**Chapter 6: Overview and Formation of Contracts**

**OVERVIEW**

This chapter, the first in the Law and Commerce unit, begins a three-chapter sequence focused on the study of contracts. Chapter 6 is a broad overview of contract law and the elements of formation. Chapter 7 covers the requirements for enforceability, rules for performance, and breach issues. Chapter 8 covers sales contracts under Article 2 of the UCC.

**KEY LEARNING OUTCOMES**

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| **Outcome** | **Accreditation Categories** |
| Distinguish between contracts based on categories, and explain the concept of mutual assent and other elements required for the formation of a valid contract. | Knowledge, Application |
| Define and apply the correct source of law. | Knowledge, Application |
| List events of termination and distinguish between termination by the parties and termination through operation of law. | Knowledge |
| Give examples of when capacity and legality are at issue. | Application, Critical thinking |

**TEACHING OUTLINE**

1. **Definitions and Categories of Contracts**

**Teaching tip: Everyday contracts**

When introducing a topic that is as significant and complex as contracts, the challenge becomes how to introduce the topic in broad based terms with which students can readily connect. Students are fascinated when they find out that contract law is a part of everyday life. This is often a good way to pique interest. I usually put the definition “promises or set of …” on the board and ask students to give me examples of contracts that they enter into on campus.

“Have any of you entered into a contract in the last week?” They typically come up with some obvious examples such as simple purchases etc.

“Let’s suppose that you promised your roommate that you would do her laundry for her if she agrees to drive you to your internship location on Tuesday and Thursday mornings. Is that a contract? Isn’t it a set of promises? If you perform your end of the bargain by doing your roommates laundry, but she refuses to drive you to your internship, can you sue her? If you forget to do her laundry one week, can she sue you? Are all promises legally enforceable?”

*Points to emphasize:*

* A contract is a **promise or a set of promises enforceable by law**.
* Overview of the elements of a contract
* ***Categories of Contracts****:* It is important to note that these categories are not mutually exclusive
  + ***Written versus Oral Contracts:***Any agreement, oral or written, may result in a binding contract so long as it meets certain requirements
  + ***Bilateral Contracts versus Unilateral Contracts:*** A bilateral contract involves two promises and two performances.
    - A unilateral contract involves one promise, followed by one performance, which then triggers a second performance from the offeror.

**Case 6.1: Augstein v. Leslie**

**Facts:** Leslie is an American recording artist whose laptop computer, external hard drive, and certain other belongings were stolen. In videos, news articles, and online postings, Leslie stated that he would pay a reward to anyone who returned his property. Spe­cifically, Leslie mentioned a $20,000 reward for the return of his property in a YouTube video, saying, “I am offering a reward of $20,000.” On November 6, 2010, a video was posted increasing the reward to $1,000,000. At the end of the video, a message reads:

In the interest of retrieving the invaluable intellec­tual property contained on his laptop & hard drive, Mr. Leslie has increased the reward offer from $20,000 to $1,000,000 USD. The increase of the reward was publicized on Leslie’s Facebook and Twitter accounts, including a post on Twitter, and an MTV interview.

Augstein found the laptop in a plastic garbage bag while walking his dog returned the laptop and hard drive to the local police and even­tually the laptop was returned to Leslie in New York. When Augstein contacted Leslie, however, Leslie refused to pay the reward.

**Issue:** Were Leslie’s reward offers via You Tube and social media sufficient to create a unilateral contract offer?

**Holding:** Yes. The court rejected Leslie’s contention that the videos were merely an advertisement because Leslie was seeking a performance—not a counter promise.

**Case Questions:**

**1.** There is no bilateral contract because Augstein never gave a counter promise to find the laptop. He accepted the offer through performance.

**2.** Leslie claimed it was an advertisement inviting someone to make an offer rather than an offer from him. The court rejected it because his videos etc could not reasonably be interpreted to be an invitation to negotiate. He was not soliciting a promise- he was soliciting the return of the property.

3. *Critical Thinking:* The intent of this question is to stimulate discussion on proactive law. Disclaimers, cautionary language, and objective intent are all implicated.

