1981

Principles of Relational Contracts

Charles J. Goetz

Robert E. Scott

Columbia Law School, rscott@law.columbia.edu

Follow this and additional works at: https://scholarship.law.columbia.edu/faculty_scholarship

Part of the [Contracts Commons](#)

Recommended Citation

Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

Available at: https://scholarship.law.columbia.edu/faculty_scholarship/400

This Article is brought to you for free and open access by the Faculty Publications at Scholarship Archive. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarship Archive. For more information, please contact scholarshiparchive@law.columbia.edu.

VIRGINIA LAW REVIEW

VOLUME 67

SEPTEMBER 1981

NUMBER 6

PRINCIPLES OF RELATIONAL CONTRACTS*

Charles J. Goetz** and Robert E. Scott***

RECENT scholarship has demonstrated that a significant proportion of private contracts do not easily fit the presuppositions of classical legal analysis.¹ One reason for this is the pivotal role played in conventional legal theory by the concept of the complete contingent contract. Parties in a bargaining situation are presumed able, at minimal cost, to allocate explicitly the risks that

* We would like to thank Tyler Baker, Michael Dooley, Ernest Gellhorn, Victor Goldberg, John Hetherington, Douglas Leslie, Saul Levmore, Harvey Perlman, Alan Schwartz, and Paul Stephan for their helpful comments on earlier versions of this article.

** Professor of Law, University of Virginia School of Law.

*** Professor of Law, University of Virginia School of Law.

¹ In the legal literature, Ian Macneil's pioneering scholarship has identified and described a variety of contractual relationships that fall outside the boundaries of the classical "bargain" model. See, e.g., Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854 (1978) [hereinafter cited as *Adjustment of Long-Term Relations*]; Macneil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691 (1974) [hereinafter cited as *Futures of Contract*]. Many others, of course, have recognized this largely uncharted territory. See, e.g., L. FRIEDMAN, *CONTRACT LAW IN AMERICA* (1965); Fuller, *Collective Bargaining and the Arbitrator*, 1963 WIS. L. REV. 3; Leff, *Contract as Thing*, 19 AM. U.L. REV. 131 (1970); Macaulay, *Non-Contractual Relations in Business*, 28 AM. SOC. REV. 55 (1963); Summers, *Collective Agreements and the Law of Contracts*, 78 YALE L.J. 525 (1969).

In the economic literature, the work of Williamson, Goldberg, and others has been equally instrumental in identifying the limitations of "friction-free" models in explaining contractual relationships whose purpose is to economize on transactions costs. See, e.g., O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976); Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX. L. REV. 91 (1979) [hereinafter cited as *Vertical Restrictions*]; Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979) [hereinafter cited as *Transaction-Cost Economics*]; Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV. 953 (1979) [hereinafter cited as *Assessing Vertical Restrictions*].

future contingencies may cause one or the other to regret having entered into an executory agreement.² Under these conditions, the role of legal regulation can be defined quite precisely. Once the underlying rules policing the bargaining process have been specified, contract rules serve as standard or common risk allocations that can be varied by the individual agreement of particular parties. These rules serve the important purpose of saving most bargainers the cost of negotiating a tailor-made arrangement. If the basic risk allocation provided by a legal rule fails to suit the purposes of particular parties, then bargainers are free to negotiate an alternative allocation of risks.³ All relevant risks thus can be assigned optimally—either by legal rule or through individualized agreement—because future contingencies are not only known and understood at the time the bargain is struck, but can also be addressed by efficacious contractual responses.

In a complex society, however, many contractual arrangements diverge so markedly from the classical model that they require separate treatment. Parties frequently enter into continuing, highly interactive contractual arrangements. For these parties, a complete contingent contract may not be a feasible contracting mechanism. Where the future contingencies are peculiarly intricate or uncertain, practical difficulties arise that impede the contracting parties' efforts to allocate optimally all risks at the time of contracting.⁴ Not surprisingly, parties who find it advantageous to enter into such cooperative exchange relationships seek specially adapted

² It is the occurrence of a "regret contingency" that represents the true social cost of executory contracting. The legal rules of contract facilitate the efforts of bargaining parties to minimize and allocate optimally the risks of such contingencies. See Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1271-88 (1980) [hereinafter cited as *Enforcing Promises*].

³ For a discussion of the economic justification underlying the risk-allocating rules of contract, see Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 554-77 (1977) [hereinafter cited as *Liquidated Damages*].

⁴ The limits of human capacity to respond optimally to the external conditions of uncertainty and complexity are explained by the concept of "bounded rationality." Simon defines bounded rationality as behavior that is "intendedly rational, but only limited[ly] so." H. SIMON, *ADMINISTRATIVE BEHAVIOR* xxviii (3d ed. 1976) (emphasis in original). Thus, when transactions are conducted under conditions of uncertainty and complexity, it becomes extremely costly—if not literally impossible—for parties constrained by bounded rationality to describe the complete decision tree at the time of bargaining. See O. WILLIAMSON, *supra* note 1, at 21-26.

contractual devices. The resulting "relational contracts"⁵ encompass most generic agency relationships, including distributorships, franchises, joint ventures, and employment contracts.

Although a certain ambiguity has always existed, there has been a tendency to equate the term "relational contract" with long-term contractual involvements. We here adopt a very specific construction of the term that is based more precisely on a contrast with the classical contingent contract. A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance. As the discussion below illustrates, long-term contracts are more likely than short-term agreements to fit this conceptualization, but temporal extension per se is not the defining characteristic. The contracts that we actually observe are, of course, neither perfectly contingent nor entirely relational. Legal theory has merely tended to concentrate on agreements that fall close to the one polar extreme, while our focus in this article is directed toward the other end of the continuum.

Conventional doctrine has failed to explain adequately the nature and function of these relational contracts and how they differ from more standard contracts. The resulting incomplete understanding is a prime source of costly litigation over the meaning and enforceability of key provisions of such agreements. Much of the litigation has centered on two doctrinal linchpins of relational contracts: the obligation of one party (the "agent") to use its "best efforts" to carry on an activity beneficial to the other (the "principal"), and the concomitant right of the principal to terminate the relationship.⁶ Part I of this article describes how these core provisions of relational contracts represent an optimizing response to peculiar environmental constraints of complexity and uncertainty. Appreciating the difficulty of ex ante regulation by contracting

⁵ The terminology was first used by Professor Macneil. See *Adjustment of Long-Term Relations*, *supra* note 1, at 886.

⁶ Throughout this paper we use the terms "principal" and "agent" to refer to any relationship in which one party performs an activity on behalf of another. These terms are merely convenient labels used in an informal sense and include independent contractors as well as technical agency relationships.

parties provides the basis, in Part II, for attaching a more precise legal meaning to those contractual provisions that establish the standard of future performance. Finally, Part III explores the relationship between these performance standards and other contractual provisions, particularly termination clauses. We conclude that current uncertainty over the legal treatment of these provisions impedes the ability of contracting parties to adjust to the special conditions that induce relational contracting.

I. NATURE AND FUNCTION OF RELATIONAL CONTRACTS

Parties enter into relational contracts because such agreements present an opportunity to exploit certain economies. Each party wants a share of the benefits resulting from these economies and consequently seeks to structure the relationship so as to induce the other party to share the benefits of the exchange. Typically, this is accomplished by specifying the performance standard of each party and then selecting a mechanism to ensure compliance with the agreed-upon standard.

In conventional contracts, the parties generally are able to reduce performance standards to rather specific obligations. By contrast, relational contracts create unique, interdependent relationships, wherein unknown contingencies or the intricacy of the required responses may prevent the specification of precise performance standards.⁷ Complexity and uncertainty each play conceptually distinct roles, although they frequently operate in combination. For example, suppose a homeowner attempts to write a contract providing for the care of his fine home garden during a summer when he is out of town. Uncertainty is represented by the difficulty of determining in advance the climatic conditions, incursions of the gypsy moth, wind-borne powdery mildew, etc. Complexity is involved in specifying to the gardener exactly what responses should be made in each case: how much to spend on sprays, whether to water, when a diseased plant should be cut down to prevent infection of adjacent ones, and so on.

A typical response to this problem of complexity and uncertainty is to define the performance standard in unusually general terms. The ethical standards of attorneys, brokers, and other

⁷ See notes 22-27 *infra* and accompanying text.

agents,⁸ the implied fiduciary obligation that attaches to certain relational contractors,⁹ and, most typically, "best efforts" clauses are examples of how performance obligations are articulated in relational contracts.¹⁰ Because these standards are usually described in general terms, it is difficult to apply them in any specific context. Therefore, relational contracts also require more creative control mechanisms than do conventional contingent contracts.¹¹ In any cooperative contract where performance obligations remain imprecise, there are inevitable costs in ensuring that any particular level of performance is achieved. Parties will bear this cost in various ways. For example, they may grant the principal the right to monitor the agent's efforts. Performance thus can be controlled by direct supervision or by indirect incentive systems designed to encourage the agent to consider fully the principal's interests. Alternatively, in cases where monitoring is relatively costly, the agent may seek to reassure the principal by a "bonding" agreement.¹² Liquidated damages provisions, covenants not to compete, and unilateral termination clauses are common examples of agent bonding. Ideally, the parties will select that combination of monitoring and bonding arrangements that optimizes the costs of gov-

* See, e.g., *Smoot v. Lund*, 13 Utah 2d 168, 172, 369 P.2d 933, 936 (1962) ("[A lawyer's] fiduciary duty is of the highest order . . . he must adhere to a high standard of honesty, integrity and good faith in dealing with his client."); *Johns v. Smyth*, 176 F. Supp. 949, 952 (E.D. Va. 1959) ("[O]ne of the cardinal principles confronting every attorney . . . is the requirement of complete loyalty and service in good faith to the best of his ability. . . . [A]n attorney should have no conflict of interest and . . . must devote his full and faithful efforts toward the defense of his client."). See generally ABA CODE OF PROFESSIONAL RESPONSIBILITY, Canon 5, E.C. 5-1 (1980).

* See notes 83-94 *infra* and accompanying text.

¹⁰ See notes 60-82 *infra* and accompanying text.

¹¹ See, e.g., *Vertical Restrictions*, *supra* note 1, at 99-103; *Adjustment of Long-Term Relations*, *supra* note 1, at 889-95.

¹² Professors Jensen and Meckling define "bonding" as an effort by an agent "to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions." Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANCIAL ECON. 305, 308 (1976) [hereinafter cited as *Agency Costs*]. Jensen and Meckling were the first to establish rigorously that contracting parties' incentives to economize on transactions costs are reciprocal. Because the failure of the agent in any case to achieve an optimal level of performance will be borne fully by the agent as a reduction in the "value" of his services, both parties have a parallel incentive to reduce the divergence between ideal and actual performance by selecting an appropriate mix of monitoring and bonding arrangements. *Id.* at 323-26.

erning the standard of performance.¹³

Parties will enter into relational contracts only after considering alternative methods of achieving their objectives. One obvious alternative is the vertical integration of potentially separable activities, such as manufacturing and distribution, into a single firm. An integrated firm presumably would take all the relevant cost and benefit interactions of the two activities into consideration and would provide the optimal level of manufacturing and distribution inputs so that overall profits are maximized.¹⁴ The vertically integrated firm thus provides a benchmark against which various alternative contractual arrangements can be measured. Vertical integration will be the optimal mechanism so long as the cost of monitoring within the firm is less than the associated gain from internalizing the costs and benefits of the combined activities under integrated management.¹⁵ In many commercial settings, however, vertical integration may not be a feasible alternative.¹⁶ Consider, for example, an industry in which manufacturing and distribution are specialized activities and are, at least potentially, performed much more efficiently by separate firms. Where a single integrated firm is no longer the exclusive decisionmaker, the respective parties need to engage in a form of explicit adjustment in order to ensure that the interactions between the manufacturing and distributing activities will be considered properly. How, then, can the parties trade in order to approach the optimal level of

¹³ See text accompanying notes 54-55 *infra*.

¹⁴ [T]he operation of a market costs something and by forming an organization and allowing some authority (an "entrepreneur") to direct the resources, certain marketing costs are saved. The entrepreneur has to carry out his function at less cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supersedes, because it is always possible to revert to the open market if he fails to do this. . . . A firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.

Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 392-93 (1937).

¹⁵ See, e.g., *id.* at 394-95.

