

Contracts
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Formation Defenses

I. **“Void” vs. “Voidable” Contracts**

- A. **“Void” Contract:** A contract that is unenforceable as a matter of law (*e.g.*, a contract for child prostitution).
- B. **“Voidable” Contract:** An otherwise enforceable contract that a party may avoid, as a matter of fact, based on one of the following defenses.
 - ◆ A party’s acts or statements after her right to avoidance arises (*e.g.*, ratification or reaffirmance) may cut off her ability to avoid a contract.

II. **Lack of Capacity**

- A. **Contractual Capacity:** The minimum legal capacity required to bind a party to a contract he, she, or it allegedly made.
 - ◆ Because incapacity may be **transient**, the key is whether the party has or lacks capacity **when the contract forms**.
- B. **Minority:** Unmarried minors may enter into any contract an adult can, provided that the contract is not illegal for a minor (*e.g.*, an agreement to buy cigarettes).
 - 1. **Voidability:** Unlike those entered into by adults, contracts entered into by minors are generally *voidable*.
 - ◆ Most states recognize an age before which a contract with a minor is *void*.
 - 2. **Disaffirmance:** In order for a minor to avoid or set aside a contract, she need only manifest her **intention not to be bound** by it.
 - a. The minor may manifest her intent to avoid **by words or actions**.
 - b. Generally speaking, a minor may disaffirm a contract at **any time before** and for a **reasonable time after** the minor comes of age.

- c. The minor must disaffirm the contract in its **entirety**.
 - d. A disaffirming minor may recover **all consideration** she provided to the other party – even if the other party to the disaffirmed contract subsequently transferred it to a third party.
 - e. Only the minor may disaffirm her contractual obligations; any **adult parties** to the contract **remain bound** by it unless the minor disaffirms.
 - f. A minor who fails to timely disaffirm will have **constructively affirmed** the contract.
3. **The Minor's Obligations:** Upon disaffirmance, the minor
- a. must **return any goods or other consideration in her possession**, and
 - b. may have to **restore the adult to the position he was in prior to entering the contract** by either
 - i. compensating the adult for any deterioration in value of the consideration caused by the minor's **use**, or
 - ii. compensating the adult for any **benefit** the minor derived from her use of the consideration.
4. **Emancipation:** If a child's parents/guardians have relinquished their legal right to control her, she will have the same capacity to contract as an adult.
- ◆ A **married** minor is emancipated as a matter of law.
5. **Misrepresentations Regarding Age:** Most states permit disaffirmance **even if the minor misrepresented her age** when entering into the agreement. However, some states
- a. prohibit disaffirmance in all cases where the minor misrepresented her age;
 - b. prohibit disaffirmance in cases where the minor has **engaged in business as an adult**;
 - c. refuse to allow minors to disaffirm **fully performed** contracts, unless they can return all consideration received; or
 - d. permit disaffirmance but subject the minor to **tort liability** for her misrepresentation.

6. **Liability for Necessaries:** A minor who enters into a contract to purchase food, shelter, clothing, medical attention, or other goods or services necessary to maintain her well-being will generally be liable for their **reasonable value** even if she disaffirms the contract.
7. **Parental Liability:** As a general rule, parents are not liable for contracts made by their minor children unless:
 - a. a parent **co-signs** the contract, and thereby assume personal liability for its performance, even if their minor child disaffirms the contract; or
 - b. the minor committed some wrongful act associated with the contract **at the direction of** a parent.