* + ***Express Contracts versus Implied Contracts versus Quasi-Contracts:***An express contract is created when the parties have expressly agreed on the promises and performances, an implied contract is one in which the agreement is reached by the parties actions rather than their words, and a quasi-contract is enforceable where one party suffers losses as a result of another party’s unjust enrichment.

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* ***Valid versus Void Contracts****:* When a contract has the necessary elements, it is said to a valid contract, while void contracts are those agreements that have not been formed in conformance with the law from the outset of the agreement ad, thus, cannot be enforced by either party.
* ***Voidable versus Unenforceable Contracts****:* A voidable contract is one in which though a valid contract is formed, one party may at its option, either disaffirm the contract or enforce it; an unenforceable contract, on the other hand, is one that meets the elements required by law for an otherwise binding agreement, but is subject to a legal defense.

**Teaching tips: Trouble spot- voidable versus unenforceable**

The topic of voidable versus unenforceable contracts confounds many students. Because students have not yet learned the circumstances under which a contract may meet the elements for formation but is unenforceable, it is difficult for them to understand these concepts in the abstract. I use two simple examples: age capacity to illustrate “voidable” and statute of frauds to illustrate “unenforceability”.

**B. Sources of Law**

*Points to emphasize:*

* In general, contracts for **services** or **real estate** are governed by the state **common law**, and contracts for **goods or products** are governed by state **statutory** law based on the **UCC.**
* Contracts involving terms for both goods and services are known as **hybrid contracts** and in this case, the source of law is established by determining the **predominant thrust** of the contract subject matter.

**Legal Implications in Cyberspace:** The Uniform Electronic Transactions Act

* A procedural model law that applies to transactions as long as the parties to a contract agree to use electronic commerce for that transaction.
* UETA elevates electronic signatures and records to the same legal status as are accorded to traditional signature and paper records.

**Concept Summary: Definition and Sources of Law**

**Self-Check:** Which sources of law govern this contract?

**Concept Summary:** Categories and types of contracts

**A. Overview of a Contract Transaction**

*Points to emphasize:*

* A contract is **formed** when two or more parties reach a mutual agreement on terms, and this agreement is recognized as legally binding so long as it meets certain formation requirements.
* After the formation requirements are met, the contract is governed by laws that set out requirements for **enforceability** of the agreement.
* Assuming that the contract was properly formed and is legally enforceable, **performance** then governs parties performing (or not performing) the terms of the agreement and provides compensation if one party fails to perform.
* **Table 6.1**: Overview of a Contract Transaction

**B. Contract Formation**

*Points to emphasize:*

* The formation of a contract requires **mutual assent** whereby the parties reach an agreement using a combination of **offer** and **acceptance**.
* Formation of a valid contract also requires that the agreement is supported by **consideration**, the parties entering into the agreement have **capacity**, and the subject matter and performance of the contract is **legal** and consistent with public policy.
* In order for the contract to be *enforceable*, the agreement must also be the product of **genuine assent** and, in some cases certain terms must be in writing as required by the **statute of frauds**.

**Chalk Talk: Mapping out Mutual Assent**

Students benefit from seeing the entire topic of Mutual Assent mapped out as they progress during the material. I list them on the left side of the board in a checklist format—then explain the details of each element on the right side of the board while using the checklist as a handy review device along the way. E.g.,

*Offer }* Offer

*} Agreement Objective intent of the offereor*

*Acceptance } -Advertisements*

*Consideration*

*Capacity*

*Legality*

* ***Mutual Assent Part 1: Offer****:* An offer is a **promise or commitment to do** (or refrain from doing) a specified activity in exchange for the offeree’s counter-promise to perform.
  + In order for an offer to have legal effect, the offeror must have an **objective intent** to contract when making the offer: Given the language and circumstances of the offer, would a reasonable person in the position of the offeree conclude that the offer was an **objective manifestation of serious intent to contract**?
  + Under modern case law, the importance of the parties’ intention, or lack of intention, to form a contract depends largely upon the **context** of the agreement.

