

# 3

## Problems in Formation

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## I. Overview

§3.1 As a general rule, the courts will enforce a contract that the parties entered into freely. However, in certain situations the courts, applying equitable and public policy principles, will refuse to recognize or enforce a contract. The courts and litigants have developed a number of doctrines to support an argument that a contract should be set aside because it was not properly formed. The drafter must be aware of these defenses and take care not to give the other party an opportunity to attack the contract at a later date.

In Michigan, there are five essential elements of a contract: competent parties, proper subject matter, legal consideration, mutuality of agreement (offer and acceptance), and mutuality of obligation. *Detroit Trust Co v Struggles*, 289 Mich 595, 286 NW 844 (1939); *Hess v Cannon Township*, 265 Mich App 582, 592, 696 NW2d 742 (2005); *Thomas v Leja*, 187 Mich App 418, 468 NW2d 58 (1991). Problems may arise with any of the elements, but typically formation issues arise in one of the following areas: misrepresentation, mistake, illegality and unconscionability, duress, undue influence, or capacity.

In Michigan, it has been widely accepted that a party may attempt to show a contract is voidable by reason of a false and fraudulent representation made during the procurement of the contract. *Rood v Midwest Matrix Mart, Inc*, 350 Mich 559, 87 NW2d 186 (1957). Attempting to avoid a contract due to fraudulent misrepresentation requires a showing that (1) the other party made a material representa-

tion, (2) the representation was false, (3) the other party knew the representation was false when made or made it recklessly without knowledge of its truth and as a positive assertion, (4) the representation was made with the intention to induce the plaintiff's reliance, (5) the plaintiff acted in reliance upon the representation, and (6) the plaintiff suffered injury as a result of its reliance. *In re Swantek Estate*, 172 Mich App 509, 432 NW2d 307 (1988); *Temborious v Slatkin*, 157 Mich App 587, 403 NW2d 821 (1986).

Because a contract may not be formed without the mutual assent of the parties, a mistake may bar the formation of an enforceable contract. A mistake of law is not usually grounds for equitable relief. *Schmalzriedt v Titsworth*, 305 Mich 109, 119, 9 NW2d 24 (1943). Contract law distinguishes between cases involving a mutual mistake of fact and a unilateral mistake of fact. In a mutual mistake of fact case, the court ordinarily will correct the error and reform the contract to give effect to what both parties intended. Traditionally, the courts have been reluctant to grant relief in cases of unilateral mistake.

As for illegality, contracts that violate statutes or public policy will not be enforced. The test to decide whether a contract is contrary to public policy is not what is actually done or whether harm results from the contract, but rather what may or might be done under the contract terms. *Mahoney v Lincoln Brick Co*, 304 Mich 694, 8 NW2d 883 (1943). The UCC also permits a court to refuse the enforcement of contracts for the sale of goods, in whole or in part, if the contract is unconscionable or contains unconscionable terms. UCC 2-302. Although unconscionability is often thought to be limited to consumer transactions, the doctrine has been applied in commercial cases as well.

Duress exists when a party, by the unlawful act of another, is induced to make a contract or perform some act under circumstances that deprives the party of the exercise of free will. *Beachlawn Bldg Corp v St Clair Shores*, 370 Mich 128, 121 NW2d 427 (1963). Duress can occur in either of two ways—physical compulsion of unwilling conduct or improper threats—although recent Michigan cases indicate that only illegal conduct may constitute duress.

Undue influence consists of “unfair persuasion of a party who is under the domination of the person exercising the persuasion or who by virtue of the relation between them is justified in assuming that that person will not act in a manner inconsistent with his welfare.” *Restatement (Second) of Contracts* §177(1). The courts will presume that a contract was procured by undue influence when a person in a confidential or fiduciary relationship receives a benefit from the person to whom the confidence or fiduciary is owed as a result of the relationship. *Habersack v Rabaut*, 93 Mich App 300, 287 NW2d 213 (1979).

In Michigan, all persons at least 18 years of age, MCL 722.52(1); of sound mind; and under no restraints may contract. *In re Meredith's Estate*, 275 Mich 278, 266 NW 351 (1936). As the elderly increase in number, contracting parties must ensure that all parties have the mental capacity to contract or the contract may be voidable.

