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NOTES

THE PROBLEM OF WITHHOLDING IN RESPONSE TO BREACH: A PROPOSAL TO MINIMIZE RISK IN CONTINUING CONTRACTS

WILLIAM J. GELLER

INTRODUCTION

In today's increasingly competitive economy, businesses must enter into long-term relationships with one another in order to survive. Like many long-term associations these days, these sometimes break down. When a business relationship is in the form of a continuing contract,[1] and one party breaches the contract, the other party will often want to withhold payment to compensate itself for its injuries while the performance under the contract continues. Although "the natural instinct" of an injured party[2] is to withhold payment,[3] if the party does so, it will subject itself to a great deal of uncertainty.

The uncertainties faced by a party considering withholding are demonstrated by the predicament of the construction contractor in *K & G Construction Co. v. Harris*.[4] The contractor's excavation subcontractor had breached its express contractual duty to perform in a workmanlike manner by driving a bulldozer too close to a building under construction by the general contractor.[5] This caused substantial damages when a wall collapsed.[6] The contractor was scheduled to make a progress payment to the subcontractor the next day,[7] and it had to decide whether to make this payment despite the subcontractor's breach. The contractor wanted the subcontractor to continue to perform under the subcontract and fin-

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1. "Continuing contract," as used in this Note, means a contract for which there are remaining performances and payments due. *See infra* part I.B.

2. This Note will use consistent terminology to describe parties involved in a withholding situation. "Breaching party" will describe the party who has committed the original breach in response to which the other party may wish to withhold payment. "Injured party" will describe the party against whom the breach has been committed and who may wish to withhold payment. "Withholding party" will describe the injured party after it has withheld payment.

Sometimes the withholding of payment will be considered to be a breach of the contract. The terminology will remain the same, however, even though the "withholding party" is also technically a "breaching party." In a limited number of situations, the withholding party will withhold payment without any breach or justification by the other party. Nonetheless, the terminology in those situations will remain the same for the sake of consistency.

3. 6 Samuel Williston, A Treatise on the Law of Contracts § 887G, at 564 (Walter H. E. Jaeger ed., 3d ed. 1962).

4. 164 A.2d 451 (Md. 1960).

5. *See id.* at 453-54.

6. *See id.* The accident caused $3,400.00 in damages. *See id.* at 454. The subcontractor and its insurance carrier disclaimed liability for the accident. *See id.*

7. *See id.* The progress payment was to be in the amount of $1,484.50. *See id.*

ish the excavation work. However, the contractor also wanted to make sure that it was compensated for the damages it incurred as a result of the subcontractor's breach. The contractor ultimately decided to withhold the progress payment, but notified the subcontractor that it wanted the excavation to continue.[8]

The contractor's decision to withhold payment forced the subcontractor into its own predicament. The subcontractor had to decide whether to continue to perform under the subcontract despite the contractor's withholding of the progress payment. The subcontractor did not want to work without getting paid, but it also did not want to be liable for any damages for breach of contract by stopping work. The subcontractor eventually decided to cease its performance under the subcontract.[9]

When the contractor then sued the subcontractor, the court was faced with a case in which both parties had not satisfied the express terms of the contract. The contractor withheld the contractually required progress payment and the subcontractor knocked down the wall and, later, discontinued the contractually required excavation work. After assessing the damages resulting from the bulldozer accident, the court had to decide which party should be compensated for the other's breach.[10] The court determined that the contractor was allowed to withhold the progress payment in light of the subcontractor's initial breach.[11]

Though more than thirty years have passed since *K & G Construction* was decided, a contractor, a subcontractor, or a court in the same situation today would likely be faced with the same uncertainties. Courts have applied several different standards to determine whether withholding[12] is proper[13] in the absence of a contractual provision that addresses

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8. *See id.*

9. *See id.*

10. If the contractor were liable, it would owe the amount of the withheld progress payment and the subcontractor's profit on the remaining portion of the work. *See id.* at 453-54. The measure of damages for the subcontractor's claim for "lost profit" is frequently stated as the remaining portion of the contract price less the remaining prospective cost of performance. *See* John D. Calamari & Joseph M. Perillo, The Law of Contracts § 14-28 (3d ed. 1987). In some cases, the measure of recovery may be the value of the services provided to the party that was subject to the wrongful withholding. *See* Boomer v. Muir, 24 P.2d 570, 573 (Cal. Dist. Ct. App. 1933).

If the subcontractor were liable, it would owe the additional costs incurred by the contractor in hiring another subcontractor to complete the work, in addition to the costs of the damaged wall. *See K & G Constr.*, 164 A.2d at 453-54.

11. *See K & G Constr.*, 164 A.2d at 456. The subcontractor was therefore found liable for the costs the contractor incurred as a result of the subcontractor's work stoppage. *See id.* For a description of the court's reasoning in this case, see *infra* notes 62-66 and accompanying text.

12. This Note will use the term "withholding" to refer to the withholding of payment by a party injured by a breach while that party demands that the party which caused the breach complete its performance under the contract.

This Note will use the term "cancellation" to refer to when "either party puts an end to the contract for breach." U.C.C. § 2-106(4) (1990). After cancellation "all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives." *Id.* § 2-106(3). Sometimes what is described in this Note and

this question.[14] Because of this, parties to continuing contracts face substantial risk when they make decisions concerning withholding following a breach of contract.[15]

This Note explores the right of a party injured by a breach of a continuing[16] general common-law[17] contract to withhold payment[18] without releasing the breaching party from the performance of its contractual ob-

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the UCC as "cancellation" is described by the terms "termination" and "rescission." *See* 2 E. Allan Farnsworth, Farnsworth on Contracts § 8.15 at 435 n.2 (1990).

13. *See infra* part I.C. Courts that are faced with the issue of withholding often do not recognize its special characteristics and frequently decide cases without reference to prior decisions in this area. Courts usually answer questions of withholding by direct application of the principles of material breach and constructive conditions. *See infra* part I.C. These principles were not designed to address the special problems that arise in connection with a party's withholding of payment in a continuing contract. *See infra* note 21 and accompanying text. When these principles are applied in the context of withholding, they often generate inconsistent results. Often courts of the same state use inconsistent standards in similar cases. *Compare* Morgan v. Singley, 560 S.W.2d 746, 749 (Tex. Civ. App. 1978) (allowing withholding when justified) *with* Cox, Colton, Stoner, Starr & Co. v. Deloitte, Haskins & Sells, 672 S.W.2d 282 (Tex. Ct. App. 1984) (party must elect either to cancel contract or continue contract and give full performance; withholding not allowed). Occasionally, even the same court will even use different standards in similar cases. *Compare* T. Ferguson Constr., Inc. v. Sealaska Corp., 820 P.2d 1058, 1061 (Alaska 1991) (allowing withholding when circumstances warrant) *and* Arctic Contractors, Inc. v. State, 564 P.2d 30, 43 (Alaska 1977) (same) *with* Howard S. Lease Constr. Co. & Assocs. v. Holly, 725 P.2d 712, 715-16 (Alaska 1986) (allowing withholding after first material breach or if withholding is subsequently proved valid). For a discussion of the different withholding standards, see *infra* part I.C. For a fuller examination of the Texas conflict, see *infra* note 146. For a discussion of the standards applied in Alaska, see *infra* note 101.

14. Contracting parties frequently insert provisions into their contracts that seek to address this problem. *See infra* part II.C. However, there are many situations in which parties do not provide for withholding in their contracts. *See, e.g.*, ARP Films, Inc. v. Marvel Entertainment Group, Inc., 952 F.2d 643, 646-47 (2d Cir. 1991) (copyright licensing contract with no withholding provision). Furthermore, parties to contracts that do address withholding may find themselves in situations in which the withholding provisions do not adequately address the breach. *See, e.g.*, K & G Constr. Co. v. Harris, 164 A.2d 451, 452-53 (Md. 1960) (contract clause allowing contractor to retain 10% of progress payment until completion insufficient to deal with damages from major excavation accident).

15. *See infra* part II.

16. The withholding analysis in this Note applies only to continuing contracts for which there are remaining performances and payments due. *See infra* part I.B.

17. This Note discusses withholding in contracts interpreted under common-law contract rules. Certain areas of the law have specialized rules regarding the withholding of payment. For example, Article 2 of the Uniform Commercial Code, which covers the sale of goods, has a provision which allows buyers to withhold from the unpaid purchase price any damages resulting from the seller's breach. This provision is analyzed in this Note because of the UCC's relevance to common-law contract law. *See infra* part I.D.

Other classes of cases where withholding is allowed include bankruptcy, insurance, and banking. *See* 6 Williston, *supra* note 3, § 887G. In addition, there is a well-developed body of law on the right to withhold rent under real estate leases under such theories as illegal lease and implied warranty of habitability. *See* Jesse Dukeminier & James E. Krier, Property 469-515 (2d ed. 1988). Moreover, in federal government contracts, withholding by the government is allowed pursuant to particular statutory procedures. *See* Contracts Disputes Act of 1978, Pub. L. No. 95-563, 92 Stat. 2383 (1978) (codified as amended at 41 U.S.C. §§ 601-13 (1988 & Supp. III 1992)); Avco Corp. v. United States,

ligations. This right[19] constitutes an intermediate step between the relatively drastic alternative of cancelling all remaining performance and the relatively ineffectual alternative of suing (or negotiating) for damages or other remedies.[20] Part I presents a general overview of the principles of material breach and constructive conditions and describes the different standards courts apply to resolve questions of withholding. Part II develops an analytical framework for understanding the uncertainties facing parties in this situation and evaluates the withholding standards to measure their success in minimizing these uncertainties. Part III proposes a general standard that seeks to minimize the deficiencies of the various conflicting standards. This Note concludes that the present disarray in the law concerning withholding causes unnecessary risk to contracting parties and, until courts or legislatures act to mitigate this risk, contracting parties must protect themselves by including withholding provisions in their contracts.

I. BACKGROUND

A. *Constructive Conditions and Material Breach*

The well-developed contract law principles of material breach and constructive conditions form the backdrop against which questions of withholding are decided. Courts developed these principles "to deal with the relatively simple case in which the party in breach had finished performing and the injured party refused to pay the price because the performance was defective or incomplete."[21]

Courts that examine issues of withholding usually do so by applying the doctrine of constructive conditions, under which each contracting party's duty to perform a contractual obligation is constructively conditioned on the other party's substantial performance of the prior obligations under the contract.[22] If a party fails to substantially perform the

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10 Cl. Ct. 665 (1986). The right to withhold in these situations and many others which arise under specialized bodies of law is beyond the scope of this Note.

18. This Note only considers the right of an injured party to withhold payment for a breach in the performance of a contract. A similar analysis can be used to examine a right of an injured party to withhold performance in response to a breach. Because of the complexities of applying a general analysis to a subject as varied as contractual performance, the right to withhold performance is not considered in this Note.

19. The "right" to withhold or cancel a contract is not properly a right, nor is it a remedy; it is a "legal privilege" and "a legal relation created for the benefit of the injured party." 3A Arthur L. Corbin, Corbin on Contracts § 693, at 275 (1960). This Note, for convenience, will describe withholding and cancellation as "rights" or as "responses" to breach.

20. For a discussion of the traditional common-law responses to breach, see *infra* part I.A.

21. 2 Farnsworth, *supra* note 12, § 8.15 at 435.

22. *See* Restatement (Second) of Contracts § 237 & cmt. d (1979); Calamari & Perillo, *supra* note 10, § 11-17.

The Second Restatement sets forth the rules of material breach and constructive conditions within Chapter 10, Topic 2, *Effect of Performance and Non-performance. See* Re-

contract when its performance is due, the party has materially breached the contract.[23] In the event of a material breach,[24] the constructive condition of performance has not occurred.[25] The injured party then has the right to cancel the contract and terminate the remaining executory obligations of each side.[26] The injured party may then also sue the breaching party to recover damages incurred as a result of the total breach of the contract.[27] An example of the operation of this doctrine is provided by *K & G Construction v. Harris*,[28] the case described in the Introduction.[29] In that case, the subcontractor's breach of its obligation to perform in a workmanlike manner was considered by the court to be material.[30] Thus, the contractor had the option to cancel all of the remaining obligations under the contract and sue for the remedies available for a total breach.[31]

However, a party injured by a material breach is not required to cancel the contract. Even though a constructive condition of performance has

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statement (Second) of Contracts §§ 235-248 (1979). Calamari & Perillo's hornbook provides a much more readable explanation of the operation of these rules. *See* Calamari & Perillo, *supra* note 10, §§ 11-11 to 11-18; *see also* 2 Farnsworth, *supra* note 12, §§ 8.8-8.19 (additional description of these rules).

23. *See* Restatement (Second) of Contracts § 237 cmt. d (1979); Calamari & Perillo, *supra* note 10, § 11-15. An exception may exist when there has been a delay in performance. If performance has been delayed for a reasonably short time while the time for performance is not of the essence, a material breach has not occurred even though substantial performance has not been rendered. *See* Calamari & Perillo, *supra* note 10, § 11-18(a), at 461. In this case, the breaching party will have a reasonable time to cure the breach. *See* Restatement (Second) of Contracts § 242 cmt. a (1979).

24. A discussion of whether a particular breach should be classified as material or non-material is beyond the scope of this Note. For discussions of the determination of when a breach is material, see Restatement (Second) of Contracts § 241 (1979); Restatement of Contracts § 275 (1932); Calamari & Perillo, *supra* note 10, § 11-18(a), at 459-61; 2 Farnsworth, *supra* note 12, § 8.16; Eric G. Andersen, *A New Look at Material Breach in the Law of Contracts*, 21 U.C. Davis L. Rev. 1073 (1988).

This Note does not consider the Second Restatement's position that a material breach merely permits the injured party to suspend performance. The Second Restatement's position allows the breaching party to cure the breach until enough time has passed that cancellation is warranted. *See* Restatement (Second) of Contracts § 237 reporter's note, § 242 cmt. a (1979); *see also* 2 Farnsworth, *supra* note 12, §§ 8.15, 8.18 (discussing this analysis). For criticism of this analysis, see Calamari & Perillo, *supra* note 10, § 11-18(a), at 459; William H. Lawrence, *Cure After Breach of Contract Under the Restatement (Second) of Contracts: An Analytical Comparison with the Uniform Commercial Code*, 70 Minn. L. Rev. 713 (1986).

25. *See* Restatement (Second) of Contracts § 237 & cmt. a (1979); Calamari & Perillo, *supra* note 10, § 11-18(b).

26. *See* Restatement (Second) of Contracts § 225(2), § 237 cmt. a (1979); Calamari & Perillo, *supra* note 10, § 11-18(a), at 458.

27. *See* Restatement (Second) of Contracts § 243(1) & cmt. a (1979); Calamari & Perillo, *supra* note 10, § 11-18(a), at 458. A claim for total breach is for damages based on all of the remaining rights under the contract. *See* Restatement (Second) of Contracts § 236(1) (1979).

28. 164 A.2d 451 (Md. 1960).

29. *See supra* notes 4-11 and accompanying text.

30. *See K & G Constr. Co.*, 164 A.2d at 456.