¹⁶ A variety of factors may make vertical integration less attractive than alternative contractual devices. As Goldberg has recognized, these factors are not all related to production efficiencies. Vertical integration may trigger costly forms of governmental regulation including workmen's compensation, social security, and national labor relations standards that franchisees can avoid. See *Vertical Restrictions*, *supra* note 1, at 96, 120. In addition, Williamson suggests that transactions costs, and not productive efficiency, are of crucial importance in the integration decision. See *Assessing Vertical Restrictions*, *supra* note 1, at 970-72.

combined efforts analogous to that achieved by the integrated firm?

We begin our analysis of this question by identifying some conditions that produce variations in the nature and form of relational contracting. For the sake of concreteness and ease of exposition, the discussion will be carried on in terms of a "manufacturer" and a "distributor." These are merely labels that conveniently describe relative positions of the parties in a production chain. In any particular real-world situation, the appropriate terminology may vary: franchiser-franchisee, supplier-fabricator, client-broker, etc.

A. *Optimal Contractual Performance Under Certainty*

Why do parties choose contractual forms that entail difficult problems of control? The obvious answer is that, all things considered, they are more attractive than the available alternatives.

Consider the common situation where one party is the distributor of a product supplied, at least in part, by the manufacturer. As an initial hypothetical case, assume that adjustments in distribution efforts are the only dimension of production influencing output on the margin.¹⁷ (We relax this assumption subsequently in order to examine relational contracts with several dimensions of production activity where both parties must be encouraged to undertake appropriate marginal adjustments.)¹⁸ For expository simplicity, we shall regard "distribution efforts" as units of product distributed. Although product volume has the virtue of being a clear and concrete conceptualization, the same analysis would apply if distribution efforts were reinterpreted to take the form of any other volume or quantitative adjustment, including, for example, quality level, advertising, or any other activity that affects joint profits.¹⁹ Assume also in this initial situation that the parties

¹⁷ For example, suppose that the cost and revenue conditions in the market are such that incremental investments in "manufacturing" activities will not increase the quantity of goods sold. This might occur where the manufacturer's costs of "manufacturing" were constant over the relevant range and where adjustments in the activities of the manufacturer (including promotion, advertising, etc.) were not likely to expand the market. Thus, based on such existing and projected marginal manufacturing costs, the manufacturer is capable of supplying profitably all of the goods required for any plausible level of distribution activity.

¹⁸ See notes 40-42 *infra* and accompanying text.

¹⁹ It may well be true that monitoring costs vary significantly with the nature of the productive activity and the parties' risk preferences. See Shavell, *Risk Sharing and Incentives*

each know their own costs (but not necessarily the other party's costs) and know the external market conditions during the effective period of the proposed contract.

FIGURE 1

in the *Principal and Agent Relationship*, 10 *BELL J. ECON.* 55 (1979). These patterns, however, have no fundamental effect on the basic model presented here.

In Figure 1, IMC represents the aggregate of the marginal costs of "manufacturing" (MM) and of the marginal "distributing" costs (the vertical distance between IMC and MM) where a firm carries on both manufacturing and distribution as an integrated process. If MR is the marginal revenue curve, then the intersection of MR and IMC at b determines the output volume Q that maximizes profits. In other words, Q and its associated profit level is the best that the integrated firm can do by both manufacturing and distributing. The agent presumably enters the picture because he enjoys a productive advantage over the manufacturer, such as lower marginal distribution costs as exemplified by MD in Figure 1. The joint marginal cost curve JMC would result if the parties were able to treat their separate costs as a single entity.

The potential savings from separate performance of their respective functions now provide the manufacturer and distributor with an economic incentive to enter into a distributorship agreement. Two predictions can be made as to the terms of an agreement designed to exploit that potential. First, as Figure 1 suggests, the parties will not have exploited all of the potential gains from trade in the situation unless their agreement somehow calls for the manufacture and distribution of quantity Q^* , where the sum of the marginal costs to the joint producers equals the marginal revenues from sales. From any output other than Q^* , a movement to Q^* will increase the combined profits of the parties. If, therefore, there are no special impediments in the form of bargaining or other transaction costs, one would expect to find contract terms facilitating this "joint maximization" quantity outcome.

Second, certain limits can be placed on the minimum and maximum amounts that the distributor will pay to the manufacturer for the predicted Q^* units of the product. Each party must be at least as well off under the contractual arrangement as it would have been otherwise. Consequently, the manufacturer must receive at least its additional manufacturing costs under the higher-volume distributorship agreement plus the "go-it-alone" profits that it would otherwise earn as an integrated firm.²⁰ Graphically, these sums correspond, respectively, to area *ghij* and triangle *abc* in Figure 1. The distributor would, in turn, be willing to pay a maximum

²⁰ The manufacturer's expected profits as an integrated firm represent an opportunity cost of the decision to enter into a distributorship arrangement.

of the total revenues from sales minus its distribution costs (area $kcdm$). A range of indeterminacy exists because the gains from trade (cost saving $fabz$ + profits on expanded output zbd) must be divided through bargaining between the parties. These potential net gains from the distributorship arrangement are represented by the shaded area in Figure 1.

On the bare facts presented above, one would not predict a best efforts term or another flexible performance standard in the contract. There simply is no need for it. Where the optimal output Q^* can be predetermined, a fixed quantity term would be a direct and perfectly suitable mechanism for specifying volume. Furthermore, fixed quantity terms and other precisely stated contractual obligations are generally the most efficient instruments for measuring subsequent performance. Thus, under these assumed conditions, the parties predictably will require the manufacturer to provide, and the distributor to sell, Q^* units of production. Suppose, however, that the curves depicted in Figure 1 are known only probabilistically at the time of contract formation. How is the parties' behavior altered when they are uncertain as to future conditions?

FIGURE 2

*B. Optimal Performance Standards Under Uncertainty**1. Fixed Quantity Terms*

Even under uncertain conditions, there is still a determinate output Q^* that optimizes the parties' contractual relationship based on essentially the same considerations discussed above. Assume, however, that this output must now be calculated with future cost and revenue information known only imperfectly by the parties at the time of contract formation. One approach would be to retain the fixed quantity term in the contract, specifying the volume that maximizes the expected value of the joint profits based on an *ex ante* calculation of the risks and their associated probabilities. Such a determinate volume, however, will always turn out to be "wrong" at the time set for performance.

In Figure 2, for example, a distribution contract is negotiated in the context of but a single contingency—the future imposition of a particular governmental regulation. Assuming that governmental regulation increases costs and that the probabilities of imposition and nonimposition are equal, quantity E will represent the fixed quantity term that maximizes the expected value of the exchange at the time of contracting. Nevertheless, output E will always be inferior to some other output level. If the regulation is imposed, quantity Q_1 will be the optimal output and the actual profits will diverge from the optimal profits by the cross-hatched area A in Figure 2. On the other hand, if the regulation is *not* imposed, optimal profits at volume Q_2 will exceed actual profits by the amount represented by the shaded area B . The forgone profits constitute "error costs." Under any conditions of uncertainty, an obligation designed in advance to be optimal on average will tend always to be wrong in the particular situation that ultimately pertains. In either case, therefore, the difference between actual and optimal profits is the error cost incurred by the parties from couching their agreement in terms of a fixed contractual quantity.²¹

Of course, the parties are not required to set a single output term. In Figure 2, if the uncertainties about costs and revenues are

²¹ Because the probabilities of the alternative regulatory conditions are equal, the error costs of each situation receive equal weight in generating an expected value for any fixed contractual quantity. Note, however, that the error-minimizing quantity E is not necessarily halfway between Q_1 and Q_2 ; the precise result depends both on the probability weights and on the slopes of the cost and revenue curves.

tied to a set of objectively verifiable contingencies that are few in number, the volume called for in the contract may be "keyed" to those uncertain future events. Thus, the parties can agree to quantity Q_1 if the regulation is imposed and, in the alternative, specify quantity Q_2 in the absence of regulation. Any increase in the complexity of the risk factors or any greater uncertainty about the future, however, will substantially increase the risk that any fixed volume contract will specify the "wrong" output. Such contingent volume agreements thus represent an intermediate point between the complete contingent contract and more complex forms of relational exchange.²²

2. Sequential Contingent Contracts: Responses to Strategic Behavior

One response to increasing levels of complexity or uncertainty is to limit the temporal scope of the contract. By negotiating a series of recurring contingent contracts, the parties can reduce the error costs of specifying fixed obligations.²³ But in many cases the performance of the initial agreement will produce specialized, idiosyncratic skills. Assume, for example, that the parties agree to a one-year distribution contract for a determinate quantity of the manufactured product. Once the distributor learns the skills peculiar to the distribution of the manufactured product in the market area, he enjoys a comparative advantage over the market of unskilled agents.²⁴ The distributor then has an incentive, when the contract

²² Indeed, contingent volume terms can be found in many real-world contractual arrangements. As may be inferred from the brief treatment above, their relative attractiveness is determined largely by the empirical conditions that confront the contracting parties.

²³ Placing time constraints on the risks being assigned, by arbitrarily limiting the duration of the contract, will reduce both the amount of uncertainty as to the magnitude of future regret contingencies and the extent of the decision tree required to assign these risks optimally. This explains, for example, why many sales contracts between suppliers and producers are negotiated as sequential contingent contracts even where the parties enjoy a long-term "relationship." Furthermore, so long as the performance of such sales contracts does not create firm-specific skills, the problem of strategic bargaining does not arise upon renegotiation because the contractors are able to use the market as a means of monitoring the value of performance.

²⁴ These contract-specific skills will often take the form of investments in human capital—knowledge and experience concerning the distribution of the particular product within the particular marketing area. Of course, contract-specific investment need not be limited to human capital. An identical result would occur where the distributor makes a specialized physical capital investment—e.g., building a distribution outlet at a strategic location within

is renegotiated the following year, to secure a larger compensation for similar efforts in order to exploit the advantage gained by his "on the job" training. On the other hand, his newly acquired skills can be exploited fully only if he remains as the manufacturer's representative. Thus, as specialization occurs, each party becomes more vulnerable to strategic demands by the other.²⁵ When the contract is renegotiated, the bargaining stakes are greater and both parties have incentives to use strategic or opportunistic behavior in order to secure a larger slice of the enhanced contractual "pie."²⁶ The threat of excessive renegotiation costs will, in turn, induce both parties to invest in alternative arrangements as precautions against the anticipated strategic behavior. The essence of the problem is that, even where perfectly substitutable trading parties are initially available in a competitive market, the increasing specialization of the parties vis-a-vis each other produces a species of bilateral monopoly. Continuance of the original relationship becomes increasingly desirable in order to exploit the accrued specialization advantages, but the division of those gains must be bargained out in a noncompetitive environment.

A more substantial problem exists when specialized investments yield deferred returns. For example, the manufacturer often will agree to compensate the distributor at a standard rate over the

the marketing area.

²⁵ The strategic advantage gained by the owner of contract-specific investments lies in the opportunity cost to the other contracting party of the next best available contractual substitute. Thus, the opportunity to threaten not to renew the relationship increases in potency in direct proportion to the divergence between the value of the distributor's skills in this contract and the next best distribution substitute. The distributor cannot sell his contract-specific skills to other manufacturers. On the other hand, the manufacturer cannot secure an equivalent value if he tries to sell the distribution license to another distributor. If both parties were informed of the value of the idiosyncratic transaction to the other, the opportunity for strategic bargaining would be reduced. These magnitudes typically will be a matter of speculation, however, thus increasing the parties' incentives to make opportunistic claims. These strategic opportunities have efficiency consequences as well as redistributive effects, because both parties can be expected to invest in precautionary measures up to the point where the expenditures in precautions are equal to the expected cost of the other's opportunistic demands. See Klein, Crawford & Alchian, *supra* note 1, at 298-302.

²⁶ Williamson defines opportunism or strategic behavior as "self interest with guile." See *Transaction-Cost Economics*, *supra* note 1, at 234 n.3. Opportunism includes bluffs, threats, and games of "chicken" designed to exploit another party's presumed bargaining disadvantage. Whether such behavior is independently "wrongful" depends on additional variables. Our point here is simply that the parties themselves have incentives to reduce the expected cost of the behavior.

entire expected life of the agreement. Thus, during the initial training period, the distributor will be "borrowing" against his future sales capacity in order to finance his human capital investment. A reciprocal analysis would apply where the distributor has invested in physical capital—equipment, inventory, etc.—that cannot be amortized completely during the term of the contract. In both cases, the financing of specialized investments creates asymmetrical vulnerability to the threats of dissolution for one bargainer or the other at different times during the life of the relationship.

