ENG 190
Contract Law – Lecture 2

January 28, 2013

Questions from Last Time

- Can you defeat parol evidence rule by admission?
  - Many courts will allow evidence of terms that are different from the agreement when the party opposing those terms admits that the agreement was not complete.
  - Ex: In the icehouse case, if the sellers had admitted that the written contract did not completely capture the deal, courts following this approach would have admitted evidence of the oral agreement to remove the icehouse.

Questions from Last Time (2)

- Example of reliance exception to the Statute of Frauds
  - Airline pilot case: Pilot has a job with right to take six months' leave and return to his employer. He takes leave and works for a new airline. Toward the end of the six months, he asks the new airline for an employment contract and receives a two-year oral employment contract. In reliance on this agreement, he stays past the six months and allows his right to return to expire. The new employment contract is enforceable.
- Is an corporation's offer revoked upon dissolution of a corporation?
  - Probably not.

ENG 190 Topic List
Contracts Part 2

- **Interpretation of Written Contracts**
- Good Faith
- Remedies
- Conditions, Performance and Breach
- Arbitration
- Covenants Not to Compete

Interpretation
Written Contract Interpretation Intro

- Frequently the court will be called upon to interpret (determine the meaning of) a written contract.
- There are several principles courts have used to do this.
- If the writing has more than one possible meaning (is ambiguous), the court also may look at evidence outside the writing (extrinsic evidence) to determine the meaning.

Interpretation
Written Contr. Interp. Example

- Buyer and seller sign written contract for sale of 125,000 pounds of "US Fresh Frozen Chicken, Grade A, Government Inspected," 2 ½ - 3 pounds.
- Young chickens are suitable for broiling and frying; older, tougher chickens are suitable only for stewing.
- Whether it's OK to ship the older, tougher chickens depends on the interpretation of the word "chicken" in the contract.

Interpretation
Principles of Interpretation

- Interpret writing as a whole
- Interpret writing to make contract lawful and effective.
  - Attempt to reconcile apparently contradictory terms.

Interpretation
Principles of Interpretation (II)

- Specific terms take precedence over general ones
- Try to effect contract's purpose
  - Often contracts have statements of purpose ("recitals") that can be used to determine the contract's purpose.
- Public interest
- Separately negotiated or added terms are given greater weight

Interpretation
Interpretation vs. Drafter

- Courts often tend to interpret written contracts against the drafter (the party who wrote it)
  - Important principle in insurance contracts.
  - Many highly negotiated contracts don't have a "drafter" as both sides contribute to the document.

Interpretation
Going Outside the Document - "Plain Meaning"

- What I've just gone over are principles that can be used without going outside the written document to look at the parties' likely meaning.
- Courts may very well go outside the written document, but there is a dispute over when it's appropriate to do this.
- Many courts will allow the jury to hear evidence outside the document (extrinsic evidence) only if the court determines that the document is vague or ambiguous (does not have a "plain meaning").
  - Statutes sometimes require admission of extrinsic evidence.

Interpretation
"Plain Meaning" – Policy Issues

- Pro –plain meaning
  - Evidence of intent proffered after dispute arises is likely to be distorted by the dispute itself: "self-serving recitals based upon fading recollections" (Mosk)
  - Traditional approach may make it easier to draft a secure agreement without having it second-guessed later.
- Anti-plain meaning:
  - Contracts often don't make sense without reference to the external world.
  - The plain-meaning approach risks being arbitrary because the trier of fact will not hear evidence bearing on the meaning of the contract.
  - Sometimes courts reach opposite conclusions about the "one true meaning" of a term.

Interpretation
Extrinsic Evidence Intro

- Let's say you have a written contract and the parties dispute its meaning. What evidence should the court consider in deciding what it means?
  - Ex: Contractor working on Owner's property promises to "indemnify" Owner for "damage to property."
  - Contractor damaged Owner's property – how do we decide what "indemnify" means?
  - Owner says it means (1) Contractor has to pay Owner for damage to Owner's property; Contractor says it means (2) Contractor has to pay Owner for damage to third parties' property that Owner is responsible for, not damage to Owner's property.

Interpretation
Extrinsic Evidence - Application

- In our case, Contractor wants to show that in other agreements with Contractor Owner defined "indemnify" to mean only damage to third parties' property, and that Owner admitted that it used Contractor's meaning.
  - In other words, Contractor's interpretation.
- Court strictly following plain meaning approach wouldn't allow this unless this contract was ambiguous.
  - Depending on the court, the evidence itself may be allowed to establish that the contract is ambiguous.
- Courts that reject the plain meaning approach would allow the jury to hear this evidence without worrying about whether the written contract is ambiguous.

