

## 7.2: Contract Formation

### Learning Objectives

By the end of this section, you will be able to:

- Understand the elements of common-law contracts: mutuality of agreement (offer and acceptance), consideration, legality, and capacity.
- Learn when a contract must be in writing—or evidenced by some writing—to be enforceable.

Although it has countless wrinkles and nuances, contract law asks two principal questions: did the parties create a valid, enforceable contract? What remedies are available when one party breaks the contract? The answer to the first question is not always obvious; the range of factors that must be taken into account can be large and their relationship subtle. Since people in business frequently conduct contract negotiations without the assistance of a lawyer, it is important to attend to the nuances to avoid legal trouble at the outset. Whether a valid enforceable contract has been formed depends in turn on whether:

1. The parties reached an agreement (offer and acceptance);
2. Consideration was present (some “price was paid for what was received in return);
3. The agreement was legal;
4. The parties entered into the contract with capacity to make a contract; and
5. The agreement is in the proper form (something in writing, if required).

### The Agreement: Offer and Acceptance

The core of a legal contract is the agreement between the parties. That is not merely a matter of convenience; it is at the heart of our received philosophical and psychological beliefs. As the great student of contract law, Samuel Williston, put it:

It was a consequence of the emphasis laid on the ego and the individual will that the formation of a contract should seem impossible unless the wills of the parties concurred. Accordingly we find at the end of the eighteenth century, and the beginning of the nineteenth century, the prevalent idea that there must be a “meeting of the minds” (a new phrase) in order to form a contract. (1921, p. 365)

Although agreements may take any form, including unspoken conduct between the parties (UCC Section 2-204(1)), they are usually structured in terms of an *offer* and an *acceptance*. Note, however, that not every agreement, in the broadest sense of the word, need consist of an offer and acceptance, and it is entirely possible, therefore, for two persons to reach agreement without forming a contract. For example, people may agree that the weather is pleasant or that it would be preferable to go out for Chinese food rather than seeing a foreign film; in neither case has a contract been formed. One of the major functions of the law of contracts is to sort out those agreements that are legally binding—those that are contracts—from those that are not.

In interpreting agreements, courts generally apply an objective standard. The *Restatement (Second) of Contracts* defines agreement as a “*manifestation of mutual assent by two or more persons to one another.*” (Section 3) The UCC defines agreement as “the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance.” (Section 1-201(3)) The critical question is what the parties said or did, not what they thought they said or did.

The distinction between objective and subjective standards crops up occasionally when one person claims he spoke in jest. The vice president of a manufacturer of punchboards, used in gambling, testified to the Washington State Game Commission that he would pay \$100,000 to anyone who found a “crooked board.” Barnes, a bartender, who had purchased two that were crooked some time before, brought one to the company office, and demanded payment. The company refused, claiming that the statement was made in jest (the audience before the commission had laughed when the offer was made). The court disagreed, holding that it was reasonable to interpret the pledge of \$100,000 as a means of promoting punchboards:

(I)f the jest is not apparent and a reasonable hearer would believe that an offer was being made, then the speaker risks the formation of a contract which was not intended. It is the objective manifestations of the offeror that count and not secret, unexpressed intentions. If a party’s words or acts, judged by a reasonable standard, manifest an intention to agree in regard to the matter in question, that agreement is established, and it is immaterial what may be the real but unexpressed state of the party’s mind on the subject. *Barnes v. Treece*, 549 P.2d 1152 (Wash. App. 1976).

An offer is a manifestation of willingness to enter into a bargain such that it would be reasonable for another individual to conclude that assent to the offer would complete the bargain. Offers must be communicated and must be definite; that is, they must spell out terms to which the offeree can assent.

To constitute an agreement, there must be an acceptance of the offer. The offeree must manifest his assent to the terms of the offer in a manner invited or required by the offer. Complications arise when an offer is accepted indirectly through correspondence. Although offers and revocations of offers are not effective until received, an acceptance is deemed accepted when sent if the offeree accepts in the manner specified by the offeror.

If the offeror specifies no particular mode, then acceptance is effective when transmitted as long as the offeree uses a reasonable method of acceptance. It is implied that the offeree can use the same means used by the offeror or a means of communication customary to the industry. For example, the use of the postal service was so customary that acceptances are considered effective when mailed, regardless of the method used to transmit the offer. Indeed, the so-called “mailbox rule” (the acceptance is effective upon dispatch) has an ancient lineage, tracing back nearly two hundred years to the English courts. *Adams v. Lindsell*, 1 Bawell & Alderson 681 (K.B. 1818).

## Consideration

Consideration, is the *quid pro quo* (something given or received for something else) between the contracting parties in the absence of which the law will not enforce the promise or promises made. Consider the following three “contracts”:

1. Betty offers to give a book to Lou. Lou accepts.
2. Betty offers Lou the book in exchange for Lou’s promise to pay \$15. Lou accepts.
3. Betty offers to give Lou the book if Lou promises to pick it up at Betty’s house. Lou accepts.