31. *See id.*

failed,[32] the injured party may elect to waive this non-occurrence of condition.[33] The injured party has the option of continuing the contract and seeking damages from a non-material breach, rather than canceling the contract and seeking damages from a total breach.[34] For example, in *K & G Construction*, even though the subcontractor's breach was material, the contractor had the option to continue the contract and treat the breach as non-material.[35] The contractor in that case exercised this option by permitting the subcontractor to continue its performance.[36]

If a breach of a contract is not material, substantial performance has been rendered and the constructive condition of performance has been satisfied.[37] The injured party does not have the right to cancel the contract; it may only seek damages for the non-material breach.[38] For example, if the subcontractor's breach in *K & G Construction* had been non-material, the contractor would have had no right to cancel the contract. Rather, the contractor could only have sought damages incurred as a result of the breach.[39]

B. *Where Questions of Withholding Arise*

An examination of the manner in which the principles of material breach and constructive conditions operate shows that the issue of withholding arises only when the contract and the breach have two particular characteristics.[40] First, for a party to be able to withhold payment, yet insist on the other party's performance of its contractual obligations, the contract must be continuing; that is, it must require continuing performance and payments at intervals.[41] This situation commonly exists in con-

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32. *See* Restatement (Second) of Contracts § 237 (1979); Calamari & Perillo, *supra* note 10, § 11-17.

33. *See* Restatement (Second) of Contracts § 243 cmt. a (1979); Calamari & Perillo, *supra* note 10, § 11-32.

34. *See* Restatement (Second) of Contracts § 243 cmt. a (1979); Calamari & Perillo, *supra* note 10, § 11-18(a), at 458, § 11-33, at 498.

35. *See* K & G Constr. Co. v. Harris, 164 A.2d 451, 456 (Md. 1960).

36. *See id.*

37. *See* Restatement (Second) of Contracts § 237 & cmts. a, d (1979); Calamari & Perillo, *supra* note 10, § 11-15.

38. *See* Restatement (Second) of Contracts § 237 & cmt. a, § 243(1) & cmt. a (1979); Calamari & Perillo, *supra* note 10, § 11-18(a), at 458.

39. *See* Craig Food Indus. Inc. v. Taco Time Int'l, Inc., 469 F. Supp. 516, 550 (D. Utah 1979).

40. "Withholding," as defined in this Note, refers to the withholding of payment on a contract in reaction to a breach while requiring the breaching party to continue its remaining performance. *See supra* note 12. "Withholding," differently defined, may arise in other types of contracts whose consideration is beyond the scope of this Note.

41. *See supra* note 1. If the contract calls only for a single payment after performance, the principles of constructive conditions and material breach are easily applied and the question of withholding does not arise. Upon the completion of performance in such a case, the withholding becomes cancellation, since withholding presupposes a demand that the breaching party complete its performance. *See supra* note 12.

tracts for construction,[42] long term sales,[43] equipment leasing,[44] licensing,[45] franchising,[46] employment,[47] and covenants not to compete.[48]

Second, the breach and withholding must occur before performance under the contract has been substantially completed. If the breaching party has substantially performed the contract by the time the withholding occurs, the only issue for a court to decide is the net recovery on the contract, an amount that is usually held to be the balance of the contract price reduced by the damages caused by the breach.[49]

Though the possibility of withholding arises when a continuing contract has been breached before substantial performance has occurred, the parties must follow a particular pattern of action in order for a court to reach the issue of withholding. First, the injured party must elect to withhold payment and require continued performance from the breach-

42. *See, e.g.*, K & G Constr. Co. v. Harris, 164 A.2d 451 (Md. 1960) (construction contract).

43. *See, e.g.*, Created Gemstones, Inc. v. Union Carbide Corp., 391 N.E.2d 987 (N.Y. 1979) (ten year sales agreement).

44. *See, e.g.*, Royal McBee Corp. v. Bryant, 217 A.2d 603 (D.C. 1966) (typewriter lease). These issues also arise in the leasing of real estate. However, courts have established specialized rules regarding rent withholding and other real estate leasing questions. Discussion of this issue is beyond the scope of this Note. *See supra* note 17.

45. *See, e.g.*, ARP Films, Inc. v. Marvel Entertainment Group, Inc., 952 F.2d 643 (2d Cir. 1991) (licensing of copyright rights of cartoon characters).

46. *See, e.g.*, Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 773 F. Supp. 1123 (N.D. Ill. 1991) (franchise of cookie outlets).

47. *See, e.g.*, Warner Bros. Pictures, Inc. v. Bumgarner, 17 Cal. Rptr. 171, 173 (Dist. Ct. App. 1962) (employment of movie actor).

48. *See, e.g.*, Hanks v. GAB Business Servs., Inc., 644 S.W.2d 707 (Tex. 1983) (restrictive covenant in sale of insurance adjusting business).

49. *See, e.g.*, J.E. Milligan Steel Erectors, Inc. v. Garbe Iron Works, Inc., 486 N.E.2d 945, 950 (Ill. App. Ct. 1985) (subcontractor that substantially performed entitled to "contract damages reduced, of course, by any damages caused by negligence"). If both sides substantially perform, the issues at trial are usually a claim by the breaching party for the amount withheld and a counterclaim by the withholding party for the amount of damage caused by the breach. *See, e.g.*, Sagebrush Dev., Inc. v. Moehrke, 604 P.2d 198, 203 (Wyo. 1979) (in contract with non-material breaches on each side, damages computed based on each individual breach).

The court must return judgments on the claim and counterclaim, but usually it does not need to consider whether the withholding was rightful or wrongful, since this has no effect on the amount of the judgments. However, there are some unusual times where the rightfulness of withholding may have some effect, such as the award of consequential damages. *See, e.g.*, Howard S. Lease Const. Co. & Assoc. v. Holly, 725 P.2d 712, 715 (Alaska 1986) (consequential damages not awarded when withholding was found to be proper). For a discussion of this case, see *infra* note 101 and accompanying text.

The issue of prejudgment interest on the amount improperly withheld is frequently noted in cases. That issue is sometimes resolved by holding that the net judgment was not liquidated and therefore not entitled to prejudgment interest. *See* Concannon v. Galanti, 202 N.E.2d 236, 239 (Mass. 1964). However, in some states, prejudgment interest is allowed on unliquidated contract claims. *See* N.Y. Civ. Prac. L. & R. 5001 (McKinney 1992 & Supp. 1993). It is beyond the scope of this Note to discuss the effects of withholding on this issue.

ing party.[50] Second, the breaching party must stop performance in response to the withholding.[51] If either of the parties do not take these actions, a court would be unlikely to discuss whether a party would have been justified in taking them.[52]

C. *Common Law Withholding Standards*

Courts considering the issue of withholding in common-law contracts have responded in a variety of different ways. The approaches taken by courts may, however, be classified into three primary groups, referred to in this Note as standards: withholding after material breach, withholding when justified, and election required. Some courts allow withholding only when the breach by the breaching party is material.[53] Others allow the finder of fact to determine whether the withholding was justified and do not apply the principles of material breach.[54] Still others hold that an injured party may not withhold, but rather require it to elect either full performance or total cancellation.[55]

1. Withholding After Material Breach

Where courts apply the withholding after material breach standard, withholding is allowed only after the conduct of the breaching party rises

50. If the injured party does not withhold, a court will rarely consider whether it would have been able to withhold. Any discussion of the right to withhold by a court would be pure dicta.

Parties that may be eligible to withhold often do not do so because of the risks that withholding involves. *See infra* notes 171-72 and accompanying text. If an injured party does not withhold, it still has the right to sue for a non-material breach. *See supra* notes 37-39 and accompanying text.

If a party withholds and refuses to allow continued performance, a cancellation has occurred. *See supra* note 12. In that case, the question becomes purely one of material breach. *See, e.g.*, Geotech Energy Corp. v. Gulf States Telecom. & Info. Sys., Inc., 788 S.W.2d 386, 391 (Tex. Ct. App. 1990) (when company was unsatisfied with equipment installation and refused to pay or allow replacement, "only a material breach would preclude recovery on the contract").

51. If the breaching party continues performance, it has effectively elected to treat the withholding as a non-material breach, if it is a breach at all. *See, e.g.*, *Sagebrush Dev.*, 604 P.2d at 203 (when breaching water service provider sued for withheld payments but continued performance, there was no question of "total breach"). This deprives the court of the opportunity to consider whether the breaching party could have canceled its performance, as any discussion of the possibility of cancellation would be pure speculation and dicta.

52. An exception would be found if, for example, the breaching party were to sue for a declaratory judgment that it could cease its performance under the contract in response to a withholding. Then a court would be able to consider whether withholding was proper even though the breaching party had not yet ceased performance. *See, e.g.*, Craig Food Indus., Inc. v. Taco Time Int'l, Inc., 469 F. Supp. 516, 550 (D. Utah 1979) (franchisor counterclaimed for declaratory judgment that franchise agreement was terminated because of withheld franchise fees).

53. *See infra* part I.C.1.

54. *See infra* part I.C.2.

55. *See infra* part I.C.3.

to the level of a material breach.[56] Using this analysis, a withholding is appropriate after a material breach,[57] since the constructive condition to the injured party's performance has not occurred.[58]

Under this standard, if a material breach does not precede a withholding, the withholding itself is considered a breach of the contract.[59] This analysis would, however, require the first breaching party to tolerate a withholding that is not a material breach of the contract.[60] In such a situation, the first breaching party may not respond by ceasing its performance, because the withholding does not constitute a material breach that would allow the first breaching party to cancel the contract.[61]

An example of how a court applied the withholding after material breach standard can be found in *K & G Construction v. Harris*.[62] In that case, the subcontractor's bulldozer accident was found to be a material breach of the contract.[63] That material breach by the subcontractor was held to excuse the contractor's failure to make the progress payment.[64]

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56. *See* Restatement (Second) of Contracts § 237 cmt. b (1979); 2 Farnsworth, *supra* note 12, § 8.15, at 439-40. This standard considers whether the breach that preceded the withholding or the withholding itself constituted a material breach. The withholding after material breach standard is also referred to as the "first material breach" standard. *See* 2 Farnsworth, *supra* note 12, § 8.15, at 439-40.

57. *See* Restatement (Second) of Contracts § 237 cmt. d (1979); *see also, e.g.*, Ernst v. Ohio Dep't of Admin. Servs., 590 N.E.2d 812, 819 (Ohio Ct. App. 1990) (government agency entitled to withhold progress payments from contractor who abandoned job site). It is generally held to be immaterial whether the withholding party knew of the breach before the withholding. *See* Restatement (Second) of Contracts § 237 cmt. c (1979).

58. *See supra* note 25 and accompanying text.

59. *See, e.g.*, M & W Masonry Constr., Inc. v. Head, 562 P.2d 957, 961-62 (Okla. Ct. App. 1976) (holding that contractor improperly withheld payments to subcontractor that had substantially performed).

60. An initially breaching party could, however, sue the withholding party for damages. In return it would be subject to a counterclaim for the damages resulting from the original breach. *See* Sagebrush Dev., Inc. v. Moehrke, 604 P.2d 198, 203 (Wyo. 1979) (breaching water supplier sued homeowner for withheld payments; homeowner counterclaimed for damages from breach of supply contract).

61. *See, e.g.*, Stewart v. C & C Excavating & Constr. Co., 877 F.2d 711, 714 (8th Cir. 1989) (contractor's withholding of relatively small portion of total payment was nonmaterial breach and did not entitle subcontractor to abandon job).

62. 164 A.2d 451 (Md. 1960). The facts of *K & G Construction* were described in the Introduction. *See supra* notes 4-11 and accompanying text.

63. *See K & G Constr.*, 164 A.2d at 456.

64. *See id.* In finding that the withholding was proper, the court relied on a quotation from section 708 of Corbin, which states:

> "The failure of [the subcontractor's] performance to constitute 'substantial' performance may justify [the contractor] in refusing to make a progress payment .... If the refusal to pay an installment is justified on the [contractor's] part, the [subcontractor] is not justified in abandoning work by reason of that refusal. His abandonment of the work will itself be a wrongful repudiation that goes to the essence, even if the defects in performance did not."

Id. (omission in original) (quoting 3A Corbin, *supra* note 19, § 708). However, the language omitted by the court explains that refusing to pay progress payments without terminating the contract is only allowed because "the time for curing defects may not have expired." 3A Corbin, *supra* note 19, § 708. The court's analysis is criticized for this reason in Andersen, *supra* note 24, at 1131 n.182, 1122 n.149.

Though the court considered the breach to be material, the court allowed the contractor to treat the breach as non-material and required the subcontractor to continue performance.[65] Accordingly, the court determined that the subcontractor breached the contract again when it discontinued work, and therefore was liable for the contractor's increased cost of procuring substitute performance.[66]

The other side of the withholding after material breach standard is illustrated by *M & W Masonry Construction, Inc. v. Head*,[67] in which a withholding was disallowed when a breach was held to be non-material.[68] In *M & W Masonry*, a masonry subcontractor stopped work and sued after it had not been paid any progress payments.[69] The contractor explained its non-payment by claiming that "the brickwork was faulty—some were crooked and some had head joints that were not full."[70] The court, after beginning its analysis with the oft-stated proposition that failure to pay a progress payment is a material breach of the contract,[71] noted that "the stated rule contemplates that the subcontractor has sub-

65. *See K & G Constr.*, 164 A.2d at 456. In finding that the contractor could treat the breach as non-material, the court relied on another section of Corbin, section 954, which it quoted as stating that " 'For a failure of performance constituting such a 'total' breach, an action for remedies that are appropriate thereto is at once maintainable. Yet the injured party is not required to bring such action. He has the option of treating the non-performance as a 'partial' breach only . . . .' " *Id.* (omussion in original) (quoting 4 Corbin, *supra* note 19, § 954 at 830). The court omitted the end of the last sentence, which states that the consequence of exercising this option is that the injured party may "get[ ] a judgment therefor without barring a later action for some subsequently occurring breach. It is reasonable for him to expect performance of the remainder of the contract as agreed and to ask a judicial remedy in case of disappointment." 4 Corbin, *supra* note 19, § 954 at 830.

66. *See K & G Constr.*, 164 A.2d at 456.

67. 562 P.2d 957 (Okla. Ct. App. 1977).

68. *See id.* at 961-62.

69. *See id.* at 959-60.

70. *Id.* at 959. The contractor also complained about the color of the brick. However, the contractor had furnished the brick and the court did not consider this to be as an excuse for non-payment. *See id.*

Even though the contractor had complaints about the subcontractor's brickwork, the contractor told the subcontractor to continue working and that other work would be approved. *See id.* The subcontractor continued its performance and corrected items on the "punch list," a construction term for a list of items needing correction. *See id.* The subcontractor requested a progress payment on May 3. *See id.* The payment should have been paid five days later, but the contractor neither paid nor supplied an additional punch list. *See id.* The only explanation given by the contractor for the withholding was, "We can't give you no money because your work's unsatisfactory." *Id.* Neither the subcontractor nor the architect could find anything wrong with the work. *See id.*

The subcontractor pulled its men off of the job on May 11 after the contractor again refused to make the progress payment. *See id.* A few days after the subcontractor terminated performance, the contractor requested a weekly payroll report for the job. *See id.* The court dismissed any consideration of whether the failure to supply this report excused the progress payment by saying the request was "somewhat of an afterthought," because the contractor never complained of not having the report before. *Id.* at 961.

