

6. Does the warning on cigarette packages that "Smoking by Pregnant Women May Result in Fetal Injury ..." operate as an exculpatory clause to the cigarette company?
7. If an action (e.g., murder) is a crime by reason of a statute, will it usually also be a crime by reason of public policy?

## TERMS FOR STUDY

*ab initio*

blue laws

capacity

disaffirmance

exculpatory clause

insanity

intoxication

minor

necessaries

public policy

usury

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## PRACTICAL APPLICATION

1. Just after his seventeenth birthday, Murdock Minor signs a contract with Scholarship Books, Inc., for a correspondence course in geology. The cost of this course is \$1,000, payable in 20 monthly installments of \$50.00 each. There are 20 units, each completed monthly. Murdock completes 14 units and makes monthly payments promptly. In the fifteenth month, he seeks to rescind the contract. Can he do so?
2. Fran Flighty, the 17-year-old daughter of wealthy parents, is visiting an aunt in Honolulu. While there, she signs a contract with the ABC Dancing School whereby she is to be taught "all sophisticated modern dances for young and old alike" in "12 easy lessons." Fran takes no lessons, makes no payments, and seeks to rescind the contract when the ABC Company threatens to sue.
  - (a) What will be the result?
  - (b) What would happen if she took the lessons and refused to pay just after her eighteenth birthday?
3. Dan Diver is a 22-year-old student at Ambiance Air Academy in Smalltown, Any State. He joins a parachute diving club to "experience the exhilaration of diving" and to "engage in the world's most exciting sport," according to a contract he signs with the club, Live-Long Divers, Inc. The contract also contains an exculpatory clause releasing the club for damages due to any reason whatsoever, "including negligence by the Club." While descending via parachute on his first jump, Dan collides with electric power lines and is seriously injured. Would the exculpatory clause excuse Live-Long Divers, Inc., if it should be found negligent?

## ANSWERS

### KNOW THE CONCEPTS

1. The term “capacity” relates to the ability of one mind to meet another mind. This ability may not yet be developed in a minor and may be clouded or confused by insanity.
2. A reason for permitting such a suit is that fraud is a tort, and minors are responsible for this kind of tort if all other requirements of fraud are met. A reason not to permit such a suit is that it indirectly permits the adult party to obtain the same benefits he/she would have received for the minor’s breach of contract.
3. A court of law cannot be a party to that which is unlawful.
4. Public policy is “grounded” in common morality. Thus, an agreement contrary to public policy is simply one that is contrary to general morality. Restraint of trade is contrary to fairness and good morals. The same is true of an excessively broad exculpatory clause, as well as other illegality.
5. An intoxicated person becomes intoxicated by reason of his/her own freedom of action and is not within a class of persons whom society seeks to protect. Thus, unless the intoxication is evident to the other party, he/she is bound by a contract made while intoxicated.
6. In current cases, cigarette companies are attempting to use the Surgeon General’s warning as an exculpatory clause. However, such a clause does not excuse their negligence, or active, intentional infliction of harm, if a jury finds such to be the case.
7. Actions made criminal by statute are usually contrary to prevailing morality and, hence, contrary to public policy. Murder, arson, robbery, and so forth are contrary to public policy. Some crimes—speeding, failure to file income tax returns, failure to register securities being offered to the public—arguably are criminal only because they are in violation of a statute.

### PRACTICAL APPLICATION

1. No. Murdock has ratified the contract by continuing to take the course and making payments after his eighteenth birthday.
2. (a) This contract by a minor is not enforceable as an express or implied-in-fact contract. The dance studio might argue that it is a contract for necessities and that there is a liability in quasi contract. However, since the lessons were never taken and no benefit has been received, there is no such liability.

- (b) If Fran had taken the lessons, she might be required to pay in quasi contract if the lessons could be considered necessities. Whether “sophisticated modern dancing” lessons are “necessary” for the teenage daughter of wealthy parents is a jury question.
3. Dan Diver does not have to take parachute diving lessons, and even if he did he could choose some other club—thus the parties are in equal bargaining positions. However, the clause should not operate to excuse the club from its own negligence, even though Dan proceeded to take the lessons at his own risk.

# 7

## THE STATUTE OF FRAUDS; PAROL EVIDENCE RULE; PRIVACY

### KEY TERMS

**Statute of Frauds** the statutory requirement that certain agreements must be evinced by a memorandum in writing

**Parol evidence** evidence concerning a written agreement that is not part of the writing

**privity** the requirement that a person be one of the parties to a contract in order to have a legal interest in the contract

Up to this point we have emphasized the mental nature of contracts—in fact, we have stated that written and oral words are mere evidence of the mental condition comprising the contract. However, some contracts require more than a provable mental condition.

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## THE STATUTE OF FRAUDS

In 1677, the British Parliament passed “An Act for the Prevention of Frauds and Perjuries,” generally referred to as the **Statute of Frauds**. *This act was designed to prevent the perpetration of frauds arising out of purely oral agreements.* It required that there be specified evidence in writing (called a “memorandum”) about certain kinds of contracts that the Parliament considered particularly subject to perjury, abuse, and frauds.

When the various states adopted the common law of England in 1776, this common law included the English statute law then in effect, including the Statute of Frauds. All 50 states, to this very day, follow the old English Statute of Frauds as part of their common law, and in addition follow the Uniform Commercial Code statute of frauds provision relating to sales contracts. The British, however, have repealed the original Statute of Frauds.

The Statute of Frauds has two features: (1) it covers certain categories of contracts, and (2) it requires that there be a written memorandum about contracts within these stated categories.

## SCOPE OF THE STATUTE OF FRAUDS

The Statute of Frauds relates to six kinds of contracts that require written evidence:

1. A contract calling for the sale of land or an interest therein.
2. A contract not to be performed within one year.
3. A contract for the sale of goods for a price of \$500 or more.
4. A promise by one person to pay the debt of another.
5. A promise made in consideration of marriage.
6. A promise by the executor or administrator of an estate to pay a debt of the estate out of his/her own funds.

The meanings of specific words and phrases in contracts within these six categories are, of course, subject to judicial interpretation.

A brief explanation of each of these various contract categories follows.

1. **A contract for the sale of land or an interest in land.** This category covers real estate contracts, leases, and easements (rights of way and the like), as well as buildings, growing crops, trees, and other property attached more or less permanently to real estate. There is one important exception to the written evidence requirement: most states, by statute, provide that an oral lease for one year or less is valid.

2. **A contract not to be performed within one year.**

If it is *possible* for a contract to be performed within a year, a memorandum is not necessary.

A contract made January 1 for 2 years must have a written memorandum; a contract made January 1 for 1 year may be oral since the contract can be performed within a year. A contract to do work "for life" may also be oral, since the law acknowledges that a person may die within a year and thus fully perform the contract. Similarly, a contract for 5 years terminable at any time upon 90 days, prior notice (or some other notice provision of 1 year or less) is a valid oral agreement.<sup>1</sup>

3. **A contract for the sale of goods for a price of \$500 or more.** This requirement is embodied in Uniform Commercial Code (UCC) section 2-201. UCC 2-201(3)(c) makes it clear that the statute covers only fully executory (unperformed) contracts. Once the goods have been delivered, the money can be recovered on an oral agreement; likewise, if the money has been paid, the goods can be demanded, again on an oral contract.

4. **A promise by one person to pay the debt of another.** This provision generally relates to *contracts of guaranty*, and is sometimes called the "suretyship provision." The contract of guaranty actually involves two contracts: (1) X is indebted to Y on a contract, and (2) as part of a separate contract between A and Y (with consideration going from each party to the other) A assures Y that, if X does not pay, A will pay. It is this second contract, a guarantee of one person's performance by another person, that is subject to the Statute of Frauds. Such contracts are generally not enforceable if oral.

5. and 6. **A Promise made in consideration of marriage and executors' contracts.** These two categories are somewhat archaic and narrowly technical. The category relating to marriage was not intended to be applicable to the promise to marry, that is, it does not involve an engagement to marry, which itself is not a legally binding contract. Rather, it was intended to involve **dowry**—the agreement of a woman (or her father) to pay consideration (money or land) to the intended husband. Although dowry agreements are not common in the United States, *prenuptial (or antenuptial) agreements are covered by the Statute of Frauds since such agreements usually involve a division of property upon death or separation and are made in consideration of marriage.*

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<sup>1</sup> This possibility test states that if the terms of the contract do not require completion to occur more than one year after the contract was entered into and if it is at all possible for the contract to be completed within that first year, then the contract does not fall under the Statute of Frauds. However, a minority of states, including Florida, require that more contracts evince a writing than does this possibility test. Instead of just looking for possibilities of performance within a year, however remote, this minority approach is as follows: (1) When a contract does not provide any agreed upon time period, the court is to examine the contract's purpose and the surrounding circumstances to decide whether the parties must have intended for the contract period to extend longer than a year. (2) If it clearly appears that a longer period was intended, although less than a year was possible, then the contract (under this minority approach) must meet the Statute of Frauds.

The executors' contract relates to the promises of administrators or executors (sometimes called "personal representatives") to pay the estates' debts from their own pockets. This promise is like the agreement to pay the debts of another, and the memorandum in writing is required.

## THE MEMORANDUM IN WRITING

**Caution:** It is misleading to say that the Statute of Frauds requires that certain contracts be in writing.

The Statute of Frauds requires, not that the entire contract be reduced to a written document, but only that there be some written evidence of the agreement. Several documents, letters, or notations may be read together as a memorandum if all clearly pertain to the disputed transaction.

The memorandum in writing must meet the following minimum requirements:

1. It must identify all the essential parts of the transaction. (This requirement is satisfied if only the *quantity of goods* is referred to in a sales contract subject to exceptions made by the Uniform Commercial Code).
2. It must have been signed by the party being charged (sued) in case of a dispute.
3. It must identify the other party to the agreement.

The contents of item 1 may vary from circumstance to circumstance, but usually a description of the price or consideration, as well as the nature or identification of the items being sold or the work to be done, is required. Note in items 2 and 3 that, although both parties must be identified, both parties do not have to sign; only the party against whom suit is being brought or against whom the claim is being made must have signed. Many legal writers and courts are critical of this one-sided requirement, since only one party (the signer) may be sued, not the other party. Moreover, in this rule, as well as most other rules of law pertaining to signing, *any* signing is sufficient: initials, a stamped or typed signature, a nickname, and the like.

Since the common law favors the enforceability of agreements, *the Statute of Frauds is strictly applied*; that is, if possible, a court will permit an agreement to stand if there is reasonable evidence that the written memorandum is adequate (or, in some cases, if a party asserting the

statute has admitted there was in fact a contract, e.g., under UCC 2-201(3)(b), an admitted oral sales contract is enforceable up to the quantity of goods admitted). Moreover, the statute of frauds will not bar enforcement of a contract for specially-made goods, even though it is a sale for \$500 or more and lacks the necessary written evidence. UCC 2-201(3)(a) states that such a contract is enforceable “if the goods are to be specially manufactured for the buyer and are not suitable for sale to others in the ordinary course of the seller’s business and the seller, before notice of repudiation is received and under circumstances which reasonably indicate that the goods are for the buyer, has made either a substantial beginning of their manufacture or commitments for their procurement.”

## THE UETA AND ESIGN

The **Uniform Electronic Transaction Act** of 1999 (**UETA**), a model state law enacted in 41 states, and the federal **Electronic Signatures in Global and National Commerce Act** of 2000 (**ESIGN**) both try to bolster enforcement of electronic contracts. They are procedural statutes that defer to existing substantive law but remove any barriers in those substantive laws that are based upon the method of transaction. For example, UETA permits notary publics to act electronically, thus eliminating stamp or seal requirements.

The UETA strives to eliminate obstacles that the Statute of Frauds might impose by stating four basic principles, at §7: (a) A record or signature may not be denied legal effect solely because it is in electronic form; (b) A contract may not be denied legal effect solely because an electronic record was used in its formation; (c) If a law requires a record to be in writing, an electronic record satisfies the law; and (d) If a law requires a signature, an electronic signature satisfies the law. Pursuant to these principles, electronic records and signatures may take the place of traditional paper and ink, “The medium in which a record, signature, or contract is created, presented or retained does not affect its legal significance,” UETA §7, comment 1.

ESIGN also permits parties to sign online—“a signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form.” ESIGN thus likewise counters any Statute of Frauds defense, as people can buy insurance, open bank accounts, buy securities, get a new mortgage, or take other online actions without signing a piece of paper. The electronic signature under ESIGN can take many forms, whether with passwords, a person’s voice on an answering machine, a digital signature, using the standard web page click-through process, identifiers based on thumbprints, or other evolving technologies.

*UETA and ESIGN do not mandate the use of electronic records or signatures and thus apply only if the parties agree to conduct transactions by electronic means.* The documents offered electronically to consumers must be transmitted “in a manner that reasonably demonstrates that the consumer can access information in the electronic form,” the Federal Trade Commission has held.

If a law outside the UETA requires a person to provide, send, or deliver information in writing to another, that information may be communicated in an electronic record that the recipient is able to retain. To be effective, the electronic record must follow any formatting, type size, or other requirements imposed by the law requiring the information. If, however, the law explicitly requires that the information be communicated by a specific method (e.g., registered U.S. mail), that method must be used. (The UETA even provides that, in a legal proceeding, evidence of a record or signature may not be excluded solely because it is in electronic form, UETA §13.)

ESIGN protects customers in the following six ways. (1) A customer cannot be forced to use an e-signature—the company has to offer the option of a paper contract, although it can charge extra for it. (2) A customer must be told how to withdraw his/her consent for an electronic account and have notices sent by mail, instead. (3) E-signature deals have to be confirmed by computer to prove that the customer understood the rules. (4) All notices about an account will arrive by e-mail so that the company also has to confirm that the customer's system can open the electronic envelopes. (5) The electronic contract is to be saved via a method that renders the document unalterable. (6) Critical notices (e.g., utility shutoffs, evictions, foreclosure notices, terminations of health insurance, and most product recalls) must still be sent via the U.S. mail.

Neither UETA nor ESIGN applies to the writing requirements for UCC articles 3 through 9 (every article but 2 and 2A) and/or for the creation of wills, codicils, or testamentary trusts. Because the UETA and ESIGN are similar, it usually would not matter which law applies. However, ESIGN specifically provides that *if a state has enacted UETA, then UETA rather than ESIGN will govern* the exceptions to the state's Statute of Frauds. Therefore, as the UETA has now been adopted in so many states, the UETA is the governing law in most cases.

## OTHER COMMENTS ON THE STATUTE OF FRAUDS

*The Statute of Frauds relates only to executory contracts.* Once an oral agreement has been carried out by both parties, the court will not nullify the performed agreement. Moreover, if the oral agreement has been partly or fully performed by one party, a quasi-contract action may be

brought for the value of benefits rendered.

With regard to real estate contracts subject to the Statute of Frauds, an oral contract may be enforceable by the buyer even without the memorandum in writing if he/she has paid some or all of the purchase price *and* has taken possession of the property.

**Practical advice:** Regardless of whether the Statute of Frauds applies, put agreements in writing.

1. While writing, one often thinks of things that should be covered.
2. The writing process helps to clarify terms, hence making the contract better.
3. The written document serves as (a) evidence that there was a contract, and (b) evidence of the agreement terms. Memories fade, but written evidence remains.

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## PAROL EVIDENCE RULE

*The parol evidence rule prohibits either of the parties from contradicting or invalidating a fully written contract by means of evidence prior or contemporaneous to the contract and external to the contract.* If the parties have reduced their agreement to writing, why should they be permitted to introduce other evidence contrary to their own written understanding?

Although the word “parol” is derived from a Latin word meaning “oral,” the rule prohibits *any* outside (extrinsic) evidence that contradicts or alters the written agreement. Great care should be used, however, in attempting to apply this broadly stated rule, because the exceptions are also broad and the courts are reluctant to withhold evidence of clear understandings freely assented to by both parties.

The following types of evidence may be introduced concerning matter *outside* the written contract:

1. *Evidence explaining, clarifying, or elaborating upon the agreement.*
2. *Evidence concerning later dealings* between the parties, particularly if there was mutual consideration, or reliance by either party, with respect to such dealings.
3. *Evidence tending to prove* that the parties did not intend the writing to be a contract, or that the transaction was signed under duress or tainted by fraud, or that other factors would render the agreement void *ab initio*.

4. *Evidence completing* an incomplete written agreement.
5. Evidence that a condition was to occur before the contract was to be enforced, and that condition did not happen.
6. For a sale of goods, explanatory or supplemental evidence of a custom (trade usage) or of the parties' prior repeated actions (course of dealing, course of performance) in similar situations (UCC 2-202).