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**Landmark Case 6.2 Lucy v. Zehmer**

**Facts:** Lucy was a farmer who knew Zehmer for a period of 15-20 years and, during a meeting at a restaurant over drinks, offered to buy Zehmer’s farm. Lucy’s previous offers to buy Zehmer’s farm had been rejected, but during this meeting Lucy persuaded Zehmer to put it writing that he would sell Lucy the farm for $50,000. The parties modified the writing several times and discussed the terms over a period of 30-40 minutes before signing the contract. The next day, Zehmer failed to acknowledge the contract, and claimed that had understood the whole transaction as a joke and that he was as **“high as a Georgia Pine”** while modifying the contract. Thus Zehmer argued that the contract void because it lacked objective intent to contract.

**Issue:** Is the contract between Lucy and Zehmer enforceable even though Zehmer had no **actual** intent to sell the farm and may have been joking?

**Ruling:** Yes. The court ruled that actual intent is not required for formation of a contract; rather, the objective standard is used in determining that a reasonable person would have construed Zehmer’s actions and words as a serious intent to contract.

**Answers to case questions:**

**1.** The court applies the objective standard in determining that a reasonable person would have construed Zehmer’s *actions* and *words* as a serious intent to contract. In this case they examined first that there was the appearance of the contract, that this contract was under discussion for forty minutes or more before it was signed, Lucy’s objection to the first draft, and the discussion of what was to be included in the sale and other terms.

2. Any actions or words that would lead a reasonable person to believe that no contract existed could have changed the courts determination. Here, if Zehmer expressly indicated that he would not sell Lucy the farm and therefore ended the negotiations after only a few minutes, the objective standard would be much more difficult to satisfy. Similarly, the court might find that no contract existed if Zehmer omitted discussion on any material terms of the contract such as price.

3. *Critical Thinking:* The intent of this question is to stimulate discussion on the limits of “objective intent” and what can be a “meeting of the minds.”

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* + ***Advertisements as an Offer****:* Advertisements are generally not considered an offer; rather, they are an invitation for the consumer to make an offer to a seller of goods or services.
    - Certain advertisements can be considered an offer when the advertisement is specific enough to constitute a unilateral contract.

**Case 6.3 Leonard v. PepsiCo. Inc.**

**Note to the instructor:** The actual video of the Pepsi commercial involved may be found via a link on this textbook’s website.

**Facts:** Pepsi produced a television advertisement promoting its Pepsi Points program whereby consumers could obtain points by purchasing Pepsi products, or for a certain dollar figure, and then redeem the points for certain apparel and other items found in a catalog. The advertisement featured many of the apparel items and, in an obvious joke, a Harrier Jet for 7,000,000 points. Leonard noticed the catalog did not include the Harrier Jet, so he wrote the item on the order form and sent the order to Pepsi with a check for $700,000, the amount necessary to purchase the requisite points as stated in the advertisement. Pepsi refused to transfer title on the basis that no contract existed.

**Issue:** Was the Pepsi Points advertisement specific enough to constitute a valid offer or a unilateral contract?

**Ruling:** No. While certain advertisements could be an offer if the promise is clear, definite, and explicit, such was not the case here because the advertisement reserves the details of the offer to a separate writing (the catalog).

**Answers to case questions:**

1. By definition, a unilateral contract is a contract involving one promise, followed by one performance, which then triggers a second performance from the offeror. Here, the initial promise would be the advertisement whereby Pepsi indicated that one could obtain a Harrier Jet if they could raise 7,000,000 Pepsi Points. This was followed by Leonard’s performance in obtaining the requisite points, which then would trigger the second performance in Pepsi tendering a Harrier Jet to Leonard. In order to support this theory, Leonard had to show that the initial promise was clear, definite, and explicit. Under this notion, facts indicating that the catalog mentions a Harrier Jet, or the commercial itself directed anyone who appeared at Pepsi headquarters with the 7,000,000 Pepsi Points on a certain date would receive the Harrier Jet would support a clear, definite and explicit promise necessary for a unilateral contract.

2. Given this hypothetical, it is still unlikely that the outcome of the case would be any different. Though such a finding would help support Leonard’s argument, it still does not make Pepsi’s promise any more clear, definite or explicit. In light of the obvious absurdity of the commercial, an indefinite order form by itself would not be sufficient to change the outcome of the case.