C. **Mental Illness or Incompetence**

1. **Tests for Incompetence**
 - a. **Cognitive:** Did the promisor lack the ability to understand the nature of the transaction or its consequences? R2 § 15(1).
 - ◆ **M’Naghten Test:** A person lacks the mental capacity to commit a crime that requires any *mens rea* if he is incapable of distinguishing right from wrong.
 - b. **Volitional:** Did
 - i. the promisor lack the ability to act reasonably in the transaction and
 - ii. the promisee know or have reason to know the promisor’s condition? R2 § 15(2).
2. **Effect of Incompetence:** Contracts made by mentally incompetent parties may be void, voidable, or valid, depending on the circumstances.
 - a. **Void Contract:** A party who has been **adjudged** mentally incompetent by a court of law **prior to** entering into a contract and who has a **court-appointed guardian** cannot enter into a legally binding contract.
 - b. **Voidable Contract:** A party who has not been adjudged mentally incompetent by a court of law may, nonetheless, avoid a contract if, at the time of contracting, he (1) did not know he was entering into a contract or (2) lacked the mental capacity to understand its nature, purpose, and consequences.

- ◆ Only the incompetent party has the option of disaffirming his contractual obligations; **any competent party to the contract remains bound** unless released by the incompetent party's disaffirmance.
 - c. **Valid Contract:** An otherwise incompetent party who understood the nature, purpose, and consequences of entering into the contract is bound by it.
 - 3. **Burden of Proof:** The law presumes competency, so the party seeking to void or avoid the contract bears the burden of proving incompetence.
- D. **Intoxication:** A transient condition in which a person's normal capacity to act or think is inhibited by alcohol or some drug.
 - 1. If a party was so intoxicated at the time she entered into a contract as to either be cognitively or volitionally incompetent and the other party knew or had reason to know of her condition, then she may **avoid** the contract, *even if her intoxication was purely voluntary.*
 - 2. Most courts will look for **objective indications** that the allegedly intoxicated party possessed or lacked the necessary capacity – *e.g.*, negotiating the terms of the contract, committing it to writing, etc.
 - 3. If a party is entitled to avoid her contract due to intoxication, she may **disaffirm** it, in the same way as a minor. However, unlike minors in some jurisdictions, she will likely be required to make full restitution to the other party before being allowed to disaffirm.
- E. **Ratification:** Accepting and giving legal force to an obligation that previously was voidable. Ratification may be either **express** or **implied**.
 - 1. **Express Ratification:** A person lacking contractual capacity at the time he formed a contract may, upon (re)gaining the necessary capacity to do so, expressly ratify the contract by **stating, orally or in writing, that he intends to be bound** by the contract.
 - 2. **Implied Ratification:** Likewise, a person lacking contractual capacity at the time he formed a contract may, upon (re)gaining the necessary capacity to do so, impliedly ratify the contract
 - a. by acting in a manner that is **clearly inconsistent with disaffirmance or avoidance** or,
 - b. in the case of a minor, by **failing to disaffirm within a reasonable time** after reaching the age of majority.

F. **Representative Capacity**

1. **Agency:** “[T]he fiduciary relationship that arises when one person (a ‘**principal**’) manifests assent to another person (an ‘**agent**’) that the agent shall **act on the principal’s behalf** and **subject to the principal’s control**, and the agent manifests assent or otherwise consents so to act.” RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (emphases added).
2. **Actual Authority**
 - a. **Express Authority:** Authority declared in clear, direct, and definite terms, orally or in writing.
 - b. **Implied Authority:** Authority that is
 - i. conferred by **custom**,
 - ii. inferred from the **position** the agent occupies, or
 - iii. inferred as being **reasonably necessary** to carry out the agent’s express authority.
3. **Apparent Authority:** Authority that arises when a principal causes a third party to believe that an agent has authority to act, even though the agent has no express or implied authority with regard to the matter at hand.
 - a. If the third party changes his or her position **in reliance on the principal’s representations** regarding the agent’s authority, the principal may be estopped from denying that the agent had authority to act.
 - b. By contrast to *agency-by-estoppel*, where the principal may be estopped from denying that a non-agent is acting on the principal’s behalf, here the person acting on the principal’s behalf is an agent – just not one who has express or implied authority to act with regard to the particular matter at hand.
4. **Ratification by the Principal:** The express or implied affirmation of a previously unauthorized act of a purported agent. In summary:
 - a. The agent must have acted **on behalf of the principal** who subsequently ratified the action;
 - b. The **principal must affirm** the agent’s act **in its entirety**;
 - c. The principal must affirm **before the third party withdraws** from the transaction;

