Chapter 4: Contractual Relationships and Conduct

A. An Introduction to Relational Contracts

B. Coping With Uncertainty: Preliminary Negotiations and Preliminary Agreements

1. Preliminary Negotiations

a. *Coley v. Lang* (p. 284): Buyer negotiated with seller to purchase the name and goodwill of a corporation but none of the assets. The parties signed a document that was either a binding contract (as argued by the seller) or a preliminary letter of intent (as argued by the buyer).

i. The Specific Performance Issue: The court finds the agreement too indefinite to justify specific performance. Why is greater specificity needed when the remedy is specific performance? The court says (in the last full paragraph on page 287): "[I]t is admitted that there was no full and definite agreement on terms." In general, courts require greater specificity to order specific performance than to order other remedies. We will return to this issue in the chapter on remedies.

ii. Promissory Estoppel: Why did the court hold that no promissory estoppel would lie? Insufficient reliance? Note that most of the reliance in this case arose from the inability of the plaintiff to bid on certain government contracts. Since we cannot know whether such bids would have been successful nor how much profit (if any) would have been made if the bids had been successful, protecting the reliance in this case was no easier than protecting the expectation. If the justification for the broad view of promissory estoppel (that is, the use of promissory estoppel as a cause of action in itself and not merely a consideration substitute) is that reasonable reliance justifies some protection even if a promise is too indefinite to support a contract action, then when the reliance is difficult to prove, promissory estoppel offers no advantage over contract. Is it reasonable to rely on promises made as part of preliminary negotiations? Indeed, if the negotiations were merely preliminary, what "promises" were made?

iii. What terms of the agreement were left to be determined? See page 286 (IRS details). What about the shareholder approval? What if the sellers were not majority shareholders? Could this have been interpreted as a binding, conditional contract where the two conditions (not within the control of either party) were IRS approval and shareholder approval. To me, that seems a fair reading.

b. *Hoffman v. Red Owl Stores, Inc.* (p. 289):

i. What gratuitous promise was made by the defendant? None.

ii. Is the plaintiff unable to state a pure contract claim because of a lack of consideration furnished or because no enforceable promise was made? No promise was made.

iii. If no agreement had ever been finalized because plaintiff had refused to accept some reasonable term offered by defendant, should plaintiff still recover in promissory estoppel? For example, what if the defendant had never asked for more money, but plaintiff and defendant could not agree on the terms of the building lease/purchase agreement?

iv. Is there any way we can state a claim under a theory of pure contract? Was there a promise by each party to negotiate in good faith? Was it breached? Consider Note 7 (at 228) and the theory articulated by Judge Leval in *TIAA v. Tribue Company* (cited at 228).

c. Problems (p. 299):

i. Problem a: Why no contract? Once again the problem seems to be indefiniteness. Are these cases saying that the proper remedy for breach of an indefinite promise is protection of the reliance interest?

ii. Problem b: Consideration for the release? Prior joint and several liability may preclude, but what about giving up right of indemnity by Brill?

2. Indefinite and Preliminary Agreements

a. Landlord and tenant sign a ten-year commercial lease at a monthly rent of $8,000 per month. The rental agreement gives the tenant the right to renew for an additional ten years, and if the tenant exercises the renewal option, the landlord is obligated to improve the premises to ensure they are up to then-contemporary standards and tenant will pay a reasonable additional rental amount on account of such improvements? Does the tenant have an enforceable agreement?

b. Does your answer change if the agreement provides that the landlord will make such improvements as agreed upon by the parties?

c. What if the agreement provides that rental payments will be adjusted by inflation as determined by the Congressional Budget Office, and by the time the lease has been agreed upon, the CBO has stopped computing annual inflation?

d. Last class, we looked at contracts which had not been fully negotiated; that is, some of the terms remained undecided. How do these case differ from those cases? Here, the terms are agreed upon but indefinite. Should a court treat this problem the same as the prior one (*Hoffman v. Red Owl*)? If we say that we should only hold a party to a promise voluntarily accepted, then the cases seems quite similar. But note that what was lacking last class was an intention to be bound while what is lacking here are the terms that are intended to be binding.

e. *Trimmer v. Van Bomel* (p. 30): Plaintiff argues that the defendant agreed in an oral contract to provide funds for a "sumptuous living" and failed to do so. The court refused to enforce the alleged oral contract (on a motion for summary judgment), holding that there is no basis to determine what is "sumptuous." The court asserts (final paragraph on page 32) that the contract was at will. Is that necessarily true? And the court was concerned about the remedy if the plaintiff was fired for cause. Is that a legitimate concern?

