



## Contracts

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### Background

A contract is an agreement between two parties that creates an obligation to do or refrain from doing a particular thing. The purpose of a contract is to establish the terms of the agreement by which the parties have fixed their rights and duties. Courts must enforce valid contracts, unless one party has legal grounds to bar enforcement.

Consumers and commercial entities both depend on the enforceability of contracts when conducting business relations. When consumers or commercial entities enter a contract to buy goods or services at a particular price, in a particular amount, or of a particular quality, they expect the seller to deliver goods and services that conform to the contract. Manufacturers, wholesalers, and retailers similarly expect that their goods and services will be bought in accordance with the terms of the contract.

A legal action for breach of contract arises when at least one party's performance does not live up to the terms of the contract and causes the other party to suffer economic damage or other types of measurable injury. The injury may include any loss suffered by the plaintiff in having to buy replacement goods or services at a higher price or of a lower quality from someone else in the market. It may also include the costs and expenses incurred by the plaintiff in having to locate replacement goods or services in the first place.

Contract disputes may be governed by the [COMMON LAW](#), [STATUTORY](#) law, or both. Each state has developed its own common law of contracts, which consists of a body of [JURISPRUDENCE](#) developed over time by trial and [APPELLATE](#) courts on a case-by-case basis. For contracts involving commercial transactions, all fifty states have enacted, at least partially, a body of statutory law called the [UNIFORM COMMERCIAL CODE](#)(UCC), which governs a variety of commercial relations involving consumers and merchants, among others.

State legislatures have also enacted a host of other statutes governing contracts that affect the [PUBLIC INTEREST](#). For example, most states have passed legislation governing the terms of insurance contracts to guarantee that sufficient financial resources will be available for residents who are injured by accident. Congress has passed a number of laws governing contracts as well, ranging from laws that regulate the terms of [COLLECTIVE BARGAINING](#) agreements between labor and management to laws that regulate [FALSE ADVERTISING](#) and promote fair trade.

## Elements of a Contract

The requisite elements that must be established to demonstrate the formation of a legally binding contract are (1) offer; (2) acceptance; (3) consideration; (4) mutuality of obligation; (5) competency and capacity; and, in certain circumstances, (6) a written instrument.

### *Offer*

An offer is a promise to act or refrain from acting, which is made in exchange for a return promise to do the same. Some offers anticipate not another promise being returned in exchange but the performance of an act or forbearance from taking action. For example, a painter's offer to paint someone's house for \$100 is probably conditioned on the home-owner's promise to pay upon completion, while a homeowner's offer to pay someone \$100 to have his or her house painted is probably conditioned upon the painter's successfully performing the job. In either case, an offeree's power of acceptance is created when the offeror conveys a present intent to enter a contract in certain and definite terms that are communicated to the offeree.

Courts distinguish preliminary negotiations from formal legal offers in that parties to preliminary negotiations lack a present intent to form a contract. Accordingly, no contract is formed when parties to preliminary negotiations respond to each other's invitations, requests, and intimations. Advertisements and catalogues, for example, are treated as forms of preliminary negotiations. Otherwise, the seller of the goods or services would be liable for countless contracts with consumers who view the ad or read the catalogue, even though the quantity of the merchandise may be limited.

However, sellers must be careful to avoid couching their advertisements in clear and definite terms that create the power of acceptance in consumers. For example, sellers have been found liable to consumers for advertising a definite quantity of goods for sale at a certain price on a "first come, first serve" basis, after consumers showed up and offered to pay the advertised price before the goods sold out. In such situations, the seller may not withdraw the offer on grounds that market factors no longer justify selling the goods at the advertised price. Instead, courts will compel them to sell the goods as advertised.

The rejection of an offer terminates the offeree's power of acceptance and ends the offeror's liability for the offer. Rejection might come in the form of an express refusal to accept the offer or by implication when the offeree makes a [COUNTEROFFER](#) that is materially different from the offeror's original proposal. Most jurisdictions also recognize an offeror's right to withdraw or revoke an offer as a legitimate means of terminating the offer.