## II. Distinctions Between Void and Voidable Contracts

§3.2 When a contract is deficient in its formation, it imposes no legal obligation on the parties. When discussing such cases, courts often use the terms *void* and *voidable* without careful attention to their legal significance. A contract is void when it produces no legal obligation on the promisor. For example, “an exchange of promises which lacks consideration is frequently said to be a void contract.” John D. Calamari & Joseph M. Perillo, *The Law of Contracts* §1-11 at 18 (3d ed 1987). However, “[i]t would be more exact to say that no contract has been created.” *Id.* For example, a contract between a physician and a personal injury litigant in which the physician is paid a percentage of the sum recovered in the suit in exchange for testimony is void as against public policy. *Sherman v Burton*, 165 Mich 293, 130 NW 667 (1911).

Contracts that suffer from formation problems such as misrepresentation, mistake, and the like are voidable. This is the case because “one or more of the parties has the power to elect to avoid the legal relations created by the contract or by ratification to extinguish the power of avoidance.” *The Law of Contracts* §1-11 at 18. For example, fraud is a defense to contract formation. A contracting party who has been defrauded must act promptly to repudiate the contract and must do nothing to affirm the contract after discovering the fraud. *LeRoy Constr Co v McCann*, 356 Mich 305, 96 NW2d 757 (1959). Similarly, a contract induced by fraud is not void, but it is voidable at the option of the defrauded party. An affirmative action on the part of the defrauded party is required to relieve that party of its contractual obligation. The contract will be treated as valid until the party having the right of rescission takes some action to accomplish rescission. *Jack Mann Chevrolet Co v Associates Inv Co*, 125 F2d 778 (6th Cir 1942). Generally, a void provision of an otherwise valid contract may be severed from the contract if it is not an essential part of the whole contract. *Peeples v Detroit*, 99 Mich App 285, 297 NW2d 839 (1980). It should be noted that an integration or merger clause may nullify antecedent claims, including claims relating to formation problems. If a contract contains a valid merger clause, only fraud can vitiate the contract but only if the fraud would invalidate the merger clause itself, i.e., fraud relating to the merger clause or fraud that invalidates the entire contract including the merger clause. *Dedvukaj v Equilon Enters, LLC*, 301 F Supp 2d 664, 671 (ED Mich 2004), *aff'd*, 2005 US App LEXIS 8408 (6th Cir 2005).

## III. Misrepresentation

### A. In General

§3.3 In reviewing contracts, courts traditionally have been concerned with abuses of the bargaining process as opposed to the substance of the resulting bargain or contract. 1 E. Allen Farnsworth, *Farnsworth on Contracts* §4.9 at 399 (2d ed 1990). The result is a system based on informed assent, in which the courts allow the recipient of the misrepresentation to rescind the contract by avoiding it, leaving the misrepresented party in the position it was in before the contract was entered into. 1 *Farnsworth on Contracts* §4.9 at 399–400. The remedy for misrepresentation in contract should not be confused with the remedy for tortious fraud. Unlike in tort, the remedy for the aggrieved party to a contract is to make the con-

contract voidable, not to establish a claim for damages. *Restatement (Second) of Contracts* chapter 7 introductory note.

In Michigan, it has been widely accepted that a party may attempt to show a contract is voidable by reason of a false and fraudulent representation made during the procurement of the contract. *Rood v Midwest Matrix Mart, Inc*, 350 Mich 559, 87 NW2d 186 (1957). A misrepresentation is an assertion that is not in accord with the facts. *Restatement (Second) of Contracts* §159. Under the *Restatement*, a misrepresentation may have three distinct effects: (1) it may prevent the formation of any contract at all, *id.* at §163; (2) it may make a contract voidable, *id.* at §164; and (3) it may be the grounds for a decree reforming the contract, *id.* at §166. *Restatement (Second) of Contracts* introductory note to chapter 7, topic 1. The most common of these effects is making the resulting contract voidable. *Id.*

Many of the rules regarding mistake may also be applicable in the instance of a misrepresentation, because a misrepresentation results in a contract made while one party is operating under a mistake. *Id.* Additionally, a party who has the power to avoid a contract, as in the case of misrepresentation, owes no duty of performance. *Restatement (Second) of Contracts* §385(1). A party may also choose to affirm the contract, despite the misrepresentation. Unintentional ratification may occur by accepting the benefits of the contract or by delaying rescission of the contract. *Restatement (Second) of Contracts* §380(2). Note too that an integrated contract does not bar an argument that the contract is void by reason of false and fraudulent representations in its procurement. *Rood*.