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* ***Mutual Assent Part 2: Acceptance****:* An acceptance is the offeree’s **expression of agreement** to the terms of the offer, which can be exercised so long as the offer is still in force.
  + ***Events of Termination of the Power of Acceptance:* *Action of the Parties versus Operation of Law:*** An offer may be terminated by action of the parties in one of three ways: (1) **revocation**, (2) **rejection**, and (3) **counteroffer**; offers may also be terminated by **operation of law**.
    - *Revocation:* Where the offeror revokes (withdraws) the offer by expressly communicating the revocation to the offeree prior to acceptance.
    - Most states follow the rule that revocation is only effective upon receipt by offeree or the offeree’s agent.
    - Certain offers are considered irrevocable:
    - *Option Contracts:* The offeror agrees to hold an offer open for a certain period of time in exchange for consideration.
    - *Partial Performance and Detrimental Reliance:* An offer can be temporarily irrevocable if the offeree, prior to actual formation of the contract, takes some action that **relies on the offer** (partial performance), or if the **offeree makes preparations** prior to acceptance based on a reasonable reliance on the offer (detrimental reliance).
    - *Rejection and Counteroffer:* An offer is terminated once the offeree has either rejected the offer outright or makes a counteroffer by rejecting the original offer and making a new offer.
    - The **mirror image rule** requires that any acceptance by the offeree must be the mirror image of the original offer, any deviation from the original offer results in a rejection and counteroffer.
  + ***Operation of Law****:* An offer may also be terminated by certain happenings or events including lapse of **time**, **death** or **incapacity**, and **destruction** of the subject matter.
    - *Lapse of Time:* Offers expire by operation of law after a time limit as attached by the offeror or after a reasonable time given the circumstances.
    - *Death, Incapacity, or Destruction:* In the event that the offeror or the offeree either dies or becomes incapacitated, or the subject matter of the contract is destroyed before acceptance, the offer is considered terminated by operation of law.
  + ***When Acceptance Is Effective: The Mailbox Rule:***The acceptance of an offer is generally effective upon dispatch using a commercially reasonable manner
  + **Table 6.2: When Is Acceptance Effective?**
* **Self-Check**: Mailbox Rule: For each transaction, does a contract exist? If yes, and what is the date of the contract. If no, why not?

**Concept Summary: Mutual Assent**

* ***Insufficient Agreement:***In some cases the parties may actually have satisfied the elements of offer and acceptance, but the agreement **still lacks mutual assent** and is therefore insufficient to constitute a properly formed contract.
  + ***Indefinite Terms****:* For an offer to be valid, the parties must reach mutual assent on all of the essential terms of the agreement (parties, subject matter, time, and consideration).
    - Even though an agreement does not contain all the required terms, courts have held that the court may supply missing terms when the term may be implied as “reasonable” or by the course of past dealing.
    - *Agreements to Agree:* In cases where parties leave essential terms unfilled, intending to agree upon the term in the future, so long as the court determines that the parties themselves intended to make a binding contract, the agreement is enforceable and a court may supply the missing term.
* ***Mistake****:* The law recognizes certain mistakes and provides a remedy intended to make the parties whole again.
  + - A mistake is defined in contract law as an erroneous belief that is not in accord with the existing facts.
    - A mutual mistake may be the basis for canceling a contract when both parties hold an erroneous belief concerning a basic assumption on which a contract was made.
    - Generally, courts will not consider market conditions or financial ability as a mistake that allows a contract to be avoided.
    - A unilateral mistake is when only one party had an erroneous belief about a basic assumption in the terms of the agreement and, generally, it is not a valid reason to avoid a contract unless the nonmistaken party had reason to know of the mistake or his action caused the mistake.
    - ***Consideration****:* For a binding contract to exist the agreement must be supported by consideration, which includes a suffering a **legal detriment** and a **bargained for exchange.**
  + ***Legal Detriment:***Satisfied if the party promises to perform something that the party is not legally obligated to do or refrains from doing something that party had a right to do.
  + ***Preexisting Duty Rule:***If a party does or promises to do what she is already legally obligated to do, the law generally does not recognize this as a legal detriment.
    - There are certain exceptions to the preexisting duty rule such as when the promising party assumes additional duties, or where either party did not reasonably anticipate certain circumstances when the original contract was formed.
  + ***Bargained for Exchange:***A performance or return promise is “bargained for” only if it was exchanged for another promise.
  + ***Past Consideration:***When a promise is made in return for a detriment previously made by the promisee there is no consideration.
  + ***Amount and Type of Consideration:***Ordinarily, courts will **not look** to the amount or type of consideration, or the relative bargaining power of the parties in deciding the validity of consideration.
    - Most courts have held that nominal consideration is sufficient in meeting the consideration requirement so long as the amount is truly nominal.
  + ***Promissory Estoppel:***Theory allowing for the recovery of damages by the relying party, even though the original promise lacked consideration, if the promisee actually relied on the promise and the promisee’s reliance was reasonably foreseeable to the promisor.
* ***Capacity:*  Courts will only enforce contracts where each party had the legal capacity to enter into a contract.**
  + ***Minors:***Until a person reaches her majority age (18), any contract that she may enter into is voidable at the minor’s option.
    - A contract made by a minor is not automatically void; rather, the minor either **avoids the contract or may enforce the contract**.
    - There is an exception to the minor capacity rule for **necessities**.
  + ***Mental Incompetents:***This category includes both the obvious cases and temporary incompetence.
    - In general, a person lacks capacity because of mental incompetents if either (1) she is unable to **understand** the nature and consequences of the contract, or (2) **she is unable to act in a reasonable manner in relation to the transaction** and the other party has reason to know of her condition.
    - In most states contracts made by an incompetent are **voidable**, and can be ratified if the incompetent party regains her mental capacity or has a guardian appointed.