Offers that are not rejected, withdrawn, or revoked generally continue until the expiration of the time period specified by the offer, or, if there is no time limit specified, until a reasonable time has elapsed. A reasonable time is determined according to what a reasonable person would consider sufficient time to accept the offer under the circumstances. Regardless of how much time has elapsed following an offer, the death or insanity of either party before acceptance is communicated normally terminates an offer, as does the destruction of the subject matter of the proposed contract and any intervening conditions that would make acceptance illegal.

Sometimes offerees are concerned that an offer may be terminated before they have had a full opportunity to evaluate it. In this case, they may purchase an "option" to keep the offer open for a designated time. During that time the offer is deemed irrevocable, though some jurisdictions allow the offeror to revoke the offer by paying the offeree an agreed upon sum to do so.

## **Acceptance**

Acceptance of an offer is the expression of [ASSENT](#) to its terms. Acceptance must generally be made in the manner specified by the offer. If no manner of acceptance is specified by the offer, then acceptance may be made in a manner that is reasonable under the circumstances. An acceptance is only valid, however, if the offeree knows of the offer, the offeree manifests an intention to accept, and the acceptance is expressed as an unequivocal and unconditional agreement to the terms of the offer.

Many offers specify the method of acceptance, whether it be oral or written, by phone or in person, by handshake or by ceremony. Other offers leave open the method of acceptance, allowing the offeree to accept in a reasonable manner. Most consumer transactions fall into this category, as when a shop- per "accepts" a merchant's offer by taking possession of a particular good and paying for it at the cash register. But what constitutes a "reasonable" acceptance will vary according to the contract.

Some offers may only be accepted by the performance or non-performance of a particular act. Once formed, these types of agreements are called unilateral contracts, and they are discussed more fully later in this essay. Other offers may only be accepted by a return promise of performance from the offeree. Once formed, these agreements are called bilateral contracts, and they are also discussed more fully later in this essay.

Problems can arise when it is not clear whether an offer anticipates the method of acceptance to come in the form of performance or a return promise. Section 32 of the Restatement of Contracts (Second) attempts to address this issue by providing that "in case of doubt an offer is interpreted as inviting the offeree to accept either by promising to perform what the offer requests or by rendering performance, as the offeree chooses." A growing number of jurisdictions are adopting this approach.

Jurisdictions are split as to the time when an airtailed acceptance becomes effective. Under the majority approach, known as "the mailbox rule," an acceptance is effective upon dispatch in a properly addressed envelope with prepaid postage, even if the acceptance is lost or destroyed in transit. Under the minority approach, acceptance is effective only upon actual receipt by the offeror, no matter what precautions the offeree took to ensure that the acceptance was properly mailed.

In certain cases acceptance can be implied from a party's conduct. Suppose a consumer orders a personal computer (PC) with exact specifications for its central processing unit (CPU), hard drive, and memory. Upon receipt, the consumer determines that the PC does not match the specs. If the consumer nonetheless pays the full amount on the invoice accompanying the PC without protest, the consumer has effectively communicated a legally binding acceptance of the non-conforming good.

Acceptance cannot generally be inferred from a party's silence or inaction. An exception to this rule occurs when two parties have a prior course of dealings in which the offeree has led the offeror to believe that the offeree will accept all goods shipped by the offeror unless the offeree sends notice to the contrary. In such instances, the offeree's silence or inaction constitutes a legally binding acceptance upon which the offeror can rely.

## **Consideration**

Each party to a contract must provide something of value that induces the other to enter the agreement. The law calls this exchange of values "consideration." The value exchanged need not consist of currency. Instead, it may consist of a promise to perform an act that one is not legally required to do or a promise to refrain from an act that one is legally entitled to do. For example, if a rich uncle promises to give his nephew a new sports car if he refrains from smoking cigarettes and drinking alcohol for five years, the law deems both the uncle's promise and the nephew's forbearance lawful consideration.

A court's analysis as to whether a contract is supported by sufficient consideration typically focuses more on the promise or performance of the offeree than the promise or performance of the offeror. Courts often say that no consideration will be found unless the offeree suffers a "legal detriment" in making the return promise or in performing the act requested by the offeror. As a general rule, legal detriment is found if the offeree relinquishes a [LEGAL RIGHT](#) in fulfilling his or her contractual duties. Thus, promises to give love and affection or make a gift or donation are not sufficient consideration to support a contract because no one is under a legal duty to give or refrain from giving these things to others. Similarly a promise to perform an act that has already been completed in the past fails to offer consideration to support a new agreement.

