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INTERPRETIVE RISK AND CONTRACT INTERPRETATION: A SUGGESTED APPROACH FOR MAXIMIZING VALUE*

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INTRODUCTION

When parties draft a contract, they reach an agreement on terms that reflect the best means of achieving their individual goals. If a dispute arises about the meaning of the agreed on terms, or if subsequent events cause one party to regret its obligations under the contract,[1] one or both parties may seek a court's assistance in enforcing the contract. The court's enforcement role begins with ascertaining the parties' intent objectively by looking to the contract's language.[2] A court may need to decide whether a dispute should be resolved solely by reference to the contract's express terms, or by examining evidence outside the contract.[3] If it looks to external evidence, a court might

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[1] This is the famous idea of the "regret contingency" discussed by Robert Scott and Charles Goetz. *See* Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1271-73 (1980).

[2] The objective theory of contract interpretation is well accepted and it suggests that courts discern intent from that manifested in the words used. E. ALLAN FARNSWORTH, CONTRACTS § 3.6 (4th ed. 2004) (discussing prevalence of objective theory).

[3] Those who advocate looking only at the contract are part of the new formalism school. *See, e.g.*, Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U.L.

advert to the parties' specific contractual objectives or ends[4] in an effort to realign the parties' obligations under a contract using equitable

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REV. 847, 851 n.11 (2000). For a contrary view suggesting that both formalistic and contextual approaches have a place in contract interpretation, with the preference for one or the other depending on a number of specific factors including risk averseness of the parties, transaction costs, the presence of transaction specific investments, and a number of other factors, *see* Avery Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496 (2004). This same tension between strict formalistic interpretation and interpretation that references objectives occurs not only in contract interpretation but also in debates surrounding the interpretation of statutes. *See, e.g.*, Frank H. Easterbrook, *Judicial Discretion in Statutory Interpretation*, 57 OKL. L. REV. 1, 3 (2004); William N. Eskridge, Jr., *Public Values in Statutory Interpretation*, 137 U. PENN. L. REV. 1007, 1008-09 (1989). Although there are parallel arguments about the role that objectives should play in interpreting statutes and contracts, as well as the extent to which courts should consult wise outcomes as a basis for judging statutes or contracts, there are differences between the two contexts. These differences make the case for textualism and the exclusion of objectives from judicial decision making less compelling in the contract interpretation context.

When judges are interpreting statutes, there may be reasons to constrain a judge's discretion by a textualist approach. Because judges in these federal cases are often afforded life tenure, there will be no means of redress if the judge gets the decision wrong. The same would not be true if a court were deciding whether to uphold a federal agency's exercise of discretion. Known as "Chevron deference," courts grant deference to federal agencies' interpretations of their own regulations, as long as the regulation is ambiguous (or it has a gap that Congress intended the agency to fill) and the agency's interpretation is reasonable. Chevron U.S.A. Inc. v. Natural Res. Def. Council, 467 U.S. 837, 843-44 (1984). In the case of federal agencies, if the agency gets it wrong and makes an unwise decision when it exercises its Chevron authority, its agents can be fired as a kind of democratic check. Easterbrook, *infra*, at 8. However, if a court strays beyond the text and makes decisions consulting objectives beyond the statutory text, as by consulting policy, it will be protected even if it reaches the wrong outcome because of life tenure. That is not the case with the President or administrative agencies who remain subject to sanction for wrong decisions (as by firing). Thus, there are reasons why judges should be constrained, at least, in the interpretation of federal statutes.

However, when common law judges are operating at the state level, and crafting common law rules or construing statutes, those judges may not have life tenure. Moreover, parties who are affected by the courts' decisions can react to and modify their behavior and contract around the rules in future cases. For that reason, since the affected parties can react and because the judges are often subject to election or recall, there is less concern that judges who get it wrong will remain on the bench and immune from criticism. Finally, since the judges deciding the cases, to the extent that they are creating common law rules and not interpreting statutes, are the ultimate crafters of the common law precedent, there is not the same concern about judges restraining their resort to policy as there is when courts are interpreting federal statutes. In common law cases, judges are the ultimate deciders of policy.

[4] These objectives may or may not be expressly referred to in the contract. According to Jody Kraus and Robert E. Scott, interpreting contracts in light of the parties' specific contractual objectives is a misguided strategy unless the parties have specifically

principles.[5] Proponents argue this approach might be especially useful when the contract, as drafted, no longer serves the parties' goals.

In resolving cases, a court may have to first decide if the contract is ambiguous, and then, how to resolve that ambiguity.[6] A court may also be asked, or may decide on its own, to imply terms or fill in gaps. Traditionally, these latter interventions by courts have been separated from questions of interpretation, as interpretation focuses not on the court's imposition of meanings, but rather on the search for the parties' intent as reflected in the terms of their contract.

This demarcation between implied terms and interpretation masks the fact that, in many cases, a court must develop a methodology for resolving what approach to take when the language itself does not resolve contractual meaning because it is ambiguous, the parties left a gap, or the contract is incomplete.[7] Recently, some contract theorists, including Professors Jody Kraus and Robert Scott, suggested that courts applying equitable principles in resolving disputes have misguidedly looked to the parties' contractual objectives.[8] Such theorists

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directed courts to consider such objectives. *See* Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023, 1026 (2009).

[5] *Id.* at 1033-34 (discussing judicial interventions beyond the formal contract terms as governed by equity).

[6] *See* STEVEN J. BURTON, ELEMENTS OF CONTRACT INTERPRETATION 12-15 (2008) (helpfully distinguishing between the existence of an ambiguity from the means of resolving that ambiguity).

[7] *See* Symposium, *Incomplete Contracts: Judicial Responses, Transactional Planning, and Litigation Strategies,* 56 CASE W. RES. L. REV. 135 (2005) (surveying literature on incomplete contracts).

[8] Kraus & Scott, *supra* note 4, at 1026. As Professor William Whitford points out, "objectives" is a slippery term. *See* E-mail from William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (June 23, 2009, 19:34 EDT) (on file with author). Kraus and Scott appear to be using the term "objective" to refer to a specific goal that the parties adverted to and jointly intended to achieve by the particular language that they adopted, even where the objective is not incorporated in the express text of the contract. For problems with the concept of joint objectives, see *infra* text accompanying note 20. Additionally, Kraus and Scott seem to equate objectives of the parties with narrowly defined contractual objectives and it is not clear whether the contractual objectives refer to the parties' joint goals. In contracts, these joint goals would include the maximization of contractual surplus and minimization of transaction costs. In identifying contractual goals, Kraus and Scott seem to refer to a very specific goal of only one party for whose benefit it was drafted. That lack of precision on whose objectives are intended and how broadly those goals are conceived of complicates the analysis in ways that will be explored later. If Kraus and Scott intended to refer to the overall objective of welfare improvement, then the courts' willingness to refer to the

argue courts should only look to those objectives or use equitable principles when the parties use broad terms such as "best efforts" to signal they want a court to intervene.[9] Absent such language, Kraus and Scott argue that courts should "faithfully enforce" the terms chosen by the parties,[10] since the parties' failure to use a broad term represents a tradeoff by the parties. Parties who adopt specific terms have made a conscious choice to depend exclusively on informal, non-legal enforcement for things not expressly covered in the agreement, and would prefer a formal doctrinal approach only to the specified terms.[11] The Kraus and Scott article divides the world of contracts into: (1) contracts with terms that are capable of strict enforcement; and (2) contracts with open-ended terms. Kraus and Scott also appear to imply the same result for ambiguous contract terms.[12] Alternatively, they may be implying that ambiguity in contracts does not exist.

This Article will examine and question a number of the key assumptions underlying Kraus and Scott's argument. It will suggest its own framework for an interpretive methodology in Contracts cases and offer examples from Contract law to illustrate how, and when, courts should engage in interpretation to further the goals of the parties. It will also show that when Kraus and Scott's assumptions break down, the reach of their theory becomes limited.

Kraus and Scott's approach will negatively impact the parties' welfare, unless the precise parameters of their approach are delineated. Judicial decisions about whether to intervene and interpret contracts should not depend solely on whether the parties have chosen to use open-ended or precise terms. Instead, a court should use a variety of tools of interpretation in order to maximize the parties' joint surplus (even if the parties used specific terms), including: ordinary meaning,

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parties' objectives in setting default rules or aggressively interpreting terms in contract would make sense. To the extent courts are using such objectives to override express terms, a different analysis might follow. When contracts are regarded as incomplete, or when express terms are ambiguous, then it might be justifiable to consult welfare improvement as an overall goal. Kraus and Scott largely ignore the notion of incompleteness, or ambiguity in meaning, in their analysis.

[9] Kraus & Scott, *supra* note 4, at 1030.

[10] *Id.* at 1031.

[11] *Id.* at 1026.

[12] They do not say so expressly, but it would seem implicit in their argument. It is also possible that they would deny that ambiguity ever exists.

trade usage, the entire contract, the purpose of the contract, the surrounding circumstances, and reasonableness.[13]

This Article agrees with one aspect of the recent criticism—that courts overstep when they resort to interpreting contracts by overriding the parties' chosen means (such as assuring the seller a price term equivalent to three percent above its costs) to implement specific objectives as a form of *ex post* equitable adjustment. However, that does not mean that courts should universally adhere to the chosen terms using formal doctrine in all other cases. Application of such a literalistic approach in cases where the parties used specific terms poses a dead end for courts confronted with a truly ambiguous meaning and risks (perhaps unintentionally) negative welfare effects.

Thus, courts should eschew specific contractual objectives and instead concentrate on determining whether the interpretation will maximize gains from trade and minimize deadweight losses and transaction costs.[14] This unifying methodology can help to determine when courts should broadly interpret terms, imply terms, or add default rules.

Premising contract interpretation on specific contractual objectives presents difficulties for courts. Since such objectives are often not part of an express contract, and parties may adopt "shadow" terms that are designed to achieve their objectives,[15] the parties may argue about how much weight, if any, should be given to such non-express contractual objectives.[16] If the shadow term were to give one party less than *its* contractual objective, that would not necessarily matter to the *other*

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[13] BURTON, *supra* note 6, at 14-15.

[14] Professor Kostritsky argues that courts do, in fact, take account of these broader contractual goals of maximizing joint surplus and minimizing transaction costs in the way that they apply the contract doctrine of interpretation to curb opportunistic behavior which would otherwise act as a drag on gains on trade. *See* Juliet P. Kostritsky, *Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation*, 96 KY. L.J. 43, 44-45 (2007-08).

[15] The parties in the Kraus and Scott paradigm did not actually agree to a price term based on assuring the seller three percent above its costs; instead, the price term was a shadow term tied to an index designed to achieve the same result. *See infra* Part II.B.2.

[16] Unlike the case with statutory interpretation where official legislative history exists, in contract negotiation there is no definitive objective record to indicate the parties' intentions. *But see* Frank Easterbrook, *Text, History and Structure in Contract Interpretation*, 17 HARV. J. L. & PUB. POL'Y 61, 64-65 (1994) (cautioning against misuse of legislative history given its many possible meanings).

party and therefore should not necessarily influence a court's interpretation of a contract.

Kraus and Scott's argument is premised on a distorted and exaggerated view of the deleterious effects of judicial intervention and an overly narrow view of when intervention is justified (only when the parties explicitly ask for it through an open-ended clause). This bifurcated framework fails to account for the full range of judicial interventions that are widely embraced in Contracts.

For example, a judicially supplied default rule[17] to interpret contract terms with trade usages may maximize gains from trade while minimizing transaction costs, even without an express directive to courts to interpret a term using trade usages.[18] Despite its obvious benefits, this approach would likely be proscribed under Kraus and Scott's literalism approach.

A court's decision to intervene and interpret contractual terms, or decline intervention altogether (thereby relegating the parties to informal sanctions), should not depend solely on whether the parties adopted specific terms. Instead, decisions regarding the appropriateness of judicial intervention should depend on whether intervention will achieve the parties' objective of maximizing gains from trade at a lower cost, or more effectively, than the alternatives.[19] Will welfare improvement be greater with judicial enforcement supplementing informal enforcement,[20] or with exclusive reliance on informal mechanisms? Since there is often no evidence of the parties' thinking, the implicit assumptions underlying the argument that parties prefer informal enforcement when they use specific terms and omit vague terms must be carefully examined before accepting the conclusion that legal enforcement should *always* be restricted to the chosen means.

Kraus and Scott's theory that courts should respect the parties' chosen means to the exclusion of contractual objectives depends on a paradigm case in the context of a particular fact pattern. The difficul-

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[17] E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Aug. 19, 2008, 13:10 EDT) (on file with author) (discussing legislatively supplied default rules as an alternative).

[18] *See* Kostritsky, *supra* note 14.

[19] Parties designing contracts wish to economize on the costs of contracting and to achieve their objectives at the least cost; this goal of welfare improvement is a shared goal.

[20] Roy Kreitner, *Fear of Contract*, 2004 WIS. L. REV. 429, 430.

ties of constructing a theory of contract design built on this particular example will be examined in depth in the Article.[21]

Kraus and Scott's reliance on a misguided case, together with language that can be read to proscribe *any* intervention beyond the parties' chosen means—regardless of whether that intervention is to effectuate an *ex post* equitable adjustment or an interpretation designed to (prospectively) maximize joint surplus—wrongly suggests that where an open-ended or vague term is not used to delegate judicial intervention, a court should *always* refrain from intervening to achieve the parties' goals and adhere solely to formal doctrinal enforcement of the specific terms.

This debate about whether the means of the parties should have primacy and the ends excluded unless the parties delegate authority to a court is fundamental to contract law. By arguing that courts should privilege the parties' written terms, which the authors imbue with a mythical certainty, Kraus and Scott suggest that courts act improperly whenever they overlook specific express terms to achieve some larger goal—such as the avoidance of forfeiture.[22] Their approach seems to exclude the application of many judicially supplied default rules, including: the effect of part performance in a unilateral contract,[23] implied terms of good faith, reasonableness in contract interpretation,[24] and the incorporation of trade usages into contracts.[25] It also appears to preclude a variety of default rules, including a preference for construing ambiguous terms as promises rather than conditions,[26] because

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[21] *See infra* Part II.B.2.

[22] Courts thus also act improperly when they interpret express conditions as constructive conditions of exchange to avoid forfeitures.

[23] *See* RESTATEMENT (SECOND) OF CONTRACTS § 45 (1981).

[24] Roy Kreitner suggests that the logic and conceptual framework of the new instrumentalists would exclude law-supplied default rules, contextualized interpretation, and pre-contractual non-bargained for liability. Kreitner, *supra* note 20, at 429. In their article on *Contract Design and Intent*, Kraus and Scott do not admit that they intend to reject all law-supplied rules, including such rules as the legal default rule incorporating trade usages that are not specifically negated, implied constructive conditions of exchange, the implied non-revocability of offers on which the offeree has begun part performance, or the preference for interpreting ambiguous terms as creating duties and not conditions. Nevertheless, by suggesting that parties who adopt specific terms and who do not use vague terms to signal the parties' wish to have a court intervene, Kraus and Scott seem to bring into question the legitimacy of a myriad of implied terms or rules in contract law. Further U.C.C. § 1-303 clarification may await their next article.

[25] U.C.C. § 1-303 (2009).

[26] RESTATEMENT (SECOND) OF CONTRACTS § 227 (1981).

such a preference would be premised on the parties' presumed objectives of welfare maximization.

The debates over (1) the proper role of courts in contract disputes; (2) how much primacy to afford explicit terms; (3) whether courts should interpret the contract in order to achieve the parties' specific objectives;[27] and (4) whether the court should resolve disputes over meaning by intervening in ways beyond the parties' chosen means, all involve the fundamental issue of when judicial intervention in contracts is justified.[28] In advocating adherence to the parties' chosen terms, and in charting the alternative as one in which courts override those chosen means, Kraus and Scott pose the problem of judicial intervention in an overly narrow way and ignore the broader question of whether judicial intervention would serve efficiency or improve welfare. Their approach suggests that if the courts would only "faithfully enforce" the chosen means and terms, they would serve the preferences of "commercially sophisticated parties."[29] Under this stylized view, the only types of intervention are those where the court invokes the parties' specific contractual objectives in cases which necessarily involve a court in making decisions that depend on unverifiable information. Because they fail to consider cases where courts consider broader welfare goals, Kraus and Scott portray all considerations of ends beyond the chosen means as improper.

Kraus and Scott's: (1) misguided belief in certainty of terms; (2) reliance on outlier cases ignoring the overall welfare improvement principle; and (3) incorrect assumption that the inclusion of specific terms is meant to categorically foreclose judicial intervention, offers a distorted and incomplete view of Contracts rules and case law. If terms are admittedly uncertain, then courts cannot "faithfully enforce" them. Consequently, courts will not be seen as overriding the parties' terms, but rather as consulting goals of joint surplus maximization.

This Article will explore various examples of law-supplied default rules in Contracts that reflect judicial departures from, additions to, or broad interpretations of the parties' chosen means (assuming that cho-

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[27] *See* Kraus & Scott, *supra* note 4.

[28] *See* Kostritsky, *supra* note 14, at 61.

[29] *Id.* at 44 (confining thesis to consideration of commercial parties' preferences). As William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, suggested, even commercial parties will differ, particularly if they are in a relational contract. *See* E-mail from William C. Whitford to Juliet P. Kostritsky, *supra* note 8.

sen means are limited to mean the explicit terms of the contract).[30] In these examples, courts seem to routinely reject the argument that courts should not intervene in contracts unless explicitly requested to do so through a broad delegation.[31] The examples[32] suggest there are limits inherent in Kraus and Scott's argument and those limits hamper that argument's ability to resolve a broad range of contracts issues.

Courts should always consider the possibility that the parties' chosen means or terms (1) are not completely unambiguous and self-defining; (2) can be economically incomplete[33] or ambiguous;[34] and (3) do not necessarily signal an unequivocal intent that courts should refuse to intervene. The threshold question is whether a court should add to, interpret, or even override a term to achieve the parties' broad goals of maximizing gains from trade (while also minimizing transaction costs and the costs of opportunism).[35] Courts should consider all possible types of intervention to determine when it will improve the parties' welfare, while remaining cautious about embracing those interventions that facilitate the other party's counter-opportunistic behavior.[36]

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[30] This assumes that Kraus and Scott equate the chosen means with the specific contract terms.

[31] This is the specific opt-in provision. One such example that shows the limitation of the Kraus and Scott approach is Section 45 of the RESTATEMENT (SECOND) OF CONTRACTS, which governs unilateral contracts. If one were to literally apply the Kraus and Scott approach, the court should have played no role because the parties had not signaled their desire, through the use of a vague term, that the court should play an active role.

[32] *See infra* Part IV.

[33] The distinction between contracts that are obligationally complete but economically incomplete is treated in the literature. *See, e.g.*, Kostritsky, *supra* note 14, at 64; Richard Craswell, *The "Incomplete Contracts" Literature and Efficient Precautions*, 56 CASE WES. L. REV. 151, 154 (2005) (discussing the idea of economic incompleteness and describing such a contract as "one that specified exactly what S and B [parties] should do, in order to achieve maximal efficiency . . . ").

[34] Judge Posner pays particular attention to the problem of ambiguity in language and posits that the problem in such a case involves "disambiguating" ambiguous language. *See* Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1586 (2005).

[35] OLIVER E. WILLIAMSON, MECHANISMS OF GOVERNANCE 60 (1996) (discussing contribution to surplus from efficient control of opportunism problem).

[36] Counter-opportunistic behavior that results from judicial intervention refers to a situation that might "arise if a court intervenes to condition parties' obligations on nonverifiable factors (such as demand)." *See* Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What To Do When the Parties Have Drafted Imperfect Contracts*, 2004 WIS. L. REV. 323, 369. Counter-opportunistic behavior arises if one party

Part II of this Article examines Kraus and Scott's arguments against current trends in contract adjudication, including the allegation that courts ignore parties' chosen contractual means in order to promote their contractual goals. This section seeks to determine the nature of their objections. It examines the assumptions underlying the critique as a means of determining how conclusions about the proper approach to take to discerning contractual intent might be altered if those assumptions changed or proved too limited. Part III proposes an overall framework for judging intervention in contracts. Part IV looks at several doctrinal areas in contracts to see how judicial intervention can be justified using a normative framework. In each of these doctrinal areas, the law departs from the limited language of the contract (the parties' chosen means) and implies a liability rule or adds a default rule or a law-supplied term. These departures present a puzzle for lawmakers concerned with when it is permissible to go beyond the express agreement of the parties. This Article will show that these departures can be justified in welfare improvement (efficiency) terms.

II. Discerning Contractual Intent from the Parties' Express Terms: The New Instrumentalism and Interpretive Authority for Courts

It is tempting to think that parties can agree on terms that are clear and unambiguous and, in effect, self-defining.[37] This would mean that problems of interpretation would never arise and contracts would be self-enforcing.[38] However, because of uncertainty about future contingencies and behavior, parties face large transaction costs that act as a barrier to detailed express arrangements.[39] While parties could invest *ex ante* in costs, some uncertainties will never be eliminated and there will be a "budget constraint" limiting investment to deal with or resolve those uncertainties.[40] Alternatively, the parties could consciously de-

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could falsely claim low demand to get a low price and other parties (the seller and the court) would have difficulty assessing the true demand for the buyer's products.

[37] Kostritsky, *supra* note 14, at 49.