There are specific contractual mechanisms that can be used to reduce the costs of such investment asymmetry. A covenant not to compete is a common agreement that provides security for the manufacturer's investment in on-the-job training. Similarly, a provision that requires the manufacturer to "buy back" inventory and equipment offers the distributor a guaranteed market for his specialized physical capital. In many circumstances, however, limitations on the effectiveness of such specific controls on strategic opportunities will induce the parties to restrict themselves mutually in a long-term contract.²⁷ Thus, the opportunities for strategic behavior can be minimized by ex ante negotiation of a compensation package that extends over the expected life of the relationship. Such a fixed term contract, however, reintroduces uncertainty and complexity and reduces the parties' ability to arrive at accurate and specific performance standards in advance.

a. Requirements Contracts

As an alternative, the parties may enter into a requirements contract, thus confronting the problem of strategic behavior by encouraging competition in the market for manufacturers and distributors. Under this kind of arrangement, the manufacturer is obligated to supply each distributor with the product quantity it "requires," but does not offer any particular distributor the exclu-

²⁷ The utility of covenants not to compete is limited by the restrictive legal treatment accorded such agreements. See generally Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 684-88 (1980). "Buy back" provisions are freely enforceable, but the repurchase terms are difficult to specify accurately for the very reasons that motivated the parties to negotiate such a relational contract. The parties will have incentives to invest in specific monitoring mechanisms to the point where the cost of such precautions equals the expected reduction in the cost of strategic behavior.

sive right to a marketing area. The requirements contract permits marginal adjustments in distribution efforts by the distributors because the quantity "required" will vary as conditions change over time.²⁸ The advantage of this arrangement lies in the use of a competitive distribution market to monitor any individual distributor's "requirements." The availability of close market substitutes for any particular distribution contract will prevent any single distributor from using contractually based discretion to extort special advantages. In addition, where there are substitutes for the manufacturer's product, the ability of distributors to switch products will curtail strategic behavior by the manufacturer.²⁹

b. Exclusive Dealing Arrangements

Frequently, however, the profit-maximizing level of distribution activity cannot be achieved in a market characterized by unrestrained competition. The conditions that characterize a natural monopoly—substantial fixed costs coupled with relatively modest marginal costs, or restricted market size—occur in many relational contexts, especially when the distribution takes place in spatially limited submarkets. When classical natural monopoly conditions arise, the economies of scale associated with an activity are not exploited fully unless the number of firms is limited, possibly even to a single distributor. Under these conditions ordinary requirements contracts are inefficient as well as unstable. The manufacturer will

²⁸ The distributor does not have unlimited flexibility to adjust his requirements. Output and requirements contracts were often subject to judicial limitation at common law on the theory that unfettered discretion suggested a lack of mutuality of obligation. See, e.g., *Mowbray Pearson Co. v. E.H. Stanton Co.*, 109 Wash. 601, 187 P. 370 (1920); *Hoffmann v. Pfingsten*, 260 Wis. 160, 50 N.W.2d 369 (1951). Modern courts and the Uniform Commercial Code, however, have validated such indefinite quantity agreements by implying both good faith limitations on opportunistic behavior and a quantity range based on prior dealings or some other relevant context. See U.C.C. § 2-306(1), Comment 2. See generally Weistart, *Requirements and Output Contracts: Quantity Variations Under the UCC*, 1973 DUKE L.J. 599.

²⁹ A competitive distribution market at the initial contracting stage will not necessarily remain competitive over time. As the relationship develops with individual distributors, transaction-specific capital investments ultimately may produce the bilateral monopoly problem that impairs sequential contingent contracting. In such cases, exclusive dealings assignments emerge over time as competitors abandon the market. This occurs, we suggest, because natural monopoly conditions exist in many distribution markets. Either the size of the market or the existence of large economies of scale following capital investment will generate equilibrium in the long run only when a single distributor remains.

examine the market and conclude, either because economies of scale are large or market size is limited, that having a single distributor is the most profitable arrangement. If he licenses more than one distributor, the potential returns from the distribution arrangement will be diminished because competition among distributors will produce an inefficient investment in distribution activities.³⁰

Under these conditions, the parties may agree to an "exclusive dealing" contract in which the manufacturer will offer the distributor exclusive rights within a defined market. The exclusivity of these rights creates a relationship of dependence and vulnerability for the manufacturer during the life of the contract. In response, the manufacturer generally will attempt to limit his vulnerability from the exclusive arrangement by securing the agent's promise to use his "best efforts" to promote sales.³¹ The tensions inherent in such a situation are obvious. If a sequential contingent contract is negotiated, the parties once again expose themselves to future strategic demands for increased compensation. Alternatively, if the compensation agreement extends for the life of the relationship, either the parties must specify an "erroneous" fixed-volume term or the manufacturer will be vulnerable to a failure by the distributor to extend those "best efforts" that were paid for in the original

³⁰ Competition will produce inefficiencies, for example, if the distributors elect not to make optimal capital investments in distribution activities because the opportunity to capture fully the benefits of such investments through increased economies of scale is blunted by the existence of competitors in the market area.

³¹ Frequently, the "best efforts" obligation will be undertaken explicitly where the parties agree to an exclusive dealing arrangement. Such explicit agreements, however, merely confirm the obligation implied by law in the absence of specific agreement. In the ordinary requirements contract, the distributor's efforts are constrained by "good faith" and prior practice. Both common law courts and the Uniform Commercial Code, however, imply an additional obligation to use "best efforts" to promote sales where the agreement specifies an exclusive dealings arrangement. See *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214 (1917); U.C.C. § 2-306(2), Comment 5.

This implied obligation to use "best efforts" is consistent with the increased vulnerability of the manufacturer in the exclusive dealing arrangement. Where the seller relinquishes his right to market his goods through a competitor, most parties would assume that the buyer would agree to exercise a correspondingly greater effort to provide a market because, we suggest, such increased efforts would produce a larger contractual "pie" for the parties to divide. See notes 40-41 *infra* and accompanying text. Thus, the legal rule unplying "best efforts" in exclusive dealings contracts is merely another illustration of the principal function of contract rules: to provide common or typical risk allocations, thereby saving most parties the expense of bargaining to cover this contingency.

compensation agreement.

In the simple model described above, where a manufacturer licenses a single distributor, the exclusive licensing agreement is adequate to induce an optimal investment in distribution activities. More typically, however, the manufacturer will license a number of distributors, granting each a form of access to a limited submarket. Once a network is established, the parties face a second-order "free rider" problem. Optimal distribution activity will frequently include pre-sales advertising and promotion. Yet, any individual distributor will be reluctant to invest in such services where the prospective customers can learn about the product through one distributor's promotion efforts and then purchase the product from another distributor. To protect the integrity of the distribution network, therefore, parties to an exclusive dealings arrangement typically will bargain for territorial restrictions on the market each distributor is entitled to serve. These restrictions serve to prevent a distributor from "poaching" on either the customers or the distribution efforts of other distributors in the network.³²

3. *Indirect Monitoring Mechanisms: Price Adjustments*

As we have suggested above, where contractually fixed quantity terms are not an effective means of achieving joint profit maximization, the parties instead may specify a flexible performance

³² Contractual restrictions between manufacturer and distributor, of course, are subject to scrutiny under the antitrust laws. Under current law, manufacturer restrictions on the distributor's resale prices are per se violations of § 1 of the Sherman Act. See *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911). But cf. *United States v. Colgate & Co.*, 250 U.S. 300 (1919) (resale price maintenance not a Sherman Act violation if enforced by refusals to deal). Since the recent decision by the United States Supreme Court in *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), non-price contractual restrictions imposed by a manufacturer—such as territorial limitations—are no longer per se illegal, but are subject instead to the broader rule-of-reason test. These restrictions, which facilitate contractual marketing strategies in lieu of vertical integration, obviously allow the parties to maximize the benefits of private contracting, and, in that sense, are reasonable. The antitrust literature, however, reflects the widespread belief that various market imperfections produce a divergence between private and social costs. Whether these external anticompetitive effects justify a continuing examination of vertical restrictions depends largely on one's view of the enforcement costs associated with such scrutiny. See generally Bork, *Vertical Restraints: Schwinn Overruled*, 1977 SUP. CT. REV. 171; *Vertical Restrictions*, *supra* note 1, at 112-17; Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1 (1977); *Assessing Vertical Restrictions*, *supra* note 1; Baker, *Interconnected Problems of Doctrine and Economics in the Section One Labyrinth: Is Sylvania a Way Out?* (forthcoming in 67 VA. L. REV.).

standard such as the "best efforts" obligation. This arrangement, however, will require some system of monitoring the level of effort undertaken by the distributor or agent. Direct monitoring is feasible in contexts such as franchising where operating procedures are standardized and one agent's efforts can be compared to those of similar agents. Indeed, franchisors may retain vertically integrated distributional outlets in representative locations in order to provide benchmarks against which franchisee operations can be compared.³³ Such direct forms of monitoring may not always be practical, however. Under many circumstances, discretionary distribution efforts can be better controlled by indirect means. One indirect instrument for adapting volume to uncertain future conditions is the proper calibration of the marginal price between the manufacturer and the distributor. Because the distributor has de facto control of the maximum volume sold by the parties, the objective should be to set pricing terms that will induce the distributor to choose a close approximation of the optimal quantity Q^* at all times, even when he is nominally free to choose any volume level at all. Marginal cost to the distributor is the sum of his own marginal distribution costs plus the marginal contractual price payable to the manufacturer. In practice, this "price" typically will be termed a royalty, license fee, franchise fee, or some other term appropriate to the business context. Because the distributor will choose the output that equates marginal cost with marginal revenue ($MC = MR$) in order to maximize his own profits, a proper calibration of price by the manufacturer can induce selection of the Q^* optimal output. The optimal output will be chosen voluntarily by the distributor only if his marginal costs can be made to approximate the aggregate marginal costs of distribution and manufacturing ($MD + MM$), i.e., what we previously have termed the joint marginal costs.

a. Profit-based Pricing

One useful contractual scheme is to provide for sales to the distributor at marginal manufacturing costs (MM), but then to re-

³³ Although manufacturer-owned distribution outlets have been scrutinized under the antitrust laws as anticompetitive, the monitoring advantages of establishing a vertically integrated comparable entity suggests a plausible and benign explanation for this commonly observed arrangement.

quire the distributor to pay over to the manufacturer some share (K) of the distributor's net profits in the form of a franchise fee, license, or royalty. Marginal cost to the distributor then becomes

$$MC = MD + MM + K [MR - (MD + MM)]$$

and leads automatically to the selection of Q^* . This result will occur because the distributor's own profit maximization calculus will lead him to expand volume until

$$(1-K) [MR - (MD + MM)] = 0,^{34}$$

where the square-bracketed term is the increment in joint profits and $(1-K)$ is the fractional share of those joint profits that the distributor is allowed to keep. Indeed, $(1-K)$ may be reinterpreted as a fractional "commission" payment paid over to the distributor or agent out of the proceeds of any sales. The above formulation directly reflects the common sense purpose of this pricing scheme, because it illustrates why the distributor cannot maximize his own profits without also fully exploiting any opportunities for joint profits as represented by the square-bracketed term. In addition, a simple algebraic manipulation demonstrates that the formulation implicitly yields a result wherein $MR = MD + MM$, which is the underlying general condition for joint profit maximization: marginal revenue equals marginal cost where both costs and revenues are summed over all affected parties.

Unfortunately, there are numerous practical drawbacks to the implementation of a profit-sharing arrangement such as that just described. One limitation is that the pricing scheme requires information on the manufacturer's marginal costs. Because accurate incremental cost information is much harder to acquire than total cost information, the parties may not wish to tie the contract to magnitudes that are costly to ascertain or otherwise impractical to monitor. This limitation is less important when marginal manufacturing costs are either insignificant in magnitude or closely approximated by average cost, which is a more readily ascertainable value. For instance, marginal "manufacturing" costs frequently are negligible when the "manufacturer" is providing only a license

³⁴ The equation states the marginal condition for profit maximization. It does not imply that profits will be zero at the optimal point but rather that adjustments in efforts will not generate more profits.

rather than some actual product.