## YOU SHOULD REMEMBER

The Statute of Frauds requires that there be written evidence (called a "memorandum") for certain kinds of contracts: a contract for the sale of land or an interest in land, a contract not to be performed within a year, a provision by one person to pay the debts of another, a promise made in consideration of marriage, an executor's promise to pay a debt of the estate from his/her own funds. In addition, the Uniform Commercial Code requires written evidence for a contract for the sale of goods for \$500 or more.

The memorandum in writing does not have to be a fully written contract, but it must (1) include all the essential parts of the transaction, (2) have been signed by the party being sued, and (3) identify the other party to the agreement.

The parol evidence rule prohibits any extrinsic (outside) evidence that contradicts or alters a written agreement. Exceptions to the rule, however, are very broad.

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## PRIVITY

Privity is the old common law requirement that *for a person to have a legal interest or right in a contract he/she must be a party to the contract.*

### Exceptions to the Privity Doctrine

Modern common law has grafted two very important exceptions onto the privity doctrine: first, one party to the contract can assign his/her rights to someone else; second, sometimes an outside party intended to benefit by the contract may sue on the contract in order to obtain his/her benefit.

## ASSIGNMENT OF RIGHTS

Each party to a contract enjoys a right but is also burdened with a duty. If A agrees to sell his hat to B for \$20 and B agrees to buy A's hat for \$20, A has a right (to receive \$20) and A also has a duty (to deliver the hat); B has a right (to receive the hat) and B also has a duty (to deliver the \$20).

*Rights are freely assignable.* Thus A could assign his right to receive the \$20 to C; B could assign his right to receive the hat to D.

*Example: Assignment of Rights*

Smith gives Thompson an option contract to purchase his property, known as Blackacre, for \$100,000. Thompson can freely assign the option (the right to buy Blackacre) to Sanders, and Sanders can show up at the place of sale and purchase the property in the place of Thompson.

Whenever rights are assigned, the party to whom they are assigned (called the **assignee**) is simply substituted for the person making the assignment (called the **assignor**). In the example above, Thompson is the assignor, and Sanders is the assignee. This substitution of parties gives the assignee precisely the same rights and duties as the assignor, that is, the assignee is said "to stand in the shoes of the assignor."

This "standing in the shoes" principle is one of the most important rules of contract law and of commercial law generally.

Suppose that one purchases a boat and signs a contract of sale calling for making certain payments. If the seller of the boat assigns to any third party, such as a bank, the right to receive the payments under the contract, the assignee is substituted for the seller (assignor). If a dispute arises, *any defense (breach of contract, defects in the boat, or other claim of any kind) is good against the assignee to the same extent as against the seller (assignor).*

### • **TWO RIGHTS THAT CANNOT BE ASSIGNED**

*The right to receive personal services* cannot be freely assigned. Thus, if Employee X agrees to perform clerical services in Y's store, and Y sells her store to Z, Z cannot claim the services of Employee X even though Y may have attempted to assign this employment agreement to Z.

Also, *the right to purchase goods on credit* generally cannot be assigned because it is based on a credit rating of the original party.

### • **PROHIBITION OF ASSIGNMENT**

The contract *may expressly forbid assignment* by one or by both parties. A milder prohibition may require that the person wanting to assign must obtain the consent of the other party. To this requirement of consent is sometimes added the phrase “which consent shall not unreasonably be withheld.”

In case of doubt, if you do not want your contract assigned, place a prohibition in the contract, or require consent of both parties for an assignment.

## DELEGATION OF DUTIES

Whether duties to be performed under a contract can be delegated to someone else must be examined on a case-by-case basis. Routine duties, that is, duties that do not require any personal skill or reliability, can be delegated. On the other hand, if the performing party was chosen because of talent, skill, reputation, standing, credit, or the like, such a performing party cannot assign or delegate the duty to perform to some other party. The person contracting to receive this performance is entitled to the work of this skilled or highly regarded person, be he/she a lawyer, doctor, engineer, artist, musician, actor, cabinetmaker, electrician, or other such person; this performer cannot delegate his/her duties to another.

A delivery service, messenger service, meter reader, storekeeper, or other party may perform routine duties that *can* be delegated, but a provision can be made in the contract prohibiting delegation.

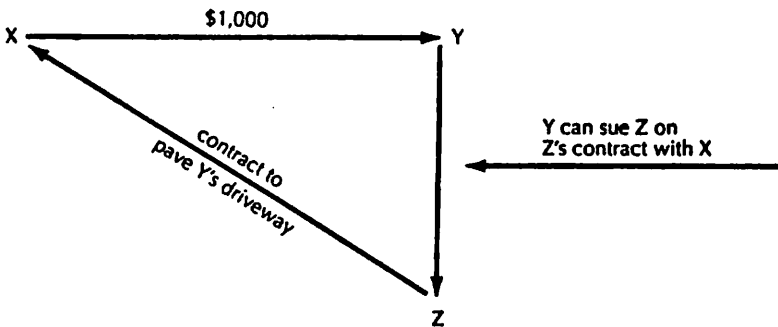
## NOVATION

A **novation** is an agreement among the two contracting parties and a third party whereby all parties agree that this third party shall perform the duties of one of the original parties to the contract. For example, if a patient agrees that a new doctor may assume the duties of a prior doctor under an original contract, and the new doctor accepts the delegation of these duties, this three-way agreement is a novation and the first doctor is relieved of the obligation.

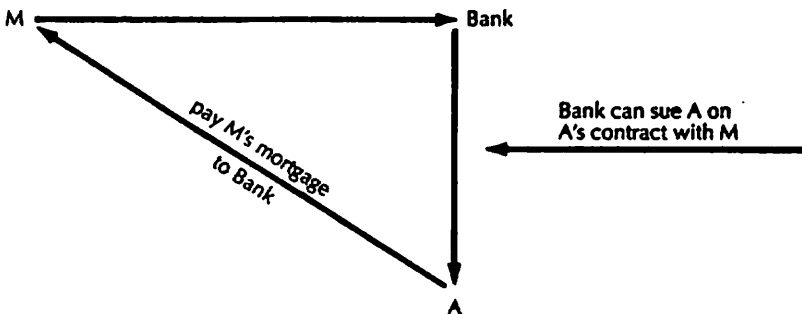
## THIRD-PARTY BENEFICIARIES

The rights of an assignee in a contract constitute one exception to the privity requirement; the other exception is the right of a third-party beneficiary in a contract. A **third-party beneficiary** is a person for whose benefit a contract is made but who is not an actual party to the contract. Two categories of such beneficiaries can bring suit on a contract even though they are not parties to the contract: the creditor beneficiary and the donee beneficiary.

A **creditor beneficiary** is a person who is owed the performance of a contract. If X owes Y \$1,000, which X agrees to pay by having Z pave Y's driveway, Y is the creditor beneficiary of the paving contract between X and Z. Y can sue Z to compel him to perform the paving agreement between Z and X. Of course, if Z cannot or does not perform, Y can still sue X for the \$1,000 original debt.



A common third-party creditor beneficiary is a bank holding, say, a mortgage of M that is assumed by a new party, A. Under the assumption contract, A agrees with M that she will take over (pay) M's mortgage. The bank is the creditor beneficiary of this assumption agreement and may bring suit against A even though the bank is not in privity with M and A on their contract. Of course, the bank may also sue the original mortgagor, M, if A does not pay.



A **donee beneficiary** is the recipient, by gift, of a contractual performance agreed to by two other parties. Thus, if Mr. Smith makes a contract with an insurance company whereby Mrs. Smith will be given certain benefits upon the death of Mr. Smith, Mrs. Smith is a third-party donee beneficiary who can bring suit directly on Mr. Smith's contract with the company if payment is refused upon the death of Mr. Smith.

*Beneficiaries of contracts other than creditor or donee beneficiaries cannot sue on the contracts of other parties.* These "**incidental**" **beneficiaries** do not have a substantial interest in the contract. Although such a person may show a benefit under the contract, the contract was not made expressly *for* him/her or *for* his/her benefit. Thus, if a landlord were to employ security guards for an apartment complex and through the negligence of these guards a tenant's apartment was burglarized, the tenant would have no cause for action (under the lease) against the guards.

## YOU SHOULD REMEMBER

Privity is the requirement that a person must be a party to the contract to bring suit on the contract. There are two major exceptions: the assignment of rights and third-party beneficiaries.

Most rights can be assigned, but as a rule certain others (e.g., the right to receive personal services) cannot.

Routine duties can be delegated, but duties requiring personal skill or reliability generally cannot.

Novation is a three-party agreement permitting one of the parties to be excused and another person to take his/her place.

There are two important types of third-party beneficiaries: creditor beneficiaries and donee beneficiaries.

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## KNOW THE CONCEPTS

### DO YOU KNOW THE BASICS?

1. Does the Statute of Frauds require that certain contracts be in writing?
2. Is an agreement to work for a person for the lifetime of that person subject to the Statute of Frauds?
3. What is the meaning of the sentence "The assignee stands in the shoes of the assignor"?

4. Would the right to enter another person's property and pick fruit from fruit trees be subject to the Statute of Frauds?
5. Explain why an incidental beneficiary cannot sue on contracts to which he/she is a party.

## TERMS FOR STUDY

assignee	novation
assignor	parol evidence
creditor beneficiary	privity
donee beneficiary	Statute of Frauds
dowry	third-party beneficiary
ESIGN	UETA
"incidental" beneficiary	

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## PRACTICAL APPLICATION

1. Evan Eager telephoned the Ardent Cosmetic Company asking for a job as manager of sales. Ardent had advertised this job in a trade publication, stating, in part, as follows: "Exciting opportunity for sales manager with leading cosmetics manufacturer. \$75,000 per year; 2 years to make good."
 

The president of Ardent, Amy Ardent, agreed on the telephone to employ Evan, and he reported for duty the following Monday. Amy also wrote Evan, stating, "Glad you saw our ad in *Cosmetics World*; welcome aboard!"

Amy fires Evan after 6 months, and he sues for 18 months' compensation. What will be the result?
2. Guana Fertilizer Company made a written contract with Rufus Rural to mine phosphate from the "Rural farm in Boise County, Idaho." The contract required Guana to pay a royalty of \$35 per ton for all mineable phosphate taken from the property.
  - (a) Discuss whether parol evidence can be introduced for each of the following purposes: (1) to describe the location of the farm; (2) to define phosphate; (3) to state the depth to which Guana must dig to remove phosphate subject to the royalty.
  - (b) Decide whether the royalty can be paid in Guana Company stock as opposed to cash.
3. Irene Instructor made an agreement to teach at a well-known university for a period of one year for a salary of \$40,000 per year.

- (a) Discuss (1) Irene's right to delegate her teaching position to her friend, Smith, a highly qualified and respected teacher in the same field; (2) The university's right to assign this contract to a nearby university.
- (b) Discuss Irene's right to assign her salary to a bank as collateral for a large farm.

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## ANSWERS

### KNOW THE CONCEPTS

1. The Statute of Frauds requires that there be written *evidence* of certain contracts. This written evidence is a so-called memorandum, not a full contract.
2. No. It is possible for this contract to be performed within one year.
3. The sentence simply means that the assignee has exactly the same rights as did the assignor. The other party to the contract does not have a better or worse position because the contract has been assigned.
4. Yes. Since the fruit is attached to trees, which are in turn attached to the real estate, and since the right to enter property is a right affecting real estate, a memorandum should be prepared as evidence of the agreement.
5. An incidental beneficiary's benefit is too indirect and too remote. When persons make a contract, they should not have to expect that any person in the world can bring suit on their private agreement.

### PRACTICAL APPLICATION

1. This 2-year contract is covered by the Statute of Frauds. There is probably a good memorandum, since the ad contains the basic terms of the contract and Amy's letter is a signed document that can be read with the ad, thus meeting the requirements of the Statute of Frauds.
2. (a) Items (1), (2), and (3) are definable in court by parol evidence, since they do not contradict the terms of the contract. (b) Since the use of a dollar value suggests cash or the equivalent, Guana stock does not meet these requirements and would, therefore, contradict the writing.
3. (a) (1) The teaching position cannot be delegated, since teaching is a personal service and substitution is not permitted. (2) The same answer is true of the right to receive the teaching skill, since again the relationship between the employer and the employee is personal. (b) Irene can assign her salary, however, since this is the mere right to receive money.

# 8

# DISCHARGE; DAMAGES AND OTHER REMEDIES

## KEY TERMS

**discharge** termination or completion of the contract

**condition** a fundamental requirement that must be met by one party before the other party has an obligation under the contract

**damages** the compensation owed to the nonbreaching party to recover any financial loss or injury caused by a breach of contract

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## DISCHARGE

**Discharge** is a general legal term describing the termination or completion of a contract. This word is much broader than “performance,” which denotes only one of several ways in which a contract is brought to an end.

## DISCHARGE BY PERFORMANCE

When a contract is performed by both parties, it is said to be discharged by performance. By “performance” is meant substantial performance, not necessarily performance to the very last detail. To determine whether the essential parts of the contract have been performed, one must usually look at the main provisions of the contract; if these have been achieved, the contract has been substantially performed. Thus, if a contract to build a house and to grade and prepare the lot and lawn is fulfilled except for grading the lot, the contract is “performed,” but the

cost of completing the work can be subtracted from the agreed-upon price. On the other hand, if the contract is not substantially performed, that is, if the house itself is not completed, the contractor can recover, not on his unperformed express contract, but only in quasi contract for the quantum meruit ("going market value"; see Chapter 4) of his limited performance. Of course, the contractor is responsible for his unperformed express contract. Moreover, in many states, a contractor who willfully departs from the contract cannot recover even in *quantum meruit*.

**Tender of Performance:** occurs when a party tenders (presents) an unconditional offer to perform, and the party is truly ready, willing, and able to perform. If the other party rejects the tender, it is as if the first party **performed**.

## CONDITIONS

Conditions are events whose occurrence or nonoccurrence changes, limits, precludes, gives rise to, or terminates a contractual obligation. **Conditions are distinguished from promises.** There is breach of contract liability for broken promises, but with non-completed conditions, there simply is no contract (rather than a breached contract).

There are a number of ways to classify conditions: by formation, there are (1) express conditions and (2) implied conditions; by timing, there are (1) conditions precedent, (2) conditions concurrent, and (3) conditions subsequent.

### • EXPRESS CONDITIONS

**Express conditions** are conditions that the contracting parties *deliberately* create as such in making the contract. Usually, such phrases as "under the following conditions," "on condition that," "of the essence," and "subject to" are used to describe the agreed-upon essentials of the contract. In making a contract, each party should carefully state as essentials or conditions the things that must be done in order to call forth his/her obligation to perform.

### • IMPLIED CONDITIONS

Most contracts, whether oral or written, contain **implied conditions**, some implied in fact or by the nature of the agreement, others implied by law (constructive).

*Example: Implied Condition*

If Arnold agrees to sell his hat to Bert for \$25, it may be implied that the hat to be sold is the hat Arnold is wearing. This would be a condition implied in fact. The law implies that the \$25 is to be cash and not a check.

The conditions set out in the example are implied from the nature of the transaction even though they are not expressly or consciously stated by the parties.

**• TIME OF PERFORMANCE**

Time of performance is usually not an implied condition; if one of the parties strictly requires performance at a certain time, express words of condition should be used. Thus, if a contract to have a house built for A provides "completion to be on or before September 1," failure to add such a phrase as "time being of the essence," or other words of condition, will require A to accept late completion, that is, September 20 or even October, as substantial performance. On the other hand, in the sale of highly perishable goods or of stocks and bonds having rapidly fluctuating values, time of performance could be implied as a condition because of the unusual or peculiar circumstances.

**• SATISFACTORY PERFORMANCE**

*Satisfactory performance* may be called for in the contract. Whether satisfaction is guaranteed as a condition depends on whether the "satisfaction" called for is subjective (a matter of personal taste) or whether the "satisfaction" can be objectively proved. If the satisfaction is subjective, the performer is saying, in effect, "I guarantee that the contract will be completed to your taste," and satisfaction is a condition. Thus, an agreement by painter P to paint C's portrait "to the satisfaction of C" sets up a subjective condition that must be met by P before C is obligated to pay under the contract.

On the other hand, an agreement by B to build a club basement for H "as per plans and specifications attached hereto, to the satisfaction of H," sets up an objective satisfaction for H. In other words, if the plans and specifications are complied with, H cannot unreasonably claim that he is not satisfied. In this case, satisfaction is not a matter of taste, and not a condition.

