opportunity to understand the terms of the contract, or were the important terms hidden in a maze of fine print and minimized by deceptive sales practices? Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld.

no consent - little know of terms

In determining reasonableness or fairness, the primary concern must be with the terms of the contract considered in light of the circumstances existing when the contract was made. The test is not simple, nor can it be mechanically applied. The terms are to be considered "in the light of the general commercial background and the commercial needs of the particular trade or case."[11] Corbin suggests the test as being whether the terms are "so extreme as to appear unconscionable according to the mores and business practices of the time and place." 1 Corbin [§128].[12] We think this formulation correctly states the test to be applied in those cases where no meaningful choice was exercised upon entering the contract.

terms so extreme its unconscionable

Because the trial court and the appellate court did not feel that enforcement could be refused, no findings were made on the possible unconscionability of the contracts in these cases. Since the record is not sufficient for our deciding the issue as a matter of law, the cases must be remanded to the trial court for further proceedings.

So ordered.

DANAHER, Circuit Judge (dissenting). The District of Columbia Court of Appeals obviously was as unhappy about the situation here presented as any of us can possibly be. Its opinion in the *Williams* case, quoted in the majority text, concludes: "We think Congress should consider corrective legislation to protect the public from such exploitive contracts as were utilized in the case at bar."

My view is thus summed up by an able court which made no finding that there had actually been sharp practice. Rather the appellant seems to have known precisely where she stood.

There are many aspects of public policy here involved. What is a luxury to some may seem an outright necessity to others. Is public oversight to be required of the expenditures of relief funds? A washing machine, e.g., in the hands of a relief client might become a fruitful

11. Comment, Uniform Commercial Code §2-30[2].

12. See Henningsen v. Bloomfield Motors, Inc. [32 N.J. 358, 161 A.2d 69 (1960)]; Mandel v. Liebman, 303 N.Y. 88, 100 N.E.2d 149 (1951). The traditional test as stated in Greer v. Tweed, 13 Abb. Pr., N.S. [427] at 429 [(N.Y. 1872)], is "such as no man in his senses and not under the delusion would make on the one hand, and as no honest or fair man would accept, on the other."

source of income. Many relief clients may well need credit, and certain business establishments will take long chances on the sale of items, expecting their pricing policies will afford a degree of protection commensurate with the risk. Perhaps a remedy when necessary will be found within the provisions of the "Loan Shark" law, D.C. Code §§26-601 et seq. (1961).

I mention such matters only to emphasize the desirability of a cautious approach to any such problem, particularly since the law for so long has allowed parties such great latitude in making their own contracts. I dare say there must annually be thousands upon thousands of installment credit transactions in this jurisdiction, and one can only speculate as to the effect the decision in these cases will have.

I join the District of Columbia Court of Appeals in its disposition of the issues.

NOTE AND QUESTION

Unconscionability is a wild card doctrine in our law. Dealing as it does with basic fairness, the concept has been attacked as meaningless, untamable, dangerous. The seminal law review article advocating this view was the late Professor Arthur Leff's Unconscionability and the Code: The Emperor's New Clause, 115 U. Pa. L. Rev. 485 (1967), in which the author casually proposed a two-part test for unconscionability that has proved very popular with the courts. Leff stated that before a court could deem a contract or any part thereof unconscionable, the court must find both *procedural* and *substantive* unconscionability. Procedural unconscionability, according to Leff, meant unfairness in the bargaining process (typically because one party, having the superior position, dictates the terms and refuses to bargain at all). Substantive unconscionability, on the other hand, refers to harsh terms in the resulting contract. How does this compare with the definition of unconscionability given by Judge J. Skelly Wright in the last case?

Wright does both

procedural

MAXWELL v. FIDELITY FINANCIAL SERVICES
Arizona Supreme Court, 1995
907 P.2d 51

FELDMAN, C.J. Elizabeth Maxwell petitions us to review a court of appeals opinion affirming a trial court ruling that the doctrine of novation barred Maxwell's claim that a contract was unconscionable and therefore unenforceable. See Maxwell v. Fidelity Fin. Servs., Inc., 179 Ariz. 544, 880 P.2d 1090 (Ct. App. 1993). We granted review to examine the law dealing with grounds for novation and unconscionability and to determine whether the principles of contract interpretation announced in Taylor v. State Farm Mut. Auto. Ins. Co., 175 Ariz. 148, 854 P.2d 1134 (1993), are applicable to these issues.

FACTS AND PROCEDURAL HISTORY

The facts, taken in the light most favorable to Maxwell, against whom summary judgment was granted, are that in December 1984, Elizabeth Maxwell and her then husband, Charles, were approached by Steve Lasica, a door-to-door salesman representing the now defunct National Solar Corporation (National). Lasica sold the Maxwells a solar home water heater for a total purchase price of $6,512. Although National was responsible for installation, the unit was never installed properly, never functioned properly, and was eventually declared a hazard, condemned, and ordered disconnected by the City of Phoenix. Thus, although the unit may have been intrinsically worthless, the question of unconscionability is determined as of the time the contract was made. A.R.S. §47-2302.

Financing for the purchase was accomplished through a loan to the Maxwells from Fidelity Financial Services, Inc. (Fidelity). The sale price was financed for a ten-year period at 19.5 percent interest, making the total cost nearly $15,000.

At the time of the transaction, Elizabeth Maxwell earned approximately $400 per month working part-time as a hotel maid and her husband earned approximately $1,800 per month working for the local paper. At Fidelity's request, an appraisal was made of the Maxwells' South Phoenix home, where they had resided for the preceding twelve years. The appraisal showed that the Maxwells lived in a modest neighborhood, that their 1,539 square foot home was in need of a significant amount of general repair and maintenance, and that its market value was approximately $40,000.

In connection with the financing transaction, Elizabeth Maxwell signed numerous documents, including a loan contract, a deed of trust, a truth-in-lending disclosure form, and a promissory note and security agreement. The effect of these documents was not only to secure the deferred purchase price with a lien on the merchandise sold, but also to place a lien on Maxwell's house as additional security for payment on the water heater contract. The forms and their terms were unambiguous and clearly indicated that Maxwell was placing a lien on her house. Included in the consumer credit contract between Maxwell and Fidelity was a clause expressly stating that Fidelity was subject to all claims by and defenses that Maxwell could assert against National.

Despite the fact that the water heater was never installed or working properly, Maxwell made payments on it for approximately three and one-half years, reducing the deferred purchase balance to $5,733. In 1988, Maxwell approached Fidelity to borrow an additional $800 for purposes unrelated to the original loan. In making this second loan, Fidelity required Maxwell to again sign a bundle of documents essentially identical to those she signed in 1984. Instead of simply adding $800 to Maxwell's outstanding balance on the 1984 contract, Fidelity created a new contract that included the unpaid balance of $5,733 on the 1984 loan, a term life insurance charge of $313, as well as the new $800 loan. In all, Maxwell financed the sum of $6,976 with this second loan. The terms of this latest loan also included interest at 19.5 interest and payments for a period of six years, making Maxwell's new payments, including interest, total nearly $12,000. The combined amount Maxwell would pay under the two contracts for a non-functioning water heater and the additional $800 loan thus totals approximately $17,000, or nearly one-half the value of her home.

Maxwell continued to make payments until 1990, when she brought this declaratory judgment action seeking, inter alia, a declaration that the 1984 contract was unenforceable on the grounds that it was unconscionable.

Following discovery, Fidelity moved for summary judgment asserting, among other things, that the statute of limitations had run on Maxwell's claim of unconscionability and, if not, that the 1988 contract worked a novation, thereby barring any action by Maxwell on the 1984 contract. Maxwell filed a memorandum in opposition to this motion and pointed to sworn testimony in her deposition, which Fidelity submitted with its motion, as raising genuine issues of material fact.

In a brief order, the trial court granted Fidelity's motion on the theory of novation:

> The court has had under advisement [Fidelity's] motion for summary judgment. The court has considered the pleadings, the argument, and the authorities. It is ordered granting the motion. By way of explanation, the court is of the opinion that although the statute of limitations does not bar this action, the doctrine of novation does.

Minute Entry, May 31, 1991.

The court of appeals affirmed. . . .

3. THE HISTORY OF UNCONSCIONABILITY

Traditionally, equity courts recognized the defense of unconscionability in denying relief to plaintiffs who were guilty of unconscionable conduct. See Dan B. Dobbs, 2 Law of Remedies 703 (2d ed. 1993). Because barring relief was a matter of the chancellor's discretion, equity never developed a clear set of rules for analyzing claims of unconscionability. See id. Additionally, in equity unconscionability served as a remedial doctrine, limiting a party's remedies without truly affecting its substantive legal rights. Id. at 704. However, the enactment of an unconscionability defense under U.C.C. Article 2 changed that. The rule as it now exists is largely substantive, working primarily as a defense both in law and in equity and applying to claims for damages as well as specific performance. Id. at 704-05.

Although U.C.C. §2-302 recognized and codified the amorphous equitable doctrine, it did little to provide a set of rules for analyzing claims of unconscionability. Also lacking in the statutory recognition of unconscionability is a definition of that term. Courts and respected commentators alike have grappled with defining and applying unconscionability under the Code since its adoption. To this day, both groups remain divided on the proper method for doing so, though they share some common ground on defining such a test.

Within this common area, the elements of unconscionability can be ascertained to fulfill the Code's obvious intent of protecting against unconscionable contracts while not unnecessarily denying parties the benefit of their bargain. Although no litmus test exists, the cases do provide a reasonable, workable analysis.

4. DIVISIONS OF UNCONSCIONABILITY UNDER THE U.C.C.

This court previously has acknowledged that the unconscionability principle involves an assessment by the court of

> whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract. . . . The principle is one of the prevention of oppression and unfair surprise . . . not of disturbance of allocation of risks because of superior bargaining power.

making of the contract

Seekings v. Jimmy GMC of Tucson, Inc., 130 Ariz 596, 602, 638 P.2d 210, 216 (1981) (citations omitted). This somewhat circular articulation of the principle, however, is not readily applicable to the infinite variety of cases that may involve the doctrine of unconscionability.

The framework upon which the vast majority of courts construct their analysis consists of the well recognized division of unconscionability into substantive and procedural parts. See, e.g., James J. White & Robert S. Summers, 1 Uniform Commercial Code 204, n.8 and cases cited therein; John D. Calamari & Joseph M. Perillo, Contracts 406 (3d ed. 1987). Professor Dobbs provides the following explanation of the difference between these two types:

> Procedural or process unconscionability is concerned with "unfair surprise," fine print clauses, mistakes or ignorance of important facts or other things that mean bargaining did not proceed as it should. Substantive unconscionability is an unjust or "one-sided" contract. Substantive unconscionability is important in two ways. First, substantive unconscionability sometimes seems sufficient in itself to avoid a term in the contract. Second, substantive unconscionability sometimes helps confirm or provide evidence of procedural unconscionability.

Dobbs, supra at 706 (footnote omitted). This dichotomy evolved from a distinction made by the late Professor Leff in his oft-cited article Unconscionability and The Code — The Emperor's New Clause, 115 U. Pa. L. Rev. 485, 487 (1967). In his article, Professor Leff distinguished between "bargaining naughtiness" (procedural unconscionability) and overly harsh terms (substantive unconscionability). Id.

Over the years, courts have refined the two divisions of unconscionability and identified several factors that are indicative of each.

Procedural unconscionability was well-explained in Johnson v. Mobil Oil Corp.:

Def. of proc.

> Under the procedural rubric come those factors bearing upon . . . the real and voluntary meeting of the minds of the contracting party: age, education, intelligence, business acumen and experience, relative bargaining power, who drafted the contract, whether the terms were explained to the weaker party, whether alterations in the printed terms were possible, whether there were alternative sources of supply for the goods in question.

415 F. Supp. 264, 268 (E.D. Mich. 1976) (internal quotations omitted). As Professors White and Summers have noted, procedural unconscionability bears a strong resemblance to its "common-law cousins" of fraud and duress. White & Summers, supra at 204.

Substantive unconscionability concerns the actual terms of the contract and examines the relative fairness of the obligations assumed. Resource Management Co. v. Weston Ranch & Livestock Co., 706 P.2d 1028, 1041 (Utah 1985). Indicative of substantive unconscionability are contract terms so one-sided as to oppress or unfairly surprise an innocent party, an overall imbalance in the obligations and rights imposed by the bargain, and significant cost-price disparity. Id. (citations and internal quotations omitted).

We believe these authorities provide useful illustrations of both divisions of unconscionability under the U.C.C., although we do not restrict applicability of the doctrine to the factors outlined.

5. APPLICATION

The point of agreement by courts on the substantive-procedural elements also marks a point of departure in analyzing claims of unconscionability. See generally White & Summers, supra at 218-20. Many courts, perhaps a majority, have held that there must be some quantum of both procedural and substantive unconscionability to establish a claim, and take a balancing approach in applying them. Id. at 219. See also 2 William D. Hawkland, Uniform Commercial Code Series §2-302:05 (1984) and cases cited therein. Other courts have held that it is sufficient if either is shown. See, e.g., Gilman v. Chase Manhattan Bank, N.A., 534 N.E.2d 824, 829 (N.Y. 1988) ("While determinations of unconscionability are ordinarily based on the court's conclusion that both the procedural and substantive components are present . . . , ~~there have~~ been exceptional cases where a provision of the contract is so outrageous ~~as to~~ warrant holding it unenforceable on the ground of substantive unconscionability alone.") (citing State v. Wolowitz, 96 A.D.2d 47 (N.Y. 1983)). In addition to the numerous courts holding that either procedural or substantive unconscionability is sufficient, the leading commentators in this field have also endorsed this position. See White & Summers, supra at 220 (advocating the sufficiency of excessive price alone).

The cases that require a showing of both procedural and substantive unconscionability appear to be rather fact-specific, based more on the historical reluctance of courts to disturb contracts than on valid doctrinal underpinning.

> In some cases substantive unconscionability is found because the contract price is grossly excessive (or sometimes grossly inadequate). Most of these cases present additional elements such as actual misrepresentations, gross mistreatment of people who are already disadvantaged, or a subject matter such as premarital settlements that calls for intense state scrutiny by judges. *In some of them, the substantive unconscionability really seems to be evidentiary only, that is, as confirming the conclusion that the process of bargaining was itself defective.*

Dobbs, supra at 707 (footnote omitted) (emphasis added); see also Calamari & Perillo, supra at 406 ("[C]ontracts involving grossly unequal exchanges almost always involve some impropriety in the negotiating process or disability of a party."); White & Summers, supra at 218 ("Almost all of [the cases finding substantively unconscionable terms] exhibit creditor behavior that may be regarded as both procedurally and substantively unconscionable.").