[38] *See* Jules L. Coleman, et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 Harv. J.L. & Pub. Pol'y 639, 640 (1989) (discussing conditions for self-enforcing contracts under conditions of perfect information and fully contingent contracts).

[39] *See* Oliver E. Williamson, Economic Institutions of Capitalism: Firms, Markets, Relational Contracting 45 (1985) (discussing "bounded rationality").

[40] E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Oct. 17, 1996, 11:23 EDT) (on file with author).

cide to expressly delegate all or some subset of matters to courts through an open-ended term when courts will have information *ex post* that the parties lack *ex ante*.

Moreover, even if a contract employs a specific term, courts cannot necessarily assume that parties invested large front-end costs to arrive at the optimal term, or that in doing so they intended to foreclose all judicial intervention. Very often, the parties settle on a specific term, not because they intend it to apply in all cases, but because uncertainties about the future caused them to omit more complex terms that would vary based on circumstances that were unknowable (at any cost) *ex ante*.[41] Also, the parties may settle on specific terms they assume will be understood as they are used in trade—without realizing that an express delegation to the court might be necessary. The absence of such a delegation might preclude the parties' desired outcome and might require them to translate all their trade terms into the language of others, even when they assumed that the meaning that they assigned to their terms is the ordinary one.

Finally, although Kraus and Scott assume that it is possible to generalize across all contracts involving sophisticated parties and assume that all such parties will make conscious decisions trading off the front-end drafting costs with the back end enforcement costs,[42] there may be reason to think that not all commercially sophisticated parties will make the trade off in the manner envisioned by Kraus and Scott. For example, it may be that parties negotiating a bond indenture do not negotiate in the same manner as parties in a relational contract. In relational contracts, not as much planning is exerted into the drafting of the formal contract terms because parties assume that the terms can be renegotiated later. This is different from not drafting specific terms and relying on informal enforcement of matters not included, and may affect the analysis of when it is proper to go beyond the express terms.[43]

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[41] E-mail from Ronald J. Coffey to Juliet P. Kostritsky, *supra* note 17.

[42] Kraus & Scott, *supra* note 4, at 1028-29.

[43] William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, contributed this insight. E-mail from William C. Whitford to Juliet P. Kostritsky, *supra* note 8.

A. *Kraus and Scott's Argument in Favor of Enforcing the Chosen Means*

Kraus and Scott argue that courts should give preference to parties' chosen means even if it "defeats their contractual ends,"[44] except where the parties have explicitly delegated authority to the courts to broadly interpret the terms by using open-ended or vague terms such as "best efforts."[45] If the parties do not invoke the court's aid by the use of such terms, Kraus and Scott posit that courts should apply "formal contract doctrine"[46] in order to find the "formal contract terms."[47]

Kraus and Scott cite autonomy as a reason for giving exclusive effect to the parties' chosen means.[48] They argue that adhering to the parties' chosen means upholds party autonomy because the chosen means reflect the parties' actual agreement more accurately than a court's attempt to discern the parties' intentions.[49] The authors assume that, even if the parties fail to abide by value-maximizing behavior, their implicit choice to rely exclusively on informal sanctions to police one another's conduct should be implemented.

Kraus and Scott also posit that adhering to the parties' chosen means enhances efficiency and reliability.[50] This assumption of efficiency is premised on a particular type of legal intervention employed when a court overrides chosen means to achieve the parties' specific contractual objectives.[51] When the means and the contractual objectives conflict, the authors argue that it is an error to "conflate" the means and ends.[52] Kraus and Scott assume that commercially sophisticated parties prefer that courts apply strict or "formal contract doctrine" to the contractual language—even if doing so defeats the parties' joint contractual objectives.[53]

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[44] Kraus & Scott, *supra* note 4, at 1027.

[45] *Id.* at 1030.

[46] *Id.* at 1031. Although the Kraus and Scott article does not put itself forward as a theory of contract interpretation, their theory would have implications for interpretation since it seems to foreclose courts from determining the content of the agreement by reference to matters outside the contract, such as contractual objectives.

[47] *Id.* at 1025 n.1.

[48] *Id.* at 1028.

[49] *Id.* at 1079-80 (discussing "judicial speculation").

[50] *Id.* at 1028.

[51] *Id.* at 1031.

[52] *Id.* at 1069.

[53] *Id.* at 1027. The authors suppose that the court will only depart from those terms if it looks outside the contract by considering the parties' contractual objectives. In the example discussed, resort to those objectives results in a departure from the express

Kraus and Scott's advocacy of a literal interpretation of the chosen means and the exclusion of the parties' ends stems from their assumption that judicial intervention would embroil courts in inquiries that they are ill-equipped to make.[54] The unspoken premise of this argument is that adherence to the explicit terms would be beneficial, since it would preclude the court from making decisions based on inadequate information.[55] It would also coincide with the parties' preferences, since it would avoid the potential for opportunistic exploitation by one party—the moral hazard danger.[56]

Kraus and Scott also assume that by adopting specific terms, the parties chose to invest in drafting costs *ex ante* and foreclose the back-end costs of delegating decisions to the courts *ex post*.[57] If a court intervenes, the projected intervention takes *the particular form* of rewriting the parties' terms to achieve their particular contractual ends or objectives by substituting those ends for the actual terms.[58] Because the parties deliberately eschewed express incorporation of those objectives to avoid back-end costs and potential moral hazard, Kraus and Scott contend that the projected back-end costs are quite high.[59]

Despite agreement on express terms, parties have assumptions and predictions about the future. So, agreement on one or more terms[60] does not necessarily mean that there is a single objective that a court could look to in resolving meanings. A joint contractual intent or objective is really a superficial (and perhaps misleading) notion, since parties intend contract terms to serve different functions.[61] Courts will

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terms, while a contrary approach confined to applying standard contract doctrines will presumably result in the enforcement of the parties' explicit terms.

[54] *Id.* at 1030-31.

[55] *Id.*

[56] *See id.* at 1053-55 (discussing potential for opportunistic conduct when evidence of bid shopping is difficult to prove). *See also* WILLIAMSON, *supra* note 39, at 47; Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 274 (1992).

[57] Kraus & Scott, *supra* note 4, at 1030-31.

[58] *Id.* at 1025.

[59] *Id.* at 1030.

[60] Parties reach agreement somewhere on the contract curve if there are gains from trade. E-mail from Ronald J. Coffey, Professor of Law Emeritus, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Sept. 30, 2008, 12:57 EDT) (on file with author) (discussing Edgeworth Box).

[61] E-mail from Peter M. Gerhart, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (on file with author).

therefore face a Sisyphean task of contract interpretation if they interpret terms using a joint contractual objective as a deciding factor.

Divergent views on how a term will function in reality, with each party's predictions about the future inclining it to think that the clause will favor oneself rather than one's opponent, suggest that courts should resolve contract disputes not by reference to joint objectives[62] or to joint intent, but *solely* by reference to the express terms.[63] Such a formalist strategy offers the perceived advantage of certainty, since there is only one contract agreed to by both parties.

Under this view, ignoring the specific terms to achieve the parties' objectives would ignore the parties' choice for a rule-based approach,[64] decrease reliability,[65] and increase back-end costs.[66] Kraus and Scott argue that these results should be avoided in order to decrease costs, enhance efficiency, and implement the parties' intentions.[67]

For these reasons, Kraus and Scott find the modern trend in which courts overlook the chosen means in order to promote the parties' overall goals to be a misguided one.[68] To ensure efficiency, Kraus and Scott urge courts to reverse course and hew to the contractual

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[62] *Cf.* Kreitner, *supra* note 20, at 430 (discussing how contract depends not only on actual consent, but on the regulation of obligation as well).

[63] Much of the current law and economics scholarship adopts this approach.

[64] The conclusion that parties intend for courts to use a rule-based system based on the fact that they have used a specific term rather than an open-ended one seems to rest on the conclusion that since parties know how to delegate broad authority to courts through vague terms, that when they do not use such terms, they intend a rule-based approach. Yet, there is no necessary logic between the use of a specific term and the exclusion of broad judicial interpretation or interpretation that involves reference to contract objectives. In the trade usage area, courts conclude that if parties do not specifically negate trade usages, they are deemed incorporated into the contract. *See* U.C.C. § 1-303 cmt. 3 (2009). In that context, at least courts do not draw the conclusion that if the parties used a specific term, such as "one dozen," they necessarily foreclosed courts from implying those terms into the contract. The decision of the court to incorporate and to look beyond the precise terms must depend on a consideration of what approach would be value maximizing. The use of a precise term does not by itself contain any explicit indication that a strict or rule-based system of interpretation is intended.

[65] Kraus & Scott, *supra* note 4, at 1026-27 (suggesting that parties dislike the unreliability of the two-stage adjudicative approach conflating means and ends).

[66] Back-end costs include judicial enforcement and litigation costs. *See* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 825-31 (2006).

[67] Kraus & Scott, *supra* note 4, at 1025-32.

[68] *Id.* at 1027. This assumes that the "chosen means" in a contract is synonymous with the explicit terms of the contract.

means "even when doing so defeats their contractual ends."[69] They argue that "commercially sophisticated parties" prefer this more restricted approach to contract interpretation.[70] The authors' argument, elevating the parties' means over their goals, belongs to a recent intellectual movement embracing greater formalism in contract.[71]

To determine whether the modern trend of overriding the parties' chosen terms can be justified, Kraus and Scott examine a paradigm factual scenario involving judicial departures from strict terms to discern the purported rationale for such interventions.[72] They conclude that courts feel free to "override [contract terms] by invoking equitable doctrines if they believe that doing so is necessary to substantially 'correct the parties' contract by realigning it with their contractual intent."[73] Kraus and Scott posit that the traditional rationale used to justify such a departure is that the parties themselves would prefer it whenever courts have additional information *ex post* which indicates that the means chosen will fail to achieve the parties' initial goals. Courts intervene and override terms on the supposition that "had the parties known at the time of formation what the court knows at the time of adjudication, the parties themselves would have crafted different terms."[74]

Kraus and Scott then criticize this trend of overriding parties' chosen means to achieve contractual goals, arguing that courts improperly offer parties a default "insurance policy" by intervening whenever it turns out that the contractual terms no longer serve their overall con-

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[69] *Id.*

[70] *Id.* at 1026. Although Kraus and Scott focus exclusively on commercial parties' preferences and assume uniformity in those preferences, there are reasons to doubt whether such uniformity exists. See *infra* Part II.B. In addition, while purporting to craft rules only for commercial parties, some of the examples used by Kraus and Scott do not exclusively involve contracts between commercial parties. *See* Kraus & Scott, *supra* note 4, at 1085-94 (discussing the *Corthell* case).

[71] This intellectual movement has embraced plain meaning over contextualized interpretation. Scholars embracing formalism argue that it saves parties from back-end litigation and judicial enforcement costs, costs which have been ignored by the contextualists. *See* Scott, *supra* note 3, at 848.

[72] Kraus & Scott, *supra* note 4, at 1025.

[73] *Id.*

[74] *Id.* at 1027. However, as Scott and Kraus aptly point out, even if parties would have drafted a different contract had they been aware of information not yet available to them, they would not necessarily empower courts to revise the contract *ex post* to better align with contractual goals given the costs of judicial error and reduced reliability of terms. *Id.*

tractual ends.[75] To illustrate this point, the authors use examples from (1) cases in which courts override express conditions or interpret terms as promises and not conditions to avoid forfeiture; (2) the parol evidence rule in which courts overlook the express contract to improperly admit oral evidence of conditions; and (3) excuse doctrines exemplified by the ALCOA case.[76] Courts should intervene, they argue, only if the parties have explicitly opted into such a system delegating that discretion to the court.[77]

Yet, many Contracts doctrines permit courts to supply a term or a default rule even if the parties have not agreed on it expressly and even if they have not expressly delegated that decision to the courts. The doctrines of good faith and best efforts,[78] if adopted by courts or the legislature without parties' use of open-ended terms, constitute doctrinal examples where courts will imply terms or performance obligations into contracts. In other instances, courts intervene by creating legal liability rules, such as holding the promisor responsible for the promisee's reliance costs in Section 90 cases.[79] In other instances, the court may decide on an appropriate default rule, such as one in which trade usages are used to interpret terms in a contract, unless specifically negated.[80] The effect of such a default rule is to interpret the parties' terms based on trade usage, even without any party-adopted open-ended term directing a court to intervene. If intervention in contracts is as flawed and costly as Kraus and Scott project, one wonders why parties fail to opt out of many standard contract default rules.

The next section will examine the limitations of Kraus and Scott's arguments to determine what circumstances or factual contexts call for a different approach. It will suggest an analytic framework and taxonomy of heuristics to determine when legal intervention might be beneficial and when it should be proscribed because it would merely reallocate risks and give one party an insurance policy that it did not pay for.[81]

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[75] *Id.* at 1025.

[76] *Id.* at 1031.

[77] *Id.* at 1030. They are free to do so through the adoption of open-ended standards in the contract which delegates such discretion to the court.

[78] Courts are willing to supply a best efforts term even if not agreed on expressly. *See e.g.*, U.C.C. § 2-306 (2009).

[79] *See* RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

[80] *See* U.C.C. § 1-303 cmt. 3 (2009).

[81] *See* Kraus & Scott, *supra* note 4, at 1025.

The next section also argues that a dichotomous approach is too narrowly conceived if it either enforces the contract's express terms and proscribes all intervention absent an express delegation in the form of an open-ended term, or intervenes beyond the parties' chosen terms if an open-ended term exists.

B. *Limitations of Kraus and Scott's Argument*

Kraus and Scott's argument recommends a dichotomous approach precluding all judicial resort to contractual objectives whenever the parties have not explicitly delegated such authority to the courts.[82] This argument is based on several assumptions that exaggerate the negative effects of judicial intervention and fails to account for the many cases where intervention is justified. The first assumption is that if the parties used a specific contractual term, they have determined that judicial intervention would not achieve welfare gains for the parties. However, even where the parties have not explicitly delegated authority to the courts through the adoption of a vague standard, a court should not hesitate to intervene when doing so would be welfare improving, especially if there are reasons to think that parties had reasons for not expressly delegating authority and discretion to the courts. The parties might have omitted such a term because (1) they were not even aware that there were unresolved matters that warranted an express delegation clause; (2) they assumed that because of a relational contract, matters would be renegotiated between the parties later; or (3) parties assumed that courts would intervene without an express delegation. Yet another assumption is that if a court intervenes, intervention will take a particular form which overrides specific terms or chosen means in order to achieve specific contractual objectives particular to the transaction and implement equitable results. By conceptualizing legal intervention so narrowly, Kraus and Scott ignore other types of judicial intervention where the justification for intervention is premised on the broader basis of maximizing joint surplus.

When these assumptions are questioned, it is possible to envision a different view of bargaining that goes beyond the dichotomous perspective of parties adopting either: (1) specific terms to exclude courts; or (2) vague terms to invite judicial intervention.[83] Under such a view,

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[82] *Id.* at 1030-31.

[83] As Kraus and Scott explain, "By framing their agreement in vague terms, the parties embed their legal obligations in broad standards that delegate discretion to courts *ex post* . . . ." Kraus & Scott, *supra* note 4, at 1030 (emphasis added).

there is a third alternative: parties may adopt contracts that are incomplete in certain respects, relying on courts to interpret terms or fill in gaps. In this third category of cases, a court will have to decide if the particular type of judicial intervention at issue would improve welfare, even if parties failed to expressly delegate decision-making authority to a court. This approach recognizes that parties might fail to see the need for an express open-ended term, or might fail to expressly delegate authority to the court because they assume that both parties will adhere to the performance obligation in a way that restrains discretion and maximizes welfare. Parties may also assume that if they fail to abide by value-maximizing behavior, informal sanctions may be available, and that legal enforcement to restrain such discretion will be available for cases in which informal sanctions are not effective.[84]

1. The Bargaining Model: Implications for Approaches to Interpreting the Means Chosen

The first problem with Kraus and Scott's argument is that it mistakenly assumes that if the parties employ specific terms and not a vague, open-ended standard, they intend to entirely foreclose judicial intervention on the back-end in all cases. That argument depends on a theory of how parties bargain and trade off front-end and back-end costs.[85] Kraus and Scott posit that if parties have invested enough transaction costs to result in specific terms, and failed to use open-ended terms to delegate decision-making authority to a court, they have deliberately chosen to exclude courts.[86] In such cases, courts should rigorously adhere to the explicit contractual means chosen by the parties, spurning any judicial strategy that overrides the parties' chosen means in order to secure the parties' contractual objectives or intent.[87]

This Article disputes this account of contract formation by questioning the conclusion that exclusive emphasis should be placed on the parties' chosen means, unless the parties have expressly signaled a desire for judicial intervention. It is not clear that a contract with spe-

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[84] This is the complementary theory of formal enforcement supplementing informal enforcement.

[85] *See* Scott & Triantis, *supra* note 66, at 835-39 (exploring the front-end/back-end cost tradeoff).

[86] Kraus & Scott, *supra* note 4, at 1030-31.

[87] *Id.* at 1027.

cific terms and no vague term represents a deliberate choice to exclude all judicial intervention.

The Kraus and Scott argument is built on a number of assumptions about what most parties would want if they ended up in litigation, and yet it is not clear that there is hard evidence to support all of these assumptions. One assumption is that parties would want the court to approach the dispute as a New Formalist would, and that they are implicitly assigning more contextualized interpretation exclusive to informal processes. This approach assumes that the parties have a low regard for the legal system which, again, is a belief supported by at least some evidence since parties routinely fail to contract out of certain default rules which subject them to contextualized approaches.

Another unsupported implicit assumption is that parties would prefer the court to adopt a rigid formalistic approach and exclude all consideration of the parties' basic contracting goals. Yet, it is at least arguable that if you thought of parties choosing an interpretive technique behind a Rawlsian "veil of ignorance,"[88] that they would want courts to read contracts to promote the joint goals of the parties.[89]

The use of a specific term such as "wife" or "dozen" should not prevent a court from looking beyond the express terms even when the parties have not used an open-ended term.[90] An unwavering rule that focuses exclusively on the means chosen may generate negative welfare effects,[91] and the certainty promised by such a strategy[92] might prove illusory. The belief in the certainty of terms ignores the myriad criticism of the plain meaning rule, including: that express terms rarely resolve contract disputes, that parties often disagree about plain meaning, that even formalist regimes under Chevron-type regimes generate

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[88] JOHN RAWLS, A THEORY OF JUSTICE 11 (rev. ed. 1999) ("The principles of justice are chosen behind a veil of ignorance. This ensures that no one is advantaged or disadvantaged in the choice of principles by the outcome of natural chance or the contingency of social circumstances.").

[89] E-mail from Robert W. Gordon, Professor of Law, Yale Law School, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (July 8, 2009, 15:41 EDT) (on file with author).

[90] *See, e.g., In re* Soper's Estate, 264 N.W. 427, 432 (Minn. 1935). Parties designing contracts wish to economize on the costs of contracting and to achieve their objectives at the least cost; this goal of welfare improvement is a shared goal.

[91] *See* Kostritsky, *supra* note 14, at 44 (questioning whether a unitary default rule of literal interpretation confined to the express terms is welfare enhancing across the board).

[92] Kraus & Scott, *supra* note 4, at 1028 (citing benefits of increase in "reliability of formal contract terms").

disputes, and that plain meaning "fetischism" can generate opportunism.[93]

For instance, Kraus and Scott assume that it is possible for a court to identify—with reasonable certainty—what the contractual terms are. Without this assumption, the conclusion that courts could "faithfully enforce" those terms would fail. If terms are not ambiguous or incomplete, then insistence on enforcing the chosen terms is the preferred strategy because it implements the terms chosen by the parties, who "are better informed than courts about their contractual purposes and have better incentives to pursue them efficiently."[94] The myth that terms will always be certain, as portrayed by Kraus and Scott, makes judicial departures from those terms to achieve the parties' contractual objectives appear necessarily wrong. When courts intervene by ignoring the parties' chosen terms in ways that will require them to ascertain unverifiable data to achieve specific goals of the parties, they may well add to back-end enforcement costs.

Parties may agree on specific terms and fail to expressly delegate authority to the courts through a vague term for a variety of reasons. However, not all of these reasons suggest that courts should refuse to intervene beyond the express terms. Agreement on specific terms does not mean that parties intend for courts to look exclusively at the parties' chosen means and to refuse to interpret a term or intervene in the contract. Nor does such agreement necessarily mean that the parties have invested large front-end costs in drafting. For instance, parties could agree on a specific, rigid term because of uncertainties, particularly uncertainties where "information barriers that prevent parties from controlling moral hazard when the future states of the world depend on their own actions."[95] There, parties could still rely on a court

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[93] *See* Kostritsky, *supra* note 14, at 67.

[94] Kraus & Scott, *supra* note 4, at 1031. *See also* FRIEDRICH A. HAYEK, RULES AND ORDER 120-22 (1973).

