

Abstract: This paper consists of the Table of Contents and Introductory chapter of a new book, *Framing Contract Law: An Economic Perspective*. The central theme of the book is that an economic framework--incorporating such concepts as information asymmetry, moral hazard, and adaptation to changed circumstances--is appropriate for contract interpretation, analyzing contract disputes, and developing contract doctrine. The value of the approach is demonstrated through the close analysis of major contract cases. In many of the cases, had the court (and the litigators) understood the economic context, the analysis and results would have been very different. Topics and some representative cases include consideration (*Wood v. Lucy, Lady Duff Gordon*), interpretation (*Bloor v. Falstaff* and *Columbia Nitrogen v. Royster*), remedies (*Campbell v. Wentz*, *Tongish v. Thomas*, and *Parker v. Twentieth Century Fox*), and excuse (*Alcoa v. Essex*).

Framing contract law: an economic perspective

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Introduction

I have been teaching the first-year Contracts course for a number of years now. As one of the small band of Contracts teachers trained in Economics (and the even smaller band without a law degree), I come to the case law from a somewhat unorthodox angle. I sometimes find myself exasperated by various features of the reported decisions, including, but not limited to, the outcomes. Too often I find the facts as stated to be incomplete, irrelevant, or inaccurately stated. Absent a framework for organizing the inquiry, the courts often fail to ask the relevant questions, in no small measure because both the courts and the lawyers who present the case exhibit a lack of understanding about the underlying economics of the transactions in dispute.

At about the same time that I began teaching Contract Law, Ron Gilson and I, along with some colleagues, were developing a transaction-oriented course—Deals: The Economic Structure of Complex Transactions, known informally as Deals. The central theme of Deals is that transactions that appear very different on their face—long-term supply contracts, securitizations, corporate acquisitions and divestitures, and so forth—present many of the same problems and similar tools can be employed to deal with them. The transactional lawyer is, in effect, a transaction-cost engineer, designing structures to cope with problems such as information asymmetry, moral hazard and the like. It has become clear to me that there is a significant disjunction between the intellectual frameworks of the transactional lawyer structuring deals and the litigator interpreting those transactional structures after problems have arisen.

The central conceit of the essays comprising this book is that the theoretical framework of the transaction-cost engineer is appropriate for analyzing contract disputes and for developing contract doctrine—at least for business to business transactions. The analysis relies heavily on recent developments in economics. However, those accustomed to seeing the economics of contract law as being permeated by the concept of efficient breach and the technique of formal mathematical modeling will be surprised to find very little of the former and none of the latter. The economic analysis here focuses on the transaction. I ask: Why might reasonable, profit-seeking actors structure their relationship in a particular way? How should the answer to that question affect the interpretation of a contract or suggest the appropriate contract law rule? Hereafter, when I invoke “economics” I mean this particular brand of economics. The features of that brand will emerge in the course of this book.

The best way to demonstrate the usefulness of the transactional framework is to apply it. Most of the essays comprising this book analyze particular cases, with an emphasis on cases common to many Contracts casebooks. The essays come at the subject from different angles. Some involve going back to the briefs and record of a case in an attempt to understand what actually happened and how the court came to frame the story in the way it did. Others take the facts as stated by the courts as a jumping off point. While the methods vary from essay to essay, the theme remains constant.

Like virtually all contracts scholars, I start with the presumption that the purpose of contract law is to facilitate private ordering. The parties are the best judges of their interests and the law should, as much as possible, stay out of the way. There are exceptions—there might be

good reasons to discourage or prohibit certain classes of promises (for example, disclaimers or promises to commit illegal acts) or to be suspicious of the manner in which agreements have been reached (for example, the battle of the forms or duress). Still, the facilitation of voluntary exchange remains the primary goal of contract law. Voluntary exchange is not a zero-sum game; it allows parties to achieve gains from trade. The parties enter into their agreement because they each expect to be better off. They might, of course, turn out to be wrong. It might have seemed a good idea at the time, but conditions might have changed leaving one party to regret having entered into the agreement. Or, one party might simply have misperceived the possible outcome. Had it known more (or been a more intelligent processor of available information), it would not have entered into the deal. Regardless, the basic presumption that there are gains from trade is the economic foundation for a facilitative law of contract.

The facilitative nature of contract law means that if parties don't like a particular rule, they can change it. Formal contract law provides only a set of default rules. If drafting around the rules were always easy, then the precise content of the rules would be of little consequence. Economic analysis would be of value to transactional lawyers, but less so for judges and litigators, although the analysis would still be useful for interpretation. Not everything, however, is negotiable. At the extreme, some rules are mandatory. More generally, default rules can be sticky either because the law imposes hurdles to drafting around the defaults or because of non-legal factors (for example, the costs of negotiating). The stickiness of the defaults, which includes the uncertainty that any particular deviation will survive in litigation, means that in at least some instances the default rules will matter.