### ***Mutuality of Obligation***

Closely related to the concept of consideration is the mutuality of obligation doctrine. Under this doctrine, both parties must be bound to perform their obligations or the law will treat the agreement as if neither party is bound to perform. When an offeree and offeror exchange promises to perform, one party may not be given the absolute and unlimited right to cancel the contract. Such arrangements attempt to allow one party to perform at her leisure, while ostensibly not relieving the other party of his obligations to perform. Most courts declare these onesided arrangements null for lack of mutuality of obligation. Some courts simply invalidate such contracts for lack of consideration, reasoning that a party who is given absolute power to cancel a contract suffers no legal detriment.

To avoid having a contract subsequently invalidated by a court, the parties must be careful to limit their discretion to cancel the contract or otherwise not perform. As long as the right to avoid performance is dependent on some condition or event outside the control of the party seeking to cancel the contract, courts will find that mutuality of obligation exists. Thus, a farmer might lawfully be given the right to cancel a crop-watering service if the right to cancel were conditioned upon the amount of rain that fell during a given season, something outside the farmer's control. But a court would find mutuality lacking if the farmer were given the right to terminate the service short of full performance simply by giving notice of his or her intention to cancel.

### ***Competency and Capacity***

A natural person who enters a contract possesses complete legal capacity to be held liable for the duties he or she agrees to undertake, unless the person is a minor, mentally incapacitated, or intoxicated. A minor is defined as a person under the age of 18 or 21, depending on the [JURISDICTION](#). A contract made by a minor is voidable at the minor's discretion, meaning that the contract is valid and enforceable until the minor takes some affirmative act to disavow the contract. Minors who choose to disavow their contracts entered may not be held liable for breach. The law assumes that minors are too immature, naïve, or inexperienced to negotiate on equal terms with adults, and thus courts protect them from being held accountable for unwisely entering contracts of any kind.

When a party does not understand the nature and consequences of an agreement that he or she has entered, the law treats that party as lacking mental capacity to form a binding contract. However, a party will not be relieved from any contractual duties until a court has formally adjudicated the issue after taking [EVIDENCE](#) concerning the party's mental capacity, unless there is an existing court order declaring the party to be incompetent or insane. Like agreements with minors, agreements with mentally incapacitated persons are voidable at that person's discretion. However, a [GUARDIAN](#) or personal representative may ratify an agreement for an incapacitated person and thereby convert the agreement into a legally binding contract.

Contracts entered into by persons under the influence of alcohol and drugs are also voidable at that person's discretion, but only if the other party knew or had reason to know the degree of impairment. As a practical matter, courts rarely show sympathy for defendants who try to avoid contractual duties on grounds that they

were intoxicated. However, if the evidence shows that the sober party was trying to take advantage of the intoxicated party, courts will typically intervene to void the contract. Persons who are intoxicated from prescription medication are treated the same as persons who are mentally incompetent or insane and are generally relieved from their contractual responsibilities more readily than are persons intoxicated from non-prescription drugs or alcohol.

### ***Writing Requirement***

Not every contract need be in writing to be valid and binding on both parties. But nearly every state legislature has enacted a body of law that identifies certain types of contracts that must be in writing to be enforceable. In legal parlance this body of law is called the [STATUTE](#) of frauds.

Named after a seventeenth-century English statute, the statute of frauds is designed to prevent a plaintiff from bringing an action for breach of contract based on a nonexistent agreement for which the only proof of the agreement is the plaintiff's perjured [TESTIMONY](#). The statute of frauds attempts to accomplish this objective by prohibiting the enforcement of particular contracts, unless the terms of the contract are expressly reflected by written note, memorandum, or agreement that is signed by the parties or their personal representatives.

As originally conceived, the statute of frauds applied to four types of contracts: (1) promises to pay a debt owed by another person; (2) promises to marry; (3) promises to perform an act that cannot possibly be performed within a year from the date of the promise; and (4) agreements involving real estate. However, most states have since expanded the class of contracts that must be in writing to be enforceable. For example, in many jurisdictions long term leases, insurance contracts, agreements for the sale of [SECURITIES](#), and contracts for the sale of goods over \$500 will all be deemed unenforceable unless the terms of the parties' agreement are memorialized in writing.

