Limitations on Contract Remedies

by Sophia

WHAT'S COVERED

In this lesson, you will learn about several limitations or restrictions affecting when a person can claim remedies for a breach of contract. Specifically, this lesson will cover:

1. Foreseeability

If the damages that flow from a breach of contract lack foreseeability, they will not be recoverable. Failures to act, like acts themselves, have consequences.

To put a non-breaching party in the position he would have been in had the contract been carried out could mean, in some cases, providing compensation for a long chain of events. In many cases, that would be unjust, because a person who does not anticipate a particular event when making a contract will not normally take steps to protect himself (either through limiting language in the contract or through insurance).

The law is not so rigid; a loss is not compensable to the non-breaching party unless the breaching party, at the time the contract was made, understood the loss was foreseeable as a probable result of his breach.

Of course, the loss of the contractual benefit in the event of breach is always foreseeable.

↱ EXAMPLE A company that signs an employment contract with a prospective employee knows full well that if it breaches, the employee will have a legitimate claim to lost salary. But it might have no reason to know that the employee's holding the job for a certain length of time was a condition of his grandfather's gift of $1 million.

CASE STUDY: *Hadley v. Baxendale*

Joseph and Jonah Hadley were proprietors of a flour mill in Gloucester, England. In May 1853, the shaft of the milling engine broke, stopping all milling. An employee went to Pickford and Company, a common carrier, and asked that the shaft be sent as quickly as possible to a Greenwich foundry that would use the shaft as a model to construct a new one. The carrier's agent promised delivery within two days. But through an error, the shaft was shipped by canal rather than by rail and did not arrive in Greenwich for seven days. The Hadleys sued Joseph Baxendale, managing director of Pickford, for the profits they lost because of the delay. In ordering a new trial, the Court of Exchequer ruled that Baxendale was not liable because he had had no notice that the mill was stopped:

> *"Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it."*
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> *Hadley v. Baxendale (1854), 9 Ex. 341, 354, 156 Eng.Rep. 145, 151.*

Thus, when the party in breach has not known and has had no reason to know that the contract entailed a special risk of loss, the burden must fall on the non-breaching party.

As we have seen, damages attributable to losses that flow from events that do not occur in the ordinary course of events are known as consequential or special damages. The exact amount of a loss need not be foreseeable; it is the nature of the event that distinguishes between claims for ordinary or consequential damages.

> ↱ EXAMPLE A repair shop agrees to fix a machine that it knows is intended to be resold. Because it delays, the sale is lost. The repair shop, knowing why timeliness of performance was important, is liable for the lost profit, as long as it was reasonable. It would not be liable for an extraordinary profit that the seller could have made because of circumstances peculiar to the particular sale unless they were disclosed.

The special circumstances do not need to be recited in the contract. It is enough for the party in breach to have actual knowledge of the loss that would occur through his breach. So, the lesson to a promisee is that the reason for the terms he bargains for should be explained to the promisor— although too much explanation could kill a contract.

> ↱ EXAMPLE A messenger who is paid five dollars to deliver a letter across town is not likely to undertake the mission if he is told in advance that his failure for any reason to deliver the letter will cost the sender $1 million, liability to be placed on the messenger.

Actual knowledge is not the only criterion, because the standard of foreseeability is objective, not subjective. That means that if the party had reason to know - if a reasonable person would have understood - that a particular loss was probable should he breach, then he is liable for damages.

What one has reason to know obviously depends on the circumstances of the case, the parties' prior dealings, and industry custom.

> ↱ EXAMPLE A supplier selling to a middleman should know that the commodity will be resold and that delay or default may reduce profits, whereas delay in sale to an end user might not.

If it was foreseeable that the breach might cause the non-breaching party to be sued, the other party is liable for legal fees and a resulting judgment or the cost of a settlement.

Even though the breaching party may have knowledge, the courts will not always award full consequential damages. In the interests of fairness, they may impose limitations if such an award would be manifestly unfair. Such cases usually crop up when the parties have dealt informally and there is a considerable disproportion between the loss caused and the benefit the non-breaching party had agreed to confer on the party who breached.

> ↱ EXAMPLE The messenger may know that a huge sum of money rides on his prompt delivery of a

letter across town, but unless he explicitly contracted to bear liability for failure to deliver, it is unlikely that the courts would force him to ante up $1 million when his fee for the service was only five dollars.

2. Mitigation of Damages

Contract law encourages the non-breaching party to avoid loss wherever possible; this is called mitigation of damages. The concept is a limitation on damages in law.

So, there can be no recovery if the non-breaching party had an opportunity to avoid or limit losses and failed to take advantage of it. Such an opportunity exists as long as it does not impose, in the Restatement of Contract's words, an "undue risk, burden or humiliation."

The effort to mitigate does not need to be successful. As long as the non-breaching party makes a reasonable, good-faith attempt to mitigate his losses, damages are recoverable.

Mitigation crops up in many circumstances. Thus, a non-breaching party who continues to perform after notice that the promisor has breached or will breach may not recover for expenses incurred in continuing to perform. And, losses from the use of defective goods delivered in breach of contract are not compensable if the non-breaching party knew before use that they were defective.