[95] *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 452 (2009). These contractual approaches are desired by parties who are attempting to deal with the fact that transaction costs prevent them from achieving a completely contingent contract which would achieve both *ex ante* and *ex post* efficiency. A second best alternative would be a deliberately incomplete contract that commits parties *ex ante* to fixed terms. Another device is the open-ended contract. Yet each of these contracted solutions presents other problems. The hard and fast contract may fail to achieve *ex post* efficiency in some states of the world. The open-ended contract may promote moral hazard in the party with discretion or present verifiability problems to a court attempting to apply such a vague standard. Gilson *et al.* recognized the limits of this bifurcated

to interpret the contract (or fill in gaps) to maximize joint surplus. Also, because of limits on cognition, the parties may not even realize that their express language would later turn out to be ambiguous.[96] Moreover, the parties may fail to adopt an open-ended standard giving one party discretion, fearing that the open-ended clause would be useless if considered too vague to be enforceable, or failing to perceive that any element of discretion might be involved in the future.[97] Therefore, maximizing joint surplus may sometimes best be achieved through judicial intervention. For example, even without an express directive to courts to broadly interpret a term with trade usages, a judicially supplied default rule to do so may maximize gains from trade, while minimizing transaction costs.[98]

The key insight of Kraus and Scott that supports strict enforcement of the chosen terms depends on a portrait of contracting in which one can infer that the adoption of specific terms and the absence of any vague terms denotes both large investment in drafting costs (to determine the optimal term)[99] as well as a decision to foreclose all judicial intervention and deliberately opt into a rule-based, non-contextualized approach to interpretation.[100] Kraus and Scott's key argument depends on a singular view of how parties negotiate contracts which ignores the impediments to complete contingent con-

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structure when they suggested that parties may strive for other ways of curbing opportunism while maximizing *ex ante* and *ex post* efficiency. These include "a continuum of contracts that support collaborative innovation." *Id.* at 436.

[96] Even sophisticated commercial parties might not be aware of how a complicated bond indenture would allocate priorities between different classes of bondholders even though they negotiated the terms. These could include private informal enforcement, other private strategies for controlling opportunistic behavior including hostage taking, bonding, etc. Parties may also be unaware of the fact that because of inconsistent clauses, an ambiguity or interpretive problem may be created. *See* Benjamin Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 3, 71 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

[97] Kostritsky, *supra* note 14, at 80.

[98] Requiring parties to expressly delegate to courts and to expressly opt in to equitable principles before allowing a court to proceed beyond the express terms would be costly. Moreover, because parties may assume courts will act to broadly interpret terms to maximize welfare without needing to resort to equity, they may fail to delegate such authority. Without that delegation, courts would be stymied, and welfare for the parties would be reduced.

[99] Kraus & Scott, *supra* note 4, at 1071.

[100] *Id.* at 1072 ("[W]hen the parties reduce the price term to a rule, they anticipate no role for a court *ex post* in selecting a proxy in the event the precise term does not function as predicted.") (emphasis added).

tracting[101] and distorts the significance of specific terms in a contract. The Kraus and Scott view posits that parties have a choice about how much effort to devote to contract drafting and that the parties make certain dichotomous choices in contract design.[102] If there is no express term on point regarding the matter in litigation and no express delegation to a court, the Kraus and Scott view assumes that parties have *necessarily* decided *ex ante* to rely exclusively on informal enforcement to police behavior under the contract.[103]

This divided world neglects those cases in which the parties included a term that is specific and rigid, not because the parties have invested large front-end costs, but because the future is uncertain.[104] Contract design theory must account for transactions that are beset by uncertainty, which may cause parties to agree on a rigid term that fails to deal with many possible contingencies[105] or in which the contract remains incomplete because uncertainty makes it too costly to describe behaviors that need to be controlled.[106] In the latter case, there may be discretion without any express delegation to a court, which takes the form of a vague or open-ended term.[107]

Foreclosing contract interpretation based on a stylized view of negotiation in which the presence of specific, non-vague terms signals a deliberate choice to invest in front-end costs places too much meaning on the presence of specific terms and imbues those words with the choice of a single legal methodology. As noted earlier, parties in a relational contract may agree on specific terms expecting that they will later renegotiate the contract.[108] Parties may agree on specific terms without realizing the need for delegation to a court. They may not realize the need for a delegation to a court using a general form clause

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[101] The problem of incompleteness in contracting has been addressed by many recent scholars. *See, e.g.,* Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 756 (1988); Schwartz, *supra* note 56.

[102] Kraus & Scott, *supra* note 4, at 1028-29.

[103] Kraus & Scott, *supra* note 4, at 1028, 1059-60.

[104] *See* Karen Eggleston, Eric A. Posner & Richard Zeckhauser, *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 104 (2000).

[105] Steven Shavell, *On the Writing and the Interpretation of Contracts*, 22 J. L. ECON. & ORG. 289, 289 (2005). *See also* Eggleston, Posner & Zeckhauser, *supra* note 104.

[106] Pierpaolo Battigalli & Giovanni Maggi, *Rigidity, Discretion, and the Costs of Writing Contracts,* 92 AM. ECON. REV. 798, 800 (2002).

[107] *Id.* at 799.

[108] William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, contributed this insight. E-mail from William C. Whitford to Juliet P. Kostritsky, *supra* note 8.

prohibiting opportunistic behavior because the content of the implied bargain will always be similar, though the subject matter of the bargain will be different. The commonplace quality of such terms may account for parties not bothering to explicate their bargain, the terms of which might be similar to a statement of performance obligations applicable when one party invests another with discretion.[109]

Once the barriers to contracting are accounted for, there are reasons to conclude that legal intervention might be appropriate even if the parties have used specific terms and failed to use a vague term. Parties may use specific terms even when they would prefer a court to interpret them.[110] Parties may agree on a contract that gives authority to one party to act with specific terms of payment and hours, as to a children's babysitter[111] or an agent, without specifying how the discretion or performance ought to be exercised.[112] Or they may use a term that has both an ordinary meaning and a trade usage meaning assuming that their trade meaning is the ordinary meaning.[113] They may use an ordinary term such as the word "wife," but intend an idiosyncratic, non-ordinary meaning to prevail.[114]

In many cases, the parties have not expressly delegated authority to intervene through an open-ended term because they may not have anticipated the ways in which their specific contract term might be ambiguous, or they did not think of how future contingencies might affect the term or require interpretation. There is no reason to suppose, even where parties "are better informed than courts about their contractual purposes"[115] *ex ante*, that they will be able to craft such a highly detailed contract *ex ante* and that all judicial supplementation should be foreclosed.

The failure to expressly delegate to courts through a vague term may be due to the fact that contracts may remain incomplete in ways that will not be cured by delegating the job of filling in the terms *ex post*. The incompleteness may not be of the kind that can be remedied

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[109] *See* RESTATEMENT (SECOND) OF AGENCY § 379 (1958) (stating "[u]nless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has.").

[110] E-mail from Peter M. Gerhart, to Juliet P. Kostritsky, *supra* note 61.

[111] *See* Battigalli & Maggi, *supra* note 106, at 798.

[112] E-mail from Peter M. Gerhart to Juliet P. Kostritsky, *supra* note 110.

[113] Avery Katz made this valuable point in reviewing Kostritsky, *supra* note 14, at 76.

[114] *Id.*

[115] Kraus & Scott, *supra* note 4, at 1031.

by a court filling in an open term using the "benefit of hindsight"[116] in light of objectively verifiable later events or developments. Instead, the court's role would be one of simply policing the contract and of curbing opportunistic behavior[117]—matters that parties might assume courts have inherent authority over, even without any express delegation. For example, in *Hurst v. W.J. Lake & Co.*, the parties contracted for the sale of horsemeat such that the buyer would receive a discounted purchase price if the horsemeat contained less than 50% protein.[118] When the two shipments of horsemeat arrived containing 49.53% and 49.96% protein, the court prevented the buyer from acting opportunistically and receiving the discounted purchase price by relying on trade usage to illustrate that 50% protein content was meant to mean at least 49.5% protein content.[119]

While the parties have *ex ante* private information superior to a court's[120] that allows them to determine whether there *are* gains from trade, they will inevitably lack information about future states of the world and about their counter party's proclivities to behave opportunistically. Thus, parties may settle on a specific term because of such uncertainties about the state of the world (present or future) or behavior (past or future).

Recognition that the use of specific terms might be due to a type of uncertainty or ambiguity that even the parties were unaware of illustrates that the adoption of a rigid term might not indicate a conscious decision to foreclose all interpretation of that term. After all, one cannot intend to foreclose interpretation of an issue that is not known at the time of contracting. Similarly, the parties might assume that where there is a recurring pattern of behavior in which one party invests another with discretion, and where the terms of the implied bargain will always be similar across a wide variety of factual situations, the parties may have thought that there was no need to explicate a bargain since the terms are so obvious—namely an implied fiduciary-type obligation constraining the discretion of one party to prevent it from acting op-

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[116] *Id.* at 1101.

[117] Of course, as Saul Levmore points out, whether courts can do a reasonable job of policing opportunistic behavior needs to be examined by looking at actual cases. E-mail from Saul Levmore, Dean, University of Chicago School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (July 8, 2009, 16:32 EDT) (on file with author).

[118] Hurst v. W.J. Lake & Co., 16 P.2d 627, 628 (Or. 1932).

[119] *Id.* at 631.

[120] *See* HAYEK, *supra* note 94.

portunistically. Therefore, there are reasons to suggest in these cases that parties may have agreed on some specific terms *without* an intention to foreclose judicial interpretation.

Additionally, in cases where parties *ex ante* do not anticipate that the passage of time and changed conditions will create a need for judicial interpretation, they may not think in terms of an express delegation to a court. For example, where a landowner granted his neighbor an easement which prohibited the use of three-wheeled ATVs because of the dust and noise they caused, the parties did not think to delegate interpretive authority to a court because they did not anticipate the advent of other types of ATVs that would create similar dust and noise.[121] While the parties included specific terms, they most likely did not intend to foreclose the possibility of judicial interpretation, but instead assumed that the passage of time would not create a need for interpretation of the terms based on the parties' intent.

In other types of cases, the need for express delegation may not be readily apparent to the parties. For instance, a party employing an agent or entering a contract knows that there is a potential "propensity to diverge problem."[122] To control that risk *ex ante*, the parties could either draft a very detailed contract or extract a vague promise from one another to refrain from acting opportunistically. However, a detailed contract could be very costly and a party may think a court would not enforce a vague promise to refrain from acting opportunistically.[123] Alternatively, the parties could assume that the risk of opportunism or shirking is such a pervasive problem, and is likely to come up in so many aspects of contract performance, that the parties see no need to advert to the problem expressly. While parties could delegate the job of protecting against opportunistic behavior to a court, they may not expressly do so because they assume that courts will police such behavior as part of their authority and equitable jurisdiction, especially where there are greater net benefits from intervention than from non-intervention.

Alternatively, parties may simply fail to see the need for delegation to a court if they assumed that the particularized meaning they ascribed to a term (such as trade meaning) will be used to interpret a

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[121] BURTON, *supra* note 6, at 169 (citing Gillmor v. Macey, 121 P.3d 57 (Utah Ct. App. 2005)).

[122] E-mail from Ronald J. Coffey to Juliet P. Kostritsky, *supra* note 17.

[123] WILLIAMSON, *supra* note 39, at 63.

term that also has a plain English meaning. Additionally, both parties may ascribe an idiosyncratic meaning to a term of the contract. In these cases, there is reason to suppose that the contract is incomplete or ambiguous, and in such situations it may be less appropriate to simply enforce the chosen means, as there may be a plausible reason why the parties did not see the need to expressly delegate to courts.

Thus, the assumption that the use of a specific term represents a deliberate large front-end investment in drafting ignores (or at least minimizes) the multi-faceted problem of incompleteness in contracts. Incompleteness may be present in a contract even if the parties adopt a specific term such as "one dozen" without an express delegation to the court. In many cases, parties will choose specific terms, and the court must then decide whether the contract is deliberately or inadvertently incomplete.

If one accepts that the use of specific terms might be due to uncertainty or the parties' failure to anticipate the need for express delegation, then Kraus and Scott's assertion that the choice of a specific term necessarily reflects a simultaneous choice to foreclose judicial resort to contractual objectives deserves scrutiny. To conclude that judicial authority was withdrawn simply because the parties used a precise term implies a judgment by the authors that intervention in such cases is not warranted since there was no express delegation. Since the parties did not explicitly ban such intervention when they adopted specific terms, the assertion that the parties are choosing to foreclose broad judicial interpretation conceals a normative choice that Kraus and Scott themselves are making. That choice must be justified using an analytical framework based on a welfare improvement perspective.

One can imagine a term that is specific in nature, such as "one dozen." Even though the parties did not expressly delegate interpretive authority to the court, one can still imagine a situation where parties might prefer that a court resort to trade usages, and interpret that term to mean a baker's dozen (thirteen), instead of twelve. The adoption of a specific term should not automatically preclude legal intervention because "[e]ven a highly detailed term. . .typically omits explicit mention of a multitude of potentially relevant contingencies."[124] The parties may have adopted specific performance obligations without specifying the order of performance or whether tender of one party's performance should be required as a precondition to

[124] Shavell, *supra* note 105, at 292 n.4.

the other party's performance.[125] The central question in each case is whether the legal intervention will be efficient and whether it can be justified as promoting welfare gains for the parties. Whether the use of chosen means should foreclose legal intervention in the form of implied terms or a default rule should not depend merely on an assertion that the parties intended to foreclose judicial intervention, but on a complex analysis of when and if judicial intervention would lead to welfare improvement. This analysis should include an examination of why the terms or default rules were not expressly included, what private alternatives the parties had to expressly including the terms, and whether judicial intervention would be optimal.

Another assumption is that commercially sophisticated parties explicitly design their contracts to choose between legal enforcement and non-legal enforcement. If they adopt specific terms and omit vague terms, they also choose a specific means of enforcement: legal enforcement using formal doctrine of those particular terms and non-legal enforcement of anything not the subject of those terms. If they opt for vague terms, they are affirmatively choosing judicial enforcement of admittedly open-ended terms.

The assumption of a deliberate choice of the means of enforcement *ex ante* is a questionable one for several reasons. First, the deliberate choice theory (that parties choose which parts of the contract will be given legal enforcement and which only informal enforcement) seems to be built on the crowding out hypothesis.[126] It posits that because legal enforcement undermines reciprocity and other informal means of enforcement, courts should be wary about legally enforcing anything beyond the express term because they would be undermining informal means of enforcement.[127] To the extent that the conclusion about party choice is built on a problematic assumption, then the conclusion about party preference may be called into question.

The "crowding out" thesis is built exclusively on experimental data whose results may not be replicated in real life situations. Moreover, because of parties' own cognitive limitations and lack of awareness as to whether there are any ambiguities or uncertainties in the specific

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[125] *See infra* Part IV.D.2.

[126] *See, e.g.*, Kraus & Scott, supra note 4, at 1058-59 (tying "crowding out" thesis to "the claim that commercial parties would prefer formal contract doctrines that permit them to partition their agreements into legally enforceable and legally unenforceable components").

[127] *Id.* at 1059.

terms agreed on, it is not clear that the choice of specific terms means that the parties have opted exclusively for formal enforcement on a rule based system. Had the parties been aware of the ambiguity *ex ante*, they may have opted for legal enforcement, at least as a supplement to informal enforcement. They may also have assumed that a court would intervene and broadly interpret terms if a court could do so consistent with the welfare improvement principle. That assumption would be consistent with courts intervening to fill gaps or supply default rules if they can improve welfare by doing so.

There may be reasons to be suspicious of the hypothesis itself, but, in addition, there are several other reasons why the "crowding out" hypothesis, even if it accurately describes the results in certain experimental situations, should not dictate that courts refrain from intervening unless specifically asked to, or delegated authority to, by the parties. First, since informal enforcement is only effective in some subset of cases, and not 100% of the cases,[128] we cannot surmise that parties would have a uniform choice on the issue of whether they would choose legal enforcement or not. Since reciprocity does not govern in all cases, at least in those cases—which are a substantial number—there would be no reason to suppose that the parties would uniformly want courts to decline legal enforcement as the governing default rule.

Second, while "crowding out" may exist as a phenomenon in the experiments, there is data to suggest that legal enforcement can serve as a complement to non-legal enforcement, at least where the legal enforcement is of verifiable issues.[129] So the question remains whether court enforcement in particular instances would be welfare improving or whether the court would be asked to reach a result on the basis of non-verifiable or information peculiarly manipulable by one party. So, even if "crowding out" may be a theoretical problem, in some instances legal enforcement will be beneficial to social welfare and courts should not rule out legal enforcement absent express delegation as a unitary rule.

Third, the assumption seems to be that "crowding out" is likely to be particularly problematic when the court is intervening to achieve *ex*

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[128] *See* George S. Geis, *An Embedded Options Theory of Indefinite Contracts*, 90 MINN. L. REV. 1664, 1668-69 (2006).

[129] *See* Sergio Lazzarini, Gary J. Miller & Todd Zenger, *Order with Some Law: Complementarity versus Substitution of Formal and Informal Arrangements*, 20 J.L. ECON. & ORG. 261, 261-62 (2004).

post justice goals as a means of overriding the parties' chosen means.[130] Because their assessment of the merits of the two tiered bifurcated approach occurs in the context of a court using its equitable powers to serve "fairness and reciprocity,"[131] it is still an open question as to whether the authors would have the same concerns about judicial intervention if the basis for intervention is not the court's exercise of equitable powers to achieve fairness, but the court's intervention to promote gains from trade and to maximize social welfare.

2. Judicial Intervention as Override

Another problem with the argument against all judicial intervention absent an explicit authorization is that it automatically assumes that parties opt exclusively into either (1) a regime of no intervention if the parties use specific terms; or (2) judicial intervention if they use broad terms. The argument fails to tie the myriad of causes of incompleteness to the particular form of judicial intervention. Moreover, the argument assumes that because courts improperly intervene in some cases by overriding the parties' chosen specific means, it necessarily follows that judicial intervention is improper in all cases where the parties have agreed on specific terms without expressly delegating authority to courts to intervene. Their approach would foreclose judicial intervention in a broad array of circumstances, even though judicial intervention in other contexts could be justified under a welfare improvement standard.

Specifically, Kraus and Scott rest their argument on an example (the ALCOA case)[132] in which the parties agreed to a price to the seller equal to "three percent above the published [industry] price index,"[133] but the parties' goal in agreeing on this particular price term is to "provid[e] the seller with a three percent profit."[134] The ALCOA court chose to override those terms in circumstances where the court "believes that the published price index severely underrepresents the seller's actual costs"[135] and where the proxy index does not function well *ex post* and thus assures the seller less than the contractual goal of three percent above its costs. Kraus and Scott use this paradigm case

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[130] *See* Kraus & Scott, *supra* note 4, at 1058.

[131] *Id.* at 1059.

[132] Aluminum Co. of America v. Essex Group, Inc. (*ALCOA*), 499 F. Supp. 53 (W.D. Pa. 1980).

[133] Kraus & Scott, *supra* note 4, at 1025 n.1.

[134] *Id.*

[135] *Id.* at 1025.

to urge that "[s]ometimes the only way to maintain fidelity to the parties' contractual intent is to enforce the formal contract terms to which they agreed, even when doing so defeats *their* contractual ends."[136] The authors argue that overriding the chosen means to achieve the goal of assuring a three percent above costs price for the seller will hinder reliability of specific terms and involve the court in an expensive inquiry *ex post* into the seller's costs—an inquiry which the parties wished to avoid by adopting an index proxy for the seller's costs.[137]

Kraus and Scott then use the ALCOA case to illustrate how, and why, a court reaches misguided results when it overrides actual terms to achieve the parties' objectives.[138] In the ALCOA case, the seller (ALCOA) agreed to a price term that was to be adjusted—based upon an underlying index—over the life of the contract.[139] The goal, at least of ALCOA, was to achieve a return that gave ALCOA its costs "plus one penny."[140]

However, for a variety of reasons including the failure of the index specified to track ALCOA's actual costs, ALCOA's costs actually exceeded its contract price.[141] When renegotiations failed, ALCOA sought to reform the contract. The court granted reformation, holding that ALCOA did not undertake the risk that the index would malfunction.[142]

Kraus and Scott argue that the way to determine whether intervention is appropriate is to focus on how the parties designed the contract.[143] In the ALCOA case, the parties had a choice between opting for a specific price term or a more general open standard.[144] Because the seller, ALCOA, chose a specific price term premised on a specific index rather than a broad standard, Kraus and Scott conclude that the parties wanted no *ex post* intervention by a court.[145] Parties opt for standards when courts have an "informational advantage in knowing what future states have materialized" and for precise rules when the parties

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[136] *Id.* at 1027 (emphasis added).
[137] *Id.*
[138] *Id.* at 1063.
[139] *ALCOA*, 499 F. Supp. at 56.
[140] Kraus & Scott, *supra* note 4, at 1065.
[141] *ALCOA*, 499 F. Supp. at 58. The contract price was 25 cents and the costs were 35 cents. Kraus & Scott, *supra* note 4, at 1065.
[142] *ALCOA*, 499 F. Supp. at 78-80.
[143] *See* Kraus & Scott, *supra* note 4, at 1030-31.
[144] *Id.* at 1072.
[145] *See id.*

have an "informational advantage in knowing their contractual ends."[146]

Kraus and Scott argue that the parties' intention to adopt a rule based approach necessarily revealed their intention to foreclose all judicial intervention *ex post*.[147] They reach this conclusion, in part, because the parties invested large front-end drafting costs.[148] Had they wanted a court to intervene *ex post*, they would have forgone such an investment in front-end drafting costs and instead opted for a broad standard. Therefore, Kraus and Scott conclude that the court's reformation of the contract was wrong because it failed to respect the parties' choice for a rule based approach. The court's mistake will cause future courts to override the parties' clear choice, thereby circumscribing the parties' ability to have courts respect their contractual design choices.