Interpretation
Types of Extrinsic Evidence

- Course of performance – how the parties have performed this contract so far.
- Course of dealing – the parties' conduct in previous transactions establishing a basis for what they meant in this contract.
- Trade usage – how people in the business (not just the parties) use the term in question

**

- Prior negotiations – how the parties used the term when they were negotiating the contract.

Interpretation
Course of Performance Example

- How the parties have performed this contract.
- Ex: A loan contract had a payment schedule and a 9.5% interest provision, but the schedule and the interest provision are inconsistent.
- If the buyer made and the lender accepted payments according to the schedule, that could be a course of performance helping resolve which of the conflicting provisions should prevail.

Interpretation
Course of Dealing Example

- How the parties have performed prior contracts.
- Ex: Wine distributor entered into four different annual contracts with winery to purchase wine. In each contract, the buyer bottled the wine shipped without testing it for mold and the seller apparently knew this. When wine shipped under the fifth contract was moldy, buyer used this course of dealing to show that it didn't have to test.

Interpretation
Trade Usage Example

- How people in the business use the term.
- Ex: In the chicken business, pricing newsletters used the term “chicken” to mean younger birds and “fowl” to mean older birds. This trade usage supported the argument that “chicken” in the contract meant the younger birds.
- A party is held to a trade usage only if it knew or should have known of it.
  - Ex: In the chicken case, the buyer was new to the market so buyer not held to trade usage.

Interpretation
Prior Negotiations Example

- Ex: Five-year contract provides that buyer will buy from seller 50,000 units in the first year and 100,000 units in the second and later years.
  - Agreement says it is "subject to termination" if buyer does not meet the quotas.
  - Buyer doesn't meet the quota in the first year, and the question is whether the "subject to termination" is the sole remedy or whether damages also are available.
  - Buyer sought to show that the parties discussed this issue during the negotiations and agreed that termination was the sole remedy.

Interpretation
Suspicion of Prior Negotiations

- Prior negotiations are often seen as especially suspect – particularly likely to be manufactured/exaggerated by the parties after a dispute arises and thus less reliable.

ENG 190 Topic List
Contracts Part 2

- Interpretation of Written Contracts
- **Good Faith**
- Remedies
- Conditions, Performance and Breach
- Arbitration
- Covenants Not to Compete

ENG 190: Good Faith

- There is an implied obligation of good faith in every contract.
  - Parties that are in a contractual relationship have implied duties to one another that parties that are not in a contractual relationship do not have.
- It's difficult to state in the abstract what "good faith" is.
  - In general, the duty of good faith is used to prohibit one party from defeating the other's justified expectations under a contract in some way.
  - It can require the parties to cooperate and not hinder each other's efforts to perform the contract.
- Most easily understood through examples of bad faith.

Good Faith
Bad Faith Examples

- When ETS provides an opportunity to appeal its decision that someone cheated on the SAT, refusing to consider the evidence the person presented was bad faith.

Good Faith
Bad Faith Examples (cont'd)

- Where boxing promoters promised to provide the "International Boxing Federation Champion" for a fight, with that person being Leon Spinks at the time of the agreement, and then caused Spinks to forfeit his IBF title because they could make more money if he fought elsewhere, that violated the implied covenant of good faith.

Good Faith
Bad Faith Examples - Conditions

- Frequently contracts have a condition of satisfaction.
  - Ex: Contract to paint a portrait. The buyer has to accept the portrait and pay only if satisfied.
- Satisfaction must be decided in good faith.
  - Ex: Buyer can't just decide s/he doesn't want to pay for a portrait anymore and say "I'm not satisfied."
- This can be hard to prove, but if the buyer refuses to inspect or admits satisfaction to someone else, that can show bad faith.

Good Faith
Duty of Good Faith Cannot Contradict Express Term

- Many courts, including California's, state that the duty of good faith under a contract cannot contradict an express term of a contract.

Good Faith Policies

- The implied covenant of good faith has been explained in terms of parties' likely intent:
  - If the parties had actually foreseen a situation, how would they have resolved it, or how would reasonable parties have resolved it?
  - A party probably wouldn't have agreed to be taken advantage of if it had foreseen the situation.
- But it probably also has a moral and ethical aspect.
  - We want people to treat one another fairly.
  - The idea that the implied duty can't be waived fits in with this approach.