## **Types of Contracts**

### ***Contracts under Seal***

Early English common law required all contracts to be stamped with a seal before a party could enforce them in court. The seal memorialized the parties' intention to honor the terms of the contract. No consideration was required, since the seal symbolized a solemn promise undertaken by all parties to the contract.

With the onset of the industrial era during the eighteenth century, however, sealed contracts were increasingly seen as an impractical and inefficient impediment to fast paced commercial relations. Sealed contracts were gradually replaced by other types of agreements, including express and implied contracts. In fact, nearly all jurisdictions have eliminated the legal effect of sealed contracts. Thus, contracts under seal will not generally be enforced unless they are supported by independent consideration.

### ***Express and Implied Contracts***

Express contracts consist of agreements in which the terms are stated by the parties. The terms may be stated orally or in writing. But the contract as a whole must reflect the intention of the parties. As a general rule, if an express contract between the parties is established, a contract embracing the identical subject cannot be implied in fact, as the law will not normally imply a substitute promise or contract for an express contract of the parties.

Contracts implied in fact are inferred from the facts and circumstances of the case or the conduct of the

parties. However, such contracts are not formally or explicitly stated in words. The law makes no distinction between contracts created by words and those created by conduct. Thus, a contract implied in fact is just as binding as an express contract that arises from the parties' declared intentions, with the only difference being that for contracts implied in fact courts will infer the parties' intentions from their business relations and course of dealings.

Whereas courts apply the same legal principles to express contracts and contracts implied in fact, a different body of principles is applied to contracts implied in law. Also known as quasi-contracts, contracts implied in law are agreements imposed by courts despite the absence of at least one element essential to the formation of a binding agreement. The law creates these types of fictitious agreements to prevent one party from being unjustly enriched at the expense of another.

For example, suppose that a husband and wife ask a third party to hold a sum of money in trust for their children. But instead of holding the money in trust, the third party absconds with it. The law will not allow the third party to keep the money simply because all the requisite elements of a formal contract have not been proven by the husband and wife. Although the law is generally wary of imposing contracts on parties who did not agree to their terms, courts will find that a contract implied in law exists when (1) the [DEFENDANT](#) has been enriched at the expense of the plaintiff; (2) the enrichment was unjust; (3) the plaintiff's own conduct has not been inequitable; and (4) it is otherwise reasonable for the court to do so in light of the relationship between the parties and the circumstances of the case.

### ***Bilateral and Unilateral Contracts***

A [BILATERAL CONTRACT](#) arises from the exchange of mutual, reciprocal promises between two persons that requires the performance or non-performance of some act by both parties. The promise made by one party constitutes sufficient consideration for the promise made by the other party. A [UNILATERAL CONTRACT](#) involves a promise made by only one party in exchange for the performance or non-performance of an act by the other party. Stated differently, acceptance of an offer to form a unilateral contract cannot be achieved by making a return promise, but only by performance or non-performance of some particular act. Accordingly, acceptance of an offer to enter a unilateral contract can be revoked until performance is complete or until the date has passed for non-performance.

It should be remembered, however, that courts are asked to interpret contracts long after they have been formed. As a result, courts will often take into account how the parties actually acted on the terms of a particular contract. Not surprisingly, courts will avoid interpreting a contract as unilateral or bilateral when such an interpretation would leave one party in the lurch or the opposite interpretation would yield a more commercially reasonable result. This is not to say that courts do not enforce one-sided agreements, but only that the evidence of the parties' understanding must be clear before a court will do so.

### **Breach of Contract: Definition**

An unjustifiable failure to perform all or some part of a contractual duty is a breach of contract. A breach may occur when one party fails to perform in the manner specified by the contract or by the time specified in the contract. A breach may also occur if one party only partially performs his or her duties or fully performs them in a defective manner.