f. *Wagner Excello Foods, Inc. v. Fearn Int'l, Inc.* (p. 36): The plaintiff agreed to manufacture and sell certain fruit drink concentrate, with an express obligation to agree on a price every four months or the failure to agree would terminate the contract at the end of the current 4-month period. The term of the contract was five years, and there was a minimum quantity that the buyer was obligated to purchase each year. At the end of the five year term, the seller sues for breach of the minimum quantity term. *Held*, that the failure to specify how the price would adjust was not fatal under the U.C.C. and that a five year contract had been formed. Is this conclusion really necessary? The seller argued that the parties formed a new contract each four months. If that is a correct interpretation of what happened, who wins?

g. *Varney v. Ditmars* (discussed at p. 36): Here the phrase at issue was "a fair share of the profits." Is that phrase inherently ambiguous? Is this issue one that no damages can be computed? If reliance could be proven, should it be awarded when the terms of a contract are so imprecise that the usual remedy cannot be awarded? Does that explain *Red Owl*?

h. *Brown v. Cara* (p. 307): This case exemplifies the modern trend away from the *Red Owl* approach of promissory estoppel and into a more traditional contract approach. The holding of this case is that the parties can make binding promises in the middle of negotiating a larger contract, and those intermediate binding promises can be enforced even if the larger negotiation fails. If the larger negotiation is determined to have concluded with an enforceable contract, we say that the parties have a Type I preliminary agreement; that is, while it is labeled preliminary, in fact it either constitutes or is a part of a complete agreement on the underlying matter. Here, that underlying matter is construction of the Light Bridges at the Jay Street project. If the preliminary agreement is not a complete and binding agreement as to the underlying matter and a complete and binding agreement on the underlying matter is not concluded, then if the preliminary agreement itself creates binding obligations, it is a Type II agreement. Note that, from this perspective, there is no reason why the remedy awarded for breach of a Type II preliminary agreement should be limited in any way. On the other hand, given the type of agreement it is, a reliance recovery may well be all that can be proven.

i. Should we now rethink *Varney v. Ditmars* in light of *Brown v. Cara*? Note that the remedy still cannot be fashioned.

ii. In what way is *Arcadian Phosphates* (discussed in Note 1 at p. 312) different from *Brown v. Cara*? Note that the existence of an agreement to be bound to a Type II preliminary agreement is highly fact-specific. These two cases emphasize that the parties should be able to fall on either side of the line so long as they make their intentions clear.

iii. The authors of our book suggest that the failure to reach a final agreement on the underlying project in *Brown v. Cara* arose from Cara's spite (at 314). Are there facts that suggest otherwise? See the bottom of page 308 in which the court says that when Cara became offended, Brown claimed that "the wrong document" had been sent. What might actually have happened?

iv. An alternate way to resolve these issue is to interpret a Type II agreement in a slightly different way, as creating binding obligations if the overall negotiations are unsuccessful without regard to why they might fail. This seems like an especially reasonable interpretation when one party is expected by both sides to expend time and money to the project while negotiations continue. That is, we might read the Type II agreement as not containing a promise to negotiate in good faith but only as an agreement to bear some or all of the reliance costs if the negotiations fail. See the argument of Professors Schwartz and Scott at page 314. In very large corporate acquisitions, we often see such express provisions: because it is very expensive to determine the value of a large corporation, the potential buyer says that a price will be forthcoming but if no deal is reached, some fixed dollar amount will be paid by the potential seller. Why is the amount that will be paid invariably fixed in advance? What are the business concerns that inform the determination of the amount? Is there any fear that the seller might profit from the reliance expenditures?

C. Output, Requirements, and Exclusive Dealings Arrangements

1. Output and Requirement Contracts

a. Hypos:

i. Buyer agrees to buy, and seller agrees to sell, all the widgets that buyer desires to order during the next 12 months, each widget to cost $1.00. Contract?

ii. Same hypo, but buyer will purchase all widgets used in buyer's business. Contract?

iii. Same hypo as (i), but now buyer will purchase all widgets that sellers elects to manufacture. Contract?

iv. Reconsider hypo (ii). The spot price for widgets increases to $5.00, and Buyer advertises the widgets for resale. Buyer requests seller to double production. How is this hypo like the "freighting" issue in Eastern Airlines?

v. G dies owning a farm upon which stands some timber. Because the farm was encumbered, it must be auctioned to pay debts. The surviving relatives of G contract with the local mill that if the mill purchases the farm at the auction, it will sell the farm less the timber to the relative for $100,000. When is a contract formed?