71. *See id.* at 961. The court cites five cases from different jurisdictions to support this statement. *See also* 3A Corbin, *supra* note 19, § 692, at 269 n.34 (citing over 30 cases from 18 jurisdictions for the same proposition).

stantially fulfilled mutual and dependent obligations required of him."[72] The court held that the subcontractor had substantially performed its obligation and therefore had a right to quit work when not paid.[73] Accordingly, the court found the subcontractor to be entitled to be paid the money withheld and not liable for breach in terminating its performance.[74]

One variation of the withholding after material breach standard allows withholding which might otherwise be a material breach if such withholding resulted from a good faith difference in the interpretation of the contract. In *Golf Carts, Inc. v. Mid-Pacific Country Club*,[75] the court applied this variation to a dispute over the duration of an oral modification of a contract.[76] The modification increased the percentage of the

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72. *M & W Masonry*, 562 P.2d at 961. The court cites no authority for this proposition. *See id.* Corbin points out that in a construction contract completion of a specified portion of the work is a condition precedent to the right to a progress payment, but only cites one case for this proposition. *See* 3A Corbin, *supra* note 19, § 692, at 273; *cf.* Morgan v. Singley, 560 S.W.2d 746, 749 (Tex. Civ. App. 1978) (general rule is that unjustified refusal or failure to pay installments is breach). *But cf.* U.C.C. § 2-612(3) (1990) (in installment contract there is breach of the whole contract only when "default with respect to one or more installments substantially impairs the value of the whole contract").

73. *See M & W Masonry*, 562 P.2d at 962. The court found that the contractor had offered no evidence that the subcontractor's work was anything but satisfactory. *See id.* The contractor did, however, offer the excuse that it had not received progress payments from the owner covering the work. *See id.* The subcontract stated that the payments to the subcontractor were to be made "as and when Contractor receives payment from the Owner for the work performed and materials furnished hereunder." *Id.* at 958. The court found the contractor's statement that he did not receive payment for the brickwork until "45 to 60 days after we submitted our estimates" to be, if true, an unexplained breach of the prime contract. *Id.* at 962. The record indicated that the contractor had received payments for the materials it had furnished, and the court found that a "[f]ailure to timely request of owner payment for [subcontractor's] work" to be a breach of an implied obligation of the contractor. *Id.* Moreover, the court found that it was "quite a coincidence" that the contractor received payment for the brickwork shortly after the subcontractor terminated, but still made no effort to pay the subcontractor. *Id.*

74. *See id.* at 962. The subcontractor sued to recover only the $10,810 it had requested as a progress payment. *See id.* at 958. The court reversed the trial court's holding that the contractor was to receive its excess cost in completing the subcontract. *See id.* at 962.

A similar illustrative case that applies the withholding after material breach standard is *Stewart v. C & C Excavating & Construction Co.*, 877 F.2d 711 (8th Cir. 1989), in which a subcontractor also stopped work after a contractor withheld a progress payment. The subcontractor maintained that he had earned over $129,000 on the subcontract without receiving a progress payment. *See id.* at 714. The court found that, because of certain expenses that the contractor paid on behalf of the subcontractor, the net progress payment due was only $2,385.78. *See id.* Upon concluding that the wrongful withholding of this relatively small amount from a gross progress payment of $41,335 did not constitute a material breach of the contract, *see id.* at 714, the court awarded the contractor damages covering the additional costs it incurred in completing the project. *See id.* at 713-14.

75. 493 P.2d 1338 (Haw. 1972).

76. *See id.* at 1339. Golf Carts, Inc. and the country club were involved in a contract in which Golf Carts had a concession to rent golf carts for use by the country club's members and guests. *See id.* at 1338.

rental revenue to which Golf Carts, Inc. was entitled.[77] Golf Carts withheld this higher percentage and remitted the remainder to the country club, even after the country club claimed that the modification had expired.[78] Golf Carts sued the country club for reformation of the contract in accord with the modification.[79] After extensive settlement negotiations were unsuccessful, the country club canceled the contract and evicted Golf Carts.[80] The court found the country club's cancellation to be a breach, reasoning that Golf Carts' continued performance and withholding of revenues under its own good faith interpretation did not justify the country club's termination.[81] The court found the cancellation at that time improper even though Golf Cart's interpretation was later proved incorrect.[82]

2. Withholding when Justified

A second standard used by the courts allows withholding when the finder of fact determines that the withholding is justified. This determination is made without applying the doctrine of material breach or examining the materiality of the breach which prompted the withholding.[83] Courts applying this standard have approved jury instructions that treat

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77. *See id.* at 1339. The effective period of the modification was not discussed by the parties, and the modification was never reduced to writing. *See id.*

78. *See id.* Since the period of the modification was not reduced to writing, its duration was uncertain. *See id.*

79. *See id.*

80. *See id.*

81. *See id.* at 1340.

82. *See id.* The court found that the evidence of the duration of the modification was ambiguous, and concluded that the modification was only in effect while the parties abided by it. *See id.* at 1339. A dissent argued that Golf Carts failure to remit the amount which the court found was due was a material breach which would justify the termination. *See id.* at 1341 (Levinson, J., dissenting).

The good faith variation was also applied in *Oak Ridge Construction Co. v. Tolley*, 504 A.2d 1343 (Pa. Super. Ct. 1985), in which a contractor and an owner got into a dispute over the depth of a well the contractor was drilling for the owner. *See id.* at 1345-46. There, the contract provided that the contractor was to drill a water well 150 feet deep. *See id.* at 1345. If the well were required to be deeper than that, the contract provided for an additional charge per foot. *See id.* The well was eventually drilled to a depth of over 800 feet. *See id.*

The owner objected to an additional charge for the well being drilled deeper than specified in the contract, and refused to pay the charge pending arbitration. *See id.* at 1345-46. After the contractor submitted an invoice for the additional drilling, the owner wrote to the contractor saying that the charges were "in dispute or disagreement" and that all work on the well was to cease until resolution pursuant to an arbitration clause in the agreement. *Id.* at 1345.

The contractor then terminated the contract, *see id.* at 1346, relying on a clause which permitted it to terminate, upon notice, for any breach by the owner. *See id.* The court found that the refusal to pay and request for arbitration were not breaches justifying the contractor's termination, even though the owner's objection to the charge for the additional drilling had no merit. *See id.* at 1347-48.

83. *See, e.g.*, Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc., 340 A.2d 225, 232-33 (Md. 1975) (affirming trial court's finding that withholding was justified, but not examining materiality of breach).

the determination of whether a party was justified in withholding payment as entirely a question of fact.[84]

The withholding when justified standard asks the finder of fact to apply its own uncontrolled judgment as to whether the withholding party was justified in its withholding. In contrast, the withholding after material breach standard asks the finder of fact to apply the established tests used to determine whether a breach is material,[85] and then, to use that determination to conclude whether the withholding was appropriate.[86]

A good example of how the withholding when justified standard is applied is *Morgan v. Singley*,[87] in which a subcontractor ceased perform-

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84. *See, e.g.*, Shafer Plumbing & Heating, Inc. v. Controlled Air, Inc., 742 S.W.2d 717, 718 (Tex. Ct. App. 1987) (approving jury instruction asking whether "the Plaintiff was justified in abandoning the job because of the failure of the Defendant . . . to pay Plaintiff?").

85. Although there is no general test to determine whether a breach is material, courts regularly determine the materiality of a breach by considering various circumstances attending the breach. *See* Restatement (Second) of Contracts § 241 (1979). The details of the determination of whether a breach is material is beyond the scope of this Note. *See supra* note 24.

86. Although these two standards depend on different determinations to be made by the finder of fact, it is obvious that, when applied, they frequently will come to the same result. For example, in *K & G Construction Co. v. Harris*, 164 A.2d 451, 453-54, 456 (Md. 1960), the court approved the contractor's withholding of a $1,484.50 progress payment after the $3,400.00 bulldozer accident by applying the withholding after material breach standard. It seems likely that a jury considering the same facts under the withholding when justified standard would also approve such action.

There are some situations, however, in which the two standards would arrive at different results. For instance, in *Oak Ridge Construction Co. v. Tolley*, 504 A.2d 1343, 1345-46 (Pa. Super. Ct. 1985), the case described in note 82, *supra*, the owner withheld payment and attempted to invoke an arbitration clause in a dispute over the contractor's charge for additional well drilling. The court found that the owner had no valid grounds for its claim that the additional charge was improper. *See id.* at 1347-48. The court applied the good faith variation and found that the contractor had no right to terminate the contract after the owner's good faith withholding, even though the withholding was premised on an invalid claim. *See id.* at 1347. If the court had applied the first material breach standard and a jury had found that the owner's withholding based on an invalid claim to be a material breach, the withholding would have been found improper and the contractor's subsequent termination would have been allowed. In contrast, a jury confronted simply by the question of whether the owner was justified in withholding in good faith might find the owner to be justified and the contractor therefore liable for the damages from its termination.

Some courts seem to have brought the two standards together and found that the that a finding of justification implies a material breach. *See, e.g.*, Automated Housing Corp. v. First Equity Assocs., Inc., 428 A.2d 886, 888 (N.H. 1981) (conclusion by lower court that subcontractor was justified in walking off job implies finding that contractor materially breached contract); Geotech Energy Corp. v. Gulf States Telecom. & Info. Sys., Inc., 788 S.W.2d 386, 391 (Tex. Ct. App. 1990) (holding that "only a material breach would preclude recovery on the contract," but approving jury instruction stating that "[b]reach of contract is the *unjustified* failure of one of the parties to the contract to perform" (emphasis added)). Nonetheless, this Note distinguishes the two standards because of the differences in the way that they treat breaches and the way they allocate the risks between the parties. *See infra* part II.D.

87. 560 S.W.2d 746 (Tex. Civ. App. 1977).

ance after the contractor withheld two progress payments.[88] The contractor contended that it withheld the payments because of defects and deficiencies in the subcontractor's work.[89] The jury found that the subcontractor "had abandoned his work without justification."[90] It found that the subcontractor had failed to perform according to the plans and specifications of the job, and that such failure caused the contractor to incur costs to complete the work.[91] On appeal, the subcontractor argued that the failure to make the progress payments was a breach and justified the abandonment of the job.[92] The appellate court disagreed, holding that only an unjustified withholding would constitute a breach,[93] and that if the subcontractor was not in compliance with the specifications of the contract, the contractor's withholding would have been justified.[94] It therefore affirmed the jury's finding that the subcontractor's performance was defective.[95] The appellate court affirmed this finding without considering whether the subcontractor's breach was material.[96]

Another illustration of the justified standard can be found in *Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc.*,[97] a case in which a contractor withheld payment in response to a subcontractor's persistent delays in performance.[98] The trial court, sitting without a jury,[99] found that the

88. *See id.* at 748. Singley, the contractor, was, in fact, the plumbing, heating, and air conditioning subcontractor to a general contractor. Morgan was Singley's subcontractor for the plumbing portions of the job. *See id.*

89. *See id.* The subcontractor asserted that any defects had been remedied by the time he left the job. *See id.* There was also conflicting testimony as to whether the general contractor had paid Singley and whether such payment was made conditional on the subcontractor's correction of the defects. *See id.*

90. *Id.*

91. *See id.* The jury also found that the subcontractor had substantially completed a portion of the project, and was thus owed the remainder due on that portion, less the cost incurred to complete full performance. *See id.*

92. *See id.* at 748-49.

93. *See id.* at 748-49.

94. *See id.*

95. *See id.*

96. *See id.* at 748-49. The court based its analysis on a quotation from Corbin:

> "If the refusal to pay an installment is justified on the owner's part (Singley in our case), the contractor (Morgan in our case) is not justified in abandoning work by reason of that refusal. His abandonment of the work itself will be a wrongful repudiation that goes to the essence, even if the defects in performance did not."

Id. (parentheses supplied in original) (quoting 3A Corbin, *supra* note 19, § 708, at 333). In using this quotation the court ignores Corbin's immediately preceding paragraph, which states that the failure of the contractor to provide substantial performance is what justifies an owner's refusal to make a progress payment. *See id.*; 3A Corbin, *supra* note 19, § 708, at 332; *cf. supra* note 64 (discussing the application of this section in *K & G Construction*).

97. 340 A.2d 225 (Md. 1975).

98. *See id.* at 228-29. The subcontractor's performance continued until a labor strike intervened. *See id.* at 229. The contract had a provision that, in the event of a strike, the contractor would have the right to perform the subcontractor's work and charge the subcontractor for the cost of completion. *See id.* at 228. When the strike began, the

contractor was justified in withholding the progress payments.[100] The appellate court affirmed this finding without making any mention of the materiality of any breach.[101]

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contractor refused to make a progress payment which covered work the subcontractor had performed before the strike. *See id.* at 229.

The contractor was particularly concerned about the progress of the subcontractor's performance, since its general contracts provided that time was of the essence and subjected it to liquidated damages if the projects were not completed on time. *See id.* In the general contracts labor strikes were not an excusable cause of delay. *See id.*

99. *See id.* at 227.

100. *See id.* at 232.

101. *See id.* at 232-33. The appellate court found that the subcontractor's refusal to work during the strike was not itself a breach, because of the strike provision in the contract. *See id.* at 232. However, the court found that its delays in performance and refusal to cooperate with the contractor in finding an alternative to a work stoppage constituted a breach. *See id.* at 233. The court's decision did not discuss the materiality of the breach. *See id.*

The Supreme Court of Alaska used a related standard, replacing the justified question with a test that limits withholding to "circumstances which clearly warrant it." Arctic Contractors, Inc. v. State, 564 P.2d 30, 43 (Alaska 1977). These circumstances have included a party's failure to obtain required bonding, *see id.* at 43-44, protection against liability to material suppliers, *see* United States *ex rel.* D'Agostino Excavators v. Heyward-Robinson Co., 430 F.2d 1077, 1085-86 (2d Cir. 1970), *cert. denied*, 400 U.S. 1021 (1971), and a manifest inability to complete the contract, *see* T. Ferguson Constr., Inc. v. Sealaska Corp., 820 P.2d 1058, 1061-62 (Alaska 1991). Under this standard, the court examines a particular situation and balances the policies favoring withholding in that particular circumstance against a general policy of "limiting the right to withhold payments." *Arctic Contractors*, 564 P.2d at 44. For instance, in *Arctic Contractors*, the court balanced "the policy behind limiting the right to withhold payments against the policy behind requiring payment and performance bonds on public contracts." *Id.*

A different standard was applied by the Alaska Supreme Court in *Howard S. Lease Constr. Co. & Assocs. v. Holly*, 725 P.2d 712 (Alaska 1986). The test applied in this case combined the withholding after material breach standard with the justified standard. *See id.* at 715-16. Under this hybrid test, in addition to allowing withholding under the material breach standard, an injured party is justified in withholding such an amount that is necessary to compensate it for the injuries it received as a result of the other party's breach. *See id.* at 715-16. However, this approach assigns the withholding party "the risk of guessing wrong as to . . . whether the [withholding] is valid." *Id.* at 716.