Additional evidence that the dual requirement position is more coincidental than doctrinal is found within the very text of the statute on unconscionability, which explicitly refers to "the contract *or any clause* of the contract." A.R.S. §47-2302 (emphasis added). Conspicuously absent from the statutory language is any reference to procedural aspects. ~~That~~ the U.C.C. contemplated substantive unconscionability alone to be sufficient is the most plausible reading of the language in §47-2302, given that the Code itself provides for per se unconscionability if there exists, without more, a substantive term in the contract limiting consequential damages for injury to the person in cases involving consumer goods. See A.R.S. §47-2719(C). It is wholly inconsistent to assert that unconscionability under §47-2302 requires some procedural irregularity when unconscionability under §47-2719 clearly does not.

Therefore, we conclude that under A.R.S. §47-2302, a claim of unconscionability can be established with a showing of substantive unconscionability alone, especially in cases involving either price-cost disparity or limitation of remedies. If only procedural irregularities are present, it may be more appropriate to analyze the claims under the doctrines of fraud, misrepresentation, duress, and mistake, although such irregularities can make a case of procedural unconscionability. See *Resource Management Co.*, 706 P.2d at 1043. However, we leave for another day the questions involving the remedy for procedural unconscionability alone.

We conclude further that this case presents a question of at least substantive unconscionability to be decided by the trial court. From the face of it, we certainly cannot conclude that the contract as a whole is not unconscionable, given the $6,500 price of a water heater for a modest residence, payable at 19.5 percent interest, for a total time-payment price of $14,860.43. These facts present at least a question of grossly-excessive price, constituting substantive unconscionability. See Dobbs, supra at 707;

Almost always some subs. is proof of proc. bec one results from the other.

water heater
does not work
breach of contract?

White & Summers, supra at §4-5 and cases cited therein. This contract is made even more harsh by its security terms, which, in the event of non-payment, permit Fidelity not only to repossess the water heater but foreclose on Maxwell's home. The apparent injustice and oppression in these security provisions not only may constitute substantive unconscionability but also may provide evidence of procedural unconscionability. See Dobbs, supra at 706-07 (citing Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965)).

Under the U.C.C. as enacted in A.R.S. §47-2302, the court may "refuse enforcement of the contract altogether." Dobbs, supra at 705; Restatement §208. The present factual record, before the statutorily required evidentiary hearing, certainly contains some evidence that the entire 1984 contract, including sale price, security provisions, and remedies, is unenforceable. . . .

CONCLUSION

We are not satisfied from the state of this record that Fidelity had a meaningful opportunity to present evidence on the commercial setting, purpose, and effect of the 1984 contract, as required by A.R.S. §47-2302. The trial court expressly based its decision entirely on the doctrine of novation without addressing the fundamental question of unconscionability in the manner required by statute. . . .

Therefore, we vacate the court of appeals' opinion, reverse the trial court's judgment, and remand to the trial court for proceedings consistent with this opinion and A.R.S. §47-2302.

legal conclusion made by court

MARTONE, J., concurring in the judgment. I would hold that the 1984 contract and the 1988 contract are unconscionable as a matter of law. As the majority acknowledges, a declaration of unconscionability under A.R.S. §47-2302(A) is a legal conclusion to be made by the court. And the evidence referred to in §47-2302(B) "is for the court's consideration, and not the jury's." U.C.C. §2-302, Comment 3 (1962). The facts as outlined by the majority lead to one inescapable conclusion: one of unconscionability. If these contracts are not unconscionable as a matter of law, what contract would be? . . .

On the undisputed facts, the commercial setting, purpose and effect of the contracts are tragically plain. The commercial setting: a "now defunct" entity, ante, at 2, took advantage of a limited person living on the margin of human existence. The purpose: to extract "$17,000" from a "hotel maid" who earned "$400 per month." Id. at 3-4. The effect: to subject a marginal person to the risk of loss of her home, all for a hot water heater that "was never installed properly, [and] never functioned properly." Id. at 2. . . .

NOTE ON DOOR-TO-DOOR SALES

Buyers trapped in their homes and subjected to hours of salespitch all too frequently sign up for foolish ventures of the kind described in the

190 F Supp 116

case. Recognizing that those who are purchasing items in their own homes do not have the bargaining position of someone who is in the seller's store (and thus free to walk away), the Federal Trade Commission has promulgated a regulation permitting such buyers to avoid the contract without reason if a notice of rescission is mailed to the seller before expiration of midnight of the third business day following the date of sale. Further, the three-day period does not even begin to run until the seller has furnished the buyer with a form explaining this right to cancel. The rule does not apply to the sale of insurance or real estate or to transactions in which buyer is the one who initiates the contact. See Federal Trade Commission Regulations for Door-to-Door Sales, 16 C.F.R. §429.

Problem 127

Star General Construction Company contacted Wong Air Conditioning Contractors and offered to give Wong the air conditioning subcontract on a construction project recently awarded to Star General if Wong could supply the air conditioning units at $8,000 each. Wong replied that it would lose money at that rate, but Star General said that $8,000 was the best it could do. Wong is a tiny new business and needs to build its reputation. If it agrees to do the project at the quoted rate, can it later use UCC §2-302 to reform the contract and receive a greater price? Does §2-302 protect *merchants* ~~in sales contracts~~?

WEAVER v. AMERICAN OIL CO.
Supreme Court of Indiana, 1971
257 Ind. 458, 276 N.E.2d 144

ARTERBURN, C.J. In this case the appellee oil company presented to the appellant-defendant leasee, a filling station operator, a printed form contract as a lease to be signed, by the defendant, which contained, in addition to the normal leasing provisions, a "hold harmless" clause which provided in substance that the leasee operator would hold harmless and also indemnify the oil company for any negligence of the oil company occurring on the leased premises. The litigation arises as a result of the oil company's own employee spraying gasoline over Weaver and his assistant and causing them to be burned and injured on the leased premises. This action was initiated by American Oil and Hoffer (Appellees) for a declaratory judgment to determine the liability of appellant Weaver, under the clause in the lease. The trial court entered judgment holding Weaver liable under the lease.

Clause three (3) of the lease reads as follows:

> Lessor, its agents and employees shall not be liable for any loss, damage, injuries, or other casualty of whatsoever kind or by whomsoever caused to the person or property of anyone (including Lessee) on or off the premises, arising out of or resulting from Lessee's use, possession or operation

> thereof, or from defects in the premises whether apparent or hidden, or from the installation existence, use, maintenance, condition, repair, alteration, removal or replacement of any equipment thereon, whether due in whole or in part to negligent acts or omissions of Lessor, its agents or employees; and Lessee for himself, his heirs, executors, administrators, successors and assigns, hereby agrees to indemnify and hold Lessor, its agents and employees, harmless from and against all claims, demands, liabilities, suits or actions (including all reasonable expenses and attorneys' fees incurred by or imposed on the Lessor in connection therewith) for such loss, damage, injury or other casualty. Lessee also agrees to pay all reasonable expenses and attorneys' fees incurred by Lessor in the event that Lessee shall default under the provisions of this paragraph.

It will be noted that this lease clause not only exculpated the leasor oil company from its liability for its negligence, but also compelled Weaver to indemnify them for any damages or loss incurred as a result of its negligence. The appellate court held the exculpatory clause invalid, 261 N.E.2d 99, but the indemnifying clause valid, 262 N.E.2d 663. In our opinion, both these provisions must be read together since one may be used to effectuate the result obtained through the other. We find no ground for any distinction and we therefore grant the petition to transfer the appeal to this court.

This is a contract, which was submitted (already in printed form) to a party with lesser bargaining power. As in this case, it may contain unconscionable or unknown provisions which are in fine print. Such is the case now before this court.

The facts reveal that Weaver had left high school after one and a half years and spent his time, prior to leasing the service station, working at various skilled and unskilled labor oriented jobs. He was not one who should be expected to know the law or understand the meaning of technical terms. The ceremonious activity of signing the lease consisted of nothing more than the agent of American Oil placing the lease in front of Mr. Weaver and saying "sign," which Mr. Weaver did. There is nothing in the record to indicate that Weaver read the lease; that the agent asked Weaver to read it; or that the agent, in any manner, attempted to call Weaver's attention to the "hold harmless" clause in the lease. Each year following, the procedure was the same. A salesman, from American Oil, would bring the lease to Weaver, at the station, and Weaver would sign it. The evidence showed that Weaver had never read the lease prior to signing and that the clauses in the lease were never explained to him in a manner from which he could grasp their legal significance. The leases were prepared by the attorneys of American Oil Company, for the American Oil Company, and the agents of the American Oil Company never attempted to explain the conditions of the lease nor did they advise Weaver that he should consult legal counsel, before signing the lease. The superior bargaining power of American Oil is patently obvious and the significance of Weaver's signature upon the legal document amounted to nothing more than a mere formality to Weaver for the substantial protection of American Oil.

Had this case involved the sale of goods it would have been termed an "unconscionable contract" under sec. 2-302 of the Uniform Commercial

Code as found in Burns' Ind. Stat. sec. 19-2-302, IC 1971, 26-1-2-302. The statute reads as follows:

> 19-2-302. *Unconscionable contract or clause.* — If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.
>
> (2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination. (Acts 1963, ch. 317, sec. 2-302 p. 539.)

According to the Comment to Official Text, the basic test of unconscionability is whether, in light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract. Subsection two makes it clear that it is proper for the court to hear evidence upon these questions.

> An "unconscionable contract" has been defined to be such as no sensible man not under delusion, duress or in distress would make, and such as no honest and fair man would accept. There exists here an "inequality so strong, gross and manifest that it is impossible to state it to a man of common sense without producing an exclamation at the inequality of it." "Where the inadequacy of the price is so great that the mind revolts at it the court will lay hold on the slightest circumstances of oppression or advantage to rescind the contract."
>
> It is not the policy of the law to restrict business dealings or to relieve a party of his own mistakes of judgment, but where one party has taken advantage of another's necessities and distress to obtain an unfair advantage over him, and the latter, owing to his condition, has encumbered himself with a heavy liability or an onerous obligation for the sake of a small or inadequate present gain, there will be relief granted. Stiefler v. McCullough (1933), 97 Ind. App. 123, 174 N.E. 823.

The facts of this case reveal that in exchange for a contract which, if the clause in question is enforceable, may cost Mr. Weaver potentially thousands of dollars in damages for negligence of which he was not the cause, Weaver must operate the service station seven days a week for long hours, at a total yearly income of $5,000-$6,000. The evidence also reveals that *the clause was in fine print* and *contained no title heading* which would have identified it as an indemnity clause. It seems a deplorable abuse of justice to hold a man of poor education, to a contract prepared by the attorneys of American Oil, for the benefit of American Oil which was presented to Weaver on a "take it or leave it basis."

Personal circum always as is [illegible]

Justice Frankfurter of the United States Supreme Court spoke on the question of inequality of bargaining power in his dissenting opinion in United States v. Bethlehem Steel Corp. (1942), 315 U.S. 289, 326.

> [I]t is said that familiar principles would be outraged if Bethlehem were denied recovery on these contracts. But is there any principle which is more familiar or more firmly embedded in the history of Anglo-American law than the basic doctrine that the courts will not permit themselves to be used as instruments of inequity and injustice? Does any principle in our law have more universal application than the doctrine that courts will not enforce transactions in which the relative positions of the parties are such that one has unconscionably taken advantage of the necessities of the other?
>
> These principles are not foreign to the law of contracts. Fraud and physical duress are not the only grounds upon which courts refuse to enforce contracts. The law is not so primitive that it sanctions every injustice except brute force and downright fraud. More specifically, the courts generally refuse to lend themselves to the enforcement of a "bargain" in which one party has unjustly taken advantage of the economic necessities of the other.

The traditional contract is the result of free bargaining of parties who are brought together by the play of the market, and who meet each other on a footing of approximate economic equality. In such a society there is no danger that freedom of contract will be a threat to the social order as a whole. But in present-day commercial life the standardized mass contract has appeared. It is used primarily by enterprises with strong bargaining power and position. The weaker party, in need of the goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly (natural or artificial) or because all competitors use the same clauses.

Judge Frankfurter's dissent was written nearly twenty years ago. It represents a direction and philosophy which the law, at that time was taking and is now compelled to accept in our modern society over the old principle known as the *parole evidence* [sic] *rule.* The parole evidence rule states that an agreement or contract, signed by the parties, is *conclusively presumed* to represent an integration or meeting of the minds of the parties. This is an archaic rule from the old common law. The objectivity of the rule has as its only merit its simplicity of application which is far outweighed by its failure in many cases to represent the actual agreement, particularly where a printed form prepared by one party contains hidden clauses unknown to the other party is submitted and signed. The law should seek the truth or the subjective understanding of the parties in this more enlightened age. The burden should be on the party submitting such "a package" in printed form to show that the other party had knowledge of any unusual or unconscionable terms contained therein. The principle should be the same as that applicable to implied warranties, namely that a package of goods sold to a purchaser is fit for the purposes intended and contains no harmful materials other than that represented. Caveat lessee is no more the current law than caveat emptor. Only in this way can justice be served and the true meaning of freedom of contract preserved. The analogy is rational. We have previously pointed out a similar situation in the Uniform Commercial Code, which prohibits unconscionable contract clauses in sales agreements.

When a party can show that the contract, which is sought to be enforced, was in fact an unconscionable one, due to a prodigious amount of bargaining power on behalf of the stronger party, which is used to the stronger party's advantage and is unknown to the lesser party, causing a great hardship and risk on the lesser party, the contract provision, or the contract as a whole, if the provision is not separable, should not be enforceable on the grounds that the provision is contrary to public policy. The party seeking to enforce such a contract has the burden of showing that the provisions were explained to the other party and *came to his knowledge* and there was in fact *a real and voluntary meeting of the minds and not merely an objective meeting.*

have to show that a real & voluntary meeting of minds occurred

Unjust contract provisions have been found unenforceable, in the past, on the grounds of being contrary to public policy, where a party has a greater superior bargaining position. In Pennsylvania Railroad Co. v. Kent (1964), 136 Ind. App. 551, 198 N.E.2d 615, Judge Hunter, speaking for the court said that although the proposition that "parties may enter into such contractual arrangement as they may desire may be conceded in the general sense; when, however, such special agreement may result in affecting the public interest and thereby contravene public policy, the abrogation of the rules governing common carriers must be zealously guarded against."

We do not mean to say or infer that parties may not make contracts exculpating one of his negligence and providing for indemnification, but it must be done *knowingly* and *willingly* as in insurance contracts made for that very purpose.

It is the duty of the courts to administer justice and that role is not performed, in this case, by enforcing a written instrument, not really an agreement of the parties as shown by the evidence here, although signed by the parties. The parole evidence rule must yield to the equities of the case. The appeal is transferred to this court and the judgment of the trial court is reversed with direction to enter judgment for the appellant.

Holding

GIVAN, DEBRULER and HUNTER, JJ., concur.

PRENTICE, J., dissents, with opinion.