**• CONDITIONS PRECEDENT, CONCURRENT, AND SUBSEQUENT**

A **condition precedent** is one that must be complied with, or must occur, before the other party becomes obligated for his/her performance.

*Example: A Condition Precedent*

Tom agrees to buy certain property for commercial purposes, provided that Sheila, the seller, obtains proper zoning by an agreed-upon date. The zoning must be obtained before Tom becomes obligated.

**Conditions concurrent** require that performance by both parties take place at the same time. Most conditions fall within the concurrent category: the deed will be delivered when the price is paid or tendered, or the bank will make a mortgage loan when the buyer presents proof of credit.

A **condition subsequent** may abolish liability or obligation: for example, a clause that the seller will be liable for defective goods provided that the buyer gives notice within 30 days of delivery that the goods are defective. Failure to give such notice absolves the seller of any obligation for the defective goods.

## DISCHARGE BY BREACH

If one party to a contract *fails* in a material way *to perform*, the other party has no obligation on the contract—the contract is discharged by breach. Bear in mind, however, that if the contract is substantially performed it is not materially breached. Also, remember that, even when the contract is not substantially performed, the nonbreaching party is responsible for value received (*quantum meruit*) in quasi contract. This value received may be subtracted from damages recovered from the breaching party.

## DISCHARGE BY ANTICIPATORY BREACH

If one of the parties to a contract clearly states or implies that he/she cannot or will not perform as agreed, the other party does not have to sit idly by and await the due date of performance before declaring the contract breached and therefore discharged. Such a statement of nonperformance creates an **anticipatory breach**. Anticipatory breach may be implied by some clear, unambiguous action on the part of one of the parties: sale of goods under contract to the other party to some other person; failure to commence construction of a residence within several days or weeks of the date of completion.

When breach appears probable, but is not certain, the innocent party should demand assurance from the other party that the contract will be performed. For sales contracts, if no assurance is given within a reasonable time (no more than 30 days), repudiation has occurred. UCC 2-609.

## Basic Principle of Anticipatory Breach

An anticipatory breach occurs if one party to a contract clearly states or implies that he/she cannot or will not perform as agreed, even though the time of performance has not yet arrived.

## DISCHARGE BY AGREEMENT OF THE PARTIES

### • **MUTUAL RESCISSION**

Since a contract comes into being by mutual agreement, it can be ended at any time by mutual agreement or mutual rescission. **Mutual rescission** is a contract to end a contract. If the contract is wholly executory, the mutual rescission requires no additional consideration.

Parties may orally agree to end a written agreement, regardless of the formality with which the written contract was made. Indeed, most courts hold that a written agreement providing "This contract shall not be modified except in writing, duly executed by a corporate officer of each of the parties hereto" may nevertheless be orally cancelled provided that the parties effecting the cancellation have the authority to do so.

### • **ACCORD AND SATISFACTION**

Accord and satisfaction discharge a contract in that the parties agree to substitute a new performance in place of, and in satisfaction of, an existing obligation. An essential element is acceptance of the new performance, frequently the doing of an act, as full satisfaction for an obligation to pay money. The **accord** is the agreement to accept the substitution; the performance of the accord is the **satisfaction**.

*Example: Accord and Satisfaction*

Arthur owes Beth \$1,000, which he cannot pay. Arthur agrees to repair the roof on Beth's house in lieu of paying the \$1,000. The agreement to accept the repair is the accord; performance of the repair is the satisfaction.

Acceptance of a new performance in satisfaction of an existing obligation discharges the old obligation and operates as an accord and satisfaction.

### • **A “PAYMENT IN FULL” CHECK**

If there is an unliquidated debt (e.g., a partly or totally contested bill), with a colorable (real) dispute, then payment of part of the alleged debt with a conspicuous statement that payment is “in full,” usually discharges the debtor from any remaining amounts allegedly owed.

But what if the debtor cannot prove that, within a reasonable time before the creditor tried to collect on (receive payment from) the check, the creditor knew the check was tendered as a payment in full? Then, under UCC 3-311, the creditor’s claim for the remainder of the amount supposedly owed is *not discharged* (despite the cashing/depositing of a “payment in full” instrument), *if*:

1. the creditor is an organization, and the debtor was informed reasonably prior to his/her tendering the instrument that all communications about disputed debts, including attempted “payments in full,” are to be sent to a designated person, office, or place; and the instrument or accompanying communication was not received by the designated person, office, or place; or
2. the creditor is an individual or (assuming no payment went to the organization’s designated person, office, or place) is an organization and the creditor proves that, within 90 days after payment of the alleged “payment in full” instrument, the creditor tendered to the debtor repayment of the amount that the creditor received on that instrument.

### • **RELEASE**

Another type of discharge of contract by agreement of the parties is a release. A **release** is an agreement by one party to excuse the other party from performance of his contract. If A and B have a contract, and A is unable to perform or is in breach of contract, he may obtain a release from B by the payment of consideration, usually money, although anything of value will support the discharge. A release is valuable protection when a person has, or may have, breached a contract and wishes to avoid any possibility of suit.

In the case of claimed breaches by both parties, with claims and counterclaims by the contracting parties, mutual releases should be obtained in order to ensure the full discharge of the contract by both parties.

### • **WAIVER**

Section 1-107 of the Uniform Commercial Code provides that “Any claim or right arising out of an alleged breach can be discharged in whole or in part without consideration by a written waiver or renunciation signed and delivered by the aggrieved party.” A **waiver** is the voluntary relinquishment of a party’s rights in a contract. A waiver may result in acceptance of defective or incomplete performance.

One should be careful, therefore, to object to incomplete performance and to serve notice that one's rights are *not* being waived when additional time is granted for performance or a defaulting party is afforded an opportunity for correction.

## DISCHARGE BY OPERATION OF LAW

Four categories of occurrences will operate to discharge a contract as a matter of law: subsequent illegality, impossibility, bankruptcy, and the statute of limitations.

### • **SUBSEQUENT ILLEGALITY**

*Subsequent illegality* is a rather narrow category of discharge. The principle applies to contracts that are legal when made, but become illegal by the subsequent passage of a statute. The example usually given pertains to alcoholic beverages; contracts to buy and sell become illegal by reason of the passage of prohibition laws.

Generally, legislation making certain acts or conditions illegal contains a **grandfather clause**, an exemption for conditions or circumstances (including contracts) existing before the legislation was enacted. Typical of such clauses are those found in zoning statutes: uses in existence before enactment of a law may continue thereafter as "nonconforming" uses even though contrary to the new statute.

A very real, but also narrow, subsequent illegality occurs with the declaration of war. Statutes making "trading with the enemy" illegal would nullify any executory contract requiring commerce with the enemy or even with a neutral if the "enemy" could be shown to benefit. There is a distinction, however, between executed and executory contracts: if the enemy had delivered goods or licensed patent rights (an executed contract as to him) but money was owing or not yet paid (an executory contract as to the buyer or licensee), payment would be suspended until the cessation of hostilities. After the war was over, the former "enemy" could collect!

### • **IMPOSSIBILITY**

If performance becomes "*impossible*," the contract is discharged by operation of law. There are a number of occurrences that may render performance impossible:

- In a personal service contract (e.g., services of a professional such as a lawyer or teacher), the death or incapacitating illness of the performer.
- Destruction of the subject matter of the contract (the property or goods being bought or sold).

- A law or administrative act of government (such as environmental controls prohibiting disposal of wastes or regulating the chemical or toxic content in goods to be manufactured and sold under a contract) that makes performance illegal.
- Acts of God (natural occurrences such as floods or hurricanes that render performance impossible).

“Acts of God” are frequently addressed in contract provisions called *force majeure* clauses. These clauses may excuse nonperformance (or permit delayed performance) because of a *force majeure*, that is, a superior force operating beyond the control of either party to the contract. Such clauses are highly desirable in contracts where performance is vulnerable to natural occurrences or to strikes, inability to obtain raw materials, or other outside “supervening” interferences. Reliance on the general legal principles of impossibility may not suffice, in that simple discharge of contract by the affected party would leave the other party in an unprotected, precarious position. It is best to define in the contract the *force majeure* occurrence in question and to anticipate possible delays and necessary make-up work, the need to purchase elsewhere, and other events occurring because of superior force intervention.

Some courts follow the principle of *strict impossibility*: the only impossibility excusing performance is absolute factual impossibility—the contract could not be performed *at any cost by anyone* under any circumstance. Other courts follow a rule of *commercial impracticability*, that is, if the contract cannot be performed except at excessive and unreasonable cost, the party subject to such cost is excused under the doctrine of impossibility. Courts following the impracticability rule require, however, that some unforeseen contingency occurred, that such contingency was not bargained for in the agreement, and that custom or usage in the business or trade of the contracting parties did not require that one of the parties assume the risk of the contingency.

*Example: Commercial Impracticability*

An excavator agrees to excavate a cellar under an existing building for a specified price. Upon commencing work, the excavator finds that underground springs at the site disproportionately multiply the anticipated costs. Even though it might be possible to do the job at enormous loss, many courts would excuse the contractor from performance on the grounds of economic impracticability, or impossibility.

The Uniform Commercial Code (see Section 2-615) also adopts the rule of commercial impracticability with regard to sales contracts.

### • **BANKRUPTCY**

The Bankruptcy Act provides that certain contracts are discharged by compliance with the act (see Chapter 13). After a proceeding in a bankruptcy court, the debtor is released from all contractual obligations to his/her creditors.

### • **STATUTE OF LIMITATIONS**

The statute of limitations was discussed in Chapter 4. It should be emphasized that, if the promise to perform is renewed following the period of limitation, the contract obligation is revived.

## **YOU SHOULD REMEMBER**

"Discharge" means termination or completion of a contract.

A contract may be discharged by *substantial performance* of the obligation (i.e., it may be "performed" even though minor aspects have not yet been completed). The performing party may bring suit on the contract, but the court will deduct the cost of completion.

A contract may be discharged by meeting the fundamental *conditions* of the agreement. These conditions may either be agreed to in the contract specifically as conditions or be implied. It is important in making a contract to use words of condition to describe the things that are fundamental to the parties.

A contract may be discharged by *breach* if one party fails in a material way to perform his/her obligations.

If a contract is not working out to the satisfaction of both parties, it can be ended by *agreement*. In mutual rescission, this agreement may be written or oral: the only requirement is that there be a meeting of the minds to cancel.

In accord and satisfaction, the parties agree to substitute a new performance in place of, and in satisfaction of, the existing obligation. When one party has failed to perform a contract, or if there is dissatisfaction with his/her performance and fear of a suit by the other party, it is recommended that a release be obtained as protection from a later lawsuit. In a waiver one party voluntarily relinquishes his/her rights in a contract.

A contract may be discharged by *operation of law*. Four kinds of occurrences will operate to discharge a contract as a matter of law: subsequent illegality, impossibility, bankruptcy, and the statute of limitations.

Courts are not in agreement as to the meaning of "impossibility."

Since the terms of impossibility may be subject to argument, it is helpful to put into a contract a *force majeure* clause, which defines impossibilities that may occur during the life of the contract and states the consequences for the person claiming the impossibility. Generally, *force majeure* clauses relate to things beyond the control of the parties to the contract.

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## DAMAGES

The word **damages** refers to the compensation due the nonbreaching party to recover any financial loss or injury caused by a breach of contract. Damages are an essential ingredient in every contract case in a court of law.

### Essential Elements of Plaintiff's Case in a Contract Action

1. Proof of the existence of a contract.
2. Proof that the contract was breached by the defendant.
3. Proof that, as a result of defendant's breach, the plaintiff has been injured or damaged.

Whether the contract action is brought by the plaintiff *pro se* (acting as his own lawyer) in a small claims court, or is a multimillion dollar suit between giant corporations in federal court, these three elements of proof are required.

Sometimes the injury or damage to the plaintiff is negligible, that is, the financial loss to the complaining party is so small as to be practically immeasurable. In that case, the plaintiff will receive only *nominal damages* (\$1 or some other token amount), or plaintiff's case may be dismissed altogether for lack of proof of injury. *De minimis non curat lex* ("the law does not concern itself with trifles"), frequently abbreviated simply as *de minimis*, is an important principle of the law and should be carefully considered before a person goes to court to avenge some perceived violation of principle, hurt feelings, or embarrassment.

## COMPENSATORY DAMAGES

If there has been a material breach of contract and this breach has caused measurable damages to the plaintiff, the court will try to compensate the plaintiff by awarding a sum of money sufficient to make him/her "whole." This sum of money is called **compensatory damages**. In Hammurabi's Code, society compensated the injured party by permitting him to injure the other party in the same manner; modern law places a money value on the injury and takes that money from the wrongdoer as compensation to the injured party.

### *Example: Compensatory Damages*

Smith agreed to sell a new automobile, model X, to Jones for \$10,000. If Smith fails or refuses to sell that automobile to Jones, or for any reason cannot deliver, and if Jones must pay \$12,000 to some other seller for model X, the injury to Jones is \$2,000, and that amount of money from Smith will make him "whole," or will compensate him.

Three principles operate to limit compensatory damages.

### Limitations on the Ability to Be Legally Compensated for Damages

1. Damages must be proved to a *reasonable certainty*.
2. Defendant is liable only for damages that were *reasonably foreseeable* at the time the contract was made or at the time the breach occurred.
3. Plaintiff must use every reasonable effort to *mitigate*, that is, avoid or minimize, the damages.

Because of these three principles, proof of damages may be the most difficult part of the contract case.

#### • **CERTAINTY**

The first principle, *certainty*, eliminates speculative losses. Suppose, for example, that ABC Contractors, Inc. has a contract with Glass Manufacturing Company to build and have operative a glass factory by February 1, time being of the essence. Suppose that the factory is not completed on time, and the Glass Company claims that it would have made profits of over \$1 million during the period of delay in completion. These profits are generally considered too speculative to support an award of damages.

### • FORESEEABILITY

*Foreseeability* of damage at the time of making the contract or at the time of breach is the second limitation on compensatory damages. This principle is a reasonable guide for a party about to breach his/her contract: What will it cost to breach? This question can be answered only in terms of foreseen consequences. Suppose, for example, that a manufacturing company has a breakdown in its operations. It orders certain machinery parts from X Machine Company, such parts to be delivered in 24 hours. If the Machine Company is 3 days late in delivering the machine parts, the manufacturing company would have no basis for lost profits during the 3-day period if loss of these profits would not have been reasonably foreseeable by X Machine Company at the time of the breach.

### • MITIGATION

The requirement of *mitigation* is the third limitation on compensatory damages. **Mitigation** means reduction to a minimum. It is the requirement that the injured party use reasonable efforts to minimize his/her loss.

If the plaintiff fails to mitigate damages, such failure may operate as a complete bar to his/her ability to recover in a breach of contract suit.

Suppose a tenant has a valuable piano under a leaking roof in a rented apartment. If the tenant has the opportunity to move the piano from the leaking area, failure to do so will defeat a contract case (for damages to the piano) against the landlord for breach of the lease provision requiring the roof to be kept in good repair.

#### *Examples: Mitigation Requirement*

1. The duty of a wrongfully fired employee to find comparable employment at the best salary possible.
2. The duty of a landlord to find a new tenant to replace a tenant who broke her lease by moving before the end of the lease period.

Of course, the mitigating plaintiff is entitled to compensation for the cost of mitigation. The fired employee is entitled to reasonable moving expenses to his new job; both the fired employee and the landlord whose tenant moved are entitled to reasonable advertising expenses. These direct costs of mitigation which can reasonably be anticipated by the parties are called **incidental damages** and are generally allowed to plaintiffs as part of their loss.

## CONSEQUENTIAL DAMAGES

**Consequential damages** are also allowed as part of the compensatory damages if the breaching party knew or had reason to know that losses would result from the breach. These indirect damages *can* include injury and lost profits caused by faulty performance *if* the principles of foreseeability and certainty are met. If, for example, an automobile with defective brakes is delivered to a buyer pursuant to a contract, injuries to that buyer and other persons caused by this defect may be the responsibility of the seller. Lost profits may be allowed if the breaching party knew or should have known that the other party expected such profits at the time the contract was made.

It should be emphasized, however, that consequential damages are examined carefully under both the certainty and foreseeability tests; in any event, their inclusion in a specific case is usually a matter for the jury to decide.

## LIQUIDATED DAMAGES

The question of damages is not always a simple one. *It is a good idea, therefore, to consider the inclusion of a damage clause in the contract itself as part of the meeting of the minds.* It is perfectly acceptable to insert a provision that the performing party shall (or shall not) be responsible for damages. A clause creating responsibility may be preceded by a statement that the parties understand and agree that profits in certain amounts are expected and are dependent on timely completion of performance.

