"REVERSE DIVISIBILITY" AND "SUBSEQUENT MODIFICATION": EXPANDING THE SCOPE OF JUSTIFIED NON-PERFORMANCE IN MULTIPLE CONTRACT SITUATIONS

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INTRODUCTION

Parties to a contract sometimes invoke divisibility arguments in an attempt to recharacterize the contract as being two or more separate contracts. This is often done in order to limit the justified non-performance consequences of a breach of contract on their part. This short article considers the often-overlooked symmetrical possibility of a non-breaching party attempting to recharacterize two or more facially separate but closely related contracts as a single contract, expanding the scope of their justified non-performance rights after one contract is breached. I describe two complementary arguments justifying such a single-contract recharacterization of the relationship as the "reverse divisibility" and "subsequent modification" arguments. Under some circumstances, they have substantial merit and may prove advantageous to the person asserting them.

DISCUSSION

One of the basic concepts that all law students learn about in their introductory contract law course or courses is "divisibility"—the idea that what appears to be a single contract can sometimes be recharacterized as two or more related but separate contracts among the contracting parties.[2] A person who has breached a contract can sometimes successfully argue that the agreement should be recharacterized as consisting of multiple contracts with the various

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2. "If the performances to be exchanged under an exchange of promises can be apportioned into corresponding pairs of part performances so that the parts of each pair are properly regarded as agreed equivalents, a party's performance of his part of such a pair has the same effect on the other's duties to render performance of the agreed equivalent as it would have if only that pair of performances had been promised." RESTATEMENT (SECOND) OF CONTS. § 240 (AM. L. INST. 1981). In symmetrical fashion, a party's non-performance of their duties under such a paired performance apportionment would only justify the other party's non-performance of their paired duties, not their other duties.

obligations of each party compartmentalized into separate paired exchanges.[3] An important consequence of invoking divisibility is that it may limit the scope of the non-performance of contractual obligations by a non-breaching party that is justified by a contractual breach.[4]

A contractual breach can have harsh consequences for the breaching party, not only liability for damages but also sometimes justifying the non-performance of the other party or parties' contractual obligations altogether,[5] resulting in a substantial forfeiture of the value of benefits that have been conferred by the breacher prior to the breach. But if the contract is regarded as divisible into multiple separate contracts, then the non-breaching party or parties would only be justified in terminating (at most)[6] their performance of those obligations that are paired with the breached obligations in that particular breached contract and not justified in terminating their contractual performances under the other contracts.[7] This will often significantly reduce the forfeiture consequences imposed upon the breaching party.

The basic principles of divisibility that define the circumstances under which a single contractual agreement can be recharacterized as multiple separate contractual agreements are well established.[8] However, in my experience, little if any attention is paid in law school, case law, or in lawyerly advice to the possibility of a person arguing for what one might call "reverse divisibility," a recharacterization of a set of closely related (although facially separate) contracts among two or more parties as being a single contract.[9]

Sometimes a set of separate agreements among parties are simultaneous or nearly so in their execution and are so interrelated

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3. *Id.*

4. *Id.*

5. Commonly, the conditionality of obligations under a contract is implied as a matter of law rather than express or implied on the basis of evidence of the parties' intent. Under these circumstances, a person attempting to justify their non-performance based on the other party's breach would generally be required to demonstrate that the other person failed to "substantially perform" their obligations, i.e., that their breach was "material." *See, e.g.*, E. ALLAN FARNSWORTH, CONTRACTS 548 (4th ed. 2004).

6. *Id.*

7. *See supra* note 2.

8. *See, e.g.*, FARNSWORTH, *supra* note 5, at 553–56; JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 106(D) (5th ed. 2011) (each treatise citing and discussing RESTATEMENT (SECOND) OF CONTS. § 240 (AM. L. INST. 1981)).

9. The phrase "reverse divisibility" has sometimes referred to treating an entire contract as divisible to allow partial rescission or partial enforcement when there has been a breach. *See, e.g.*, Keller v. Arrieta, No. 20-CV-0259-KG/SCY, 2022 U.S. Dist. LEXIS 87140 (D.N.M. May 13, 2022). I think that this is an inapposite use of the phrase, and I use this phrase in this article to instead refer to characterizing two or more facially separate but closely related contracts as a single contract.

in their obligations that it obviously makes no sense to view them in isolation from one another; instead, they are best regarded as a single contractual agreement. And just as some might wish to invoke divisibility arguments to *limit* the justified non-performance consequences of a breach of contract on their part, others may wish to have a set of facially separate but closely related contracts recharacterized as being a single contract to *expand* the scope of their justified non-performance rights after another party breaches the contract.