PRENTICE, J. (dissenting). . . . The identical clause which Defendant here seeks to avoid was held not to be against public policy in the case of Loper v. Standard Oil Co. (1965), 138 Ind. App. 84, 211 N.E.2d 797. Defendant directs our attention, however, to Henningsen et al. v. Bloomfield Motors, Inc., et al. (1960), 32 N.J. 358, 161 A.2d 69, 75 A.L.R.2d 1, cited in Am. Jur. 2d Contract §188, where, according to Defendant, it is said: "It has been held that clauses limiting liability are given rigid scrutiny by the courts, and will not be enforced unless the limitation is fairly and honestly negotiated and understandingly entered into." The Appellate Court has accepted this statement at face value although there appears to be no Indiana authority in support of such rule. It has been given limited application in other jurisdictions and, as limited, appears to be reasonable and workable. But the defendant appears to mislead us by failing to complete the quotation, which is completed as follows: ". . . this is especially true where the contract involves services of a public or semipublic nature, but has also been applied in some controversies involving private contracts, particularly where, as in the case of a public or semipublic contract *the private contract is the only means one of the parties has of filling an important need.*" (Emphasis added.) The *Henningsen* case involved an action by a consumer against the vendor of an automobile, wherein the court declined to enforce the provision of the sales contract that provided that the express warranty was in lieu of all others expressed or implied. The case has no application to the issues raised on this appeal. Neither do the facts as found by the trial court, together with additional facts mentioned, suggest a disparity of bargaining positions warranting the application of exceptions to reasonable and well established rules or offend against my concept of fair business negotiations. A general disparity of economic or intellectual positions, while factors to be considered along with others in such cases, do not, in and of themselves, give one who is dominant in such attributes an unconscionable advantage in the particular transaction. Whether or not the contract was "understandingly entered into" by Defendant, we, of course, cannot say; but we see nothing to indicate that he was deprived of the opportunity to understand it by any acts or omissions of American. It would be a strange, and in my opinion impossible, rule if one party to a contract were to be held the guardian of the other and accountable to him for both the advantages he hoped to gain thereunder and the risks or losses that he may have failed to consider. Under such a rule, the less one knew of the provisions of the written contract which he executed, the better would be his position in the event of later dissatisfaction.

Problem with unconscionability

Chief Justice Arterburn, speaking for a majority of this Court, has concluded that the defendant was in an inferior position with respect to the lease and treats the lease as we might treat an *adhesion* contract. I find justification for neither. An adhesion contract is one that has been drafted unilaterally by the dominant party and then presented on a "take it or leave it" basis to the weaker party, who has no real opportunity to bargain about its terms. (Restatement 2d, Conflict of Law §332 a, Comment e) (17 C.J.S. Contracts §10, p.581.) Here we have a printed form contract prepared by American. There was great disparity between the economic positions of American and Defendant; and Defendant was a man of limited educational and business background. However, there is nothing from which we can find or infer that the printed lease provisions were not subject to negotiation or that, with respect to this particular lease, Defendant was not in a bargaining position equal to that of American. The fact that Defendant did not avail himself of the opportunity to read the agreement but elected to accept it as presented does not warrant the inference that his only options were to "take it or leave it." That the "hold harmless" clause was or might have been in small print, as suggested by the majority, can hardly have significance in light of the claim and finding that the defendant did not read any portion of the document.

The majority places great reliance upon the dissenting opinion of Justice Frankfurter in United States v. Bethlehem Steel Corp. (1942), 315 U.S. 289, 326. I agree that it is a well reasoned opinion and that the philosophy there expressed has had a great impact upon the parole evidence rule and rightfully so. However, I find no similarity between the actual situations under consideration. In the *Bethlehem Steel* case, the national security of the United States hung in the balance while the terms of the contract in question were negotiated. Although the negotiators for the government had a theoretical choice between accepting the proposed contract or taking over the operation, of Bethlehem, the latter subjected the nation to such grave peril as to amount to no choice at all. Bethlehem's actions clearly amounted to the taking of an unconscionable advantage of the circumstances, and there was ample authority for relieving the government of the harsh terms thusly coerced. The court there had merely to apply the fundamental principles of law that the courts will not enforce a bargain where one party has unconscionably taken advantage of the necessities and distress of the other. In the case at bar, the defendant was under no compulsion to act. There is nothing to indicate that he was motivated by any purpose other than to improve his own economic position, that the lease arrangement was to be more beneficial to American than to him, that he was financially, intellectually or emotionally incompetent or disadvantaged, that his necessities or potential distress were in any way involved or that his bargaining position with respect to this particular transaction, was not substantially equal to that of American.

The case of the Pennsylvania Railroad Co. v. Kent (1964), 136 Ind. App. 551, 198 N.E.2d 615, has no application, as it was determined upon an issue of public interest and the rules governing common carriers. Also, it is clear that the Uniform Commercial Code sections on sales cited by the majority can have no application; and Chief Justice Arterburn was careful to point out that it was referred to only to illustrate the acceptance of legal philosophies permitting and fostering fair dealings and substantive justice rather than blind and often unjust adherence to hard and fast rules. But we have neither the duty nor the right to abandon established principles whenever, in our judgment, it is necessary to avert a hardship. And should the Legislature see fit to vest us with either or both, I question that we have the requisite wisdom. It is for this reason, I believe, that our mandate is not simply to administer justice but to do so *under the law*. I hold no special interest in preserving the policy of enforcing indemnity and exculpatory contracts. It may well be that they should be greatly curtailed. But the majority opinion does not so hold. Defendant's dilemma does not spring from an unconscionable advantage taken of him either by deceit of American or by virtue of a superior bargaining position. It clearly stems from either an unwillingness or indifference upon his part to utilize the resources available to him or from a willingness to assume the risks in exchange for the rewards that he hoped to gain. Presumably he has had the benefits contracted for, and the majority decision is a grant of retrospective unilateral contractual immunity to the careless and speculative and places a premium upon ignorance. I fear that it will stand as an invitation to any litigant, who finding himself burdened by his own contract, will say that he did not understand its provisions and ask us for relief that we have neither the duty, right nor wisdom to grant.

I would accept transfer of this cause, set aside the decision of the Appellate Court, as modified, and affirm the decision of the trial court.

QUESTIONS

1. What is the difference between an exculpatory clause and an indemnity clause? Which was which here? Why not simply declare all exculpatory clauses void as against public policy?

barr of oil

2. Was there both procedural and substantive unconscionability here?

3. Can any language in the case be cited for the proposition that Indiana has abandoned the parol evidence rule entirely? See Grande v. General Motors Corp., 444 F.2d 1022 (7th Cir. 1971).

yearly income

4. If you were advising American Oil Company, how should it proceed in the future to make sure these clauses would be enforceable?

The chief reporter of the UCC, and its guiding spirit, was Professor Karl Llewellyn of Columbia Law School. Llewellyn was one of the great legal minds of his day and the author of many famous discussions of commercial problems. When he tackled the problem of unconscionability, he came up with his celebrated "true answer" to the issue of enforcing harsh clauses in contracts:

> The answer, I suggest, is this: Instead of thinking about "assent" to boilerplate clauses, we can recognize that so far as concerns the specific, there is no assent at all. What has in fact been assented to, specifically, are the few dickered terms, and the broad type of the transaction, and but one thing more. That one thing more is a blanket assent (not a specific assent) to any not unreasonable or indecent terms the seller may have on his form, which do not alter or eviscerate the reasonable meaning of the dickered terms. The fine print which has not been read has no business to cut under the reasonable meaning of those dickered terms which constitute the dominant and only real expression of agreement.

K. Llewellyn, The Common Law Tradition: Deciding Appeals 370 (1960).

Problem 128

When she went to check her coat at La Casa Restaurant, Portia Moot failed to notice a sign on the coatroom wall that stated "Not Responsible for Lost Items" in rather large letters. When she went to retrieve the coat after her meal, it was missing. Did the sign exculpate the restaurant from liability? Would it help the defense if the claim check she had been given also repeated this language?

NOTE ON UNCONSCIONABILITY IN THE LEASING OF GOODS

Article 2A of the UCC on the lease of goods contains an unconscionability section modeled on §2-302, but going a bit further. Like its predecessor, §2A-108 does not define unconscionability but does have the following rules:

§2A-108. Unconscionability.

(1) If the court as a matter of law finds a lease contract or any clause of a lease contract to have been unconscionable at the time it was made the court may refuse to enforce the lease contract, or it may enforce the remainder of the lease contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) With respect to a consumer lease, if the court as a matter of law finds that a lease contract or any clause of a lease contract has been induced by unconscionable conduct or that unconscionable conduct has occurred in the collection of a claim arising from a lease contract, the court may grant appropriate relief.

(3) Before making a finding of unconscionability under subsection (1) or (2), the court, on its own motion or that of a party, shall afford the parties a reasonable opportunity to present evidence as to the setting, purpose, and effect of the lease contract or clause thereof, or of the conduct.

(4) In an action in which the lessee claims unconscionability with respect to a consumer lease:

(a) If the court finds unconscionability under subsection (1) or (2), the court shall award reasonable attorney's fees to the lessee.
(b) If the court does not find unconscionability and the lessee claiming unconscionability has brought or maintained an action he [or she] knew to be groundless, the court shall award reasonable attorney's fees to the party against whom the claim is made.
(c) In determining attorney's fees, the amount of the recovery on behalf of the claimant under subsections (1) and (2) is not controlling.

It is possible that this expanded set of rules will influence the courts in nonlease situations when it is applied by analogy (for example, to forbid unconscionable behavior in the collection process).

VIII. IMPOSSIBILITY

If an event occurs *before* the contract is formed that causes trouble with its performance, the law of mistake is generally used to solve the difficulty. If the problem arises *after* contract formation, the rules that follow are more appropriately used (though courts are not always careful to observe this distinction).

When life goes wrong and the contract cannot be performed, who bears what risk? Where do the losses fall? Again our leading case comes from Great Britain.

TAYLOR v. CALDWELL
Queen's Bench, 1863
3 B.&S. 826, 122 Eng. Rep. 309

BLACKBURN, J. In this case the plaintiffs and defendants had, on the 27th May, 1861, entered into a contract by which the defendants agreed to let the plaintiffs have the use of The Surrey Gardens and Music Hall on four days then to come, viz., the 17th June, 15th July, 5th August and 19th August, for the purpose of giving a series of four grand concerts, and day and night fêtes at the Gardens and Hall on those days respectively; and the plaintiffs agreed to take the Gardens and Hall on those days, and pay £100 for each day.

The parties inaccurately call this a "letting," and the money to be paid a "rent"; but the whole agreement is such as to shew that the defendants were to retain the possession of the Hall and Gardens so that there was to be no demise of them, and that the contract was merely to give the plaintiffs the use of them on those days. Nothing however, in our opinion, depends on this. The agreement then proceeds to set out various stipulations between the parties as to what each was to supply for these concerts and entertainments, and as to the manner in which they should be carried on. The effect of the whole is to shew that the existence of the Music Hall in the Surrey Gardens in a state fit for a concert was essential for the fulfilment of the contract, — such entertainments as the parties contemplated in their agreement could not be given without it.

After the making of the agreement, and before the first day on which a concert was to be given, the Hall was destroyed by fire. This destruction, we must take it on the evidence, was without the fault of either party, and was so complete that in consequence the concerts could not be given as intended. And the question we have to decide is whether, under these circumstances, the loss which the plaintiffs have sustained is to fall upon the defendants. The parties when framing their agreement evidently had not present to their minds the possibility of such a disaster, and have made no express stipulation with reference to it, so that the answer to the question must depend upon the general rules of law applicable to such a contract.

There seems no doubt that where there is a positive contract to do a thing, not in itself unlawful, the contractor must perform it or pay damages for not doing it, although in consequence of unforeseen accidents, the performance of his contract has become unexpectedly burthensome or even impossible. The law is so laid down in 1 Roll. Abr. 450, Condition (G), and in the note (2) to Walton v. Waterhouse (2 Wms. Saund. 421 a. 6th ed.), and is recognised as the general rule by all the Judges in the much discussed case of Hall v. Wright (E.B.&E. 746). But this rule is only applicable when the contract is positive and absolute, and not subject to any condition either express or implied: and there are authorities which, as we think, establish the principle that where, from the nature of the contract, it appears that the parties must from the beginning have known that it could not be fulfilled unless when the time for the fulfilment of the contract

no condition in the contract is required arrived some particular specified thing continued to exist, so that, when entering into the contract, they must have contemplated such continuing existence as the foundation of what was to be done; there, in the absence of any express or implied warranty that the thing shall exist, the contract is not to be construed as a positive contract, but as subject to an implied condition that the parties shall be excused in case, before breach, performance becomes impossible from the perishing of the thing without default of the contractor.

Theory of impossibility

There seems little doubt that this implication tends to further the great object of making the legal construction such as to fulfil the intention of those who entered into the contract. For in the course of affairs men in making such contracts in general would, if it were brought to their minds, say that there should be such a condition. . . .

There is a class of contracts in which a person binds himself to do something which requires to be performed by him in person; and such promises, e.g. promises to marry, or promises to serve for a certain time, are never in practice qualified by an express exception of the death of the party; and therefore in such cases the contract is in terms broken if the promisor dies before fulfilment. Yet it was very early determined that, if the performance is personal, the executors are not liable; Hyde v. The Dean of Windsor (Cro. Eliz. 552, 553). See 2 Wms. Exors. 1560, 5th ed., where a very apt illustration is given. "Thus," says the learned author, "if an author undertakes to compose a work, and dies before completing it, his executors are discharged from this contract: for the undertaking is merely personal in its nature, and, by the intervention of the contractor's death, has become impossible to be performed." For this he cites a dictum of Lord Lyndhurst in Marshall v. Broadhurst (1 Tyr. 348, 349), and a case mentioned by Patteson J. in Wentworth v. Cock (10 A.&E. 42, 45-46). In Hall v. Wright (E.B.&E. 746, 749), Crompton J., in his judgment, puts another case. "Where a contract depends upon personal skill, and the act of God renders it impossible, as, for instance, in the case of a painter employed to paint a picture who is struck blind, it may be that the performance might be excused."

personal obligation do not have to be performed after death

It seems that in those cases the only ground on which the parties or their executors, can be excused from the consequences of the breach of the contract is, that from the nature of the contract there is an implied condition of the continued existence of the life of the contractor, and, perhaps in the case of the painter of his eyesight.

It may, we think, be safely asserted to be now English law, that in all contracts of loan of chattels or bailments if the performance of the promise of the borrower or bailee to return the things lent or bailed, becomes impossible because it has perished, this impossibility (if not arising from the fault of the borrower or bailee from some risk which he has taken upon himself) excuses the borrower or bailee from the performance of his promise to redeliver the chattel.