The question is which, if any, is a binding contract? In American law, only situation 2 is a binding contract, because only that contract contains a set of mutual promises in which each party pledges to give up something to the benefit of the other.

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures. For example, under Roman law, any contract that was reduced to writing was binding, whether or not there was consideration in our sense. Moreover, in later Roman times, certain promises of gifts were made binding, whether written or oral; these would not be binding in the United States. And in the Anglo-American tradition, the presence of a seal was once sufficient to make a contract binding without any other consideration. In most states, the seal is no longer a substitute for consideration, although in some states it creates a presumption of consideration. The Uniform Commercial Code has abolished the seal on contracts for the sale of goods.

The existence of consideration is determined by examining whether the person against whom a promise is to be enforced (the promisor) received something in return from the person to whom he made the promise (the promisee). That may seem a simple enough question. But as with much in the law, the complicating situations are never very far away. The “something” that is promised or delivered cannot just be anything: a feeling of pride, warmth, amusement, friendship; it must be something known as a legal detriment—an act, a forbearance, or a promise of such from the promisee. The detriment need not be an actual detriment; it may in fact be a benefit to the promisee, or at least not a loss. At the same time, the “detriment” to the promisee need not confer a tangible benefit on the promisor; the promisee can agree to forego something without that something being given to the promisor. Whether consideration is legally sufficient has nothing to do with whether it is morally or economically adequate to make the bargain a fair one. Moreover, legal consideration need not even be certain; it can be a promise contingent on an event that may never happen. Consideration is a *legal* concept, and it centers on the giving up of a *legal* right or benefit.

Consideration has two elements. The first, as just outlined, is whether the promisee has incurred a legal detriment. (Some courts—although a minority—take the view that a bargained-for legal benefit to the promisor is sufficient consideration.) The second is whether the legal detriment was *bargained for*: did the promisor specifically intend the act, forbearance, or promise in return for his promise? Applying this two-pronged test to the three examples given at the outset of the chapter, we can easily see why only in the second is there legally sufficient consideration. In the first, Lou incurred no legal detriment; he made no pledge to act or to forbear from acting, nor did he in fact act or forbear from acting. In the third example, what might appear to be such a promise is not really so. Betty made a promise on a condition that Lou come to her house; the intent clearly is to make a gift. Betty was not seeking to induce Lou to come to her house by promising the book.

There is a widely recognized exception to the requirement of consideration. In cases of promissory estoppel, the courts will enforce promises without consideration. Simply stated, promissory estoppel means that the courts will stop the promisor from claiming that there was no consideration. The doctrine of promissory estoppel is invoked in the interests of justice when three conditions are met:

(1) the promise is one that the promisor should reasonably expect to induce the promisee to take action or forbear from taking action of a definite and substantial character; (2) the action or forbearance is taken; and (3) injustice can be avoided only by enforcing the promise.

Timko served on the board of trustees of a school. He recommended that the school purchase a building for a substantial sum of money, and to induce the trustees to vote for the purchase, he promised to help with the purchase and to pay at the end of five years the purchase price less the down payment. At the end of four years, Timko died. The school sued his estate, which defended on the ground that there was no consideration for the promise. Timko was promised or given nothing in return, and the purchase of the building was of no direct benefit to him (which would have made the promise enforceable as a unilateral contract). The court ruled that under the three-pronged promissory estoppel test, Timko's estate was liable. *Estate of Timko v. Oral Roberts Evangelistic Assn.*, 215 N.W.2d 750 (Mich. App. 1974).

## Illegality

In general, illegal contracts are unenforceable. The courts must grapple with two types of illegalities: (1) statutory violations (e.g., the practice of law by a non-lawyer is forbidden by statute), and (2) violations of public policy not expressly declared unlawful by statute, but so declared by the courts.

## Capacity

A contract is a meeting of minds. If someone lacks mental capacity to understand what he is assenting to—or that he is assenting to anything—it is unreasonable to hold him to the consequences of his act.

The general rule is that persons younger than eighteen can avoid their contracts. Although the age of majority was lowered in most states during the 1970s to correspond to the Twenty-sixth Amendment (ratified in 1971, guaranteeing the right to vote at eighteen), some states still put the age of majority at twenty-one. Legal rights for those under twenty-one remain ambiguous, however. Although eighteen-year-olds may assent to binding contracts, not all creditors and landlords believe it, and they may require parents to cosign. For those under twenty-one, there are also legal impediments to holding certain kinds of jobs, signing certain kinds of contracts, marrying, leaving home, and drinking alcohol. There is as yet no uniform set of rules.

The exact day on which the disability of minority vanishes also varies. The old common law rule put it on the day before the twenty-first birthday. Many states have changed this rule so that majority commences on the day of the eighteenth (or twenty-first) birthday.