Even though the distributor's costs and revenues need—at least in theory—to be measured only in totals in order to arrive at the profits figure upon which the contractual payments are based, the distributor's treatment of costs may create problems. The divergence between accounting costs and economic costs may confuse profit measurement. One example of this is the exclusion of "fixed" costs as economic costs.³⁵ Perhaps most important is the problem of monitoring and segregating costs and revenues within multi-product firms where it becomes increasingly difficult to monitor the allocation of joint costs—overhead, etc.—that may be shifted strategically among various contracts.³⁶ A multi-product distributor has an incentive to impute as many costs as possible to those activities where his share of net profits is lowest.

Similarly, the distributor may "pad" costs, disguising his own returns and denying profits to the manufacturer. For instance, the distributor may provide himself with unnecessary amenities, such as a "company car," or place relatives on the payroll at unwarranted salaries. Gross abuses, of course, will be easy to detect, but cost padding can take a variety of subtle forms that are extremely difficult to discover and perhaps impractical to prove.

b. Sales-based Pricing

Given the enhanced monitoring burdens of profit-based pricing, it is not surprising that relational contractors frequently choose alternative pricing arrangements. Commonly observed, for example, are initial flat fee payments coupled with royalty payments

³⁵ Under conventional "absorption" cost accounting, fixed production costs are included as part of the costs of production. In economic or "marginal" costing, only variable manufacturing costs are regarded as production costs; fixed production costs are treated as period costs and released immediately as an expense. Compare 1 C. HORNGREN & J. LEER, CPA: PROBLEMS AND APPROACHES TO SOLUTIONS 114 (4th ed. 1974) with P. SAMUELSON, ECONOMICS 466-67 (10th ed. 1976). Obviously, the magnitude and allocation of fixed costs will influence the net "profits" produced by the distributor's efforts.

³⁶ The significant monitoring problems raised by profit sharing arrangements have been underlined recently by the widely publicized efforts of actors Fess Parker, James Garner, and Robert Wagner and Natalie Wood—all of whom had negotiated profit-based pricing agreements—to recover damages for the failure of seemingly successful television shows ("Daniel Boone," "Rockford Files," and "Charlie's Angels") to return any profits at all. See N.Y. Times, May 1, 1980, at 1, col. 2.

tied to a percentage of gross sales.³⁷ These arrangements reduce the costs of monitoring the distributor's expenditures but, in turn, also reduce the congruence of interests concerning optimal output between the manufacturer and the distributor. Once the distributor's return is reflected in a sales-based pricing mechanism, there is an inherent conflict of interest between the contracting parties over profit-maximizing output. As we demonstrate in Part II, the distributor's self-interest will induce him to produce a lesser quantity than the manufacturer's interests would demand.³⁸ Thus, these more common pricing arrangements reduce the burden of monitoring the agent's costs and revenues, but increase the burden of controlling the agent's level of effort. Presumably, firms choose sales-based pricing because the cost of monitoring the level of effort is perceived as less than the cost of monitoring operating expenditures.³⁹

4. *Mutual Adjustments by Exchanging Efforts*

In contrast to the preceding discussion, which assumed that the only relevant dimension of activity was distribution effort, profit-maximizing levels of sales in many relational contexts can be achieved only if the efforts of *both* parties are adjusted. In franchising, for example, although the franchisee must expand his distribution efforts, optimal volume also depends on the efforts of the franchisor to advertise the product and to monitor the system to ensure appropriate product quality.⁴⁰

Whenever there are two dimensions of an activity that require adjustment and only one instrumental variable, the optimal output can be reached only by coincidence. Assume, for example, that in addition to distribution efforts, marginal adjustments in advertising efforts by the manufacturer are also necessary to reach optimal quantity Q^* . Under these conditions, no combination of a sale or

³⁷ Indeed, sales-based royalty payments are the prototypical pricing scheme in relational agreements.

³⁸ See notes 50-53 *infra* and accompanying text.

³⁹ In addition to reduced monitoring costs, there are additional benefits that accrue from using a sales-based royalty arrangement in certain instances. See note 42 *infra* and accompanying text.

⁴⁰ Policing the network in order both to prevent violations of territorial restrictions and to maintain quality control is simply an additional application of the free rider problem associated with exclusive dealings arrangements. See note 32 *supra* and accompanying text.

transfer of rights in the manufactured product will produce the ideal level of *both* manufacturing and distribution activity.⁴¹ This is because the manufacturer would want the distributor to "distribute" as if he owned *all* of the property rights in the product, while the distributor similarly would want the manufacturer to undertake the same effort as if he also owned *all* of the rights. In such contexts, the parties must exchange "efforts" in order to maximize their joint gains. Consequently, division of rights to the product of that effort is only an imperfect and insufficiently potent substitute for the ideal behavioral incentives.

When regulation of the effort level of both parties is required, the implications of the pricing scheme must be reconsidered. For instance, Rubin discusses the superiority of profit-based systems over flat-fee payments when the objective is to stimulate the efforts of the manufacturer.⁴² A similar analysis might be conducted of sales-based versus profit-based royalty schemes. Generalization about which system would be superior is quite complex and fact-dependent, however. The common sense principle is that one is using sales or profits as a *proxy* for the kind of effort to be stimulated. Hence, the choice of sales or profits as a base depends on which correlates more closely with variations in the level of the kind of activity being regulated.

In sum, in cooperative ventures where each party's profits are dependent on the quantity or quality of the other party's efforts, efficient exchange requires that each party pay the other to undertake the optimal level of the respective activity. Although the exchange of efforts offers parties in bilaterally interactive ventures

⁴¹ The limitations of using a single variable to influence optimally two dimensions of an activity can be observed in numerous contexts. The negligence/contributory negligence formulation is one example where optimal risk avoidance requires both parties to act as if each one bore all the costs of the particular activity. Similarly, fines in a system of private enforcement of criminal penalties cannot be calibrated so as to influence optimally both the level of enforcement and the level of criminal activity. See Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 39 (1975).

⁴² See Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J. L. & ECON. 223, 228-30 (1978). Although Rubin compares the incentive effects on franchisors of profit-based royalties as opposed to flat-fee payments, the observation has greater generality. The closer each party's interest approximates the joint interests of both parties, the smaller the divergence between the actual efforts and the optimal level of advertising, policing, distributing, etc. As we suggest below, however, because both parties need the incentives to regard the output as entirely their own, such arrangements are still a second-best solution.

the opportunity to exploit fully the benefits from their exchange, actually securing those gains in costly environments poses significant contractual dilemmas. The following section examines typical contractual responses to these problems.

II. DEFINING THE STANDARD OF PERFORMANCE

Perhaps the most poorly understood class of relational contracts is that involving agreements wherein one party explicitly, or even implicitly, undertakes the contractual duty of using its "best efforts" to carry on an activity beneficial to the other. Some of the most common illustrations of such best efforts agreements are found in agency, licensing, franchising, and other distributorship arrangements.⁴³ Notwithstanding the frequency with which such terms are observed empirically, the precise legal meaning to be attached to a best efforts requirement is not at all clear, either from a consideration of the case law or from theoretical discussions in standard legal scholarship.⁴⁴ Nevertheless, there appears to be a relatively straightforward and persuasive definition that emerges from the preceding economic conceptualization of the problem faced by two parties who are attempting to set a contractual volume in which they have joint interests.

In this section, we relate judicial discussion of the best efforts term to the economic model already developed. We argue that the best efforts cases hinge on two factors, strategic adaptation to the conflict of interest between the parties and the problem of managerial incompetence. These elements may, of course, coexist in a single case. Because the courts appear not to have distinguished these factors clearly, it is not surprising that existing case law has been unhelpful in working out a consensus about the legal rule.

⁴³ This list is by no means exhaustive. Best efforts obligations are also used commonly to govern employment contracts, corporate relationships, joint ventures, insurance agreements, leaseholds, trusts, publishing contracts, and partnerships. See generally cases cited note 72 *infra*.

⁴⁴ Surprisingly, although scholarly inquiry has focused on related issues—particularly the nature of fiduciary responsibilities—no coherent analysis of the nature of best efforts obligations has been undertaken. For a sampling of some of the related legal scholarship, see generally Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738 (1978); Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); *Adjustment of Long-Term Relations*, *supra* note 1; Summers, *supra* note 1.

A. A Best Efforts Model

Figure 3 illustrates a contract in which the distributor faces a marginal cost curve (MC) composed of his own marginal distribution costs (MD) plus the marginal "price" (R) negotiated with the manufacturer. In addition, it is assumed that the payment takes the form of a fifty-percent royalty on gross sales.⁴⁵ Absent any other information, one might expect that the distributor would then legally be entitled to choose volume Q where his marginal costs ($MC = MD + R$) are equal to marginal revenues (MR). This is the point at which the distributor's own profits are maximized. If he were required to sell an additional quantity beyond Q, the distributor's profits would be reduced, as exemplified by the shaded triangle A in Figure 3. Suppose, however, that there were some way in which he could oblige himself to adjust to the joint maximization output that we have previously identified at Q*. In exchange for such an undertaking, which at the time it is accepted represents a loss to the distributor, the manufacturer should be willing to agree in advance to a compensatory contractual concession through which the two parties can split the additional profits generated by the higher volume.⁴⁶ These profits are represented by the cross-hatched triangle B in Figure 3.

⁴⁵ Figure 3 may be confusing initially because it illustrates a downward-sloping marginal cost curve composed of marginal distribution costs and payments to the manufacturer. The marginal cost curve is graphically correct, however, as can be confirmed by adding one-half the marginal revenue curve (which also slopes downward) to the marginal distribution curve at every point.

⁴⁶ The assumption implicit in this model is that a legal right to require the distributor to distribute more goods than his self-interest would dictate *at the time of performance* will have been paid for by the manufacturer, implicitly or explicitly, at the time of contracting. See text accompanying note 82 *infra*.

FIGURE 3

1. *Optimal Volume Definition*

The obligation to produce at the joint maximization volume is the meaning that we propose for the best efforts term in commercial contracts. This interpretation of the best efforts provision has a great deal of theoretical attractiveness because, absent the specification of an alternative construction by the parties, it directs the outcome that maximizes the net gains that parties could achieve from their contractual relationship. In sum, it is a plausible means of identifying a goal presumably desired by most parties, albeit not always well articulated. In any case, business people need not be regarded as thinking explicitly in terms of the precise marginal conditions and other terminology of economic theory.

In addition, the definition suggested above is consistent with a "fairness" obligation of the kind formulated by distributive justice theorists.⁴⁷ Under this conception, the distributor is required to treat the manufacturer "fairly," giving the manufacturer's interests (profits) equal weight with his own when output decisions are made. Moreover, such special consideration presumably has been paid for in advance by the manufacturer in the form of some compensatory concession.⁴⁸

In any specific fact situation, some retreat from the rigorous definition suggested above may be entirely appropriate. For instance, the duty of the best efforts promisor to take into consideration the other party's interests should be limited by the promisor's reasonable ability to foresee the extent of those interests. Thus, a failure by the distributor to account fully for the manufacturer's idiosyncratic accounting methods that unexpectedly reduce joint marginal costs and increase the additional volume necessary to reach Q^* would not establish a breach of the best efforts obligation. This limitation is in the same spirit as the damage limitation rule of *Hadley v. Baxendale*,⁴⁹ because it compels a party with unanticipatable interests to supply the information necessary for eco-

⁴⁷ This joint maximization conception of the obligations of individuals in cooperative endeavors—which assumes a present agreement to treat collective interests equally in the future—can be derived from the contractarian "original position" postulated by Rawls and other ex ante justice theorists. See J. RAWLS, A THEORY OF JUSTICE 347-50 (1971).

⁴⁸ See note 46 *supra*.

⁴⁹ 9 Ex. 341, 156 Eng. Rep. 145 (1854).

nomicallly efficient behavior.⁵⁰ Those parties with atypical or idiosyncratic requirements remain free to negotiate an individually tailored understanding of the best efforts obligation.