The great case of Coggs v. Bernard (1 Smith's L.C. 171, 5th ed.; 2 L. Raym. 909) is now the leading case on the law of bailments, and Lord Holt, in that case, referred so much to the Civil law that it might perhaps be thought that this principle was there derived direct from the civilians, and was not generally applicable in English law except in the case of bailments; but the case of Williams v. Lloyd (W. Jones, 179), above cited, shews that the same law had been already adopted by the English law as early as The Book of Assizes. The principle seems to us to be that, in contracts in which the performance depends on the continued existence of a given person or thing, a condition is implied that the impossibility of performance arising from the perishing of the person or thing shall excuse the performance.

In none of these cases is the promise in words other than positive, nor is there any express stipulation that the destruction of the person or thing shall excuse the performance; but that excuse is by law implied, because from the nature of the contract it is apparent that the parties contracted on the basis of the continued existence of the particular person or chattel. In the present case, looking at the whole contract, we find that the parties contracted on the basis of the continued existence of the Music Hall at the time when the concerts were to be given; that being essential to their performance.

not express, but implied

We think, therefore, that the Music Hall having ceased to exist, without fault of either party, both parties are excused, the plaintiffs from taking the gardens and paying the money, the defendants from performing their promise to give the use of the Hall and Gardens and other things. Consequently the rule must be absolute to enter the verdict for the defendants.

Rule absolute.

QUESTIONS

1. How does the court know that the burning of the music hall is an excusing event? How do you know it?

2. Would the court reach the same result if the defendant had burned down the music hall deliberately? Negligently?

3. Return to the facts of Problem 69 in Chapter 3. Would the plane crash that occurred be an event that excused the delivery company of liability to Bill Gilbert?

Problem 129

(a) Behemoth Construction Company agreed to build an office building for the city of Jordan. When the office building was 95 percent completed, it was destroyed by fire due to an act of God. There was no clause in the contract providing what was to happen in such an event (such a clause is called a *force majeure* clause, or, in Latin, a *vis major* clause). Must Behemoth Construction start over, or is the law of impossibility an excuse? See United States Fidelity & Guarantee Co. v. Parsons, 147 Miss. 335, 112 So. 469 (1927); Stees v. Leonard, 20 Minn. 494 (1874).

(b) Job Paint Contractors agreed to paint the City Council meeting room for the city of Jordan, with the city promising to pay $20,000 on completion. When Job was three-fourths done, the building holding the meeting room was destroyed in an earthquake. May Job Paint Contractors recover anything? See Albre Marble & Tile Co. v. John Bowen Co., 338 Mass. 394, 155 N.E.2d 437 (1959).

NISSHO-IWAI CO. v. OCCIDENTAL CRUDE SALES

United States Court of Appeals, Fifth Circuit, 1984
729 F.2d 1530

GOLDBERG, Circuit Judge. This diversity action involves a contract dispute between the Nissho-Iwai Company, Ltd. ("Nissho") and Occidental Crude Sales, Inc. ("Occidental"). Occidental appeals from a jury verdict awarding Nissho contract damages and fraud damages arising from Occidental's failure to perform a crude oil agreement. We hold that there was no reversible error in the finding that Occidental was liable for breach of contract. We reverse the damage award, however, and remand for a new trial limited to determining contract damages. Finally, we reverse the fraud verdict.

FACTS

Nissho is a Japanese corporation that distributes oil to Japanese buyers. Occidental is an American corporation that explores for and produces oil. In 1965, Occidental obtained a number of "oil concessions" from the High Petroleum Council and the Council of Ministers of Libya. The concessions permitted Occidental to drill for oil in two separate blocks of property ("Concession 102" and "Concession 103"). The producing wells were managed by the Libyan Government, and Occidental was responsible for pipelines that transported oil from the wells to an export terminal in Zueitina. Each concession agreement provided for a royalty payment of 12.5 percent and a tax payment of 50 percent to the Government on each barrel of oil.

On September 1, 1969, a Revolutionary Government under Colonel Moammar Khadafy deposed the King of Libya and assumed control. In January 1970, Colonel Khadafy formed a committee to negotiate higher prices with Libyan oil producers; but the companies were unwilling to comply. Khadafy imposed a series of production restrictions; and in August 1973, he nationalized 51 percent of Occidental's concessions.

THE CONTRACT

Occidental had been under contract since 1971 to provide Nissho with "Zueitina Medium" crude oil produced from Concession 102. Zueitina Medium is a low sulphur oil that is particularly useful to electric utility companies required to meet air pollution standards. After receiving the oil, Nissho would resell it to various Japanese power companies.

In 1973, Occidental, aware of the past difficulties with the Libyan Government, renegotiated its contract with Nissho. On October 4, 1973, Occidental and Nissho signed the new agreement, known as Contract 1038. Nissho agreed to purchase and Occidental agreed to supply 750,000 barrels of oil a month through December 31, 1978. The contract contains a "force majeure" clause excusing nonperformance caused by

> executive or administrative orders or acts [of the Libyan Government], . . . or by breakdown or injury to . . . producing . . . or delivering facilities, . . . or by any other event, whether or not similar to the causes specified above . . ., which shall not reasonably be within the control of the party against whom the claim would otherwise be made (i.e. Occidental in this case).

The contract also provides that it is to be governed by the laws of California.

Events Leading Up to Breach of Contract 1038

UNDERLIFTINGS BY NISSHO

The parties performed their respective duties for several months. Troubles developed, however, in 1974. First, during several months in 1974 and 1975, Nissho failed to "lift" its required allotment of oil. The reasons for these "underliftings" are disputed. There is evidence that Occidental supplied reduced quantities during January and March, 1974, because of the Arab-Israeli War. There is also evidence that some of the underliftings in late 1974 were caused by the Nereus Shipping Company ("Nereus") which "nominated" ships to receive oil at such close intervals that Occidental could not fill them. (Nereus was required to supply tankers pursuant to a contract of affreightment with Nissho.) The parties, however, continued to work under the contract. As one officer of Occidental testified, the company elected not to take legal action against Nissho, preferring to reach a commercial solution. Trial Transcript at 1101.

some
fault by
Nissho

ACTIONS OF THE LIBYAN GOVERNMENT

During this period, actions of the Libyan Government affected Occidental's production. On February 7, 1974, the Government and Occidental entered into an Exploration and Production Sharing Agreement under which the Government received 81 percent of oil production. In the following months, the Government ordered increases or decreases in production from various wells. Occidental objected to some of the charges and negotiated remedial production quotas.

The parties reached an impasse in the summer of 1975, however. On July 31, the Government announced that Occidental's production exceeded the limits set in Petroleum Regulation Number 8 and that the wells in Concession 103 would be closed temporarily for testing. Then, on

August 28, 1975, the Government issued a cutback order to become effective September 1, 1975. Occidental objected to the cutback, arguing that it violated the concession agreements and that Occidental would have "a right to look to the Government for reimbursement of all direct and consequential damages." Plaintiff's Exhibit 11. In a separate letter, Occidental objected to the Government's failure to pay for certain oil exploration (as required by the Exploration and Production Sharing Agreement).

When the Government failed to restore production within seven days, Occidental sought arbitration of the claims. In addition, on September 30, Occidental withheld $117 million that it owed the Government: including $40 million for oil purchased from the Government, and $77 million in back taxes and royalties.

The Government notified Occidental that if the payments were not made, the Government would prevent Occidental from exporting oil after October 1, 1975. Occidental refused to pay and the government placed an embargo on exports. Thus, Occidental was unable to perform its contract with Nissho that month.

The embargo on exports lasted until Occidental and the Government settled their disputes on December 3, 1975. Pursuant to the settlement agreement, the embargo order was lifted, the pending arbitrations were withdrawn, and the production of Occidental was restored to 300,000 barrels per day.

PIPELINE BREAKDOWNS

Breakdowns in the oil pipeline leading from Concession 102 to Zueitina also affected Occidental's ability to perform the contract with Nissho. Leaks appeared in early 1975; and Occidental shut down the pipeline for repairs from June 20 to July 10. The leaks persisted, however; and in October, Occidental began major repairs: the pipeline was pressure tested, holes were dug, and a section of the pipeline was removed. Fault of Occidental

After the oil embargo ended in December, 1975, Occidental attempted to reconnect the pipeline and repair any remaining leaks. Yet, when the pipeline was reattached, Occidental discovered sand in the line. To correct that problem, Occidental again had to remove a section of the line. Consequently, the pipeline was shut down from October, 1975, through May 10, 1976, and no oil was produced from Concession 102 during that period.

BREACH BY OCCIDENTAL

8 months.

In sum, Occidental failed to supply Nissho with any oil during the last four months of 1975 and the first four months of 1976. The oil embargo prevented performance between October and December, 1975. Then, pipeline problems stopped the flow of oil until May, 1976. The reason for the breach in September, 1975, is unclear. However, Occidental wrote Nissho on more than one occasion in August and early September, stating

production
looks actually

that the September cargo would not ~~be available because of production~~ restrictions. That ~~representation~~ was untrue. . . .

Occidental raises a number of challenges to the judgment in this case. It argues that Judge O'Conor erred in the first trial by recalling the jury to reconsider its verdict; thus, the original verdict should stand and Occidental is entitled to a directed judgment. We do not even reach this claim, however. Regardless of whether it was proper to recall the jury, Judge O'Conor had broad discretion to declare a mistrial and order a new trial when he detected confusion in the jury verdict.

Occidental also raises a number of issues concerning the second trial. It argues, first, that the judge erred in charging the jury about the Force Majeure clause. Occidental claims that the trial court should not have instructed the jury to consider whether an excusing event under the clause was within the reasonable control of Occidental. We hold that the instruction was proper. Moreover, we hold that Judge O'Conor properly refused a qualifying charge that Occidental had requested. . . .

Challenges to the Second Trial

FORCE MAJEURE

Occidental raises several supposed errors in the second trial as grounds for reversing that judgment. Occidental objects to the giving of one jury instruction and the failure to give another with regard to force majeure. At trial, Occidental attempted to defend its nonperformance on the ground that acts of the Libyan Government (in particular, the embargo) and pipeline breakdowns prevented Occidental from supplying oil. Both excuses come within specific provisions of the "Force Majeure" clause in Contract 1038, which provides in pertinent part:

> Neither party shall be liable for . . . loss, damage, claims or demands of any nature whatsoever due to delays or defaults in performance . . . caused by impairment in any manner of [Occidental's] crude oil supply, [by] *executive or administrative orders or acts* . . . of any . . . government, [by] *breakdown or injury to . . . producing . . . or delivering facilities,* [by] *imposition of restrictions* . . . by any . . . government, . . . or by *any other event,* whether or not similar to the causes specified above . . . , *which shall not be reasonably within the control of the party* against whom the claim would otherwise be made.

Plaintiff's Exhibit 88, at 4, §XV (emphasis added).

> Judge O'Conor instructed the jury that [i]n order to find that Occidental's nonperformance was excused under the force majeure clause you must find from a preponderance of the evidence (1) that the excusing event or events relied upon by Occidental actually prevented Occidental's performance, *and* (2) that the excusing event or events were not reasonably within the control of Occidental or its supplier.

Record at 210. Occidental objects to the second element of the charge, which required the jury to consider whether pipeline difficulties and the Libyan oil embargo were within the reasonable control of Occidental. According to Occidental, the contract clause distinguishes between specifically enumerated events and the general category of "any other event"; only the latter must be beyond the reasonable control of the Seller. Occidental points out that in California, a limiting exception applies only to the last phrase preceding it, unless the context indicates otherwise. See, e.g., In re Estate of Colyear, 17 Cal. App. 3d 173, 94 Cal. Rptr. 696, 702 (1971); Grant v. Hipsher, 257 Cal. App. 2d 375, 383, 64 Cal. Rptr. 892 (1967).

In this case, however, the California law of force majeure requires us to apply a reasonable control limitation to each specified event, regardless of what generalized contract interpretation rules would suggest. Thus, Judge O'Conor did not err in giving such an instruction. "Force majeure" has traditionally meant an event which is beyond the control of the contractor. See Squillante and Congalton, Force Majeure, 80 Comm. L.J. 4, 5 (1979). The common law defense of impossibility due to Act of God requires the defendant to prove that an excusing event is beyond his control, id. at 5; and contractual force majeure provisions typically incorporate this requirement, see Eastern Air Lines v. McDonnell Douglas, 532 F.2d 957, 991 (5th Cir. 1976).

The term "reasonable control" has come to include two related notions. First, a party may not affirmatively cause the event that prevents his performance. The rationale behind this requirement is obvious. If a contractor were able to escape his responsibilities merely by causing an excusing event to occur, he would have no effective "obligation to perform." . . . The second aspect of reasonable control is more subtle. Some courts will not allow a party to rely on an excusing event if he could have taken reasonable steps to prevent it. See Oosten v. Hay Haulers Dairy Employees & Helpers Union, 45 Cal. 2d 784, 291 P.2d 17, 20-21 (1955); 6 Corbin on Contracts, §1342, at 328; Anderson, supra. The rationale behind this requirement is that the force majeure did not actually prevent performance if a party could reasonably have prevented the event from occurring. The party has prevented performance and, again, breached his good faith obligation to perform by failing to exercise reasonable diligence. . . .

The California Supreme Court has read into contractual force majeure provisions both aspects of "reasonable control" — good faith in not causing the excusing event and diligence in taking reasonable steps to ensure performance. In *Oosten,* supra, the parties had entered into a contract for the sale of milk. Clause 12 of the contract provided:

> In case of strike, lockout, or other labor trouble . . . which shall render it impossible for [either party to perform], no liability for non-compliance with this agreement caused thereby . . . shall exist or arise.

291 P.2d at 19. The clause did not explicitly refer to "reasonable control." Yet, the Court invoked the concept in describing the obligations of a party relying on a force majeure clause:

> In the instant case we construe clause 12, with respect to impossibility of performance, the same as it is construed generally in contract law with regard to whether performance has been made impossible. The only things the clause adds are that certain things — labor disputes, strikes — may excuse performance, when without it they might not, but the question remains whether those things have been made impossible. As has been said: "We cannot always be sure what 'causes are beyond the control' of the contractor. Many fires can be prevented by the use of foresight and sufficient expenditure. Most strikes can be avoided by a judicious yielding or by an abject surrender to demands. No contractor is excused under such an express provision unless he shows affirmatively that his failure to perform was proximately caused by a contingency within its terms; that, in spite of skill, diligence and good faith on his part, performance became impossible or unreasonably expensive."

Id. at 20-21. See also Butler v. Nepple, 54 Cal. 2d 589, 6 Cal. Rptr. 767, 772-773, 354 P.2d 239, 244-245 (1960) (affirming *Oosten* rule that party must take reasonable steps to ensure performance).

To be sure, the facts in *Oosten* are distinguishable from our case. Nevertheless, the words of the California Court provide the most definitive statement of California law concerning the relationship between contractual force majeure clauses and the reasonable control limitation. The Court, in effect, requires proof that a party relying on a force majeure clause did not exercise reasonable control over the excusing event. California law supports Judge O'Conor's decision to apply the control limitation to each of the specified events in the force majeure clause of Contract 1038. Finally, we note that the Northern District of Illinois reached the same result in construing a force majeure clause under Michigan law. See Chemetron v. McLouth Steel, 381 F. Supp. 245, 256 (N.D. Ill. 1974), aff'd, 522 F.2d 469 (7th Cir. 1975). The clause at issue in that case provided:

> The failure of either Seller or Buyer to perform any of its obligations hereunder, if caused by an . . . explosion . . . or by any other circumstances beyond the reasonable control of the party so failing, shall not subject such party to any liability to the other party.