This Article disagrees with the conclusion that the determination of whether intervention is appropriate can be settled simply by determining whether the parties adopted *ex ante* a specific or open-ended term. Instead, this author suggests that how parties draft contracts and whether they opt for specific or open-ended terms does not, and should not, conclusively settle the issue of whether intervention *ex post* is justified.

First, the parties may have adopted specific terms and expected they would function as intended. However, the agreement on a precise term may not always necessarily indicate that the parties invested large front-end costs. They may settle on a specific term but, because they are involved in a relational contract, may fully expect that the term will be subsequently renegotiated.[149] The parties may also settle on a specific term, but rely on a court to intervene if it can do so in a way that will maximize the parties' gains from trade.

The key question is whether the residual risk of the index clause malfunctioning had been allocated by the parties. That is a difficult issue to resolve by simply looking to the terms agreed on. A different way to analyze this normative question is to look to the overall structure of the contract. Having done so, Victor Goldberg concludes that

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[146] *Id.* at 1073.

[147] *See id.* at 1072.

[148] *Id.* at 1073.

[149] The parties in fact tried to renegotiate the contract in ALCOA, but without success. *Id.* at 1065.

the purpose was to afford ALCOA a cost plus contract even if that were not explicitly stated.[150]

Rather than assuming that the use of a specific term forecloses all judicial intervention, this Article suggests that a court, in deciding whether to intervene, must grapple with whether doing so would be welfare-improving. Assuming that the parties adopted a term that ultimately malfunctioned, the court should focus on what the parties, *ex ante*, would have wanted to happen when the malfunction occurred. If a court could intervene and award ALCOA the expected cost plus outcome in a way that would not subject the other party to the risk of opportunistic behavior by ALCOA in the supply of the cost data, then perhaps intervention would be justified.

Kraus and Scott use this example to posit that in such cases, courts improperly assume that "had the parties known at the time of formation what the court knows at the time of adjudication, the parties themselves would have crafted different terms."[151] In this and other outlier examples, courts intervening in contracts mistakenly try to realign the contractual terms with the original joint contractual goals by taking account of *ex post* events, requiring them to make decisions using unverifiable data. Courts conclude that "parties would prefer courts to do for them in the course of adjudication what the parties would have done for themselves at the time of formation had they known what the court knows."[152] In such cases, Kraus and Scott assert, courts wrongly suppose that they should depart from and override the specific contractual means chosen (the three percent above the index) in order to accomplish the contractual goal of assuring the seller three percent above his costs.[153]

Kraus and Scott raise valid concerns that cast doubt on certain types of judicial intervention, especially those undertaken to achieve contractual goals in cases where the parties deliberately avoided adopting an express term tied to those goals. However, their criticism of judicial intervention to achieve contractual goals seems to extend to all types of judicial intervention if the parties did not signal their desire for judicial intervention through a vague term. Such an extension of their argument, however, would be misguided.

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[150] Victor Goldberg, Framing Contract Law 349 (2006).

[151] Kraus & Scott, *supra* note 4, at 1027.

[152] *Id.*

[153] *Id.*

One problematic aspect of examined intervention, when it arises in the actual ALCOA context, is that the court intervened to assure the parties that they would achieve a particular contractual objective when the express term failed to achieve that objective even (1) when it is not clear that such a joint contractual objective existed; or (2) if rewriting the contract to achieve such an objective would alone be a proper basis for judicial intervention.

Although Kraus and Scott assume that the parties' joint goal was to assure the seller a three percent profit in the price term, it is not clear that both parties subscribed to that joint goal. It is possible that the seller may have hoped that the term would operate to guarantee such a profit, while the buyer agreed to the term because the specified price term was on the contract curve. The second problem with this example is that it justifies the court's intervention *ex post* on the rationale that a court may intervene to achieve a specific contractual goal. However, the mere fact that one of the parties did not achieve its goal does not provide an adequate justification. A court should intervene only if the benefits of judicial intervention outweigh the costs. Because of potential negative *ex ante* prospective effects on other contracts, such as the increase in moral hazard when a court must substitute a proxy or ascertain a seller's true costs, a court might decide that the costs of intervention outweigh the benefits *even if* the clause no longer achieves the seller's original goal of a three percent profit. The parties in Kraus and Scott's example agreed on the specific term because an alternative, more general term which gave the seller his "cost plus three percent" would be difficult to monitor and potentially subject to manipulation.[154] A seller could claim high costs, and unless that term were verifiable, the buyer would be subject to the seller's inflated cost claims and therefore subject to opportunism. The case does not provide a solid foundation for their argument because it is an example of judicial overreaching built on a much criticized case.[155] Thus, if a more robust justificative framework were used, intervention in the paradigm case might be deemed inappropriate.

Because the parties avoided adopting an express term that tracked the seller's costs, it does not provide a sound foundation for analyzing the broader question of whether courts should look to the parties' overall objectives when interpreting incomplete contracts in a variety

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[154] *See id.* at 1070.

[155] *ALCOA*, 499 F. Supp. 53. For insightful criticism of the case, see GOLDBERG, *supra* note 150, at 348.

of contexts, particularly those that might not deeply involve the court in unverifiable matters.

If the hypothetical and the ALCOA case used by Kraus and Scott are reexamined, it is possible that it does not counsel against judicial intervention to achieve the parties' overall contractual goals whenever parties have chosen specific means or terms and failed to delegate interpretive authority to a court. It does not follow, however, that other instances of judicial intervention when parties have "chosen means" are similarly misguided.

In order to override a contract term, a court needs justification for doing so. However, it seems that the ALCOA court may have overrode a term without a complete normative framework. The mere fact that courts have improperly intervened by invoking an incomplete framework to justify overriding a specific term should not serve as the basis for widely preferring a strategy of non-intervention. The framework for judicial intervention must take account not only of the means chosen by the parties, as well as the possible costs of judicial error in resolving an open-ended inquiry, but also of a number of other factors that might counsel against judicial intervention after a more extended analysis.

One factor the judicial intervention framework should take into account is the risk that the buyer, by insisting that the courts adhere to express chosen means of the contract, is seeking to shift a risk to the seller that the seller did not assume *ex ante*. In the Kraus and Scott example, one could surmise that the seller, who was guaranteed a price of three percent above an index, was mitigating some of the risk by having a term that would move with inflation and other sources of upward pressure on prices. One could also surmise the buyer's awareness that the seller was insulating itself from some of the market risk[156] through the agreed on terms.

At the same time, the chosen means were meant to afford the seller a price that moved with the market, but did not require the court to evaluate non-verifiable matters such as the seller's costs. If the court departed from the express terms by inquiring into and substituting a price term based on the seller's costs, the court would subject the buyer to a risk of judicial error that the buyer might not have agreed

[156] However, as Victor Goldberg points out, the formula was flawed for many reasons. *See* GOLDBERG, *supra* note 150, at 351.

to—even if it were later found that the agreed on chosen means no longer assured the seller a markup of three percent above its costs. Allowing the price term to depend on the seller's costs would permit the seller to capitalize on the unanticipated circumstances while subjecting the buyer to error costs in litigation that would add to its overall costs and, perhaps, subject it to the seller's opportunistic behavior (inflating its costs).

The hypothetical example demonstrates that there are risks and costs to intervening and not intervening, and that any court must consider them before acting. Before deciding to intervene, a court should determine whether there is another proxy index that would more closely track the seller's costs and whether that proxy could be used to establish a pricing term more closely mirroring the parties' objectives, such as assuring the seller a price term equal to three percent above its costs without subjecting the buyer to the risk of an open-ended inquiry into a manipulable element, such as the seller's costs. Further, the court might require the parties to bargain in good faith towards a new pricing term[157] if it were convinced that the costs would be observable to the parties, though not verifiable to a court. Finally, the court might look to other objective indicia to determine whether either party is acting in bad faith, for instance by using the malfunctioning index to propel itself into the position of a reseller on the market.[158] By enforcing the price term as it is, through the parties' chosen means, the court would allow one party to engage in a form of conduct that is regarded as opportunistic in other contexts.

The hypothetical thus presents a situation where one could argue that if the court were to intervene by "realigning the price term with the seller's actual costs,"[159] it might in fact defeat the parties' contractual goals, if those goals are broadly conceived in terms of welfare improvement. Although the parties may have intended to provide the seller with three percent above his costs, even in cases where the published index fails to achieve that goal, one should not necessarily jump to the conclusion that the parties would want the court to intervene with an *ex post* inquiry into the seller's costs. Legal intervention should be justified only by projecting whether parties *ex ante* would think that judicial intervention would be optimal and efficient. The courts should craft legal rules and interventions using a justificative frame-

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[157] *See, e.g.*, Oglebay Norton Co. v. Armco, Inc., 556 N.E.2d 515 (Ohio 1990).
[158] GOLDBERG, *supra* note 150, at 365-68.
[159] Kraus & Scott, *supra* note 4, at 1027.

work, particularly when it finds that intervention will result in welfare gains. If the court has to calculate the seller's costs, and such information is unverifiable, the parties may indeed prefer the court to decline to intervene when the initial price index fails. The costs of judicial error may outweigh any possible benefit from the court determining its own estimate of the seller's costs, including the possibility that an open-ended inquiry might curtail some opportunistic behavior. In such a scenario, judicial intervention cannot be justified using a cost/benefit analysis, even if the seller might desire such an inquiry *ex post*.

When deciding those cases, courts should consider such presumed goals, including the likely effects on incentives and the overall goal of maximizing gains from trade or contractual surplus while minimizing transaction costs. Courts can intervene without inquiring into an unverifiable factor that the parties deliberately excluded from their contract means.[160] Courts should expand consideration beyond the parties' chosen means and beyond a specific contractual goal that was deliberately avoided by the chosen means. Courts should also consider broader goals such as minimizing transaction costs, maximizing surplus, minimizing deadweight losses, and curbing opportunistic behavior. It is difficult to see how courts can function effectively to choose optimal rules without considering "what goals or objectives will be served or jeopardized by a response awarding (or withholding) a property right or imposing (or not imposing) liability in light of responses' likely effect on those who will be affected by litigation . . . ."[161]

The paradigm example, however, is used by Kraus and Scott to bolster their broader argument that courts should refrain from judicial intervention to achieve the parties' goals if doing so would override or undermine the specific terms that have been chosen by the parties.[162] Moreover, because Kraus and Scott do not carefully distinguish between (1) the parties' contractual goals *specific to individual transactions*; and (2) the *broader economic goals* of maximizing joint surplus which are present in every transaction, readers may mistakenly conflate the two. Therefore, one weakness of the Kraus and Scott approach is its suggestion that even if a court could intervene in a contract in such a way that

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[160] Of course, the deliberate decision to exclude a decision built on an unverifiable factor like costs rests on a long standing critique of judicial intervention in such cases. *See* Schwartz, *supra* note 56, at 284-85 (discussing non-verifiability of a cost-plus contract term).

[161] E-mail from Ronald J. Coffey to Juliet P. Kostritsky, *supra* note 17.

[162] Kraus & Scott, *supra* note 4, at 1027.

it could achieve the parties' broader contractual goals of welfare maximization, it should refuse to do so unless the parties have specifically requested such intervention through vague terms. Their article is an extended argument for greater formalism in contract interpretation and for greater deference to the parties "chosen means," which are the parties' explicit terms.

Many of the examples chosen by Scott and Kraus, including the example based on the "three percent above costs" term,[163] seem to illustrate cases where a court neglects the specific terms chosen to achieve a specific contractual goal in a way that requires the court to supply unverifiable terms. Intervening with a term based on "seller's costs" may not be preferred by the majority of parties because of the negative effects on future parties who would anticipate the high back-end costs of judicial intervention. These examples, however, rather than standing for the proposition that courts should *not* intervene when the parties have chosen precise terms, demonstrate the need for courts to engage in a careful justificative analysis in deciding whether or not to intervene by determining whether intervention will result in welfare gains for both parties.

In the cases Kraus and Scott discuss, courts look at events *ex post* and find a "misalignment" between the agreed on terms of the contract and the parties' objectives, which subsequent events have rendered unachievable. The suggested justification for judicial intervention through substituting terms is that such intervention allows the parties to achieve their original contractual goals. However, normally, courts should not intervene to achieve specific contractual goals, because those goals may diverge amongst the parties. Judicial intervention should not add to or override contractual language to achieve "joint" contractual goals, since the parties are likely to share different goals. For instance one party (the seller) may hope that a term will achieve a goal such as three percent above seller's costs, while the other party (the buyer) might hope that events will make the contract profitable for it, regardless of the seller's return.

In addition, even if an *ex post* realignment could be justified on "fairness" grounds, it might not be preferred by parties *ex ante* if such intervention would adversely affect parties' incentives or lead to significant back-end costs by requiring a court to craft terms based on unverifiable data input. In this case, it is hard to see how the intervention to

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[163] *Id.* at 1025.

realign with contractual goals would be preferred by parties *ex ante*, even if one of them would prefer the intervention *ex post*. In the example posited by Kraus and Scott, the purported intervention *seems* self-evident since *ex post* events have prevented the contract terms from achieving a shared contractual goal. However, intervention should only take place *ex post* if the parties *ex ante* would both want the court to effectuate realignment in light of *ex post* events, and intervention would not negatively affect investments and incentives. While Kraus and Scott's posited example would not seem to warrant intervention under a welfare improvement standard, it does not suggest that all judicial intervention in contracts, absent express delegation, would have negative welfare effects.

III. Suggested Framework

In order to determine whether judicial intervention in a contract is justified, courts must recognize that the presence of a specific term, alone, does not resolve the issue of whether a court should intervene. Instead, courts must use an analytical framework to determine if intervention would improve welfare. Such a framework must be applicable to a wide range of Contracts cases and must extend beyond outlier cases to ascertain when courts can play a useful role.

Courts must make realistic assumptions about why a contract may be incomplete. A contract may be incomplete because of the enormous uncertainties that the parties faced. For example, parties employing agents might use a very simple contract (e.g. agreeing to employ an agent for a fixed wage) because they may have great difficulty specifying the multitude of choices to actions that should be constrained.[164] Oftentimes such a contract is silent on how an agent with discretion, such as a babysitter, should behave when faced with certain choices.[165]

Thus, one heuristic a court may employ is to determine whether a code exists outside the four corners of the contract, and if so, whether the court could easily incorporate it into the contract without great cost. Such determination would require objective evidence of prevalent trade usages or trade meanings, and a failure to give effect to context evidence in such cases would promote opportunistic behavior.[166] Therefore, if a court can interpret the term using trade usages to deter

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[164] Williamson, *supra* note 39.

[165] *See* Battigalli & Maggi, *supra* note 106, at 800.

[166] Kostritsky, *supra* note 14, at 94.

such opportunism at a low cost, it should consider doing so, even if the parties have not expressly delegated that authority.

Matters of interpretation cannot be resolved simply by arguing that parties who omit vague terms chose to foreclose judicial intervention. Even when parties adopt express terms, they often do not include additional express terms foreclosing such interpretation. A court resolving the issue must first decide whether intervention is justified, and must do so using a normative structure that relies on a number of assumptions about behavior (such as propensity to act opportunistically) and limits on cognition. Heuristics, like the method described above, may be helpful to courts in deciding when and how to intervene.

In deciding if there are net benefits to intervention, a court should consider whether intervention would promote the parties', and society's, goal of maximizing welfare while minimizing transaction costs. In making such determinations, a court should downplay the importance of specific contractual goals unless there is evidence that those goals were shared by both parties and the benefit of a court intervening to accomplish those goals is greater than the costs of such intervention. Therefore, a court must ask whether a failure to intervene will facilitate opportunistic behavior. If judicial intervention by courts through a law supplied term will control opportunistic behavior at a lower cost than alternative private strategies or informal enforcement mechanisms, then a court should consider intervening. A failure to remedy opportunistic behavior will result in deadweight losses, minimizing gains from trade.

Courts, and scholars, should focus on when judicial intervention is likely to improve welfare and limit intervention to those cases, rather than focusing on outlier cases where courts engage in *ex post* realignment that might be embraced by those concerned with *ex post* fairness[167] rather than *ex ante* efficiency and in which courts justify the results by reference to specific contractual goals (which likely diverge among the parties). If scholars move beyond outlier cases, then the cases where courts should move beyond the parties' chosen means to promote efficiency are identifiable. Often courts intervene in contracts, not to seek realignment to achieve specific goals in light of later events, but to craft rules—including default rules that would be pre-

[167] Scott, *supra* note 3, at 850-51.

ferred by the parties *ex ante* for efficiency reasons.[168] The outlier examples of judicial intervention underscore the importance of clarifying the framework and particular fact patterns under which courts intervene and whether (and how) those interventions will promote welfare improvement.

For instance, even if the parties have not used an open-ended term such as "good faith" or "fiduciary obligation," a court might have to decide whether to imply a term to govern the performance obligations of a party such as a babysitter,[169] employee, or agent, or whether it should confine its role to strict or literal interpretation of the terms. In determining whether failing to intervene will result in a lack of control over a party's discretion under the contract, the court should analyze (1) whether any express contract controls exist; and (2) the potential for robust informal sanctioning mechanisms or other private governance strategies.[170]

Deadweight losses resulting from uncontrolled discretion (because of the court's failure to intervene) must be accounted for as a cost in assessing the costs and benefits of judicial intervention. That cost must then be compared to methods of control by judicial enforcement via a law supplied term and by informal enforcement. A court must first consider the costs of parties enforcing constraints on behavior, or limiting opportunistic behavior, or shirking by an agent by informal enforcement to police such behavior. A court must consider how robust the non-legal sanctions are, and whether there is transparency and a means for parties and courts to judge whether opportunistic behavior has occurred. The court should consider whether there are possibilities of repeat play that would make reputational sanctioning and "tit for tat" strategies effective. If repeat play is not likely, the court should consider whether the experimental evidence suggests that norms of reciprocity would constrain such behavior. For those parties who choose not to be constrained by such norms, could the law play a helpful role by supplementing non-legal enforcement? The mere fact that parties have chosen not to address some matter or have failed to condition some obligation on an uncertain event does not necessarily mean that they were relying exclusively on informal means of enforcement. Instead, it is reasonable to assume that the parties

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[168] *Id.* at 849-50.

[169] *See* Battigalli & Maggi, *supra* note 106, at 798-800.

[170] *See* Gilson et al., *supra* note 95, at 454.

would prefer the courts to intervene—if doing so would maximize gains from trade.

This framework could be applied to numerous situations that might require judicial interpretation, gap filling, or adding terms. The value of this framework is illustrated by *Market Street Associates Limited Partnership v. Frey*.[171] In *Frey*, a lease provided the lessee the right to obtain financing for improvements costing at least $250,000 and obligated the lessor to consider those financing requests.[172] Under paragraph 34 of the lease, the lessor's failure to agree to the financing terms gave the lessee an option to purchase the property at a favorable price.[173]

When the lessee was unsuccessful in obtaining financing from the lessor, it demanded to purchase the property from the lessor at the price stipulated in paragraph 34 (totaling roughly $1 million).[174] When the lessor refused, the lessee sought specific performance of the option.[175] The lessor was apparently unaware paragraph 34 existed because, had it known, the lessor surely would not have repeatedly failed to respond to the lessee's multiple attempts to obtain financing, thereby allowing the lessee to purchase the property for $1 million dollars (a price apparently much lower than the property's market value).[176] The lessee benefited enormously from the lessor's failure to focus on the lease provision (paragraph 34), which meant that the failure to give financing would entitle the lessee to obtain the property at below market price.

The lessor prevailed on summary judgment based on two different, but related, grounds—each claiming that the lessee's failure to mention paragraph 34 either (1) prevented the option to purchase

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[171] I am grateful to William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, for suggesting Market St. Assoc. Ltd. P'ship v. Frey (*Frey*), 941 F.2d 588 (7th Cir. 1991), as an illustrative case for the article. E-mail from William C. Whitford to Juliet P. Kostritsky, *supra* note 8.

[172] *Frey*, 941 F.2d at 591.

[173] *Id.* ("[T]he lessee shall be entitled to repurchase the property at a price roughly equal to the price at which Penney sold it to the pension trust in the first place, plus 6 percent a year for each year since the original purchase. So if the average annual appreciation in the property exceeded 6 percent, a breakdown in negotiations over the financing of improvements would entitle Penney [the lessee] to buy back the property for less than its market value . . . .").

[174] *Id.* at 592.

[175] *Id.* at 598.

[176] Paragraph 34 permitted the lessee to purchase the property at the favorable price only if the financing negotiations failed. *Id.* at 591.

from coming into existence; or (2) constituted bad faith conduct by the lessee.[177]

On appeal, Judge Posner reversed the grant of summary judgment and remanded the case.[178] Posner believed the good faith issue could not be decided on summary judgment because it turned on facts involving the state of mind of the lessee—a matter not capable of being determined on summary judgment.[179]

In order to resolve the good faith issue, the court had to grapple with the contract language. No language in the contract obligated the lessee to specifically mention paragraph 34 in its demand for financing.[180] Thus, the court was confronted with an interpretation issue. The lessor argued that "either as a matter of simple contract interpretation or under the compulsion of the doctrine of good faith, a provision requiring Market Street Associates [lessee] to remind the pension trust [lessor] of paragraph 34 should be read into the lease."[181]

If one accepts Kraus and Scott's argument, then the court should not interject a clause into the contract requiring the lessee to notify the lessor of the existence of paragraph 34 (or read an obligation of good faith into the contract requiring such notice) because the parties did not use open-ended language delegating the court the authority to do so.