**Case 6.4: Sparrow v. Demonico**

**Facts:** A family dispute over owner­ship of what had been the family home in Woburn, Massachusetts, prompted Sparrow to file a complaint in a state trial court against her sister, Susan Demonico, and Susan’s husband, David D. Demonico (Demonicos). Prior to trial, the parties resolved their differences by entering into a settlement agreement reached dur­ing voluntary mediation. However, when Sparrow attempted to obtain a court order to enforce the agreement, the Demonicos argued that the con­tract was void because Susan Demonico lacked the capacity to enter into the agreement. A trial court agreed with the Demonicos, ruling that the con­tract was void because it may have been the product of an emotionally overwrought state of mind and Susan was not able to understand in a reasonable manner the nature and consequences of her actions. The appellate court reversed the trial court’s deci­sion and issued an order enforcing the settlement agreement.

**Issue:** Did Demonico’s condition establish incapacity as a defense to the mediation settlement agreement?

**Ruling:** No. Although the court ruled that she could establish incapacity even without proof of a permanent medical condition, Demonico did not provide any credible medical evidence to indicate that she didn’t have the ability to comprehend the reasonableness of the settlement terms.

**Case Questions:**

**1.** What was missing was any medical expert testimony to establish incapacity.

2. The trial court mistakenly focused on whether Demonico’s state of mind was “emotionally overwrought”, but did not require any medical testimony.

3. *Critical Thinking:* The intent of this question is to stimulate discussion the wider public policy view of mental capacity. Students may also consider if there is a bright line test: certain conduct equals incapacity.

* ***Legality:***In order for a contract to be enforceable, both the subject matter and performance of the contract must be legal; illegal contracts are void automatically.
* **Concept Summary:** Contract Formation

**END OF CHAPTER PROBLEMS, QUESTIONS, AND CASES**

**Chapter Review Questions**

**Theory to Practice**

1. From an objective perspective, DS did make a valid offer on Monday. The contracts had sufficiently definite terms, writing, a negotiation, and words of the parties all indicate this was intent to contract. Case: Lucy v. Zehmer.
2. Yes. Although the signature of the party is missing (which could be problematic in the future), the parties agreed to price, time, services, goods to be sold etc.
3. No. Since Quick had already accepted, the power to revoke was terminated by acceptance on Monday.
4. This is a hybrid contract that is covered under the Common Law as its predominant thrust (as seen in the price allocation) is for services.
5. No. In order for capacity to be used to void the contract, the other party has to know (or should have known) about the capacity. Here there was no evidence of a mind-altering prescription.

**Manager’s Challenge**

A sample answer to Manager’s Challenge is provided in Connect.