Often the non-breaching party can make substitute arrangements (find a new job or a new employee; buy substitute goods or sell them to another buyer) and his failure to do so will limit the amount of damages he will recover from the party who breaches.

Under the general rule, failure to mitigate when possible permits the promisor to deduct from damages the amount of the loss that the non-breaching party could have avoided. When there is a readily ascertainable market price for goods, damages are equal to the difference between the contract price and the market price.

A substitute transaction is not just any possible arrangement; it must be suitable under the circumstances. Factors to be considered include the similarity, time, and place of performance, and whether the difference between the contracted-for and substitute performances can be measured and compensated.

> ↱ EXAMPLE A prospective employee who cannot find substitute work within her field need not mitigate by taking a job in a wholly different one: An advertising salesperson whose employment is repudiated need not mitigate by taking a job as a taxi driver.

When the only difference between the original and the substitute performances is price, the non-breaching party must mitigate, even if the substitute performer is the original promisor. The non-breaching party must mitigate in timely fashion, but each case is different. If it is clear that the promisor has unconditionally repudiated before performance is due, the non-breaching party must begin to mitigate as soon as practicable and should not wait until the day performance is due to look for an alternative.

As long as the non-breaching party makes a reasonable effort to mitigate, the success of that effort is not an issue in assessing damages.

> ↱ EXAMPLE If a film producer's original cameraman breaches the contract, and if the producer had diligently searched for a substitute cameraman, who cost $150 extra per week, and it later came to light that the producer could have hired a cameraman for $100, the company is entitled nevertheless to damages based on the higher figure.

3. Certainty of Damages

A party can recover only that amount of damage in law that can be proved with reasonable certainty. Especially troublesome in this regard are lost profits and loss of goodwill.

> **IN CONTEXT**
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> Alf is convinced that next spring the American public will be receptive to polka-dotted belts with his name monogrammed in front. He arranges for a garment factory to produce 300,000 such belts, but the factory, which takes a large deposit from him in advance, misplaces the order and does not produce the belts in time for the selling season.
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> When Alf discovers the failure, he cannot raise more money to go elsewhere, and his project fails. He cannot recover damages for lost profits because the number is entirely speculative; no one can prove how much he would have made, if anything. He can, instead, seek restitution of the monies advanced. If he had rented a warehouse to store the belts, he would also be able to recover his reliance interest.

Proof of lost profits is not always difficult: A seller can generally demonstrate the profit he would have made on the sale to the buyer who has breached.

The problem is more difficult, as Alf's case demonstrates, when it is the seller who has breached.

> ↱ EXAMPLE A buyer who contracts for but does not receive raw materials, supplies, and inventory cannot show definitively how much he would have netted from the use he planned to make of them. But he is permitted to prove how much money he has made in the past under similar circumstances, and he may proffer financial and market data, surveys, and expert testimony to support his claim.

When proof of profits is difficult or impossible, the courts may grant a non-monetary award, such as specific performance.

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4. Loss of Power of Avoidance

There are several circumstances when a person may avoid a contract:

- Duress
- Undue influence
- Misrepresentation (fraudulent, negligent, or innocent)
- Mistake

But a party may lose the right to avoid, and thus the right to any remedy, in several ways.

4a. Delay

If a party is the victim of fraud, she must act promptly to **rescind** at common law, or she will lose the right and her remedy will be limited to damages in tort.

TERM TO KNOW

Rescind

The verb form of the noun rescission. Rescind means to reverse an agreement. A rescission is the abrogation, annulment, avoidance, or cancellation of a contract.

4b. Affirmation

An infant who waits too long to disaffirm (again, delay) will have ratified the contract, as will one who - notwithstanding being the victim of duress, undue influence, mistake, or any other grounds for avoidance - continues to operate under the contract with full knowledge of his right to avoid.

Of course, the disability that gave rise to the power of avoidance must have passed before affirmation works.

4c. Rights of Third Parties

The intervening rights of third parties may terminate the power to avoid.

IN CONTEXT

Michelle, a minor, sells her watch to Betty. Up to and within a reasonable time after reaching majority, Michelle could avoid (disaffirm) the contract. But if, before that time, Betty sells the watch to a third party, Michelle cannot get it back from the third party.

Similarly, Salvador sells his car to Bill, who pays for it with a bad check. If the check bounces, Salvador can rescind the deal: Since Bill's consideration (the money represented by the check) has failed, Salvador could return the check and get his car back. But if, before the check from Bill bounces, Bill in turn sells the car to Pat, Salvador cannot avoid the contract. Pat gets to keep the car.

There are, however, some exceptions to this rule.

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5. Agreement of the Parties Limiting Remedies

Certainly, it is the general rule that parties are free to enter into any kind of a contract they want, so long as it is not illegal or unconscionable.

↗ EXAMPLE The inclusion into the contract of a liquidated damages clause is one means by which the parties may make an agreement affecting damages.

But beyond that, it is very common for one side to limit its liability, or for one side to agree that it will pursue only limited remedies against the other in case of breach. Such agreed-to limitations on the availability of remedies are generally okay provided they are conspicuous, bargained-for, and not unconscionable.