- d. The principal must have the **legal capacity** to affirm both when the agent acts and when the principal ratifies; and
- e. The principal must know **all material facts** involved in the transaction.
 - ◆ A principal who ratifies without full knowledge may rescind her ratification, but must reimburse the third party for any costs incurred as a result of reasonably relying on the apparent contract.

III. **Mistake:** A belief, not in accord with the facts, relating to a basic assumption on which the contract was made. R2 §§ 151-153.

A. **Types of Mistakes**

- 1. **Unilateral Mistake:** Generally, a mistake made by only one of the parties will not excuse her performance of the contract unless:
 - a. the **other party** to the contract **knew or should have known** of the mistake;
 - b. enforcing the contract despite the mistake would be **unconscionable**; or
 - c. the mistake is one of **mathematics only**; and,

even then, her performance will only be excused if she does not bear the risk of mistake. R2 § 153.
- 2. **Mutual Mistake:** A mistake on the part of both contracting parties as to some material fact will allow either party may avoid the contract, unless that party bears the risk of mistake. R2 § 152.

B. **Risk of Mistake:** A party bears the risk of mistake if

- 1. the contract allocates the risk to her;
- 2. she makes the contract despite having limited knowledge of the relevant facts, but chooses to treat her limited knowledge as sufficient; or
- 3. a court assigns the risk to her, after the fact, because it is reasonable to do so under the circumstances. R2 § 154.

C. Only **mistakes of fact** are excused, not mistakes of law.

IV. **Misrepresentation:** An innocent party may usually avoid, for lack of genuine assent, a contract she entered into based on a material misrepresentation.

A. **Fraud** is

1. a **misrepresentation** or **omission**
2. of **material fact**,
3. made **knowingly** and with the **intent to deceive** an innocent party,
4. on which the innocent party **relied**
5. resulting in **injury** to the innocent party.

B. **Negligent Misrepresentation** shares the same elements as fraud except that the wrongdoer need not have acted knowingly or with the intent to deceive.

C. **Misrepresentation:** An assertion that is not in accord with the facts. R2 § 159.

1. The assertion must relate to something that is a fact at the time the assertion is made, not to a future event or circumstance. R2 § 159 cmt. c.

2. **Particular Types of Misrepresentations and Omissions**

a. **Predictions and Expressions of Opinion** will generally not excuse performance, unless

- i. the speaker had particular expertise and knew or had reason to know that the listener intended to rely on the statement;
- ii. the speaker misrepresented his own opinion;
- iii. the speaker owed some fiduciary duty to the listener; or
- iv. the speaker knew or had reason to know that the listener was unduly susceptible to the speaker's opinion.

b. **Misrepresentations of Law** will not excuse performance, unless the speaker is a member of a profession that commonly requires greater legal knowledge than the average citizen possesses.

c. **Misrepresentation by Conduct:** The conduct of a party – particularly a party's concealment of some material fact from the other party – will support a claim of misrepresentation. R2 § 160.

d. **Misrepresentation by Silence:** Generally, neither party to a contract has a duty to volunteer facts unless the other party asks.

However, common and statutory law create a duty to speak in certain situations, including where the disclosure is required to

- i. keep something that was said (or done) from being misleading (can't tell half of the story);
- ii. correct a basic assumption of the other party;
- iii. satisfy the duty of good faith and fair dealing;
- iv. correct a mistake about writing;
- v. satisfy a trust, confidence, or fiduciary duty; or
- vi. alert an innocent party to a serious defect or risk of injury.