The costs avoided by a justified termination of performance by a party after a breach of the contract by another party would be offset from the damages that the party recovers from the breaching party.[10] Therefore, under some circumstances, there would be no net benefit to an injured person, with regard to the amount of their recovery, in expanding the scope of their justified non-performance through obtaining a single contract characterization of the relationship since any increase in their costs thereby avoided would then be offset against their damages award. However, in those instances where the avoided costs from a justified termination of performance will exceed the amount of damages that are both awarded and are recoverable as a practical matter—and particularly in those many instances where the breaching party has no resources at all available to pay a damages award—being able to terminate one's performance without liability will be the only way for the non-breaching party to reduce their losses resulting from the breach. Under those circumstances, their obtaining a single contract characterization of the relationship justifying their non-performance of all their remaining obligations will prove advantageous to them.

Virtually all of the many judicial opinions addressing divisibility issues do so in the context of arguments regarding whether a facially single contract can be properly recharacterized as being multiple separate contracts and not whether multiple facially separate related contracts can be recharacterized as a single contract.[11] But there is

10. RESTATEMENT (SECOND) OF CONTS. § 347 (AM. L. INST. 1981).

11. *See, e.g.*, *In re* Nickels Midway Pier, LLC, 255 F. App'x. 633, 636 (3d Cir. 2007). *But see, e.g.*, United States v. Bethlehem Steel Corp., 315 U.S. 289, 298 (1942) ("Whether a number of promises constitute one contract or more than one is to be determined by inquiring 'whether the parties assented to all the promises as a single whole, so that there would have been no bargain whatever, if any promise or set of promises were struck out.'" (quoting WILLISTON ON CONTRACTS, § 863 (Rev. Ed.))); Papago Parago Partners, LLC v. Three-Five Sys., No. CV 06-2448-PHX-FJM, 2007 U.S. Dist LEXIS 48041 (D. Ariz. July 2, 2007), at *6–7 (citing approvingly to *Bethlehem Steel* on this point); Harris v. Dial Corp., 954 F.2d 990, 993 (4th Cir. 1992) (stating that the intent of the parties at the time of the agreements determines whether there is one or instead two contracts, and holding the two agreements in that case were "inseparably intertwined" so that "there was only one contract" between the parties); Morgan v. Firestone Tire & Rubber Co., 201 P.2d 976, 980 (Idaho 1948) (quoting 3 WILLISTON ON CONTRACTS 2422 (Rev. Ed.)).

nothing that prevents considering the same factors used to assess the divisibility of a single contract into separate contracts, so as to limit the scope of justified non-performance after a breach, in the context of arguments to combine facially separate contracts into a single contract so as to expand the scope of justified non-performance. There is also some related authority supporting a set of closely related contracts being characterized as a single contract under some circumstances for contract interpretation purposes,[12] as well as in certain specialized contexts where a set of facially separate agreements being characterized as a single contract can have other important practical consequences unrelated to contract interpretation or the application of the doctrine of conditions.[13]

Under some circumstances, one could also justify reaching a single contract characterization regarding a set of facially separate contracts without asserting a reverse divisibility theory. One could instead concede that there are two or more separate contracts but then argue that the earlier of these contracts was then modified in a purely supplementary manner by the immediately subsequent contract, resulting eventually in a final contract that embodied all of the terms of each of the separate contracts. This would be essentially the same single contract characterization that could be achieved through a reverse divisibility theory.

There is a well-established body of law governing the modification of contracts that applies parol evidence rule principles to determine which terms of a prior agreement will survive the modification agreement and carry forward into the new, modified

12. Indirect support for regarding such closely related agreements among the same parties as parts of a single contract is provided by the "one contract" principle of contract interpretation, under which closely related agreements are to be regarded as a single agreement for contract interpretation purposes, *see* Edward N. McConnell, *The "One Contract" Rule – What It Is and How to Use It*, LOMBARDI L. (2013), https://perma.cc/4LET-8H5L; *see also* David M. Gersten, *Clause Challenge: Multiple Contracts, One Transaction*, DAILY BUS. REV. (Oct. 13, 2014, 10:00 AM), https://www.law.com/dailybusinessreview/almID/1202673179791/ (discussing cases that support this proposition).

13. Generally accepted accounting standards require certain contracts that were entered into simultaneously among the same parties, with a single business objective, to be regarded as a single contract for revenue recognition purposes. *See* Steve Quinlivan, *Drafting Contracts under the New Revenue Recognition Standard*, STINSON (Apr. 27, 2017), https://www.dodd-frank.com/2017/04/drafting-contracts-under-the-new-revenue-recognition-standard/. In addition, seemingly separate insurance contracts are sometimes regarded as aspects of a single contract when they are designed to achieve an overall commercial effect. *See* IFRS, *Staff Paper* (May 2018), https://www.ifrs.org/-/media/feature/meetings/2018/may/trg-for-ifrs17/ap01-combination-of-insurance-contracts.pdf.

contract.[14] If two or more separate contracts between the same parties each address related aspects of the same subject matter, and if they do not contradict each other in any way, then after the first contract has been formed, the second contract entered into could be regarded as the new "final" agreement and viewed as a partially integrated agreement that can be supplemented by the terms of the first contract that had been entered into, which would now be regarded as a parol agreement with regard to that second contract.[15] Thus, the two agreements would then be regarded as a single contract embodying all of the terms contained in either agreement.[16] If a third contract addressing the same subject matter is entered into, then the second contract that now embodies the terms of the first and second contracts would be regarded as a parol agreement with regard to that third contract, again supplementing its terms.[17] Once again, the final result of this series of contractual modifications would be a single contract embodying all of the terms of each agreement.