ENG 190 Topic List
Contracts Part 2

- Interpretation of Written Contracts
- Good Faith
- **Remedies**
- Conditions, Performance and Breach
- Arbitration
- Covenants Not to Compete

Remedies
Intro

- What happens if a contract is breached?
- Two major possibilities:
  - Order to perform the contract
  - (More commonly) order to put the nonbreaching party in as good a position as it would have been in if the contract had been performed.

Remedies
Specific Performance

- The most straightforward remedy for breach of contract probably is to order the breaching party to perform ("order of specific performance")
- However, this is "unusual," even "extraordinary," in the U.S.
  - Damages is the preferred measure.
- Why? Because it's often difficult to supervise an order telling someone to perform a contract?
  - Or history?
- Trend is probably toward allowing specific performance in a wider variety of situations.

Remedies
Specific Performance - Factors

- Can an award of damages put the nonbreaching party in the position it would have been in if the contract had been performed?
  - E.g., it may be too difficult to calculate damages. Often the case with "unique" goods or land.
- Feasibility – Can the nonbreaching party effectively be ordered to perform the contract?
- Judicial economy – is an award of damages or an order to perform easier for the court to handle?

Remedies
Specific Performance – Adequacy

- Example: Contract for sale of particular Gulfstream G-II jet. Because the buyer wanted the jet for resale and bid on replacement jets, court refused to order specific performance even though G-II's typically have different configurations so each one is in a sense "unique."

Remedies
Expectation Damages

- Expectation damages/“benefit of the bargain”
- Compensate for loss relative to what the plaintiff/nonbreacher would have if contract had been fully performed.
  - Giving the nonbreaching the monetary equivalent of full performance

Remedies
Expectation Damages Example

- An award of damages sufficient to put the nonbreaching party in as good a position as performance would have done.
- I promise to buy 1 oz. of gold for $1,000/oz. on December 1.
- On December 1, market price of gold is $750/oz.
- I refuse to go through with the purchase.
- Expectation damages are $250.

Remedies
Restitution

- Return of benefits nonbreacher conferred on breaching party because of the promise.
- A, owner, contracts with B, contractor, to build a house for $100,000.
- B works on the house; the partially finished house increases the value of A's property by $30,000.
- A says, "Sorry."
- B has restitutionary interest of $30,000.

Remedies
No Punitive Damages

- Punitive damages generally are not available in contract.
- A breach of contract may also be a tort, in which case punitive damages may be available.
  - Bad faith denial of coverage by an insurance company is a tort

Remedies
Damages Limits - Foreseeability

- Foreseeability – Breaching party generally is liable only for those damages that are reasonably foreseeable based on that party's knowledge.
  - Ex: A carrier is hired to transport a part for repair. The carrier has no reason to know that the owners has no spares, so delay in repairing the part will cause large losses due to interruption of business. Even apart from any statutory protection, carrier is not liable for the damages due to business interruption.

Remedies
Damages Limits - Avoidability

- The breaching party is not liable for any damages that the nonbreaching party reasonably could have avoided.
  - Ex: Builder is hired to build a bridge. Halfway through, the owner says it doesn't want the bridge anymore and will not pay for it. Assuming it is unreasonable to continue building, the builder cannot pile up additional damages by completing the bridge.
- Net result of these limits is that in practice expectation damages are undercompensatory.

Remedies
Liquidated Damages – Intro

- Liquidated damages: A contract provision setting damages at a fixed monetary amount."
  - "If you terminate your cable contract early, you owe $150."
  - "If the contractor doesn't finish construction on time, contractor will pay owner $1,000/day."
- The basic rule is that liquidated damages provisions that are reasonable estimates of contract damages will be enforced.
  - If too large, they're seen as penalty clauses intended to coerce performance and are unenforceable.

Remedies
Liquidated Damages – “Reasonableness”

- Whether liquidated damages are reasonable can depend on ..
  - The anticipated or actual loss due to breach
  - How difficult it would be to prove the amount of damages.
  - Whether specific performance is feasible

Remedies
Liquidated Damages - Controversy

- Query whether sophisticated parties should be prohibited from entering into clauses that provide penalties clearly in excess of expectation damages as a way of showing commitment to the transaction.

ENG 190 Topic List
Contracts Part 2

- Interpretation of Written Contracts
- Good Faith
- Remedies
- **Conditions, Performance and Breach**
- Arbitration
- Covenants Not to Compete

Conditions, Performance, and Breach Conditions

- If a duty under a contract is conditional, it does not become due until the condition is satisfied.
- "I agree to buy this house if I can get financing."
  - There is no duty to go through with buying the house if the buyer can't get financing.
- Conditions are used to control the allocation of risks in a contract.