Unfortunately, a best efforts obligation, as defined above, inherently implies a serious monitoring problem. This is illustrated in Figure 3 where shaded triangle A represents the reduction in profits suffered by the distributor because he is obligated to produce at Q^* rather than Q . Hence, the best efforts promisor generally will have a strong economic incentive to "chisel" on the obligation. In a world of cost-free information, such breaches of the best efforts requirement would be easily detected, and the behavior restrained through the legal damages imposed for breach of contract.⁵¹ In a real-world situation, however, the requisite information for proof of liability or quantification of damages may be prohibitively expensive to obtain, especially when the plaintiff bears the burden of such proof. Hence, the standard legal mechanism may not be a viable one for enforcement of this kind of contract provision.⁵²

Where recourse to the courts is not an attractive option, these economic considerations suggest that a best efforts promisee—such as the manufacturer—will attempt to contract for other means of controlling the standard of performance.⁵³ Presumably, the self interest of both contracting parties will induce them to seek out that

⁵⁰ See *Enforcing Promises*, *supra* note 2, at 1299-1300.

⁵¹ Contract damage rules embrace a variety of remedial choices. . . . In most cases *A* can seek the value of what he expected from *B*'s promise. Such standard "compensatory" recovery puts *A* in the economic position he would have occupied had *B* fulfilled his obligation. There are alternatives to the compensation rules, however. Thus, *A* may seek restitution of any benefit conferred on *B* as a result of *B*'s promise. Alternatively, *A* may seek to recover identifiable costs incurred in reliance on *B*'s promise. Recovering conferred benefits and reliance expenditures has the stated objective of returning the parties to the same economic position they occupied before the promise was made.

Id. at 1263 (footnotes omitted).

⁵² We have suggested that a best efforts obligation is a contractual mechanism typically used to govern a bilateral monopoly relationship characterized by unique, contract-specific skills. Thus, breach of such a contract is peculiarly impervious to accurate measurement and proof whenever the best efforts obligation diverges from market substitutes. Because the best efforts term represents an attempt to improve on market alternatives, market substitutes by definition will be an inexact measure of the distributor's obligation. Only when a competitive market generates prices indicating the value of forgone opportunities is there reliable evidence of the position the manufacturer would have occupied had the best efforts obligation been performed.

⁵³ See *Futures of Contracts*, *supra* note 1, at 781-82.

combination of monitoring or bonding arrangements that represents the optimal tradeoff between expected costs of contractual governance and profits forgone because the ideal output Q^* is not enforced perfectly.⁵⁴ As the cost of contract-specific monitoring strategies increases, the price of contracting to the best efforts promisor similarly increases. The best efforts promisor has an incentive, therefore, to propose cost-effective bonding agreements that reduce the costs of contractual control, thereby lowering the contract "price" paid by him. The "price" reductions might take the form of a reduction in the initial license payment required by the manufacturer, or a reduction in the royalty paid to the manufacturer on the contractual product or, indeed, any other adjustment in contract terms favorable to the distributor.

A commonly observed form of bonding is a termination privilege that could be invoked by the manufacturer if he detects a breach of the best efforts obligation. Moreover, the parties might be expected to negotiate a termination clause that granted the manufacturer considerable discretion as to the circumstances under which termination would be permitted. If, instead, the termination clause were only triggered by specific events, any attempt to exercise it might create precisely those problems of proof that the clause originally was designed to circumvent. A limited right of termination embodies less reassurance of contractual performance and would presumably induce some compensatory increase in the contract "price" paid by the distributor. As we shall elaborate in the following section, a discretionary termination clause is not an ideal safeguard.⁵⁵ Often, however, it is a mutually beneficial adaptation to the inevitable conflict of interest generated by a best efforts agreement.

Although the best efforts result Q^* is in theory a clearly optimal result for the parties, the realities of enforcement, especially when coupled with the inherent chiseling incentive, may dim the practical attractiveness of such agreements. Nevertheless, the problems arising in legal regulation of such agreements should not be viewed as dispositive. Many contractual provisions are honored even where there is no effective legal sanction for their breach.⁵⁶ In

⁵⁴ See note 12 *supra*.

⁵⁵ See note 106 *infra* and accompanying text.

⁵⁶ For a discussion of the effects of extra-legal sanctions on the optimal enforcement of

some circumstances, this is due to the existence of informal, extra-legal sanctions, including a sense of commercial ethics.⁸⁷ Notwithstanding practical difficulties of securing legal enforcement, therefore, a contractual provision also has value simply as a communication of understanding between the parties as to their mutual rights and duties. Hence, the inclusion of a best efforts term may, at a minimum, serve as a signal alerting good faith bargainers that the proposed contractual relationship is one in which special concerns are to be considered.

Where courts are compelled to attach a meaning to otherwise ambiguous contractual terms, it is sensible to look to the likely intent of the parties or the goal the parties might reasonably be deemed to have sought. The "optimal-output" definition of best efforts is, we argue, the single most plausible interpretation of the underlying economic motivations involved. This proposed meaning of best efforts need not be seen as describing what the contracting parties actually intended in any particular case. Rather, it is designed to offer a plausible way in which the legal rule can allocate unknown risks in advance of individual bargaining, thus reducing the uncertainty costs of an imprecise legal standard.

2. *Best Efforts as Diligence Insurance*

Although the optimal-output interpretation may be the single most persuasive meaning for best efforts, one plausible alternative definition merits discussion: best efforts requires the exercise of due diligence and ordinary business prudence.⁸⁸ Under this alter-

promissory obligations, see *Enforcing Promises*, *supra* note 2, at 1271-73.

⁸⁷ See generally Macaulay, *supra* note 1. In his classic study of extra-legal sanctions in business contexts, Professor Macaulay observed: "Disputes are frequently settled without reference to the contract or to potential or actual legal sanctions. There is a hesitancy to speak of legal rights or to threaten to sue in . . . negotiations" in order to avoid jeopardizing the goodwill value of established business relationships. *Id.* at 61. See also Farnsworth, *The Past of Promise: An Historical Introduction to Contract*, 69 COLUM. L. REV. 576, 605 (1969).

⁸⁸ The due diligence obligation is not incorporated within the commonly accepted parameters of the obligation of good faith, even as it attaches to a merchant. U.C.C. § 2-103(1)(b), for example, defines good faith in the case of a merchant to include, in addition to honesty in fact, the exercise of "reasonable commercial standards of *fair dealing* in the trade." (emphasis added). Although this expanded definition incorporates an objective test of "cheating" behavior, it does not address the additional issue of competence. Hence, it is plausible to suppose that parties would seek to allocate this additional risk through some other contractual provision such as the best efforts clause.

native conception, a breach of the best efforts obligation would exist where the distributor's efforts diverge from the standard of diligent or reasonably prudent business conduct.

In terms of Figure 3, our previous analysis has focused on the losses from a shortfall between the optimal volume Q^* and the distributor's profit-maximizing output Q . It is interesting, however, to consider also the case where the distributor chooses an even lower output than Q , such as Q^1 in Figure 3.

Why would the distributor ever choose an output of less than Q if, under the cost and revenue conditions for the product he sells, the quantity Q represents his point of maximum profitability? One of the simplest explanations is to reinterpret Figure 3 as containing "objective" cost and revenue curves as they would exist for a typical distributor. The cost and revenue functions underlying the actual output calculus of any particular distributor may diverge greatly from the objective, either because of truly subjective elements such as misapprehension of the market or due to more concrete factors such as carelessness or incompetence in restraining production costs. The distributor, either through misapprehension or incompetence in restraining costs, perceives marginal cost to be MC^1 and selects volume Q^1 . Whatever the reason for the distributor's failure to serve even his own interests competently, the manufacturer understandably will be distressed if the original agreement was predicated on his perfectly reasonable expectation that the objective circumstances experienced "should" have motivated a volume of *at least* Q .

For at least two distinct reasons, it makes good economic sense that the distributor would be the efficient bearer of the risk of both his own and the manufacturer's lost profits from sales forgone due to business mistakes on the part of the distributor. First, the distributor is the party who has effective control of his own level of care invested in undertaking business activities and, hence, has the opportunity to adjust that level of care to the cost-effective extent. Second, the distributor is in a better position to assess *ex ante* his own capability to achieve the ordinary or expectable level of business performance. Consequently, inclusion of the best efforts term might be construed as an explicit allocation of all risks associated with the possible business blunders of the party who promises his

"best" efforts.⁵⁹

For expository ease, we shall refer to this interpretation of best efforts as the "diligence insurance" definition. Such a conception of the meaning of best efforts is not an unattractive one and provides at least a minimal standard for the term. One can argue persuasively, however, that the diligence standard properly is subsumed within the optimal output definition. This result is suggested when one attempts to give rigorous content to the question of precisely *how much* diligence is required. The response is that the obligation is to use a cost-effective amount, to, in lay terms, "do the prudent thing, taking into account the interests of both parties" in a manner similar to that mandated by the negligence standard in tort law. This is only another way of expressing the original fundamental insight that the parties can benefit mutually when the distributor acts as a joint maximizer.

Once it is granted that the parties are motivated by a concern to maximize the joint contractual product, it seems odd to restrict that kind of reasoning to a single aspect of the business relationship. On the one hand, one can be diligent and produce an "erroneous" or nonoptimal output such as the distributor's profit-maximizing quantity Q . On the other hand, the obligation to produce the jointly optimal output is easily understood as an all-encompassing optimality condition, directly mandating the "correct" result in objective terms. Because the two interpretations spring from essentially the same underlying principles, we prefer the one with greater generality.

B. Applying the Model: "Best Efforts" in the Courts

A search for the meaning of a best efforts obligation in terms of traditional legal doctrine is not very illuminating. Early common law courts were reluctant to sanction the use of such an ambiguous obligation, finding best efforts agreements vague, indefinite, or il-

⁵⁹ The present value of a risk (r) is the product of the probability of its occurrence (p) and its expected impact (i). Thus, $r = pi$. Therefore, the two critical variables that suggest a risk-bearing advantage are: (1) the ability to control the level of investment in precautions in order to undertake the optimal amount of risk avoidance, thereby producing cost-effective reductions in p , and (2) the ability to assess the likely impact of the risk in order to determine the optimal level of insurance, thereby optimizing i . In this case, both of these variables suggest that the distributor enjoys the comparative advantage in risk bearing. See *Liquidated Damages*, *supra* note 3, at 579-83.

lusory and thus lacking in mutuality of obligation.⁶⁰ Although pockets of resistance to legal enforcement remain,⁶¹ the majority of courts now concede that such obligations represent a substantial and legally enforceable obligation between the parties.⁶² Finding a generalizable meaning to be attached to the best efforts obligation, however, has proved more difficult. A typical judicial construction is that the term "takes its meaning from circumstances," but that it at least requires the promising party to "merchandise products in good faith and to the extent of its own total capabilities."⁶³

A more revealing sense for the judicial debate over best efforts can be gleaned from a close examination of those cases in which such a standard of performance was the basis of decision. The recent leading case of *Bloor v. Falstaff Brewing Corp.*⁶⁴ provides an insightful illustration of this case law. Bloor was trustee in bankruptcy for the plaintiff Ballantine Beer Company. Falstaff had contracted to take over marketing of the Ballantine brand in exchange for a lump sum payment to Ballantine of \$4,000,000 plus royalties of fifty cents per barrel. The contract required that Falstaff "use its best efforts to promote and maintain a high volume of sales" of the Ballantine brands.⁶⁵

At trial, both the parties and the court manifested an awareness of the diligence insurance concept of best efforts. A first level of dispute between Ballantine and Falstaff was whether to apply an objective or subjective standard of best efforts to Falstaff's marketing performance. Falstaff attempted to excuse itself by virtue of its allegedly precarious business position. Ballantine argued that hardship does not excuse performance of a contract, urging the standard of an "average, prudent, comparable" brewer.⁶⁶ The trial

⁶⁰ See, e.g., *Bay v. Bedwell*, 21 S.W.2d 203, 205 (Mo. Ct. App. 1929); *Barton v. Spinning*, 8 Wash. 458, 36 P. 439 (1894) (listing early cases).

⁶¹ See, e.g., *Joliet Bottling Co. v. Joliet Citizens' Brewing Co.*, 254 Ill. 215, 98 N.E. 263 (1912); *Kraftco Corp. v. Kolbus*, 1 Ill. App. 3d 635, 639, 274 N.E.2d 153, 156 (1971) ("the term [best efforts] is too vague to be fairly intelligible and too lacking in certainty to be enforceable"); *Goodman v. Motor Prods. Corp.*, 9 Ill. App. 2d 57, 132 N.E.2d 356 (1956).

⁶² See cases cited notes 72-77 *infra*.

⁶³ See, e.g., *Bloor v. Falstaff Brewing Corp.*, 454 F. Supp. 258, 266-67 (S.D.N.Y. 1978), *aff'd*, 601 F.2d 609 (2d Cir. 1979) (Friendly, J.).