Id. The seller McLouth attempted to excuse its nonperformance because of explosions in its compressor. The District Court rejected the defense, in part because "there was not an adequate showing that the explosions were beyond McLouth's control." Id. The court was clearly applying the "reasonable control" requirement to the specified event (explosions).

In sum, we conclude that Judge O'Conor was correct in requiring Occidental to prove that pipeline breakdowns or the acts of the Libyan Government were beyond its reasonable control. . . .

As we have seen, however, California law requires Occidental to take extra steps to prevent the embargo unless "extreme and unreasonable difficulty, expense, injury, or loss[es] are involved." Butler v. Nepple, supra, 354 P.2d at 245; *Oosten* supra, 291 P.2d at 20. Whether a third party violates a contract in demanding extra money from Occidental is certainly a factor in determining whether that expense is unreasonable. It is not dispositive, however. For example, if the Libyan Government had demanded that Occidental pay five extra dollars, the expense (though unlawful) would not be unreasonable in terms of Occidental's good faith obligation to perform its contract with Nissho. Therefore, Occidental's requested instruction was not accurate.

Nor was the trial court required to decide the issue of reasonable control as a matter of law. The issue is a classic jury question. Though we may disagree with the jury's result, we cannot reverse if there is substantial evidence to support the judgment. See Boeing Co. v. Shipman, 411 F.2d 365, 374 (5th Cir. 1969). If reasonable men could find that Occidental ~~was able to prevent~~ the embargo without incurring unreasonable expense, then we must affirm. See id. A review of the record in this case reveals ~~that there was sufficient~~ evidence to support such a verdict.

It is clear Occidental was aware of the threatened embargo and could have prevented it by paying $117 million. This sum in itself was not unreasonable, since the entire figure represented back taxes, royalties, and oil costs that Occidental already owed the Libyan Government. Of course, even if Occidental had paid this sum and averted the embargo, it would still have faced production restrictions. A reasonable jury could have found, though, that Occidental would be able to recoup through arbitration or settlement any losses that might result from the restrictions. The company had already commenced arbitration proceedings against the Libyan Government; and, in December, it was able to reach a settlement. To be sure, the withheld payments and the resulting embargo were factors producing that settlement. That is not to say, however, that a settlement would not have been reached in the absence of an embargo. In the past, Occidental had been able to convince the Government to back down from production restrictions. A reasonable jury might have found that Occidental would again have been able to negotiate a reasonable settlement, particularly given the threat of the arbitration proceedings.

bottom line: could have avoided production restriction

Similarly, there was sufficient evidence to support the view that Occidental had reasonable control over pipeline breakdowns. During 1975 and 1976, Occidental conducted numerous repairs on the pipeline leading from Concession 102 to Zueitina. In October, 1975, Occidental began repairs and disconnected a section of the line. The line remained severed until after the embargo ended in December. There was testimony that Occidental left the line disconnected because it did not want to spend money for repairs until after it had settled its dispute with Libya. Trial Transcript at 581. When the line was reconnected, Occidental discovered that it was clogged with sand. A reasonable jury could have found that the blockage of the line or the failure to discover the blockage earlier was caused by Occidental's delay in repairing and reconnecting the line. The evidence supported a finding that the pipeline breakdown was within Occidental's reasonable control.

In sum, there was no reversible error in either the force majeure charge given by Judge O'Conor or the jury's result. . . .

Problem 130

In 2020,when the United States began regular flights to and from the moon, strange cracking problems began to plague the barges the spaceships towed behind them. The government advertised for bids for a contractor/inventor who would guarantee the government a solution to the problem. The government explained in its advertisement that it was unsure whether current technology was advanced enough to solve the problem at all. Edison Tomorrow Company submitted the only bid and was awarded the job. After two years of steady effort, Edison Tomorrow threw in the towel and demonstrated to the satisfaction of everyone that the project was impossible; there was no way that the cracking could be prevented at this date. Edison Tomorrow then submitted its bill for its expenses, and the government refused to pay, pointing to the guarantee Edison Tomorrow had signed when awarded the contract. Edison Tomorrow took refuge in the law of impossibility. How should this come out? Was it in Edison's control?

Problem 131

Hiram Walker contracted to sell T. C. Sherwood a cow called Rose of Aberlone. Prior to the date of delivery, Rose died. Is Walker in breach of contract? See UCC §2-613. What if Rose is very sick on the delivery date? What if Hiram Walker died before the delivery date?

Problem 132

Mona's Kitchen contracted with the U.S. Navy to supply it with 100,000 chicken pot pies every year for ten years at an agreed upon price. Mona's had always purchased its chickens from the Chicken Ranch of Best, Texas, with whom it had done business for 80 years. The Chicken Ranch suddenly closed its doors, a totally unexpected event, and Mona's Kitchens was unable to find substitute chickens at a price that made the contract with the navy profitable. Is this an excusing event? See UCC §2-615, its Official Comments 4 and 5.

Problem 133

Farmer McGregor contracted to sell 10,000 potatoes to the Potter Grocery Store. Both parties knew McGregor expected to grow the potatoes on his own farm, though the contract said nothing about the expected source of the potatoes. A tornado swept through McGregor's farm and destroyed the potato crop. Is this an excusing event under UCC §2-615? See its Official Comment 9. What if the problem was caused by rabbits? See mute witness

Clark v. Wallace County Coop. Equity Exch., 26 Kan. App.2d 463, 986 P.2d 391 (1999).

SUNFLOWER ELECTRIC COOPERATIVE, INC. v. TOMLINSON OIL CO.

Kansas Court of Appeals, 1981
7 Kan. App. 2d 131, 638 P.2d 963

HERD, J. This is a breach of contract action in which the trial court relieved appellee of liability for breach under the doctrine of impossibility of performance. Sunflower Electric appeals.

Appellant, Sunflower Electric Cooperative, Inc., a member of the R.E.A. family, is a public utility in the business of generating electricity for wholesale to eight member cooperatives. Its main generating facility is located in Finney County. Appellee, Tomlinson Oil Company, Inc., is a corporation involved in oil and gas production. It owned a number of oil and gas leases in an area known as the Stranger Creek gas field in Leavenworth County.

On November 29, 1973, the parties executed an agreement for the sale and purchase of natural gas which is the subject of this action. Under the agreement, Tomlinson promised to sell and Sunflower to buy 3 MMCF (million cubic feet) of gas per day from the reserves in the Stranger Creek field. Tomlinson also promised to develop its reserves so as to guarantee delivery of 7 MMCF per day. The price was fifty-five cents per MCF (thousand cubic feet) for the first year after initial delivery, increasing one cent per MCF each year for three years. After the fourth year the price would be renegotiated or submitted to arbitration. Under an exchange agreement with Kansas-Nebraska Natural Gas Co., Inc., the gas would be delivered to a Cities Service storage facility in Leavenworth County. Kansas-Nebraska would then deliver an equivalent amount of gas to a point four miles south of Sunflower's generating facility in Finney County. Tomlinson had to build a 13.2 mile pipeline to the Cities Service storage facility and Sunflower a 4.5 mile pipeline to the Kansas-Nebraska exchange delivery point. For purposes of appeal, the following provisions of the agreement are particularly relevant:

> Section I. *Gas to be Purchased and Sold Hereunder.* The gas to be sold by Seller and purchased by Buyer under the terms of this agreement shall be produced from Seller's gas reserves now existing and that will exist during the term of this agreement under Seller's Leasehold Area. . . .
>
> Section III. *Dedication of Acreage.* Seller shall dedicate to Buyer a gas supply from the reserves under the Seller's Leasehold Area up to 7 MMCF per day for a period of fifteen (15) years. . . .
>
> Section IV. *Deliverability and Development.* Seller shall deliver not less than 3 MMCF of gas per day at the commencement of delivery of gas as herein provided for, and shall proceed to systematically and expeditiously develop its leases in Seller's Leasehold Area in such a manner as to guarantee the maximum deliverability herein contracted for at the earliest possible

> time and to continue the maximum deliverability for the full term of this agreement.
>
> Section XII. *Specific Performance.* Buyer and Seller each expressly recognize that the purchase of gas and the availability of gas to the Buyer is the essence of this Agreement, that gas is a valuable and depleting natural resource, and that the private interests of Buyer as well as the interests of the consuming public of electricity served by Buyer would be irreparably damaged in the event that Seller failed to make the deliveries of gas herein agreed upon. . . . The Seller and Buyer stipulate that the payment of money damages would not be adequate to satisfy the claims of Buyer or Seller for the breach of this agreement, and that by reason thereof this agreement shall be enforceable by specific performance, and that either party may seek specific performance thereof against the other.

reach of
u seller

Both parties constructed their respective pipelines which were completed by November 1974. Tomlinson breached the contract the first day and was never able to deliver the minimum amount of gas called for by the contract thereafter. In 1975 Tomlinson delivered only 88,479 MCF compared with 985,500 MCF it would have had to deliver to meet the minimum. In July 1976, Tomlinson stopped all production in the Stranger Creek field and hence deliveries under the contract. Sunflower had to look elsewhere for its natural gas supply. Sunflower then filed this action.

The trial court's findings of fact may be summarized as follows. The Stranger Creek field is located five to six miles northeast of an older field known as the McLouth field, now used as a storage area. The McLouth field, developed in the 1930's, at one time had 90 producing gas wells. Its history was extensively analyzed in a 1941 publication of the Kansas Geological Survey known as Bulletin 53. One of the early developers of the Stranger Creek field was Bill Iverson. Iverson was the consulting geologist on approximately fifteen wells in this field. From 1968 to 1970 Iverson and his partners, encouraged by Bulletin 53 and similarities to the older McLouth field, bought leases of 1200 acres in the Stranger Creek field. They then sold this acreage to J. A. Allisen in mid-1970. Allisen acquired additional leases and bought leased wells upon which pipe was set. In the fall of 1971, Allisen sold a one-half interest to Tomlinson and later another one-fourth interest. Ultimately Allisen and Tomlinson acquired 80 leases covering 9874.62 acres in the Stranger Creek field.

Prior to entering into the contract with Sunflower in November of 1973, Tomlinson had purchased 6 wells and drilled 6 wells. Of these twelve wells, only five (Pauley #1, Collins #1, Feverly #2, Kellison and Jones #1) were potential producers, with the remainder being dry holes or abandoned as not commercial. Multipoint back pressure tests, most of which were performed in October, 1972, by Cities Service revealed gas flows for these five wells as follows: Pauley #1 (675 MCF), Collins #1 (1200 MCF), Feverly #2 (846 MCF), Kellison (3680 MCF), and Jones #1 (589 MCF). A multipoint back pressure test measures the relationship of short-term gas flow to the back pressure of a pipeline but is not a measure of the well's long-term capacity or the gas reserves. The presence of heavy oil in all these wells was noted early.

In November, 1974, the five wells were connected to the pipeline Tomlinson had constructed to the Cities Service storage facility and gas was produced and sold under the contract starting December, 1974. Tomlinson experienced problems with heavy oil immediately but was unconcerned because three wells, Pauley, Feverly and Collins, had been shut in for some time. The Pauley well never produced as the weight of fluid was heavier than the gas. The other four wells went on the line at a good flow of gas but went into a rapid decline. On February 4, 1975, E. B. Kreiter, production manager for Tomlinson, prepared a progress report in which he noted that the wells were "declining at an abnormally high rate which would indicate a small reservoir or one of limited permeability." On April 29, Tomlinson checked fluid levels on these wells and calculated bottom hole pressure. All wells had a decline in pressure and were full of fluid. In May of 1975, Tomlinson drilled Jones #2 and Edmonds #1, neither of which were commercial wells. In June of 1975, Feverly #2 was temporarily abandoned. The remaining wells produced some small amount of gas through July of 1976, when all production stopped.

As production declined, Tomlinson found heavy oil fouling up all of its separators, tubing and meters. Kerosene and steam would not clean this equipment. The oil changed to a solid-like asphalt. A sample of the heavy oil from the Pauley #1 well was found to have a viscosity of 100,000 centipoise at 100° F with a pour point of 90° F. Normal crude oil has a viscosity of 10 to 100 centipoise. Because of the heavy oil problem, Tomlinson decided not to spend any additional time or money in developing or producing in the Stranger Creek field. . . .

From this conflicting testimony the trial court found:

> [T]hat the gas in the Stranger Creek field is exhausted and that heavy oil is a problem only because of the depletion of gas. The Tomlinson estimates of reserves when the contract was signed, were over optimistic. However, the Tomlinson development program and operation after the contract was signed was reasonable and prudent and further efforts by anyone at this time would not result in production of any significant amount of gas from the Stranger Creek gas field.

In its conclusions of law, the trial court first held that the agreement was subject to the Uniform Commercial Code and that Sunflower's measure of damages under K.S.A. 84-2-712(2), was the difference between the cost of "cover," i.e., fuel purchased in substitution for that due from Tomlinson, and the contract price. The court found that Sunflower's calculation of $2,614,011.13 based on the cost of replacement fuel for the four years of the agreement for which the price of gas was set was proper as damages under this formula. This amount is not challenged on appeal. Based on its finding that the gas in Stranger Creek was exhausted, the court denied specific performance.

cost of cover

The court then considered Tomlinson's liability for damages. The agreement contained an "uncontrollable forces" clause which the court held inapplicable. Again, this ruling is not challenged on appeal. The court did hold, however, that Tomlinson should be relieved under the doctrine of impossibility of performance. In so finding the court stated in part:

> [T]his is a contract where a particular gas field was being developed and a supply of gas from the leases and acreage dedicated in that field is a basic assumption of the contract and the only source contemplated. Failure of the Stranger Creek gas field to produce sufficient quantities of gas to fulfill the contract for any reason other than the fault of the defendant is an excuse for non-performance under Restatement of Contracts, supra, §283 or §286, unless the defendant assumed this risk.
>
> . . . Nothing in the contract guarantees, warrants or promises that a sufficient reserve exists and will exist to fulfill the contract and the Court cannot conclude that one party rather than the other assumed the risk of a particular reserve.
>
> The defendant has contended throughout that this is a case of supervening impossibility due to the unexpected problem with heavy oil. There is little question but what oil with a viscosity 10,000 times that of normal crude oil would and did produce unique and probably unsolvable problems with production. However, the weight of the evidence seems to now suggest that the Stranger Creek gas field is not similar to the McLouth field and the gas reserves in this field were quite small when the contract was signed. If this is correct, then we are dealing with original impossibility. This still makes no difference from a legal standpoint, so long as defendant Tomlinson was not at fault in failing to foresee this contingency. When the contract was signed, Tomlinson had five apparently good gas wells with multipoint back pressure tests indicating tremendous quantities of gas. Most of the geologists found similarities to the highly successful McLouth field nearby. Gas reserves are difficult to estimate prior to actual production and the plaintiff's witnesses thought the data insufficient to even try. Whether better data prior to execution of the contract would have given a better picture of the reserves is speculative. In order to accurately project reserves, it is necessary to have production, which requires a pipeline and a market, hence the contract. The Court finds that defendant Tomlinson was not at fault in failing to foresee the rapid depletion of the Stranger Creek field. The parties contracted on the basic assumption that the Stranger Creek leases contained substantial gas reserves. The defendant Tomlinson proceeded as a prudent and diligent developer in building the pipeline and then expanding its exploration. They are to be excused by reason of objective impossibility of performance, whether original or supervening. Restatement of Contracts, supra, §§281, 283, 286(1).