Conditions, Performance, and Breach
Condition and Breach

- Courts also construct conditions based on the other party's performance:
- If the other side really fails to hold up its end of the contract, you don't have to perform.
- If the other side just fails in some minor way, you still have to perform.
- This can be stated in the language of condition and breach:
  - "Unless otherwise specified, a party's duties are conditioned on the nonexistence of an uncured material breach by the other party."

Conditions, Performance, and Breach
Material Breach

- Not just any breach gives you the right to stop performing – only a material breach.
  - Something important, not something trivial.
- By contrast, any breach gives a right to recover in damages.
- So it's possible you could end up having to do your side of the contract while at the same time having a claim against the other side for breach of contract.

Conditions, Performance, and Breach Ex: Material Breach

- Generally speaking, failure to make a progress payment to a contractor in a construction contract is a material breach, and it entitles the contractor to stop working temporarily.
  - Material breach entitles the nonbreaching party to suspend performance.

Conditions, Performance, and Breach
Material Breach and Cure

- A material breach allows you to stop doing your side temporarily.
- You can't stop doing your side of the contract permanently until the other side has had a reasonable opportunity to cure.
- Ex: Although owner's missing a progress payment permits the contractor to stop working, it doesn't entitle the contractor to abandon the project entirely until a reasonable cure period has passed.

Conditions, Performance, and Breach
Reasonable Opportunity to Cure

- What is a reasonable opportunity to cure depends on the circumstances.
- In some cases, it may be reasonable to give no opportunity to cure.
  - E.g., if “time is of the essence” and the performance is late.

Conditions, Performance, and Breach Misjudgment About Cure

- Misjudgment about whether party can cure is dangerous.
- Ex: In a contract where a store owner leased a sign from a sign company and the sign company was obligated to clean the sign, the owner became dissatisfied when the sign was dirty for a week and told the company he wouldn't make any more payments. The court held that the owner should have waited longer for cure, and that the sign company was entitled to breach damages equal to the sign's value.

Conditions, Performance, and Breach
Substantial Performance

- If a party "substantially" performs, this is not material breach. This concept often comes up in construction cases.
- Ex: Owner and Contractor agree that Contractor will build a large house. Among the many, many specifications is that the plumbing pipes will be "Reading" brand. Contractor uses "Cohoes" brand pipe instead by mistake. The pipe is inside the walls so no one can see the brand. Replacing the pipe would be extremely costly.
  - The contractor has "substantially performed" and the owner has to make the last progress payment.
  - Owner has a claim for breach, which the court said was zero.

Conditions, Performance, and Breach Anticipatory Repudiation

- If the other party says “I’m not going to perform,” and the time for performance has not yet arrived, this is called “anticipatory repudiation.”
- You can treat the contract as discharged, find a replacement, and sue for breach without waiting for the time performance was due to arrive.

ENG 190 Topic List
Contracts Part 2

- Interpretation of Written Contracts
- Good Faith
- Remedies
- Conditions, Performance and Breach
- **Arbitration**
- Covenants Not to Compete

Arbitration
Intro

- Arbitration is a process of private dispute resolution that occurs (mostly) outside the court system.
- Parties can fashion their own arbitration process by contract.

Arbitration
Arbitration Agreement Issues

- Things to be covered in an arbitration agreement:
  - What disputes are subject to arbitration?
  - Who will be bound?
  - How many arbitrators and how will they be selected?
  - What opportunity will the parties have to get evidence from each other (discovery)?
  - Will the arbitrator be required to follow any particular law?
  - Will damages or other remedies be limited?

Arbitration Tradeoffs

- Cost: Arbitration often involves less "process" than litigation (limited discovery, appeal, etc.), but the parties have to pay the arbitrator. In litigation, parties don't pay judge and jury.
  - In the consumer setting, a class action may be the cheapest way for individuals to pursue claims, so arbitration clauses with class waivers may be more expensive (per claim) than class actions.
- Impartiality/Expertise: Arbitrators may specialize in subject areas and thus have greater expertise than judges, but they often know players in the field so impartiality may be compromised.