⁶⁴ 454 F. Supp. 258 (S.D.N.Y. 1978), *aff'd*, 601 F.2d 609 (2d Cir. 1979) (Friendly, J.).

⁶⁵ *Id.* at 260 (quoting contractual language).

⁶⁶ Ballantine's argument was taken from *Arnold Prods., Inc. v. Favorite Films Corp.*, 176 F. Supp. 862, 866 (S.D.N.Y. 1959), *aff'd*, 298 F.2d 540 (2d Cir. 1962). In *Arnold*, the plaintiff argued that best efforts imposed an obligation on the defendant distributor to select the

court did not reach the merits of this issue, finding that "Falstaff failed to use even its own temporarily circumscribed abilities and resources to promote the sale of Ballantine products."⁶⁷ Nevertheless, in commenting on Falstaff's specific excuse that a mishandled labor negotiation explained its failure to exploit a 1975 profit opportunity, the court noted that "Ballantine may not be charged with Falstaff's negligence in failing to terminate its labor contracts properly."⁶⁸

Would it have been acceptable conduct if Falstaff had been diligent, but had looked exclusively to its own profit interest? Quoting an analogous case involving a publisher's promotional efforts, the court recognized that mere self-interested diligence is not always sufficient:

"Although a publisher has a general right to act on its own interests in a way that may incidentally lessen an author's royalties, there may be a point where that activity is so manifestly harmful to the author and must have been seen by the publisher so to be harmful, as to justify the court in saying there was a breach of the covenant to promote the author's works."⁶⁹

Indeed, the court similarly rejected the notion that Ballantine Beer need only have been treated evenhandedly with the defendant's own Falstaff product.⁷⁰

The appellate court's affirming opinion rejected more emphatically the notion that even-handed treatment of the two brands discharged Falstaff's best efforts obligation:

While that [best efforts] clause clearly required Falstaff to treat the Ballantine brand as well as its own, it does not follow that it required no more. With respect to its own brands, management was entirely free to exercise its business judgment as to how to

most remunerative possible method of distribution. *Id.* at 865. The district court disagreed, requiring instead an objective evaluation of what a "comparable" distributor might have produced. *Id.* at 866. Recasting the debate in the terms used in this paper, the court was unprepared to agree that "best efforts" required the distributor to consider only the licensor's interests, and instead imposed a standard that incorporated potentially both the "diligence insurance" and "optimal output definition" suggested above.

⁶⁷ 454 F. Supp. at 267.

⁶⁸ *Id.* at 268.

⁶⁹ *Id.* at 269 (quoting *Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co.*, 30 N.Y.2d 34, 46, 281 N.E.2d 142, 145, 330 N.Y.S.2d 329, 334 (1972)).

⁷⁰ *Id.* at 271.

maximize profit, even if this meant serious loss in volume. Because of the obligation it had assumed under the sales contract, its situation with respect to the Ballantine brands was quite different. The royalty of \$.50 a barrel on sales was an essential part of the purchase price.⁷¹

As the *Bloor* case illustrates, courts seem aware that something more than the distributor's profit-maximizing volume Q is required to satisfy a best efforts obligation. It is not so clear, however, that the courts have adopted the optimal output Q^* as the performance standard to be applied in the absence of contrary agreement. One reason why the precise dividing line between breach and satisfactory performance is not delineated more finely seems to be that most of the litigated cases where a breach has been established are characterized by obvious and substantial failures of performance by the best efforts promisor. Typically, the defendant is found to have engaged in one or more fairly gross instances of nonfeasance or malfeasance.⁷² Most courts faced with resolving best efforts disputes have not been required, therefore, to articulate in any detail how the interests of the two parties are to be balanced. Of course, if all cases were gross instances of nonperformance, some uncertainty about the precise standard of liability might be tolerable. It is equally plausible, however, that the current ambiguity has simply created an onerous de facto burden for plaintiffs that can be overcome only in cases of substantial breach.⁷³

At least in theory, the standard of performance required of a best efforts promisor could be inferred from a court's damages

⁷¹ *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 614 (2d Cir. 1979).

⁷² See, e.g., *Contemporary Mission, Inc. v. Famous Music Corp.*, 557 F.2d 918 (2d Cir. 1977) (music publishing); *Perma Research & Dev. v. Singer Co.*, 542 F.2d 111 (2d Cir.), cert. denied, 429 U.S. 987 (1976) (patent licensing); *Stentor Elec. Mfg. Co. v. Klaxon Co.*, 115 F.2d 268 (3d Cir. 1940) (same); *Bloor v. Falstaff Brewing Corp.*, 454 F. Supp. 258 (S.D.N.Y. 1978), aff'd, 601 F.2d 609 (2d Cir. 1979) (beer distribution); *Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co.*, 30 N.Y.2d 34, 281 N.E.2d 142, 330 N.Y.S.2d 329 (1972) (book publishing); *Freeman v. Danal Jewelry Co.*, 397 A.2d 1323 (R.I. 1979) (employment contract).

⁷³ This intuition is confirmed by the significant number of cases in which allegations of a breach of best efforts have failed for lack of proof. See, e.g., *Western Geophysical Co. v. Bolt Assoc. Inc.*, 584 F.2d 1164 (2d Cir. 1978); *Browzin v. Catholic Univ.*, 527 F.2d 843 (D.C. Cir. 1975); *Arnold Prods., Inc. v. Favorite Films Corp.*, 298 F.2d 540 (2d Cir. 1962); *Weaver v. Mid-America Distrib. Corp.*, 309 So. 2d 370 (La. Ct. App. 1975); *Vondras v. Titanium Research & Dev. Co.*, 511 S.W.2d 883 (Mo. Ct. App. 1974); *Insurance, Inc. v. Sanders*, 378 S.W.2d 249 (Mo. Ct. App. 1964).

calculus. Even in cases of flagrant breach, a fully compensatory damages award requires a court to compare the value of actual performance to that of an adequate best efforts performance. Unfortunately, the damages computations in cases finding a violation of best efforts do not clarify the performance standard being applied. For instance, in *Bloor* the court awarded damages projected from the behavior of "comparable" brands that were marketed by integrated non-royalty-paying firms. Thus, the "comparable brand" volume behavior could be regarded as a good proxy for the joint-maximization outcome for the Ballantine-Falstaff contractual combination. There is, however, no real indication in the decision that use of integrated firms as comparable entities was understood or intended in this way. Unless the court was properly sensitive to the economic implications of the fact that the integrated firm situation is the de facto equivalent of a joint maximization result, its choice of the comparable firms could be interpreted just as easily as being based upon a diligence insurance or ordinary malfeasance theory of liability.⁷⁴

There remains, however, one line of best efforts cases in which the various issues subsumed in most best efforts litigation can be isolated more successfully. These cases involve disputes arising when the best efforts promisor engages in activities that directly compete with the promisee's contractual objective. Because the diligence insurance question is not in issue, the competition cases present a clearer opportunity to apply the joint-maximization model developed above.

An illustration of the competition cases may be instructive. Assume that a law book publisher enters into an exclusive publishing agreement with Professor A. By the terms of the publishing contract, the publisher promises to use its best efforts to promote the sale of Professor A's text. One year later, however, the publisher brings out a competing text written by Professor B. Subsequently, sales of Professor A's text decline by fifty percent. It is tempting to argue that permitting the hypothetical law book publisher to issue a competing text necessarily would be inconsistent with the optimal volume meaning of best efforts. This seems particularly true if the evidence also reveals that the publisher promoted the second

⁷⁴ See *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 601, 615-16 (2d Cir. 1979); 454 F. Supp. at 277-81.

text as being superior to the first. Yet, even in this circumstance, the competitive activity is not necessarily inconsistent with joint maximization principles. Indeed, a breach of the optimal best efforts standard cannot be established unless the facts also demonstrate that the market substitute had been developed by the publisher in order to further its own interests at the expense of author A. Such a breach was held to be clearly established, for example, where a virtually identical competing text was written "in house" at the behest of the original publisher and at a substantially reduced royalty payment.⁷⁵

Assume, however, that Professor A can establish only that the publisher failed to instruct its sales people to promote the books evenhandedly and, left to their own devices, the sales people encouraged sales of author B's text. Although unequal promotion may create a *prima facie* case of failure to use best efforts, under our hypothetical situation the publisher would still be pursuing a joint-maximization objective so long as B's book was promoted because there were real underlying *gains* to be derived in the market. For instance, if B's text potentially would have been produced by another publisher, introduction of the text by the best efforts obligor carries no liability. In such a case, the publisher's forbearance from earning profits on B's book would not be matched by any concomitant gains to author A.

The competition cases reveal a sensitivity by the courts to limitations inherent in a best efforts obligation. Most courts have held that the introduction of a competing product by the best efforts promisor is not a *per se* breach of the contractual arrangement.⁷⁶ Efforts in competition with the best efforts promisee have been found to violate the contract only where they demonstrate the agent's failure to consider the principal's interest equally with his own.⁷⁷ Indeed, mere dissatisfaction by the manufacturer with the

⁷⁵ Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co., 30 N.Y.2d 34, 281 N.E.2d 142, 330 N.Y.S.2d 329 (1972).

⁷⁶ See, e.g., Parev Prods. Co. v. I. Rokeach & Sons, Inc., 124 F.2d 147 (2d Cir. 1941) (distribution license); Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co., 30 N.Y.2d 34, 281 N.E.2d 142, 330 N.Y.S.2d 329 (1972) (book publishing); Wolf v. Illustrated World Encyclopedia, Inc. 41 A.D.2d 191, 341 N.Y.S.2d 419 (1973), *aff'd*, 34 N.Y.2d 834, 316 N.E.2d 342, 359 N.Y.S.2d 59 (1974) (same). Cf. Randall v. Peerless Motor Car Co., 212 Mass. 352, 99 N.E. 221 (1912) (automobile distribution).

⁷⁷ See, e.g., Foster v. Callaghan & Co., 248 F. 944 (S.D.N.Y. 1918); Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co., 30 N.Y.2d 34, 281 N.E.2d 142, 330

distributor's level of effort is not symptomatic of a best efforts violation. Under almost any pricing arrangement it is plausible that the manufacturer will want the distributor to expend additional efforts *beyond* the optimal volume Q^* .⁷⁸ Best efforts, however, does not require the agent to consider the principal's interests ei-

N.Y.S.2d 329 (1972); *Genet v. Delaware & Hudson Canal Co.*, 136 N.Y. 593, 32 N.E. 1078 (1893).

⁷⁸ This possibility is illustrated in Figure 4 below, a smaller version of Figure 3. Recall that the distributor is required by contract to pay the manufacturer a royalty equal to 50% of gross sales. Thus, the marginal revenue curve facing the manufacturer ($\frac{1}{2}$ MR) is equal to one-half the marginal revenue curve faced by the distributor. If MM represents the marginal cost of manufacturing, then the manufacturer will prefer quantity Q_m to the joint maximization quantity Q^* . Area C represents the additional profits earned by the manufacturer if output is expanded from Q^* to Q_m .

A word of caution, therefore, is in order: evidence suggesting that additional distribution efforts would have earned the manufacturer greater profits is not *prima facie* evidence of a best efforts breach. The manufacturer may not "see" all of the costs associated with distribution.

FIGURE 4

ther ahead of or instead of his own interests.⁷⁹ Rather, as was recognized in *Petroleum Marketing Corp. v. Metro Petroleum Corp.*,⁸⁰ such an interest-balancing approach requires that same level of effort as though the agent owned the entire contractual interest. The hypothetical integrated ownership established as the performance standard in *Petroleum Marketing* is equivalent to the joint-maximization criterion proposed above.⁸¹

Whenever the best efforts issue is raised in specific litigation, it is tempting to argue that imposing the optimal output obligation on the best efforts promisor is "unfair" unless the evidence clearly suggests that he has been paid in advance to produce beyond his own profit-maximizing objective. In an uncertain legal environment, however, such evidence rarely will be available. It is simply not clear under the current rule what particular bargainers actually intended by a best efforts obligation. These uncertainty costs can be reduced only by adopting a clear rule that encourages parties to signal their disagreement by negotiating variant interpretations. The optimal output definition can be supported on both distributional and instrumentalist bases if it represents—as we have argued—the outcome most parties would reach if they bargained explicitly over the issue in advance.⁸²

C. *Implied Fiduciary Obligations: Alternative Performance Standards*

The best efforts obligation is not the only performance standard commonly found in relational contracts. For a variety of cooperative arrangements—including attorneys, brokers, executors, factors, partners, and joint venturers—the performance obligation of the parties is described in terms of a general fiduciary responsibility. Although these relationships may or may not be long-term,

⁷⁹ For example, courts have not compelled the agent to enter into a "hopeless contest." *Eclipse Bicycle Co. v. Farrow*, 199 U.S. 581, 589 (1905). See also *Parev Prods. Co. v. I. Rokeach & Sons, Inc.*, 124 F.2d 147, 150 (1941) (agent not required to sell "come what may").