vi. Gross income equals your receipts, and taxable income equals gross income less costs. A loan agreement calls for the interest rate to increase if the lender's tax rate increases. Congress modifies the internal revenue code to provide that tax rates will decrease from 50% to 40%. However, deductions that used to be allowed now are eliminated, so taxable income increases. How does the interest rate change under the contract?

vii. Suppose buyer and seller agree that seller will deliver 100 boys shirts to seller on the first of each month, and buyer will pay $5.00 per shirt. Buyer has the right to cancel on 15 days notice. Is there a contract, assuming the agreement is made on January 20? What if the agreement is made on January 2? In this case, might a contract spring into existence on Janua*ry 17?*

b. *Eastern Airlines v. Gulf Oil Corp.* (p. 317): Gulf Oil agreed to furnish jet fuel to Eastern for one year, with the price adjusted in part to market changes in the price of oil. OPEC is formed, and the price of oil rockets. In response, the US prices oil in a new way, making the method of measuring oil prices in the contract inaccurate. The contract only calls for Gulf Oil to supply some of Eastern's locations, but Eastern transfers ("freights") oil to other locations. *Held*, the fuel freighting is not a breach of contract because freighting was a part of the industry prior to the oil crises.

i. If the UCC did not provide that a requirements contract imposes on the buyer an obligation to purchase a reasonable quantity based on prior behavior, would the contract fail for want of consideration? That is, suppose the buyer promises nothing more than "if I buy from anyone, I'll buy all from you." Similarly, what if an output contract was understood as reading only that the seller promises: "I will sell to you all I choose to make"? Is there any other reasonable interpretation of the language when the parties have no prior history?

ii. *Empire Gas Corp. v. American Bakeries Co.* (p. 324): The purchaser of equipment to convert its fleet of gasoline-power trucks to propane agreed to purchase its requirements from the seller, of 3,000 more or less. Ultimately, it determined it did not want to do the conversion and bought nothing. Held, that the reference in U.C.C. §2-306 to "no quantity unreasonably disproportionate to any stated estimate" does not apply to requirements contracts beyond the more general requirement of good faith.

(A) Judge Posner says (at the beginning of the second full paragraph on page 327) that the buyer converted a part of its fleet to propane using equipment from another vendor. He also indicates that this action would have been at most a "trivial" breach of the contract. Why is that?

(B) Judge Posner seems to recognize that his analysis creates a new standard of proof (see the first paragraph on page 330). Is that appropriate in a diversity action?

iv. Stanley Law Summaries (Note 5 at 335): If Stanley accedes to Deacon's change, what market risks are shifted? What are the tacit assumptions being made? Why might Deacon sell fewer outlines?

c. A Note on Relational Contracts: Many contracts contemplate not a one-shot exchange but instead a series of transactions; that is, the parties agree to enter into a relationship of extended duration. In such a relational contract, the parties must worry about (i) future events beyond the influence of either party that affect the cost of performance, (ii) future events beyond the influence of either party that affect the value of the bargained-for return performance, and (iii) events within the control of a party that can be manipulated to shift the value or nature of the exchange.

i. Consider the case of a custody arrangement in a divorce agreement. The parties negotiate detailed provisions on the assumption that they will live a few miles from one another. But what if one party loses his job and is forced to seek employment in a distant location? Is the issue fundamentally different if the party keeps his job but is offered a better job elsewhere? Why might the parties not negotiate on this issue in advance? Would it be appropriate to ask a neutral third-party to decide what is fair under the circumstances and in light of the negotiated agreement? Would the common law recognize such a provision as binding? How is this different from an "agreement to agree"?

ii. Consider the case of a manufacturer and a buyer who agree on a long-term sales contract. If the manufacturer incurs significant costs in starting production, the seller may look for reasons justifying a renegotiation because relative bargaining strength has changed. What non-judicial restraint exists on such behavior? Note the problem of post-contractual opportunistic behavior ("post-contractual opportunism") if the potential value of renegotiation is high as compared with impact on reputation (i.e., a last-period problem). Why is the last month's rent much more likely to be late or go unpaid than the first month's rent?

iii. How can one party cause the other party to reveal their true preferences? Does an auction accomplish that goal? A reverse auction? A Dutch auction? How does a parent fairly divide the last piece of cake between two children? See the book: "*Cake Cutting Algorithms.*"

2. Exclusive Dealings Contracts

a. *Wood v. Lucy, Lady Duff-Gordon* (p. 341): Wood was granted the exclusive right to market Duff-Gordon's endorsement and designs, and the parties agreed to split the profits. Duff-Gordon seeks to avoid the contract on the ground that Wood provided no consideration. *Held*, it is tacit in the agreement that Wood would use his best efforts in the enterprise, and that is an enforceable standard.

b. *Bloor v. Falstaff Brewing Corp.* (p. 343):

(i) Facts: Ballantine sold its beer production to Falstaff. Falstaff agreed to pay a royalty of $0.50 per barrel and further promised to "use it best efforts to promote and maintain a high volume of sales" of the Ballantine product. The Ballantine product had lost money for years, and Falstaff turned it around by dramatically reducing costs (especially advertising costs). Thus, volume decreased substantially but losses were reduced or eliminated.