## B. Elements for Contract Avoidance

### 1. In General

§3.4 Claims for fraudulent misrepresentation require a showing that (1) the party made a material representation, (2) the representation was false, (3) the party knew the representation was false when made or made it recklessly without knowledge of its truth and as a positive assertion, (4) the representation was made with the intention to induce the plaintiff's reliance, (5) the plaintiff acted in reliance upon the representation, and (6) the aggrieved party suffered injury as a result of its reliance. *In re Swantek Estate*, 172 Mich App 509, 432 NW2d 307 (1988); *Temborious v Slatkin*, 157 Mich App 587, 403 NW2d 821 (1986).

### 2. Misrepresentation of Fact

§3.5 As discussed in §3.3, a party alleging misrepresentation must first show that there has been a misrepresentation of fact. According to *Restatement (Second) of Contracts* §159, a misrepresentation is an assertion that is not in accord with the facts. Although this requirement may be a straightforward assertion, many issues arise in its application. For example, a prediction of future events or a statement of opinion may not be a representation of fact. *Restatement (Second) of Contracts* §159. However, "a prediction of future events may by implication involve an assertion that facts exist." *Restatement (Second) of Contracts* §159 comment c. For example, an assertion that a machine will perform at a certain level implies that the design of the machine makes it capable of performing as prom-

ised, even if it is not legally binding as a promise. *Id.* A mere expression of opinion is not a representation of an actual existing fact when the parties to a contract are dealing at arm's length. *A&M Land Dev Co v Miller*, 354 Mich 681, 94 NW2d 197 (1959).

### 3. Fact Must Have Been Material or Fraudulent

§3.6 If the person making the misrepresentation knows that it is likely that the representation will induce the recipient to enter into the contract (even if it would not so induce a “reasonable person”), the representation is material. *Restatement (Second) of Contracts* §162. False representations, no matter how they are acted upon, are insufficient to invalidate an otherwise valid agreement unless they are material. *Lebeis v Rutzen*, 289 Mich 1, 286 NW 134 (1939). The misrepresentation does not need to be material if it is fraudulent. *Restatement (Second) of Contracts* §164 comment b. However, as discussed in §3.7, it is essential that the misrepresentation actually induce assent. *Restatement (Second) of Contracts* §162 comment a.

### 4. Reliance on Representation

§3.7 Reliance on alleged fraudulent statements is a necessary element of proof in a case seeking equitable relief based on fraudulent statements. *Windham v Morris*, 370 Mich 188, 121 NW2d 479 (1963). A party to a contract may not merely cite a misrepresentation to the court. Rather, a party seeking relief must be able to show that the misrepresentation substantially contributed to the decision to enter into the contract. *Restatement (Second) of Contracts* §167. However, the misrepresentation need not have been the only or dominant factor that induced assent to the contract. *Restatement (Second) of Contracts* §167 comment a.

An assertion of one's opinion generally does not create justifiable reliance unless the recipient (1) stands in a relation of trust and confidence to the person asserting the opinion such that the recipient is reasonable in relying on it; (2) reasonably believes that, as compared with himself or herself, the person asserting the opinion has special skill or judgment regarding the subject matter; or (3) is for some other reason particularly susceptible to a misrepresentation of the type involved. *Restatement (Second) of Contracts* §169; 1 E. Allen Farnsworth, *Farnsworth on Contracts* §4.14 (2d ed 1990), citing, in part, *Casper v Bankers Life Ins Co*, 238 Mich 300, 212 NW 970 (1927) (insured relied on opinion of insurer's general agent, whom he believed to be friend). However, while statements regarding quality are generally taken as an opinion, statements about the quality of goods may be actionable as a breach of warranty under UCC 2-313.

A party who consults with a person in trust may not argue reliance on the misrepresentation. In upholding the trial court's grant of summary disposition against a terminated employee seeking to invalidate a release in a severance agreement in *Hungerman v McCord Gasket Corp*, 189 Mich App 675, 677, 473 NW2d 720 (1991), the Michigan Court of Appeals noted that plaintiff had consulted both his wife and an attorney before signing the release, indicating that plaintiff did not rely on defendant's statements.