The problem with that approach is that the refusal to intervene with a broad interpretation that might require notice to the lessor under particular circumstances might facilitate opportunistic behavior by the lessee and add to transaction costs. As Judge Posner explains: "The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties' joint goal."[182]

Therefore, the inquiry should be: (1) whether, and why, the lessee must act in good faith in performing its obligations under the lease; (2) what that obligation of good faith should require; and (3) whether,

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[177] *Id.* at 592.
[178] *Id.* at 598.
[179] *Id.* at 597-98.
[180] *Id.* at 593.
[181] *Id.*
[182] *Id.* at 595. *See also* Todd D. Rakoff, *Good Faith in Contract Performance:* Market Street Associates Ltd. Partnership v. Frey, 120 HARV. L. REV. 1187 (2007).

and why, it would ever be the case that a failure to give the lessor notice of a particular paragraph under the lease would constitute bad faith.

In deciding the case, Judge Posner found the "dispositive question in the present case [to be] simply whether Market Street Associates tried to trick the pension trust and succeeded in doing so."[183] To determine whether a trick was played and therefore whether opportunistic behavior occurred, Judge Posner thought that summary judgment was inappropriate because factual information was required to determine what the lessee knew.[184]

Regardless of whether one agrees with Judge Posner's approach, or whether opportunistic breach of the good faith obligation might include other conduct that did not amount to a conscious trick,[185] it seems that insisting the court cannot go beyond the express terms to interpolate or add clauses could have negative welfare effects. This would be the case if the costs of judicial intervention were less than the aggregate costs from the "defensive expenditures" that parties would make to ward off opportunistic behavior, less than the chill on contracting that would occur due to the parties' fear of opportunistic behavior, and less than the costs of informal policing of such behavior.

If one accepts that parties will want *ex ante* to deter opportunistic behavior to promote an increase in joint gains, then it seems reasonable that Judge Posner was willing to consider the possibility that the contract might require one party to do more than was technically required under the terms of the lease.

IV. Doctrinal Applications: Illustrating a Framework for Justification of Judicial Intervention

Courts can promote welfare improvement by intervening in contracts in a variety of ways, even when the parties have not deliberately opted into back-end arrangements that delegate matters to courts *ex post*. Kraus and Scott argue that courts should intervene only when the parties have explicitly signaled their intention to opt into judicial intervention through terms that are explicitly vague.[186] Vague standards allow parties to delegate to courts that will have certain hindsight

[183] *Frey,* 941 F.2d at 596.
[184] *Id.* at 597-98.
[185] *See* Rakoff, *supra* note 182, at 1195-96.
[186] Kraus & Scott, *supra* note 4, at 1026.

advantages *ex post* because new facts or information will have been revealed.

This bifurcation by Kraus and Scott suggests that many doctrines in contract law—such as Section 45,[187] the Drennan rule of irrevocability,[188] the good faith doctrine, and the incorporation of trade usage doctrines and constructional preferences involving conditions—are misguided because they allow courts to intervene (without express delegation) by implying a term that constrains discretion or broadly interpreting contracts by incorporating matters not expressly adverted to. Kraus and Scott's bifurcated structure is too narrow to accommodate what courts are actually doing in many areas of contract law.

Courts seem comfortable implying duties in a variety of settings, even when the parties have agreed on specific terms and failed to expressly delegate authority to a court through an open-ended term. By incorporating or implying terms and duties that were not expressly agreed upon, courts exercise their authority to restrain parties' opportunistic behavior.

In deciding whether it should go beyond the parties' chosen means, a court should not assume that the choice of specific means without a vague term indicates the parties decided to exclude all legal intervention or that they intended the court to follow a rule based approach. Every term presents the court with a possible interpretive question that cannot be resolved with a unitary rule, especially one that looks only to the chosen means and forbids the court from considering contractual goals.

A. *Oral Conditions and the Parol Evidence Rule*

Kraus and Scott discuss *Hunt v. Doliner* to illustrate the means/ends conflict.[189] In that case, Kraus and Scott suggest the court erred in looking to a contractual goal that the parties' articulated prior to signing rather looking exclusively to the parties' chosen means (i.e. their words).[190] Kraus and Scott argue that because the contract lacked an express contractual provision for the goal, the parties intended to rely exclusively on informal means.[191] Therefore, the court over-

[187] *See* RESTATEMENT (SECOND) OF CONTRACTS § 45 (1981).
[188] *See* Drennan v. Star Paving Co., 333 P.2d 757 (Cal. 1958).
[189] Hunt Foods & Indus., Inc. v. Doliner, 270 N.Y.S.2d 937 (App. Div. 1966).
[190] Kraus & Scott, *supra* note 4, at 1051-52.
[191] *Id.* at 1053.

stepped its authority by providing legal enforcement to terms or agreements not in the formal contract. However, a close examination of the case reveals that there are contrary arguments to support looking beyond the written words to effectuate joint goals of restraining opportunistic behavior.

During negotiations for Hunt Food's purchase of the Eastern Can Company ("Eastern"), Doliner, the owner of 73% of Eastern's stock, requested a recess in the negotiations.[192] To deter Doliner from using the recess to shop Hunt Foods' offer to other companies, Hunt Foods insisted on securing, as the price for acquiescing in the recess, an option to purchase all of Doliner's stock for $5.50 per share.[193] The option was to be exercised prior to June 1, 1965, and would be considered void if notice was not given by that date.[194] During oral negotiations, Hunt Foods allegedly assured Doliner that the option would *not* be exercised unless Doliner shopped the bid during the recess, even though no such provision was included in the writing.[195]

The parties reconvened after the recess but failed to reach agreement.[196] Hunt Foods then sought to exercise the option and enforce it on a motion for summary judgment.[197] Doliner then sought to introduce evidence of the oral condition, arguing that because Doliner had not shopped the bid, the option was not operative.[198] Hunt Foods sought to exclude evidence of the oral condition on the ground that the parol evidence rule barred evidence of prior oral agreements.[199]

Despite Hunt Foods' arguments, the court admitted evidence of the oral condition on the implicit assumption that the agreement was only partially integrated.[200] As a partially integrated agreement, extrinsic evidence would be admitted unless that evidence contradicted the written agreement;[201] thus, *additional* oral terms would be admissible. The court then adopted a very narrow test for contradiction: contradiction would occur only if the term negated an actual term in the writ-

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[192] *Doliner*, 270 N.Y.S.2d at 939.
[193] *Id.*
[194] *Id.*
[195] *Id.*
[196] *Id.*
[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *Id.* at 940.
[201] *Id.* at 939-40 (citing U.C.C. § 2-202 (amended 2001)).

ing.[202] Kraus and Scott criticize that result in this case on a number of grounds, concluding that "commercial parties. . .would prefer that a court faced with the issues in *Hunt Foods* would rule inadmissible the evidence of an oral condition on an option."[203] Kraus and Scott argue that:

> If the parties intended the written option to be the final expression of the option term, and if it is clear that the proper interpretation of the option as written is that it is unconditional, then allowing evidence that the option was conditional undermines the parties' agreement that the written option term is a final expression.[204]

The authors also argue that the standard applied by the court ignored the basic "allocation of contractual benefits and burdens."[205]

Kraus and Scott assume the *Hunt Foods* court reached the wrong result because it improperly attempted to vindicate Doliner's contractual intention to grant a conditional option, even though the writing granted an expressly unconditional option. In their view, the court should have adhered to the written document only, and ignored the parties' intention to grant only a conditional option.

In suggesting that a contrary result—one that excluded oral evidence of the condition—would have been the preferred outcome, Kraus and Scott offer an explanation for why Doliner would have agreed to a written, unconditional option after he had already reached an oral, conditional agreement. That explanation is: Hunt Foods insisted on an unconditional option because it knew the Doliner's bid shopping condition would not be easily verifiable if it occurred.[206] Because Doliner agreed to the unconditional option, the authors conclude that Doliner chose to rely exclusively on non-legal enforcement in the event that Hunt Foods exercised the option without any evidence of Doliner's bid shopping. Had Doliner intended to preserve an option that was *legally* enforceable only if the bid shopping occurred, then he would never have agreed to an unconditional option. The implication of Kraus and Scott's explanation is that the court should strictly enforce the express option and deny evidence of the oral condition.

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[202] *Id.* at 940.

[203] Kraus & Scott, *supra* note 4, at 1059.

[204] *Id.* at 1051-52 (citation omitted).

[205] *Id.* at 1052.

[206] *Id.* at 1054.

Such reasoning ignores the possibility that Doliner might have agreed to the option without any express condition because he assumed that a court might find the option agreement to be "only partially integrated until the condition occurs."[207] Doliner might have assumed that a court would admit evidence of the condition by finding (1) that the agreement was only partially integrated; and (2) that there was no contradiction between the written agreement and the oral condition. In fact, such an assumption might not have been farfetched since the RESTATEMENT (SECOND) OF CONTRACTS provides that agreements are only partially integrated with respect to conditions.[208] Therefore, evidence of an oral condition should be routinely admissible, even though the final written agreement contains no condition, so long as it does not contradict the writing. When one accepts the possibility that Doliner signed the agreement believing that a court would likely admit evidence of the oral condition, then the conclusion that Doliner did not expect the court to incorporate the oral condition into a legally enforceable agreement becomes less plausible.

Kraus and Scott's view that parties who omit oral conditions intend them to be enforceable exclusively through informal means is not logically compelled since THE RESTATEMENT (SECOND) OF CONTRACTS permits evidence of oral conditions to be admitted even when those conditions are not included in the final written agreement.[209] The supposition behind this view may be that because neither party was to be obligated unless Doliner bid shopped and Hunt Foods then exercised its option, evidence of the condition should be admitted since it would show that no enforceable contract existed in the first place, or that if a contract existed, the duty to sell was discharged.[210]

Therefore, Doliner might have expected that a court would enforce the oral condition even though it was not part of the express agreement because legal counsel might have informed him that courts admit evidence of oral conditions under certain circumstances, despite a final written agreement. Thus, one party's agreement to an unconditional written agreement does not conclusively establish that the party acceding to the exclusion of the oral condition decided to rely exclu-

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[207] RESTATEMENT (SECOND) OF CONTRACTS § 217 cmt. b (1981).

[208] *Id.* § 217. It is based on the earlier RESTATEMENT (FIRST) OF CONTRACTS § 241 (1932).

[209] RESTATEMENT (SECOND) OF CONTRACTS § 217 (1981).

[210] *See* FARNSWORTH, *supra* note 2, § 7.4 (discussing the no contract existed rationale for admitting evidence of oral conditions as an exception to the parol evidence rule).

sively on informal enforcement,[211] as it might have counted, at least partially, on formal enforcement via an exception to the parol evidence rule. Once those considerations are present, one can see that a court's determination to admit evidence of the oral condition was not as illogical or misguided as Kraus and Scott argue.

When, as in *Hunt Foods*, an agreement by itself does not conclusively establish the parties' desire that a court should not interfere or admit evidence of an oral condition, a court should determine whether admitting such evidence of the prior oral condition is appropriate. A court may admit such evidence for two reasons, including (1) to show that no agreement existed until the condition occurred; or (2) to show that the agreement was only partially integrated. Under the latter approach, a court must still decide whether evidence of the oral condition contradicted the express agreement.

It might be useful to reexamine *Hunt Foods* to see why a court might admit evidence of the oral condition to maximize joint gains. In deciding whether to intervene by going beyond the chosen means and admitting evidence of the oral agreement, the court may have considered the following: the contract, as agreed to, allowed one party, Hunt Foods, the right to protect itself unilaterally in the event that the other party, Doliner, acted opportunistically by bid shopping Hunt Foods' offer. Because bid-shopping is not easily verifiable to a court, this would allow Hunt Foods to maximize its gains from the contract by cheaply controlling for opportunism.

However, even though the contract as agreed to would allow Hunt Foods to maximize its gains, the structure of the express option subjected Doliner to a substantial risk of opportunism—Hunt Foods could unjustly claim that Doliner had bid shopped and then could exercise the option even if no evidence of such conduct existed.[212] Under Kraus and Scott's view, the only protection Doliner would have against such conduct by Hunt Foods would be the reputational sanctions that Doliner could impose.

The court might therefore have seen that one party, Hunt Foods, had adopted a private strategy—a contractual option—that gave it per-

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[211] This is an implication in the Kraus & Scott article. *See* Kraus & Scott, *supra* note 4, at 1055-56. It is also supported by a statement made by Doliner to his lawyer. *See* Trial Transcript, Hunt Foods & Indus., Inc. v. Doliner, 270 N.Y.S.2d 937 (App. Div. 1966) (Index No. 8062-1965).

[212] Kraus and Scott discuss this possibility. Kraus & Scott, *supra* note 4, at 1056-57.

fect protection against opportunistic behavior from Doliner. Doliner, on the other hand, was subject to the risk that Hunt Foods would act opportunistically by falsely claiming bid shopping and had no similar private protection.

With such disparity in express protections against the risk of opportunistic behavior, the court might have concluded that in interpreting the contract, it would find the agreement to be only partially integrated, thereby admitting evidence of the oral condition. If the court adopted Kraus and Scott's view, and instead relegated Doliner exclusively to reputational sanctions, Doliner would face many of the same problems of verifiability that made Hunt Foods reluctant to condition the option on bid shopping because Doliner would have to prove to other parties that Hunt Foods had wrongfully exercised the option. Moreover, it would be difficult for Doliner to sanction Hunt Foods following its acquisition of Eastern, especially if Eastern might cease to exist as a company.

Reputational sanctions are not uniformly effective,[213] particularly where the likelihood of proving the wrongful conduct at issue is not 100%, where the parties lack an effective means of efficiently transmitting information, and where there may be reason to discount the information because it is offered by a disgruntled target company.[214] In such cases, particularly where there is also a risk of opportunistic behavior that is not controlled by other means, the court may have good reason to look beyond the parties' chosen means and admit evidence of the oral condition thereby allowing one party the opportunity to rely on legal sanctions. A court's refusal to do so would subject that party to the risk of opportunistic behavior (wrongful exercise of the option) by insisting that the party rely exclusively on informal means of enforcement. The results of such a decision could reduce the party's gains from trade and minimize the overall joint gains from the transaction.

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[213] *See* Geis, *supra* note 128, at 1679. Geis states, after describing relational contracts similar to the ones involving Jewish diamond dealers, that ". . . self-enforcing contracts are generally thought to represent just a small share of all agreements that are formed." *Id.* (citing Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1644, 1646 (2003) (stating that "it is generally assumed that many (if not most) contracts fall outside the self-enforcing range.")).

[214] That would be the case here.

One possible solution might be to shift the burden of proof to Doliner to prove that he had not bid shopped.[215] That solution responds to Kraus and Scott's concern that, by admitting evidence of the oral condition, the value of the option to Hunt Foods "would be of little value in court because it would have great difficulty carrying its burden of proof."[216] That solution would put the burden on the party with the best access to the underlying information about the bid shopping. It would also permit the evidence of the oral condition to come in a manner that would protect against opportunistic exercises of an option, but mitigate against the other party opportunistically bid shopping and then terminating the agreement.

B. *Section 45: Constraining Discretion*

The same risk of opportunism identified in *Hunt Foods* is pervasive in other contexts within Contract law. For instance, in some contracts, one party (the offeror) hires another to do an action and wants an acceptance by performance rather than verbally. The terms are specific and contain no open-ended term delegating any authority to courts. Under Kraus and Scott's approach, the presence of specific terms without express delegation forecloses judicial intervention.[217] Yet courts frequently intervene in such cases, as they have developed a doctrine that constrains the discretion of the offeror to revoke offers once the offeree partially performed.[218] Justification for such intervention lies in the notion that parties do not anticipate all the myriad of ways their counterparty can act opportunistically and therefore may fail to devise specific constraints on that discretion. Without such constraints, offerors would have the freedom to revoke until complete performance. The prospect of such unremedied opportunism would therefore act as a disincentive for parties to begin performance on future offers, and would act as a deadweight loss to both parties. The judicial implication of a law-supplied rule is optimal in circumstances where the parties did not expressly invite legal intervention, but where the benefits of such intervention include a remedy to restrain unbridled opportunist behavior.

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[215] William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, contributed this valuable insight. E-mail from William C. Whitford to Juliet P. Kostritsky, *supra* note 8.

[216] Kraus & Scott, *supra* note 4, at 1054.

[217] *Id.* at 1030-31.

[218] Restatement (Second) of Contracts § 45 (1981).

In a unilateral contract, one might ask why a court should intervene with an implied term when the parties did not expressly invoke judicial intervention through an express delegation clause. Resolving that issue should begin with the language in the contract which might state: "I will pay you $50 if you walk across the Brooklyn Bridge."[219] How and why did courts decide to abandon the traditional rule permitting revocation until the performance was completed and embrace an alternative rule prohibiting revocation upon the beginning of part performance? Courts resolve that issue by deciding the language in the contract is ambiguous or that it contains a gap (what to do in the case of part performance) by looking to the parties' overall objectives of preventing opportunistic hold up of the promisee's investment in part performance.[220]

The counterargument might be that there is no need for a court to supply an implied term of non-revocation because the market might regulate the content of offers.[221] Perhaps offerors who failed to offer protection for part performance would lose market share and would not attract promisees' performance.

Yet, as in other cases where a contract is ambiguous, a court might decide to supply the implied term of non-revocation by reference to the parties' overall goals of minimizing the drags on trade presented by opportunism. If most parties would prefer such opportunism to be constrained and judicial intervention in the form of an implied term is low cost, the parties might well prefer that approach, especially if the market might not work properly if the parties did not pay attention to the effect of part performance on the price since it was a non-salient term.

C. *Trade Usage and Plain Meaning: Why a Unitary Approach Will Not Work*

The use of a specific term in a contract often cannot resolve the normative question of whether courts should intervene by: (1) interpreting specific terms of a contract using extrinsic evidence of trade

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[219] *See* I. Maurice Wormser, *The True Conception of Unilateral Contracts*, 26 YALE L.J. 136 (1916-17). This is the classic example of a unilateral contract.

[220] *See, e.g.*, 1 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 5:13 (4th ed. 2007).

[221] William C. Whitford, Professor of Law Emeritus, University of Wisconsin School of Law, contributed this insight. E-mail from William C. Whitford to Juliet P. Kostritsky, *supra* note 8.

usages; or (2) resorting to an objective standard of reasonableness to interpret express terms. Even when parties seem to have chosen specific means and not used open-ended terms to delegate decision making authority to a court, courts can play a useful role by incorporating trade usages and customs to interpret express contractual terms. Yet, under Kraus and Scott's view, many contracts that allow for broad interpretation of contractual terms through trade usages would be interpreted literally, since parties often fail to invoke the court's authority through the use of a vague or open-ended term. Adhering to the Kraus and Scott injunction would lead to potential costs in terms of unremedied opportunism, that is, unless the non-contractual means of policing against such opportunism proved uniformly robust and effective. This section will attempt to illustrate the beneficial functional effects of courts implying trade usages into a contractual agreement, including the control of opportunistic behavior.

When parties do not explicitly delegate to courts the discretion to go beyond the chosen terms, the courts still incorporate trade usages to determine the meaning of those terms so long as the parties have not specifically negated such incorporation.[222] Rather than assuming the failure to expressly invoke the trade usages necessarily means that parties intend to exclude those usages from legal enforcement and rely exclusively on informal enforcement, the courts seem to determine whether incorporation of the usage would help the parties achieve their overall goals, including the control of opportunistic behavior.[223] In making such determinations, courts must first consider whether literal enforcement of the chosen terms, without incorporation of trade usages, would advance or hinder those instrumental goals. Courts should also consider the reasons that might have prevented the parties from expressly incorporating those usages into a contract because different reasons might counsel for or against court intervention. Finally, the court should consider whether there are structural conditions[224] that would contribute to successful informal enforcement, and if so,

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[222] U.C.C. § 1-303 cmt. 3 (2009).

[223] The case law reflects this consideration. *See* Juliet P. Kostritsky, *Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem*, 39 CONN. L. REV. 451, 492 (2006).

[224] These would include a robust and active trade group. *See, e.g.*, Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 MICH. L. REV. 1724, 1751-52 (2001); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1797-98 (1996).

whether the parties might still be pressured to deviate from commercial norms because of the potential for large gains. As in other areas of Contracts, courts do not uniformly adhere to the parties' chosen means. Instead, they demonstrate a willingness to go beyond the parties' chosen means even without express delegation. Decisions about whether to intervene should be made based on a taxonomy of factors or heuristics, rather than on the assumption that a failure to expressly incorporate the usages signals the parties' intent to rely exclusively on informal means of enforcement.