Courts distinguish total breaches from partial breaches. A total breach of contract is the failure to perform a material part of the contract, while a partial breach results from merely a slight deviation. In determining whether a breach is total or partial, courts typically examine the following factors: (1) the extent to which the

non-breaching party obtained the substantial benefit of the contract despite the breach; (2) the extent to which the non-breaching party can be adequately compensated for the breach with money damages; (3) the extent to which the breaching party has already performed or made preparations for performance; (4) the extent to which the breaching party mitigated the hardship on both parties by not fully performing; (5) the willful, negligent, or innocent behavior of the breaching party; and (6) the likelihood that the breaching party will perform the remainder of the contract if allowed.

### **Breach of Contract: Defenses**

A number of defenses are available to defendants sued for breach of contract, many of which are alluded to earlier in this essay. For example, a defendant might assert that no breach was committed because no valid contract was never actually formed due to the lack of an offer, an acceptance, consideration, mutuality of obligation, or a writing. Alternatively, a defendant might assert that he or she lacked capacity to enter the contract, arguing that the contract should be declared void on the grounds that the defendant was incompetent, insane, or intoxicated at the time it was entered.

The law also affords defendants several other defenses in breach of contract actions. They include (1) unconscionability; (2) mistake; (3) [FRAUD](#); (4) undue influence; and (5) [DURESS](#). First, a defendant might assert that a contract should not be enforced because its terms are unconscionable. Unconscionable contracts are those that violate [PUBLIC POLICY](#) by being so unjust as to offend the court's sense of fairness. Sometimes called "contracts against public policy," unconscionable contracts usually result from a gross disparity in the parties' bargaining power, as can happen when one party is a savvy business person and the other party is elderly, illiterate, or not fluent in English. But a mere disparity in bargaining power will not suffice to overturn an otherwise valid contract, unless a court finds that the resulting contract is one that no mentally competent person would enter and that no fair and honest person would accept.

Second, a defendant might assert that a contract should not be enforced because of a mistake made by one or more parties. Ordinarily, to constitute a valid defense in an action for breach of contract the mistake must be a mutual one made by all of the parties to the contract. However, when the mistake is obvious from the face of the contract, knowledge of the mistake will be imputed to each party. Thus, a contract that by its terms designates a horse as the subject matter will be enforced unless both parties agree that a different subject matter was intended. On the other hand, if the same contract designates a pig as the subject matter in 99 paragraphs of the agreement, but mentions a horse in only one paragraph, a court will not force the defendant to sell his horse if it is obvious that the one paragraph contains an error.

Third, a defendant might assert that a contract should not be enforced because it is the product of fraud. Fraud occurs when one party intentionally deceives another party as to the nature and consequences of a contract, and the deceived party is injured as a result. In most cases, fraud requires an affirmative act, such as willful misrepresentation or concealment of a material fact. In a few cases where a special relationship exists between the parties, such as between attorney and client, simple nondisclosure of a material fact may amount to fraud. Regardless of the underlying relationship between the parties, however, a court will not void a contract due to fraud unless the defendant demonstrates that he or she was induced to enter the contract by the [FRAUDULENT](#) conduct and not merely that the plaintiff made a false statement at some point in time.

Fourth, a defendant might assert that a contract should not be enforced because it is the product of undue influence. Undue influence occurs when one party exercises such control over a second party as to overcome the independent judgment and free will of the second party. In reviewing claims of undue influence, courts look to see whether the plaintiff preyed on and exploited a known psychological or physical weakness when securing the defendant's assent to a contract. However, evidence that the plaintiff merely used aggressive and

unsavory tactics in securing the defendant's assent will not suffice to overturn a contract on grounds of undue influence, unless those tactics had the effect of substituting the plaintiff's will and judgment for the defendant's.

Fifth, a defendant might assert that a contract is not enforceable because it is the product of duress. Duress consists of any wrongful act that coerces another person to enter a contract that he or she would not have entered voluntarily. **BLACKMAIL**, physical violence, a show of force, and threats to institute **LEGAL PROCEEDINGS** in an abusive manner may all constitute sufficient duress to void a contract. However, a defendant claiming duress must demonstrate that sufficient harm was threatened or inflicted to justify finding that the defendant had no reasonable choice but to enter the contract on the terms dictated by the plaintiff.

### **Breach of Contract: Remedies**

The five basic remedies for breach of contract are money damages, **RESTITUTION**, rescission, reformation, and specific performance. Money damages is a sum of money that is awarded as compensation for financial losses caused by a breach of contract. Parties injured by a breach are entitled to the benefit of the bargain they entered, or the **NET** gain that would have accrued but for the breach. The type of breach governs the extent of damages that may be recovered.