To the Vice-President of Sales,

FarmCo’s Sales Manager is proposing a divisible contract with a rescission clause based on sales performance. They are proposing that each delivery of four tractors be considered a separate contract. After the delivery of the second batch, they will have the opportunity to cancel remaining tractor orders should they have six or more tractors in their inventory. The ultimate effect regarding TractorCo is that we will be guaranteed the sale of eight tractors. Any future lots of four will be subject to FarmCo’s sales and inventory.

If we consider accepting their proposal, I recommend that dates be specified regarding when their inventory is counted. “At any time during the contract” is not in our best interests. For example, should they sell two tractors from the first batch, immediately upon receiving the second batch they would be at six tractors and be eligible to cancel the contract. If accepting their proposal, we should specify that their inventory be determined at some set time, perhaps three days before the first of the month when a new batch of tractors to be shipped.

Certainly you understand that rejecting their proposal would obligate them to accept all 20 tractors for the full $1million cost should they go ahead with the contract.

**Legal Strategy 101:** Negotiation strategy

Overview: Ticketmaster's Strategic Contracts

Critical Thinking Questions: [Answers to these questions posed here will be subjective]

**Case Summary 6.1**: Unilateral Contract: Chambers v. Travelers Companies

1. Had Chambers performed her job well, the climate survey come back positive, and no irregularities occurred in her expense reports but she was still terminated

due to cutbacks, could she have compelled Travelers to pay her the bonus?

A. Probably not. A unilateral contract requires a definite offer and any language that the bonus was discretionary (rather than fulfilling certain conditions).

2. Was Travelers’ bonus statement in the compensation summary a unilateral offer that could be accepted by performance?

A. No. the language was not definite enough to constitute a unilateral offer.

**Case Summary 6.2:** Void Contract: Rochon Corp. v. City of Saint Paul

1. The city claimed that it benefited the public by allowing the bid change because it resulted in monetary savings for the city. Does this explanation justify the city’s disregard of established precedent? Can the court of appeals disregard established state precedent?

A. This question is intended to spur discussion on the topic of whether or not courts should revisit precedent.

2. Shaw-Lundquist was able to prove that its original bid was wrong due to a legitimate clerical error. Should this have mattered?

A. Yes. Where the other party knew or should have known of such a mistake, the bid should be allowed to be amended as a mistake.

3. Why is it good policy to not permit amendments of bids in competitive bidding situations?

A. Such a rule discourages corruption resulting from bidders changing bids after they have seen competing bids.

**Case Summary 6.3**: Implied Contracts: Forest Park Pictures v. Universal Television Network, Inc.

1. Who wins and why?

A. Forest Park. They have alleged an enforceable implied contract on the price terms because of an industry standard that sets such a price.

2. What allows Forest Park to argue that this is an implied contract?

A. California recognizes an implied contract when a party submits and idea (offer) that the other party subsequently uses (acceptance) without compensating the offeror (breach).

**Case Summary 6.4**: Unenforceable Contracts: Morrow v. Hallmark Cards, Inc.,

1. Employment agreements for binding arbitration are valid only if agreed to. Should Morrow’s continued employment be considered an agreement to the

Hallmark Dispute Resolution Program terms?

A. The court ruled that neither the promise of access to the DRP, nor Ms. Morrow’s continued employment, gave her enforceable rights against Hallmark which could constitute consideration. Thus, the agreement is unenforceable against her.

2. Should the binding arbitration provision of the Hallmark Dispute Resolution Program be found enforceable or unenforceable? Why or why not?

A. This question is intended to spur debate on the propriety of ADR clauses in employment contract.

**Case Summary 6.5**: Arizona Cartridge v. Lexmark

1. Typically, yes. If the offer is marked as terms of service and the consumer can reject it, it’s enforceable.

**Case Summary 6.6:** Biomedical v. GE Marquette

1. Perhaps. In this case, the court found that it was reasonable to believe that the terms of the contract had become illegal.

2. Not necessarily. It would not render a term illegal in most cases.

**Case Summary 6.7:** Mistake: Reed's Photomart, Inc. v. Monarch

1. Reed wins due to a unilateral mistake. Given that his course of dealing over several years was to order 4,000 labels at a time, Monarch had reason to know that the order for 4,000,000 labels was a mistake.

2. This is a unilateral mistake. As opposed to mutual mistake, in unilateral mistake, only one of the parties has an erroneous belief about the facts regarding the basis of the agreement.