Parties may have failed to include a term expressly incorporating a trade usage or alternatively adopting a vague or open-ended term for several reasons. For instance, in the trade usage context, parties may agree on a specific term such as "one dozen" because they assume the trade meaning they associate with the term *is* the ordinary meaning a court would apply. They may fail to see the need to expressly incorporate the trade meaning, or to delegate interpretive authority to a court by including an open-ended term. A court applying Kraus and Scott's framework to such a situation would confine its consideration to the express terms, and assume the parties intended to foreclose judicial intervention invoking their contractual objectives by interpreting the term according to prevailing trade usages. However most courts would reject that framework and would interpret "one dozen" to mean a baker's dozen, using the prevailing trade meaning. The decision by courts (and by legislatures via the U.C.C.) to incorporate trade usages and other trade practices can be rationalized if one takes account of parties' overall goal of maximizing joint surplus. The incorporation doctrine helps parties to achieve goals such as the control of opportunistic behavior and other such hazards that might be difficult to control *ex ante* by express means.

Of course, Kraus and Scott would resist the judicial incorporation of trade usages unless expressly invoked because they fear courts having the discretion to decide on that usage. They fear the uncertainty surrounding what a court will find to be a trade usage and they fear an increase in moral hazard when parties strategically insist on contract terms being interpreted in accordance with private or trade meanings.[225]

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[225] *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 586 (2003).

This Article argues that judicial discretion in the interpretation of terms, including those whose meaning might involve trade usages or custom, is inevitable given the intractability of language. In many instances, a contextualized interpretation (not a plain meaning) will maximize gains from trade by curbing opportunistic behavior. Courts should continue to rely on such usages, absent negation, especially where the usages are designed to solve problems of opportunistic behavior and otherwise maximize gains from trade and where the evidence of self-sanctioning and informal enforcement is not robust. In such cases, there is often reason to believe that incorporation and enforcement of the trade usage will maximize gains from trade by curbing the risk of opportunism. Without such enforcement, parties would have to extract a higher price to account for the risk of unremedied opportunism.

Midwest Television[226] illustrates the benefits of incorporating trade usages even absent express language incorporating them and even absent delegation through an open-ended term. In *Midwest Television*, the court had to decide whether an advertising agency would be responsible for the cost of televised ads when the company that placed the ads went bankrupt.[227] Because the ad agency disclosed the principal to the TV station when it contracted with the stations, the ad agency argued it should not be responsible for the fee based on the normal rule that disclosure of the principal resulted in a contract between the client and the TV station.[228]

Instead of relying on the normal rule[229] which might have exempted the agency, the court looked to the prevailing industry practice.[230] That practice made the ad agency responsible for the costs of the ads unless the agency specifically disclaimed such responsibility to the TV station. The court incorporated this practice in interpreting the contract,[231] despite the absence of any express incorporation or delegation to the courts through a vague or open-ended term.

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[226] Midwest Television, Inc. v. Scott, Lancaster, Mills & Atha, Inc., 252 Cal. Rptr. 573 (Ct. App. 1988). This case is discussed in Kostritsky, *supra* note 223, at 502-04.

[227] *Midwest*, 252 Cal. Rptr. at 575.

[228] *Id.*

[229] Under the normal rule, the disclosure would result in a contract between the client and the TV station, absolving the agency of liability upon disclosure of the principal. *See* RESTATEMENT (SECOND) OF AGENCY § 320 (1958).

[230] *Midwest,* 252 Cal. Rptr. at 579.

[231] *Id. See also* Kostritsky, *supra* note 223, at 503.

A number of factors indicate that incorporation of trade practices into the *Midwest Television* contract, and other similar agreements, would be welfare maximizing for all parties. For instance, because the ad agency in *Midwest Television* had direct contact with the client and was most intimately acquainted with the client's creditworthiness risks, any default rule of interpretation should assess the risk against the agency rather than the television station. This would prevent agencies from selling clients' ad time without disclosing the risks to the television station, and would force the ad agency to account for the full effects of the client's bankruptcy. Because trade practice incorporation would prevent ad agencies from claiming immunity from liability, it would reduce the possible drag on gains that would result if future stations became reluctant to enter into advertising contracts in the future based on the risk of opportunistic behavior by ad agencies.[232]

Unlike the court in Kraus and Scott's central example,[233] most courts that intervene by incorporating trade usages do so in such a way that the court is not relying on information about *ex post* events, so the decision does not depend on unverifiable information. Rather, incorporation of trade usages is a judicial decision that results in interpreting the contract based on extrinsic material in order to deter opportunism. Where the parties have not specifically delegated authority to the court, such intervention must be justified using an analytical framework that encompasses a cost-benefit analysis.

Similarly, when a court decides to broadly interpret a contract beyond the literal chosen means or plain meaning, it must advert to a normative framework[234] to justify its intervention. For instance, in an employment contract between a company and a headhunter, where the company agrees "to pay for any of the headhunter's referrals that the company actually hires,"[235] a court applying Kraus and Scott's approach would adhere to the parties' chosen means, concluding that because the parties did not use any vague terms, they intended to foreclose the possibility that a court interpreting the contract would resort to the parties' goals or objectives. However, this approach is problem-

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[232] *See* Kostritsky, *supra* note 223, at 504.

[233] The paradigm example involves a case in which the parties agreed to a term giving the seller a price equal to three percent above an index. *See* Kraus & Scott, *supra* note 4, at 1025.

[234] Cost-benefit analysis is central here.

[235] This is Professor Aaron Edlin's example discussed in Kostritsky, *supra* note 14, at 69-70.

atic because the contract at issue is economically incomplete. While the agreement imposes a ministerial obligation upon the company (paying the headhunter for referrals that are actually hired), it does not specify how the headhunter must perform his duties in order to fulfill his obligations under the contract. Application of Kraus and Scott's approach—by denying a court the right to consult goals of the parties absent express delegation—would leave open the possibility that a headhunter could simply transmit thousands of resumes without screening them in advance and then demand a payment should the company sift through those resumes and actually hire someone.

When an economically incomplete contract creates such a possibility, the court should instead resort to the parties' overall objectives to determine: (1) the nature of the headhunter's performance obligation; and (2) whether the headhunter has complied. In doing so, the court should look beyond the literal terms of the agreement and should invoke a "reasonable" interpretation of the term in order to discourage any opportunistic behavior that might act as a drag on gains from trade.

The cases involving trade usages and the reasonableness test differ in several important ways from those cases where intervention is not justified. First, cases involving trade usages or a reasonableness test do not require a court to access unverifiable information. For instance, in cases like *Midwest Television*, the decision to invoke trade usage seems to be a purely legal one that does not depend on accessing unverifiable private information that is peculiarly and exclusively available to the parties. Unlike manipulable factors, such as seller's costs, trade usages are objective in nature since they must have reached a level of uniformity in observance in order to be considered as such.

Similarly, a court's resort to the "reasonableness" test in determining a party's performance obligation does not require it to access private or unverifiable information. For instance, in the headhunter example, the court need only assess what a reasonable interpretation of the terms would entail, and how its interpretation will impact certain contractual goals such as deterrence of opportunistic behavior, a shared goal of the parties.

Second, unlike Kraus and Scott's example, trade usage cases are not situations where hindsight will benefit the parties by allowing courts access to information about the future state of the world that was not available to the parties at the time of formation. Therefore, there is less likelihood, in such cases, that one party will act opportunis-

tically by relying on a court to adjust the terms *ex post* when the contract as written results in a bad outcome for that party

Third, in trade usage cases, the debate centers on the question of (1) whether the trade usages should govern as a default rule (unless the parties negate them); or (2) whether courts should require parties to opt into such rules if they are to govern the contract. This debate cannot be resolved by simply pointing to the fact that parties agreed on a specific term. Nor can it be clear that the use of such terms was intended to foreclose all judicial interpretation of those terms.

Kraus and Scott focus on a hypothetical grounded in the ALCOA case, where the court may well have intervened without adequately analyzing whether intervention would be welfare-improving.[236] Because they assume that all cases in which parties use specific terms and not open-ended terms are like ALCOA, the authors conclude that any judicial intervention in such cases would embroil the court in inquiries that they are ill-equipped to make.[237] Instead of assuming that any intervention in those cases will decrease welfare by forcing the court to make decisions based on information accessible only to a private party, courts must determine whether the type of intervention would either necessitate access to unverifiable information *ex post*, or whether it could be accomplished based on objective evidence such as trade usages or projections about whether intervention will deter or promote opportunistic behavior. In addition, courts should consider whether a particular type of intervention would achieve gains from trade by promoting the disclosure of information designed to allocate risks to the least cost avoider (as in the *Midwest Television* case).

D. *Conditions: Other Interpretive Questions*

A court may have to decide a different sort of interpretive question when determining whether a party has performed or breached its contractual obligation. In making those decisions, the court may have to analyze the meaning behind the contractual language, and may have to determine issues not directly addressed by the contract terms. This is so even if the parties have crafted specific terms detailing the

[236] *But see* GOLDBERG, *supra* note 150.
[237] *See* Kraus & Scott, *supra* note 4, at 1072-73.

parties' obligations[238] and have not expressly invoked the court's aid through a deliberately vague term.

For instance, judicial interpretation may be necessary to determine (1) whether a breach has occurred; and, if so, (2) the consequences of one party's non-performance for the other party. Although determination of whether performance occurred might seem to be a technical matter that could be decided solely by consulting the language of the agreement, certain performance questions may not be resolved so easily. In such cases, when the court decides to supply a default rule that the parties have not explicitly agreed to (such as the required order of performance), then the court must decide those unresolved issues using a normative or justificative framework which considers how a particular rule would affect the parties' joint goal of welfare improvement.

Many of the key issues surrounding contract performance can be rationalized as means to increase gains from trade and contractual surplus. Such issues include the degree of nonperformance that constitutes a breach,[239] the timing of performance obligations,[240] and whether and when performance may be excused.[241]

In cases that raise these questions, Kraus and Scott would prefer that the court reliably enforce the parties' chosen contractual means without resorting to their specific contractual objectives. Kraus and Scott's logic would also presumably bar resort to the parties' broader goals of maximizing gains from trade.[242] The result of a court's decision not to intervene could thereby discourage trade and increase the costs of contracting.

However, given certain barriers of bounded rationality and the uncertainties about parties' behavior and the future state of the world, one could imagine how judicial intervention might nonetheless be op-

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[238] If a court finds that one party has failed to perform its contractual obligations, then the breaching party will be subject to a successful action for damages by the other party; non-performance may also excuse the other party from performing. At first, the victim of the breach will be entitled to suspend her own performance. After a certain time, the victim of the breach may be discharged altogether from any further performance obligations under the contract. *See* RESTATEMENT (SECOND) OF CONTRACTS § 237 (1981).

[239] Courts must decide whether a breach is material or trivial to decide what duties are owed.

[240] *See* RESTATEMENT (SECOND) OF CONTRACTS § 241 (1981).

[241] *Id.* § 229.

[242] Kraus & Scott, *supra* note 4, at 1025.

timal because it could solve a problem for the parties at lower cost than non-intervention alternatives.

Kraus and Scott assume that if the parties choose specific terms, they do not want a court to intervene because doing so will increase back-end costs too much by embroiling courts in making choices that should be left to the parties since "they are better informed than courts about their contractual purposes and have better incentives to pursue them efficiently."[243] Kraus and Scott seem to automatically conclude that in the absence of a direct delegation of authority to courts, the parties must have intended for the court to refrain from supplying a term or liability rule. However, a court's intervention should not be based on automatic assumptions, but rather on a comparison between the costs of intervention and of non-intervention. Without that comparison, a court cannot surmise what the parties' preference would be in the absence of any expressed intention.

Therefore, each decision about legal intervention must depend on the type of intervention called for and must involve an assessment of whether the court's choice will depend on private information or, alternatively, on the effect of formulating legal rules about incentive effects and overall gains from trade. The calculation must consider the costs of opportunistic behavior from intervening or failing to intervene as well as the costs of private contractual solutions and informal enforcement.

1. Interpretation Issues and Conditions

In some cases, where performance issues are not answered by the contract and the parties have not expressly delegated interpretive authority, courts rely on principles of maximizing surplus and intervene by applying default rules and suggested rules of interpretation.

The general principle of allocating the risk of future performance difficulties to the obligor is subject to an exception.[244] If a party can anticipate a future event that will make performance more costly, he may condition his performance on the occurrence or non-occurrence of that event, thereby insulating himself from the risk that performance will become too costly.[245]

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[243] *Id.* at 1031.

[244] *See* RESTATEMENT (SECOND) OF CONTRACTS § 225 (1981).

[245] *Id.*

When one party conditions its obligation in this way, it clearly intends to shift the risk of the non-occurrence to the other party.[246] Presumably, if the parties allocated a risk in a particular way, absent reason to believe the agreement was involuntary or procured through fraud, the court will enforce the agreed upon risk-allocation.[247] Generally, courts require strict compliance with such express conditions[248] because the price that each party agreed to most likely reflects the risk that a future event may or may not occur. For example, a buyer of real estate might be willing to pay a higher price if the seller assumes the risk that the buyer may fail to obtain bank financing. Thus, if a buyer conditions her contractual obligation on obtaining bank financing and then fails to secure such financing, she is no longer obligated to buy since the condition shifted the risk of nonoccurrence to the seller.

Presumably, whatever deal the parties reached to allocate a risk that was known in advance and adverted to by both parties in pricing their contract would maximize the parties' surplus. Were a court to upset that risk allocation and insist on performance despite the nonoccurrence of a condition, it would be redefining the performance obligations of the parties. Because the court would not be enforcing the terms as agreed upon, there is no reason to assume the agreement would still produce gains for the parties.[249] When the parties have identified a certain event as an express condition, the results are generally clear and the court usually gives effect to the condition by allowing one party to suspend its performance until the condition can no longer be met, thereby discharging the party from its obligations altogether.[250]

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[246] *See* Farnsworth, *supra* note 2, § 8.2.

[247] One major exception is the refusal of courts to enforce express conditions in circumstances where it would result in forfeiture. *See infra* Part IV.D.4.

[248] *See, e.g.*, JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS §§ 11.8-11.9 (5th ed. 2003); 13 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 38.12 (4th ed. 2000) ("Since an express condition, like a condition implied in fact, depends for its validity on the manifested intention of the parties, it has the same sanctity as the promise itself. Although the court may regret the harshness of such a condition, as it may regret the harshness of a promise, it must, nevertheless, generally enforce the will of the parties unless to do so will violate public policy.").

[249] *See* George M. Cohen, *Implied Terms and Interpretation in Contract Law*, *in* 3 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE REGULATION OF CONTRACTS (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

[250] This is not always the case. In some instances, a court may choose to construe an express condition as a constructive condition of exchange or excuse an express condition in order to avoid forfeiture.

Under Kraus and Scott's approach, it would seem that when the parties build an express condition into their contract, that condition constitutes their chosen means. The court should give effect to the parties' chosen means and refuse to rewrite the contract in light of the parties' contractual objectives.

Although Kraus and Scott seem to argue that courts should always give effect to express conditions that parties built into their contracts, and never look to the parties' contractual objectives (absent an express delegation), courts are often presented with contracts where the parties have not clarified a number of issues, despite the presence of specific terms outlining their obligations. Such issues may include (1) whether performance is intended to be expressly conditional on another party's performance; (2) which party is to perform first; and (3) the degree of performance necessary to trigger the other party's obligation to perform. In cases raising these issues (i.e. where the chosen means are unclear), it may be necessary to determine whether welfare improvement justifies a court's application of a default or liability rule. Under the welfare improvement principle, two judicial doctrines must be justified,[251] including (1) the judicial preference for interpreting an unclear term as a promise rather than a condition;[252] and (2) the preference for implying constructive conditions of exchange when the required order of performance is unclear.[253] These doctrines provide examples of instances where courts look not only to the parties' chosen means but also to their contractual objective of maximizing surplus. Judicial intervention under these doctrines can be optimal and efficient despite the absence of any express delegation.

It is not absolutely clear whether Kraus and Scott would foreclose all judicial interpretation to determine whether a condition or promise was intended by the parties' language. However, Kraus and Scott seem to condemn such doctrine when they question the "*ex ante* version" of the anti-forfeiture principle.[254]

In Kraus and Scott's example on the interpretation of language as a promise or condition, a court must address two provisions of a contract to determine whether one clause (and obligation) was intended

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[251] Both doctrines often apply where the chosen means of the parties are not clear, the parties have not deliberately omitted the implied terms from the contract, and the court does not need to wrestle with inaccessible and unverifiable information.

[252] RESTATEMENT (SECOND) OF CONTRACTS § 227 (1981).

[253] *Id.* § 234.

[254] Kraus & Scott, *supra* note 4, at 1082-83.

to be conditioned on another.[255] Kraus and Scott's hypothetical contract denied the employer the right to terminate an employee without just cause and contained a provision that an employee "will, within thirty days of termination, give written notice to the employer of any claim of wrongful termination and will not take any legal action based on the claim within six months of such notice."[256] Under one reading of the contract, the employer's duty not to terminate for just cause was conditioned on the employee's duty to give timely notice. Under the alternate interpretation, the employee merely gave an independent promise to give timely notice for breach of which he could be liable in damages to the employer. A court resolved the matter by invoking the anti-forfeiture norm.[257] According to Kraus and Scott, courts interpret the employee's duty to give notice of a claim as independent of the just cause provision, based on its reluctance to create a forfeiture following the employee's reliance on the apparent guarantee of job security.[258] Because their Article suggests that courts should not take account of an objective such as the avoidance of forfeiture in interpreting language, one can assume they would find any decision based on anti-forfeiture to be misguided simply because it uses *an objective* to decide a contract interpretation issue.

Kraus and Scott posit that underlying courts' preference for finding promises rather than conditions is a rationale based on contractual intent and not on public policy.[259] The notion, they argue, is that because "parties would not have understood the condition to create such a risk [of forfeiture] at the time of formation," courts use the anti-forfeiture norm to "stack[ ] the deck heavily against the finding and enforcement of conditions."[260] Although the authors advert to the intent rationale and do not directly criticize the likely result in the employment example, one must still suppose that Kraus and Scott would disapprove of the resort to an anti-forfeiture norm, especially where parties did not expressly invoke judicial aid through a vague term.[261]

Rather, because Kraus and Scott seem to be certain that the parties will resolve interpretation issues through specific chosen means *or* will deliberately leave matters for future decision by a court through

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[255] *Id.*
[256] *Id.* at 1082.
[257] *Id.*
[258] *Id.* at 1083.
[259] *Id.*
[260] *Id.* at 1083-84.
[261] *See id.* at 1084.

open-ended terms, the authors would limit the court to enforcement of the parties' chosen means. Because Kraus and Scott's approach limits its consideration of any matters outside the parties' chosen means (including reference to the anti-forfeiture norm), it would deny courts the ability to consider the parties' objective of welfare maximization when deciding whether a condition or promise was intended.

However, courts often invoke the parties' contractual objectives to promote efficiency by implementing a preference for interpreting ambiguous language as creating promises rather than conditions, and a presumption that mutual covenants are dependent upon each another. Therefore, it is perfectly reasonable to suppose that a court, in order to minimize the drag on gains on trade, might conclude that parties would embrace an anti-forfeiture norm as a means of policing against opportunistic behavior (unless the parties expressly understood that there was a forfeiture risk).

The question that remains, however, is whether it is appropriate for courts to consider the anti-forfeiture principle in determining whether language in a contract creates a condition or not.[262] A classic case of interpretation involves such clauses requiring the completion of work within a stated period.[263] Because courts prefer an interpretation that creates a duty rather than a condition,[264] courts will construe such language as creating an independent duty to complete within ten days, rather than as making payment conditional upon completion within that time.

Although Kraus and Scott are highly critical of courts' consideration of forfeiture when construing ambiguous language,[265] one can understand why courts might prefer this approach as the default rule to govern ambiguous language. For instance, if a contractor were to risk forfeiture when no language expressly allocated such risk to the con-

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[262] A separate and more difficult question is whether courts should override language that clearly creates a condition to implement an anti-forfeiture policy. That issue will be taken up later. *See infra* Part IV.D.4.

[263] *See* FARNSWORTH, *supra* note 2, § 8.4.

[264] *Id.*

[265] Kraus & Scott, *supra* note 4, at 1082-83 (criticizing rationale for anti-forfeiture norm). Their criticisms are partly premised on the idea that, in some specific cases, a forfeiture might be the correct or rational result where the alternative interpretation would result in the court awarding payment when one party needed to be given the discretion to impose a forfeiture result because the value would depend on matters that were unverifiable to a court which would suggest that the supposed benefit had no value at all.

tractor through a clearly designated express condition precedent, the severe risk of forfeiture might act as a drag on trade in *future* transactions. Contractors faced with contract language that does not contain a clear condition might fear that courts following the Kraus and Scott mandate will be dissuaded from considering anti-forfeiture principles in interpreting ambiguous language. Since the risk of forfeiture could allow the recipient of services to act opportunistically and seize upon a minor deviation as a reason to refuse all payment, a court might consider that risk in justifying a rule that minimizes opportunistic behavior, and therefore maximizes gains from trade by reducing the deadweight loss that could result from unremedied opportunism.