If the breach is a total breach, a plaintiff can recover damages in an amount equal to the sum or value the plaintiff would have received had the contract been fully performed by the defendant, including lost profits. If the breach is only partial, the plaintiff may normally seek damages in an amount equal to the cost of hiring someone else to complete the performance contemplated by the contract. However, if the cost of completion is prohibitive and the portion of the unperformed contract is small, many courts will only award damages in an amount equal to the difference between the diminished value of the contract as performed and the full value contemplated by the contract.

For example, if the plaintiff agreed to pay the defendant \$200,000 to build a house, but the defendant only completed 90 percent of the work contemplated by the contract, a court might be inclined to award \$20,000 in damages if it would cost the plaintiff twice as much to hire someone else to finish the last 10 percent. The same principles apply to damages sought for contracts that are fully performed, but in a defective manner. If the defect is significant, the plaintiff can recover the cost of repair. But if the defect is minor, the plaintiff may be limited to recovering the difference between the value of the good or service actually received and the value of the good or service contemplated by the contract.

Restitution is a remedy designed to restore the injured party to the position occupied prior to the formation of the contract. Parties seeking restitution may not request to be compensated for lost profits or other earnings caused by a breach. Instead, restitution aims at returning to the plaintiff any money or property given to the defendant under the contract. Plaintiffs typically seek restitution when contracts they have entered are voided by courts due to a defendant's **INCOMPETENCY** or incapacity. The law allows incompetent and incapacitated persons to disavow their contractual duties but generally only if the plaintiff is not made worse off by their disavowal.

Parties that are induced to enter contracts by mistake, fraud, undue influence, or duress may seek to have the contract set aside or have the terms of contract rewritten to do justice in the case. Rescission is the name for the remedy that terminates the contractual duties of both parties, while reformation is the name for the remedy that allows courts to change the substance of a contract to correct inequities that were suffered. Like contracts implied in law, however, courts are reluctant to rewrite contracts to reflect the parties' actual agreement, especially when the contract as written contains a mistake that could have been rectified through pre-contract

investigation. Thus, one court would not reform a contract that stipulated an incorrect amount of acreage being purchased, since the buyer could have ascertained the correct amount by obtaining a land survey before entering the contract. *Little Stillwater Holding Corp. v. Cold Brook Sand and Gravel Corp.*, 151 Misc.2d 457, 573 N.Y.S.2d 382 (N.Y.Co.Ct. 1991).

Specific performance is an equitable remedy that compels one party to perform, as nearly as practicable, his or her duties specified by the contract. Specific performance is available only when money damages are inadequate to compensate the plaintiff for the breach. This ruling often happens when the subject matter of a contract is unique.

Every parcel of land by definition is unique, if for no other reason than its location. However, rare articles that are not necessarily one of a kind are still treated by the law as unique if it would be impossible for a judge or jury to accurately calculate the appropriate amount of damages to award the plaintiff in lieu of awarding him or her the unique article contemplated by the contract. Heirlooms and antiques are examples of such rare items for which specific performance is usually available as a remedy. However, specific performance may never be invoked to compel the performance of a personal service, since the Thirteenth Amendment to the U.S. Constitution prohibits slavery.

## Additional Resources

*American Jurisprudence*. West Group, 1998.

<http://www.findlaw.com/01topics/07contracts/index.html>. FindLaw for Legal Professionals: Contracts Law.

*Restatement (Second) of Contracts*. American Law Institute, 2001.

*West's Encyclopedia of American Law*. West Group, 1998.

## Organizations

### ***Consumer Contact Services, Inc.***

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Phone: (219) 486-2453  
Primary Contact: Karen L. Gonzagowski, President

### ***National Organization of Bar Counsel***

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Phone: (202) 638-1501  
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URL: <http://www.nobc.org>  
Primary Contact: Robert J. Saltzman, President

### ***Office of Consumer Protection, Federal Trade Commission***

600 Pennsylvania Avenue NW  
Washington, DC 20580 USA  
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URL: <http://www.ftc.gov/ftc/consumer.htm>

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