⁸⁰ 396 Pa. 48, 151 A.2d 616 (1959).

⁸¹ "[D]efendants had the duty at least to use such effort as it would have been prudent to use in their own behalf if they had owned the receivables, or such effort as it would have been prudent for the plaintiffs to use if they had retained possession of them." *Id.* at 51, 151 A.2d at 619.

⁸² See note 46 *supra* and accompanying text.

they nonetheless are properly analyzed as relational contracts because they tend to be characterized by uncertainty about factual conditions during performance and an extraordinary degree of difficulty in describing specifically the desired adaptations to contingencies. In such relationships, where the obligor occupies a position of special confidence, superiority, or influence,⁸³ a "special duty" exists to protect the interest of the other.⁸⁴ Unlike the best efforts obligation, the fiduciary obligation has a well-developed doctrinal foundation. Fiduciaries are required, *inter alia*, to act "primarily for the benefit of another on matters relating to the undertaking."⁸⁵

To what extent, then, does the joint maximization model inform the meaning to be given to the standards of performance in fiduciary relationships? Initially, several differences can be observed in the doctrinal basis of fiduciary standards. First, the fiduciary obligation of loyalty and fidelity is one that is stated in mandatory terms. Rather than deriving its justification from the terms of the contract itself, it is imposed as a condition of the relationship, irrespective of efforts by individual bargainers to negotiate an alternative standard.⁸⁶ Second, fiduciary performance standards typically are described with more demanding and uncompromising rhetoric

⁸³ "The fiduciary relation may exist wherever special confidence is reposed, whether the relationship be that of blood, business, friendship, or association, by one person in another when they are in a position to have and exercise . . . influence over each other." *Dawson v. National Life Ins. Co.*, 176 Iowa 362, 376, 157 N.W. 929, 933 (1916).

⁸⁴ See generally 5 A. SCOTT, *THE LAW OF TRUSTS* § 495 (3d ed. 1967).

⁸⁵ *Nagel v. Todd*, 185 Md. 512, 516, 45 A.2d 326, 327 (1945) (quoting *RESTATEMENT OF AGENCY* § 13, Comment (a)). See also *Weisbecker v. Hosiery Patents*, 356 Pa. 244, 250, 51 A.2d 811, 813 (1947); *Haluka v. Baker*, 66 Ohio App. 308, 312, 34 N.E.2d 68, 70 (1941).

⁸⁶ It is noteworthy that although the obligation of loyalty and "unqualified fidelity" is mandatory, the parties are free by contract to define the specific duties required of the fiduciary. See *Anderson, supra* note 44, at 760.

In *Bayer v. Beran*, 49 N.Y.S.2d 2 (1944), the court expressed this critical distinction in the following terms:

The fiduciary has two paramount obligations: responsibility and loyalty. . . . The responsibility—that is, the care and the diligence—required of an agent or of a fiduciary, is proportioned to the occasion. It is a concept that has, and necessarily so, a wide penumbra of meaning

. . . .

The concept of loyalty, of constant, unqualified fidelity, has a definite and precise meaning. The fiduciary must subordinate his individual and private interests to his duty . . . whenever the two conflict.

Id. at 5 (emphasis added).

than is found in best efforts arrangements. For example, in *Mersky v. Multiple Listing Bureau, Inc.*,⁸⁷ the propriety of the sale of real estate to a relative of an agent in the broker's firm was at issue. The court stated:

Furthermore, there flows from this agency relationship and its accompanying obligation of utmost fidelity and good faith, the legal, ethical, and moral responsibility on the part of the listing broker as well as his subagents, to exercise reasonable care, skill, and judgment in securing for the principal the best bargain possible; to scrupulously avoid representing any interest antagonistic to that of the principal in transactions involving the principal's listed property, or otherwise self-dealing with that property, without the explicit and fully informed consent of the principal.⁸⁸

The plain meaning of such language seems to suggest an even higher level of performance than the obligation to take both interests equally into account. Indeed, if attention is focused on the parallel line of cases in which fiduciaries act in competition with the interests of their clients, the courts have expressed far greater reluctance in these settings than in commercial contexts to sanction such activities.⁸⁹ For example, in *Strickland v. Arnold Thomas Seed Service, Inc.*,⁹⁰ the court found that the agent had not sustained its burden of showing that sales in competition with the seed pool that it represented were made "in the exercise of its best judgment considering *only the interests of the pool members*."⁹¹

Nevertheless, it is difficult to attach literal meaning to the conventional legal statement of the performance standard owed by a

⁸⁷ 73 Wash. 2d 225, 437 P.2d 897 (1968).

⁸⁸ *Id.* at 229, 437 P.2d at 899.

⁸⁹ One of the earliest cases involving fiduciary competition is *Rice v. Davis*, 136 Pa. 439, 20 A. 513 (1890), in which a stockbroker received some stock from the purchaser as well as a commission from the seller. In discussing the rule that no agent can serve two principals, the court noted: "It forbids that anyone intrusted with the interests of others shall in any manner make the business an object of personal interest to himself . . ." *Id.* at 442, 20 A. at 514. See also *Grievance Comm. v. Rottner*, 152 Conn. 59, 203 A.2d 82 (1964) (law firm may not accept any action against a person whom they are representing presently even though there is no relationship between the two cases); *Vic Hansen & Sons, Inc. v. Crowley*, 57 Wis. 2d 106, 203 N.W.2d 728 (1973) (secured party, an automobile dealer, could not resell the secured car to itself without making good faith efforts to secure a "commercially reasonable" price).

⁹⁰ 277 Or. 165, 560 P.2d 597 (1977).

⁹¹ *Id.* at 177, 560 P.2d at 604 (emphasis added).

fiduciary. Although the attorney, broker, or partner may be held to the highest standards of fidelity to his client's interests, the fiduciary clearly is not required to extend efforts to his client's behalf *regardless* of the costs. Once it is recognized, however, that the costs—the interests—of the agent are relevant, the same inevitable question recurs: How are the relative interests of the parties to be balanced in individual cases? If the question is posed in these terms, a joint maximization definition of the required standard of performance offers the interpretation that optimizes the fiduciary relationship. Accordingly, the fiduciary would be required to act with reference to his principal so as to apply that level of effort which takes both the principal's and his own interests equally into account. Imposing any higher standards on the fiduciary reduces the social value of the relationship; mandating any level of effort beyond the optimal point Q^* would mean that the relationship would be incurring unnecessary losses. Such a solution would, in turn, be unstable in the sense that the parties would have an incentive to agree to a lesser standard in order to share the gains derived from readjusting to the joint optimum level of effort.

Application of the joint-maximization model to fiduciary relationships is, despite a superficial dissimilarity, closely analogous to the more commercial relationships first discussed. Formally, a client who entrusts the pursuit of his cause of action to an attorney stands in quite the same position as a patent-holder to his licensee or an author to his publisher. The fiduciary is in control of the level of efforts expended on the client's behalf; a conflict of interests over the proper level of efforts, similar to that discussed in the manufacturer-distributor context, predictably will arise. Because the conflict may reduce the value of the relationship, monitoring and bonding arrangements may be desirable.

This interpretation does not imply that the exhortatory rhetoric associated with fiduciary performance standards is devoid of significance. It is plausible to hypothesize that the higher level of aspiration in terms of fidelity and good faith that attaches to the fiduciary's obligation represents a substitute for the more commonly observed termination agreements in commercial best efforts contracts.⁹² This is not to suggest that implied rights to terminate

⁹² A closer reading of the cases confirms this intuition. The anti-competition rule in fiduciary relationships, for example, is justified as a means of policing against the enhanced risk

cannot be associated with fiduciary relationships. Nevertheless, even though implied rights of unilateral termination are found in attorney-client and broker-client relationships,⁹³ termination rights may not serve the same reassurance function in these settings.⁹⁴ It is plausible, therefore, that the extravagant statements of fidelity and obligation are substitute bonding provisions serving functions similar to the termination authorizations in more commercial settings. In Part III, we test this hypothesis by examining more rigorously the use of termination clauses and their substitutes as mechanisms to control uncertain standards of performance.

III. ADJUSTING PERFORMANCE: TERMINATION AND ITS SUBSTITUTES

A. Optimizing Agency Costs

As we have emphasized above, relational agreements inevitably involve costly conflicts of interest that may prevent the parties from achieving a desired result. Contracting parties will seek means of reducing such "agency costs" by establishing cost-effective monitoring or bonding mechanisms. Monitoring methods include direct supervision through auditing and pre-established standards of performance as well as incentive systems designed to reduce conflicts of interest.⁹⁵ Thus, depending on the empirical re-

of cheating in fiduciary relationships. Thus, one court has noted:

[O]ne who has the power will be too readily seized with the inclination to use the opportunity for serving his own interests at the expense of his principal. . . . It matters not that no fraud was meditated, and no injury done. *The rule is not intended to be remedial of actual wrong, but preventive of the possibility of it.*

Rice v. Davis, 136 Pa. 439, 442-43, 20 A. 513, 514 (1890) (emphasis added).

Substitute bonding provisions condemning self-dealing are also found in the self-imposed ethical standards of attorneys and brokers. See, e.g., ABA CODE OF PROFESSIONAL RESPONSIBILITY, Canon 5, E.C. 5-2 to -13 (1980).

⁹³ See, e.g., Gair v. Peck, 6 N.Y.2d 97, 160 N.E.2d 43, 188 N.Y.S.2d 491 (1959):

The special quality of a retainer contract is recognized by the cases holding that in spite of section 474 of the Judiciary Law the client may terminate it at any time, leaving the lawyer no cause of action for breach of contract but only the right to recover on *quantum meruit* for services previously rendered.

Id. at 106, 160 N.E.2d at 48, 188 N.Y.S.2d at 497 (emphasis in original).

⁹⁴ A partnership or joint venture organized for a definite term cannot be dissolved at the pleasure of one of the partners. Dissolution in such instances is available only if "reasonable cause" is shown. See, e.g., Cole v. Moxley, 12 W. Va. 730, 747 (1878). For an analogous problem of "illiquidity" restrictions on termination of close corporations, see Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977).

⁹⁵ See *Agency Costs*, *supra* note 12, at 308-10, 323.

alities, parties may find it advantageous to integrate vertically, thereby invoking the complex network of internal controls on managers and labor that characterizes the firm.⁹⁶ Alternatively, parties may select various forms of relational contracting such as franchising, distributorships, and joint ventures. Where the parties choose private contracts rather than vertical integration, different monitoring patterns will be observed.

Monitoring arrangements are costly to both parties, and such costs are reflected in the terms received by the agent in the original contract.⁹⁷ Agency cost, and thus the contract price, may be improved by substituting reassurances of performance in the form of bonding provisions. As we have suggested, among the variety of possible bonding arrangements are capital contributions, covenants not to compete, self-imposed ethical standards for agents, and unilateral termination authorizations.⁹⁸

Perhaps the most important and controversial of these various bonding arrangements is the unilateral termination clause. Although the parties' choice of a termination clause suggests that such a provision promises a reduction in agency costs, the termination of a distributor may have grave effects. It is tempting, therefore, to question the social utility of termination clauses because they rarely are found in those relational contexts where employees, franchisees, or other agents have engaged either in collective bargaining or political activity. If a termination clause represents an optimizing response to agency costs, presumably it would emerge from collective activity as well as from individual bargaining. Most collective bargaining agreements, however, include job security provisions that prevent unilateral termination by employers.⁹⁹

⁹⁶ See Alchian & Demsetz, *Production Information Costs and Economic Organization*, 62 AM. ECON. REV. 777, 777-83 (1972).

⁹⁷ Jensen and Meckling have established that agency costs—which reduce the value of the agent's services to the principal—will be fully borne by the agent as reductions in the market price of his services. Thus, the agent has a clear incentive to substitute bonding provisions for monitoring activities where these adjustments will economize on agency costs. See *Agency Costs*, *supra* note 12, at 313-19.