Because of the potential it creates for forfeiture, a court's conclusion that an event is an express condition can be devastating for a party who relied in advance of performance. If a term is construed as an express condition and that condition does not occur, the other party is discharged[266] and any reliance costs incurred by the relying party would be non-compensable. If, however, the term is construed as a duty, the relying party would still be entitled to payment, subject to the other party's entitlement to damages for any breach.[267]

To determine whether the parties intended an express condition, the court requires a normative framework for justifying legal intervention to fill a gap in the parties' agreement. In assent-based transactions, the court should use a model of average behavior to determine what rule parties would seek in determining the order of performance if their goals or objectives included one or more of the following: (1) minimization of transaction costs; (2) control of the opportunism hazard; (3) allocation of risks to the least cost avoider; and (4) maximization of the parties' gains from trade, irrespective of who ends up with that share of the gain.

In reaching determinations about whether a term should be construed as a condition or a duty, the RESTATEMENT indicates that "it is sufficiently unusual for [a party] to assume the risk"[268] of forfeiture where the event is not within that party's control, and that consequently the court should avoid interpretation that results in forfeiture.[269] Instead, courts should construe terms as creating a duty to

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[266] RESTATEMENT (SECOND) OF CONTRACTS § 225 (1981). *See also* Dove v. Rose Acre Farms, Inc., 434 N.E.2d 931 (Ind. Ct. App. 1982).

[267] *See* RESTATEMENT (SECOND) OF CONTRACTS § 225 cmt. d (1981).

[268] *Id.* § 227 cmt. b (1981).

[269] *Id.*

perform so that a breach would not result in forfeiture, but would instead entitle the other party to recover damages without discharging its own performance obligation.

For example, courts are sometimes asked to determine whether an event is designated by the parties as a means of measuring time, or whether that event is attached to one party's duty. The RESTATEMENT gives an example in which "A, a general contractor contracts with B, a sub-contractor, for the plumbing work on a construction project. B is to receive $100,000, 'no part of which shall be due until 5 days after Owner shall have paid Contractor therefor.' "[270]

The RESTATEMENT example forces a court to decide whether ambiguous language ("not to pay until 5 days after Owner shall have paid") will be construed as an express condition or merely a contractual duty. More specifically, the court must decide whether the general contractor's duty to pay the sub-contractor was expressly conditioned on the owner paying the general contractor, or whether the language merely designated a time frame within which the subcontractor would be paid. According to the RESTATEMENT, courts should opt *against* an interpretation that would make the general contractor's duty expressly conditional on the owner's prior payment, as such an interpretation could result in a forfeiture for the subcontractor if the owner became insolvent and failed to pay the contractor.[271] Through its preference for duties over conditions, the RESTATEMENT seeks to avoid such a result, and to instead maximize gains for both parties.

In dealing with these issues of interpretation, one question arises: why would the RESTATEMENT prefer an interpretation that avoids forfeiture for a party that has relied on the contract? That question then becomes, why would the RESTATEMENT wish to avoid such a result when interpreting a term as either a condition or a duty? One could rationalize the RESTATEMENT's preference for duties over conditions as a way of maximizing the parties' joint surplus. For example, in every contract, there is a risk that one party will act opportunistically. Because of uncertainty about the propensity for such conduct and the variety of ways that such propensity might manifest itself, it will be difficult for parties to control the potential for such behavior *ex ante* in a detailed contract. Inserting even more general clauses into the contract, such as

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[270] *Id.* at illus. 1.

[271] *Id.* at cmt. d.

promises to behave in a joint maximizing way, may not be effective because their vagueness might render them unenforceable.[272]

In such cases where the paying party's behavior is not tightly controlled, a court must decide whether that party should have absolute discretion over whether to pay the performing party when circumstances over which the performing party has no control arise—such as when the owner fails to pay the contractor in the above example. If the performing party (the sub-contractor) has relied and that reliance resulted in a benefit to the Contractor, the court will prefer an interpretation that finds no condition, allowing the subcontractor to get paid despite the nonoccurrence of the Owner's payment to the Contractor.

Were the court to reach a contrary result in such a case, it would in effect be giving discretion to the paying party to refrain from paying the performing party based on reasons having nothing to do with the performing party's fulfillment of its contractual obligations. If one assumes that rational parties would want to control that kind of moral hazard and mitigate it *ex ante*, and one accepts the "presumption that the performing party would not have wanted to put himself at the mercy of the paying party's whim,"[273] then it makes sense for the law to presume a duty rather than a condition. The effect of such a construction is to restrain the paying party's discretion to withhold payment that is due, and to ensure that payment is made for services that have been rendered. Consequently, the possibility that forfeiture will result to a party who has satisfactorily performed its obligation is similarly constrained in this respect.

2. Order of Performance Interpretation Issues: Constructive Conditions

The law of contracts must also address instances where the parties have not clearly indicated whether performance is discretionary or required, the order in which performance will proceed, and whether there are preconditions to performance. In doing so, the court must first decide whether there are any implied conditions that must be satisfied before the other party's performance obligations under a contract become due. When courts intervene to create implied or constructive conditions in a bilateral contract, they must grapple with

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[272] WILLIAMSON, *supra* note 39, at 63.

[273] Morin Bldg. Prods. Co.v. Baystone Constr., Inc., 717 F.2d 413, 415 (7th Cir. 1983) (Posner, J.).

issues concerning the sequence of performance, where important questions may arise. For instance, if nothing is stated in the contract, how will the court decide when the respective performances are due? Is there any doctrine that would make reciprocal performance a constructive condition of the other party's duty to perform? How should the court deal with the absence of any chosen means or express delegation to the court through a vague standard?[274]

Historically, when two parties exchanged commitments without stating that one party's performance obligation was dependent upon the other party's performance, the obligations were deemed independent.[275] Therefore, one party could sue the other for breach, even if he were in breach of his own obligations under the contract.[276]

Thus, an interpretive question for courts in resolving performance issues is whether reciprocal performance is an implied or constructive condition of the other party's duty to perform where the parties have not expressly conditioned their own performance on a reciprocal performance by the other party. A subsidiary issue is whether that reciprocal performance is due simultaneously or at a prior time. Historically, the answer to this question was that, absent an express agreement, a party had to perform regardless of whether the other party was ready or willing to perform its obligations.[277] This independence of contractual obligations was presumed under the doctrine of mutual and independent covenants.[278]

However, the reversal of this doctrine began with Lord Mansfield who argued that the "dependence, or independence, of covenants, was to be collected from the evident sense and meaning of the parties, and, that, however transposed they might be in the deed, their prece-

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[274] The Kraus and Scott article does not make clear how a court should proceed in the absence of any relevant chosen means and in the absence of any delegation to the court through an open-ended term.

[275] JOHN E. MURRAY, MURRAY ON CONTRACTS, § 104 (3rd ed. 1990) ("Thus, for the purpose of enforcement, the law treated the two exchanged promises like two separate and distinct contracts. They were *independent* promises (covenants) bearing no relationship (dependency) to each other.").

[276] *Id.*

[277] *See, e.g.*, 15 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 44:32 (4th ed. 2000).

[278] Smith v. Wiley, 60 Tenn. 418, 419-20 (Tenn. 1872) ("[T]he class known in the law as mutual and independent covenants, [is] where either party may recover damages from the other for the injury he may have sustained by a breach of the covenants in his favor, and where it is no excuse to the defendant to allege a breach of the covenants of the plaintiff in bar of his action.").

dency [sic] must depend on the order of time in which the intent of transaction requires their performance."[279] The decision to find either dependent or independent covenants depends on the projected assumptions about which approach would be instrumental in achieving maximum gains from trade.

The modern presumption is that in a bilateral executory contract the duties are presumed to be dependent and due simultaneously.[280] Therefore, to prevail in an action for breach, a party must first allege its own performance as an implied condition of the other party's performance in the absence of a material breach by the claiming party.[281]

The question for Kraus and Scott is why the law would imply such a constructive condition of exchange in a contract if the parties have not specifically delegated that task to the court through the use of an open-ended term. To answer that question, one must imagine what kind of contracting world would remain if a party to a contract were required to go forward with his own performance despite the non-performance of the other party. That situation creates the risk that a party would have to furnish its own performance (which is, in effect, a sunk cost) without any assurance that the other party's performance is forthcoming.[282] The injured party would then be left to rely solely on damage remedies, which might not be collectible for various reasons.

In deeming the promises dependent rather than independent and deciding that one party did not have to go forward if the other demonstrated no willingness to perform, the Mansfield court implied a term into the contract even though the parties did not expressly delegate authority to the court through a vague term. The implied term

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[279] Kingston v. Preston, (1773) 99 Eng. Rep. 437 (K.B.), *reported in* Jones v. Barkley, (1781) 99 Eng. Rep. 434, 437-38 (K.B.). *See also* 8 Catherine M.A. McCauliff, CORBIN ON CONTRACTS § 32.5 (Joseph M. Perillo ed., rev. ed. 1999). *But see* IAN AYRES & RICHARD E. SPEIDEL, CONTRACT LAW 830 (7th ed. 2008) (questioning whether Mansfield was the originator of the doctrine of the mutual dependency of covenants) (citing William McGovern, *Dependent Promises in the History of Leases and Other Contracts*, 52 TUL. L. REV. 659, 703 (1978)).

[280] *See* RESTATEMENT (SECOND) OF CONTRACTS § 234 (1981).

[281] *Id.* § 241.

[282] The Introductory Note to Chapter Ten of RESTATEMENT (SECOND) OF CONTRACTS explains that "[t]o the extent possible, simultaneous performance by both parties is desirable, since this gives each party the opportunity to withhold his own performance until he is sure that the other party's performance will be forthcoming and requires neither party to finance the transaction before he receives the other's performance." *Id.* ch. 10, introductory note, at 194-95 (1981).

made one party's performance obligation dependent on prior or simultaneous performance by the other party. This type of intervention can be justified in terms of welfare improvement because it eliminates the chance that one party could act opportunistically by initiating a lawsuit to demand performance from the other party, without ever taking steps toward his own performance. If left unguarded, the risk of opportunistic behavior would add to the costs of contracting,[283] as parties would have to charge a premium price to take account of the risk that one's assets would be appropriated.[284] The risk of uncontrolled opportunism could also discourage some parties from contracting altogether, resulting in lost potential gains from trade.

A court's willingness to imply dependent covenants is an example of judicial intervention[285] that minimizes transaction costs and maximizes parties' joint gains. In deciding whether an implied term of dependency would advance those goals, one must assess the risks that future parties would face in its absence. Without a specific agreement of dependency, parties would remain unprotected from the risk that one party would act opportunistically by demanding performance from the other party without performing itself. That risk would require one party to turn over assets or money to another party who has done nothing in return to demonstrate a willingness to perform.

To respond to that risk, a party could protect itself by insisting on dependency through an agreement that would make reciprocal performance by the other party a condition of continuing to perform. Some might argue that court intervention is unnecessary because parties could create such security themselves by prescreening partners to rule out opportunistic players. However, adverse selection problems, such as a tendency to hide one's proclivities for opportunism, could make such an arrangement costly.

Alternatively, the parties could individually craft language of dependency to indicate their intention to make the promises reciprocal obligations. However, it is cheaper for the law to supply the term by implying dependency as a default rule in every contract. By judicially implying a term of dependency, the courts can create a collective

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[283] *See* WILLIAMSON, supra note 39, at 63.

[284] *Id; See also* E-mail from Ronald J. Coffey to Juliet P. Kostritsky, *supra* note 17.

[285] Other instances of judicial intervention include gap filling.

good[286] that all parties can rely on for automatic protection against opportunism in future transactions. Such protection lowers transaction costs and encourages contracting that otherwise might not occur. Without assurances that the other party will be restrained from acting opportunistically, a party might hesitate to contract, thereby sacrificing the potential joint gains. Because the law-supplied term of dependency provides the assurance necessary to encourage contracting and reliance, it offers parties a cheap form of security. The law's intervention would achieve the parties' goals at a low cost because such intervention would not involve the court in costly tasks, such as attempting to verify unverifiable contingencies. In that sense it is an efficient default—a simple rule that can be applied easily by courts.[287]

These doctrinal examples illustrate that courts regularly intervene to maximize surplus by implying terms of dependency or imposing strong judicial preference for promises rather than conditions and they provide a challenge to Kraus and Scott's argument. In their examples, because courts are ill-equipped to ascertain the contracting parties' true intentions and are subsequently at risk of being manipulated by one party's opportunistic behavior,[288] judicial intervention may indeed be inefficient.[289]

Doctrines governing performance, including dependency of covenants and preference for promises rather than conditions, demonstrate that even in instances where specific terms are used and express delegation to the court is not articulated, default rules that move beyond the parties' chosen means to take into account parties' contractual objectives can lower transaction costs and maximize contractual surplus. By using interpretations of contractual language and law-supplied rules that a majority of contracting parties would prefer, courts routinely fill in gaps, such as order of performance, that have been left

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[286] *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 286-87 (1985) (discussing the idea of a collective good of terms).

[287] *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law,* 113 YALE. L.J. 541, 595 (2003-04).

[288] Scott and Kraus seem to focus on price rules or other terms with specificity and contrast them with terms that the parties explicitly set up as vague. This seems to omit from consideration certain types of rules and doctrines such as the doctrine implying a constructive condition of exchange. Kraus and Scott have identified a scenario where a court's intervention might not be helpful or optimal but that does not suggest that the court's intervention in every case lacking an open-ended term would be similarly harmful.

[289] Kraus & Scott, *supra* note 4, at 1056-62.

open by an incomplete contract. Such doctrines provide efficient ways of adhering to the welfare principle of assent-based transactions by devising default rules and interpretations based on a model of average contracting behavior[290] which looks to minimize costs, maximize gains, control opportunism, and allocate risks to the least cost avoider. By assuming default rules instead of requiring parties to spend time and money to contract for them, these doctrines implement presumptions which a majority of contracting parties would prefer *ex ante*, thus decreasing the overall contracting costs and increasing overall gains.

3. Substantial Performance

A third performance issue is the degree of performance required from one party before the other party must perform. When the parties themselves do not resolve this issue, courts must make the decision based on the doctrine of substantial performance.

In service and construction contracts, for example, one party must substantially perform its contractual obligation before the other party's performance becomes due.[291] If the performance by one party is substantial, then the other party must render its own performance, and will be relegated to a suit for damages.[292] However, if the court determines that one party's performance is not substantial, therefore constituting a material breach, the victimized party may suspend its own performance.[293] If a party remains in substantial breach after the period of time for cure has passed, then the victimized party is discharged from its obligations to continue performance and may sue the breaching party for damages.[294]

What justification can rationalize this approach to the issue of breach? Why should the legal default rule require a victim of a breach to continue performing when the other party's breach is trivial but allow the victim to be discharged from performance when the breach is a substantial one? The answer may begin to make sense in terms of maximizing gains from trade if one examines an alternative rule. For

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[290] *See* E-mail from Ronald J. Coffey to Juliet P. Kostritsky, *supra* note 17.

[291] *See* RESTATEMENT (SECOND) OF CONTRACTS § 237 cmt. d (1981). *See also* MCCAULIFF, *supra* note 279, § 36.1 ("When a contract has been made for an agreed exchange of two performances, one of which is to be rendered first, the rendition of this one substantially in full is a constructive condition of the other party's duty to render the second part of the exchange.").

[292] RESTATEMENT (SECOND) OF CONTRACTS § 237 cmt. d (1981).

[293] PERILLO, *supra* note 248, § 11.18.

[294] *Id.*

instance, if the law allowed a party to seize upon trivial defects to excuse performance, it would be sanctioning opportunistic behavior by allowing parties to capitalize on trivial defects to end all contractual obligations. As we have seen before, the risk of uncontrolled opportunistic behavior raises the cost of contracting in many ways and may discourage contracting altogether by parties who are unwilling to assume the risks of their counterparty's uncontrolled opportunistic behavior. Risks of opportunism may also raise contracting costs by forcing parties to build in higher prices in order to account for the increased risk.

Therefore, a rule that would *ex ante* lower the risk of one party acting opportunistically would foster a greater joint surplus. In the absence of such a rule, a concerned party could demand a higher contract price or forego contracting altogether. Kraus and Scott illustrate this phenomenon using the example of a construction contract.[295] As they explain, "[t]he owner-promisee would have an incentive to exploit this situation—threatening to reject the entire project due to a minor defect in construction . . . [v]iewed *ex ante*, the parties themselves would prefer the less draconian substantial performance rule in these settings in order to reduce opportunistic behavior."[296] An owner would be able to capitalize on the vulnerable position in which the contractor finds himself and demand to lower the price because the contractor's expended sunk costs would prevent a ready exit to the market. Therefore, legal intervention through an implied term requiring substantial performance by one party before the other party must perform can be justified by a desire to curb opportunism.

The law, however, takes a different approach when only a trivial defect is present. The question for legal intervention in such cases is whether the parties *ex ante* would want a legal rule entitling them to stop performing when only a trivial defect was involved, or instead whether a damage remedy would suffice. Because a legal rule granting the right to suspend or be discharged in the event of a trivial breach would encourage opportunism, parties would not likely favor such an option. Therefore, the question is whether a damage remedy alone would suffice to provide the correct incentives for performance. Since a party guilty of a trivial breach would still have to pay damages, and

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[295] JODY S. KRAUS & ROBERT E. SCOTT, CONTRACT LAW AND THEORY 690 (4th ed. 2007).
[296] *Id.* (emphasis added).

since those damages are expected to provide optimal incentives, the damage remedy should suffice.

In addition to reducing the risks of opportunism, the doctrine requiring parties to continue performing despite an immaterial breach reduces transaction costs because it prevents parties from having to account for the rare possibility that a co-party might insist on a rule entitling them to stop performance in the face of a trivial breach. Because such parties are extremely rare, it only makes sense that a default rule would protect other parties from having to contract around a non-optimal rule that they are unlikely to encounter anyway.

4. Overriding the Parties' Chosen Means: Interpreting Conditions to Avoid Forfeiture: A Study in Judicial Methodology in the RESTATEMENT (SECOND) and in *Jacob & Youngs*

The cases generating the most criticism under Kraus and Scott's critique are those cases in which courts override or overlook the parties' chosen means to implement a goal such as the avoidance of forfeiture. To illustrate the deleterious effect of this practice, Kraus and Scott focus on an example from the RESTATEMENT,[297] which is based on the *Jacob & Youngs* case. However, because of limitations in the RESTATEMENT example and its abstraction from the facts of the underlying case, Kraus and Scott draw erroneous conclusions about the negative effects of the court's consideration of forfeiture. In addition, while the authors rationalize strict enforcement of the condition because such an approach reduces the cost of verifying the difference in quality to a court, the actual case that provided the basis for the RESTATEMENT example—*Jacob & Youngs*[298]—involved few verifiability problems. This renders the authors' purported rationale less compelling, particularly in cases that do not involve problems of verifiability. Finally, in their criticism, Kraus and Scott ignore the key role that the court's willingness to consider forfeiture issues plays in improving joint welfare by reducing the costs of opportunism.

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[297] *See* Kraus & Scott, *supra* note 4, at 1095. In the RESTATEMENT hypothetical, a party chooses to condition its payment obligation on the satisfaction of a condition to install a particular brand of pipe. RESTATEMENT (SECOND) OF CONTRACTS § 229 cmt. b, illus. 1 (1981). In cases where a court finds that a condition, such as the use of a particular pipe, "is relatively unimportant" to the party that specified the condition, the RESTATEMENT allows the court to excuse the condition and enforce the party's obligation to pay despite the condition's nonoccurrence. *See* Kraus & Scott, *supra* note 4.

[298] Jacob & Youngs, Inc. v. Kent, 129 N.E. 889 (N.Y. 1921).

Kraus and Scott argue that setting aside an express condition undermines "*ex ante* contractual intent,"[299] and ignores the cost reasons why parties chose an express condition. For instance, Kraus and Scott argue that the owner in the RESTATEMENT hypothetical might want to insist on a strict condition, such as Reading brand pipe, in order to save on the back-end costs that would result if the owner had to prove that the installed pipe was of an inferior quality.[300] Thus, Kraus and Scott posit that when parties adopt such an express condition, it is wrong for courts to either "interpret" the express condition as a constructive condition of exchange (allowing the substantial performance doctrine to apply), or to excuse the condition altogether.[301]

Kraus and Scott's criticism of the RESTATEMENT approach to the excuse of conditions is meant to illustrate the general problem of courts overlooking parties' express terms or supplying default rules that were not expressly agreed to. Yet, their effort to delegitimize judicial approaches to excusing express condition is based on a stylized RESTATEMENT hypothetical and has limitations that are explored in this section. Once the actual case on which the RESTATEMENT example is based is made the central focus of the analysis, the willingness of courts to interpret express conditions as constructive conditions may be justifiable in terms of welfare improvement.

The authors base their argument on the idea that parties prefer the risk of forfeiture over the costs of judicial intervention, and that the inclusion of an express condition indicates a decision to save costs and rely on informal means to police against opportunistic behavior.

However, this conclusion is flawed for several reasons. First, the mere fact that parties agreed on an express condition does not necessarily mean that the parties chose to rely solely on informal mechanisms to police against opportunistic behavior. While informal enforcement and reputational sanctions may be less costly than judicial intervention in some contexts, parties might have good reasons to choose formal enforcement mechanisms instead. Parties should be able to decide between formal and informal enforcement mechanisms based on several factors, including whether reputational sanctions are likely to be effective, whether there are likely repeat dealings between the parties, whether the gains from repeat play will be outweighed by a

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[299] Kraus & Scott, *supra* note 4, at 1095 (emphasis added).

[300] *Id.* at 1097.