Whether parties do contract around a particular rule provides a test of the economic sense of a rule. If parties routinely accept the rule and the legal barriers to contracting around the default are low, then there ought to be at least a presumption that the court (or legislature) got it right. So, when I argue below that the lost profits remedy is too liberal (chapter 13) or that certifiers of quantity or quality should not be liable for the consequential damages arising from erroneous measurement (chapter 15), the failure of contracts to conform with my expectations necessitates my providing a satisfactory explanation of the divergence between theory and practice.

Months might pass between the time the parties enter into a contract and the date it is to be performed. Performance itself might take place over time. As time passes, things change—both conditions and the information available to the parties. The recurring theme in these essays is that because contracting takes place over time, contracts will have to determine how to respond to the changed circumstances. Some changes are simply the inevitable risks of doing business, risks assigned by the contract. The more interesting questions concern adaptation as new information is revealed, termination being the extreme form of adaptation. The contract could give one or both parties the explicit right to terminate, perhaps for a price. The right could be unconditional, or it could require a specific trigger (for example, an excusing circumstance). The right to terminate could be implicit—the right to breach and pay damages. The contract could give one party discretion to adapt and it could require that party to compensate the other if the adaptation would impose costs on it.

In Part I, I begin with a short note sketching the analytical tools that will be used

throughout the book. I then go into greater depth examining a puzzle: Why is it that in the movie business the compensation of many of the actors, writers, and producers is based in part on “net profits,” despite the widespread belief that Hollywood accounting means that most movies will never show any net profits? This provides a fairly painless introduction to a number of the themes developed in the rest of the book, particularly the importance of adapting to new information; it has the added virtue of touching on one area of contract law not otherwise covered in this book—unconscionability.

Parts II and III focus on problems involving fuzzy language, in particular the abuse of “good faith” and “best efforts.” In a number of cases courts have dealt with the apparent lack of consideration by invoking an implied duty of good faith. This I believe to be a mistake, although in the long run it does not do much direct harm, since by and large these are agreements that the parties easily could have made enforceable without any such implication. The interesting problem is not whether the agreements are enforceable, but what is to be enforced. By imposing a near-mandatory “good faith” or “best efforts” duty on the promisor, the law raises barriers to efficient contracting. The consideration cases, including the classic *Wood v. Lucy, Lady Duff Gordon*, are the focus of Part II.

Interpretation is the theme of Part III. I return to “good faith” and the treatment of variable quantity contracts (for example, requirements contracts). Having found that a contract exists, courts then have to interpret what it means. Variable quantity contracts grant one party discretion in determining the quantity for good reason—to facilitate adaptation to changing circumstances. To protect the interests of the counterparty, the contracts almost always impose

limits on the quantity-determining party's discretion. Notwithstanding that, the courts have taken to invoking good faith to impose different limits, undoing the allocation worked out by the parties. I next show how the one "best efforts" case that makes it into the casebooks (*Bloor v. Falstaff*) poses the wrong question and comes to the wrong conclusion. The two remaining essays in Part III concern very different interpretation issues. First, I consider the role of custom and usage in interpreting a contract. I explore the notorious *Columbia Nitrogen* decision in which the court claimed that the apparently clear and unambiguous language of the contract regarding the minimum quantity could be modified by alleged custom and usage and the course of dealing of the parties. I conclude Part III with my proposal for coping with the "battle of the forms" problem—the "best-shot" rule.

In Part IV, the discussion shifts to remedies. My primary focus is on monetary damages. However, I begin with an examination of the specific performance remedy in the context of *Campbell Soup v. Wentz*. The court would have granted specific performance, but for its conclusion that the contract was unconscionable. However, the court's misunderstanding of the contract made it doubly wrong. It erred both in finding the contract unconscionable and in identifying the rationale for awarding specific performance.

The balance of Part IV focuses on the damage remedy. While a common criticism of contract law is that the remedies are undercompensatory, I argue that in many instances the opposite is true. The standard remedy is expectation damages and the usual statement of the rule is that expectation damages should make the victim of the breach as well off as she would have been had the contract been performed. I would propose instead that the question be: what

remedy would reasonable parties have put in the contract in the first place? The remedy is (or, rather, ought to be) just another contract term for the parties to choose in designing their relationship. The two questions give the same answer when the remedy is the contract price-market price differential (what I refer to as the narrow expectation interest). But in other instances, notably the “lost-volume” seller’s lost profits and “foreseeable” consequential damages, making the victim whole would produce an overcompensatory remedy. Ironically, in the one instance in which some commentators complain about overcompensatory remedies—awarding the contract-market differential to a hedged middleman—I argue that these commentators are wrong.

The decision to breach can be viewed as an option, with the damage rule establishing the price of the option. Katz (2004) and Scott & Triantis (2004) make a persuasive case for this. The line between this implicit option and more explicit options is an artificial one. Two casebook favorites—*Parker v. Twentieth Century Fox* and *Wasserman v. Township of Middletown*—were treated by the courts as raising difficult questions regarding remedies for breach. Properly framed, they are easy cases in which there was no breach, only the exercise of an option. Although they invariably appear in casebooks in the chapter on Remedies, I have broken these out into their own section in Part V. It should become clear, however, that the label has no bearing on the appropriate analysis.