In *Howard S. Lease*, a contractor performed work that was the subcontractor's responsibility under the contract and withheld payment for the cost of that work. *See id.* at 714. The court, calculating the difference between the amount that should have been withheld and the amount actually withheld, found this difference to be $767.11. *See id.* at 716. The court held that this amount was small enough that a wrongful withholding of it was merely a non-material breach of the contract. *See id.* Accordingly, the court denied the subcontractor damages for consequential injuries it suffered because of the withholding. *See id.*

Apparently, in Alaska, withholding is allowed if it qualifies under either of the two standards: the *Arctic Contractors* "circumstances which clearly warrant it" test or the *Howard S. Lease* combination test. *T. Ferguson Construction*, the latest Alaska case to address this issue, applies the *Arctic Contractors* "clearly warrant" test, but notes *Howard S. Lease* and its combination standard. *See T. Ferguson Constr.*, 820 P.2d at 1061 n.10.

The Supreme Court of Alaska has attempted to address the issue of withholding by reaching fair results in the cases which have come before it. However, the tests which these cases spawn provide no coherent scheme by which withholding may be considered. As the Alaska standards have limited applicability, the risks involved with them will not be discussed in part II, *infra*.

3. Election Required

Applying a third approach, some courts have held that a contracting party injured by a material breach cannot withhold payment while demanding continued performance, but must instead make a definite election between two alternatives: cancellation of the contract or affirmance with full performance. If the injured party cancels the contract, it terminates the remaining obligations on both sides. If the injured party affirms the contract, it must continue its own performance in order to require the breaching party to continue its performance as well.[102] Upon affirmance, the injured party may, however, maintain a suit for non-material breach.[103] Under this analysis, an injured party that withheld payment of a material amount would be foreclosed from any remedy for the other party's termination of its performance, because a court would treat the withholding as a cancellation of the contract.[104]

The election standard was applied in *ARP Films, Inc. v. Marvel Entertainment Group, Inc.*,[105] which involved a dispute over the film rights to well-known comic book characters.[106] In this case, ARP brought suit against Marvel, the owner of the rights to the characters, correctly alleging that Marvel's distribution of videocassettes featuring the characters violated ARP's exclusive license to use the characters in films.[107] During the course of the dispute, Marvel sent ARP a letter purporting to terminate this licensing agreement.[108] Despite the receipt of this letter, ARP continued to market its films and collect commissions,[109] but it soon began to withhold the licensing payments which were due Marvel.[110] The court held that by continuing its performance in marketing its films, ARP had made an election to affirm the contract and treat the termina-

102. *See, e.g.*, ARP Films, Inc. v. Marvel Entertainment Group, Inc., 952 F.2d 643, 649 (2d Cir. 1991) (after finding affirmance of contract, holding plaintiff's refusal to pay impermissible).

103. *See* Restatement (Second) of Contracts § 236 cmt. b (1979).

104. *See id.*

105. 952 F.2d 643 (2d Cir. 1991).

106. *See id.* at 646. The defendant, Marvel, had a licensing agreement with the plaintiff, ARP Films, which granted ARP the exclusive right to produce and exploit cartoon films featuring Spiderman and other cartoon characters whose copyrights were owned by the defendant. *See id.*

107. *See id.* When efforts to agree on the videocassette rights failed, ARP sued Marvel alleging that Marvel had breached the licensing agreement. *See id.* Marvel claimed that ARP had no videocassette rights and that ARP had breached the agreement. *See id.* The jury found that ARP had the rights to distribute the videocassettes, *see id.* at 648, a finding that was upheld on appeal. *See id.* at 651.

108. *See id.* at 647. The termination letter operated as a repudiation, which is a material breach of the contract. *See* Calamari & Perillo, *supra* note 10, § 12-4(a).

109. *See ARP Films*, 952 F.2d at 647. The termination letter offered to allow ARP to continue to distribute the films on a "courtesy" and "at will" basis if all procedures under the agreement were followed. *See id.* By continuing to distribute the films and collect commissions, ARP was treating the termination as a non-material breach. *See id.* at 649.

110. *See id.* at 647. ARP also ceased providing Marvel with required reports of their marketing activity. *See id.*

tion letter as a non-material breach.[111] The court found that, having elected to treat the termination letter as a non-material breach, ARP had renounced its ability to withhold payment under the contract.[112] Thus, ARP was not permitted to withhold payment even though it suffered significant injuries as a result of Marvel's breach of the exclusive licensing agreement.[113]

D. *Uniform Commercial Code*

Article 2 of the Uniform Commercial Code takes a liberal view in allowing a buyer of goods to withhold damages resulting from the seller's breach.[114] Given the Code's widespread applicability[115] and broad subject matter coverage,[116] an examination of its withholding provision is useful for providing a counterpoint to the common-law standards. Furthermore, courts often apply UCC solutions to problems that arise in common-law contract settings.[117]

Courts have broadly construed Article 2's withholding provision, section 2-717, to allow withholding when it is commercially reasonable.[118] Under section 2-717 the buyer may deduct from the unpaid purchase

111. *See id.* at 649.

112. *See id.*

113. *See id.* at 648.

The election standard was also applied in *White River Development Co. v. Meco Systems, Inc.*, 806 S.W.2d 735 (Mo. Ct. App. 1991), which involved a dispute between a developer and a general contractor that had contracted to build a condominium complex for the developer. *See id.* at 736. The structures built by the contractor contained significant instances of deficient workmanship, much of it irreparable. *See id.* at 740-41. These problems prompted the developer to withhold payment from the contractor. *See id.* at 737. The court found that the developer's withholding of the payments entitled the contractor to cease its performance, *see id.* at 742, even though the developer's damages from the contractor's breach exceeded the amount withheld. *See id.* at 737, 742.

When the developer withheld payment and demanded that the contractor continue its performance, the court treated the withholding as an election to cancel the contract, excusing the contractor from further performance. *See id.* at 742. Under this decision, the developer withheld damages and tried to have the contractor complete its performance. Because the developer withheld, not completing its performance, the court held that the contractor was entitled not to complete its performance. *See id.* For the developer to have had the contractor complete the job and be fully compensated, it would have had to make full payment to the contractor, without withholding, and sue the contractor for non-material breach.

114. *See* U.C.C. § 2-717 (1990).

115. Article 2 of the UCC has been adopted in every state except Louisiana, as well as the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. Uniform Commercial Code, *Table of Jurisdictions Wherin Code has been Adopted*, 1 U.L.A. 1, 1-2 (Supp. 1993).

116. Article 2 of the Code covers all transactions in goods. *See* U.C.C. § 2-102 (1990).

117. *See, e.g.*, Romig v. deVallance, 637 P.2d 1147, 1152 (Haw. Ct. App. 1981) (applying U.C.C. §§ 2-609, 2-610 to transaction for sale of real estate); *see generally* Daniel E. Murray, *Under the Spreading Analogy of Article 2 of the Uniform Commercial Code*, 39 Fordham L. Rev. 447 (1971) (discussing applicability of UCC to general contract law); Note, *The Uniform Commercial Code as a Premise For Judicial Reasoning*, 65 Colum. L. Rev. 880 (1965) (same).

118. *See, e.g.*, Carbontek Trading Co. v. Phibro Energy, Inc., 910 F.2d 302, 305-06

price all damages resulting from any breach of contract by the seller, provided that sufficient notice is given to the seller.[119] The official comment to that section makes two points: the buyer is allowed to withhold all damages[120] incurred under the same contract,[121] and the buyer must give notice of this withholding to avoid being in default.[122]

(5th Cir. 1990) (allowing of withholding of price reduction for non-conforming coal when alternatives not were commercially reasonable).

119. Section 2-717 of the Code provides: "The buyer on notifying the seller of his intention to do so may deduct all or any part of the damages resulting from any breach of the contract from any part of the price still due under the same contract." U.C.C. § 2-717 (1990).

120. The official comment points out that this section allows the deduction of damages resulting from any breach by the seller. *See* U.C.C. § 2-717 cmt. 1 (1990). This section expands the scope of the earlier Uniform Sales Act withholding provision, which limited withholding to damages from breach of warranty. *Id.*

121. "[T]he breach involved must be of the same contract under which the price in question is claimed to have been earned." *Id.* cmt 1.

122. *See id.* cmt. 2. However, "no formality of notice is required and any language which reasonably indicates the buyer's reason for holding up his payment is sufficient." *Id.*

Most of the case law which interprets this section has been concerned with the points which are raised in the section's official comment. The case law construing this section has held that the buyer must show that it incurred damages based on a breach of contract which was caused by the seller. *See, e.g.*, Columbia Gas Transmission Corp. v. Larry H. Wright, Inc., 443 F. Supp. 14, 19-20 (S.D. Ohio 1977) (holding that evidence of tampering with gas meters was not breach of contract without evidence of who caused tampering). In *Columbia Gas* the court noted that UCC § 2-717 "is not a general set-off provision permitting a buyer of goods to adjust its continuing contract obligations according to the equities perceived by the buyer. The buyer must incur damages from a *breach of contract* before UCC § 2-717 permits it to deduct anything from the contract price . . . ." *Id.* at 20.

In addition, the breach must be of the same contract as that under which the buyer is withholding its damages. *See, e.g.*, Cliffstar Corp. v. Riverbend Prods., Inc., 750 F. Supp. 81, 89 (W.D.N.Y. 1990) (finding contracts for lemon concentrate and tomato paste to be different, even though negotiated at same time); Hellendall Distribs., Inc. v. S.B. Thomas, Inc., 559 F. Supp. 573, 574-75, (E.D. Pa. 1983) (distributorship agreement held to be different contract than contract for sale of goods under distributorship), *aff'd*, 755 F.2d 920 (3d Cir. 1985); Sharp Elecs. Corp. v. Arkin-Medo, Inc., 452 N.Y.S.2d 589, 590 (App. Div. 1982) (same), *aff'd*, 448 N.E.2d 799 (N.Y. 1983).

Further, the buyer must give the seller reasonable and timely notice of its withholding. *See, e.g.*, M.K. Assocs. v. Stowell Prods., Inc., 697 F. Supp. 20, 21-22 (D. Me. 1988) (holding notice improper and when first notice was in answer to complaint); Quaker Alloy Casting Co. v. Gulfco Indus., Inc., 686 F. Supp. 1319, 1344 (N.D. Ill. 1988) (denying withholding when notice of breach was in "reactive counterclaim after suit was filed"); Custom Automated Mach. v. Penda Corp., 537 F. Supp. 77, 86 (N.D. Ill. 1982) (buyer need not explicitly declare amount withheld, but must notify seller that it is withholding because of breach). In *M.K. Associates*, the court found the policies behind timely notice to be "first, to enable the seller to cure or replace, second, to give the seller an opportunity to prepare for negotiation and litigation, and third, to ensure finality." *M.K. Assocs.*, 697 F. Supp. at 21.

Courts often interpret section 2-717's notice requirement in conjunction with the notice requirement found in section 2-607(3), which bars any remedy for breach unless the buyer notifies the seller of the breach within a reasonable time after discovery. *See, e.g.*, *M.K. Assocs.*, 697 F. Supp. at 21-22 (applying §§ 2-717 & 2-607). The comment to that section points out that the notice should "let the seller know that the transaction is still

II. RISK IN WITHHOLDING

Every time a party makes a contract, it faces some uncertainty.[123] Although that party hopes for a successful, profitable contractual relationship, the unexpected may occur.[124]

When a contracting party is faced with a breach of contract by the other party, uncertainties beyond those considered in the contract surface, because the injured party has not received its expected, contracted-for performance.[125] If the breach causes harm, the injured party may not be fully compensated for that harm.[126] Moreover, the breach, even if it is minor, may be an indication of other breaches to come.[127] Further, if the injured party has to make a decision regarding the contract, it may be unsure of the consequences of that decision.[128] The party may not know what legal standard a court will use to determine the propriety of that decision.[129] Even if it does know what legal standard the court will apply, it may be unsure how the court will apply that standard to the par-

troublesome and must be watched" and that notice "opens the way for normal settlement through negotiation." U.C.C. § 2-607 cmt. 4 (1990).

The one other question of interpretation that this section raises is a procedural point. When, after withholding, a buyer sues for breach and the seller counterclaims for the price of the goods, or vice versa, the seller often seeks summary judgment on its claim for the price of goods delivered. Courts have generally denied summary judgment, holding that section 2-717 operates to extinguish the seller's right to the price of the goods delivered to the extent that the seller has caused damages by the breach. *See, e.g.*, Created Gemstones, Inc. v. Union Carbide Corp., 391 N.E.2d 987, 989-90 (N.Y. 1979) (denying summary judgment on counterclaims for price of goods until after trial on claims for breach); Pacific W. Resin Co. v. Condux Pipe Sys., Inc., 771 F. Supp. 313, 316-18 (D. Or. 1991) (holding same and collecting cases on this issue).

123. *See* Alex Y. Seita, *Uncertainty & Contract Law*, 46 U. Pitt. L. Rev 75, 77-83 (1984).

124. *See* Arthur I. Rosett, *Contract Performance: Promises, Condition and the Obligation to Communicate*, 22 UCLA L. Rev. 1083, 1083 (1975).

125. *See* Andersen, *supra* note 24, at 1095.

126. This uncertainty results from many factors: the extent of the damages may not be determinable when the breach occurs; the cost of its effects may not be quantifiable; it may cause irreparable harm for which there is no adequate compensation; and the incidental effects of the breach to the injured party and others may never be known. Even if the harm from the breach may be quantified into a monetary amount, the injured party still may not be fully compensated, as the breaching party may be unwilling to pay immediately the injured party the full amount of its injury.

If the injured party sues for compensation, it still may not be fully compensated: the full amount of the injury may not be compensable as damages at law; the party may incur uncompensated legal expenses; and the litigation may not be fully successful. *See* Seita, *supra* note 123, at 106-08. Even if a judgment is obtained, it may be uncollectable.

The risk engendered by the uncertainty of compensation is analyzed in this Note and referred to as the compensation risk. *See infra* part II.A.1.

127. *See* Andersen, *supra* note 24, at 1096. The risk engendered by the uncertainty of future performance is analyzed in this Note and referred to as the performance risk. *See infra* part II.A.1.

128. *See* Seita, *supra* note 123, at 80.

129. *See* Seita, *supra* note 123, at 109; *supra* note 13 and accompanying text. The risk engendered by the uncertainty of the legal standard to be applied in future litigation is analyzed in this Note and referred to as the rule determination risk. *See infra* part II.A.2.

ticular facts of its case.[130]

When a contracting party confronts a decision about the withholding of payment on a continuing contract, this uncertainty becomes more pronounced. This part analyzes the risks which result from the uncertainties a party encounters when it faces a decision about withholding. This part further examines the ways in which parties react to these risks, and the manners in which the various legal standards distribute, and in some cases amplify, the risks the parties encounter.

A. *Classifications of Risk*

Both an injured party in a position to withhold payment on a continuing contract and a breaching party whose payment may be withheld face significant risks. These risks result from both the hazards of the situation the parties are in,[131] and the perils of the legal consequences of their decisions.[132] These two types of risk may be identified as the situational risk and the legal risk.