Clauses specifying the dollar amount due upon breach are called **liquidated damage** clauses. When these clauses reflect reasonable efforts by the parties to calculate damages, they are enforced by the courts, particularly if the subject matter is such as to make the actual assessment of damages difficult. However, if the clause is found to be a *penalty* (i.e., an unreasonable or arbitrary amount) for nonperformance or breach, it is not judicially enforceable.

## PUNITIVE DAMAGES

**Punitive damages** (to punish), sometimes called **exemplary damages** (to serve as an example), are recoverable in tort cases as punishment for the outrageous, malicious, and oppressive conduct of the defendant. Generally the amount of such damages is a matter for the jury, which may consider not only the oppressiveness or maliciousness

of the conduct, but also the wealth (or lack of wealth) of the defendant, since wealth is a factor in assessing the degree of punishment.

*A distinct majority of the states do not allow punitive damages for breach of contract.* However, when a breach of contract is accompanied by an independent tort (e.g., fraud), this tort (a tort is a private wrong against a person or his/her property; see Chapter 19) may give rise to punitive damages. Also, actions that breach a contract may accompany conduct that is tortious (constitutes a tort), in which case the suit may have both contract and tort counts, the latter seeking punitive damages.

*Example: A Suit with Both Contract and Tort Counts*

Under a contract to deliver goods to the plaintiff's pier by barge, the defendant's barge captain negligently strikes the pier and destroys it. The suit may be both in contract (negligent performance) and tort (negligent destruction of property). If the captain were malicious (acted out of spite) or intoxicated (gross negligence), punitive damages may also be recovered.

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## OTHER REMEDIES

### SPECIFIC PERFORMANCE

In Chapter 1, the equity courts first established in England by the Norman kings were discussed. Certain extraordinary relief requiring the power of the king, such as **specific performance** of contract or injunction, were reserved to the king's equity court; money damages were available in the regular English law courts. This division exists to this day as a matter of technical procedure; however, as in the old law, equity is used only as a matter of last resort. If damages will suffice, the plaintiff must seek them in a regular court of law.

#### Basic Principle of Law

Specific performance of a contract will not be granted if a money award of damages will make the plaintiff "whole."

Suppose X has agreed to sell a new automobile, model Z, to A for \$10,000. If X refuses to perform her contract of sale, A cannot obtain

specific performance in an equity suit. A must buy model Z for the best obtainable price and sue X for the difference in damages.

## Two Kinds of Cases in Which Equity Can Be Counted on for Relief

1. The subject matter of the contract is unique (not available in the marketplace).
2. There is a contract for the conveyance of real estate.

Since real estate is, in a sense, unique, the two categories can really be considered as one.

Suppose that, in the example of the new automobile, the car, instead of being new model Z, were an irreplaceable antique. Equity would then grant relief in specific performance. The same result would apply to parcels of ground, houses, and other items of realty: either buyer or seller can order specific performance in equity.

There is one kind of contract in which specific performance is *not* available: a personal service contract for the work of either a laborer or a professional. These personal service contracts are not enforceable in equity. Courts cannot supervise work to be done; moreover, they cannot be a party to involuntary servitude—a jail term for contempt of court arising out of breach of contract would be a giant step backward in modern law.

## INJUNCTION

Injunction is a second form of relief available in equity in certain situations. An **injunction** is a court order to a person or party to do, or refrain from doing, a specific thing. The equity court order may prohibit a breach of contract that has not yet occurred if the prospective breach threatens “irreparable injury.” For example, in an employment contract in which a person agrees not to work for a competitor in a specific area for a specific period of time after termination of employment, injunction may be obtained to block the person from violation of his/her agreement. In such a case, great injury may result if the employee works for a competitor even briefly, since the new employer may have full access to the first employer’s business secrets through this breach of contract.

## REFORMATION AND RESCISSION

If a judge can determine what the parties truly intended, but a written contract does not reflect the parties' intent, the judge may reform the contract. A *reformation* thus states the actual agreement of the parties. When reformation is impractical or the law of mistake otherwise prevents the "rewriting" of a contract, the judge may order a *rescission*. This equitable remedy means that the contract is canceled (rescinded).

### YOU SHOULD REMEMBER

The law does not concern itself with trifles, and litigation for abstract principles that have no financial implication should be avoided. An award of money damages is the general goal of contract litigation.

The courts will award compensation for damages only if (1) damages can be proved with reasonable certainty, (2) they were reasonably foreseeable when the contract was made, and (3) the plaintiff used every reasonable effort to mitigate damages.

To receive consequential damages for injury or lost profits, the principles of foreseeability and certainty must be met.

A liquidated damage clause should be considered as a provision in every contract. This is an attempt to specify the anticipated dollar loss should the contract be breached. If the amount is unreasonable, it is not enforceable.

Punitive damages are not generally available in a suit involving a simple breach of contract, since they represent a tort remedy. If, however, there is a tort aspect (e.g., fraud) to the contract suit, punitive damages may be claimed.

Equity actions—specific performance and injunction—are extraordinary relief and will not be allowed if money damages will make the plaintiff "whole." Specific performance may be obtained when the subject matter of the contract is unique or it is impossible to have satisfaction without the contract actually being performed. Injunction should be considered where "irreparable" damages will occur in the absence of a court order requiring performance.

## KNOW THE CONCEPTS

### DO YOU KNOW THE BASICS?

1. What is the difference between the words “discharge” and “performance”?
2. Assume that plaintiff P and defendant D had a contract, with P to perform specified services in return for D’s payment. P claims that he has performed the required services, but D refuses to pay P anything. P sues D. What damages award can P receive if:
  - (a) P substantially, but not fully, performed the services?
  - (b) P’s performance of the contract had barely begun and D received only a small benefit?
3. In a contract what words and phrases create express conditions?
4. When does the law consider “satisfaction” to be objective and not a matter of taste? What difference does this distinction make in setting up a “condition”?
5. How can a contract be breached before the date of performance arises?
6. When should one obtain a release?
7. Discuss the legal significance of the word “impracticable.”
8. Is an “act of God” the same as a *force majeure*?
9. Is a contract obligation “wiped out” by the passage of time provided in the statute of limitations?
10. What are the three essential elements to a contract case in court? Which is most difficult to prove?
11. What limits are placed on compensatory damages?
12. When are consequential damages not allowed?
13. What prevents the parties, by mutual agreement, from placing any desired dollar amount of damages in their contract as the definition of liquidated damages if the contract is breached?
14. Why does the court permit a jury to hear about a defendant’s wealth in a case involving punitive damages?
15. Name two equity remedies available in some breach of contract cases.

## TERMS FOR STUDY

accord and satisfaction  
 anticipatory breach  
 breach  
 compensatory damages

conditions  
 conditions concurrent  
 conditions precedent  
 conditions subsequent

consequential damages  
damages  
*de minimis*  
discharge  
exemplary damages  
express conditions  
*force majeure*  
grandfather clause  
implied conditions  
incidental damages

injunction  
liquidated damages  
mitigation  
mutual rescission  
punitive damages  
reformation  
release  
rescission  
specific performance  
waiver

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## PRACTICAL APPLICATION

1. In a contract dated February 15, Wright agreed to build a drugstore on a lot owned by Peoples, near Washington, D.C. The drugstore was to be completed and ready for occupancy by January 1 of the following year. In September, a hurricane struck the Washington area and flooded the work site, where excavations had just been commenced. No further work was done, and Wright walked off the job. On December 1, Peoples declared Wright to be in breach of contract and employed Turner to complete the job. What damages are available to Wright and Peoples, respectively?
2. Gunther, a German national, was the owner of a valuable patent covering dehydrated food processing filed in the U.S. Patent Office. In July 1936, he made a contract with Samson whereby Samson received exclusive rights to manufacture, market, and sell foodstuffs in the United States in accordance with the patent. Samson agreed to pay Gunther a royalty of 12% on all foodstuffs made and sold in accordance with the patent. Samson's payments were duly made until December 7, 1941, at which time Samson ceased these payments for "patriotic reasons." In July 1946, Gunther sued for an "accounting" (statement of sales and amounts due) and for back royalties. What would be the result?
3. Willis, a senior at Charlestown University, rented a room from Thomas by oral lease for a period of 10 months to expire June 1. On January 1, Willis moved from the room without notice to Thomas, but left the room occupied by Goldman, also a student. Thomas accepted Goldman's personal check for the January rent, but Goldman moved out on February 1. Thomas now seeks rent from Willis for the months of February, March, April, and May. Can he collect?
4. Singleton was transferred from employment in Dayton, Ohio, to Atlanta, Georgia. In June, he purchased an old house in Atlanta and made a

contract with “We Fix It” to have the house ready for occupancy by September 1, “time being of the essence.” The contract contained a “liquidated damage” clause providing for damages to Singleton in the amount of \$100 per day for each day, after September 1, required for completion. The house was not ready until October 10. Is this damage clause enforceable if (a) the price of the work was agreed to be \$10,000 and (b) Singleton had a family that included two teen-age children, and (c) the fair rental value of the house was \$400 per month?

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## ANSWERS

### KNOW THE CONCEPTS

1. “Discharge” refers to any of the ways in which a contract may be completed or ended; “performance” is one way to discharge.
2. (a) Because the contract has been substantially, but not fully, performed, P is entitled to the contract amount minus the cost of completion.  
(b) Because performance of the contract has barely begun, P cannot recover on the express contract; P may be entitled, however, to the fair value of the work performed based on quasi contract.
3. “Condition,” “of the essence,” “subject to,” and equivalent words or phrases.
4. “Satisfaction” is considered to be objective if the contract contains a definition of performance, such as a reference to plans and specifications, or if performance is determined by ascertainable criteria. If satisfaction can be objectively proven, it is not a condition.
5. Anticipatory breach may occur before the date of performance arrives, if one party signifies or implies that he/she cannot or will not perform.
6. A release should always be obtained if there could reasonably be a question of performance of one’s contract.
7. Many courts consider that a contract performance is “impossible” if it is commercially “impracticable.” However, some unforeseen contingency must occur that was not bargained for and that custom or usage in the trade or business does not require one to assume.
8. *Force majeure* (superior force) is broader than “act of God” (natural forces), although it includes acts of God. *Force majeure* applies to any third force or action beyond the control or power of the contracting parties.
9. The statute of limitations does not “wipe out” the contractual obligation. This obligation may be revived by renewal of the promise.

10. These three elements are (1) that there was a contract, (2) that defendant breached it, and (3) that as a result of the breach, plaintiff was damaged. Depending on the nature of the case, difficulty of proof varies. An implied-in-fact contract is sometimes hard to prove; where performance is complicated, breach may be difficult to show; damages are difficult to prove when bills were not rendered or accounts not kept.
11. The limits are (1) reasonable certainty, (2) reasonable foreseeability, (3) mitigation of damage.
12. Consequential damages are not allowed if they were not reasonably foreseeable.
13. The parties cannot agree upon an unreasonable, unconscionable amount of damages under the guise of “liquidated” damages. To be enforceable, the agreed-upon damages should be related in some way to the expected or anticipated loss that would occur upon breach.
14. In order to assess an appropriate amount for such damages. A person of great wealth is not punished by a money damage award against him/her to the same extent as is a person of more modest means who is subject to the same award.
15. Specific performance of contract, and injunction to prevent breach of contract.

## PRACTICAL APPLICATION

1. Peoples is entitled to a completed drugstore for the same price as agreed upon by Wright. This “make whole” principle governs this case. Wright is entitled to the value of the work performed in quasi contract, but this amount would no doubt be absorbed by People’s greater damages. The September storm, an act of God, could be *force majeure*, excusing late performance, but Wright gave no notice—he merely walked off the job. Employment of Turner should have occurred early in order to mitigate damages; leaving the work unattended and uncompleted would conflict with the mitigation requirement. Compensatory damages are probably too uncertain; however, incidental damages caused by getting a new contractor to complete the work may well be allowable.
2. Gunther is entitled to the “accounting” and to back royalties during the war years. Samson’s obligations were only suspended during this time (World War II).
3. Thomas is required to mitigate damages by finding a new tenant comparable to Willis, if possible. He found this tenant when he accepted Goldman and Goldman’s rent for January—probably a novation. Willis has no further obligation on the oral lease.

4. Is \$100 a day liquidated damages, or is it an unenforceable penalty? This \$4,000 penalty for 40 days amounts to nearly half the price of the work. It is also too large when compared with the fair rental value of the house (\$400 per month). In all events, there should have been a ceiling (e.g., \$1,000) on the \$100 per day penalty; moreover, it should have been tied to some other ascertainable dollar cost—rental of two hotel rooms, for example. Conclusion: this damage clause is an unenforceable penalty.

# 9

# SPECIAL PROBLEMS CONCERNING SALES CONTRACTS

## KEY TERMS

**chattel** an item of personal property; a movable piece of property

**merchant** one who deals in goods or has knowledge or skill with regard to goods

**sale** transfer of title to goods for a consideration or price

This chapter deals specifically with sales contracts and Article 2 of the Uniform Commercial Code. It serves also as a review of Chapters 4 through 8 on general contract principles. A comparison of the law of sales with the common law of contracts will be helpful in understanding both.

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## ARTICLE 2 OF THE UNIFORM COMMERCIAL CODE

Article 2 of the UCC deals specifically with contracts for the sale of personal property or movables, that is, **chattels** (goods). In many cases the code does not change the common law of contracts, but merely restates or expands that law as it applies to sales. In other cases, although Article 2 is drawn only for the sales contracts of personal property, the courts have tended to extend the code's principles to contracts generally, not just sales contracts.

## YOU SHOULD REMEMBER

Sales contracts are singled out for special treatment in Article 2 of the UCC. However, much of Article 2 is the same as the common law or merely expands upon the general law of contracts. In addition, much of the general law of contracts is applicable to contracts of sale.

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## PRINCIPAL CHANGES FOR SALES CONTRACTS IN ARTICLE 2

### HIGHER STANDARDS FOR MERCHANTS

Article 2 imposes higher standards of conduct on merchants than on nonmerchants. Section 2-104(1) defines a **merchant** as one “who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction....”

A number of provisions of the code implement the higher standards for merchants. For example:

(a) Section 2-103(1)(b): *Every* contract imposes on the parties an obligation of “good faith.” “Good faith” in the case of *a merchant* means both “honesty” and the observance of “reasonable commercial standards of fair dealing in the trade.”

(b) Section 2-201(2): A written confirmation *from one merchant to the other* of an oral agreement satisfies the Statute of Frauds unless the recipient, within 10 days, objects in writing.

(c) Section 2-205: A written firm offer of a *merchant* to buy or sell goods is irrevocable even without consideration, for up to 3 months. (See page 84.)

(d) Section 2-207(2): *Between merchants*, an acceptance may vary the offer, without being treated as a rejection, unless (i) the offer prohibits such varying, (ii) the proposed terms *materially* alter the offer, or (iii) the offeror objects within a reasonable time. Section 207(1) provides that, as to nonmerchants, an acceptance with new terms is an acceptance of the offer as made, not a rejection. The new terms are treated as proposals for additions to the contract unless the offeree specifies, as a condition, that they must be part of the agreement. This section attempts to solve a

“battle of forms” in which each party tries to bind the other to his/her version of the contract by a last communication containing such a version. How can merchants avoid the “battle of the forms”? Merchants should limit acceptance to the terms of the offer or should closely monitor the form of all “acceptances.”

(e) Sections 2-312(3) and 2-314(1): These provide for implied warranties of merchantability and ownership by merchants.

## STATUTE OF FRAUDS

Under the UCC, an agreement for the sale of goods for \$500 or more is subject to the Statute of Frauds. The requirement that the principal terms of the agreement be stated is satisfied if there is “some writing sufficient to indicate that a contract for sale has been made between the parties,” but the contract is not enforceable for any quantity of goods beyond that shown in the writing. A reference to price is not required.

## GREATER FLEXIBILITY

In general, *more relaxed, flexible rules* are permitted in the creation of sales contracts to carry out the intent of the parties. For example, the common law requires agreement on price before a contract can be said to have been formed. Under the code, a contract for the sale of goods may be silent about price, permitting the parties to set as a price whatever is “reasonable” at the time of delivery of goods. A clause permitting either party to fix the price is enforceable under the code, requiring the party setting the price to act in good faith.