When circumstances change, a disadvantaged party might ask the court to excuse its performance, or at least modify it. The many variations on the excuse doctrine are the subject of Part 6. Force majeure clauses are not mere boilerplate. There is an economic logic to them and

that provides the basis of the analysis of the excuse cases where the contract is silent. I argue that the standard warhorses, *Taylor v. Caldwell*, *Krell v. Henry*, and the Suez Canal cases were rightly decided, but I suggest an alternate route to those outcomes. The court's analysis in *Alcoa v. Essex* was dubious, but the deeper problem was that the transactional lawyers had written a badly flawed contract. The main flaw was not, however, the one on which the court focused. In the final essay in Part VI, I consider the case generally cited for the proposition that if performance is "too expensive" it will be deemed impractical and therefore the party will be excused: *Mineral Park v. Howard*. When properly framed it is clear that the impracticality was irrelevant. Holding the promisor to the bargain would have led to the efficient outcome and would not have been unduly burdensome to the promisor.

Economic analysis, whether right or wrong, will not be of much use in deciding cases if its application requires training and skills beyond those of judge and jury. In some instances, the economics simply helps pose the proper question. Litigation is story-telling and if the parties use the right framework, the answer becomes obvious. The following chapters are full of examples of such clean kills, for example, *Parker v. Twentieth Century Fox*, *Bloor v. Falstaff*, *Feld v. Levy*, *Tongish v. Thomas*, and *Mineral Park v. Howard*. Perhaps the most useful role of my proposed framework is in providing a plausible rationale for classes of contract clauses that can shield them from judicial modification or nullification with interpretative tools like "good faith" or trade usage. To the extent that the moral of such analyses is "don't meddle," the economics makes the court's task easier. I do not mean to suggest that the analysis will inevitably make life easier—there is some pretty tricky stuff yet to come. But my belief is that a little economics can go a long way in helping to decide contract disputes.

One source of tension in contract law concerns the weight that should be given to factors beyond the actual wording of the contract in dispute. Variations on this problem crop up in many forms: objective versus subjective theories of interpretation; the parol evidence and plain meaning rules; the incorporation of trade usage and custom into agreements (and, more generally, the inferences that formal adjudications can make from the informal resolution of disputes). I do not want to confront these issues directly, although I lean toward the objective view and am quite skeptical regarding trade usage and custom. The reasons for this will, I hope, become clear after we work through the analysis. For now it is sufficient to acknowledge that these views appear to be in conflict with my theme, namely that placing transactions in their economic context is necessary for the proper resolution of disputes, and that part of my task will be to resolve that apparent conflict.

Some of these essays have been published before, not always in easily accessible places. These are hardly sacred texts and I have edited and, in some instances, revised them. In particular, I have eliminated some of the over-footnoting common to law review articles. By putting these essays together in one place, with some connective tissue, I believe the power of a transactionally sensitive economic approach to contract law will become apparent. If the book works as I hope it will, on a first reading many of the arguments should seem counter-intuitive and wrong. But on further reflection the same arguments should appear obvious, if not trivial. Because of the focus on individual cases, I have had to sacrifice breadth for depth. Still, I believe that the essays cover a broad enough spectrum of the case law to illustrate the virtues of the transactional framework for analyzing both specific contract disputes and broader issues of contract doctrine.

The book is, first and foremost, a work of scholarship aimed at contracts scholars. I have tried to write it in such a way as to make it (or at least most of it) accessible to a wider audience. First, of course, it is meant for those who teach contract law. For them it can be both a sword and a shield. On my more optimistic days I think of it as a sword, providing a framework for analyzing contract law questions. When in a more cynical mood, I believe it can at least shield the professor from the embarrassment of being blind-sided by a student who has read the book and can show why the professor has the facts or the interpretation (or both) wrong. I would hate to be teaching *Wood v. Lucy* and have a student inform me that months before entering into his arrangement with Lucy, Otis Wood had sued another client for breach of a contract that included an explicit best efforts clause. That leads to the second audience—first-year contracts students. To be sure, some of the analysis here will be hard going for One L's, but I believe that enough of it is accessible to make the book a worthwhile supplement to a first-year course. For students it provides both a way of thinking about contract law and an introduction to the transactional side of lawyering, which is under-represented in the three-year curriculum and otherwise absent in the first year.

Influencing how faculty and students frame contract questions is a deep investment in legal change. My other audiences—lawyers and judges—are more directly involved. While they have the potential for an immediate impact, their contact with contract law is more episodic. Unlike corporate law, there is no specialized bar. For the Delaware bench, keeping up with the corporate law literature is essential. They engage in an ongoing dialogue with academics and a group of high-powered lawyers who keep up with the literature and feel comfortable incorporating concepts from the literature in litigation. Since contract disputes typically account

for only a small portion of the case load for both judges and lawyers, their incentives to engage with the literature are less keen. Contract law's place in the general lawyer's mind was driven home to me a few years ago when I was being deposed. After I alluded to the "famous case of *Hadley v. Baxendale*," my interrogator (a good lawyer and a Columbia grad, by the way) said, "excuse me, professor, but I'm not familiar with that case. . . ." So, while my target audience includes practitioners and judges, I am mindful of the fact that making inroads here will not be easy.