1. Situational Risk

a. *Injured Party*

A party, injured by the breach of a continuing contract and considering whether to withhold, faces considerable situational risk. Situational risk is caused by the uncertainties inherent in the situation that the party is in. The injured party's situational risk results from two factors: the risk that it will not be compensated for the breach which has occurred, and the risk that the other party will not complete its performance, further breaching the contract.[133] These two components of a party's situa-

130. *See* Seita, *supra* note 123, at 109-11. The risk engendered by the uncertainty of how a legal standard would be to be applied to a particular factual situation is analyzed in this Note and referred to as the fact application risk. *See infra* part II.A.2.

131. *See infra* notes 133-43 and accompanying text.

132. *See infra* notes 144-50 and accompanying text.

133. *See supra* notes 125-27 and accompanying text.

Professor Andersen has identified two interests which may be impaired when a contract is breached: the interest in present performance and the interest in the likelihood of future performance. *See* Andersen, *supra* note 24, at 1095-1101.

The interest in present performance comes into being when performance is due. When a party breaches, this interest is impaired because the party has not received the performance which it is owed. *See id.* at 1095. The risk that the impairment of this interest will not be compensated is identified in this Note as the compensation risk.

The interest in the likelihood of future performance comes into being when the contract is formed. *See id.* at 1096. When parties form an executory contract, they do so in order to secure the benefits of confidence about probable future performance. This confidence allows the parties to plan for the future. *See id.* at 1096-97. This interest is not limited to the likelihood that the other party will perform. A party may have a substantial interest in being able to plan its future duties. *See id.* at 1097.

When a breach occurs the interest in the likelihood of future performance may be impaired. *See id.* at 1096; *see also id.* at 1099-1101 (examples of how breaches may impair this interest). The risk that this interest may be substantially impaired is identified in this Note as the performance risk.

tional risk may be identified as the compensation risk and the performance risk.

The injured party's compensation risk results from its uncertainty about whether it will be compensated for the damages it has incurred from past breaches. An example of compensation risk may be seen in *K & G Construction.*[134] In that case the contractor faced the risk that it would never be fully compensated for the injuries that it suffered as a result of the subcontractor's breach of its duty to perform in a workmanlike manner.[135] The subcontractor and its insurance company had disclaimed liability for the accident.[136] Though the contractor had a right of action for breach against the subcontractor as soon as the accident occurred,[137] recovery on that action could have taken years and might have cost a great deal in litigation expenses. By that time, any judgment the contractor might receive might be uncollectible.

The injured party's performance risk results from its uncertainty about whether the other party's future performance will be completed as required by the contract. An example of performance risk is evident in *K & G Construction.* After the subcontractor drove its bulldozer too close to the building,[138] the contractor could reasonably conclude that the accident had demonstrated that the subcontractor had a propensity for further equipment mishaps. The question of the subcontractor's ability to complete the job successfully raised by the accident increases the contractor's risk of future deficient performance. The degree of the contractor's performance risk depends on what the subcontractor's remaining duties are.[139] If the remainder of the project involved no work near other buildings, the contractor's increased performance risk probably would be minimal. If the rest of the work were in close proximity to other buildings, the contractor's performance risk could be substantially increased.[140]

134. K & G Constr. Co. v. Harris, 164 A.2d 451 (Md. 1960). For the facts of *K & G Construction*, see *supra* notes 4-11 and accompanying text.

135. *See* Andersen, *supra* note 24, at 1100.

136. *See K & G Constr.*, 164 A.2d at 453.

137. *See* Restatement (Second) of Contracts § 236 cmt. a (1979).

138. *See supra* notes 4-11 and accompanying text.

139. The contractor's insecurity may also be mitigated if it has the right to demand assurance of performance from the subcontractor. *See* Restatement (Second) of Contracts § 251 (1979); U.C.C. § 2-609 (1990). Though the Second Restatement allows an insecure party to demand assurances, the extent to which this right is applied by the courts is unclear. *See* 2 Farnsworth, *supra* note 12, § 8.23, at 491.

140. *See* Andersen, *supra* note 24, at 1100.

Another case in which the performance risk is illustrated is *Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc.*, 340 A.2d 225 (Md. 1975), which is described *supra* at notes 97-101 and accompanying text. In that case, a contractor withheld payment after a subcontractor had repeatedly delayed its performance. These delays were exacerbated when the subcontractor's workers walked off the job in a strike, an action which was not itself a breach of contract. Nonetheless, in that situation there was a great risk that the contractor would never receive its contracted performance, particularly since it was facing a tight deadline in completing the overall project. *See Bart Arconti*, 340 A.2d at 229.

b. *Breaching Party*

A breaching party also experiences significant situational risk. Even without considering the possibility of the injured party's withholding payment, the breaching party will be uncertain whether the injured party will claim a material breach and cancel the contract. If the breach is in fact material, this could discharge the injured party's duty to pay compensation under the terms of the contract.[141] Even if the breach were not material, the cancellation would extinguish the breaching party's confidence in being able to perform as planned.[142] For example, the subcontractor in *K & G Construction* faced increased risk when it breached the contract. The subcontractor's compensation risk was increased because the contractor might not have been required to pay the full contract price in light of the breach. The subcontractor's performance risk also was increased because the contractor might have ordered it off the job due to its faulty work.[143]

2. Legal Risk

a. *Injured Party*

When an injured party is considering withholding payment, it faces the risk that it will be unable to determine the legal consequences of its decision.[144] This risk, the legal risk, results from two factors. The injured party may be unsure what legal rule a court will apply in determining whether its decision to withhold is proper. The injured party may also be unsure how a court will apply the rule selected, given the facts of its case.

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141. When a contracting party materially breaches a contract, it has not substantially performed, and therefore has not fulfilled a constructive condition to the injured party's performance. *See supra* notes 22-26 and accompanying text. Since this condition has not occurred, the breaching party is not entitled to compensation pursuant to the contract. In some jurisdictions, however, the breaching party may be entitled to a quasi-contractual recovery for the work performed. *See* Mills v. Denny Weikhorst Excavating, Inc., 293 N.W.2d 112 (Neb. 1980); Restatement (Second) of Contracts § 237 cmt. a (1979); *see also* Calamari & Perillo, *supra* note 10, § 11-22, at 477 (describing this view as the "modern trend"); *see generally id.* § 11-22 (describing the conflict in the law in this issue); Robert J. Nordstrom & Irwin F. Woodland, *Recovery by Building Contractor in Default*, 20 Ohio St. L.J. 193, 198-204 (1959) (same). Other jurisdictions do not allow for quasi-contractual recovery after a material breach. *See, e.g.*, Russo v. Charles I. Hosmer, Inc., 44 N.E.2d 641, 643 (Mass. 1942) (holding that a contractor that did not substantially perform under the contract was not entitled to quantum meruit recovery).

142. *See* Andersen, *supra* note 24, at 1097.

If the breach were not material the cancellation would be wrongful, but it still would operate as a repudiation of the contract. *See* Calamari & Perillo, *supra* note 10, § 12-2. The canceling party would be liable in damages to the other party for its wrongful cancellation, but the other party would still be unable to complete its contracted performance. *See id.* § 12-3.

143. The breaching party's uncertainty may be increased even further when the injured party's response to the breach is neither a clear cancellation nor a clear waiver of the breach, but an equivocal statement in between. *See* Arthur Rosett, *Partial, Qualified, and Equivocal Repudiation of Contract*, 81 Colum. L. Rev. 93, 93-95 (1981).

144. *See supra* notes 128-30 and accompanying text.

These two elements of a party's legal risk may be referred to as its rule determination risk and its fact application risk.

The injured party's rule determination risk results from its uncertainty as to what legal standard a court will apply in considering the propriety of a decision to withhold payment. Contracting parties are frequently uncertain as to what legal rule a court will determine to be applicable to them.[145] For example, when the contractor in *K & G Construction* decided to withhold, there apparently had been no common-law standard for withholding established in its state.[146] Because of the number of standards which are applied to the question of withholding, and the way in which courts apply these standards, this risk is particularly acute for withholding decisions.[147]

The injured party's fact application risk results from its uncertainty as to how, given a particular legal standard, a court will construe its actions given the facts of its case.[148] This type of risk is also illustrated in *K & G Construction*, where, even if the contractor had been sure that the court

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145. *See* Seita, *supra* note 123, at 109-11.

146. The case was one of first impression in Maryland's Court of Appeals, that state's highest court. In the relevant part of its decision, the court cites no Maryland authorities when it determined that the withholding after material breach standard applies. *See* K & G Constr. Co. v. Harris, 164 A.2d 451, 456 (Md. 1960).

Even if a standard had been determined under that state's law, a court still could apply a different standard in a later case. For instance, when the Maryland Court of Appeals decided *K & G Construction*, it applied a withholding after material breach standard. Fifteen years later, the same court decided *Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc.*, 340 A.2d 225, 233 (Md. 1975), which applied a justified standard. The court in *Bart Arconti* cited *K & G Construction* as the basis for its decision, but nonetheless applied a different standard than was applied in that case. *See id.* at 232.

Sometimes, courts will decide questions of withholding without reference to some of the state's prior decisions on this issue. For example, Texas has two different lines of cases which address the issue of withholding. In *Morgan v. Singley*, 560 S.W.2d 746, 748-49 (Tex. Civ. App. 1978), the Texas Court of Civil Appeals, an intermediate appellate court, applied a justified standard to the question of withholding, citing the Maryland case *K & G Construction*, which applied a withholding after material breach standard. In a later case which did not involve the withholding of payment, but rather a covenant not to compete, *Hanks v. GAB Business Services, Inc.*, 644 S.W.2d 707 (Tex. 1982), the Texas Supreme Court found that the standard in *Morgan* was inapplicable to the case's facts, and applied an election standard for the withholding of the injured party's contractual performance. *See id.* at 708. Subsequently, Texas intermediate appellate courts have applied both *Morgan*'s justified standard and *Hanks*' election standard to cases involving withholding of payment. *Compare* Geotech Energy Corp. v. Gulf States Telecom. & Info. Sys., Inc., 788 S.W.2d 386, 391 (Tex. Ct. App. 1990) (following *Morgan*); Hampton v. Minton, 785 S.W.2d 854, 858 (Tex. Ct. App. 1990) (same) *and* Shafer Plumbing & Heating, Inc. v. Controlled Air, Inc., 742 S.W.2d 717, 719-20 (Tex. Ct. App. 1987) (same) *with* C.H. Leavell & Co. v. Leavell Co., 676 S.W.2d 693, 701 (Tex. Ct. App. 1984) (applying election standard from *Hanks*) *and* Cox, Colton, Stoner, Starr and Co. v. Deloitte, Haskins & Sells, 672 S.W.2d 282, 286-87 (Tex. Ct. App. 1984) (same) *and* Greenstein v. Simpson, 660 S.W.2d 155, 160 (Tex. Ct. App. 1983) (same).

147. *See supra* note 13 and accompanying text.

148. Fact application risk also results when a court will determine the propriety of a party's decision based on information that comes to light after the party makes the decision. An example of this element of risk may be seen in the difficulties involved in determining the proper amount of withholding in *Howard S. Lease Construction Co. & Assocs.*

were going to apply the withholding after material breach standard, it might have been unsure whether the subcontractor's breach would be considered material. If the facts indicated that the breach were material, the contractor would be allowed to withhold; if the breach were not material, the contractor could not withhold. In *K & G Construction*, the court found the breach to be material solely on the basis of the fact that the damages caused were more than double the amount of the progress payment.[149] However, the court could have used a wide range of other factors to determine whether the breach were material.[150]

b. *Breaching Party*

A breaching party faces a similar legal risk when it must respond to withholding by an injured party. Like the injured party, the breaching party is subject to uncertainty as to which legal rule a court will apply to determine whether withholding is appropriate. Similarly, the breaching

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v. Holly, 725 P.2d 712 (Alaska 1986), a case between a contractor and a grading subcontractor, described in detail at note 101, *supra*.

In *Howard S. Lease*, the court calculated the proper amount to withhold, using all of the information the court had at the time of the decision, including information that was unavailable at the time the injured contractor made its withholding decision. *See Howard S. Lease*, 725 P.2d at 716. An examination of the numbers used in this case shows how much fact application risk this calculation places on a withholding party. *See id.*

In the case, the contractor "backcharged" the subcontractor $52,844.89 for work that was contractually the responsibility of the subcontractor but performed by the contractor. *See id.* at 714. The contractor withheld a $35,000.00 progress payment in partial satisfaction of this backcharge, although it eventually paid the subcontractor $10,000.00 of the progress payment. *See id.* Both the trial court and the Supreme Court of Alaska made a calculation of the amount that the contractor was entitled to withhold from the progress payment under a combination withholding after material breach and justified standard. *See supra* note 101.

When the trial court made its calculation, it allowed $44,440.69 of the $52,844.89 as the proper amount of the backcharge. *See Howard S. Lease*, 725 P.2d at 714-15. The trial court allowed counterclaims for other work the subcontractor performed which was not billed until after the withholding, and came up with a net judgment of $26,243.20. *See id.* at 714-16. This net judgment was then reduced upon reconsideration to $18,955.05. *See id.* at 715. The trial court held that withholding was not allowed and the contractor was liable for this net judgment. *See id.*

In reversing the trial court, the Supreme Court of Alaska took a different view of the numbers. It took the $26,342.00 of counterclaims allowed by the trial court and added that to the $35,000.00 withheld to determine what the total payment to the subcontractor should have been, before withholding, $61,342.00. *See id.* at 716. The court then reduced that amount by the 10% that the contract provided would be retained until completion of the project, leaving $55,207.80. *See id.* From that amount, the court determined the excess withholding by deducting the $10,000.00 which was paid to the subcontractor after the withholding and the $44,440.69 which the trial court found to be the appropriate amount to withhold. *See id.* The net excess withholding was found to be $767.11. *See id.* The court found that this amount was so insignificant as to not be the cause of the subcontractor's damages. *See id.* If the court had used any of the other calculations, however, the case might have been resolved very differently.

149. *See* K & G Constr. Co. v. Harris, 164 A.2d 451, 456 (Md. 1960).

150. *See* Calamari & Perillo, *supra* note 10, § 11-18(a), at 459-60; Andersen, *supra* note 24, at 1131-32.

party may not know how a court will interpret the facts of its situation under the rule.

B. *Allocation of Risk by Withholding*

When a contracting party is in a situation of uncertainty, it will often try to mitigate the risk that it faces. One method of reducing risk is to withhold payment due to the breaching party. As previously noted, an injured party faces uncertainty as to whether it will be compensated for the breach and whether the breaching party will properly complete the remainder of its contractual performance.[151] The injured party may decide to respond to the breach by withholding. If it does so, it may reduce some of the elements of risk that it faces. However, by doing so it may increase other elements of its risk and change the risks faced by the breaching party. When a party withholds, it changes the way that the uncertainty is allocated, both among the elements of its own risk and between itself and the breaching party.

When an injured party withholds, it reduces its compensation risk. By immediately retaining money, it may reduce its uncertainty that it will not get that money after a future determination of the damages from the breach. Withholding contemporaneously compensates the injured party for a deficiency in the breaching party's performance.[152]

The reduction in compensation risk is not without cost, however. When an injured party withholds, it faces significant uncertainty as to the legal consequences of its action.[153] This uncertainty may subject it to the costs and risks of future litigation over the propriety of its withholding. In addition, when an injured party withholds, it may face an increase in its performance risks. This increased performance risk results from uncertainty as to whether the breaching party will continue to perform in light of the injured party's withholding.[154]

By withholding, the injured party may cause the breaching party to face increased uncertainty about its own compensation.[155] When payment is withheld, the breaching party may be unsure whether it will be paid the excess of the contract price over the amount of the damages resulting from the breach.[156] Furthermore, the breaching party may dis-

151. *See supra* notes 133-43 and accompanying text.