## INTERPRETATION OF THE AGREEMENT

To interpret a contract a jury or court tries to determine the intention of the parties. Article 2 of the code sets out certain criteria for determining the meaning of a sales contract. These principles, developed from the common law of contracts, are that intent is shown by (a) “the course of performance accepted or acquiesced in without objection” [Section 2-208(1)] and (b) “a sequence of previous conduct between the parties ... as establishing a common basis of understanding for interpreting their expressions and other conduct,” and (c) “practice or method of dealing ... in a place, vocation or trade....” These rules of interpretation, although specifically for sales contracts, are widely used by the courts to determine the meaning of any contract.

**Caution:** As stated previously, Article 2 of the code is limited to *sales of personal property* (movables or chattels). It does not cover sales of real estate, nor does it apply to contracts for services or for employment. If personal property is conveyed along with real estate, or if the contract calls for both services and sales (such as supplying and installing automobile parts, or supplying blood for a blood transfusion), the courts attempt to determine whether the predominant factor, or primary purpose, of the contract is to supply services (not covered by the code) or goods (covered by the code). This primary purpose, of course, is shown by the intent of the parties, the nature of the transaction, the terms of the contract, and the like. Thus the sale of a residence, including furniture and lawn equipment, would *not* be covered by the code; a blood transfusion has been held by some courts to be covered by the code, although other courts disagree. However, a vaccination is generally considered a sale of vaccine and hence a transaction under the code!

## YOU SHOULD REMEMBER

The principal ways in which the UCC changes sales contracts are as follows:

1. For merchants the code provides that
  - (a) higher standards of conduct must prevail;
  - (b) written confirmation of an oral agreement may satisfy the Statute of Frauds;
  - (c) a firm offer to buy or sell goods may be irrevocable;
  - (d) an acceptance may vary an offer without being considered a rejection;
  - (e) implied warranties of merchantability and ownership are established.
2. The code establishes a Statute of Frauds for the sale of goods for \$500 or more.
3. The code provides for more flexible rules in determining the existence of a sales contract.
4. The code lays down specific criteria for determining the meaning of a sales contract; these criteria are less technical and rely on performance, past conduct, and custom.
5. The sales contract changes in the UCC have influenced courts with regard to the conduct of sellers (courts have become buyer oriented) and the interpretation of contracts generally.

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## **THE CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS**

Although international trade has taken place since there were first "nations," the emergence of multinational and global business enterprises is a twentieth-century phenomenon. As early as the 1930s, the political, legal, and business leaders of many nations saw the need for, and began to develop, uniform laws to cover contracts for the international sale of goods. The ultimate result of this important legal development was the 1980 Vienna Convention on Contracts for the International Sale of Goods, or CISG. Sixty-two countries, including most important trading nations, have ratified the CISG. (Key nonsignatories include Brazil, India, Japan, and the United Kingdom.) The CISG, as a compromise between the common law/UCC system and the Civil Law system, has been picked upon by courts and other authorities as evidence of international custom.

The United States ratified the CISG in 1987. It thereby became the governing law for most international sales transactions carried out by U.S. firms.

The CISG applies only to contracts between business entities located in two different countries, both of which have ratified the CISG. The application of CISG provisions is not mandatory, however, because any U.S. company dealing with a firm located in another signatory country can, by agreement, provide that another law, and not the CISG, will apply. The specific language used in such a provision must be as follows:

The provisions of the Uniform Commercial Code as adopted by the state of [e.g., Florida] and not the Convention on Contracts for the International Sale of Goods, apply.

The CISG does not apply to domestic sales (e.g., between parties both from the same country), to noncommercial sales (consumer sales of goods bought for family, household, or personal use), or to the sale of services. In situations in which an international contract calls for both services and goods, if the sale of goods outweighs the sale of services then the CISG applies. In these respects, the CISG is very similar to the Uniform Commercial Code.

Like the UCC for domestic sales, the CISG generally controls only when the parties to an international transaction have failed to specify in writing the precise terms of the contract. That is when the CISG fills in the terms for the parties. Here are some specific contract law resolutions under the CISG that differ from domestic American law.

## THE FIRM OFFER RULE

The CISG's firm offer rule does not, as the UCC does, require a signed writing (except in those nations that specifically require written contracting). Further, *the creation of a CISG firm offer is more casually established than under the UCC*. CISG Article 16(2) states, "An offer cannot be revoked: (a) if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable; or, (b) if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer." Additionally, the CISG does not limit firm offers to a three-month maximum, as the UCC does.

## THE BATTLE OF THE FORMS

The *mirror image rule* has been followed in many nations (e.g., under both the common law tradition of Great Britain and the Civil Law of France). It is, in effect, the law under CISG Article 19(3), which defines "additional or different terms" (material terms) between an offer and an acceptance in such broad, sweeping language—covering, among other things, anything related to price, payment, quality and quantity of goods, place and time of delivery, liability, and settlement of disputes. Thus, *almost all offer/acceptance differences appear to be material alterations and mean that no contract was formed*.

The offeror could ignore the significance of a contrary response and act as if a contract has been formed. Thus the offeror may have "accepted" the offeree's proposed terms. The offeror's conduct—by not objecting (not even orally) to the reply's discrepancies could lead, under CISG Article 19(2), to a contract, with the terms those of the so-called acceptance rather than the offer. Moreover, trade usage, course of performance, and industry standards are clearly important under the CISG. Article 9 of the CISG says, "(1) The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves; (2) the parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned."

Still, CISG Article 19(1) states that any reply to an offer purporting to be an acceptance but containing "additions, limitations or other modifications" is a rejection and a counteroffer (not an acceptance). Also, CISG Article 19(2) states, "However, a reply to an offer which purports to be an acceptance but contains additional or different terms which do not

materially alter the terms of the offer constitutes an acceptance, unless the offeror, without undue delay, objects orally to the discrepancy or dispatches a notice to that effect." If there is no objection, the terms of the contract are "the terms of the offer with the modifications contained in the acceptance."

## STATUTE OF FRAUDS

There is no CISG Statute of Frauds. The international practice of oral contracting is lawful under CISG Article 11, which states, "A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses." This means that CISG-covered sales contracts need no writing to be enforceable (except for those signatory states that, under CISG Article 96, exempted themselves from the provision). Nine CISG nations (Argentina, Belarus, Chile, Estonia, Hungary, Latvia, Lithuania, the Russian Federation, and Ukraine) specifically reserve the right to demand writing for sales contracts. (One other CISG nation, China, has filed a similar declaration, but it is not couched in the precise phraseology called for by CISG Article 96.) Therefore, an American business contracting, for example, a business located in Argentina or Russia (both of which opted to retain a writing requirement) would still be governed by a writing requirement in regard to purely executory contracts. *The United States, when it ratified the CISG, did not opt out of the CISG oral contracting rules.* The effect is that domestic U.S. sales law (the UCC) has a Statute of Frauds while international U.S. sales law (the CISG) usually does not.

## PAROL EVIDENCE

The CISG has no parol evidence rule. Parol evidence is admissible.

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## NONSALES TRANSACTIONS

Before sales transactions can be fully understood, it is necessary to understand nonsales transactions. The law sets up three important categories of nonsales: bailments, leases, and gifts.

## BAILMENT

A **bailment** is a transfer of *possession, care and/or control* of personal property by the owner or possessor (**bailor**) to another (**bailee**) *for a limited time for a special purpose*. Bailments include temporary conveyance of goods for storage, repair, cleaning, and other such transfers of possession of chattels without transfer of title or ownership. There is a detailed discussion of bailments in Chapter 20.

## LEASE

A **lease** is a transfer of rights of *possession* by the owner (**lessor**) of real or personal property to another (**lessee**) *for that person's use during a period of time* for an agreed-upon consideration (rent). First proposed in 1987, UCC Article 2A applies many general UCC principles (course of dealings, trade usages, etc.) to the leasing of goods and has been adopted by every state except Connecticut and Louisiana.

## GIFT

A **gift** is a transfer of *title* by the owner of goods (**donor**) to another person (**donee**) without consideration. Whereas an executory (promised) gift is not an enforceable agreement, a fully executed (completed) gift will not be legally disturbed. An executed gift requires (a) delivery, (b) donor's intent to make a gift, and (c) donee's acceptance.

### YOU SHOULD REMEMBER

Transfer of possession of property by bailment or lease is a transaction arising out of contract.

Since there is no consideration, a gift transaction does not arise out of contract but it does convey ownership.

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## DEFINITION OF A SALE

Both the code (Section 2-106) and the common law agree that a **sale** of

goods is the transfer of title from a seller to a buyer for a consideration known as the price.

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## TRANSFER OF TITLE

One of the cornerstone principles of the common law is that a seller can transfer only the title (rights) that he/she has. If the seller has no title (e.g., a thief) or has a defective title (e.g., subject to mortgage or lien) he/she transfers merely these limited rights, even though the parties may call the transaction a "sale."

The code, however, recognizes three exceptions to the common law, three circumstances in which a buyer may obtain a better title than the seller has had:

1. A person with a **voidable title** (i.e., title received by a buyer subject to cancellation by the seller) can pass a good title to a bona fide purchaser (a purchaser who has no knowledge of defect).
2. A person who in good faith buys goods from a retailer in the regular course of the retailer's business will get a good title even though the retailer *has transferred a prior interest to* others.
3. A person who in good faith buys goods from a dealer in such goods obtains a good title even though the goods in question may have been entrusted to the dealer by others.

In the first circumstance the seller's right to cancel under the code generally occurs because of some kind of fraud practiced by the buyer: giving a bad check, for example, or making some false representation. The buyer, thus in possession and with color (appearance) of title, *can* transfer title to a good-faith purchaser. The original seller who trusted the original buyer can sue only the buyer with whom he/she dealt.

The other two code exceptions to the common law rule against a buyer acquiring a good title from a seller having a less than perfect title involve *dealers in goods*. In the first, the dealer may have previously sold or committed the goods to another person, for example, on "layaway"; in the second, the goods were entrusted to the dealer or merchant for a special purpose—e.g., repair or storage (as in a bailment)—and the bona fide purchaser reasonably believes the dealer or merchant to be the rightful owner. In both of these dealer situations, the real owner's only remedy is against the dealer, not against the innocent buyer from the dealer.

## YOU SHOULD REMEMBER

The common law provided that a seller could convey no more than he/she owned. The UCC permits three exceptions:

1. A person with a voidable title can pass a good title to a bona fide purchaser.
2. A person may get a good title from a retailer who has already sold the goods to others.
3. A person may get a good title from a dealer in goods even though the dealer is holding the goods for someone else.

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## RISK OF LOSS

Before the widespread adoption of the Uniform Commercial Code, the risk of loss of goods *in the process of being sold and delivered* hinged on the answer to the question, "Who had title at the time of loss?" Thus, if goods were lost during the process of delivery, that is, on the high seas, or were stolen from a warehouse, or were damaged while in rail cars, legal questions of title at the moment of loss or damage determined the liability for repair or replacement.

Under the code, buyer and seller are expected to deal with the problem of potential loss, before or in the course of delivery, by *contract provisions*.

If there are no contract provisions, the code establishes general principles for determining risk of loss, depending on whether the contract of sale and delivery is a "shipment contract" or a "destination contract" (Section 2-509).

## SHIPMENT CONTRACTS

A **shipment contract** passes the risk of loss to the buyer when the seller delivers the goods to a carrier. The carrier is deemed the agent (representative; see Chapter 14) of the buyer *in any situation in which the contract does not include a requirement for the seller to deliver the goods to a specified destination*.

Frequently, the use of certain shipping phrases creates a shipment contract:

1. *FOB (free on board)*, sometimes with “point of origin,” “seller’s plant,” or “manufacturing facility,” together with the statement of FOB point, imposes the risk and cost of loss on the buyer at the FOB point, including the cost of shipment and loading at that point, the seller’s factory. However, FOB car or vessel (statement of a different FOB point) requires the seller to load the goods into the buyer’s carriage facilities.
2. *FAS (free alongside ship)* requires the seller to deliver the goods at his/her expense and risk to a specified ship and port. For example, “FAS *White Star*, Baltimore, Maryland” would require the seller to deliver the goods to the dock alongside the *White Star* in Baltimore. Cost of loading onto the ship is for the account of the buyer.
3. *CIF (cost, insurance, and freight)* means that the price of the goods includes the cost of shipping and insuring the goods to the buyer’s delivery point. These costs are thus passed to the seller.
4. *C & F (cost and freight)* means the same as CIF *without* the insurance obligation falling on the seller.

## DESTINATION CONTRACTS

A **destination contract** passes the risk of loss to the buyer when the goods are delivered to the specified destination. The following terms create destination contracts:

1. *FOB destination*: See item 1.
2. *Ex-ship*: This term does not require that the contract name a specific vessel; risk and expense of loss are borne by the seller until the goods have actually been unloaded from the ship.
3. *No arrival, no sale* (UCC, Sections 2-324; 2-613): If the goods do not arrive, there is no contract; and neither buyer nor seller has an obligation to the other unless the seller has caused the nonarrival. If the goods arrive damaged or in violation of the contract, the seller is responsible.

## OTHER PRINCIPLES TO DETERMINE RISK OF LOSS

Sometimes it is difficult or impossible to ascertain whether the contract is a shipment or a destination contract *and* there may be no terms in the

contract providing for risk of loss. *Section 2-509(3) provides that, if the seller is a merchant, he/she bears the risk of loss until delivery to the buyer; if the seller is not a merchant, risk of loss passes to the buyer when the goods are tendered for delivery, that is, become available to the buyer.* This is another example of the higher duty imposed by the code on merchants.

Occasionally, contracts call for delivery of goods held by a person other than the seller or buyer. If the agreement does not describe the movement of these goods, then the buyer takes the risk of loss once he has the power to possess the goods (e.g., receives a document of title).

Lastly, for breaches: (1) if goods are nonconforming and unaccepted, the risk of loss stays with or reverts to the seller; and (2) if there are identifiable, conforming goods, a buyer who repudiates the contract is liable for a commercially reasonable time for any uninsured loss or damage.

## SALE ON APPROVAL/CONSIGNMENT

On occasion, a seller may deliver goods to a buyer for the buyer's inspection and approval (on trial) or for the buyer's resale (*consignment*), title remaining in the seller (*consignor*) and subject to the terms of a contract between the parties. *Until approval* (approval may be express, implied, or conveyed by silence after the passage of a contractually specified period of time), *risk of loss remains in the seller. However, if the goods are delivered on consignment, risk of loss passes to the consignee (person receiving delivery) and this person may convey title freely to others.*

Consigned goods may be seized or possessed by the consignee's creditors. The consignor may protect his/her interest in the goods by placing the public on notice of the consignor's ownership through proper filing of a notice of a security interest under the code, or placing a sign or other clearly visible statement of ownership where the goods are held for sale.

### YOU SHOULD REMEMBER

Goods delivered for the buyer's approval remain titled in the seller and subject to his/her loss until the buyer approves.

If the goods are delivered on consignment (for the buyer to sell them), risk of loss passes to the buyer upon delivery of the goods to him/her.

## PERFORMANCE OF THE SALES CONTRACT

Performance of the sales contract is governed by Part 5 of Article 2 of the Uniform Commercial Code. Before the provisions of Part 5 are discussed, it will be helpful to review both the common law of contracts and some other provisions of the code that touch on the question of performance.

As always, the performance obligations of parties to a contract are to be found, if possible, in the contract itself. At the beginning of this chapter we discussed the code requirement of “good faith”—“honesty” and, in the case of a merchant, observance of standards of “fair dealing” applicable to his/her trade. In truth, the code did not create the requirements of “good faith,” “honesty,” or “fair dealing”; they were, and are, part of the common law.

Unless specific provisions of the code affect or define the performance obligations of the parties, questions of performance are determined by the contract itself or by the general law of contracts.

### TENDER

Section 2-507(1) of the UCC requires that the seller of goods “tender” their delivery as a condition of the buyer’s duties to accept them and, unless otherwise agreed, to pay for them. Section 2-511(1) requires that, unless otherwise agreed, the buyer’s “tender” of payment is a condition to the seller’s duty to “tender and complete delivery of the goods.”

The word “tender,” as used here, means merely “to proffer” or “make available.” However, “tender” is a legal term with specific shades of meaning as defined by the code and the general law.

#### • **WHO TENDERS FIRST?**

Although the code sections may seem to create an impasse as to whether the seller or the buyer makes the first tender, in practice an impasse rarely occurs. In most contracts, whether shipment contracts or delivery contracts, including FOB place of shipment or buyer’s plant and FAS seller’s or buyer’s port, the first move must be made by the seller: he/she must tender (make available) the goods to the buyer unless the contract specifically requires that the buyer tender payment, or part payment, before the seller’s tender is made.

