February 1994
Question 2

Al was a painting contractor who was in the process of incorporating his business under the name Paintco, Inc. Al frequently purchased materials on account from Retailer. On May 1, Al entered into a written contract to purchase 200 gallons of latex paint from Retailer for $2,500. A1 signed the contract as follows: "Al, as President of Paintco, Inc., a corporation to be formed." A boldface clause on the front of the contract read that the paint was being sold on an "as is" basis. The $2,500 purchase price was carried as a balance on Al's existing account with Retailer.

On May 10, Al concluded the formation of Paintco by filing Articles of Incorporation with the Secretary of State. Al is the president and principal shareholder of Paintco. At its first meeting, the board of directors of Paintco adopted a resolution accepting the contract with Retailer. On June 1, Retailer delivered the 200 gallons of latex paint to Paintco, which was conducting business in the same location where A1 had previously operated his sole proprietorship.

Al used the paint on a new project that had been undertaken by Paintco after the formation of Paintco. The job specifications on the project called for a single-coat application, and Al had bid the job on that basis The work was done the day after a rain, which had left the painting surfaces damp. Ordinarily, latex paint can be applied over a damp surface. On this occasion, the paint failed to adhere properly, requiring that Al apply a second coat.

The next day, A1 called Retailer and demanded a credit in the full amount of the purchase price for the paint. Initially, Retailer refused. Al then said, "I'll never buy another thing from you unless you refund the price of the paint, and I'll see to it that nobody else does, either." Retailer, which was already experiencing financial problems, said it would give Al the $2,500 credit.

Several days later, Retailer assigned all of its open accounts to Finance Co. In return, Retailer received the full amount of the accounts, less the usual ten percent discount charged by Finance Co. The assignment included Al's account with Retailer, which was still shown on Retailer's books with a $2,500 balance.

At month's end, Finance Co. notified Al that his account with Retailer had been assigned to Finance Co. and demanded payment. Al refused to pay, asserting first, that Retailer had agreed to give him a $2,500 credit and, second, that Paintco had adopted the contract with Retailer.

What rights and remedies, if any, does Finance Co. have against:

1. Al? Discuss.
2. Paintco? Discuss.
3. Retailer? Discuss.

ANSWER A TO QUESTION 2

1. Finance Co. v. Al

Retailer may assign its contractual rights and duties under its contract with Al to Finance Co. Finance Co., as the assignee, may assert any arguments that Retailer, the assignor, may have against Al, the obligor.

Here, the U.C.C. applies because the subject matter of the contract is goods over $500. Much of the common law of contracts is still applicable, but the UCC controls if there is a conflict.

A1 liable as promoter on pre-incorporation contract

When Al entered into the contract with Retailer, he was acting as a promoter on behalf of Paintco, a corporation which had not yet been formed. A promoter remains liable on pre-incorporation contracts, even if the corporation is formed and later adopts the contract, as Paintco did here. A promoter is relieved of liability on the pre-incorporation contract only if the contract expressly provides this (which the facts do not indicate it did) or if there is a novation, i.e., a new contract between Paintco and Retailer and Al which expressly relieves A1 of liability under the new contract.

Al's liability for cost of paint

Accordingly, unless A1 has a valid defense, he will be liable to Finance Co. for the cost of the paint, which he accepted pursuant to a written contract.

a. Implied Warranty of Merchantability and Fitness for a Particular Purpose

Ordinarily, all goods are covered by an implied warranty of merchantability and fitness for a particular purpose. Here, the facts indicate that latex paint ordinarily adheres to damp surfaces. Retailer's latex paint did not adhere, so ordinarily there would be a breach of this implied warranty, and Al would be entitled to damages in the form of the foreseeable costs associated with having to apply a new coat of paint, i.e., compensatory damages and any foreseeable damages such as additional payment to painter.

b. Disclaimer

The facts state, however, that the clause in the contract said in boldface that the paint was sold "as is." Ordinarily, this disclaimer would be effective to negate the implied warranty of merchantability and fitness for a particular purpose. Accordingly, Al would be liable to Retailer for the cost of the paint, regardless of its failure to live up to the implied warranty.

c. Credit Demanded from Retailer

Ordinarily, under the UCC, a good faith modification of a contract does not require consideration. However, if the subject matter of the contract, as modified, would be within the Statute of Frauds, the modification must be in writing. Here, Al demanded a credit for goods that had a price of over $500. Accordingly, the modification of the contract would probably have to be in writing to be enforceable.

Moreover, it is questionable whether Al's actions constitute a good faith request for modification of the contract. Assuming the disclaimer of the warranty was effective, Al had no good faith basis to threaten to disparage Retailer's business to others unless Retailer gave him a credit for the entire amount of the paint. The facts do not indicate whether Al knew of Retailer's financial problems, but assuming he did, his threats under those circumstances would seem to be more evidence that he was not acting in good faith.

Accordingly, it appears that Finance Co., as assignee of the contract, has a good cause of action against Al for the contract price of the paint, and Al's various possible defenses are likely to fail, as explained above. Since legal remedies appear adequate, injunctive relief in the form of specific performance of the contract is not available.

2. Finance Co. v. Paintco

Since Paintco adopted Al's contract with Retailer, it would also be liable to Finance Co., as the assignee, under the same theories as Al is liable, i.e., no good faith modification, disclaimer effectively negated implied warranty, etc.