D. **Materiality:** A misrepresentation is material if it would be likely to induce a reasonable person to manifest his assent, or if the maker knows that it would be likely to induce the recipient to do so. R2 § 162(2).

1. Materiality is judged from the maker's viewpoint, while the justification of reliance is judged from the recipient's viewpoint. R2 § 162 cmt. c.
2. A misrepresentation is material if
 - a. it would likely induce a reasonable person to manifest assent, or
 - b. the maker knows that for some special reason it would likely induce the particular recipient to manifest assent.

E. **Scienter:** A defendant acts with the intent to deceive if he:

1. **knows** a statement to be false,
2. makes a statement he **reasonably believes** to be false,
3. makes a statement **recklessly**, without regard to its truthfulness, or
4. implies that a statement is made on the basis of information that he does not possess or on some other basis on which it is not, in fact, based.

F. **Reliance:** The party seeking to avoid the contract must have acted **based on** (although not necessarily *solely* based on) the misrepresentation. Moreover, in some jurisdictions, her reliance must have been objectively **reasonable**.

G. **Injury:** Courts generally do not require a showing of actual injury in order to rescind; but actual injury is required before a plaintiff can recover damages.

V. Duress

- A. Historically, a contract induced by actual or threatened physical harm or death was **void** as a matter of law. Over time, the threats that give rise to duress have grown, and a contract induced by duress is now **avoidable**, rather than void.
- B. R2 § 175 allows a promisor to avoid a contract if her assent was induced
1. by an **improper threat** by the promisee or a third party
 - ◆ If the threat came from a third party, the promisor can only avoid the contract if the promisee (1) had reason to know of the threat or (2) did not give value or otherwise materially rely on the promise prior to the promisor's attempt to avoid.
 2. that left the promisor with **no reasonable alternative** but to assent.

C. Improper Threats

1. R2 § 176(1): The following threats are **improper per se**:
 - a. a threat of **crime or tort**, including a threat that would itself be a crime or tort;
 - b. a threat of **criminal prosecution**;
 - c. a threat to bring a **civil suit in bad faith**; or
 - d. a threat that breaches the **duty of good faith and fair dealing** owed to the victim.
2. R2 § 176(2): The following threats are improper when **coupled with an exchange on unfair terms**:
 - a. the threatened act would harm the recipient and would **not significantly benefit** the party making the threat;
 - b. a threat compounded by **prior unfair dealing** by the party making the threat; or
 - c. a threat to use power for **illegitimate ends**.

VI. **Undue Influence:** Taking an unfair advantage of another's weakness of mind or taking an oppressive and unfair advantage of another's necessity or distress.

- A. Like duress, undue influence involves **coercing** a promisor into acting **against their free will**.
- B. Unlike duress, undue influence requires **no threat**, nor does it require that the promisor was left with no **other reasonable alternative** than that sought by the dominant party.
- C. R2 § 177: Undue influence can arise when the promisor is unfairly persuaded by
 - 1. someone in a **dominant position** relative to the promisor, or
 - 2. someone who, because of the **close relationship** between the promisor and the persuading party, the promisor reasonably believes is looking out for the promisor's best interest.
- D. Factors relevant to undue influence
 - 1. discussion of transaction at **inappropriate time**
 - 2. consummation of transaction in an **unusual place**
 - 3. **insistent demand** that business be finished at once
 - 4. extreme emphasis on untoward **consequences of delay**
 - 5. using **multiple persuaders** against a single servient party
 - 6. **absence of third-party advisers** to the servient party
 - 7. statements that there is **no time to consult** advisers

VII. **Unconscionability**

- A. **Procedural Unconscionability:** Arises when one party to the contract lacks or is deprived of any meaningful choice regarding the terms of the contract due to
 - 1. **inconspicuous** print,
 - 2. **unintelligible** language,
 - 3. lack of opportunity to **read the contract** before signing, or
 - 4. lack of **bargaining power**.