### • ***SELLER'S TENDER; THE PERFECT TENDER RULE***

Under the common law of contracts, substantial performance of a contract is considered performance. The code changes this rule with regard to the seller's obligation to tender conforming goods; the goods must be made available strictly in conformity with the contract (the **perfect tender rule**). Substantial performance will not suffice. Section 2-601 of the code provides that, if the *tender of delivery or if the goods* "fail in *any respect* to conform to the contract," the buyer may do one of three things: (a) reject all the goods, (b) accept all, or (c) accept conforming goods and reject the rest. The buyer must pay for all accepted goods.

This rule of "perfect tender" is a hard rule, but the courts have held that it means what it says.

Other aspects of the seller's tender are also governed by the code, but these are generally mere codifications (statutory enactments) of the common law. The seller must hold the goods for the buyer for a reasonable time; the goods must be tendered within a reasonable time; if the contract does not specify or imply an obligation to deliver to a specified place, the place of tender is the seller's place of business. Here, also, such terms as "FOB," "FAS," "CIF," "C & F," and "No arrival, no sale," discussed earlier in this chapter, also apply.

### • ***BUYER'S TENDER***

In the absence of contract provisions to the contrary, once the seller has made the goods available to the buyer, the buyer must tender payment before taking possession. Section 2-511 provides that "payment" is sufficient if in accordance with the ordinary course of business. This permits payment by check; if the seller requires cash, the buyer must be given a reasonable period of time within which to procure it. Of course, if the check is dishonored, the buyer's title to the goods is voidable and the goods may be repossessed by the seller.

## **BUYER'S RIGHT OF INSPECTION**

Section 2-513 of the UCC provides that the buyer has the right to inspect the goods before payment or acceptance. Cost of inspection must be borne by the buyer unless the goods do not conform to the contract; then these expenses—and the risk of loss—revert to the seller. *A C.O.D. delivery does not provide the buyer with the right of inspection before payment of the price [Section 2-513(3)(a)].*

## YOU SHOULD REMEMBER

The contract itself is the best guide to determine the performance obligations of the parties to a contract.

In the absence of express provisions in the contract, the seller has an obligation to tender (make available) the goods; the buyer is obligated to tender payment. Generally, the first move must be made by the seller. The code requires perfect tender (absolute compliance with the contract) by the seller.

The buyer generally has the right to inspect the goods before accepting or paying for them. Ordinarily the buyer may pay for the goods by check; if cash is required, he/she is entitled to a reasonable period of time to obtain it.

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## REMEDIES FOR BREACH OF SALES CONTRACTS

### GENERAL PROVISIONS; THE "MAKE WHOLE" PRINCIPLE

Section 1-106(1) of the code provides that the remedies provided for shall "be liberally administered to the end that the aggrieved party shall be put in as good a position as if the other party had fully performed..." This code provision is a statutory confirmation of the general contract rule for damages (see Chapter 8). The expression "liberally administered" requires the courts to lean over backward in complying with the "make whole" principle in attempting to assess damages.

*The code (Section 2-718) provides for liquidated damage clauses in sales contracts (if not unconscionable, penal, or excessive), as does the general law.* Section 2-719 permits the parties to exclude or limit consequential damages (e.g., lost profits). However, such a limitation is considered *prima facie* unconscionable in the sale of consumer goods (where it would protect the merchant), but not so in the sale of commercial goods (sold to a merchant or in the course of trade).

There is one other important general provision in the code concerning remedies: *the statute of limitations for a sales contract (period within which suit must be filed) is 4 years from date of breach (Section 2-725).*

The code goes on to state that the contract may provide for a shorter period down to 1 year, but may not extend the period beyond 4 years. Limitations for other kinds of contracts vary from state to state.

## **SELLER'S REMEDIES FOR BREACH BY BUYER**

A buyer may breach a sales contract by (i) wrongfully refusing to accept the goods, (ii) wrongfully returning the goods, (iii) failing to pay for the goods when payment is due or (iv) expressing an unwillingness to go forward with the contract.

The code is quite detailed as to a seller's remedies (right to be made whole) upon the occurrence of a breach. Among other things, the seller may cancel the contract and hold up delivery, resell the goods to another buyer and recover damages for any difference in price (see Section 2-706 for this procedure), or recover damages for nonacceptance or repudiation. These rights are cumulative (the seller does not have to choose one to the exclusion of others). As stated, unless limited by contract, the seller is entitled to consequential and incidental damages. (See pages 147–148.)

## **BUYER'S REMEDIES FOR BREACH BY SELLER**

A seller may breach a sales contract by (i) failing to deliver the goods as agreed, (ii) delivering goods that do not conform to the contract, or (iii) expressing an unwillingness to go forward with the contract.

As in the case of the seller's remedies, the code is detailed as to the buyer's remedies upon breach by the seller. The buyer (Section 2-712) may buy other goods (known as "covering") and recover damages for any difference in price plus additional expenses, recover damages based on the difference between the contract price and the current market price (Section 2-713), recover damages for goods that do not comply with the contract, or obtain specific performance if the goods are unique (see pages 149–150).

The reader should compare the provisions of the code for breach of sales contracts with the general common law provisions already discussed. The code does not attempt to rewrite the law; it attempts to improve where appropriate and possible, and to make uniform.

## YOU SHOULD REMEMBER

The UCC applies the “make whole” principle to damages incurred by buyer or seller when a sales contract is breached. The statute of limitations is set at 4 years after date of breach, but may by contract be reduced to a shorter term (no less than 1 year).

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## KNOW THE CONCEPTS

### DO YOU KNOW THE BASICS?

1. Why is there a special article in the Uniform Commercial Code dealing with sales contracts but not an article dealing with contracts in general?
2. Give some examples of the higher standard of dealing imposed on merchants by the code.
3. Name two legal transactions that transfer possession, but not title.
4. How does the UCC permit a possessor of property to convey a *better* title than the possessor himself/herself has?
5. Does the UCC rely entirely on contract terms in determining risk of loss during the process of sale and delivery of goods?
6. How does the perfect tender rule change the common law rule of performance?

### TERMS FOR STUDY

Article 2

bailee

bailment

bailor

chattel

CISG

covering

destination contract

disclaimer

donee

donor

gift

lease

lessee

lessor

merchant

method of dealing

perfect tender rule

prima facie case

sale

shipment contract

tender

voidable title

---

## PRACTICAL APPLICATION

1. Anderson, purchasing manager for Fast Kolor Paint Company, mailed a purchase order to AB Can Corporation for 100,000 cans. The order form contained 17 printed conditions on its reverse side. The third condition stated: "Buyer may reject any defective goods within 30 days of delivery." AB Can sent a letter confirming the order, but the letter stated: "Any objection to goods shipped must be made in writing within 5 days of receipt of goods." Anderson sought to object to 10,000 of the cans, as defective, on the seventh day after receipt. What would be the result?
2. AG Gas Wells, Inc. and Trans-American Pipelines Company enter into a contract whereby AG agrees to sell natural gas to Trans-American. The price is to be set by AG based on "the average price then being obtained by gas producers in the state of Oklahoma for sales of gas in interstate commerce." If all essentials other than price are established in the contract, is the contract binding as to price?
3. Smith takes an overcoat to XYZ Dry Cleaners to be dry cleaned. He inadvertently left a \$20 gold piece in one of the pockets. XYZ sells this coin to Gould, a coin collector. Can Smith recover the coin from Gould?

---

## ANSWERS

### KNOW THE CONCEPTS

1. Sales contracts involve both consumers and merchants, categories with high levels of visibility and concern in the law of business. Also, there is a greater need for uniformity of law in these categories.
2. Merchants must observe not only rules of honesty, but also reasonable standards of fair dealing in their trade; they are subject to an implied warranty of merchantability; their contracts are interpreted in accordance with methods of doing business in their trade; they have a high standard of duty to make disclosures to uneducated and untrained buyers; they may be subject to strict liability in tort; they have limited ability to disclaim liability for consequential damages in their sales contracts.
3. Bailment and lease.
4. A person with a voidable title can pass a good title to a bona fide purchaser; a purchaser from a retailer who had previously sold an interest in the goods to some other person can acquire a good title; a purchaser may get a good title from a dealer in goods even though the dealer is holding the goods for someone else.

5. If the contract terms are clear about risk of loss, these terms control. If the contract contains no provision, the seller bears the risk until delivery of goods to the buyer.
6. The common law rule of performance considers “substantial” performance as an acceptable performance. The perfect tender rule requires absolute compliance with the contract before the tender is considered to have been performed.

## PRACTICAL APPLICATION

1. This is a “battle of forms” question. If Anderson objected to the 5-day notice-of-defect provision in the seller’s letter of confirmation, he should have promptly notified the seller. Failure to object sets up the 5-day requirement as part of the contract, and the buyer cannot object after this period of time since the proposed term did not “materially vary the offer.”
2. An agreement permitting one of the parties to set the price is enforceable if that party acts in good faith. The gas producer must make a genuine effort, and document this effort, to determine an average price being charged for interstate gas sales in the state of Oklahoma.
3. Smith cannot recover the coin from Gould, a bona fide purchaser, from a party in possession with a voidable title. Smith can, however, sue XYZ Dry Cleaners for the value of the coin.

# COMMERCIAL RELATIONS

# 10

# NEGOTIABLE INSTRUMENTS: DEFINITIONS, CONCEPTS, AND NEGOTIATION

## KEY TERMS

**commercial paper** in its broadest sense, documents used to facilitate the transfer of money or credit

**negotiable instrument** a type of commercial paper; a written, signed, unconditional promise or order to pay a fixed amount of money to order or bearer either on demand or at a definite time

**negotiation** the process by which both possession of, and title to, an instrument are transferred from one party to another, with the transferee becoming a "holder"

**holder** a person who possesses a negotiable instrument issued, drawn, or indorsed to that person or his/her order or to bearer

The term "**commercial paper**" encompasses a variety of documents used to facilitate the exchange of money, including extensions of credit. There are two important types of commercial paper: a *promise* to pay money (e.g., the promissory note and the certificate of deposit) and an *order* to pay money (e.g., the draft and the check).

Chapters 10 through 12 will discuss the major forms of commercial paper and the uniform law governing those forms.

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## THE NEGOTIABLE INSTRUMENT AS A FORM OF COMMERCIAL PAPER

The development and use of commercial paper resulted from, and in turn helped to accelerate, the growth of trade. As the words themselves suggest, only after the development of *commerce* did people need *commercial* paper. Once it became impracticable to pay always in cash or commodities, society needed a money substitute that would have the ready acceptability of cash, but would entail much less risk of loss or theft. Various types of commercial paper, including the check, have met these requirements.

Commercial paper, though, is not merely a substitute for cash. It can also serve as a means of extending credit. The borrower agrees in writing to repay his/her loan, and that document (e.g., a promissory note), like a simple money-substitute document (e.g., a check), is a special type of commercial paper: the **negotiable instrument**.

Negotiable instruments are constantly being used by businesses and consumers. Most major business transactions depend on credit. Without negotiable instruments, there would be no efficient, readily understood method of extending credit on such a grand scale. Likewise, consider the check: it is clearly the most common form of commercial paper (excluding money itself), and millions of checks are written every day.

### YOU SHOULD REMEMBER

Commercial paper can serve as a substitute for cash and/or as a means of extending credit. Special types of commercial paper—negotiable instruments—play a fundamental part in most business transactions.

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## DEVELOPMENT OF THE LAW GOVERNING NEGOTIABLE INSTRUMENTS

In England, negotiable instruments law was part of a field of law known as the *law merchant*, which was first developed and enforced in special merchant courts. Based on the customs among merchants, this law's major concern was to aid, not hinder, the growth of trade.

The merchant courts were abolished in 1756. By then, the law merchant had been incorporated into the common law but remained incomplete and chaotic. Lord Mansfield, Chief Justice of the King's Bench from 1756 to 1788, extended the commercial law and refined the terms and rights of parties under that law.

Relying on Mansfield's work, the British Parliament formally codified the negotiable instruments law by enacting the Bills of Exchange Act in 1882. Many American lawyers, judges, and bankers realized that the United States needed a similar codification, and by 1924 all of the states had enacted a set of proposed uniform laws termed the "Negotiable Instruments Law."

By the late 1940s, changes in commercial practice, as well as divergent interpretations by state courts, led to the belief that negotiable instruments law had to be reformed and made truly "uniform."

## YOU SHOULD REMEMBER

The American law of negotiable instruments originated in England. Despite previous efforts, by the late 1940s there remained a need to codify the law and make it uniform throughout the United States.

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## THE UNIFORM COMMERCIAL CODE, ARTICLES 3 AND 4

Negotiable instruments law is part of the Uniform Commercial Code, specifically Article 3 (Negotiable Instruments) and Article 4 (Bank Deposits and Collections). These articles, like the overall code, do not represent a brand-new approach to an old subject; rather they attempt to simplify, clarify, and make uniform the nation's commercial law. The process is ongoing. Indeed, a 1990 revised form of Article 3 has been adopted by 48 states (all but New York and South Carolina). Almost all of the law stated in Chapters 10–12 applies to either the original or revised article, but the discussion and UCC references concern revised Article 3.

Although some negotiable documents, such as documents of title and investment securities, are covered in other articles of the UCC, Articles 3 and 4 concern the two fundamental, omnipresent forms of commercial paper: promises to pay money and orders to pay money. As mentioned

earlier, promissory notes and bank certificates of deposit are examples of promises to pay money. An order to pay money is called a draft. By far the most common type of draft is the check, which is an order directed to a bank.

## **YOU SHOULD REMEMBER**

Articles 3 (Commercial Paper) and 4 (Bank Deposits and Collections) of the Uniform Commercial Code clarify and make uniform commercial law governing the two basic forms of commercial paper: promises to pay money and orders to pay money.

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## **ELEMENTS OF NEGOTIABILITY**

Section 3-104(a) of the Uniform Commercial Code states the requirements for negotiability. To be negotiable an instrument must:

- (a) be written;
- (b) be signed by the maker or drawer;
- (c) contain an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the instrument; and no other undertaking or instruction given by the maker or drawer, except as authorized by Article 3;
- (d) be payable on demand or at a definite time; and
- (e) be payable to order or to bearer.

An instrument that meets all of these requirements except the last one (i.e., it is not payable to order or to bearer) is treated like a negotiable instrument if it is otherwise a check (e.g., payable on demand and drawn on a bank) (UCC 3-104(c)(f)).

The five requirements given above are strictly construed. Ambiguities are resolved in favor of nonnegotiability; and, if an instrument is plainly nonnegotiable, the parties to that instrument cannot agree to make it negotiable.

Section 3-104(a) negotiability is thus restricted to drafts, checks, certificates of deposit, and notes. Section 3-102(a) states that funds transfers (Article 4A) and money are not governed by Article 3. While other forms of commercial paper, including investment securities, may be negotiable instruments under Article 3, any conflicting rule in the Federal Reserve System or in Articles 4 (Bank Deposits and Collections), Revised Article 8 (Investment Securities), or Revised Article 9 (Secured Transactions) prevails over Article 3 for those instruments (UCC 3-102).

## SIGNATURE OF MAKER OR DRAWER

A “signature” is any symbol that a party executes or adopts in order to authenticate a writing [UCC 1-201(39)]. It need not be handwritten, but must be on the instrument itself [UCC 3-401].

The law presumes that a signature is authentic and authorized, that is, made with the actual, implied, or apparent consent of the person who is to be bound by the signature [UCC 3-308(a)]. In some cases, even an unauthorized signature is treated as if it were authorized (UCC 3-403); for instance, if the person whose signature is unauthorized knew about it but failed to inform innocent parties who reasonably believed that the signature was authorized. UCC 3-403(a).

## UNCONDITIONAL PROMISE OR ORDER TO PAY

The term “unconditional” generally means that the promise or order is not limited or changed by a clause or any other item contained within or incorporated into the instrument. Conditions include tying payment to the occurrence of an event or to the performance of an agreement.

### • *INTACT NEGOTIABILITY*

Numerous statements can be placed on an instrument without destroying its negotiability. Such statements, which are not deemed to be conditions on the promise or order to pay, include mentioning:

- (a) the transactions or agreements that gave rise to the instrument;
- (b) the instrument’s consideration;
- (c) a separate writing;
- (d) that the obligor waives the benefit of laws (e.g., on debt collection) intended for his benefit;
- (e) that rights concerning collateral, acceleration, or prepayment are in a separate writing;
- (f) that the instrument is secured (but inclusion of the security agreement or mortgage in the instrument itself will make it conditional);
- (g) that a confession of judgment is authorized upon default.

These statements are covered in UCC 3-104(a) and 3-106.