Both the subsequent modification-based theory and the reverse divisibility-based theory as to why there is only a single contract formed by facially separate agreements would be easier for courts to embrace when each of the separate agreements contains an explicit or at least an implicit reference to the other agreements. But this may not be necessary if the close relationship between the agreements is otherwise apparent. Moreover, there is no reason that the reverse divisibility and subsequent modification arguments could not be advanced together as alternative justifications for a single contract recharacterization of a set of facially separate agreements.

Let me provide one illustrative example of a practical situation where a person might wish to advance a single contract characterization of two facially separate but very closely related contracts so as to expand the scope of that person's justified non-performance rights after the other party breaches one of the contracts.[18] Assume that Persons A and B have entered into a contract under which Person A will allow Person B to list goods for sale on Person A's online auction website, with Person B then having sales commission payment obligations to Person A for any sales made through that website. Assume also that the parties have near-simultaneously also entered into a separate non-competition agreement under which Person A has agreed not to attempt to solicit

14. Under the parol evidence rule, if a contract is regarded as only a "partial integration," a final agreement as to some but not all of the terms of the contract, then it can be supplemented by the terms of prior or contemporaneous agreements that are consistent with its terms. FARNSWORTH, *supra* note 5, at 418–20.

15. *Id*.

16. *Id*.

17. *Id*.

18. This example is drawn from a matter that I was involved in as an expert witness.

from any vendors from which Person B acquires goods for resale on Person A's website any agreements under which Person A will later list those vendors' goods for auction on the website in direct competition with Person B's listings. Assume also that Person B then later materially breaches its commission payment obligations and is insolvent or near-insolvent, and Person A then contacts Person B's vendors and agrees to list its goods on Person A's website in competition with Person B's listings.

Consider now if Persons A and B now enter into litigation, with each party claiming that the other party has breached a contract. Under a separate contract characterization of the situation, they would each have a valid claim. Person A's claim would be for Person B's failure to meet its commission payment obligations under the auction listing agreement, and Person B's claim would be for Person A's violation of its obligations under the non-competition agreement. Each party's damages would have to be determined, and then the damages awards would have to be netted out to determine the final payment obligation.

However, Person A could and should argue for a single contract characterization of the two agreements in either or both of two ways, and its arguments would be quite strong. First, Person A could point out that the non-competition agreement between the parties made no sense except in the context of the parties having entered into a closely related online auction agreement, which justifies a single contract characterization of the two agreements on reverse divisibility grounds. Second, Person A could also argue that since the two agreements are consistent with one another, and since each agreement, while arguably complete enough to be regarded as a freestanding contract, is really an incomplete expression of their arrangement without consideration of the other agreement, then the second agreement that was executed should be regarded as being a modification of the first agreement that carries forward its original terms into the now meaningfully complete agreement.

Under this single contract characterization, however it is justified, only Person B would have breached the contract since Person A's subsequent non-performance of its contractual non-competition obligations would be justified by Person B's prior material breach—B's failure to meet its commission payment obligation. So, Person B would not be entitled to any damages for Person A's non-performance.[19] And since Person B is insolvent or near-insolvent, Person A's avoided costs from its justified non-

19. Let me note this argument would only work for Person A if it could establish that Person B's breach of its commission payment obligation preceded its own non-performance of its non-competition obligation. Otherwise, Person B could then offer justified non-performance arguments of its own against being held liable for breach. The question of who materially breached first is obviously critical under a single contract characterization of such a situation.

performance would reduce its losses in a way that a partially or wholly uncollectable damages award against Person B probably would not.

One can easily envision numerous other contexts where a single contract characterization of a set of facially separate but closely related contracts could have important consequences for expanding the scope of justified non-performance by the non-breaching party or parties, thereby allowing them to reduce their losses from the breach more than a damages award would alone.

CONCLUSION

I recommend that contract law instructors take a little time to include in their coverage of basic divisibility principles the idea that divisibility is, in an important sense, a symmetrical concept. Those principles sometimes allow for making plausible arguments for combining facially separate but closely related contracts into a single contract, as well as arguments for dividing a contract into separate paired exchanges. Such a single contract characterization of facially separate agreements can sometimes have important consequences for the scope of justified non-performance after a contract breach.

Instructors should also make clear to their students the flexibility that sometimes exists to characterize certain contracts as being supplementary modifications of prior agreements, rather than as free-standing separate contracts, and that this is another possible approach for achieving the same single contract characterization result.

I also recommend that practicing lawyers note for future reference the availability and persuasiveness of these reverse divisibility and subsequent modification arguments for providing their clients possible grounds for a justified non-performance defense to breach of contract claims or counterclaims that may arise in the context of multiple agreements among the same parties.