- B. **Substantive Unconscionability:** Arises when the terms of the contract substantially deprive one party of the benefit of its bargain or of any meaningful remedy for breach by the other party. Put another way, the terms of the contract are so grossly unfair as to “shock the conscience” of the court.
 - C. Courts generally require both substantive and procedural unconscionability. However, some courts will find substantive unconscionability (but not procedural unconscionability) alone sufficient.
 - D. Unconscionability is tested when the contract is formed. R2 § 208. If the contract turns out to be horrible later, that alone does not make it unconscionable.
 - E. If a court determines the contract was unconscionable when made, it may
 - 1. **refuse to enforce** the contract *in its entirety*,
 - 2. **sever** the unconscionable clause and enforce the remainder of the contract, or
 - 3. permit the unconscionable clause to be applied only if its **effect** is not unconscionable.
 - F. The doctrine is designed to prevent oppression and unfair surprise, not to disturb the parties’ allocation of risks due to superior bargaining power. (*See* UCC § 2-302 cmt.)
 - G. Unconscionability is a question of law for the court, but can usually only be decided after the jury has made findings of fact.
- VIII. **Illegality:** A contract made illegally or for an illegal purpose may be unenforceable, even if it was not illegal when made.
- A. Statutes sometimes **proscribe** certain types of contracts or contractual provisions. For example:
 - 1. **Usury:** Virtually every state has a statute that sets the maximum rate of interest that can legally be charged for different types of transactions, including ordinary loans. Usurious contracts may be void in their entirety, but most states simply limit the interest the lender is permitted to collect.
 - 2. **Gambling:** Most gambling contracts are illegal and void, even in states where certain forms of regulated gambling are permitted.
 - 3. **Blue Laws:** Some states and localities prohibit engaging in certain business activities on Sundays.

4. **Licensing:** All states require that members of certain professions (*e.g.*, attorneys, doctors, architects) be licensed by the state. Any contract with an unlicensed individual is illegal and may be unenforceable.
 5. **Exculpatory Clause:** A contractual provision purporting to release a party from liability for its own misdeeds, regardless of fault.
- B. **Contracts in Restraint of Trade:** Contracts that tend to reduce competition for the provision of goods or services in a market (*e.g.*, covenants not to compete).
1. **Restrictive Covenants in the Sale of a Business:** Many agreements for the sale of an ongoing business require the seller not to open a competing business within a specified area including the business being sold. To be enforceable, the geographic restriction must be reasonable, and must be effective only for a reasonable period of time after the sale is completed.
 2. **Restrictive Covenants in Employment Contracts:** Many employment agreements, likewise, require the employee to refrain from working for a competitor or starting a new business in competition with the employer for a reasonable period of time, and within a reasonably defined geographic area, after the employment relationship ends.
 3. A restrictive covenant is generally permitted when it is *ancillary* to an otherwise enforceable contract. If it is not ancillary to an otherwise enforceable contract, or if its terms are too restrictive, the covenant is *void*.
- C. **Effect of Illegality:** An illegal contract – one that is contrary to statute or to public policy – is, generally, *void*; and, therefore, unenforceable on its face. In most cases, both parties to a void contract are considered to be **equally at fault** (*in pari delicto*), and therefore cannot enforce the contract against the other party. There are some exceptions:
1. **Justifiable Ignorance:** When one of the parties to an illegal contract has no knowledge or any reason to know that the contract is illegal, that party will be entitled to be restored to its pre-contractual situation.
 2. **Protected Classes:** When a statute protects a class of people, a member of that class may enforce an otherwise illegal contract, even though the other party cannot.
 3. **Withdrawal from an Illegal Agreement:** If a party withdraws from an agreement before any illegality occurs, she may recover its value to her.
 4. **Fraud, Duress, or Undue Influence:** A party induced to enter an illegal contract by fraud, duress, or undue influence may either enforce the contract or recover its value to her.