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WHAT TO KNOW ABOUT ENTERING INTO CONTRACTS

What is a contract?

A contract is a legally binding agreement between two or more parties to exchange something of value. A contract typically involves the transfer of goods, services, money, or a promise to transfer any of these in the future.

Contracts serve several important purposes, including formalizing relationships, outlining legal obligations, and providing a record of rights and responsibilities. Contracts are crucial in business for managing relationships with partners, customers, and suppliers, as they help minimize risks by providing predictability and clarity regarding each party's duties. If one party doesn't fulfill their contractual obligations ("a breach of contract"), the injured party may seek remedies such as money damages or a court order that the breaching party complete their obligations.

What is needed to form a contract?

A contract is formed when there is a mutual understanding and agreement between the parties, often called a "meeting of the minds." To form a legally enforceable contract, the agreement must meet several requirements:

1. **Offer:** A promise by one party to perform or refrain from performing a specific action in the future. For example, a store displaying a book with a \$15 price tag is making an offer to sell it for that price.
2. **Acceptance:** An expression of approval to the terms of the offer by the other party. For example, when you bring the \$15 book to the cashier and agree to pay for it, you are accepting the store's offer.
3. **Consideration:** "Something" of value must be exchanged between the parties, which distinguishes a contract from a gift. For example, your payment of \$15 for the book is the consideration you provide, and the book you receive is the consideration from the seller.
4. **Capacity:** Each party entering into a contract must be of legal age and have the ability to understand the agreement well enough to determine whether they want to enter into the contract. For example, when an adult buys a book, it is assumed they have the legal capacity to make the purchase, unlike a young child who might not. Contracts that have been accepted by someone who lacks contractual capacity may not be enforceable.

5. **Legality:** The subject matter of the contract must be legal and not against public policy. Contracts must comply with the appropriate federal, state, and local laws. Contracts cannot support criminal activity. For example, buying a book from a store is a legal transaction, but buying stolen goods is not.
6. **Mutual Assent:** Both parties must clearly understand and agree to the terms of the contract, often referred to as a “meeting of the minds”. For example, both you and the store must agree on the book being sold for \$15 for the contract to be valid.

What are the different types of contracts?

A contract can take several distinct forms. It can be a formal written document or as simple as a handshake agreement. A contract can be created by both parties agreeing to fulfil their obligations or a contract could require additional steps before it becomes official. The following section discusses the types of contracts.

Types of Contracts

- **Written:** A written and signed contract creates a clear record of each parties’ expectations and obligations. Some contracts must be in writing to be enforceable like those: (1) selling real estate, (2) selling securities, (3) selling goods valued over \$500, (4) using marriage as a term of a contract, (5) needing longer than a year to complete all the tasks, and (6) paying for someone else’s debt. While most contracts may be written or oral, it is often best practices for clarity to write down the terms of the agreement.
- **Oral:** In most cases, a contract can be formed when the parties vocally agree to the arrangement. Oral contracts are easy to enter into because the parties don’t have to take any further steps to solidify the relationship. While a verbal agreement can create a contract, the lack of writing can be problematic when needing to prove the exact terms agreed to by the parties. Evidence supporting that an oral agreement occurred may include witness testimonies, correspondence and documentation of an oral contract, and actions taken by either party that are consistent with the contract terms.
- **Implied:** Sometimes, a contract is created through the actions and behaviors of the parties involved or by the circumstances of the situation. A contract could be implied even if all the terms were never discussed or written down. For example, if you order goods and they are delivered as requested, the contract is implied by accepting the goods.
- **Acceptance by Performance:** Some contracts can be accepted through actions rather than agreeing orally or in writing. In these contracts, one party makes a promise in exchange for the completion of a specific act by the other party. For example, if someone offers a reward for the return of a lost dog, the contract is created only when the other person returns the dog. Promises to look for the dog do not create an enforceable contract.