152. *Cf. supra* note 133 (discussing interest in present performance impaired by breach).

153. *See supra* notes 144-50 and accompanying text.

154. *Cf. supra* note 133 (discussing interest in likelihood of future performance).

The breaching party may cease performance as a result of its own independent decision. However, it may also have difficulty in continuing its performance because it does not have use of the withheld funds, which may cause it to be unable to pay its suppliers. *See* 3A Corbin, *supra* note 19, § 692, at 269-70.

155. *Cf. supra* notes 141-43 and accompanying text (discussing compensation and performance risks of breaching parties without considering withholding).

156. A contracting party obviously would be reluctant to continue contractual performance for which it will never be paid. If the damages exceed the remaining contract price, however, a breaching party will still be benefitted by completing the contract, be-

pute the amount the injured party is withholding.[157]

The breaching party may mitigate its compensation risk by stopping performance and canceling the contract. This would eliminate the breaching party's risk that it would do future work for which it would not be compensated. However, this also forecloses any interest the breaching party has in the opportunity to complete the work.[158]

In addition to changing the compensation risk, a breaching party's cancellation in response to withholding may subject it to significant legal risk. The breaching party may be unsure which legal standard a court would use to determine whether the injured party's withholding is proper. Further, the injured party may be uncertain how a court would apply the facts of the case to the applicable standard.[159] If the breaching party cancels the contract when it is not entitled to do so, it may give the injured party the right to claim further damages.[160]

C. *Parties' Reactions to Risk*

Because of the risks involved, many contracting parties insert provisions into their contracts which seek to protect them by delineating the situations in which withholding is appropriate. For example, it is common to encounter clauses allowing partial retainage[161] until satisfactory completion of the contract,[162] arbitration clauses,[163] backcharge clauses,[164] and clauses allowing withholding in specific situations.[165]

In the construction industry, contract provisions addressing withholding are common. The American Institute of Architects has produced a series of contract documents that are used widely in the industry.[166] Its standard construction agreement between owner and contractor provides

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cause the contractual value of its performance will be deducted from the amount of damages it will be required to pay. Further, the breaching party will not have to pay the increased costs which may be incurred by the injured party by hiring someone else to complete the contract.

157. *See* Andersen, *supra* note 24, at 1122.

158. *Cf. supra* note 133 (discussing interest in likelihood of future performance).

159. *See supra* notes 144-50 and accompanying text.

160. *See* 2 Farnsworth, *supra* note 12, § 8.15, at 436.

161. "Retainage" is a construction industry term describing the percentage of the progress payments due to the contractor retained by the owner to be paid at the completion of the contract. *See* Stewart v. C & C Excavating & Constr. Co., 877 F.2d 711, 713 (8th Cir. 1989).

162. *See, e.g., id.* (clause allowing 10% retainage); K & G Constr. Co. v. Harris, 164 A.2d 451, 452 (Md. 1960) (same).

163. *See, e.g.*, Oak Ridge Constr. Co. v. Tolley, 504 A.2d 1343, 1346 n.3 (Pa. Super. Ct. 1985) (clause requiring arbitration of payment disputes).

164. *See, e.g.*, Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc., 340 A.2d 225, 228 (Md. 1975) (clause requiring subcontractor to reimburse contractor for backcharges).

165. *See, e.g., In re* Nemko, Inc., 143 B.R. 980, 984 (Bankr. E.D.N.Y. 1992) (clauses allowing withholding if subcontractors are not paid or claims are made against owner).

In some situations, parties may wish to disallow withholding. *See, e.g.*, Heinhold Holdings, Inc. v. Geldermann, Inc., No. 89 C 1870, 1991 WL 14068, at *3 (N.D. Ill. Feb 1, 1991) ("no set-off" provision disallowing withholding).

166. *See* Justin Sweet, Sweet on Construction Industry Contracts at v. (1987). The

that the contractor is to submit pay requests to the architect on the project.[167] The architect then issues a certificate of payment for the amount it determines is due, withholding certification for the amount it feels is not due.[168] The owner is then required to pay the contractor the amount that the architect has determined.[169] If the architect and owner do not promptly fulfill their duties of certifying and making payment, the contractor may, on seven days written notice, suspend its performance until paid.[170] Though this contract provision is effective in major construction projects where there is an independent, professional architect who is available to scrutinize each pay request, a similar provision would not be effective for contracts in which there is no similar independent adjudicator available to decide each payment question.

In the absence of a contractual provision dealing with withholding, uncertainty as to the legal consequences of their actions often causes parties to act in ways that do not reflect the optimum minimization of their compensation and performance risks.[171] For instance, in *K & G Construction*,[172] if the subcontractor had admitted liability for the damages from the bulldozer accident, and was unlikely to damage any other buildings, withholding of payment by the contractor would have minimized the contractor's risks. By withholding, the contractor would have immediately secured its compensation from the breach, avoiding the risk of the subcontractor's subsequent insolvency. Further, the contractor would have faced a low risk of the subcontractor ceasing its performance, since the subcontractor's interest would be to continue its performance, avoid damages from the contractor's cost of replacement, and receive the remainder of the payment when the breach damages were worked off. Even under these circumstances, where the situational risks strongly favor withholding, the contractor may nevertheless refrain from with-

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American Institute of Architects construction contracts are approved and endorsed by the Associated General Contractors, a construction industry trade association. *See id.*

167. *See* American Inst. of Architects, *General Conditions of the Contract for Construction* (Doc. No. A201), art. 9, § 9.3.1 (1987) [hereinafter *General Conditions*], *reprinted in* 3 American Inst. of Architects, Architect's Handbook of Professional Practice (11th ed. 1988) [hereinafter Architect's Handbook]. The *General Conditions* document is a statement of terms which is incorporated by reference into the American Institute of Architect's standard construction agreement. *See* American Inst. of Architects, *Standard Form of Agreement Between Owner and Contractor* (Doc. No. A101), at 1 (1987), *reprinted in* 3 Architect's Handbook, *supra.*

168. *See General Conditions, supra* note 167, §§ 9.4, 9.5. The architect may withhold certification in the event the owner is damaged. *See id.* § 9.5.1.5.

169. *See id.* § 9.6.1.

170. *See id.* § 9.7. When this happens, the contractor is allowed the reasonable costs of shut down, delay, and start-up. *See id.*

171. *Cf.* Seita, *supra* note 123, at 103-12 (arguing that legal risk encourages inefficient contract decisions).

172. K & G Constr. Co. v. Harris, 164 A.2d 451 (Md. 1960). In *K & G Construction* the contract at issue had a 10% retainage clause. *See id.* at 452. The amount of damages was, however, far in excess of the retainage amount, so this clause had no effect on the withholding issues.

holding because of uncertainty as to how a court would construe the withholding.

D. *Analysis of Withholding Standards*

Each of the withholding standards previously discussed[173] allocates risk to the parties in different ways by allowing the parties to minimize some risks at the expense of increasing others. By analyzing the way each of these standards deals with the uncertainties of withholding, their costs and benefits may be compared.[174]

1. Withholding After Material Breach

Although the withholding after material breach standard sometimes allows withholding when it is warranted by the risks of the situation, the standard's use of the material breach doctrine occasionally prevents withholding in situations where it would be warranted. This standard provides that after the conduct of one of the parties rises to the level of a material breach, all future breaches are excused.[175] Under this standard, material breach is the dividing line between allowing and prohibiting withholding.

The withholding after material breach standard takes material breach, a doctrine applied to ascertain the fairness of cancellation,[176] and applies

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173. *See supra* part I.C-D.

174. Since this section deals specifically with each of the standards as they are applied, it does not examine the rule determination risk involved when parties are faced with the possibility of more than one of the standards being applied.

175. *See supra* notes 56-74. The principles involved in the withholding after material breach standard, as well as those involved in the other withholding standards, may be illustrated by reference to the well-known children's game "Mommy, he hit me—But, she hit me first" played in automobile back seats across the country. In this game, a brother and sister on a long car trip will annoy each other in a gradually escalating pattern. The brother will make a face at his sister. In response, she will poke him. He will poke her back, whereupon she'll pinch him. He'll kick her; she'll kick him; he'll kick her back harder; and so on.

This game will go on until one of the siblings, in this example the sister, cries out, "Mommy, he hit me." The brother will respond, "But she hit me first." The sister then will retort, "But he kicked me." The brother will explain that she kicked him first, and so on.

In the contractual withholding context, "Mommy" is the court, which must decide which party was in the wrong. Under the withholding after material breach standard, Mommy must decide which party's conduct was the first to cross the line into a material breach of back seat etiquette. Mommy might decide that it is fine to make faces, a little back seat poking and pinching is to be expected, but when the kicking starts, *that's it.* She would then punish the first offender who kicked his or her sibling. The other sibling's actions would be considered excused because they occurred after a material breach.

176. *See* 2 Farnsworth, *supra* note 12, § 8.16, at 442; Andersen, *supra* note 24, at 1139-40. It is impossible to come up with a simple test to determine whether a breach is material. *See* Restatement (Second) of Contracts § 241 cmt. a (1979); Restatement of Contracts § 275 cmt. a (1932); Calamari & Perillo, *supra* note 10, § 11-18, at 459-60. Both Restatements list circumstances to be considered in determining whether a breach is material. Restatement (Second) of Contracts § 241 (1979); Restatement of Contracts § 275 (1932). They each acknowledge, however, that the purpose of the determination is

it to determine the fairness of withholding while demanding continuing performance. Since the doctrine of material breach was developed to determine the fairness of canceling a contract, rather than the fairness of withholding in a continuing contract, the withholding after material breach standard balances the withholding decision on a point which has little relevance to risks of withholding. This discrepancy results in withholding being denied in some cases where it would most effectively reduce the risks that the parties face.[177]

Furthermore, the withholding after material breach standard provides no protection to the breaching party. When the breaching party commits a material breach, all of the injured party's obligations to perform under the contract are discharged.[178] Under this standard, the injured party may evade all of its own performance while insisting on full performance by the breaching party.[179]

Moreover, under this standard, the insufficient protection given to the breaching party causes the injured party considerable performance risk. The injured party is allowed to withhold all payments when the breaching party commits a material breach, thereby reducing the risk that the injured party will not be compensated for the breach. However, by allowing the withholding of all payment upon a material breach, while still requiring the breaching party to complete performance, the breaching party is exposed to a risk of never being compensated for its performance.[180] Since the breaching party, having committed a material breach,

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to answer the question of "when does a failure to perform a promise discharge the duty to perform the return promise for an agreed exchange." Restatement of Contracts § 275 cmt. a (1932); *accord* Restatement (Second) of Contracts § 241 cmt. a (1979) (standard of materiality applied "to further the purpose of securing for each party his expectation of an exchange of performances.").

177. For example, Corbin notes that "[a] builder's nonperformance of a part of the contract may also be so injurious to the owner as to justify him in renouncing the contract wholly, stopping performance, and suing for damages as for a total breach. But many such a nonperformance will justify withholding payment without justifying renunciation." 3A Corbin, *supra* note 19, § 692, at 273.

178. It is a condition of each party's duty to perform under a contract that the other party commit no material breach of a duty due at an earlier time. *See* Restatement (Second) of Contracts § 237. When such a condition fails, it prevents the injured party's performance from coming due. *See id.* cmt. a.

179. *See* Restatement (Second) of Contracts § 237 cmt. b (1979). Though the withholding after material breach standard described in this Note allows unfettered withholding after a material breach, the cases applying the standard have not necessarily gone this far. None of the cases that have allowed withholding under the standard have upheld withholding an amount grossly out of proportion to the injury from the breach. *See, e.g.*, K & G Constr. Co. v. Harris, 164 A.2d 451, 456 (Md. 1960) (approving withholding of $1,494.50 progress payment for $3,500.00 damages); Southeastern Drywall, Inc. v. Yeargin Constr. Co., 214 S.E.2d 303, 306-07 (N.C. 1975) (remanding for consideration of whether withholding of $1,054.62 of total debt of $8,818.23 was material). If an injured party were to withhold an excessive amount, courts might fashion an exception to the material breach standard.

180. The breaching party would have the right to sue the withholding party for the withheld payment, but this right subjects the breaching party to all of the risks, costs, and delays of litigation.

has abrogated its right to payment under the contract, it has little incentive to continue performance.[181] This increases the injured party's risk that the breaching party will not complete performance under the contract.

When the original breach is non-material, the parties face a smaller amount of risk. When the breach is non-material, the injured party may withhold payment as long as the amount is small enough that the withholding itself will not be considered a material breach.[182] Each party is uncertain whether it will eventually be compensated fully for its performance or damages. This risk is somewhat mitigated, however, as the amount of money withheld is limited to amounts that are small enough to be considered merely non-material breaches.

Beyond the situational risks engendered by this standard, a party will often be uncertain about whether a court would find a breach to be material.[183] The withholding after material breach standard depends on a determination of whether a party has committed a material breach. The risk of incorrectly determining the materiality of the breach falls squarely on the shoulders of the party taking action, whether that action is withholding or canceling in response to withholding.[184] In many circumstances, it is difficult to ascertain whether particular conduct constitutes a material breach.[185] Courts have been accused of determining the materiality of breach without any coherence, rationality, or justification.[186] Parties taking action under this standard face a substantial risk that their own estimation of the materiality of the breach, given the facts of the case, will be found to be incorrect in later litigation.[187]

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181. In some states the breaching party may be able to recover the value of its performance, reduced by any damages resulting from the breach, under a quasi-contractual remedy. In some states, however, no recovery is available after a party commits a material breach. *See supra* note 141 and accompanying text.

The breaching party may have some incentive to continue, because if it completes the remainder of the performance under the contract, it avoids liability for the costs the injured party may incur in arranging for substitute performance. *See* 2 Farnsworth, *supra* note 12, § 8.15, at 438.

182. *See supra* notes 67-74 and accompanying text.

183. *See* Rosett, *supra* note 124, at 1087-93.

184. *See* 2 Farnsworth, *supra* note 12, § 8.15, at 435-36; *cf.* Howard S. Lease Constr. Co. & Assocs. v. Holly, 725 P.2d 712, 716 (Alaska 1986) (under combination withholding after material breach and justified standard, "contractor runs the risk of guessing wrong as to whether the subcontractor has not substantially performed"); *supra* note 148 (discussing magnitude of risk).

185. *See* Restatement (Second) of Contracts § 241 & cmt. a (1979); Restatement of Contracts § 275 & cmt. a (1932); Calamari & Perillo, *supra* note 10, § 11-18(a), at 459-61; 2 Farnsworth, *supra* note 12, § 8.16; Andersen, *supra* note 24, at 1074-76, 1081-92.

186. *See* Andersen, *supra* note 24, at 1089-92.

