EXAMINERS' ANALYSIS OF QUESTION NO. 7

Paula's counterclaim for rescission:

A contract may be rescinded on the basis of mutual mistake. "[R]escission is indicated when the mistaken belief relates to a basic assumption of the parties upon which the contract is made, and which materially affects the agreed performances of the parties." *Lenawee County Bd of Health v Messerly,* 417 Mich 17, 29 (1982), citing Restatement (Second) of Contracts § 152(1) ("Where a mistake of both parties at the time a contract was made as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances, the contract is voidable by the adversely affected party unless he bears the risk of the mistake . . . ."); *see also Britton v Parkin,* 176 Mich App 395, 397-98 (1989) (same). "The erroneous belief . . . must relate to a fact in existence at the time the contract is executed." *Messerly,* 417 Mich at 24.

Here, Sally and Paula both mistakenly assumed that the property was suitable for human habitation, which relates to the basic assumption of both parties that the apartment complex could be utilized to generate income. The performance of the parties has been materially affected because Paula paid, and Sally received, consideration for property that turned out to be worthless. Their mistake related to a fact in existence--the defective septic system--at the time they executed their contract.

Rescission, however, "is an equitable remedy which is granted only in the sound discretion of the court." *Messerly,* 417 Mich at 31; *see also Stanton v Dachille,* 186 Mich App 247, 260 (1990) (same). "In cases of mistake by two equally innocent parties," a court must "determine which blameless party should assume the loss resulting from the misapprehension they shared." *Messerly,* 417 Mich at 31 (footnote omitted). Since neither Sally nor Paula knew of the problem with the septic system, a court must decide which of these "blameless" parties should assume the loss resulting from their mutual mistake.

"Rescission is not available . . . to relieve a party who has assumed the risk of loss in connection with the mistake." *Id.* at 30, citing Restatement (Second) of Contracts § 154(a) ("A party bears the risk of a mistake when . . . the risk is

allocated to him by agreement of the parties . . . ."). "'As is' clauses allocate the risk of loss arising from conditions unknown to the parties." *Lorenzo v Noel,* 206 Mich App 682, 687 (1994). Here, the sales contract stated that the purchaser agreed to accept the property "as is," indicating that Sally and Paula agreed to allocate the risk of loss to Paula. Consequently, Paula's counterclaim for rescission will fail.

Under an alternative analysis, a party's duty to render performance under a contract may not arise because of existing frustration or may be discharged by supervening frustration. No duty arises "[w]here, at the time a contract is made, a party's principal purpose is substantially frustrated without his fault by a fact of which he has no reason to know and the nonexistence of which is a basic assumption on which the contract is made. . . ." Restatement (Second) of Contracts § 266(2). Similarly, the duty may be discharged "Mhere, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the nonoccurrence of which was a basic assumption on which the contract was made. . . ." *Id.* 265. Here, one could argue that at the time the contract was made, Paula's performance was substantially frustrated by the fact that the septic system was defective; alternatively, one could argue that after the contract was made, Paula's performance was substantially frustrated by the septic system failure, the condemnation of the property and the injunction. Paula was not at fault for the defective septic system and had no reason to know of the defect, nor was she at fault for the system's failure and the consequent condemnation and injunction. These facts/events frustrated her purpose in contracting, which was to acquire an income-generating apartment complex. But, as with the doctrine of mistake, a court would likely not grant the equitable remedy of rescission under these doctrines because the "as is" clause placed the risk of loss on Paula.

Sally's claim for damages due to breach of contract:

Paula breached the contract by failing to make the required payments. Since her claim for rescission of the contract will fail, Sally's claim for breach of the contract will succeed.

"The remedy for breach of contract is to place the nonbreaching party in as good a position as if the contract had been fully performed." *Corl v Huron Casings, Inc,* 450 Mich 620, 625 (1996) (footnote omitted). *See also Frank W Lynch & Co v*

Flex Techs, 463 Mich 578, 586 n 4 (2001) ("Damages awarded in a common-law breach of contract action are 'expectancy' damages designed to make the plaintiff whole.")

"Under the rule of *Hadley v Baxendale,* the damages recoverable for breach of contract are those that arise naturally from the breach or those that were in the contemplation of the parties at the time the contract was made." *Kewin v Mass Mut Life Ins Co,* 409 Mich 401, 414 (1980) (citation omitted); *see also Lawrence v Will Darrah & Assocs, Inc,* 445 Mich 1, 13 (1994) (same). Damages are recoverable only if the defendant "reasonably knew or should have known that in the event of breach" such damages would result. *Id.* at 14-15.

Sally seeks to recover Paula's missed payments under the contract, as well as the penalty for Sally's loan default. Since Sally is entitled to expectancy damages that will put her in as good a position as if the contract had been fully performed, she can recover Paula's missed payments under the contract. However, she cannot recover the penalty for her own loan default. Sally's default did not "arise naturally" from Paula's breach, but arose from an independent and unrelated cause--Sally's taking of a loan to purchase a boat. Moreover, there is no evidence that Paula knew or could have known that her failure to make payments under her contract with Sally would result in Sally's failure to make payments under a loan agreement. Consequently, Paula is not responsible for the penalty.