(ii) Issue: At issue was Falstaff's promise to "maintain a high volume of sales."

(iii) Holding: Per Judge Friendly, the appellate court upheld the trial court's determination that a breach had occurred because Falstaff failed to show that it considered ways to make Ballantine profitable other than by drastically reducing sales. Note Judge Friendly's attention to the burden of proof (at p. 347).

(iv) Notice also the damages issue (p. 348), with Judge Friendly willing to accept less certain proof of specific injury when the breach is established and the injury is one not easily susceptible of more accurate determination.

(v) How might the parties have avoided the problem?

(A) They might have provided that the royalty paid by Falstaff to Bloor would be a percentage of net income rather than gross income. This would avoid the conflict of interest created when Falstaff determined that it would be more profitable to make the Ballantine line a low volume, high margin sales item. However, Bloor would now be forced to worry that Falstaff would improperly measure its profit from the Ballantine line. Note that measuring profit from one line in a business is more problematic than measuring the company's over-all profit because in measuring profit product line by product line, company fixed costs ("overhead") must be apportioned among the various product lines.

(B) They might have provided that Falstaff would pay Bloor only a fixed fee. By eliminating the royalty, Bloor would have no interest in Falstaff's marketing of the Ballantine line, and so Bloor would not have to incur any monitoring costs. However, without providing for a royalty, the parties cannot tune the sale price to the future success of the Ballantine line. In such circumstances, Bloor would have a strong incentive to overstate Ballantine's past commercial success, and so Falstaff would have to incur substantial expense in determining the likely success of the Ballantine line after the sale.

3. Termination Clauses and Covenants Not to Compete

a. Termination Clauses

i. Hypo: You desire to hire a real estate agent to sell your house. You interview several agents, and each says that he requires an exclusive contract with a minimum of three months duration because substantial effort must be invested such as arranging listings, obtaining an appraisal, and such. During the contract period, the agent will use her best efforts to sell your house. What other provisions might you put in the contract?

(A) Some objective minimum performance standards?

(B) A termination provision. How should this termination provision read? Can you fire the agent if:

(1) The agent insists on telling prospective buyers that the roof leaks. It does, but assume state law does not law requires such a disclosure unless asked.

(2) Same issue as (1), but assume the disclosure is required by law.

(3) The agent refuses to make you a loan.

(4) The agent refuses to date you.

ii. *Wagenseller v. Scottsdale Memorial Hospital* (p. 356):

(A) Facts: Wagenseller was an employee of the Hospital; she was terminated allegedly because she refused to engage in distasteful social behavior suggested by her boss on a rafting trip. (Note: there is no showing that the rafting trip was sponsored by the Hospital.) Prior to her termination, she was an at-will employee except to the extent the Hospital's personnel policy manual modified that status. The trial court granted summary judgment for the hospital.

(B) *Held*: If the employee had been fired for refusing to violate a state indecent exposure, such firing would be illegal even if provided for in the contract. Quaere: what if the firing was not for the violation but rather because the refusal had created tension in the office? What if the tension continued for several months? What if the supervisor felt uncomfortable in the presence of the employee: she was a reminder of the supervisor's prior immaturity?

(C) *Held*: Even though the company manual states that its protections for employees are subject to listed exceptions as well as other, nonspecified exceptions, its precise statement of employee rights could be understood to modify the at-will relationship.

(D) *Held*: The requirement that each party to a contract deal in "good faith" does not modify "at-will" status such that employees can be terminated only for good cause.

iii. *Consumers International, Inc. v. Sysco Corp. (p. 362)*: Plaintiff CI was a smaller distributer of Sysco food products. The distribution agreement provided (a) that either party could terminate on 30 days notice based on a breach of the agreement, (b) that Sysco could terminate at any time of CI's financial position deteriorates, or (c) that either party could terminate on 60 days notice. Sysco exercised the 60-day termination provision, and CI argued that Sysco must establish a good reason for the termination based on the general contractual requirement imposed on every contracting party to act in good faith and fair dealing. *Held*, the requirement of good faith and fair dealing does not impose a "good cause" obligation and exercise of the express termination provision of the contract does not imply a bad cause for the termination.