3. Finance Co. v. Retailer

Finance Co, as the assignee of Retailer's contract with Al, might have a claim for breach of the implied warranty that comes with an assignment of a contract. Retailer, as the assignor, impliedly warrants that the obligers on the contract have no valid defenses to enforcement of the contract. Assuming, as discussed above, that Al and Paintco have no valid defenses to the enforcement of the contract, then Retailer has not breached its implied warranty to Finance Co. If, on the other hand, A1 and/or Paintco prevails in an action by Finance Co. because the contract is held unenforceable, then Finance Co. would have an action against Retailer. Damages would be the expectation damages, i.e., what Finance Co. expected to receive under its contract with Al and Paintco, and any consequential damages that were foreseeable.

ANSWER B TO QUESTION 2

Introduction:

This case involves the sale of goods, which is within the purview of the UCC. Questions regarding the impact of incorporation would be governed by the state statute for the state in question concerning incorporations.

Finance Co. (F) v. Al (A).

Under state incorporation law, filing of Articles of Incorporation setting forth the statutorily required data including names of incorporators and capital shares commences the existence of a corporation.

Prior to incorporation, when a promoter incurs debts in the name of a corporation to be formed, these debts may be collected against the promoter individually. This remains true even after the corporation by resolution of its board of directors formally adopts the debt as its own, following organization and completion of the requisite filing.

Here Al signed the contract in question as President of a corporation to be formed. This put Retailer (R) on notice that Paintco (P) the putative contracting party was not yet in existence and that Al, with whom R had a preexisting relationship, would be liable.

Later when P adopted the contract, it agreed to become liable for the debt created by the contract. This act obligates P, but does not absolve A from his personal liability on the contract. This is due to the fact that at the time the contract was entered into, P had not been formally established, R knew of it and so there could have been no reliance upon credit worthiness of P by R. Instead, on these facts it is certain that R relied upon A individually for the contract payment. This avoids any argument by A that R was really relying upon P for payment. Such arguments, not applicable here on these facts, are known as incorporation by estoppel.

Accordingly, Al will be liable to the extent that the contract entered into was valid and required his payment to be made as a result of performance by R. These issues, and the validity of an attempted modification and assignment are discussed below, under the liability of Paintco, but each such issue and analysis is applicable to Al as well, such that Al will have liability to F to the extent that P has liability to F, all as discussed below.

P's liability to F.

As noted, P's board of directors adopted the contract, and accordingly P will have liability for the contract duties.

Valid Contract.

To be valid a contract requires mutual assent and consideration. Mutual consent consists of an offer (promise communicated to identified offeree which is definite and certain) and an acceptance (unequivocal statement by the identified offeree communicated to the offeror that he agrees to the offer). Consideration is any exchange of bargained for legal detriment.

On these facts the written contract constitutes evidence of all of the mutual assent and consideration elements needed to form a valid contract. Moreover, it is in writing, and so satisfies the requirements of the UCC's statute of frauds (writing for contracts over $500 containing statements of parties, subject matter and consideration).

This written document names P, states the quantity (a material element in a contract for goods), states the consideration and is signed by the parties against whom enforcement is sought.

Accordingly, it is a valid contract made in compliance with the UCC.

Implied Warranty Merchantability

When a merchant enters into a contract for the sale of goods, he makes an implied warranty of merchantability. This warranty is a promise that the goods will be fit for their intended purpose.

Here the goods in question are latex paint which under normal circumstances should be suitable for application over damp surfaces. On these facts, it rained the previous day to the application of the paint, leaving the walls damp. However, the application did not work, and the paint ran. This means the paint did not comply with the warranty of merchantability.

Impact of the "as is" clause.

Contracting parties can avoid the warranty of merchantability by contracting around it, i.e., expressly stating that it does not apply. Although courts will look with great care at such "as is" clauses in consumer contracts, this deal was between two businesses, and the "as is" clause will probably be held to be a valid waiver of the warranty.

Modification of the Contract's "as is" clause.

Under the UCC parties may modify a contract without further consideration if the modification is made in good faith. Here A makes a threat to R that he will harm his business if R does not give a credit to P and A's account. This attempt to modify the contract by deleting the "as is" clause, effectively restoring the warranty of merchantability, will be held invalid because the threat cannot be construed as the required good faith.

Moreover, the attempt to modify the contract was oral and it is questionable whether an oral modification to the written contract would be valid. The best view is that the warranty of merchantability is not restored to the contract and that the contract be interpreted to include it.

Assignment of the Contract to F.

An assignment is evidenced by a concurrent statement of intent to convey from the assignor (party to whom contract performance is due) to the assignee (the new party to whom contract performance will be rendered) the benefit due under the contract.

The facts state that F took an assignment of the accounts for payment to R of 10% of their face amounts. This constitutes an assignment for value giving to the assignee, F, the right to demand contract performance from the promisor under the original contract.

On these facts, both Al and Paintco would be liable to F. The assignment was valid, the promised performance is therefore due. Defenses

A and P may try to assert their defenses against the contract in F's suit for payment. However, as noted above, their defenses do not appear good.

The attempted modification was invalid for the reasons stated. Accordingly the "as is" clause remains as a valid contract provision. Since R delivered the paint in accordance with the contract terms both A and P are liable to F for performance, i.e., payment of the $2,500 price.

Remedies

F will be able to assert full contract remedies, including payment of the price and incidental damages against both A and F.

F. v. R

An assignor for value makes an implied warranty of assignment when he assigns a contract benefit for payment to an assignee. Here R assigned the right to collect the $2,500 from P (for which A is also liable, as noted) but he did not disclose the potential claim of contract modification.

The warranty of assignment states the party making the assignment has the right to assign and that the benefit assigned may be obtained from the promisor of the underlying contract.

If A or P are successful in asserting any defenses against the contract when F sues them, F will thereafter be able to sue R for breach of the warranty of assignment. In such action, F will be able to recover the full amount of the loss, i.e., the 10% fee paid or $250.