187. The good faith variation, described *supra*, notes 75-82 and accompanying text, is an improvement over the withholding after material breach standard in those few cases in which withholding is based on a difference in contract interpretation. Under the good faith variation, a breaching party who is subjected to withholding based on a good faith difference in contract interpretation by the injured party has a reduced risk that it will not be compensated. Presumably, the withholding party will return the proper compensa-

2. Withholding when Justified

Although the withholding when justified standard represents an attempt by the courts to allow withholding where a party would be reasonably expected to do so, it leaves contracting parties with no direction as to how they should conduct themselves.[188] This standard recognizes the useful nature of withholding and brings it outside of the restrictive limitations of material breach.[189] However, leaving the justification decision entirely up to the finder of fact provides no guidance for parties that want a standard upon which they can base their withholding decisions. Furthermore, this standard may subject the parties to arbitrary and capricious jury decisions, decisions which are not subject to effective review upon appeal.[190]

The justified standard allows the finder of fact the opportunity to examine the situation that the withholding party was in, and determine whether its response was appropriate, given the risks with which it was faced. However, though the finder of fact has the opportunity to consider the risks of the situation, this standard does not require the finder of fact actually to consider those risks, because the finder of fact has uncontrolled discretion as to what it may consider when coming to its decision.

Under this standard, a party has no means to determine whether an action it takes will subsequently be found unjustified. The party has no way to reduce its fact application risk, the risk that the finder of fact will disagree with it as to whether it was justified in withholding.

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tion when and if its contract interpretation is proven incorrect. This should reduce the incentive to terminate and the risk of non-performance. In addition, this standard reduces the withholding party's risk of an incorrect determination of its legal status when it withholds in a good faith dispute over contract interpretation.

188. *See supra* notes 83-101 and accompanying text. The withholding when justified standard may also be explained in terms of the children's game "Mommy, he hit me." *See supra* note 175. Under this standard, Mommy, the court, would decide whether each sibling's previous conduct justified the other's conduct. Mommy might decide that the sister, having been hit, was justified in hitting back. Further, the brother, having been kicked, was justified in hitting in the first place. This would go on until Mommy found the first time a response was out of line with the previous chain, perhaps when the sister poked her brother just because he made a face.

189. This standard may provide some protection for the breaching party, unlike the withholding after material breach standard. *See supra* notes 178-79 and accompanying text. Under the withholding when justified standard, a withholding which exceeds the amount reasonably required to protect the interests of the injured party might be found to be unjustified. There appears to be no case law on this issue, however.

190. Under this standard, an appellate court examining the finder of fact's determination on whether withholding was justified may set aside the verdict only when it meets the strict standard applied to appellate review of factual determinations. For instance, in Texas, an appellate court must "consider only that evidence and the reasonable inference therefrom which viewed in its most favorable light support[s] the jury finding and [it] must reject all evidence or reasonable inferences to the contrary." Shafer Plumbing & Heating, Inc. v. Controlled Air, Inc., 742 S.W.2d 717, 720 (Tex. Ct. App. 1987). Upon consideration of the evidence, the appellate court " 'should set aside the verdict only if it is so contrary to the overwhelming weight of the evidence as to be clearly wrong and unjust.' " *Id.* (quoting Cain v. Bain, 709 S.W.2d 175, 176 (Tex. 1986)).

3. Election Required

The election standard forces a contracting party injured by a breach to choose between two often unattractive alternatives: it may completely cancel all of the performance under the contract and sue for total breach; or it may fully complete its own performance, require the breaching party to finish its performance, and sue for non-material breach.[191] The injured party may not withhold and require the breaching party to continue performance. Neither of these two recognized alternatives acknowledges the benefits of withholding in appropriate situations.[192]

Because the election standard denies an injured party the right to withhold, the party is unable to minimize its risk of incomplete compensation without totally abrogating its performance rights. The injured party must choose between the alternatives of cancellation and full performance, each of which protects only a portion of the party's interests. If the injured party cancels, it reduces its compensation risks, but does so at the expense of totally eliminating each party's interest in the future performance of the contract.[193] If the injured party instead continues its full performance while suing for non-material breach, it does not suffer any additional risk of deficient performance, but it also does not improve its interest in compensation for present injuries.[194]

Under this standard, parties that do not elect to cancel avoid the significant legal risks inherent in cancellation. By refraining from cancellation, they are treating the breach as non-material, a position which generally subjects them to few legal uncertainties.[195] Conversely, parties that cancel the contract face the often substantial risk in determining whether a material breach has occurred.[196]

In sum, though this standard reduces some of the uncertainties pro-

191. *See supra* notes 102-13 and accompanying text. The election standard may also be explained in terms of the game "Mommy, he hit me." *See supra* note 175. In this variation—which, I, as the older brother of a little sister, know well—the brother is not allowed to hit the sister back. (Perhaps a few immaterial breaches, like a poke or pinch, here or there, would not be punished, but he can't *really* hit her.) In this case, the sister is allowed to annoy the brother, kicking or hitting him as long as she wants, until he gets thoroughly fed up and hits her. When the sister cries out, "Mommy, he hit me," Mommy, the court, may respond one of two ways. She may either say to the brother, "You know you shouldn't hit your sister," or say to the sister, "I saw what was happening; you've been bugging your brother for the last ten minutes; you deserved it."

192. One way that a party may partially get around the election standard's disallowance of withholding is to wait until performance is completed, then retain the last payment. This retention of the last payment is, however, outside of this Note's definition of withholding, which requires that there be both payments and performance remaining. *See supra* part I.B.

193. *See supra* note 133.

194. *See supra* note 133.

195. A party is always allowed to take no action in response to a breach, electing to treat it as non-material. However, if the breach is deemed to be a repudiation and the party does not react, the avoidable consequences rule may bar the injured party from recovering some damages that it could have mitigated. *See* Rosett, *supra* note 143, at 94.

196. *See supra* notes 183-87 and accompanying text.

duced by withholding, it does not take into consideration the many situations where withholding represents a valuable compromise between cancellation and a suit for damages.

4. Uniform Commercial Code

In contracts for the sale of goods, section 2-717 of the Uniform Commercial Code grants the buyer an unencumbered right to withhold[197]—a right which is justified by the reduced risk and additional protection present under the UCC.

The uncertainties in the sale of goods context are somewhat different from those that arise under common-law contracts. The risk of inadequate compensation is often lower in contracts for the sale of goods. It is frequently easier to value tangible goods in the market, and therefore assess the damages resulting from a breach, than it is to value services or intangibles.[198] Moreover, the types of remedies available to the buyer are expressly delineated in the Code.[199] The risk of incomplete performance is often lower because the injured party may be able to purchase substitute goods.[200] Furthermore, the notice requirement protects the breaching seller from risk by reducing its uncertainty about the buyer's intentions.[201] In addition, the UCC expressly provides that if a party is

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197. *See supra* notes 114-22 and accompanying text.

198. *See* U.C.C. § 2-714(2) (1990).

199. Section 2-714 sets forth the buyer's damages for accepted goods. It provides that

> (1) Where the buyer has accepted goods and given notification (subsection (3) of Section 2-607) he may recover as damages for any nonconformity of tender the loss resulting in the ordinary course of events from the seller's breach as determined in any manner which is reasonable.
> (2) The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount.
> (3) In a proper case any incidental and consequential damages under the next section may also be recovered.

U.C.C. § 2-714 (1990). Section 2-715 allows for incidental and consequential damages. It provides that

> (1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.
> (2) Consequential damages resulting from the seller's breach include
> (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and
> (b) injury to person or property proximately resulting from any breach of warranty.

U.C.C. § 2-715 (1990). Other sections cover the buyer's remedies when the seller repudiates or the buyer rejects the goods, *see* U.C.C. §§ 2-711 to 2-713 (1990), and the buyer's right to specific performance or replevin, *see* U.C.C. § 2-716 (1990).

200. *See* U.C.C. 2-712 (1990).

201. The notice requirement serves to give the parties an opportunity to resolve their

insecure about the performance of the other party, the insecure party may demand assurances of due performance.[202]

The risk that the parties face under the UCC is enhanced, however, by the unavailability of cancellation. Goods that do not conform to the contract specifications of the buyer may be accepted by the buyer,[203] and the acceptance of these goods may occur even when the buyer does not know of their non-conformity or defects.[204] Goods that are accepted must be paid for,[205] and acceptance can only be revoked in limited circumstances.[206] The risk of loss caused by the unavailability of cancellation is offset however, by the buyer's right to make good faith withholding of payment upon breach.[207]

The uncertainties relating to how a court will view withholding under this section of the UCC are minimal. Every state except Louisiana has adopted section 2-717,[208] providing a uniformity in the standard that is applied. Only a small proportion of cases involving withholding for goods would implicate the three questions of interpretation which courts have addressed: the existence of a breach, whether the breach was of the same contract, and whether notice was given in a timely manner.[209] Aside from the uncertainty engendered in these few questions, there is little uncertainty in the legal application of this section, as courts have consistently applied this section in the manner in which it is written.[210]

The Uniform Commercial Code section 2-717 withholding standard is a good solution within the limited context in which it operates—the sale of goods—though it would provide insufficient protection to the parties if it were applied in the broader context of common-law contracts. Even

difference through negotiation and settlement. *See* U.C.C. § 2-607 cmt. 4 (1990); *see also supra* note 122 (examining courts' interpretations of U.C.C. § 2-717's notice requirement); *see generally* Rosett, *supra* note 124 (advocating duty of communication between contracting parties).

202. *See* U.C.C. § 2-609 (1990).

203. *See* U.C.C. § 2-601 (1990).

204. *See* U.C.C. §§ 2-602(1), 2-606(1) (1990); *See also* Intervale Steel Corp. v. Borg & Beck Div., 578 F. Supp. 1081, 1085-87 (E.D. Mich. 1984) (finding that buyer had accepted non-conforming goods even though buyer did not know of defects in the goods), *aff'd*, 762 F.2d 1008 (6th Cir. 1985).

205. *See* U.C.C. § 2-607(1) (1990).

206. *See* U.C.C. § 2-608 (1990).

207. In addition, a party that is injured by a breach of a installment contract may be entitled to cancel the remaining installments of the contract. Section 2-612 of the Code covers installment contracts. *See* U.C.C. § 2-612(1) (1990). It provides that it is a breach of the whole contract when "non-conformity or default with respect to one or more installments substantially impairs the value of the whole contract." *See* U.C.C. § 2-612(3) (1990).

208. *See* Uniform Commercial Code, *Table of Jurisdictions Wherin Code has been Adopted*, 1 U.L.A. 1, 1-2 (Supp. 1993).

209. *See supra* note 122 and accompanying text.

210. *See* Carbontek Trading Co. v. Phibro Energy, Inc., 910 F.2d 302, 305 (5th Cir. 1990); Intervale Steel Corp. v. Borg & Beck Div., 578 F. Supp. 1081, 1088 (E.D. Mich. 1984), *aff'd*, 762 F.2d 1008 (6th Cir. 1985); Custom Automated Mach. v. Penda Corp., 537 F. Supp. 77, 86 (N.D. Ill. 1982).

though it is fair to allow the buyer of goods to withhold, considering the protections that Article 2 of the UCC provides, generally allowing injured parties to withhold for all common-law contracts would be unfair without providing the breaching parties additional protection. Nonetheless, some of the ideas contained in this code section would be useful if they were carried over into general contract law.[211]

III. Proposed Standard

A. *Requirements for an Improved Standard*

This section examines the requirements for an improved withholding standard that may be applied to general common-law contracts to determine the propriety of a party's withholding of payment upon another party's breach of a contractual obligation. All of the standards now applied by the courts fail to meet the needs of contracting parties. None of them succeed at meeting the challenge of effectively minimizing the risks faced by both the injured and the breaching parties.

An improved standard for withholding would minimize the risks faced by the parties. It would allow the injured party to withhold damages resulting from a breach of contract, reducing the risk of not being compensated for the breach. It would also encourage the breaching party to continue to fulfill its contractual obligations, minimizing the risk of incomplete performance. The standard would, however, need to provide protection for the breaching party, so that the reduction of risk to the injured party is not at the expense of significantly increased risk to the breaching party.[212] Further, the improved standard must discourage withholding that is made in bad faith or for an improper purpose.[213]

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211. For example, a requirement of notice may be beneficial in a common-law withholding standard. *See infra* notes 214-15 and accompanying text; *cf.* Murray, *supra* note 117 (discussing general applicability of the Code to common-law contracts).

212. This proposed standard attempts to minimize the risks faced by both of the parties. It attempts to avoid mitigating the risks of one party at the expense of disproportionately increasing the risks of the other.

Other standards allocate the risk differently. For instance, the election standard places a significant portion of the risk on the injured party. Under that standard, the injured party must choose between full performance, which allows no reduction of the compensation risk, and cancellation, which allows no reduction of the performance risk. *See supra* part II.D.3.

Under a law and economics analysis, the risk might be allocated according to the parties' relative aversions to risk. *See* A. Mitchell Polinsky, An Introduction to Law and Economics 119 (1983). However, under a standard of general applicability, the relative risk aversions of the parties will not be known.

Under a punitive standard, the majority of the risk should be allocated to the breaching party, as the one who caused the damages in the first place. However, this does not take into account that breaches often occur through no willful action of the breaching party. Further, this does not take into account the interest each of the parties may have in having a fair contract law system which encourages parties to cooperate to solve their contract problems, rather than to behave oppressively and punitively toward those who do not complete their contractual obligations.

213. A general requirement of good faith is often imputed into the performance of

An improved standard should also encourage the parties to resolve their differences through communication, negotiation, and settlement rather than through the costly, risky processes of cancellation and litigation.[214] The standard should provide for each party to give the other notice of its actions, so as to open the door for communications and reduce the risk of misunderstanding.[215]

In addition to reducing the risk inherent in the situation, an optimal test for withholding should minimize the risk that the parties will be unable to identify the results of a legal determination of their situation. The legal standard must be clearly identified and specified to reduce the uncertainty as to the rule to be applied. This could be done through legislation or decisional law, and can be done in the case of individual contracts through terms within the contract. In addition, the risk of incorrectly determining the legal positions of the parties should be minimized by clear standards that are ascertainable by the parties when they withhold based on information that they have at that time.

An improved standard must not sacrifice fairness for legal definiteness, however. The standard must provide enough flexibility to apply to a wide variety of situations. It must further prevent a party from avoiding the spirit of the rule through strict adherence to its letter. This flexibility is provided by gauging the standard on the reasonable conduct of the contracting parties.[216]

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contracts. *See* Restatement (Second) of Contracts § 205 & cmts. (1979); Calamari & Perillo, *supra* note 10, § 11-38; *see generally* Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 Cornell L. Rev. 810 (1982) [hereinafter Summers, *General Duty*] (discussing good faith in contract law); Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195 (1968) (same). However, no single, adequate definition of good faith has ever been proposed. *See* Summers, *General Duty*, *supra*, at 829-30. The Second Restatement, while noting that good faith varies with the context in which it is used, does attempt to give some shape to its definition by pointing out examples of what is not good faith. Restatement (Second) of Contracts § 205 cmt. a, illus. 1-7 (1979); *see also* Summers, *General Duty*, *supra*, at 820-35 (describing the Restatement's "excluder" analysis and arguing for its validity). The Second Restatement notes that bad faith has been recognized in subterfuges, evasions, inaction, "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance." Restatement (Second) of Contracts § 205 cmt. d (1979).