### • *DESTROYED NEGOTIABILITY*

Under UCC 3-106(a), two types of statements make an instrument conditional, and thus nonnegotiable:

1. An express condition on payment.
2. A statement that the instrument is subject to or governed by another agreement.

Any instrument that is not a check can be rendered nonnegotiable by issuing it with a conspicuous statement that it is "Not Negotiable." UCC 3-104.

## FIXED AMOUNT OF MONEY

To constitute a fixed amount, the amount must be expressly stated or readily verifiable from the terms of the instrument. An amount is "fixed" even if it includes a specified interest rate, installment payments, particular discounts or additions, collection costs, attorney's fees, or other charges.

The term "money" encompasses all means of exchange authorized by some government as part of its currency. Therefore an instrument payable in dinars, francs, or some other foreign currency can be negotiable (UCC 3-107).

## PAYABLE ON DEMAND OR AT A DEFINITE TIME

To be negotiable, an instrument must be payable either on demand or at a definite time (UCC 3-108).

### • **ON DEMAND**

A negotiable instrument that does not state a time for payment, states that it is payable on demand, or at sight, or otherwise indicates that it is payable at the will of the holder is a demand instrument (e.g., a check) (UCC 3-108). It becomes due (is to be paid) simply upon being presented for payment.

### • **AT A DEFINITE TIME (UCC 3-108(b))**

A "definite time" instrument may be payable:

at a fixed date or dates;

at a fixed period after sight (presentment) or acceptance;

at a time which was readily ascertainable when the instrument was issued;

at a fixed or readily ascertainable time subject to (i) prepayment, (ii) acceleration (advancing the date of payment to a sooner, definite time), (iii) extension (postponing the date of payment) at the holder's option, or (iv) extension to a further definite time if by the maker or acceptor or if automatic (upon or after a specified act or event)

The payment time cannot be based on a special act or event that is uncertain as to time of occurrence, *even though the act is certain to happen some time*. Thus an instrument is nonnegotiable if it is payable on Mr. X's death; although death is a certainty, when Mr. X's death will occur is uncertain.

## **PAYABLE TO ORDER (UCC 3-109(b)) OR TO BEARER (UCC 3-109(a))**

“To order” includes instruments that state:

(i) pay to the order of A (an identified person) and (ii) pay to A or his/her order.

“To bearer” includes instruments that do not state a payee, and instruments that state:

- (a) pay bearer;
- (b) pay to the order of bearer;
- (c) pay A or bearer; and
- (d) pay cash or to the order of cash

A person can indorse an instrument in such a way as to convert it from order to bearer paper, or vice-versa.

## **RULES OF CONSTRUCTION**

Negotiable instruments may be postdated, antedated, or undated (UCC 3-113), and need not state the place where the instrument is drawn or payable (UCC 3-111). The dates on instruments are presumed correct.

Rules of agency (see Chapter 14) are applicable. Thus authorized agents may complete an instrument (UCC 3-115).

If it is unclear whether a negotiable instrument is a draft or a note, the holder may treat it as either (UCC 3-104(e)).

When there are disputes as to the terms of an instrument, the following rules govern:

1. Handwriting prevails over typewriting and print.
2. Typewriting prevails over print.
3. Words prevail over numbers.
4. An unspecified rate of interest is treated as being the same as the judgment rate (interest rate earned on unpaid judgments) for the place where the instrument is paid. Unless stated differently in the instrument, interest runs from the date of the instrument or, if undated, from the issue date. (UCC 3-112, 3-113, and 3-114)

Two or more persons may sign in the same role (e.g., as comakers or codrawers). Unless otherwise specified, each such person is fully responsible for any liability charged to that “role,” be it maker, drawer, or whatever.

**REMEMBER:** The fact that an instrument is nonnegotiable does not mean it is worthless. It still may evince a valid, enforceable contract.

## **YOU SHOULD REMEMBER**

To be negotiable, an instrument must (a) be written; (b) be signed by the maker or drawer; (c) contain an unconditional promise or order to pay a fixed amount of money, and no other undertaking or instruction given by the maker or drawer, except as authorized by UCC Article 3; (d) be payable on demand or at a definite time; and (e) be payable to order or to bearer. The four types of negotiable instruments are promissory notes, certificates of deposit (a type of note), drafts, and checks (a type of draft).

Signatures need not be handwritten, can consist of any symbol used to authenticate a writing, and are presumed (as are the dates on an instrument) to be authorized. "Fixed amount" generally means that the amount is expressly stated or readily verifiable from the terms of the instrument. "Unconditional" means that the promise or order is not limited or changed by a clause or anything else within the instrument; however, UCC Article 3 specifies numerous statements that do not render an instrument "conditional."

If an instrument does not state when payment is due, the instrument is deemed to be a demand instrument. A "definite time" can include acceleration or extension, but payment cannot be contingent upon an act or event uncertain as to when it will occur (even though the act or event has in fact occurred or is certain to happen some time).

A person can indorse an instrument in such a way as to convert it from order to bearer paper, or vice versa. Authorized agents may complete an instrument, and two or more persons may sign in the same role (e.g., as comakers or codrawers). If there is a dispute as to the terms of an instrument, handwriting takes precedence over typewriting and print, typewriting takes precedence over print, and words take precedence over figures (unless the words are ambiguous).

A nonnegotiable instrument may still be evidence of a valid, enforceable contract.

# TYPES OF NEGOTIABLE INSTRUMENTS

## NOTE

The **note**, often called a promissory note, is a two-party instrument in which one person (the **maker**) makes an unconditional, written promise to pay another person (the **payee**), or a person specified by the payee, a fixed amount of money either on demand or at a particular time in the future.

\$ <u>10.02</u>		Date <u>May 30, 2003</u>
<u>Ninety days</u> after the date above <u>I</u> promise to pay to		
the order of <u>Matthew Klein</u>		
<u>.....ten dollars and 02/100.....</u>		
No. <u>8165</u>	Due: <u>August 28, 2003</u>	<u>Jim Jones</u>

Jim Jones is the maker, and Matthew Klein is the payee.

Issued by a *financial institution* (e.g., a bank) as an acknowledgment that the institution has received a particular sum of money, the certificate of deposit is the institution's note to pay the depositor that sum of money, plus a stated rate of interest.

## DRAFT

A **draft** is a three-party instrument in which one person (the **drawer**) orders a second person (the **drawee**) to pay a fixed amount of money to a third person (the **payee**), or another person specified by the payee, either on demand or at a particular time in the future.

\$ <u>76.54</u>	<u>Washington, D.C.</u>	<u>April 17, 2004</u>
<u>60 days after date</u> Pay to the order of		
<u>Pseudo Manufacturing Company</u>		
<u>Seventy-six dollars and 54/100.....</u>		
Value received and charge the same to account of:		
TO: <u>Erstwhile Services, Inc.</u>		
<u>Anytown, U.S.A. 12345</u>	<u>Tom Thompson</u>	
	Drawer	

Thompson is the drawer, Erstwhile is the drawee, and Pseudo is the payee.

## CHECK

A **check** is a special type of draft in which the *drawee* is always a *bank* and the instrument is *payable on demand*.

	Date <u>September 2, 2003</u>
Pay to the order of <u>Mary Merchant</u>	<u>\$ 2.00</u>
<u>Two</u> .....	..... dollars
NAME OF BANK	
For: <u>Memorandum</u>	<u>Bob Buyer</u>
012345666 70 114679	

Mary Merchant is the payee, Bob Buyer is the drawer, and Name of Bank is the drawee.

A check drawn by a bank upon itself is a *cashier's check*. The *traveler's check* is likewise a check in which the financial institution is both drawer and drawee, but with the payee/holder required to sign a specimen signature on the instrument when it is issued and then sign it again when cashing it. *Certified checks* are checks that have been "accepted" by the drawee bank, that is, the bank certifies that there is money in the drawer's account to cover the check.

---

## THE PARTIES TO A NEGOTIABLE INSTRUMENT

A note originates with two parties:

1. The maker, who promises to pay.
2. The payee (depositor), who will be paid by the maker.

All drafts start with three parties:

1. The drawer, roughly comparable to the note's maker.
2. The drawee, the party ordered by the drawer to make payment.
3. The payee, essentially equivalent to the note's payee.

Whereas the maker of a note simply promises to pay, more or less directly, the payee, the drawer of a draft states that a third-party, the drawee, will actually pay the payee. The drawee pays with funds from an account the drawer maintains with the drawee.

Both notes and drafts may have additional parties known as indorsers. Although indorsements come in different forms, they all have a common feature: the signature of the indorser.

## YOU SHOULD REMEMBER

A note has two initial parties: a maker and a payee. A draft has three initial parties: a drawer, a drawee, and a payee. Both notes and drafts may have additional parties who are indorsers.

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## ADVANTAGES OF NEGOTIABLE INSTRUMENTS OVER ORDINARY CONTRACTS

Negotiable instruments are frequently preferred over nonnegotiable types of commercial paper or ordinary contracts. *The major reason for this preference is that, in exchange for greater formal requirements, the negotiable instrument conveys to its holder rights superior to those of someone trying to enforce an ordinary contract* (e.g., a nonnegotiable instrument). (See page 191 for the definition of “holder.”) Also, rights, duties, and liabilities of the parties are generally clearer under Article 3 of the UCC than under the common law of contracts.

In the ordinary contract, consideration must be proved. With a negotiable instrument, consideration is presumed unless evidence to the contrary is introduced. Even if the other party proves that there was no consideration, the holder's case will generally not be affected if he/she is deemed to be a *holder in due course* (HIDC) defined in Chapter 11. Whereas past consideration (e.g., a pre-existing debt) is not usually an enforceable basis for ordinary contracts, it is sufficient for negotiable instruments. Most important, the assignee of an ordinary contract is sub-

ject to personal defenses (see Chapter 11), but a HIDC generally is not (i.e., many defenses ordinarily available under contract law are not as readily available against some holders).

## YOU SHOULD REMEMBER

Negotiable instruments are often easier to enforce than ordinary contracts because (1) consideration is presumed, (2) past consideration is sufficient, (3) a HIDC usually need give no consideration, and (4) a HIDC is generally not subject to personal defenses.

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## THE ASSIGNEE OF A CONTRACT VERSUS THE HOLDER OF A NEGOTIABLE INSTRUMENT

### ASSIGNEE OF CONTRACT

In the “ordinary” contract, one party may be able to assign to someone else his/her rights under the contract (e.g., the right to receive money or goods). The party to the contract is called the **assignor**, and the person to whom the assignor assigns his/her contractual rights is the **assignee**. Although not usually a party to the original contract, the assignee “steps into the shoes of the assignor” and not only gains all of the assignor’s contractual rights, but also is subject to all of the contractual defenses to which the assignor was subject.

#### *Example: Rights and Risks of an Assignee*

Otto’s Outerware Outlet (OOO) contracts with Brenda’s Bikini Boutique (BBB); OOO is to supply BBB with 25 specially designed “OOO-La-La outfits” at \$40 per outfit. If OOO later assigns to a third party, Inga, its rights under the OOO-BBB contract, then Inga has whatever rights OOO had at the time of the assignment. Inga would be entitled to receive \$1,000 from BBB if the 25 outfits were delivered to BBB in proper condition and on time. The money would properly belong to Inga because OOO had performed as promised, was thus entitled to the money from BBB, and had assigned to Inga the right to receive the money from BBB.

But what if OOO failed to conform to the terms of the contract, perhaps by not delivering the outfits or by delivering cheap imitations of the “OOO-La-La” line? Then Inga would be subject to BBB’s defense against payment to OOO.

The assignee takes a risk, particularly if he/she cannot verify the rights and defenses that are being assumed. For this reason, the potential assignee may request a “premium” (high or extra payments) for taking assignments, and may instead insist on taking a negotiable instrument whenever possible.

## HOLDER OF NEGOTIABLE INSTRUMENT

For commercial paper to be readily accepted as a safe substitute for cash, the potential “acceptor” must be confident that the commercial paper does not entail many of the risks assumed by the assignee of an ordinary contract.

A holder possesses an instrument passing to him/her via an unbroken chain of negotiation, if transferred (see below) and (1) issued, drawn or indorsed to him/her or to his/her order, or (2) payable to bearer. To qualify as a **holder in due course (HIDC)**, the holder must have good title to an instrument for which he/she paid value, against which the holder had no notice of any claims or defenses, and which the holder acquired in good faith. See Chapter 11 for a detailed discussion of the holder in due course.

### *Example: Advantages of a HIDC*

If Hollis is the HIDC of a check issued by Baker Co. to pay for an industrial appliance sold by Smith, then Hollis is not subject to Baker’s claim against the seller for breach of warranty or for fraud inducing the sale. These are personal defenses against payment on the instrument, which the buyer, Baker, cannot assert against a HIDC. However, these defenses can be used against Smith and any assignee of Smith.

## YOU SHOULD REMEMBER

A holder possesses an instrument passing to him/her via an unbroken chain of negotiation (if transferred) and issued, drawn, or indorsed to the holder or to his/her order, or payable to bearer. If the instrument is negotiable, and the holder is a HIDC, then the HIDC generally can defeat personal defenses that would work against an assignee.

## NEGOTIATION

The inherent value of negotiable paper rests largely on the easy, relatively safe manner in which possession of such paper and title to it can be transferred. The transfer process is called **negotiation**. The negotiable instrument is “negotiated” (transferred) to a **holder**.

**Bearer paper**, such as checks made out to “Cash” or indorsed in blank (the holder’s name is signed on the back without any accompanying instruction, such as “Pay to the order of X” or “For deposit only”), can be *negotiated merely by a change in possession*, that is, by “delivery.” Holders of such instruments may not be the lawful owners; for instance, a thief may take bearer paper.

**Order paper** negotiation, on the other hand, requires not only delivery but also the proper indorsement(s).

An instrument payable to the order of Joe Smith is not negotiated to Barbara Brown until delivered to her with Joe Smith’s indorsement. Without the indorsement, Barbara (and anyone else who acquires the instrument from her) is a mere transferee.

To have rights under an instrument (e.g., obtain payment), a mere transferee (someone to whom the instrument was transferred, but to whom there was no effective negotiation) must prove that the instrument is valid and that he/she has title to it. There are no presumptions in favor of the transferee’s claim.

A holder, though, benefits from negotiation. Opposing parties have the burden of proving that the holder is not entitled to payment.

### YOU SHOULD REMEMBER

For negotiation to occur, an instrument must be negotiable. Negotiation involves transfer of possession of the instrument and title to it. Bearer paper is negotiated by mere delivery; order paper negotiation requires delivery and the proper indorsement(s).

A holder is not necessarily the “owner” of an instrument. A holder can obtain payment on an instrument, however, unless the opposing party proves a defense to payment. Mere transferees, though, must prove their right to payment.

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# INDORSEMENTS

## DEFINITION

Written on a negotiable instrument by or on behalf of the holder, an **indorsement** is the signature of the holder, with or without additional or qualifying words, so that title to the instrument and the holder's property interest in the instrument are transferred to a new holder. An instrument may be indorsed on its front or back, or on an **allonge** (a paper physically attached to, and made a part of, the instrument). When the role of a signatory is ambiguous, his/her signature is treated as an indorsement. Moreover, if a name is misspelled in the instrument, the indorsement may be made in either the correct name, the name as misspelled, or both. (Dual indorsement can be demanded by the person taking the instrument.)

## TYPES OF INDORSEMENTS

There are several different types of indorsements.

**Blank** (general) **indorsements** specify no particular indorsee; a mere signature constitutes a blank indorsement. The effect is to make the instrument payable to bearer. UCC 3-205(b).

**Special indorsements** specify the person to whom, or to whose order, the instrument is payable. Such an indorsement makes the instrument order paper. UCC 3-205(a).

### *Example: Special Indorsement*

John Smith, the payee of a check, specifically indorses the check to Mary Jones by writing on the instrument "Pay to the order of Mary Jones [signed] John Smith."

John Smith could simply indorse "Pay Mary Jones," and it would still be a special indorsement. It renders the instrument order paper (to Mary Jones), even though the front of a negotiable instrument should not be made out that way (see page 185 and UCC 3-104(a)(1)).

An instrument may have any number and combination of blank and special indorsements. The last (most recent) indorsement determines whether the instrument is bearer or order paper.

A third type of indorsement is the **restrictive indorsement**. There are four main types of restrictive indorsements:

1. Those that are conditional. Indorsements can contain conditions that would destroy negotiability if they were in the instrument itself.

However, despite its negotiability, no holder (except a bank handling or paying instruments in the normal course of collection) has any right to enforce the conditionally indorsed instrument until the condition is met. UCC 3-206.