~~Should~~ could not have forseen

basic assumption

The court also denied charges to Sunflower for the $262,209.55 it had spent on the pipeline constructed under the agreement in Finney County. From these rulings, Sunflower appeals. . . .

Issue

Accordingly, this court must determine whether the trial court's findings of fact are supported by the evidence and whether those findings support the legal conclusion that Tomlinson should be excused from its obligation under the contract because of the doctrine of impossibility of performance. The latter determination is one of law. Restatement (Second) of Contracts, ch. 11, Introductory Note, pp. 309-310 (1981). Moreover, insofar as determination of this case requires interpretation of the agreement itself, the standard of review is that regardless of the construction of a written instrument made by the trial court, on appeal the instrument may be construed and its legal effect determined by the appellate court. State Bank of Parsons v. First National Bank in Wichita, 210 Kan. 647, Syl. ¶1, 504 P.2d 156 (1972).

The law has long since recognized that impossibility, or as stated by the more modern authorities, impracticability of performance *may* relieve a promisor of liability for breach of contract. Such impracticability may arise after the contract, in which case it is referred to as "supervening" or may exist at the time of the contract, in which case it is referred to as "original" or "existing." The trial court found this to be a case of existing impracticability in that the weight of the evidence suggested that Stranger Creek never contained sufficient reserves to meet the contract requirement. The general rule as to existing impracticability is stated in Restatement (Second) of Contracts §266 (1981):

after the contract law

> Where, at the time a contract is made, a party's performance under it is impracticable without his fault because of a fact of which he has no reason to know and the non-existence of which is a basic assumption on which the contract is made, no duty to render that performance arises, unless the language or circumstances indicate the contrary.

This statement of the general rule encompasses the exceptions to relief: (1) the impracticability must not have been caused by the promisor (fault), (2) the promisor must have had no reason to know of the impracticability (foreseeability); and (3) the language or circumstances may indicate that the promisor not be relieved because of the impracticability (assumption of the risk).

The Restatement rule adopts in large part the rationale of section 2-615 of the Uniform Commercial Code. The Code clearly applies here. The sale of gas contemplated by the agreement was the "sale" of "goods." K.S.A. 84-2-105 to 106. See Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114 (10th Cir. 1974). K.S.A. 84-2-615 provides in pertinent part:

> Except so far as a seller may have assumed a greater obligation. . . .
> (a) Delay in delivery or nondelivery in whole or in part by a seller . . . is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made. Official comments 5 and 8 indicate that fault and foreseeability, as well as assumption of the risk are exceptions to relief under this provision.

A distinction is also drawn between impracticability which is "subjective" and "objective." This has been described as the difference, respectively, between "I cannot do it" and "the thing cannot be done." See State Highway Construction Contract Cases, 161 Kan. 7, 67, 166 P.2d 728 (1946). Only objective impracticability may serve to relieve a party of his or her contractual obligation.

There appears to be no real dispute that the existence of sufficient reserves in Stranger Creek to meet the contract requirements was a "basic assumption" of the agreement. Since under the trial court's findings sufficient reserves do not exist, the general rule provides that Tomlinson should be relieved from liability, unless one of the exceptions applies. Sunflower's six points on appeal are overlapping and repetitious but may be reduced to the following: (1) the impracticability of performance was subjective, (2) Tomlinson was at fault in developing Stranger Creek, (3) lack of sufficient reserves was foreseeable by Tomlinson, (4) Tomlinson assumed the risk of impracticability, and (5) it would be inequitable to grant relief under the circumstances of this case.

We first consider the argument that this is a case of subjective impossibility. As the trial court found, most of the Kansas cases which have considered the doctrine of impossibility of performance have been found to involve subjective impossibility and thus relief has been denied. The general rule is stated in White Lakes Shopping Center, Inc. v. Jefferson Standard Life Ins. Co., 208 Kan. 121, Syl. ¶2, 490 P.2d 609 (1971):

> When one agrees to perform an act *possible in itself* he will be liable for a breach thereof although contingencies not foreseen by him arise which make it difficult, or even beyond his power, to perform and which might have been foreseen and provided against in the contract. (Emphasis added.)

In *White Lakes* the alleged impossibility was that more financing was needed for a construction project than had previously been agreed to in a loan commitment. Impossibility, if it was such, was held to be subjective. . . .

What about forsee ability

Sunflower's argument that the agreement for the sale of gas is a thing possible "in itself" ignores the agreement which was expressly limited to sale of gas produced from Stranger Creek. The trial court's findings of fact that Stranger Creek is exhausted and further efforts by anyone would not result in production is supported by the evidence. The trial court's finding also disposes of Sunflower's argument that "the use of pumping units and bottom hole heaters could have been utilized to improve production. . . ." Thus, the sale of gas from Stranger Creek is impossible for anyone to perform, making this a case of objective impossibility.

Second, Sunflower argues that the fault exception applies to Tomlinson because it failed to expeditiously develop Stranger Creek. This argument appears to be based on the fact only five wells were connected to the pipeline constructed to deliver gas under the agreement, and after it became apparent these wells would not produce sufficient gas to meet the contract requirements, only two additional wells were drilled, neither of which produced. This argument must fail for two reasons. First, the trial court found "defendant Tomlinson proceeded as a prudent and diligent developer in building the pipeline and then expanding its exploration." This finding is supported by the evidence. Secondly, failure to drill additional wells cannot be deemed "fault" in light of the trial court's finding that the reserves are exhausted. Failure to develop Stranger Creek, whether expeditiously or not, did not contribute to the impracticability involved in this case, i.e., the lack of reserves.

Because of the manner in which we dispose of this case we will discuss Sunflower's third and fourth arguments together. Those arguments are: the lack of reserves was foreseeable by Tomlinson and Tomlinson assumed the risk that the reserves would be insufficient. As both the Restatement and the Code indicate, the language *or circumstances* of a contract may indicate that a party has assumed an obligation to perform despite impracticability. Such an assumption of the risk may be implied and foreseeability may be a factor in such a determination. . . .

Was the lack of reserves in Stranger Creek "sufficiently foreshadowed" at the time of contracting to be considered a risk assumed by Tomlinson? The trial court found Tomlinson was not "at fault" in failing to foresee the lack of reserves in Stranger Creek. This was based on the fact that when the contract was signed, Tomlinson had five wells with multipoint back pressure tests indicating sufficient gas to meet the contract requirements and the fact that most of the geologists found similarities to the successful McLouth field. The court also found, however, that multipoint back pressure tests do not provide a measure of reserves. The court specifically found that "[g]as reserves are difficult to estimate prior to actual production and the plaintiff's witnesses thought the data insufficient to even try." We think the court applied too strict a standard of foreseeability. It may well be true under prudent business standards, Tomlinson *assumed* it has reserves in Stranger Creek. However, the evidence is overwhelming and the trial court's own findings are to the effect that such reserves are inherently unknown. Tomlinson, in its brief, supports this conclusion when it states that "[a]ll the experts agreed one does not know what is below the ground and that the responsible estimates can be way off." Green and Yates gave Tomlinson a negative report on reserves. The favorable reserve reports were by Tomlinson's employees. They based their opinion on Bulletin 53 pertaining to the McLouth field and a pressure test which admittedly did not pertain to reserves. We conclude Tomlinson should have foreseen Stranger Creek might not contain sufficient reserves. . . .

Tomlinson would have us abandon the rule that if the event was foreseeable the parties must make provision for it in the contract or be bound. It points out that Williston finds this rule "descended in the law from a time when it was more nearly true than it now is, because impossibility was more rarely an excuse." 18 Williston on Contracts §1953 (3d ed. 1978), p. 118. That treatise proposes the following test which Tomlinson would have us apply here:

> If the event causing the impossibility in question could not only have been anticipated but its occurrence could have been guarded against by the promisor (not the effect of it by a provision in the contract but the occurrence itself by preventing its happening), it is reasonable to assume that the promisor took the risk of the continued possibility of performance. p. 119.

Even were we to adopt this test of foreseeability, however, the present case falls within the next sentence of §1953, which provides:

> A similar argument is appropriate where the promisor, although having no power to prevent the contingency, had superior knowledge of the possibility of its happening.

Here, Tomlinson, as a company in the business of oil and gas production, and as the owner of the Stranger Creek leases, and as the party making the estimates as to reserves, must be held to have had superior knowledge as to the possibility that the reserves might prove insufficient.

Having concluded that the lack of reserves was foreseeable to Tomlinson, we also conclude that Tomlinson assumed the risk that such would prove to be the case. The trial court correctly found that the agreement contains no express assumption of such an obligation by Tomlinson, but as indicated above, this may be implied by the circumstances of a particular case. Besides the factor that the lack of reserves was foreseeable to Tomlinson, we note that the agreement provided that "the purchase of gas and the availability of gas to Buyer is the essence of this agreement" and that Tomlinson was to develop the field so as to "guarantee" the maximum deliverability under the agreement. We find these provisions, particularly the former, significant. Sunflower agreed to build a 4.5 mile pipeline and loan Tomlinson the cost of its gathering system, a total outlay of in excess of a half million dollars, based on Tomlinson's assurances of adequate reserves.

Most cases with analogous facts are simply applications of the general rule that relief will be allowed absent one of the exceptions. The general rule is particularly applicable where the existence of a specific thing is necessary for the performance of the contract and that specific thing is destroyed or fails to come into existence. See Restatement (Second) of Contracts §263 (1981). Thus, one who contracts to sell and deliver a crop of fruit, vegetables, grain, or hay then growing on a specific tract of land, or to be grown on such a tract within a specified growing season, is discharged from duty by the destruction of that crop without fault. Mercantile Co. v. Canning Co., 111 Kan. 68, 206 P. 337 (1922). This rule has been applied to an oil sales contract when the well which was the subject of the contract ceased to produce. North American Oil Co. v. Globe Pipe Line Co., 6 F.2d 564 (8th Cir. 1925). See also Housing Auth. v. E. Tenn. Etc. Co., 183 Va. 64, 31 S.E.2d 273 (1944), where it was held that a contract to supply natural gas which the parties contemplated would come from a particular field was excused when the field ceased to produce. It is of note that this was a jury case and that the instructions provided that the supplier must not have assumed the risk of failure of the field. The jury verdict for the supplier was affirmed.

Even when a specific thing is necessary for performance, however, the circumstances may demonstrate that a party has assumed the risk. 6 Corbin on Contracts §1339 (1962), states: "In any such case, however, the expressions of the parties, interpreted reasonably, may show that one party has assumed the whole risk, has warranted the possibility of performance or made himself an insurer. One who contracts to supply pasturage on specific land for a number of cattle may be found to have warranted that grass will grow and water run [citing Berg v. Erickson, 234 F. 817 (8th Cir. 1916)]. One who promises to supply water for irrigation must look out for droughts and find the water at the favorable time and place; [citing Northern Irr. Co. v. Watkins, 183 S.W. 431 (Tex. Civ. App. 1916)]; it is the risk of drought, usual and unusual, that the promisee expects to eliminate. The water company may, of course, protect itself by a clause respecting drought and other causes beyond its control." p. 398.

A reasonable interpretation of the contract in this case shows that it was the risk of obtaining a supply of natural gas, which the contract recognized as a "depleting natural resource" which Sunflower sought to eliminate. The fact that the agreement was specifically tied to the Stranger Creek field is significant in determining whether Tomlinson should be relieved. We gave effect to this limitation regarding Sunflower's argument of subjective impossibility. In light of the other circumstances, however, we conclude that the fact the agreement was so limited does not in itself compel relief for Tomlinson.

This is not a case where a crop failed through some natural disaster or even where an oil or gas field which had been producing so as to meet contract requirements failed. In this case a contract was entered into to supply a specified quantity of gas before it was determined that that quantity existed and without any provision being made in the contract for such a contingency. . . .

That Tomlinson assumed the risk reserves might be insufficient is, we think, demonstrated by (1) the language of the contract making purchase and availability of gas to Sunflower the essence of the agreement, (2) Tomlinson's foreseeability that the reserves might not be sufficient, and (3) Tomlinson's expertise and superior knowledge as to the possibility of inadequate reserves. This compels a finding that Tomlinson not be relieved of liability for its breach. To hold otherwise would mean an oil or gas producer could enter into a long term supply contract, borrow money on it, gamble on the extent of its supply, know the purchaser is relying and expending sums thereon, then escape with impunity when the supply proves inadequate. If the producer wishes to be relieved of liability where its reserves are unknown, appropriate language can be inserted in the contract. In this case, it was not. . . .

The judgment is reversed and remanded with directions to enter judgment for plaintiff in the amount of $2,806,298.13 and costs.

forseeability

QUESTIONS

1. How do we distinguish this case from the destruction of the potato crop in Problem 133?

2. How do we distinguish this case from the death of the cow in Problem 131?

KRELL v. HENRY
Court of Appeal, King's Bench, 1903
2 K.B. 740

The plaintiff, Paul Krell, sued the defendant, C. S. Henry, for 50£, being the balance of a sum of 75£, for which the defendant had agreed to hire a flat at 56A, Pall Mall on the days of June 26 and 27, for the purpose of viewing the processions to be held in connection with the coronation of His Majesty. The defendant denied his liability, and counterclaimed for the return of the sum of 25£, which had been paid as a deposit, on the ground that, the processions not having taken place owing to the serious illness of the King, there had been a total failure of consideration for the contract entered into by him.

The facts, which were not disputed, were as follows. The plaintiff on leaving the country in March, 1902, left instructions with his solicitor to let his suite of chambers at 56A, Pall Mall on such terms and for such period (not exceeding six months) as he thought proper. On June 17, 1902, the defendant noticed an announcement in the windows of the plaintiff's flat to the effect that windows to view the coronation processions were to be let. The defendant interviewed the housekeeper on the subject, when it was pointed out to him what a good view of the processions could be obtained from the premises, and he eventually agreed with the housekeeper to take the suite for the two days in question for a sum of 75£.

