as ***"gross"*** or ***"culpable."*** But under the Restatement view, fault will not deprive a party of avoidance unless it "amounts to a failure to act in ***good faith*** and in accordance with reasonable standards of ***fair dealing***." Rest. 2d, § 157.

Example: Assume that on the facts of the above example, Contractor asks Sub-contractor to check his figures to make sure that there has been no mistake. If Sub-contractor says that he has done so, when in fact he has not (and when a check would have revealed the error), Sub-contractor's conduct will be held to show a lack of good faith and fair dealing, and he will be prevented from rescinding the contract. Rest. 2d, § 157, Illustr. 2.

2. **Failure to read writing:** If the mistake for which rescission is sought stems from a party's ***failure to read the contract***, he will ***not*** normally be entitled to rescind. "[O]ne who assents to a writing is presumed to know its contents and cannot escape being bound by its terms merely by contending that he did not read them; his assent is deemed to cover unknown as well as known terms." Rest. 2d, § 157, Comment b. (However, if there has been a prior oral agreement, which the written agreement does not match, the party who has failed to read the writing may be able to obtain reformation; see *infra*, p. 170.)

B. Remedies: There are several distinct remedies which may be appropriate for mistake, depending on the situation.

1. **Avoidance:** The most common remedy is that of ***avoidance*** of the contract. "Avoidance" is synonymous with ***"rescission."*** If this remedy is granted, the court will essentially treat the contract ***as if it had never been made***, and will attempt to ***return each party to the position he was in*** just prior to execution of the contract.

   a. **Restitution as element of avoidance:** Often, returning each party to the position he was in prior to execution of the contract will mean that one party must pay ***restitution*** to the other. (Restitution is discussed more fully *infra*, p. 330.) In essence, the requirement of restitution means that ***each party must return to the other benefits she has received from that other.*** In the simple case of a contract for the sale of land or goods, restitution will mean that the seller must return any money she has received from the buyer, and the buyer must return the goods or re-convey the property.

Example: Seller agrees to sell its interest in a particular parcel of vacant land to Buyer. The contract calls for a down payment plus annual installments. Buyer makes it clear to Seller that Buyer's only intended use for the property is to grow the shrub jojoba on it, something which requires adequate water supplies. After the purchase, wells drilled by Buyer show that there is no adequate water beneath the property. Buyer sues Seller for rescission on grounds of mutual mistake.

Held, for Buyer. Buyer is entitled to return of its down payment. However, Buyer must pay Seller for the ***fair rental value*** of the property during the time Buyer had possession of it. Conversely, Seller must compensate Buyer for any increase in the value of the property brought about by Buyer's efforts. (But Buyer may not recover its reliance damages, i.e., the money it spent drilling test wells.) *Renner v. Kehl*, 722 P.2d 262 (Ariz. 1986).

2. **Reliance damages:** Occasionally, restitution will not be adequate to place the parties in the position they were in prior to execution of the contract. In that event, the court may use other measures of damages; for instance, ***reliance*** damages may be awarded.

3. **Adjustment of contract as substitute for avoidance:** The court may conclude that justice is best served by making an ***adjustment to the contract*** rather than by permitting either party to avoid it entirely on account of mistake. Under the Restatement approach, the availability of an adjustment to the contract is to be taken into account in determining whether the mistake has a "material effect on the agreed exchange of performances" (Rest. §§ 152(1) and (2)) — if such an adjustment would redress the unfairness, the requisite "material effect on the agreed exchange" will not be present.

Example: Seller agrees to convey Blackacre to Buyer. The parties both believe that the tract has 100 acres, and the contract price is calculated based on a per-acre figure. The tract turns out to have only 90 acres. The court will probably order a 10% reduction in the purchase price, rather than allowing Buyer to avoid the contract entirely. Rest. 2d, § 158, Illustr. 1.

Note: Observe that the availability of a court-ordered adjustment to the contract terms may prevent a party from weaseling out of the contract, i.e., seizing upon a mistake to avoid a bargain that is (for reasons entirely unrelated to the mistake) a bad one. For instance, on the facts of the above example, suppose that Buyer realized after making the contract that, apart from the acreage, the price per acre was far above market value. Avoidance would let Buyer escape the bad bargain entirely, whereas adjustment of the purchase price to reflect the missing acreage would keep the basic bargain intact, certainly the fairer result.

VI. REFORMATION AS REMEDY FOR ERROR IN EXPRESSION

A. Error in expression: A quite different kind of mistake is that in which the parties orally agree on a deal, but by mistake prepare and execute a ***document*** which ***incorrectly reflects the oral agreement***. In this situation, either party may obtain from the court a ***reformation*** (i.e., a re-writing) of the written document, so that it correctly reflects the prior agreement.

Example: Seller orally agrees to sell Blackacre to Buyer for $100,000; their oral deal includes a provision that Buyer will also assume an existing mortgage of $50,000. Buyer's lawyer, in preparing the written agreement, neglects to include the assumption provision, and neither Buyer nor Seller notices the omission. At either party's request, the court will reform the document so that it includes the assumption provision. See Rest. 2d, § 155, Illustr. 1.