In consumer transactions, courts are more likely to find a contracted-for limitation of remedies unconscionable than in commercial transactions, and under the Uniform Commercial Code (UCC) there are further restrictions on contractual remedy limitations.

IN CONTEXT

Juan buys ten bags of concrete to make a counter and stand for his expensive new barbecue. The bags have this wording in big print:

"Attention. Our sole liability in case this product is defective will be to provide you with a like quantity of non-defective material. We will not be liable for any other damages, direct or indirect, express or implied."

That's fine. If the concrete is defective, the concrete top breaks, and Juan's new barbecue is damaged, he will get nothing but some new bags of good concrete. He could have shopped around to find somebody who would deliver concrete with no limitation on liability. As it is, his remedies are limited by the agreement he entered into.

6. Election of Remedies

Another limitation is the concept of election of remedies. The nature of a loss resulting from a contract breach may be such as to entitle one party to a choice among two or more means to redress the grievance, where the choices are mutually exclusive.

6a. At Common Law

At classic common law, a person who was defrauded had an election of remedies: She could, immediately upon discovering the fraud, rescind, or she could retain the item (real estate or personal property) and attempt to remedy the fraudulently defective performance by suing for damages, but not both.

CASE STUDY: *Merritt v. Craig*

A buyer purchases real estate from a seller for $300,000 and shortly discovers that the seller fraudulently misrepresented the availability of water. The buyer spends $60,000 trying to drill wells. Finally, he gives up and sues the seller for fraud, seeking $360,000. Traditionally at common law, he would not get it. He should have rescinded upon discovery of the fraud. Now he can only get $60,000 in damages in tort.

Merritt v. Craig, 746 A.2d 923 (Md. 2000).

The purpose of the election of remedies doctrine is to prevent the victim of fraud from getting a double recovery, but it has come under increasing criticism.

6b. Under the Uniform Commercial Code

The doctrine of election of remedy has been rejected by the UCC, which means that the remedies are cumulative in nature. According to Section 2-703(1), "Whether the pursuit of one remedy bars another depends entirely on the facts of the individual case."

Section 2-721 provides that neither demand for rescission of the contract in the case of misrepresentation or fraud, nor the return or rejection of goods, bars a claim for damages or any other remedy permitted under the UCC for non-fraudulent breach.

7. Tort vs. Contract

Frequently a contract breach may also amount to tortious conduct.

> ↱ EXAMPLE A physician warrants her treatment as perfectly safe but performs the operation negligently, scarring the patient for life. The patient could sue for malpractice (tort) or for breach of warranty (contract).

The choice involves at least four considerations:

1. *Statute of limitations:* Most statutes of limitations prescribe longer periods for contract than for tort actions.
2. *Allowable damages:* Punitive damages are more often permitted in tort actions, and certain kinds of injuries are compensable in tort but not in contract suits— for example, pain and suffering.
3. *Expert testimony:* In most cases, the use of experts would be the same in either tort or contract suits, but in certain contract cases, the expert witness could be dispensed with, as, for example, in a contract case charging that the physician abandoned the patient.
4. *Insurance coverage:* Most policies do not cover intentional torts, so a contract theory that avoids the element of willfulness would provide the plaintiff with a surer chance of recovering money damages.

8. Legal vs. Extralegal Remedies

A party entitled to a legal remedy is not required to pursue it. Lawsuits are disruptive not merely to the individuals involved in the particular dispute, but also to the ongoing relationships that may have grown up around the parties, especially if they are corporations or other business enterprises.

Buyers must usually continue to rely on their suppliers, and sellers on their buyers. Not surprisingly, therefore, many businesspeople refuse to file suits even though they could, preferring to settle their disputes privately or even to ignore claims that they might easily press.

Indeed, the decision whether or not to sue is not one for the lawyer but for the client, who must analyze a number of pros and cons, many of them not legal ones at all.

SUMMARY

In this lesson, you learned that the law places certain limitations on contract remedies. For example, damages that flow from a breach of contract must have **foreseeability**, meaning the loss could have been reasonably anticipated by the breaching party at the time of the breach. Non-breaching parties have a duty to **mitigate damages** (i.e., avoid losses) if they have a reasonable opportunity to do so, otherwise the damages they are entitled to may be reduced. **Certainty of damages** must exist, meaning a party can only recover damages that they can quantify with reasonable certainty.

There are circumstances in which a party who could have gotten out of a contractual obligation suffers a **loss of power of avoidance**, and therefore their right to remedy: if they **delay** rescission, if they **affirm** the contract through their actions, or if the **rights of third parties** interfere with their power to avoid. An **agreement of the parties limiting remedies** is common in contracts, as are contracts that

require an **election of remedies**. This approach developed **under common law** but is not allowed **under the Uniform Commercial Code**.

Finally, there are circumstances when a person may choose not to pursue remedies at all, such as when a **contract** breach rises to the level of a **tort**, or when **extralegal remedies**, such as a private settlement, make more sense for the preservation of a business relationship.

Best of luck in your learning!

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TERMS TO KNOW

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