When to Use Each Contract Type and Examples

Use a written contract when:

- It is advisable to have details and expectations clearly established before starting the business relationship.
- You want a contract that helps ensure both parties understand and agree to the terms, reducing the risk of misunderstandings.
- Easier enforcement is a priority of the business relationship.

Examples when written contracts are used:

- Significant Financial Transactions – A business putting contract terms into writing when purchasing expensive equipment or entering into long-term supply agreements.
- Long-term Business Relationships – A retailer signing a multi-year contract with a supplier for regular deliveries or a service provider for ongoing support.
- Employment and Independent Contractor Agreements – An employer using a written agreement to help define the terms of employment or contract work.

Use an implied contract when:

- A formal agreement has not been explicitly stated but the conduct of the parties involved, the circumstances, or established expectations suggest that a contract exists.
- Fairness or justice requires acknowledging a mutual understanding between parties.

Examples when implied contracts are used:

- Employment Relationships – An employer's policies or practices suggest an understanding about job security, pay raises, or promotions.
- Providing Goods or Services – One party provides goods or services with the expectation of payment, and the other party accepts those goods or services.
- Ongoing Business Relationships – Parties routinely working together create actions or communications that imply certain terms, such as payment, delivery schedules, or service quality.

Use an acceptance by performance contract when:

- You want to incentivize action but not be obligated unless the action is completed.
- Performance can be easily observed and verified (e.g., completing a specific task, achieving a result).
- You seek to minimize risk by only being bound if the desired outcome is achieved.

Examples when acceptance by performance contracts are used:

- Service Contracts – A business offers a unilateral contract where payment is promised only if the service is completed to certain standards. The contractor is only paid upon completing the agreed-upon work.
- Employment Recruitment with Conditional Offers – A company offers a bonus to employees if they refer qualified candidates who are hired and stay employed for a certain period.
- Construction or Freelance Projects – A client offers payment for specific deliverables (e.g., a completed design, software code, or a repaired structure), the contract is accepted only when the contractor or freelancer completes the work.

When do my communications become a contract?

Contracts are commonly negotiated and finalized without the creation of a formal contract document. Contracts can be formed through a series of emails or by accepting a purchase order. For small business, informal contracts created through communications may be as common as, and in some cases more common, than forming formal contracts.

Given the prevalence of informal contracts being created through communication, it is important for small businesses to be careful in day-to-day business interactions to ensure that they are not prematurely entering into contracts. Negotiation communications can transition into a contract and create performance obligations if it appears that the parties have reached agreement on the issue. It is important to communicate clearly and understand where you are in the process.

Here are some points on how to approach your communications:

- Negotiation documents like letters of intent, memoranda of understanding, or heads of terms can sometimes be binding if they include all essential elements and indicate an intent to be bound.
- Electronic communications like emails can be binding and a typed signature can be used to show acceptance of the terms.
- Choose your words carefully, both orally and in writing. Ambiguous or vague statements could be interpreted differently and used as evidence against you.
- Use phrases like “subject to contract” or “negotiations ongoing” to indicate that a final agreement has not been reached.
- Indicate that any documents or terms shared are only drafts or for discussion purposes.
- Send follow up emails to oral conversation stating the topics discussed and any consensus reached.
- Summarize your understanding of the agreement into a single communication (e.g. email) to ensure that all the relevant contract terms are in one place.
- Make sure that EVERYTHING that was discussed is clearly included in the final contract.

Conclusion

Understanding the basics of contracts and how they work is essential to running a successful business. Contracts are at the center of your business relationships with suppliers, vendors, customers, and workers. With the above knowledge, you can better navigate discussing potential agreements with other parties and enter contracts only when you are ready.

Looking for legal help? Contact the following legal organizations to see if you qualify for free legal assistance!

Legal Food Hub
legalfoodhub.org
legalfoodhub@clf.org
1-844-LAW-GROW (1-844-529-4769)

Northeastern University Community Business Clinic
<https://law.northeastern.edu/experience/clinics/community-business/>
617-373-6435

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