

# Contract Formation

by Sophia



## WHAT'S COVERED

In this lesson, you will learn about how contracts are created and what makes them enforceable or unenforceable. Specifically, this lesson will cover:

## 1. Requirements of Contract Formation

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).
3. The agreement was legal.
4. The parties entered into the contract with capacity to make a contract.
5. The agreement is in the proper form (something in writing, if required).

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## 2. 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 values. Although agreements may take any form, including unspoken conduct between the parties, 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.

➞ **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 CONTEXT

In interpreting agreements, courts generally apply an objective standard. The Restatement (Second) of Contracts (Section 3) defines agreement as a “manifestation of mutual assent by two or more persons to one another.”

The UCC (Section 1-201(3)) 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.”

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, as in the case below.

## CASE STUDY: *Barnes v. Treece*

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.



#### TERMS TO KNOW

##### Offer

A manifestation of willingness to enter into a contract. If the terms of an offer are definite and are accepted, a contract is formed. An offer can be withdrawn before it is accepted.

##### Acceptance

A manifestation of assent to all the terms of an offer, thus forming a contract.

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## 3. 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.



#### THINK ABOUT IT

Consider the following three “contracts.” Which, if any, is a binding contract?

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.*

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. In situation 1, Lou does not have to give up anything; the promise is merely a gift and is not enforceable due to lack of consideration. In situation 3, Lou has not given up anything, but if Lou had to travel a great distance to Betty’s house or suffer hardship to get there, this promise may well be enforceable.

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures.

#### IN CONTEXT

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.

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 forgo 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.



#### TERMS TO KNOW

##### Consideration

The requirement that a contract involve a quid pro quo or exchange of value. Without consideration, a contract is not enforceable; therefore, a one-sided promise to give a person money without requiring anything at all in return is not enforceable.

##### Quid Pro Quo

A Latin term representing something of value given or received in exchange for something else.

### 3a. Elements of Consideration

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 scenarios involving Lou and Betty, you can easily see why only in the second is there legally sufficient consideration.

➞ **EXAMPLE** In the first scenario, 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 scenario, 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.

### 3b. Exception to Consideration

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.
  3. Injustice can be avoided only by enforcing the promise.

#### **CASE STUDY: *Timko v. Oral Roberts Evangelic Association***

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).*



#### **TERM TO KNOW**

##### **Promissory Estoppel**

A legal doctrine that allows a person to recover in contract when a promise has been made and that person has detrimentally relied on the promise. An example would be a promise to convey real estate to a party in possession who has made substantial improvements to the property in reliance on the promise.



#### **SUMMARY**

In this lesson, you learned that there are **requirements of contract formation** that make a contract legally valid and enforceable. A legal contract must have **agreement**, which is composed of an offer with definite terms and an **acceptance** communicated between two parties. Contracts also require **consideration** between parties, which involves a promise to exchange something of legal value.

The two **elements of consideration** are whether the promisee has incurred a legal detriment and whether that detriment was bargained for by the promisor. There is an **exception to consideration** known as promissory estoppel. In some cases, courts will enforce a promise that lacks consideration in the interest of justice for the promisee.

Best of luck in your learning!

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## TERMS TO KNOW

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A manifestation of assent to all the terms of an offer, thus forming a contract.

### **Consideration**

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### **Offer**

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### **Promissory Estoppel**

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