B. Failure to read: The party resisting reformation may generally ***not*** do so on the grounds that the party seeking reformation was ***negligent*** in not carefully reading the writing to see whether it conformed with the prior agreement. This rule may be viewed as an application of the more general rule that a party's negligence does not prevent him from obtaining relief for mistake (see *supra*, p. 168). See Rest. 2d, § 157, Comment b.

C. Not a remedy for underlying disagreement about deal: Note that reformation is a proper remedy only when the writing ***incorrectly summarizes*** the parties' joint understanding, ***not when the parties fundamentally disagree on what the deal is*** and the writing matches the understanding of one party. In the latter circumstance, typically a court will conclude that there is ***no contract at all*** on account of a ***mutual mistake*** that prevented a meeting of the minds.

Example: Owner has two small structures at the back of his property, a tool shed and a storage shed. He stands with Contractor on the deck of the house overlooking the back yard, and says "Tear down that shed." First, suppose that both parties understand that Owner was referring to the tool shed, but that a writing prepared by Contractor's assistant mistakenly specified the storage shed, and both parties signed without noticing the problem. Here, reformation would an appropriate remedy — a court will order that the document be interpreted as if it called for demolition of the tool shed.

But now, suppose that Owner intended to refer to the tool shed, but Contractor reasonably believed that Owner was referring to the storage shed. If Contractor's assistant drafts a writing calling for demolition of the storage shed, and both parties sign it without Owner's recognizing that it doesn't match his understanding, reformation will not be an appropriate remedy because the parties do not agree on what the underlying deal is. Instead, the correct remedy is to discharge the contract for mutual mistake about a basic aspect of the agreement (see *supra*, p. 157).

D. Relevance to parol evidence rule: The right to obtain reformation of a writing that does not correctly reflect a prior agreement may be viewed as an exception to the ***parol evidence rule***. That rule (*infra*, p. 176) prevents a party to certain types of writings from showing that there were prior written or oral understandings that conflict with the writing.

Quiz Yourself on
DEFENSES, REMEDIES AND REFORMATION

44. Oliver Douglas enters into the following contract with Arnold Ziffel: "Douglas hereby agrees to sell and Ziffel hereby agrees to buy Green Acres, a 10-acre parcel, at the price of $600 per acre for a total of $6,000." Ziffel plans to use the property as a country home, as Douglas knows.

    (A) Before the deal is completed, Lisa, a county surveyor, measures the property and informs the parties that it is only nine acres. Ziffel wants out of the contract. What relief, if any, would a court likely grant?

    (B) Assume instead that the survey showed the property was really only five acres, and that this would be insufficient for Ziffel's stated purpose for the land. Before the parties learned of this mistake, Ziffel invested in farming equipment at a cost of $3,000. He bought the equipment used at an "As Is" sale, cannot return it, and is not likely to buy a comparable property any time soon at which he could use the equipment. What relief, if any, would a court likely grant?

45. Little Jack Horner enters into an oral agreement with Big Bad Wolf ("BBW") whereby, if BBW can obtain two blackberry pies baked by Little Red Riding Hood's mother within the next two weeks, Little Jack Horner will buy them for $3 a pie. BBW has his attorney draft up a written confirmation of the agreement. The attorney mistakenly writes up the contract as being for three pies at $2 each. No one notices the problem until after the contract is signed; both parties are equally at fault in this. A week later, BBW wants to enforce the terms of the agreement. Little Jack Horner reviews the contract and offers either to take the pies for $2 apiece or rescind the contract. BBW refuses to do either, and seeks the court's assistance to enforce the terms of the oral agreement ($3 price for 2 pies). What result?

Answers

44. (A) Adjustment of the price to $5,400. Although the parties were under a “mutual mistake” with respect to the size of the property, the court will probably not allow the contract to be rescinded, because: (1) the 10% deviation in the size of the property does not have a “material effect on the agreed exchange of performances” (a requirement for relief under the doctrines of both mutual and unilateral mistake); and (2) an adjustment to the contract could alleviate any unfairness created by the mistake. The court will therefore probably adjust the contract to reflect the actual size of the parcel: $600 per acre for *nine* acres, for a total of $5,400.

(B) Rescission, plus a splitting of Ziffel’s out-of-pocket loss. In contrast to the facts in (A), here the mistake appears to go to the very purpose of the contract. Therefore, a court would likely grant rescission of the contract. Rescission, however, will not be sufficient to put the parties back in the positions they were in before the contract was made, since Ziffel has incurred $3,000 in reliance expenses which he cannot avoid by returning the equipment or using it somewhere else. A court will try to split the loss the best it can. Reliance damages may probably appropriate here, and would likely take the form of an order for Ziffel to sell the equipment and then, if there is a shortfall, recover half that shortfall from Douglas.