(A) What is the "public policy" exception? The court refers to the state's constitution and statutes as well as to the public conscience. Could the contract be terminated because CI hired or fired someone based on race? On gender? On sexual orientation? Because the worker smoked or ate meat? Missed work to vote?

(B) Why might a legislature protect franchisees or franchisors in a particular industry?

b. Conventions Not to Compete

i. *Valley Med. Specialists v. Farber* (p. 372:)

D. Modification of Existing Agreements

1. *Alaska Packers' Ass'n v. Domenico* (p. 381): A shipowner hired workers to fish off the coast of Alaska. Once there, the workers refused to work unless they were given a raise. The master of the ship agreed to the raise, and the workers now sue to collect it. *Assume* that at trial, the workers allege that the nets were substandard. Because the workers were paid, in part, per fish caught, substandard netting would affect their compensation. The court found as a fact that the nets were in fact of acceptable quality. *Held*, the promised increase in wages is unenforceable as lacking consideration because the workers had no right to quit working. Quaere: if the workers in good faith believed that the nets were substandard, does that not give them the right to settle their claim on whatever terms they and the master will accept? Note, though, that the master here had no economically viable option but to accept the workers' terms. If the workers had agreed to perform some extra duties as part of the renegotiated contract, the pre-existing duty rule would not apply. However, the court might still refuse to enforce the new terms on the theory of economic duress (sometimes called duress of goods). Is this case really about *consideration* or about *voluntary bargaining*?

a. The court treats this case as turning on a lack of consideration; that is, a *pre-existing duty rule* case. How could the fishermen have ensured they could avoid the pre-existing duty rule?

b. Suppose there were a general principle that if performance of a contractual duty turned out to be harder than anticipated because of unanticipated conditions beyond the control of the promisor, the contractual duty could be avoided. How would such a rule affect the willingness of parties to renegotiate their contracts?

i. Is Restatement of Contracts (2d) §89 (p. 13) consistent with such a general principle?

ii. Is U.C.C. §2-209 (p. 148) consistent with Restatement of Contracts §89?

2. *Ralston Purina Co. v. McNabb* (p. 1974): The seller of goods was unable to make a timely delivery because of bad weather conditions, and the buyer agreed to extend the delivery date. The seller was unable to meet the extended date, and the buyer sues for breach. Because the price of the goods was rising throughout the extension period, damages will be greater if calculated as of the extended delivery date then they would be if calculated as of the original delivery date. The jury found as a fact that the buyer knew that the seller would not be able to make the extended delivery date, and so its willingness to extend was not made in good faith but was made only to increase its damages at trial. Accordingly, damages will be measured as of the original delivery date. Note that under U.C.C. §2-209, contract modifications may be modified without consideration. If the seller agreed to the extension, should he bound to it? Here, the seller alleges that he never agreed to the extensions but the court does not accept that argument. Rather, it seems to say that Ralston Purina knew that the extension would only work to the disadvantage of McNabb, and so by proposing it, Ralston Purina was acting in bad faith. Is this rationale troublesome? How is this case different from *Alaska Packers?* Should one party to a contract be charged with ensuring the well-being of the other party to the contract, especially when the contract does *not* establish a long-term working relationship or joint venture?

E. Collaborative Contracting

1. *Eli Lilly & Co. v. Emisphere Techs, Inc.* (p. 391): The two parties to the case entered into an agreement to jointly develop technology invented by Emisphere. Lilly formed a secret group to exploit that technology without involving Emisphere. The contract included a provision that read: "Lilly shall have no rights to use [the Emisphere technology] outside of the joint undertaking." (at 392) Emisphere treated this behavior as justification for terminating the collaboration and the license agreement, and the court upheld that decision: "Emisphere understandably and justifiably feels it can no longer trust Lilly to protect the confidentially of Emisphere's valuable intellectual property." (at 393) The court suggested that the outcome would not have been different even if the quoted language had not been in the agreement. Why? How is this case like *Wood v. Lucy, Lady Duff-Gordon*?

2. Hypos:

a. Writer and Publisher agree that Writer will provide a manuscript for a book on woodworking and Publisher will publish and market the finished book. Can Publisher publish a competing book by another author? How would you define "competing"?

b. Can Writer contract with a competing publisher for a different book on a different subject? On the same subject?

c. An Apple user sends an unsolicited product suggestion to Apple. Can Apple steal the idea?