

## Thinking like a Lawyer - Contracts 101

I once heard a saying which has since become a guiding principal in the way I do business. One day when the events of a deal turned unexpectedly in my favor, one of my colleagues told me that in the world of business there is no such thing as a “good surprise”. It took me a brief moment to let go of my happiness due to the unexpected windfall and to truly understand the meaning of those words. What my colleague meant was the very fact that I was surprised by the outcome, whether positive or not, was already a failure on my part. In business you want to foresee the outcomes of your actions as much as possible. You need to know exactly what will happen if your deal goes as planned and even more importantly, you need to know what will happen if your deal goes badly. This is where the law of contracts can be particularly useful. Generally speaking, contract law exists to make sure that people keep their promises. More importantly, however, contracts are used to determine what happens when people do not keep their promises. In short, a good contract will help you avoid surprises.

In the world of business certainty is an invaluable asset however, writing down some terms on paper and slapping your signature on the bottom will not necessarily create an enforceable contract. On the other hand you may find yourself in a contract without having executed any writing at all. In fact, a contract can be written or oral. Moreover, a contract can be created even in the absence of express language or by your actions alone. For example if you fill up your car at a gas station, your actions create a contract for the sale of gas. This type of contract is called an implied contract. In this type of contract your actions alone show your agreement to be bound by the terms that you knew or should have known exist. We all know that gas costs a certain amount on the other hand, not everyone knows that if you use a credit card at certain gas stations you are agreeing to pay an extra fee for that privilege. However, although you may not have known this to be true, in the eyes of the law you “should have known”. In reality you were probably given notice of this extra charge by some obscure sign or sticker somewhere on the pump... as I said “should have known”.

Contracts are a creation of the law and as such must satisfy certain legal standards in order to be enforceable. Generally speaking in order for a contract to be enforceable the following three elements must be present: 1) Mutual Assent, 2) Consideration, and 3) No Defenses. As with so many things in the law, the above mentioned elements require some explanation.

### Mutual Assent

This element requires for both parties to accept the terms of the contract. In order for this element to be satisfied there must be an “Offer” made by one side and an “Acceptance” by the other. The Offer is a promise or commitment made by one side to do something or to refrain from doing something. The Offer must include the essential terms of the deal. The essential terms of the deal can vary depending on the subject of the deal but typically include the price, quantity, and time for the performance of the duties contemplated by the contract. The Acceptance must be made with knowledge of the terms and within a reasonable time. In other words the acceptance must occur while the offer is still in effect. The acceptance must also “mirror” the offer. Thus, you must accept the terms being offered and not

introduce new terms. If you do accept the offer but include additional or different terms, your acceptance constitutes a counter-offer and is treated as a rejection of the original offer.

### Consideration

In order for a contract to exist there has to be an exchange of something of legal value by each side. In other words, each side must give something to the other in order for a contract to exist. Something of legal value does not have to be a tangible thing, foregoing an otherwise legal right is considered to have legal value. For example, if one party to the contract gives the other a basket of oranges and the other party in turn agrees not to buy oranges from anyone else, this is considered an exchange of consideration by both sides. One side is giving oranges while the other side is giving up its right to purchase oranges from other vendors. Thus consideration can exist when only one party transfers tangible property while the other party gives up an otherwise legal right, to buy from other vendors. In fact, consideration can exist even if no tangible property changes hands when, for example, both parties give up legal rights or promise to do something in the future which they were not obligated to do otherwise.

### No Defenses

This is a catch all element which basically states that there cannot be anything legally wrong with the contract. There can be no mutual mistakes, an example of a mutual mistake is when in a contract for the sale of a "mustang", the buyer thinks he will obtain a car and the seller believes he is contracting to sell a horse. This kind of mistake renders a contract unenforceable. In most circumstances if only one side is mistaken the contract will be enforceable. In order for a mistake to render the contract unenforceable both sides have to be mistaken. Both parties to the contract must have the proper capacity to enter into contracts, meaning, the parties must not be legally insane or minors. Lastly, the contract cannot be for something that is illegal or in violation of public policy.

Moreover the duty to act in good faith is implicit in all contracts. Good faith is an important element which is implied in any contract, so if someone makes a contract with the intent to defraud you in any way, that contract is unenforceable because it lacks the element of good faith. For example, if the seller of a "mustang" knows that the buyer thinks he is purchasing a car, but secretly intends to sell the buyer a horse, the seller is not acting in good faith and the contract will not be enforceable. Keep in mind however, that it can be very difficult to prove what someone intended.

Above is a basic description of the various ways in which a contractual relationship could arise and of the basic elements of a contract. Going beyond the basic elements, a contract is only as useful as the provisions contained within. A carefully thought-out contract can greatly decrease the cost of doing business. Recall that one of the most useful features of a contract is that they can be used to govern what happens when a deal fails. For example most cell phone companies make you sign a contract providing for an early termination fee. In the language of the law the early termination fee is called a liquidated damages clause. The effect is that if you breach your part of the bargain by terminating the agreement early you will pay a set amount of damages. These damages have been predetermined meaning that the phone company does not need to prove the amount of damages it incurred. More

likely than not your contract with the phone company also contains an Attorney's fees provision which could make you responsible for their legal fees and collection costs. This means that if you breach the agreement, not only will you pay the phone company the early termination fee, but also if you do not pay what you owe, you will be responsible for paying them the money they spend collecting this debt from you.

Even, if for some reason you think you had the right to cancel your contract with the phone company, for example if their service never worked, you would still be in a losing position from a strategic point of view. Pursuant to their contract the phone company would charge you the termination fee and it will be up to you to file a lawsuit against them. You will be responsible for paying the court costs and for proving to the court that you have a right to relief. Moreover, you will be facing the risk of being forced to pay the bill for the phone company's attorney's time if you lose. The end effect of having these provisions makes it very expensive and risky for you to file a lawsuit against the phone company. As you probably know if you have ever cancelled your cell phone services early, the phone company's contract is a very good deal for the phone company and a very bad deal for you. However, it is this strategic advantage that the phone company wanted to accomplish with their contract and it is for the sake of this advantage that the phone company hired very expensive attorneys to draft their contracts.

Knowing the value of contracts and using contracts properly to conduct your business puts the power of contract law in your hands. A proper contract at the very least provides you with certainty and predictability and could also provide you with as many advantages in a business deal as you can negotiate. Thus, the next time you consider going into a deal, consider drafting a contract first. It will be well worth the expense.

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