45. **The court will reform the contract to reflect the intended price and quantity.** When parties have reached an oral agreement and then the agreement is incorrectly reflected in a written document, the court will in essence re-write the agreement to make it conform to the original agreement. This is called a “reformation.”

EXAM TIPS ON MISTAKE

Mistakes as to Existing Fact

- Use the term “mistake,” and the analysis in this chapter, only to cover those situations involving a mistake as to the facts ***as they existed just***

prior to the contract. Where the parties are operating under a mistaken assumption about ***future*** events (e.g., future market prices), use the Impossibility/Impracticability analysis given in Ch. 12.

Mutual Mistake

☛ The topic most frequently tested from this chapter concerns a mistaken assumption made by ***both*** parties to the contract (mutual mistake). Before concluding that there has been a mutual mistake — and that the contract can therefore be avoided by a party who is injured by the mistake — make sure that all 3 requirements are met:

(1) Mutuality. Make sure that ***both parties*** made the same (ultimately wrong) assumption when entering into the agreement.

(2) Materiality. Make sure the assumption was ***"basic"*** to the bargain, and that the mistake had a ***material effect*** on the agreed-upon exchanges. Watch for these situations:

- ☞ **Real estate transactions.** Look out for a sale where there has been a ***mistaken acreage count*** and the total acreage contained in the contract can't be conveyed by the seller.
  - ☞ If the portion of land that cannot be conveyed is large or otherwise significant, then its inclusion was probably a basic assumption of the contract. Bit if the parcel that cannot be conveyed is insignificant (e.g., a 3-foot-wide strip along one end of a 50 acre parcel), then it probably would not be considered a basic assumption of the contract.
- ☞ **Purchase of a unique good.** Look for the purchase of a unique work of art where the parties are mistaken as to its origin or creator. These will probably be basic assumptions.

Example: D, an art dealer, receives from one of her purchasing agents a painting entitled "Sunset" which she is informed was painted by Van Goon. C, an art collector, sees the painting at D's gallery and says to D, "What an interesting Van Goon." D responds (honestly believing that he's telling the truth), "Yes, it is." C pays $50,000 for the painting, its worth had it been a genuine Van Goon. C later finds out that the painting is a forgery worth only a few hundred dollars and stops payment on her check. The assumption about authorship was almost certainly a basic assumption, so C's nonperformance is probably not a breach.

(3) Allocation of risk. Make sure the parties did not explicitly or implicitly ***allocate the risk*** of the mistake to the party who is now trying to avoid the contract. (If they did so allocate the risk, that party can't use the doctrine.) Also, remember that the court can allocate the risk of mistakes wherever it is "reasonable" to do so.

Examples of situations where courts usually find an implicit allocation of risk of mistake:

☞ **Minerals in the land:** The risk that there will turn out to be valuable mineral deposits is allocated to the ***seller***. (*Example:* S and B enter into an agreement for the sale of Farmland for \$8 an acre . Oil is then discovered under the land. S may not avoid the contract, because he'll be found to have implicitly borne this risk, assuming the contract is silent.)

☞ **Building conditions:** In a construction contract, the risk of undiscovered unfavorable building conditions (e.g., unexpected rock that makes excavation much more expensive) is normally allocated to the ***contractor***.

However, always make sure that the contract language or surrounding circumstances don't effectively allocate the risk in a different way.

Unilateral Mistake

☛ Where only ***one party*** has made a mistake (unilateral mistake), he is excused from performance ***only if the other party knew or should have known of the mistake.***

☞ If you don't know whether the other party knew or should have known of the mistake, argue the evidence in support of each view, and then state that the result depends on which way the "knew/should have known" issue is resolved.

☞ *Common fact pattern: A* makes *B* an ***offer*** that *B* realizes (or should realize) is ***"too good to be true"*** (e.g., because it looks like *A* made a computational error). If *B* tries to "snap up" the offer, *A* will likely to able to get the contract rescinded or reformed for unilateral mistake.

☞ **Distinction:** On the other hand, if the error in an offer or bid is ***not obvious*** to one in the offeree's position, then when the offeree accepts, unilateral mistake probably ***won't*** apply.

Example: C, a contractor, solicits bids from sub-contractors for a construction job to be performed for X. S, a sub-contractor, delivers a bid for the foundation work in the amount of $140,000. The next lowest bid that is submitted to C is $150,000. Relying on S's bid, C immediately submits its overall bid to X. Fifteen minutes later, S telephones C and says that there was a mistake in the calculation and revises its bid to $170,000. Since the next lowest bid was only $10,000 more than S's bid, C probably did *not* have reason to know that S's bid was a mistake, in which case S will be not be able to rescind based upon unilateral mistake.

Reformation

☛ If there is a clerical error and a written agreement ***doesn't accurately reflect the parties' agreement,*** the aggrieved party can have the contract ***reformed*** to reflect the prior agreement. This usually occurs regarding price: the contract states a different price than the one agreed upon, or leaves out the agreed-upon price altogether.

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1. For the offer-and-acceptance aspect of the case, see *supra*, p. 12.