A minor's contract is voidable, not void. A child wishing to avoid the contract need do nothing positive to disaffirm; the defense of minority to a lawsuit is sufficient. Although the adult cannot enforce the contract, the child can (which is why it is said to be voidable, not void).

When the minor becomes an adult, he has two choices: he may ratify the contract or disaffirm it. She may ratify explicitly; no further consideration is necessary. She may also do so by implication—for instance, by continuing to make payments or retaining goods for an unreasonable period of time. (In some states, a court may ratify the contract before the child becomes an adult. In California, for example, a state statute permits a movie producer to seek court approval of a contract with a child actor in order to prevent the child from disaffirming it upon reaching majority and suing for additional wages. As quid pro quo, the court can order the producer to pay a percentage of the wages into a trust fund that the child's parents or guardians cannot invade.) If the child has not disaffirmed the contract while still a minor, she may do so within a reasonable time after reaching majority.

In most cases of disavowal, the only obligation is to return the goods (if he still has them) or repay the consideration (unless it has been dissipated). However, in two situations, a minor might incur greater liability: contracts for necessities and misrepresentation of age.

## Contract for Necessities

At common law, a "necessity" was defined as an essential need of a human being: food, medicine, clothing, and shelter. In recent years, however, the courts have expanded the concept, so that in many states today necessities include property and services that will enable the minor to earn a living and to provide for those dependent on him. If the contract is executory, the minor can simply disaffirm. If the contract has been executed, however, the minor must face more onerous consequences. Although he will not be required to perform under the contract, he will be liable under a theory of "quasi-contract" for the reasonable value of the necessity.

## Misrepresentation of Age

In most states, a minor may misrepresent his age and disaffirm in accordance with the general rule, because that's what kids do, misrepresent their age. That the adult reasonably believed the minor was also an adult is of no consequence in a contract suit. But some states have enacted statutes that make the minor liable in certain situations. A Michigan statute, for instance, prohibits a minor from disaffirming if he has signed a "separate instrument containing only the statement of age, date of signing and the signature." And some states "estop" him from claiming to be a minor if he falsely represented himself as an adult in making the contract. "Estoppel" is a refusal by the courts on equitable grounds to listen to an otherwise valid defense; unless the minor can return the consideration, the contract will be enforced.

Contracts made by an *insane* or *intoxicated* person are also said to have been made by a person lacking capacity. In general, such contracts are voidable by the person when capacity is regained (or by the person's legal representative if capacity is not regained).

## Form

As a general rule, a contract need not be in writing to be enforceable. An oral agreement to pay a high-fashion model \$1 million to pose for a photograph is as binding as if the language of the deal were printed on vellum and signed in the presence of twenty bishops. For centuries, however, a large exception has grown up around the Statute of Frauds, first enacted in England in 1677 under the formal name "An Act for the Prevention of Frauds and Perjuries." The purpose of the Statute of Frauds is to prevent the fraud that occurs when one party attempts to impose upon another a contract that did not in fact exist. The two sections dealing with contracts read as follows:

[Sect. 4] ...no action shall be brought whereby to charge any executor or administrator upon any special promise, to answer damages out of his own estate; (2) or whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriages of another person; (3) or to charge any person upon any agreement made upon consideration of marriage; (4) or upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them; (5) or upon any agreement that is not to be performed within the space of one year from the making thereof; (6) unless the agreement upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.

[Sect. 17] ...no contract for the sale of any goods, wares and merchandizes, for the price of ten pounds sterling or upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain, or in part of payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract, or their agents thereunto lawfully authorized.

Again, as may be evident from the title of the act and its language, the general purpose of the law is to provide evidence, in areas of some complexity and importance, that a contract was actually made. To a lesser degree, the law serves to caution those about to enter a contract and "to create a climate in which parties often regard their agreements as tentative until there is a signed writing." (*Restatement (Second) of Contracts* Chapter 5, statutory note)

The Statute of Frauds has been enacted in form similar to the seventeenth century act in most states. However, in the twentieth century Section 7 was replaced by a section Uniform Commercial Code. The UCC requires contracts for the sale of goods for \$500 or more and for the sale of securities to be in writing.

## Key Takeaways

A contract requires mutuality—an offer and an acceptance of the offer; it requires consideration—a "price" paid for what is obtained; it requires that the parties to the contract have legal capacity to know what they are doing; it requires legality. Certain contracts—governed by the statute of frauds—are required to be evidenced by some writing, signed by the party to be bound. The purpose here is to avoid the fraud that occurs when one person attempts to impose upon another a contract that did not really exist.

## Exercises

1. What are the required elements of a contract?
2. When was the Statute of Frauds first enacted, by whom, and why?
3. Basically, what does the Statute of Frauds require?

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