*Example: Conditional Indorsement*

John James, the payee of a check, indorses it as follows:

“Pay Jane Jones when she delivers 250 shares of Blue Chip Stock to me [signed] John James.”

John then delivers the check to Jane, who in return promises to transfer the stock to John. Jane could negotiate the check to another holder. However, until she met the condition, most subsequent holders could not enforce payment.

2. Those that attempt to prohibit further transfer of the instrument. Like a conditional indorsement, an indorsement prohibiting further transfer has no effect on the instrument’s negotiability. An example is: “Pay to the order of Joe Doe only.” In effect, the UCC [Section 3-206(a)] converts such an indorsement to “Pay to the order of Joe Doe.”
3. Those that include the words “for collection,” “for deposit only,” “pay any bank,” or similar expressions. Like conditional indorsements, those made to facilitate deposits or collections have no effect on negotiability. However, the holder who first receives such an indorsed instrument must obey that indorsement, although subsequent holders need not. “Pay any bank” also means that only a bank may be a holder of the instrument unless it is specially indorsed by the bank or returned to the indorser. UCC 3-206(c).
4. Those that state that they are for the benefit or use of the indorser or another person. An example of this type of indorsement is: “Pay X in trust for Y.” The instrument’s first new holder must take any money transferred to him/her via the instrument and apply the money in accord with the indorsement. Subsequent holders have no such constraints unless they know that the terms of the indorsement were violated. UCC 3-206(d).

Regardless of type, the indorsement can have a **disclaimer**. Such an indorsement places subsequent holders on notice that the indorser disclaims liability on the instrument if it is not paid. The most frequent disclaimer is the phrase “without recourse” (a *qualified indorsement*).

## YOU SHOULD REMEMBER

An indorsement can be blank (which makes the instrument bearer paper), special (to a particular person or his/her order), or restrictive. Restrictive indorsements can be conditional, can try to proscribe further transfer, can be designated for deposit or collection, or can be for the benefit of—or in trust for—the indorser or someone else. Indorsements can create conditions and impose certain requirements that, if originally placed in the instrument, would render it nonnegotiable.

Any indorsement may have a disclaimer of liability on the instrument (“without recourse”).

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## KNOW THE CONCEPTS

### DO YOU KNOW THE BASICS?

1. Name two purposes of commercial paper.
2. (a) Name the parties to a note.  
(b) Name the parties to a draft.
3. (a) What article of the UCC covers the law of negotiable instruments?  
(b) What article of the UCC covers the law of bank deposits and collections?
4. How is a check different from other drafts?
5. The role of consideration is different when one attempts to enforce a negotiable instrument rather than an ordinary contract. State the differences.
6. What advantage does a holder-in-due-course have over the assignee of a contract?
7. Which usually requires greater formality (adherence to specific requirements for proper formation): a negotiable instrument or an ordinary contract?
8. What are the requirements for an instrument to be negotiable?
9. *True or false?*  
(a) Ambiguities are to be resolved in favor of negotiability.  
(b) By agreement of the parties, a nonnegotiable instrument can become negotiable.

10. What types of statements may affect the amount due under an instrument, but do not leave the instrument without a fixed amount?
11. What types of statements do not make a promise or order conditional?
12. *True or false?*
  - (a) An instrument “payable upon drawer’s death” is negotiable.
  - (b) Agents may complete an instrument for their principals (e.g., employers).
  - (c) Dates and signatures on an instrument are presumed correct.
13. In disputes about the terms of an instrument, which usually takes precedence?
  - (a) Handwriting or typing
  - (b) Typing or print
  - (c) Handwriting or print
  - (d) Words or numerals
14. How are negotiable instruments negotiated?
15. What is the effect of a blank (general) indorsement?

## TERMS FOR STUDY

allonge	holder in due course
assignee	indorsement
assignor	maker
bearer paper	negotiable instrument
blank (general) indorsement	negotiation
certificate of deposit	note
check	order paper
commercial paper	payee
disclaimer	promissory note
draft	restrictive indorsement
drawee	special indorsement
drawer	UCC Articles 3 & 4
holder	

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## PRACTICAL APPLICATION

1. Weaver, who had an account at Boris’s Bank & Trust, borrowed money from Porter. In an attempt to repay Porter, Weaver sent him to Boris, Sr., President of Boris’s, with this writing:

April 21, 2003
<p>To: Boris's Bank &amp; Trust                  From: W. Weaver</p> <p>I would be very appreciative if you would pay to the order of J. B. Porter \$100.00 (one hundred dollars).</p> <p style="text-align: right;">(signed)                  W. Weaver</p>

Is this a negotiable instrument?

2.

January 20, 2004	<u>78-84</u> 1397
BANK OF MAYFLOWER	
Pay _____ Wallace Wimpy _____	\$ 58.70
<u>Fifty eight and 70/100-----Dollars</u>	
For _____ Career Counseling _____	_____/s/_____ Eddie Eager
:1585::0045::802:5	

Is this a negotiable instrument?

3. (a) Miss O'Hara obtains a loan of \$300 from Mr. Butler, to whom she dates and signs a written "I owe you" (IOU) for \$300.00. Soon thereafter, Butler expresses to O'Hara his resolute apathy as to her future whereabouts and seeks recovery of the \$300 from O'Hara. Is the IOU a negotiable instrument? Is the IOU crucial, merely helpful, irrelevant, or in fact harmful to his case?
- (b) Suppose Butler, in order to get some cash quickly, discounts his IOU from O'Hara and transfers it to Mr. Dashing Silkes for the sum of \$200, with Butler placing his "indorsement" on the back of the IOU. May Silkes collect from O'Hara on the IOU?

4.

<b>LAST COUNTY BANK OF KINGSVILLE</b>	
<u>\$2,500.00</u>	August 22, 2003
<u>Arnold Anonymous</u> has deposited in this bank	
<u>Two thousand five hundred and no/100 dollars</u> payable to <u>Arnold Anonymous</u> at maturity <u>6</u> months from date upon return of this instrument properly indorsed, with interest at 9¼% per annum from date.	
<u>E. Moneybags</u> Cashier	

Is this a negotiable instrument? If so, what type?

5. A promissory note states that one year from the instrument's date the maker will pay the amount set out in the note "with interest at the current rate." Is this a negotiable instrument? If so, what type?
6. (a) Jerry Joker makes a note payable to Kid Kooke "five days after Nate Nerd's first kiss." Is the note negotiable?  
(b) What if Kid gets tired of waiting and plants one, that is, a kiss, on Nate?
7. An instrument from A to the order of C is handed by C to B.  
(a) What should B request from C?  
(b) What may B do if he is afraid that A may not be good for the money and a subsequent holder may seek the money from B, instead?

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## ANSWERS

### KNOW THE CONCEPTS

1. Extension of credit, money substitute.
2. (a) Maker, payee.—(b) Drawer, drawee, payee.
3. (a) Article 3.—(b) Article 4.
4. The drawee of a check is always a bank, and a check, unlike some drafts, is payable on demand.
5. Ordinary contract: consideration must be proved; past consideration generally insufficient.  
Negotiable instrument: consideration presumed; consideration unnecessary for holder-in-due-course; past consideration sufficient.

6. A holder-in-due-course is usually not subject to personal defenses, as an assignee is.
7. The negotiable instrument. Some special contracts (e.g., land transactions) must meet formal requirements to be enforceable. Generally, though, contracts do not require such formality.
8. It must be (1) in writing, (2) signed by the maker or drawer, (3) an unconditional promise or order to pay a fixed amount of money, (4) without any other undertaking or instruction, except as permitted by UCC Article 3, (5) payable on demand or at a definite time, and (6) payable to order or to bearer.
9. (a) False. (b) False.
10. Specified interest rate, stated installments, collection costs, attorney's fees, particular discounts or additions.
11. Statements that mention: the underlying transaction or agreement; the instrument's consideration; a separate writing; that the obligor waives the benefit of laws intended for his protection; that rights concerning collateral, acceleration, or prepayment are in a separate writing; that the instrument is secured; that upon default a confessed judgment is permitted.
12. (a) False. (b) True. (c) True.
13. (a) Handwriting. (b) Typing. (c) Handwriting. (d) Words.
14. Bearer instrument: by delivery  
Order instrument: by delivery and proper indorsement.
15. It makes the instrument bearer paper.

## PRACTICAL APPLICATION

1. No. The instrument does not contain a promise to pay or an order to pay. It merely says that Weaver would be very appreciative.
2. Yes. Although it is not to bearer or to order (it should read: *Pay to the order of Wallace Wimpy*), the instrument is otherwise negotiable. Under UCC 3-104(c), it is treated as negotiable because it is otherwise a check (payable on demand and drawn on a bank—the Bank of Mayflower).
3. (a) The IOU should be helpful. Although not a negotiable instrument, it is evidence of a loan to O'Hara from Butler.  
(b) Perhaps. Silkes is, at best, an assignee of Butler's rights and duties under Butler's contract with O'Hara (the IOU). Silkes is subject to personal defenses O'Hara may have had against Butler.
4. Yes. A type of note known as a certificate of deposit.

5. No. A “current” interest rate is unclear. Thus there is no sum certain. (If the interest rate were not specified at all, then the judgment rate could be used, so as to render a fixed amount.)
6. (a) No. It is not payable at a definite time.  
(b) The note is still not a negotiable instrument. The happening of an uncertain event does not convert an indefinite as to time (hence nonnegotiable) instrument into a negotiable instrument. However, such a triggering event could make enforceable the contract that may underlie the nonnegotiable instrument.
7. (a) An indorsement.  
(b) When B cashes the instrument, he should indorse it “without recourse.”

# 11

# NEGOTIABLE INSTRUMENTS: THE HOLDER IN DUE COURSE, DEFENSES, LIABILITY, AND DISCHARGE

## KEY TERMS

**holder in due course (HIDC)** a holder who takes an authentic-appearing negotiable instrument (1) for value, (2) in good faith, and (3) without notice that it is overdue, has been dishonored, or has certain defenses or claims against it

**“real” (“universal”) defenses** defenses to the enforcement of an instrument that are good against anyone, including HIDCs

**personal (limited) defenses** any defenses not “real” defenses; generally, insufficient against HIDCs

**dishonor** to refuse to pay (or accept for later payment) an instrument

**discharge** the removal of parties’ liability on an instrument, usually by payment

The holder in due course (HIDC) of a negotiable instrument is not generally subject to claims or personal defenses that could be raised by the original parties to the instrument. This protection from claims or defenses is the central tenet of negotiable instruments law.

In Chapter 10 you learned what negotiable instruments are and how their title and possession can be transferred (negotiated). This chapter mainly concerns HIDCs, other holders, defenses, and liability among parties. In essence, it covers what happens when something goes wrong.

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## HOLDER IN DUE COURSE

A holder, you have learned, possesses a negotiable instrument drawn, issued, or indorsed to the holder or his/her order or to bearer. The **holder in due course (HIDC)** is a special type of holder, one who takes possession and title free of most personal defenses (see pages 209–210) that could be raised against the HIDC's transferor.

Payees can be HIDCs. However, in the vast majority of cases, the payee was directly involved in the transaction that caused the instrument to be issued (e.g., the payee sold goods or services to the maker or drawer). So the payee very likely would have had notice of any claim or defense against his/her being paid by the maker or drawer, and the payee would not be a HIDC (UCC 3-302(a)(2)(v) & (vi)).

## REQUIREMENTS FOR A HIDC

For a holder to be a negotiable instrument's HIDC:

(1) the instrument when issued or negotiated to the holder must not bear evidence of forgery or alteration or other irregularities or incompleteness calling into question the instrument's authenticity; and (2) the holder must take the instrument (i) for value, (ii) in good faith, and (iii-vi) without notice that it is overdue, has been dishonored or altered, contains an unauthorized signature, or has certain defenses or claims against it (UCC 3-302(a)).

### • *TAKING FOR VALUE*

#### **EXTENT OF CONSIDERATION, SECURITY INTEREST, OR LIEN ON INSTRUMENT**

A holder takes an instrument for "value" to the extent that (1) the agreed-upon consideration has been performed, or (2) he/she acquires a security interest or lien on the instrument (UCC 3-303(a)(1-2)). "Value" does not arise, however, from security interests or liens obtained via legal proceedings, such as deficiency judgments. (For more on security interests or liens, see Chapter 13.)

*Example: Taking for Value*

Carrie is to pay Bart \$500 in order to receive a check from Anne to Bart in the same amount. If Carrie pays Bart \$500, then Carrie can be a HIDC for the full amount of the check. If Carrie gives less than \$500, however, then she can be a HIDC for *only* that amount for which she actually gave value to Bart. It does not matter what consideration, if any, passed between prior parties, such as Anne and Bart.

Although an executory promise (to do something in the future) is generally good consideration for contracts, including those under the UCC, it does *not* constitute the “value” necessary to make a HIDC.

### **PREEXISTING CLAIMS, RECIPROCAL NEGOTIABLE INSTRUMENTS, AND IRREVOCABLE COMMITMENTS**

There is also HIDC “value” when a person takes an instrument as security or payment for a preexisting claim, whether or not that claim is due (UCC 3-303(a)(3)). If Baker claimed that Connor owed him money, an instrument from Connor to pay Baker’s claim would be for “value.” HIDC “value” also occurs when, in order to take an instrument, a person gives a negotiable instrument or makes an irrevocable commitment to a third party (UCC 3-303(a)(4-5)). For instance, Smith gives “value” by giving Jones a check in return for taking Jones’s promissory note.

The following are not HIDC “value”: (1) gifts, (2) inheritances, (3) unperformed promises (except binding ones to third parties), (4) purchases pursuant to legal proceedings such as foreclosures; and (5) bulk transfers not made in the ordinary course of business.

#### **• GOOD FAITH**

A person takes an instrument in **good faith** if he/she acts honestly [UCC 1-201(19)]. The test is *subjective*: Did the holder actually believe that the instrument was regular (genuine, authorized, and conforming with the law)? It is usually irrelevant that a reasonable person (the “objective” test) might have acted differently.

Obvious defenses may, though, lead to a presumption against subjective good faith. In addition to the size of any discount from the instrument’s face amount, courts will look at the parties’ relationship, the instrument’s appearance, the time remaining before the due date, and the time and place of the instrument’s transfer.

#### **• ABSENCE OF NOTICE**

Most disputes about HIDC status concern alleged notice of a claim or defense; whether “value” was given is generally easy to determine, and good faith is usually assumed.

“Notice” includes both what the holder actually knew and what he/she should have known from all of the facts and circumstances [UCC 1-

201(25)]. Under this *objective* test, obvious forgeries, alterations, or blanks in material terms are themselves sufficient to suggest potential claims or defenses to the instrument; hence nothing else is necessary to show notice. In most other cases, the court will have to look beyond the instrument itself to determine notice.

UCC 3-302(a)(2) covers the defects about which a holder, in order to be a HIDC, must not have had notice.

1. *The instrument is overdue.* For *time* instruments (those with a specific due date), “overdue” means that some or all of the amount of the instrument remains unpaid after the due date. Unless the holder knows that acceleration has occurred, there is no notice of an overdue instrument merely because an installment note or draft contains an acceleration clause.

For *demand* instruments, “overdue” means either that a demand for payment has been made, yet money remains due, or that the instrument has been outstanding for an unreasonable period of time (more than 30 days, presumably, for certified checks; longer for other instruments).

2. *The instrument has been dishonored.* To **dishonor** an instrument is to refuse payment on, or acceptance of, the instrument. For drafts the dishonoring is generally by the drawee, while for notes it is usually by the maker.
3. *There are defenses against, or claims to, the instrument.* Aside from obvious forgeries or alterations (UCC 3-302(a)(1)), notice of claims or defenses arises from awareness that the obligations of one or more parties are voidable or that the parties have been discharged.

Merely filing a document or recording it (e.g., in the land records, with a governmental agency or the like) does not provide notice to a holder (UCC 3-302(b)). Courts look beyond such “constructive” (legally implied) notice to determine whether the holder actually knew or should have known about that defense or claim.

#### *Example: Notice of a Defense*

If Gary Gullible pays Skippy Skunk \$10,000 in cash to obtain a check payable to Skippy in the amount of \$11,000 and with the words “trustee for Molly Minor” written in bold face in the memorandum section of the check, Gary may be deemed to have notice of a defense to payment. The words in the memorandum section seem to indicate that payment is intended to be for the benefit of Molly Minor, but from the \$1,000 discount and the fact that payment is in cash a person could reasonably infer that Skippy will keep the money for himself.

Without the discount or the cash payment, Gary probably could argue successfully that he neither knew nor should have known that Skippy