On June 20, the defendant wrote the following letter to the plaintiff's solicitor:—

> I am in receipt of yours of the 18th instant, inclosing form of agreement for the suite of chambers on the third floor at 56A, Pall Mall, which I have agreed to take for the two days, the 26th and 27th instant, for the sum of 75£. For reasons given you I cannot enter into the agreement, but as arranged over the telephone I inclose herewith cheque for 25£ as deposit, and will thank you to confirm to me that I shall have the entire use of these rooms during the days (not the nights) of the 26th and 27th instant. You may rely that every care will be taken of the premises and their contents. On the 24th inst. I will pay the balance, viz., 50£, to complete the 75£ agreed upon.

On the same day the defendant received the following reply from the plaintiff's solicitor:—

> I am in receipt of your letter of to-day's date inclosing cheque for 25£ deposit on your agreeing to take Mr. Krell's chambers on the third floor at 56A, Pall Mall for the two days, the 26th and 27th June, and I confirm the agreement that you are to have the entire use of these rooms during the days (but not the nights), the balance, 50£, to be paid to me on Tuesday next the 24th instant.

The processions not having taken place on the days originally appointed, namely, June 26 and 27, the defendant declined to pay the balance of 50£ alleged to be due from him under the contract in writing of June 20 constituted by the above two letters. Hence the present action. Darling J., on August 11, 1902, held, upon the authority of Taylor v. Caldwell and The Moorcock, that there was an implied condition in the ~~contract that the procession should take place, and gave judgment for the defendant on the claim~~ and counter-claim.

The plaintiff appealed.

WILLIAMS, L.J. [After discussing Taylor v. Caldwell and Roman civil law, the court continued:] I do not think that the principle of the civil law as introduced into the English law is limited to cases in which the event causing the impossibility of performance is the destruction or non-existence of some thing which is the subject-matter of the contract or of some condition or state of things expressly specified as a condition of it. I think that you first have to ascertain, not necessarily from the terms of the contract, but, if required, from necessary inferences, drawn from surrounding circumstances recognised by both contracting parties, what is the substance of the contract, and then to ask the question whether that substantial contract needs for its foundation the assumption of the existence of a particular state of things. If it does, this will limit the operation of the general words, and in such case, if the contract becomes impossible of performance by reason of the nonexistence of the state of things assumed by both contracting parties as the foundation of the contract, there will be no breach of the contract thus limited. Now what are the facts of the present case? The contract is contained in two letters of June 20 which passed between the defendant and the plaintiff's agent, Mr. Cecil Bisgood. These letters do not mention the coronation, but speak merely of the taking of Mr. Krell's chambers, or, rather, the use of them, in the daytime of June 26 and 27, for the sum of 75£, 25£ then paid, balance 50£ to be paid on the 24th. But the affidavits, which by agreement between the parties are to be taken as stating the facts of the case, shew that the plaintiff exhibited on his premises, third floor, 56A, Pall Mall, an announcement to the effect that windows to view the Royal coronation procession were to be let, and that the defendant was induced by that announcement to apply to the housekeeper on the premises, who said that the owner was willing to let the suite of rooms for the purpose of seeing the Royal procession for both days, but not nights, of June 26 and 27. In my judgment the use of the rooms was let and taken for the purpose of seeing the Royal procession. It was not a demise of the rooms, or even an agreement to let and take the rooms. It is a licence to use rooms for a particular purpose and none other. And in my judgment the taking place of those processions on the days proclaimed along the proclaimed route, which passed 56A, Pall Mall, was regarded by both contracting parties as the foundation of the contract; and I think that it cannot reasonably be supposed to have been in the contemplation of the contracting parties, when the contract was made, that the coronation would not be held on the proclaimed days, or the processions not take place on those days along the proclaimed route; and I think that the words imposing on the defendant the obligation to accept and pay for the use of the rooms for the named days, although general and unconditional, were not used with reference to the possibility of the particular contingency which afterwards occurred. It was suggested in the course of the argument that if the occurrence, on the proclaimed days, of the coronation and the procession in this case were the foundation of the contract, and if the general words are thereby limited or qualified, so that in the event of the non-occurrence of the coronation and procession along the proclaimed route they would discharge both parties from further performance of the contract, it would follow that if a cabman was engaged to take some one to Epsom on Derby Day at a suitable enhanced price for such a journey, say 10£, both parties to the contract would be discharged in the contingency of the race at Epsom for some reason becoming impossible; but I do not think this follows, for I do not think that in the cab case the happening of the race would be the foundation of the contract. No doubt the purpose of the engager would be to go to see the Derby, and the price would be proportionately high; but the cab had no special qualifications for the purpose which led to the selection of the cab for this particular occasion. Any other cab would have done as well. Moreover, I think that, under the cab contract, the hirer, even if the race went off, could have said, "Drive me to Epsom; I will pay you the agreed sum; you have nothing to do with the purpose for which I hired the cab," and that if the cabman refused he would have been guilty of a breach of contract, there being nothing to qualify his promise to drive the hirer to Epsom on a particular day. Whereas in the case of the coronation, there is not merely the purpose of the hirer to see the coronation procession, but it is the coronation procession and the relative position of the rooms which is the basis of the contract as much for the lessor as the hirer; and I think that if the King, before the coronation day and after the contract, had died, the hirer could not have insisted on having the rooms on the days named. It could not in the cab case be reasonably said that seeing the Derby race was the foundation of the contract, as it was of the licence in this case. Whereas in the present case, where the rooms were offered and taken, by reason of their peculiar suitability from the position of the rooms for a view of the coronation procession, surely the view of the coronation procession was the foundation of the contract, which is a very different thing from the purpose of the man who engaged the cab — namely, to see the race — being held to be the foundation of the contract. Each case must be judged by its own circumstances. In each case one must ask oneself, first, what, having regard to all the circumstances, was the foundation of the contract? Secondly, was the performance of the contract prevented? Thirdly, was the event which prevented the performance of the contract of such a character that it cannot reasonably be said to have been in the contemplation of the parties at the date of the contract? If all these questions are answered in the affirmative (as I think they should be in this case), I think both parties are discharged from further performance of the contract. I think that the coronation procession was the foundation of this contract, and that the non-happening of it prevented the performance of the contract; and, secondly, I think that the non-happening of the procession, to use the words of Sir James Hannen in Baily v. De Crespigny, was an event "of such a character that it cannot reasonably be supposed to have been in the contemplation of the contracting parties when the contract was made, and that they are not to be held bound by general words which, though large enough to include, were not used with reference to the possibility of the particular contingency which afterwards happened." The test seems to be whether the event which causes the impossibility was or might have been anticipated and guarded against. It seems difficult to say, in a case where both parties anticipate the happening of an event, which anticipation is the foundation of the contract, that either party must be taken to have anticipated, and ought to have guarded against, the event which prevented the performance of the contract. . . .

I myself am clearly of opinion that in this case, where we have to ask ourselves whether the object of the contract was frustrated by the non-happening of the coronation and its procession on the days proclaimed, parol evidence is admissible to shew that the subject of the contract was rooms to view the coronation procession, and was so to the knowledge of both parties. When once this is established, I see no difficulty whatever in the case. It is not essential to the application of the principle of Taylor v. Caldwell that the direct subject of the contract should perish or fail to be in existence at the date of performance of the contract. It is sufficient if a state of things or condition expressed in the contract and essential to its performance perishes or fails to be in existence at that time. In the present case the condition which fails and prevents the achievement of that which was, in the contemplation of both parties, the foundation of the contract, is not expressly mentioned either as a condition of the contract or the purpose of it; but I think for the reasons which I have given that the principle of Taylor v. Caldwell ought to be applied. This disposes of the plaintiff's claim for 50£ unpaid balance of the price agreed to be paid for the use of the rooms. The defendant at one time set up a cross-claim for the return of the 25£ he paid at the date of the contract. As that claim is now withdrawn it is unnecessary to say anything about it. . . .

Appeal dismissed.

parol case here

overturne direct subject matter

QUESTIONS

1. How does this case differ from the burning of the music hall in Taylor v. Caldwell?

2. Do you agree with the learned judge's resolution of his hypothetical concerning the Derby Day cab? — no

3. If the defendant had not dropped his cross-claim for the return of the deposit, how would the issue be decided? — should get money

Problem 134

Henry Higgins asked Eliza Doolittle to go with him to the Embassy Ball and for that purpose ordered a special gown to be made for her by Shaw of London, a famous designer. Shaw created the dress for her after several fittings, but before it could be delivered Eliza suddenly died. Must Higgins pay for the dress? What if the Embassy Ball were cancelled? no

yes

Problem 135

In 1970, Monopoly Oil Company entered into a ten-year contract with Icarus Airlines by which it contracted to furnish the airline with all the gasoline it would need for that period at a set price per barrel. The next year the oil-producing countries created for the first time a cartel to fix oil prices and suddenly the price of oil skyrocketed. Monopoly Oil Company, unable to get oil at the cheap old price, tells you, its attorney, that it will go bankrupt if it is forced to honor its contract with Icarus. Advise your client. Does UCC §2-615 provide an avenue of escape? Read it and its Official Comment 4 carefully.

GROSETH INTERNATIONAL v. TENNECO, INC.

Supreme Court of South Dakota, 1987

410 N.W.2d 159

SABERS, Justice (on reassignment). Groseth International, Inc. and Clifford Groseth appeal from summary judgments in favor of International Harvester Company, in one action, and J. I. Case Company and Tenneco, Inc., in the second action. The cases are consolidated on appeal pursuant to SDCL 15-26A-3. We affirm in part, reverse in part, and remand.

Tenneco

Case] equipment manf.

FACTS

IHC, Groseth] franchisor dealer / IHC

farm equip. manf.

Tenneco Inc. (Tenneco) is the parent company of J. I. Case Company (Case), an equipment manufacturing corporation. Until 1985, International Harvester Company (IHC) manufactured farm equipment, construction equipment, and trucks. Groseth International, Inc. (Groseth) is a closely held corporation located in Yankton, South Dakota. Until 1985, Clifford Groseth was a franchised dealer of IHC farm equipment.

As a result of economic depression in the agricultural economy and farm equipment operating losses, IHC's financial condition deteriorated. IHC began to search for potential buyers of its farm equipment division in 1982.

In 1984, IHC negotiated a purchase agreement with Case/Tenneco structured as a purchase and sale of assets. The acquisition covered selected assets and liabilities from IHC's North American group. The base purchase price was $246,700,000 cash. Although Case was the acquiring corporation, IHC received $161,300,000 of participating preferred stock of Tenneco. IHC became Navistar International. While Navistar could no longer manufacture farm equipment, it could continue to market trucks under the name "International." Case's farm equipment line became "Case-International."

The IHC dealer network was of particular interest to Case/Tenneco since it offered a chance to immediately command an existing market. However, Case/Tenneco did not "acquire" the franchise network. Instead, it received "access" to IHC dealers, many of whom eventually received a Case franchise. In 400 "conflict areas," areas in which both Case and IHC dealerships were located, Case offered only one franchise contract. In nearly two-thirds of the conflict areas the IHC dealer received the franchise. In this case, however, the Case Implement dealer in Yankton, Mark's Machinery, was chosen over the IHC dealer, Groseth.

THE FACTS MUST BE TAKEN IN THE LIGHT MOST FAVORABLE TO GROSETH FOR THE PURPOSE OF SUMMARY JUDGMENT

Groseth was a family-owned corporation which employed fifteen people. Pursuant to the franchise agreement with IHC, Groseth's employees attended service and sales schools, training sessions, sales meetings, and other requirements of the franchise agreement. Groseth abided by the terms and conditions of the franchise agreement.

In December 1984, Groseth was called to a meeting in Dallas, Texas, and notified by Case/Tenneco that Case would be acquiring IHC. Speakers at the meeting stated that cities where Case and IHC dealers existed were "conflict cities" and one dealership would be terminated. Case requested information concerning Groseth's business on December 14, 1984, and Groseth responded. However, the decision to close Groseth's business had already been made by Case on December 6, 1984.

Despite Case/Tenneco's assertion that there would be a "painstaking evaluation" of dealers in conflict cities, none of their representatives contacted Groseth to view his business operation, inspect the business premises, evaluate the financial aspects of his business, or perform any investigation whatsoever concerning the nature of his business as an IHC franchisee. Termination decisions were not based on any market analysis or study.

Without warning or explanation, Case/Tenneco representatives came to Groseth's business on January 3, 1985, and informed Groseth that he was not to be awarded a franchise agreement and that his current dealer agreement with IHC was terminated. Contrary to the direct language of the IHC agreement, he was not given six months notice of his termination nor any opportunity to rectify any claim of breach of the agreement. He was denied information as to why his franchise was terminated.

Groseth was not allowed to have anyone else in the room with him when the Case/Tenneco personnel were present. They attempted to get Groseth to sign a termination agreement, which by its own terms, indicated that Case/Tenneco was terminating the IHC franchise with Groseth. It also contained provisions releasing Case, Tenneco, and IHC from any liability resulting from Groseth's termination and further offered a $10,000 bonus to dealers who would sign within ten days. Groseth refused to sign the termination agreement.

On January 31, 1985, Case/Tenneco acquired the assets of IHC in relation to its agricultural division. It acquired IHC's patents, trademarks, manufacturing facilities, personnel, and the North American dealership network of IHC franchisees. The purchase agreement between the defendants required Case/Tenneco to undertake negotiations with IHC dealers resulting in their termination. This was done, according to IHC officials, so that IHC franchisees would not attempt to require IHC to buy back their equipment and parts pursuant to the franchise laws of various jurisdictions and the IHC franchise agreement.

According to the chief executive officer of IHC, Mr. Lennox, all responsibilities concerning the IHC franchisees were turned over to and assumed by Case/Tenneco pursuant to the purchase agreement between those entities. From the time of consummation of the purchase agreement between those entities, Case/Tenneco undertook termination of hundreds of IHC franchisees throughout the United States, including Groseth in South Dakota. Case/Tenneco formed a group within its organization called the "transition task force." This group was composed mainly of Case/Tenneco officials who were internally referred to as a "swat team." They met with a clinical psychologist, hired by Case/Tenneco, in order to more effectively deal with franchisees they were to terminate. This group was to obtain franchisee signatures on termination agreements which would have released Case/Tenneco from statutory obligations such as those found under South Dakota's franchise law.

According to the IHC franchise agreement in effect at the time of Groseth's termination, specifically Section 25(c), Groseth was required to be given an opportunity to cure any supposed breach of his franchise agreement. He was also entitled to notice, of not less than six calendar months, of his termination period. None of the defendants complied with these provisions. Defendants made no study of South Dakota franchise laws. However, Case/Tenneco dealt differently with IHC dealers in other states. For example, in Wisconsin, a dealer received a termination letter from J. I. Case providing both notice and an opportunity to cure the alleged deficiency in market penetration.