[301] *Id.*

larger benefit from opportunistic behavior, and whether the opportunistic behavior can be easily detected. By assuming that parties who have agreed on express conditions would always prefer informal enforcement mechanisms, Kraus and Scott's approach prevents courts from conducting this assessment and denies parties the ability to effectively mitigate the potential for opportunism and the drag on gains from trade at the least cost (which might involve a court excusing a condition).

Second, it is wrong to assume that parties would prefer the risk of forfeiture over the costs of judicial intervention in all cases. For instance, consider a case where two parties have a 500-page contract for the construction of an office building and have made the owner's payment to the contractor expressly conditional on the satisfaction of 100,000 specifications, ranging from the brand of light switch to the type of steel beam to be used. Given the large forfeiture that would result, it would not logically follow that parties in such a case intended for courts to strictly enforce each condition, thereby allowing the owner to pay nothing for a $1 million building simply because a minor specification for a particular brand of light switch had not been met. Although a builder might have agreed to the conditional language, he might have assumed that no reasonable court would impose a forfeiture for such a minor deviation.

Yet, under the logic of Kraus and Scott's critique, a court should strictly enforce each and every condition, relieving one party of a burden of proof on equivalence,[302] despite the potential for forfeiture. This insistence on adhering to the parties' chosen means, even at the cost of large forfeiture, should be rejected in favor of an approach that examines whether judicial intervention can improve welfare for the parties. A court's decision to intervene should thus depend on factors such as (1) whether one party is using verifiably insignificant defects to gain a large windfall at the expense of the other party's forfeiture; and (2) whether judicial departure from strict enforcement would embroil the court in matters that are not verifiable (such as personal taste and aesthetic judgment) when determining whether performance has been satisfied. Kraus and Scott seem to view *Jacob & Youngs* as a case where judicial intervention undermined contractual intent—either by excus-

[302] Kraus and Scott admit in a footnote that the result in the actual *Jacob & Youngs* case may have been justifiable since it "might plausibly be seen as having actually enforced the condition as written but as having interpreted the express condition to require the installation of Reading quality . . . pipe." *See* Kraus & Scott, *supra* note 4, at 1097 n.261.

ing an express condition that reflected the parties' chosen means, or by interpreting the express condition as a constructive condition of exchange. However, further review of the underlying facts of the case shows such judicial interpretation was necessary to prevent one party's opportunistic attempt to capitalize on a specific term in the contract despite the parties' intentions.[303]

The case centers on the construction of a mansion for George Kent by the New York construction firm Jacob & Youngs.[304] The contract contained a specification that "[a]ll wrought-iron pipe must be well galvanized, lap welded pipe of the grade known as 'standard pipe' of Reading manufacture."[305] When Kent realized, almost a year after construction had ended, that some of the pipe in his home was not in fact manufactured by Reading, Kent's architect subsequently directed Jacob & Youngs to completely replace the non-Reading piping.[306] However, because replacing the piping would require demolition of substantial areas of the house, Jacob & Youngs left the work untouched and asked for their final payment of $3,483.46, which was to be paid upon final completion of construction.[307] Kent refused payment based on the non-satisfaction of the condition, and Jacob & Youngs sued for payment.[308]

Writing for the Court of Appeals of New York, Judge Cardozo found that the evidence showing that all pipe used in the house was of the same quality and price as Reading pipe should have been found admissible at the trial level, and that in light of that evidence, Jacob & Youngs' failure to use only Reading brand pipe was insignificant in relation to the project.[309] Thus, the condition for Reading pipe fell into Cardozo's category of promises that "though dependent and thus conditions when there is departure in point of substance, will be viewed as

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[303] It should be noted that Kraus and Scott make a distinction between the actual case of *Jacob and Youngs* and the RESTATEMENT's illustration. *See id.* However, the emphasis on the RESTATEMENT illustration rather than the real world result found in the court's decision seems to be misplaced.

[304] Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 890 (N.Y. 1921).

[305] *Id.*

[306] *Id.*

[307] *Id.*

[308] *Id.* At trial, evidence showing that all pipe used in the house was of the same quality and price as Reading pipe was held inadmissible, and a directed verdict was entered in favor of Kent. *Id.* The New York Appellate Division then reversed and granted a new trial. *Id.* The Court of Appeals of New York affirmed the reversal, and entered a directed verdict in favor of Jacob & Youngs. *Id.* at 892.

[309] *Id.* at 890.

independent and collateral when the departure is insignificant."[310] Based on this finding, the court held that Jacobs & Young was entitled to payment of the remaining $3,483.46, while Kent would only be entitled to the negligible difference in value between a house with all Reading brand pipe and his actual house, which contained non-Reading piping.[311]

However, as Kraus and Scott point out, one question remains: why did the parties specify the use of Reading pipe as a condition in the first place if it was "insignificant" to the project? As Richard Danzig explains,[312] there was no indication that Kent had any professional or financial connection to the Reading Company whatsoever.[313] A further review of Reading's annual reports showed no mention or affiliation to either the Kent or Grace (the maiden name of Kent's wife) families from 1915-1945.[314] Thus, Danzig argues, Kent must have requested the specific pipe for another reason,[315] which may be illustrated by the explanation below.

At the time of contracting, the four companies manufacturing wrought iron pipe were largely non-competitive,[316] since the quality, price, appearance, composition, and durability of each of the four brands was substantially identical, differentiated only by the name of the manufacture stamped onto the pipe.[317] However, because manufacturers of lower cost, lower-quality *steel* pipe often used names such as

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[310] *Id.* Cardozo goes on to say that when deciding whether terms should be considered independent promises, dependent conditions or, as here, somewhere in between, "[c]onsiderations partly of justice and partly of presumable intention are to tell us whether this or that promise shall be placed in one class or in another." *Id.*

[311] *Id.* at 891.

[312] RICHARD DANZIG & GEOFFREY R. WATSON, THE CAPABILITY PROBLEM IN CONTRACT LAW: FURTHER READINGS ON WELL-KNOWN CASES (2nd ed. 2004).

[313] *Id.* at 109-10.

[314] *Id.*

[315] This seems to discount Scott and Kraus's thoughts that Kent may have "had an emotional, reputational, or business reason for preferring Reading brand pipe over pipe of equivalent quality." *See* Kraus & Scott, *supra* note 4, at 1097 n.261.

[316] DANZIG & WATSON, *supra* note 312, at 110-11.

[317] *Id.* at 111. While Kraus and Scott posit that the "Reading brand pipe" may have been made a condition rather than "Reading quality pipe" in order to lower expected costs of verifying and enforcing the requirement (Kraus & Scott, *supra* note 4, at 1097), the costs of verifying Reading quality pipe would arguably be slim to none, since any wrought iron pipe would have been virtually identical to Reading brand. In fact, an employee of the Reading company was prepared to testify to this fact, and Kent admitted in his brief on appeal that each manufacturer's product was of the same quality. DANZIG & WATSON, *supra.*

"wrought pipe" to mislead buyers, manufacturers like Reading warned consumers that "it is safer to mention the name of a manufacturer known not to use [steel] scrap" when drafting a contract where wrought iron pipe is desired.[318] Thus, despite the identical quality of the different brands, Danzig concludes that Reading pipe was specified "because it was the normal trade practice to assure wrought iron pipe quality by naming a manufacturer."[319] This conclusion is bolstered by language in the contract that states "Where any particular brand of manufactured article is specified, it is to be considered as a standard. Contractors desiring to use another shall first make application in writing to the Architect, stating the difference in cost and obtain their written approval of the change."[320] This suggests that the use of Reading *quality* pipe was more essential than Reading *brand*, and as Danzig points out, Reading did not even make the "lap welded" pipe requested in the contract in all the sizes required for construction of Kent's house.[321]

The question then becomes, as Danzig notes,[322] why Kent would go through three layers of litigation over a difference in piping that, by all accounts, was of the same quality as what was requested. Danzig's investigation into the construction of the house and Kent's overall unhappiness with how construction proceeded indicates that because of "other dissatisfactions" in his relationship with Jacob & Youngs,[323] Kent intended to seize on a small and insignificant deviation from the specific words of the contract to avoid paying the final amount owed.[324]

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[318] *Id.* Danzig cites one publication which stated that even specifying "genuine wrought iron pipe" did not always exclude wrought iron containing steel scrap. *Id.*

[319] *Id.*

[320] *Id.* at 111-12.

[321] *Id.* at 112 n.8. Kraus and Scott note that "Jacob & Youngs might plausibly be seen as having actually enforced the condition as written but as having interpreted the express condition to require the installation of Reading quality, rather than Reading brand, pipe. So interpreted, Jacob & Youngs . . . actually satisfied the condition." Kraus & Scott, *supra* note 4, at 1097 n.261.

[322] DANZIG & WATSON, *supra* note 312, at 112.

[323] *Id.*

[324] According to Jacob & Youngs' complaint, additional work totaling over $7,000 was needed during the course of construction, and because of delays allegedly caused by Kent, the parties had to sign an agreement extending the time frame for completion indefinitely. *Id.* at 113. Additionally, Kent also deducted $4,031.41 from the original price due to "certain alterations and omissions" by Jacob & Youngs. *Id.* (quoting Complaint at 8, Jacob & Youngs, Inc. v. Kent, 129 N.E. 889 (N.Y. 1921)). Thus, while work on the house was supposed to be finished by December 15, 1913, Kent was not able to actually move into the house until June of 1914, and "minor details of work" remained

Thus, *Jacob & Youngs* presents a situation where both sides acknowledged that what was received was substantially the same as what was requested, and where objective evidence showed and a variety of witnesses were willing to testify that the brands of pipe used in Kent's house were of the quality he wanted. Additionally, based on Danzig's research, the court does not appear to have been dealing with an issue of Kent's personal taste and thus did not have to struggle with unverifiable information. When considering the parties' intentions, the court was in a position to evaluate not only the chosen means, but also the parties' objectives and contractual ends, and to make a decision that prevented Kent from acting opportunistically and capitalizing on a meaningless deviation in order to avoid final payment. As Danzig demonstrates, if the court had denied compensation to Jacob & Youngs, it would have been fostering opportunistic behavior by allowing Kent to avoid payment despite having received substantially what he bargained for.

In contrast to *Jacob & Youngs*, the case of *O.W. Grun Roofing and Construction Co. v. Cope*[325] illustrates a situation where a court may decide against intervention. There, the dispute involved issues of taste and aesthetics, leaving the court ill-equipped to substitute its objective judgment for that of the contracting parties. In *Grun*, the plaintiff homeowner, Cope, contracted with defendant Grun to have a new roof placed on her house for a price of $648.[326] Both parties acknowledged that the roof was to be a uniform color, with the contract calling for shingles that Grun identified as a "brown varied color."[327] Upon completion, Cope complained that certain shingles formed yellow streaks across her new roof,[328] and when Cope refused to pay, Grun instituted a mechanic's lien and filed suit. At trial, the jury denied Grun any recovery,[329] and awarded Cope $122.60, the estimated amount that would

incomplete as of November, 1914. *Id.* at 114. These problems cost Kent over $11,000, while the plumbing contract itself was priced at only $6,000. *Id.* at 113-14. As such, Kent was likely discontented and frustrated by the situation. One can thus imagine how a small deviation from the contract terms could be seized upon to show built up disapproval and anger for the overall construction of the house.

[325] O.W. Grun Roofing & Constr. Co. v. Cope, 529 S.W.2d 258 (Tex. Civ. App. 1975).

[326] *Id.* at 260.

[327] *Id.* at 260-61.

[328] *Id.* at 261. Grun attempted to remedy the situation by replacing the streaky shingles, but the new shingles did not match the originals, and photographs showed that the roof was still not a uniform color. *Id.*

[329] *Id.* at 260.

be necessary, in addition to the original price of $648, to hire a new contractor to replace the roof.[330]

On appeal, testimony indicated the only way for Cope to have a uniform roof, as originally agreed upon, was to have a "completely new roof" installed.[331] Therefore, the case centered on whether Grun's installation of a roof that was not a uniform color constituted substantial performance of the contract. In making this determination, the court grappled with the object and purpose of the parties: "Was the general plan to install a substantial roof which would serve the purpose which roofs are designed to serve? Or . . . to install a substantial roof of uniform color?"[332] The court found that the non-uniform roof did not constitute substantial performance, concluding that:

> We cannot say, as a matter of law, that the evidence establishes that in this case that a roof which so lacks uniformity in color as to give the appearance of a patch job serves essentially the same purpose as a roof of uniform color which has the appearance of being a new roof.[333]

In both *Jacobs & Young* and *Grun*, the court had to grapple with contractual terms and the parties' intentions to determine whether substantial performance occurred. The different outcomes in the two cases can be explained by (1) the court's hesitation to substitute its own judgment for that of the homeowner in cases where certain information is difficult to verify; and (2) the court's desire to curb opportunistic behavior in accordance with the welfare improvement principle.[334] For instance, In *Jacob & Youngs*, the homeowner's preference for Reading brand pipe appears not to have been simply the homeowner's personal preference, as it was in *Grun*, but rather an objective standard of quality. Thus the court was more willing to intervene, since it did not have to struggle with whether its objective judgment would override the personal judgment and satisfaction of the homeowner. Additionally, in *Jacob & Youngs*, it is likely that the homeowner was acting opportunistically, trying to capitalize on what was, by all accounts, an insignificant defect. Thus, when the court intervened by interpreting the parties' intentions, it did so to restrain Kent's opportunistic behavior and to maximize gains from trade.

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[330] *Id.*
[331] *Id.* at 263.
[332] *Id.* at 262.
[333] *Id.* at 263.
[334] *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 227, 234 (1981).

On the other hand, *Grun* involved a situation where the tendered performance clearly deviated from what was bargained for, and where the issue was a matter of personal taste. Unlike piping, meant only to be functional, a new roof is meant to be both functional and aesthetically pleasing, and the court was ill-equipped to make a judgment about whether the homeowner's personal preferences had been satisfied. Rather than applying the doctrine of substantial performance as the court did in *Jacob & Youngs*, the court in *Grun* deferred to the homeowner's opinion that substantial performance had not occurred.[335]

Thus, *Jacobs & Young* and *Grun* show that by analyzing the likelihood of opportunistic behavior, the effectiveness of non-judicial enforcement mechanisms, and the availability of objectively verifiable information regarding the parties' intentions and objectives, a court is able to decide whether judicial intervention would be optimal for the parties.

E. *Other Examples: Hadley v. Baxendale*

One way of deciding if Kraus and Scott's approach makes sense is to ask what would happen to certain, well accepted rules if they were adopted as the governing rule. For example, one way to assess whether we should bar legal intervention absent express delegation involves "penalty defaults"[336]—such as the *Hadley v. Baxendale*[337] rule.[338] The *Hadley* rule states that parties are barred from recovering full expectancy damages unless they previously disclosed the relevant special circumstances prior to the other party's nonperformance.[339] The theory behind those law supplied rules, such as *Hadley*, is that courts want to encourage parties to be explicit about the risks they are taking or assuming at the time of contracting. Yet, it seems that Kraus and Scott would disallow that approach because, in *Hadley*, there was no indica-

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[335] The court noted that "[i]n the matter of homes and their decoration . . . mere taste or preference, almost approaching whimsy, may be controlling with the homeowner, so that variations which might, under other circumstances, be considered trifling, may be inconsistent with that 'substantial performance' on which liability to pay must be predicated." *Grun*, 529 S.W.2d at 262.

[336] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 101-02 (1989).

[337] Hadley v. Baxendale, (1854) 156 Eng. Rep. 145 (Ex.).

[338] *See* Ayres & Gertner, *supra* note 336. I am grateful to Robert W. Gordon, Professor of Law, Yale Law School, for his insights here. *See* E-mail from Robert W. Gordon to Juliet P. Kostritsky, *supra* note 89.

[339] *See id.*

tion that the parties delegated authority to a court to intervene to craft a limit on expectancy damages—since the parties employed no vague term doing so. Absent such delegation, Kraus and Scott would maintain the parties are not entitled to have a court intervene with a term limiting expectancy damages.[340]

Yet, denying the law supplied term (limiting expectancy damages) would have negative welfare effects. One can argue that the penalty default rule promotes efficiency. It provides an incentive for high risk shippers to disclose their true type. That disclosure promotes efficient behavior by permitting shippers to take efficient precautions depending on the risk category and potential liability of the shipper. Courts should have authority to intervene with these types of law supplied rules if doing so will enhance efficiency and social welfare.

V. Conclusion

While many contracts do not contain a broad or open-ended term signifying the parties' choice to afford the court discretion to fill in terms *ex post*, courts still intervene in ways that can be justified under the framework outlined above. This Article has examined a number of doctrines—including Section 45, conditions, order of performance, and substantial performance—all of which demonstrate the court's willingness to intervene despite the absence of an express delegation by the parties. If such intervention by courts were as costly and deleterious as Kraus and Scott suggest, one wonders why more parties do not opt out of standard default and interpretive rules. The fact that more parties do not opt out suggests that perhaps judicial intervention is of value to them. The Article concludes that rather than opting for a unitary approach proscribing all intervention absent a party's express invocation of judicial authority in the form of an open-ended term, the court should determine whether the net benefits and efficiency gains of contracting will be greater if the court intervenes. In making such a determination the court should consider a variety of factors, including (1) whether the intervention or non-intervention is likely to curb opportunistic behavior, thereby creating value for the parties by minimizing a drag on gains from trade; (2) the ease and cost of the court's intervening, including whether the court will have to access unverifiable information that is also subject to manipulation by one party (such as seller's costs); (3) whether the court can intervene by con-

[340] *See* Kraus & Scott, *supra* note 4, at 1101.

structing a liability rule or deciding a legal question (such as the order of performance) that does not depend on private information but on considerations of projected effects on parties' behavior given average assumptions about human behavior; (4) whether there are impediments to express contracting; (5) whether informal sanctioning mechanisms exist that include transparency, repeat play and other salient factors; and (6) the effect of intervention or non-intervention on the prospect of uncontrolled discretion in a performance obligation.

This Article has identified a framework to use in determining whether judicial intervention would be optimal, even absent an express delegation. These include cases in which the chosen means are ambiguous, where specific terms nevertheless fail to place any limits on one party's discretion, where the parties have omitted a term, or where the contract is economically incomplete and evidence suggests that a court can improve welfare by supplementing the parties' chosen means. These examples suggest that the absence of an open-ended term should not and does not deter courts from, for example, deciding to imply a subsidiary[341] promise not to revoke an offer once there is partial performance even if a party failed to adopt a vague term delegating authority to a court.

Courts should not determine whether or not to intervene in contracts solely on the basis of whether an express delegation exists through the use of a vague standard.[342] That requirement would add to transaction costs and, in many cases, would—by suggesting an invariant rule—preclude courts from intervening even if intervention were welfare improving.[343] There is always a tradeoff involved in judicial intervention or interpretation questions, and courts should weigh the benefits of intervention or interpretation (transaction costs saved, op-

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[341] This Article reviews Section 45 cases in which courts were confronted with the question of what should be the effect, if any, of partial performance on the offeror's power to revoke an offer. The contract itself, in these cases, contained express terms which provided for payment in return for an action.

[342] For an interesting exploration of the continued use of vague MAC (no material adverse change) clause as a form of *ex ante* signaling of quality by sellers, see Albert H. Choi & George G. Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 893 (2010).

[343] Moreover, because the only way for a party to invoke judicial intervention in a contract seems to be through the adoption of an open-ended term, in many cases, parties might want an intervention that does not lend itself to a vague or open-ended term. In the case of the unilateral contract, it is not clear how the parties would help themselves or the court resolve the issue of the effect of part-performance through the use of a vague term.

portunism deterred) against the costs.[344] Because the Kraus and Scott approach elevates contractual means over ends, fails to account for incompleteness or ambiguity in contracts, and assumes that all forms of legal intervention to achieve the parties' goals would uniformly be deleterious, it ignores the costs that could result under this approach, including: reduced trade, increased transaction costs, and increased opportunism. A justificative framework for understanding how contracts are designed and the obstacles parties face in drafting unambiguous complete agreements includes the deadweight costs of uncertainty, bounded rationality and sunk costs which act as natural barriers to contracting.[345] The framework recognizes the back-end costs (including enforcement costs which include additional costs when one party can manipulate certain data) that are central to the new instrumental formalists, but argues that parties' goals or objectives (broadly defined in terms of welfare improvement) must play a central part in any framework for analyzing whether judicial intervention in a contract is likely to be optimal.

This framework suggests that courts should adopt the strategy that yields the greatest net benefits. This strategy could include supplying a default rule to fill in price terms where parties have not agreed on a price, relying on trade usages to interpret express terms, or employing a liability rule to govern precontractual negotiation to regulate the risk of hold-up and strategic behavior.[346] Assessing the net benefits of intervention would also require a court to determine whether there are particular governance mechanisms already in place which would curb the problem of opportunism.[347] Presumably, no net benefits would be obtained from judicial intervention where private governance mechanisms are already in place. However, the absence of such mechanisms might suggest a role for courts.

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[344] *See* Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1587 (2005).

[345] *See* E-mail from Ronald J. Coffey to Juliet P. Kostritsky, *supra* note 17.

[346] *See* Juliet Kostritsky, *Uncertainty, Reliance, Preliminary Negotiations and the Hold Up Problem*, 61 SMU L. REV. 1377, 1399-1409 (2008).

[347] *See* Gilson et al., *supra* note 95.