214. *See* Rosett, *supra* note 124 *passim* (discussing benefits of communication between contracting parties in disputes and arguing that courts should consider the communication between the parties as a factor in judging their conduct); Rosett, *supra* note 143 *passim* (encouraging communication between parties in cases of repudiation and urging that courts take notice of that communication).

215. *See* Rosett, *supra* note 124 *passim*; *see also* U.C.C. § 2-607 cmt. 4 (1990) (notice "opens the way for normal settlement through negotiation"); *cf.* U.C.C. § 2-609 (1990) (allowing parties to request assurances of due performances). Notice is discussed in several of the cases dealing with withholding. *See, e.g.*, Arctic Contractors, Inc. v. State, 564 P.2d 30, 42-43 (Alaska 1977) (requiring notice before withholding); *see also* 2 Farnsworth, *supra* note 12, § 8.15, at 440 n.17 (noting that withholding after material breach standard does not require notice).

216. *See* 1 Farnsworth, *supra* note 12, § 3.28; E. Allan Farnsworth, *Good Faith Per-*

B. *Proposed Standard*

This section sets forth a proposed standard that may be applied to determine when withholding should be allowed. This standard is designed to cover a wide range of situations, minimize the risks faced by the parties, and encourage the parties to communicate in hopes of settling differences. It is intended to be applied by courts when parties have not specified the terms of withholding within their contract.[217] It may also be enacted by a legislature as a statutory default rule.[218] It is, however, phrased as a paragraph which may be included by parties within a specific contract, since, until a standard is universally applied, parties may wish to protect themselves by including a withholding rule within their contracts. This standard may, in addition, be implemented by statute or judicial action with slight modification. The notes accompanying the standard provide an analysis and explanation of how each section operates.[219]

WITHHOLDING OF PAYMENT

In the event of a breach of this contract, a party injured by such breach may withhold payment in compensation for such breach according to the provisions of this paragraph:[220]

1. *Scope:* This paragraph shall apply to the withholding of payment under this contract where the contractual obligations of each of the parties are not terminated. It shall not limit the rights of the parties to cancel the contract and all remaining obligations of each party in the event of a "material" breach of the contract, except that a canceling party must give express notice that it is canceling the contract, and not

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formance and Commercial Reasonableness under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666 (1963).

The concept of commercial reasonableness has been used extensively within the Uniform Commercial Code. *See, e.g.*, U.C.C. § 1-204 (1990) (defining reasonable time). Accordingly, reasonable withholding can be determined by reference to the cases which have interpreted the Code's withholding provision. *See* Carbontek Trading Co. v. Phibro Energy, Inc., 910 F.2d 302, 307 (5th Cir. 1990); Intervale Steel Corp. v. Borg & Beck Div., 578 F. Supp. 1081, 1088 (E.D. Mich. 1984), *aff'd*, 762 F.2d 1008 (6th Cir. 1985); Custom Automated Mach. v. Penda Corp., 537 F.Supp 77, 84 (N.D. Ill. 1982).

217. Even though the standard is set forth as a series of detailed procedures, a court need not insist on full performance of the details of that procedure. Substantial compliance with the concepts contained within the procedure would be sufficient.

218. Legislatures are generally reluctant to interfere with the operation of common-law contract principles. *But see, e.g.*, N.Y. Gen. Oblig. Law § 5-1109 (McKinney 1989) (providing for irrevocability of written offer made without consideration). However, this standard could be set out as a statutory safe harbor to protect a withholding party that follows its procedures.

219. These notes, with minor modifications, may be used as an official commentary to a statutory enactment of this standard.

220. This standard only address the right of an injured party to withhold payment in the event of a breach. It does not cover the right of an injured party to withhold any other measure of performance under the contract. There are many situations where the withholding of part performance in response to a breach would be appropriate, and the standard may be modified to take those situations into account.

withholding under this paragraph.[221]

2. *Definitions:* The "Injured Party" shall be the party which has suffered damages from a breach. The "Breaching Party" shall be the party which has committed such breach; the Breaching Party shall remain so designated even if the injured party has withheld in violation of the terms of this paragraph, thereby committing a breach itself. The "Estimate" shall be the estimate of the damages proximately caused by the breach computed pursuant to subparagraph 3 of this paragraph.[222]

3. *Estimate:* Prior to withholding, the Injured Party shall make an Estimate of the reasonable amount of damages caused by the breach of the Breaching Party. Such Estimate shall generally be computed with reference to the damages which would be recoverable for the breach under applicable legal and equitable rules. However, if the breach was of a provision that was to provide the injured party with security for performance or against claims, the Estimate may be for the amount such security was reduced. The Estimate shall be made using all information reasonably available to the Injured Party at the time it is made. The Injured Party shall not be liable for an Estimate which, based on information that was not reasonably available to the Injured Party at the time of the Estimate, is later determined to be unreasonable, unless the Estimate is not updated pursuant to subparagraph 7 of this paragraph.[223]

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221. This section points out the difference between cancellation and withholding. It provides that the standard does not interfere with the common-law right of cancellation. This right is also known as the right of "recision" or "termination." *See supra* note 12. However, any party that wants to cancel the contract must give express notice of the cancellation. This notice will avoid situations where a party is unsure whether another party is canceling the contract or merely withholding payment.

222. This section describes the parties using definitions which are consistent with those used in this Note. *See supra* note 2. In addition, it defines the "Estimate" which is provided for in the next section.

223. This section requires the injured party to make a reasonable estimate of its damages before withholding payment. Explicitly requiring such an estimate to be made points out to the injured party the difference between withholding and cancellation. Under withholding, the injured party may only withhold the amount of its damages; under cancellation, the party may cease making all future payments. *Cf.* Andersen, *supra* note 24, at 1120-22 (arguing that retention of excess amounts after cancellation should be prohibited).

The reasonable amount to be withheld would normally be computed with reference to the legal damages which would be recoverable in an action on the breach. However, when the breach is of a term of the contract which is intended to provide security for the injured party, such as a payment bond requirement, it would be reasonable for the injured party to withhold the amount of that reduced security. *Cf.* Arctic Contractors, Inc. v. State, 564 P.2d 30, 42 (Alaska 1977) (finding withholding warranted when required payment bond fails); *General Conditions*, *supra* note 167, § 9.5.1.6 (allowing architect to reduce amount of payment certification when subcontractors have not been paid, thereby allowing owner to withhold payment to contractor).

The estimate must be made considering all of the information reasonably available to the injured party at the time of estimate, and the injured party should not be liable if subsequent information comes to light which would indicate that the amount estimated was incorrect. However, any subsequent information would have to be included in later updates of the estimate of the damages, as required in subparagraph 7. *Cf.* *supra* note 148 (showing complexity of calculation of proper withholding using subsequent information).

4. *Withholding:* The Injured Party may withhold up to the amount of the Estimate from any payments due to the Breaching Party. If, at any time, the amount due the Breaching Party exceeds the amount of the Estimate, the Injured Party shall pay the Breaching Party the excess at the time the payment would otherwise be due.[224]

5. *Notice:* The Injured Party shall give written notice of the withholding to the Breaching Party at the time and place which would have been required for payment, or a reasonable time thereafter (but if this contract has a provision that the time for payment is "of the essence," then notice shall be given by the express time required for payment). Such notice shall indicate that the Injured Party is withholding payment and the reasons therefor. It shall also indicate the amount of the Estimate of the damages which will be withheld to compensate it for the breach and how such amount was computed.[225]

6. *Continued Performance:* The Breaching Party shall be required to continue performance of all of its obligations under the contract unless the withholding is of an unreasonable amount or not made in good faith. A withholding which is unreasonable in amount or not in good faith shall be a material breach of the contract, but the Breaching Party must notify the withholding party of its intent not to complete performance, and give the withholding party a reasonable opportunity to modify the withholding, before ceasing performance and canceling the contract. If the Breaching Party cancels after complying with the notice requirements of this subparagraph, the Injured Party shall have the burden of proving that its withholding was reasonable and in good faith. If, after being notified that the Injured Party is withholding under this paragraph, the Breaching Party cancels without giving the notice required by this subparagraph, it shall be considered to have materially breached the contract and any breach by the Injured Party in improperly withholding shall be excused.[226]

7. *Duty to Update Estimate:* The Injured Party shall have a continu-

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This provision reduces the injured party's fact application risk by foreclosing judicial determinations based on information which was not available to the party at the time of the decision. *See supra* note 148.

224. This section allows the injured party to withhold up to the amount of the estimate from payments due to the breaching party. However, it explicitly requires that amounts due in excess of the estimate shall be paid over to the breaching party. The provisions of this section reduce the breaching party's risk that it will not be compensated after it has performed enough to cover the breach. *Cf. supra* notes 178-79 and accompanying text (describing risk of non-compensation under withholding after material breach standard).

225. This section requires that the injured party give the breaching party full notice of the terms of the withholding at the time when payment would be required (including a reasonable time thereafter if the contract does not provide that the time for payment is of the essence). This reduces the performance risk of both parties because the breaching party, knowing the terms of the withholding, is more likely complete its performance. *Cf.* Rosett, *supra* note 143, at 94 (discussing risks to parties when unsure of terms of repudiation). Further, it encourages the parties to communicate and negotiate, rather than cancel and litigate. *See supra* notes 214-15 and accompanying text.

226. This section provides that the breaching party must generally continue its performance after the withholding. It provides that a proper withholding does not affect the obligations of the breaching party. This section, however, allows a limited exception with

ing duty to update the Estimate of the damages at reasonable intervals. Such updates shall be based on additional information as it becomes reasonably available to the Injured Party. If the Breaching Party presents a written request for an adjustment of the Estimate, the Injured Party shall, within a reasonable time, provide a written response to such request. In the event of cure of the breach or a reduced Estimate of the damages from the breach, the Injured Party shall promptly pay the Breaching Party the excess withheld amount.[227]

C. *Discussion of Standard*

The standard outlined above provides for the good faith withholding of an amount reasonably necessary to compensate an injured party for a breach of contract. Each party receives notice of the actions of the other party. The injured party must have a reasonable basis for the withholding, and such basis must be promptly communicated to the breaching party. The breaching party may cancel the contract for an unreasonable or bad faith withholding only after providing the withholding party with notice and an opportunity to respond. This standard incorporates some

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specific conditions that must be satisfied before the breaching party may cease its performance.

This section reduces the risk to the injured party that the breaching party will not perform. However, it provides an outlet that allows the breaching party to cancel in the face of an unfair withholding.

The breaching party may cancel in the face of a withholding which is unreasonable in amount or not made in good faith, but only after it has given notice that it intends to cancel, and has allowed the injured party a reasonable time to respond. This notice prior to cancellation serves the same purposes as the notice of withholding that is required pursuant to subparagraph 5.

If the breaching party gives notice and cancels, the burden of proof of the reasonableness and good faith of the withholding is put onto the injured party. This provides a disincentive for an injured party to withhold when it cannot demonstrate that it has done so reasonably and in good faith. This counterbalances the power that the injured party has to be the judge of its own remedy.

If the breaching party cancels without giving notice, it will be thereby considered to have materially breached the contract. The injured party will then be excused from any breaches it may have committed in withholding. This emphasizes the importance of the requirement that the parties communicate before cancellation.

227. This section provides that the injured party has a continuing obligation to reevaluate the amount that it is withholding, as new information about the damages becomes available. Any excess that is withheld after revision of the estimate must be promptly paid to the breaching party. This continuing obligation reduces the breaching party's risk of not being compensated if it takes action to cure or mitigate the breach.

The injured party is only obligated to revise its estimate at reasonable intervals. What would be considered reasonable intervals would be determined by reference to the amount and pace of information relevant to the withholding received by the withholding party. It would also be influenced by the duration of the contract and the intervals at which payment was normally made.

The injured party will not be liable if it does not reduce its withholding as soon as information suggesting reduction is received, but must merely do so within a reasonable time thereafter. However, the breaching party may, at any time, make a written request that the estimate be adjusted. The injured party must promptly respond to such request in writing, or, if appropriate, pay the breaching party the requested amount.

of the provisions of the UCC standard and makes refinements which allow it to apply to general contracts. If this standard is followed, it will prevent many of the contractual disputes that would otherwise cause agreements to become enmeshed in litigation.

The standard reduces the risks the parties face due to the uncertainties attending their situation. The injured party is allowed to withhold an amount sufficient to provide compensation for the damages it has incurred, but no more. So long as this withholding is reasonable and in good faith, the breaching party will be required to complete its performance. The breaching party is assured that it will be compensated for the value of the performance that it provides in excess of the damages for the breach. Further, it has assurances that its continuing performance is demanded. Each party has clear notice of the actions of the other party, so misunderstandings are reduced and negotiation and settlement is encouraged.

Further, the standard minimizes the risk of legal uncertainties. The uncertainty as to the governing legal formulation is reduced because the standard provides a clear enumeration of the duties of the parties. By proceeding in a reasonable, good faith manner,[228] and giving notice of and the reasons for their actions, the parties can minimize the risk that courts will interpret the facts of their case in an unexpected manner.[229]

CONCLUSION

A party injured by a breach of a continuing common-law contract faces considerable confusion in the rules governing its right to withhold payment without jeopardizing its ability to require the breaching party to perform fully its remaining contractual obligations. This confusion subjects both parties to risks that they might not otherwise face. Until the law becomes settled in this area, contracting parties must protect them-

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228. The precise boundaries of reasonable, good faith behavior are, of course, impossible to delineate. *See* Summers, *General Duty*, *supra* note 213, at 820-24. Some examples concerning withholding, however, are useful to illustrate the concept. In *K & G Construction Co. v. Harris*, 164 A.2d 451 (Md. 1960), it was reasonable for the contractor to withholding a $1,484.50 progress payment after a bulldozer accident causing $3,400.00 in damages. In *M & W Masonry Construction, Inc. v. Head*, 562 P.2d 957 (Okla. Ct. App. 1976), it was unreasonable for a contractor to withhold all progress payments to a masonry subcontractor because of brickwork containing some crooked bricks and some faulty head joints. In *Golf Carts, Inc. v. Mid-Pacific Country Club*, 493 P.2d 1338 (Haw. 1972), there was a good faith withholding when a licensee withheld the amount to which it thought it was entitled under an oral modification which was later found ineffective. In *Smith v. Empire Sanitary District*, 273 P.2d 37 (Cal. Dist. Ct. App. 1954), an owner's withholding of payment to a contractor because it was without funds was found to be in bad faith.

229. There are, of course, some detailed determinations which must be made at the boundaries of the standard. As the standard defines the conduct of the parties in terms of reasonable behavior, the cases which push the limits of the standard must be decided on their facts. The standard, however, will provide for effective determination of many of the questions which have arisen under the present standards. *See supra* part II.D.

selves from these risks by addressing the issue of withholding within their agreements.

Courts and legislatures must move toward a clear expression of a single coherent withholding standard that minimizes the risks that parties face when they withhold. This standard must be fair to all parties to the contract, as well as encourage communication between them. In addition, it must allow the parties to understand their legal positions and clearly outline the ways in which the parties may proceed. Finally, the standard selected must expressly define the rights and responsibilities of the contracting parties, so that when they confront a situation in which withholding is appropriate, they are well prepared to make an informed choice.