Following termination of Groseth's franchise without compliance with the franchise agreement or South Dakota law, Groseth was unable to continue his operation as an IHC farm equipment dealer. His business is presently open, but engaged only in repair and service of farm equipment and the sale of trucks. He is no longer allowed to sell IHC farm equipment, parts, or service IHC goods under warranty. He effectively has been removed from the farm equipment business.

IHC claims it took no action to "terminate" Groseth. IHC merely "voluntarily withdrew" from the agricultural equipment market after selling its agricultural equipment division to Case/Tenneco for nearly a half billion dollars.

Groseth's Claims

Groseth claims that either IHC or Case/Tenneco, or both, are liable for damages associated with losing the franchise and that the trial court erred in awarding summary judgment in both cases. . . .

1. Breach of Franchise Agreement

Groseth argues that the trial court erred in granting summary judgment to IHC on Groseth's claim of breach of franchise agreement.

According to the terms of the franchise agreement IHC could unilaterally terminate the agreement only after written notice of termination. Such notice could not be issued *at all* unless: (a) the dealer, having breached certain duties and obligations, was given an opportunity to cure those defects, or (b) if in IHC's judgment, the dealer's trade area no longer offered a sufficient market for IHC goods. Furthermore, termination could not become effective until after six months from the date of such notice.

Section 2 of the franchise agreement further provided:

> The agreement shall cover all those items of agricultural tractors, machines, equipment and attachments, which appear in the Agricultural Equipment Price List issued by the Company, and service parts. The company reserves the right to make additions to and eliminations from such List, including but not limited to reductions resulting from the discontinued production of a line or lines of such tractors, machines, equipment and attachments, without incurring any responsibility to the Dealer.

IHC argued, and the trial court agreed that Section 2 gave IHC the unrestricted right to discontinue its farm equipment business whenever in its judgment such event was advantageous or demanded as a result of severe economic hardship. As a result, the court concluded that Section 2 allowed IHC to discontinue production of all lines of farm equipment without incurring any liability to Groseth.

Generally, the court and not a jury construes contracts. Lien v. Northwestern Engineering Co., 73 S.D. 84, 39 N.W.2d 483 (1949). We believe that the court erred as a matter of law in concluding that Section 2 authorized a complete discontinuation of all product lines. Section 2 did not state that IHC could discontinue all product lines without liability. Instead, the section allowed "additions to and eliminations from" and "reductions" to the "List" of products. While the "List" could constantly change, there was a basic assumption that there would always be some group of products being marketed by IHC. Arguably, by eliminating all product lines on the list, the list itself would no longer exist. However, the language in Section 2 clearly does not contemplate discontinued production of all agricultural equipment. Therefore, we conclude that IHC did not reserve the right to cancel the contract by operation of Section 2. Accordingly, summary judgment was improperly granted on this issue.

In its memorandum opinion the trial court indicated that even absent Section 2 of the franchise agreement it would discharge IHC from contractual liability to Groseth because of the frustration of purpose (commercial frustration) and commercial impracticability doctrines.

A. *Commercial Frustration*

The Restatement (Second) of Contracts defines the doctrine of commercial frustration:

> Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or circumstances indicate the contrary.

Restatement (Second) of Contracts §265 (1981).

Three factors are necessary to establish commercial frustration.

> First, the purpose that is frustrated must have been a *principal purpose* of that party in making the contract. It is not enough that he had in mind some specific object without which he would not have made the contract. The object must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense. (Emphasis supplied.)

Restatement (Second) of Contracts §265, comment a (1981).

Under the first factor, there must be an investigaton into the principal purpose of the contract and a determination of the frustrating event that destroys the primary basis of the contract. If the frustrating event was within the promisor's control or due to the promisor's "fault," then he is not excused. 18 Williston, Contracts §1954 (1978); 17A C.J.S. Contracts §464 (1963).

The second factor needed to establish commercial frustration is:

not within the risk

> [T]he frustration must be *substantial*. It is not enough that the transaction has become less profitable for the affected party or even that he will sustain a loss. The frustration must be so severe that it is not fairly to be regarded as within the risks that he assumed under the contract. (emphasis supplied)

Restatement (Second) of Contracts §265, comment a (1981).

Under this factor, the degree of hardship is used as the standard for relief. In order that contracts may be relied on with certainty, frustration is limited to cases of extreme hardship and must be substantial. The fact that performance has become economically burdensome or unattractive is not sufficient to excuse performance. Neal-Cooper Grain Co. v. Texas Gulf Sulphur Co., 508 F.2d 283 (7th Cir. 1974); United States v. Wegematic Corp., 360 F.2d 674 (2d Cir. 1966); Transatlantic Financing Corp. v. United States, 124 U.S. App. D.C. 183, 363 F.2d 312 (1966). A promise will not be discharged because the performance promised in return has lost value on account of unforeseeable supervening circumstances unless those circumstances nearly or quite completely destroy the purpose both parties to the contract had in mind. Williston on Contracts, §1954 (1978). The question is whether the equities, considered in the light of sound public policy, require placing the risk of disruption or complete destruction of the contract's viability on one party or the other. Lloyd v. Murphy, 25 Cal. 2d 48, 153 P.2d 47, 50 (1944).

unforseeable

Finally, the third element of commercial frustration is

basic assumption

> [T]he non-occurrence of the frustrating event must have been a *basic assumption* on which the contract was made. This involves essentially the same sorts of determinations that are involved under the general rule on impracticability. (emphasis supplied)

Restatement (Second) of Contracts §265, comment a (1981).

Under the third factor, the Restatement adopts the central notion of Uniform Commercial Code §2-615 (see SDCL 57A-2-615) of "a contingency the non-occurrence of which was a basic assumption on which the contract was made" in dealing with commercial frustration. Introductory Note to Chapter 11, Reporter's Note; Rest. 2d §265, and comment a and b; Rest. 2d §261 and comment b.

> b. *Basic assumption*. In order for a supervening event to discharge a duty under this Section, the non-occurrence of that event must have been a "basic assumption" on which both parties made the contract. . . . Its application is also simple enough in the cases of market shifts or the financial inability of one of the parties. The continuation of existing market conditions and of the financial situation of the parties are ordinarily not such assumptions, so that mere market shifts or financial inability do not usually effect discharge under the rule stated in this Section.

Restatement (Second) of Contracts §261, comment b (1981). Using the "basic assumption test" courts, in effect, imply a condition excusing both parties from performance. This is based upon the theory of an implied term which, in the eyes of the law, the parties themselves would have regulated by agreement if the necessity had occurred to them. See Patch v. Solar Corp., 149 F.2d 558, 560 (7th Cir. 1945), cert. denied, 326 U.S. 741 (1945); 119 Fifth Avenue, Inc. v. Taiyo Trading Co., Inc., 190 Misc. 123, 73 N.Y.S.2d 774, aff'd 275 App. Div. 695, 87 N.Y.S.2d 430 (1949). If the frustrating event was neither foreseen nor reasonably foreseeable, the promise was not in fact intended by the parties to extend to such a contingency. If the event was foreseeable when the contract was made, then the party will be presumed to have assumed the risk of its occurrence. 18 Williston, Contracts §1954 (1978); 17A C.J.S. Contracts §§463(2), 464 (1963).

The application of the doctrine of commercial frustration, is a question of law, to be determined by the court from the facts of the case. Glens Falls Indem. Co. v. Perscallo, 96 Cal. App. 2d 799, 216 P.2d 567 (1950). Here, the trial court found that IHC's losses of one million dollars a day due to the depressed farm economy threatened the company's survival. The court held:

> Under such circumstances it would be commercially senseless to obligate I.H. to performance under its franchise agreement with Groseth. Consequently, the court finds that I.H.'s financial loss was of such a magnitude that it constitutes a supervening circumstance not fairly within the risks assumed under the contract or within the contemplation of the parties at the time of the agreement, that it strikes at the very root of the agreement essentially destroying the purpose for which the contract was made, and that performance would result in extreme and unreasonable hardship to I.H. Thus, regardless of Section 2 of the I.H.-Groseth agreement, I.H. is discharged from performance of the franchise agreement under the frustration of purpose doctrine.

The circuit court's memorandum opinion closely matches analysis of the elements made by IHC: First, profit was the primary purpose of the dealership agreement. Second, the primary purpose was substantially frustrated. IHC had lost almost two billion dollars in shareholder equity between 1980 and 1982 due to write-offs from plant closings and actual operating losses, had lost almost one million dollars a day in 1984 from its agricultural division, and could possibly be bankrupt the following year if

unforeseeable

such losses continued. Third, there was a basic assumption of the parties that there would continue to be profits to justify IHC's presence in the market. Fourth, the economic downturn in the farm economy and IHC's losses were unforeseeable and not the fault of IHC.

The trial court agreed with the analysis in Aluminum Co. of America v. Essex Group, Inc., 499 F. Supp. 53 (W.D. Penn. 1980) (ALCOA), that profit earning or loss avoidance can be the principal purpose of a contract. See also Printing Industries Ass'n v. International Printing, 584 F. Supp. 990 (N.D. Ohio 1984). We cannot accept the logic in *ALCOA,* supra at 77. All of the Restatement illustrations center on purposes other than making a profit. Furthermore *ALCOA* broadens the scope of the frustration doctrine in a manner that further confuses the distinction between frustration and commercial impracticability.

In this case, the dominant purpose of the contract was to create a franchise mechanism for IHC to market its equipment. Paragraph one of the agreement stated that the general purpose of the agreement was to *establish Groseth as a dealer* of the goods covered under the agreement and to govern the relationships between the dealer and the company in *promoting the sales of those goods*. Certainly, it can be inferred from the dealer

basic assumption

agreement and the surrounding circumstances that mutual profitability was intended by the parties. Few commercial contracts are made in which a profit is not an object. However, there is no evidence that this was the basis of the contract realized by both parties at the time of making the contract. Reduced market share or economic losses by IHC would not destroy the purpose for IHC having a franchise network to sell and service its products.

The frustrating event cited by IHC and the memorandum opinion is the economic depression in the farm economy and the serious losses to IHC that resulted. Even if we agreed that this was the true cause, there is no evidence that economic downturn, stiff competition, or other problems that developed for IHC were unexpected and therefore not assumed risks. Moreover, even if there was no assumption of risk, the Restatement is clear that the continuation of existing market conditions and the financial situation of the parties are not ordinarily basic assumptions or implied conditions which must exist in order to enforce a contract. Restatement (Second) of Contracts §261, comment b (1981); 17A C.J.S. Contracts §464 (1963).

The actual frustrating event was IHC's decision to sell off its division assets and withdraw from the market. IHC was responsible for this event. If the frustrating event was within the promisor's control or due to the promisor's "fault," he is not excused. 18 Williston, Contracts, §1954 (3d ed. 1978); 17A C.J.S. Contracts §463(2), 464 (1963). Since the frustrating event was a decision made by IHC, IHC cannot be discharged. Martin v. Star Publishing Co., 50 Del. 181, 126 A.2d 238 (1956); Williston, supra, §1960. Therefore, the doctrine of commercial frustration does not discharge IHC from its duty to perform under the franchise agreement.

B. Commercial Impracticability

IHC also argues that it should be excused under the doctrine of commercial impracticability. In the trial court's discussion of commercial frustration, there appeared the following sentence:

> Given today's rapidly changing business climate, the more enlightened view should be that where massive financial losses and difficulty of compliance is so great as to be prohibitive, it amounts to such an impracticability as to constitute impossibility in legal contemplation excusing non-performance.

The authority for this cite is 84 A.L.R.2d at 112, which was the only reference to commercial impracticability offered by the trial court.

As a general rule, unexpected difficulty, expense, or hardship involved in performance will not excuse performance where performance has not become objectively impossible. Nevertheless, there may be excuse from performance where very greatly increased difficulty is caused by facts not only unanticipated, but inconsistent with the facts that the parties obviously assumed would likely continue to exist. See American Trading and Production Corp. v. Shell Internat'l Marine Ltd., 453 F.2d 939 (2d Cir. 1972); *Transatlantic Financing Corp.,* supra; Iowa Electric Light and Power Co. v. Atlas Corp., 467 F. Supp. 129 (N.D. Iowa 1978). The most important question is whether an unanticipated circumstance has made performance of the promise vitally different from what the parties contemplated when they entered the contract. Williston, supra, §1931. This principle of allowing discharge due to extreme and unreasonable difficulty, expense, injury or loss involved is established in Restatement (Second) of Contracts, §261, as the commercial impracticability doctrine.

The doctrines of commercial frustration and impracticability focus on different kinds of disappointment of a contracting party. Impracticability focuses on occurrences which greatly increase the costs, difficulty, or risk of the party's performance. Frustration, on the other hand, focuses on a party's severe disappointment caused by a frustration of his principal purpose in entering the contract. *ALCOA,* supra at 73. It is extremely difficult to separate and apply these two doctrines. Nevertheless, we note that the facts of this case are more properly analyzed under the test for severe impracticability.

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At the time of breach, performance may have become vitally different from what the parties had contemplated when they entered the contract. Forcing IHC to continue its farm equipment operations merely to sustain its franchise contracts may have been impracticable. Although it was only speculated, another year of similar losses may have merely resulted in IHC's bankruptcy. The excuse of severe impracticability could therefore require that the risk that IHC's condition would suffer severely not be thrown upon IHC. Simply allowing discharge, however, would not fairly allocate the unexpected risks that occurred in this case.

IHC may not have been entirely responsible for the financial condition of the company that developed, but IHC was responsible for selecting the attempted solution. There is a material issue of fact as to what the issue about IHC losses

actual financial situation of IHC was at the time of sale. Most important, there is a question as to whether the parties could have terminated the contract by mutual agreement as provided in the contract. If IHC breached its contract by unilaterally terminating Groseth's franchise, the question is whether IHC could have avoided this breach by offering Groseth, Inc. a fair share in the moneys IHC received from the sale of its assets. There is also an issue as to what options, other than a sale of its assets, were available to IHC. A sale of assets was the obvious choice for IHC to escape liability to its franchise and at the same time allow Case/Tenneco to merely offer contracts to IHC dealers when it was advantageous for them. Therefore, we reverse the court's summary judgment on this issue and remand for a jury trial on the issue of impracticability. . . .

issue about impracticability

NOTE AND QUESTION

1. How would this court have resolved the issue in Problem 135?

2. The court refuses to follow the lead of the controversial case of Aluminum Co. of America v. Essex Group, 499 F. Supp. 53 (W.D. Pa. 1980), in which the court completely rewrote the contract to give each party the profits originally expected. The *Alcoa* fact pattern, however, is unique. In that case the parties had employed eminent economist Alan Greenspan (later chair of the Federal Reserve System) to devise a pricing index for the sale of aluminum. When the index chosen proved to be dramatically out of line with the expectations of the parties (because of the unexpected actions of OPEC in the early 1970s the pricing formula awarded one party huge gains while costing the other a loss of $75 million), the court reformed the contract to bring it back into line with the original understanding. The case was settled rather than appealed, leaving on the books a citation permitting a court enormous freedom to rewrite contracts where the need to do so is strong.