ENG 190 Topic List
Contracts Part 2

- Interpretation of Written Contracts
- Good Faith
- Remedies
- Conditions, Performance and Breach
- Arbitration
- **Covenants Not to Compete**

Covenants Not To Compete Intro

- A covenant not to compete is a promise that one party won't compete with another.
- Covenants not to compete are defined along various dimensions:
  - Scope of activity: "in the nail salon business."
  - Geographic area: "in Davis"
  - Duration: "for three years."
- Under antitrust law, a covenant not to compete must help accomplish some legitimate purpose or it is illegal.

Covenants Not to Compete Type #1: Sale of Business

- Ancillary to sale of business.
  - The legitimate purpose here protect the seller's ability to turn the business's "good will" into money by protecting the buyer from competition.
  - Ex: Sale of nail salon. Buyer won't pay as much for business if it thinks the seller will just open up another salon, taking most of its customer base with it.
  - The problem can be solved by an agreement prohibiting the seller from competing for a given period of time.
- Although courts scrutinize these covenants for reasonableness, they are relatively uncontroversial.

Covenants Not to Compete
Type #2: Employment

- Ancillary to employment:
  - Legitimate purpose here: Protect employer's confidential information acquired by the employee during employment.
  - Examples: trade secrets, customer lists, etc.
- The idea here is that if the employee could use this information to compete with the employer, that makes it more difficult for the employer to share this information with the employee.

Covenants Not to Compete

- Covenants related to employment are controversial.
  - Although it is generally recognized that the employer has the right to protect trade secrets, it's controversial whether it's legitimate to do so through covenants not to compete.
- Scrutinized for reasonableness more aggressively – CA may ban altogether.

Covenants Not to Compete

- In jurisdictions where employment-related covenants not to compete are enforced, a covenant not to compete is unenforceable if:
  - Restraint is greater than needed to protect employer's legitimate interest
  - Employer's need is outweighed by hardship to employee and likely injury to public.

Covenants Not to Compete Reasonableness – Confidential Info

- Two major factors in the analysis:
  - Nature of the information
  - Efforts of employer to protect the information
- These tie to the general definition of a trade secret:
  - Information that has commercial value
  - Because it's kept secret
  - And that owner makes reasonable efforts to keep secret.

Overbroad Covenants Not to Compete Remedies

- If a court decides that a covenant not to compete is overbroad, it may limit it so that it’s not overbroad anymore.

Covenants Not to Compete
Dowell v. Biosense Webster

- Covenant not to compete forbids, for 18 months, employment with a "Conflicting Organization" in which employee's services "could enhance the use or marketability of a Conflicting Product by application of Confidential Information" to which employee had access.
- Doesn't just forbid use of trade secret information to help competitor, which is probably prohibited without contract.

Covenants Not to Compete
Dowell v. Biosense Webster (II)

- Under California Business & Professions Code § 16600, prohibiting restraints of trade "The interests of the employee in his own mobility and betterment are deemed paramount to the competitive business interests of his employers."
- What about protecting trade secrets? The court "doubts" that you can use contract at all to protect trade secrets in CA.
  - It's possible to get a court to order an ex-employee not to use trade secrets to compete – but you can do that without a contract – it's "wrongful independent of any contractual undertaking."

Covenants Not to Compete
Dowell v. Biosense Webster (III)

- Even if there is a "trade secret" exception to the ban on covenants not to compete, the court finds that the terms here are broadly worded enough to restrain competition.
- Note that the primary basis for this is that the terms are similar to other terms invalidated in a previous case(*D'Sa*).
  - Note importance of <u>precedent</u> in court's thinking.
- Court refuses to read the covenant not to compete more narrowly in order to save it.

Covenants Not To Compete
EMC v. Donatelli

- "For a 12-month period" after employment, agrees "not to directly or indirectly compete with the Company … including the provision of services to any entity that is developing, producing [etc.] products or services competitive with products or services … of the Company."
- Shorter time period, but otherwise seems more restrictive than the CA agreement – no reference to use of confidential information, just competition .

Covenants Not To Compete
EMC v. Donatelli (II)

- Test under MA law is pretty different: "Covenants not to compete are valid if they are reasonable in light of the facts in each case."
  - Protect legitimate business interest, reasonably limited in time and space, public interest.
- No reference to public policy of employee mobility or employee interests being "paramount."
  - Court acknowledges that CA has a more pro-employee rule but decides to apply MA law.

Covenants Not To Compete
EMC v. Donatelli (III)

- Court grants preliminary injunction enforcing the covenant not to compete.
  - Preliminary = until we hear more of the facts.
- Apparently employee has some chance to show that the covenant is overbroad on the ground that only 20% of his old and new jobs overlap.

Covenants Not To Compete
CA and MA