⁹⁸ The list is illustrative and not exhaustive. Additional examples include performance bonds and liquidated damages provisions that can be invoked against particularly obvious and egregious breaches of agreed-upon standards of performance.

⁹⁹ Ninety percent of the collective bargaining agreements negotiated in the United States contain some form of job security provision that limits the unilateral power of termination. [1979] 2 COLLECTIVE BARGAINING NEGOTIATIONS AND CONTRACTS (BNA) 40:1.

Similarly, collective political action by franchisee associations has produced good cause limitations on unilateral termination provisions in franchise contracts.¹⁰⁰ Prior to such collective action, broad termination provisions were observed commonly in these contexts,¹⁰¹ and they continue to be widely employed in relational agreements that remain unregulated.¹⁰²

Commentators have proposed a variety of hypotheses to explain the apparent divergence between individual and collective goals. One hypothesis is that individual agreements authorizing unilateral termination are explicable in terms of the imperfect information available to individual bargainers. Once individual bargainers organize collectively, it is argued, they come to appreciate both the value of job security and the relative costs of termination-at-will provisions.¹⁰³ As an empirical matter, this "myopia" hypothesis seems quite implausible. The transactions costs of acquiring information concerning the risks of termination do not appear different from the information costs associated with many other contractual risks allocated by private bargaining.

A more defensible hypothesis focuses on the change in market conditions that follows a grant of cartelization rights to a group of agents. First, collective recognition will increase, either implicitly or explicitly, the total compensation paid to these bargainers because collective action permits them to demand more than they could in a competitive environment. Second, cartelization of em-

¹⁰⁰ Federal legislation includes the Automobile Dealers Day in Court Act, Pub. L. No. 84-1026, 70 Stat. 1125 (1956) (codified at 15 U.S.C. §§ 1221-1225 (1976)) and the Petroleum Marketing Practices Act, Pub. L. No. 95-297, 92 Stat. 322 (1978) (codified at 15 U.S.C. §§ 2801-2806 (Supp. III 1979)). At the state level, as of June 1, 1978, 15 jurisdictions had enacted legislation with general limitations on franchise terminations, 36 statutes limited termination rights in vehicle franchise contracts, and 20 limited termination in petroleum franchises. See STATE BUSINESS FRANCHISE DISCLOSURE AND RELATIONSHIP LAWS (CCH) ¶ 99 (1978).

¹⁰¹ Indeed, in employment relationships, as well as other contractual agreements with an indefinite term, the common law presumes a right to terminate at will. See 9 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1017, at 129-37 (3d ed. 1967); note 107 *infra* and accompanying text.

¹⁰² The termination-at-will rule, for example, continues to govern the majority of American workers who are not employed under collective bargaining agreements. See, e.g., *Pearson v. Youngstown Sheet & Tube Co.*, 332 F.2d 439 (7th Cir. 1964); *Hablas v. Armour & Co.*, 270 F.2d 71 (8th Cir. 1959).

¹⁰³ See Note, *Protecting At Will Employees Against Wrongful Discharge: The Duty to Terminate Only in Good Faith*, 93 HARV. L. REV. 1816, 1830-33 (1980).

ployees or other agents will also alter the prices they pay for individual contract provisions, including the price of job security. For example, under collective bargaining agreements, grievance procedures and other enforcement measures uniformly are established because collective action, by pooling risks, can reduce the costs of these measures to individual employees. Reductions in enforcement costs ultimately will increase the value of limitations on the power of termination. Thus, it can be argued that in collective bargaining contexts effective job security costs less than it does when "purchased" by individual bargainers.¹⁰⁴

Perhaps the most sophisticated hypothesis draws a distinction between "average" agents, whose contractual preferences are dominant in collective decisions, and "marginal" agents, whose preferences control the terms of individually bargained contracts.¹⁰⁵ Suppose that an "average" agent, because he is older and more established, faces relatively higher dislocation costs if terminated. Average franchisees then would have incentives to seek legislative limitations on franchise termination. Similarly, average employees would bargain for good faith limitations on termination. In each case, mandating the result favorable to the average agent reduces the market impact of the marginal agent who, upon entering the industry, would prefer to bargain for a termination clause as a substitute for alternative bonding devices.

A number of interesting implications flow from this conception of the divergence between individual and collective agreements. First, *ex post* legislation limiting termination of franchisees results in a wealth transfer to those franchisees who "purchased" their franchise with a broad termination clause. Second, such a change makes it more expensive for prospective franchisees to "purchase" distribution rights, assuming good cause legislation limiting termination cannot be waived by contract. Employment contracts are affected similarly to the extent that termination limitations restrict "entry" by new employees, although to the extent that *future* employment conditions must still be negotiated, the costs of such provisions will be borne by all employees.

¹⁰⁴ See *Vertical Restrictions*, *supra* note 1, at 124-25; D. Leslie, *The Economics of Trade Unions* 24-25 (unpublished paper on file with the Virginia Law Review Association).

¹⁰⁵ See Freeman & Medoff, *The Two Faces of Unionism*, 57 *PUB. INTEREST* 69 (1979); *Vertical Restrictions*, *supra* note 1, at 124-25; D. Leslie, *supra* note 104, at 24-25.

At least the latter two hypotheses seem useful and interesting, but they are not fully explanatory. Focusing on the contractual objective of optimizing agency costs may offer an additional insight. It appears plausible that the conditions that produce collective action parallel the conditions under which monitoring costs are low relative to bonding provisions, such as the right to terminate. In many labor agreements, for example, job performance can be routinized and described precisely, thereby reducing the employer's costs of monitoring the efforts of employees. Indeed, where the labor market involves specialized, idiosyncratic skills—*e.g.*, performing artists or professional athletes—collective agreements do not provide continuing job security for individual members. Franchise agreements offer additional confirmation of this hypothesis. Franchising arrangements require an extensive monitoring system for policing the agent's qualitative performance in order to retain the goodwill value of the franchise name and trademark.¹⁰⁶ Once extensive quality control is required, it becomes less costly to expand such control in order also to monitor quantitative efforts to reach optimal output.

In sum, the attractiveness of termination clauses as a means of enhancing assurances of performance will vary depending upon the cost and availability of substitute methods of reducing agency costs. Because varying factual circumstances will determine to a large extent the relative value of substitute methods of controlling and adjusting performance, this explanation of termination provisions argues for permitting contracting parties to select freely that combination of monitoring and bonding arrangements that optimizes total agency costs. This necessarily assumes, however, that the benefits of termination clauses in reducing agency costs are not exceeded by the social costs of enforcing termination-at-will agreements. In order to evaluate the costs of enforcing termination provisions, we review the legal enforceability of such arrangements in the following section.

B. The Legal Enforcement of Termination Clauses

1. The Common Law

The common law of contract provides a relatively straightfor-

¹⁰⁶ See H. BROWN, *FRANCHISING REALITIES AND REMEDIES* 69-75 (2d ed. 1978).

ward treatment of the termination of relational contracts. When the agreement calls for successive performances, but is by its terms indefinite in duration, it is terminable at the will of either party upon reasonable notification.¹⁰⁷ This implied right of termination is subject to qualification in circumstances where the agent has made a substantial capital contribution in the enterprise. An investment beyond mere efforts to perform provides the basis for implying a reasonable duration to the agreement so that the agent may recoup his initial investment.¹⁰⁸ A legal rule implying a unilateral right of termination in general, coupled with a recoupment limitation in specific instances, is merely an application of the well-recognized function of contract law to supply common or typical allocations of risk between contracting parties where their agreement does not suggest a specially tailored arrangement.

The common law rule implicitly assumes, therefore, that termination at will, subject only to a recoupment limitation, is the result most relational contractors would reach in the absence of specific agreements concerning duration. It follows that an express provision between contracting parties authorizing either party to terminate the agreement either at will or on specified notification ordinarily would be legally enforceable according to its terms. Indeed,

¹⁰⁷ See generally 1 A. CORBIN, CONTRACTS § 96 (1963). In *Consolidated Theatres, Inc. v. Theatrical Stage Employees Local 16*, 69 Cal. 2d 713, 447 P.2d 325, 73 Cal. Rptr. 213 (1968), the court observed that:

While the initial effort of the court, in construing contracts of continuing performance or forbearance which contain no express terms of duration, must always be that of implying a term of duration commensurate with the intentions of the parties, in some cases the nature of the contract and the totality of surrounding circumstances give no suggestion as to any ascertainable term. In such cases the law usually implies that the term of duration shall be at least a reasonable time, and that the obligations under the contract shall be terminable at will by any party upon reasonable notice after such a reasonable time has elapsed. *This rule is generally applicable, for instance, to exclusive sales agency and distributorship contracts.*

Id. at 727-28, 447 P.2d at 335, 73 Cal. Rptr. at 223 (emphasis added; citations omitted). See also *Alpha Distrib. Co. v. Jack Daniel Distillery*, 454 F.2d 442 (9th Cir. 1972); *Meadows v. Radio Indus., Inc.*, 222 F.2d 347 (7th Cir. 1955); *Goldinger v. Boron Oil Co.*, 375 F. Supp. 400 (W.D. Pa. 1974); *Garlock v. Motz Tire & Rubber Co.*, 192 Mich. 665, 159 N.W. 344 (1916); U.C.C. § 2-309(2).

¹⁰⁸ See *Clausen & Sons, Inc. v. Theo. Hamm Brewing Co.*, 395 F.2d 388 (8th Cir. 1968); *Allied Equip. Co. v. Weber Engineered Prods., Inc.*, 237 F.2d 879, 882 (4th Cir. 1956); *Glover v. Henderson*, 120 Mo. 367, 377, 25 S.W. 175, 177 (1894); *General Tire & Rubber Co. v. Distributors, Inc.*, 253 N.C. 459, 472, 117 S.E.2d 479, 489 (1960). The recoupment limitation and its implications are discussed thoroughly in Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465, 479-83.

such express termination clauses were enforced freely at common law.¹⁰⁹ Recently, however, some courts and commentators have argued for limitations on the enforceability of either implied or express termination clauses.¹¹⁰ Because the doctrinal basis for such limitations remains unclear, a brief review of the regulatory choices is important to a further understanding of the termination issue.

2. *Unconscionability and Good Faith as Limitations on Termination*

In several recent cases, courts have invoked the related doctrines of unconscionability and good faith to limit the exercise of contractually reserved rights to terminate distribution contracts. Both of these justifications for judicial intervention in relational contracting require critical analysis.

Although an unconscionability analysis does invite intervention in specific cases, it is rarely invoked in agreements between commercial parties because its doctrinal foundations rest on assumptions of imperfect information and related claims of bargaining process unfairness.¹¹¹ Those few courts using unconscionability as a

¹⁰⁹ [S]uch right to terminate was not subject to question on the ground of unreasonableness, unfairness, lack of good faith, bad faith or because of motive, intent or resultant detriment to [the terminated dealer]. . . .

. . . .
. . . It is beyond the power of the judiciary to engraft conditions upon the exercise of such a contractual right.

Martin v. Ford Motor Co., 93 F. Supp. 920, 921 (E.D. Mich. 1950). See also Corenswet, Inc. v. Amana Refrigeration, Inc., 594 F.2d 129 (5th Cir.), cert. denied, 444 U.S. 938 (1979); Jay-El Beverages, Inc. v. Miller Brewing Co., 461 F.2d 658 (3d Cir. 1972); Myers Motors, Inc. v. Kaiser-Frazer Sales Corp., 178 F.2d 291, 303 (8th Cir. 1949); Zaidan v. Borg-Warner Corp., 228 F. Supp. 669, 671 (E.D. Pa. 1964), aff'd, 341 F.2d 391 (3d Cir. 1965).

¹¹⁰ See, e.g., Blades, *Employment At Will vs. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 COLUM. L. REV. 1404 (1967); Gellhorn, *supra* note 108; Hewitt, *Good Faith or Unconscionability—Franchisee Remedies for Termination*, 29 BUS. LAW. 227 (1973); Horton, *Legal Remedies of a Distributor Terminated Pursuant to a Contractual Provision of Termination Upon Notice*, 3 CREIGHTON L. REV. 88 (1970). See also cases cited note 112 *infra*.

¹¹¹ The unconscionability doctrine represents an ambitious effort to bring the traditional categories of unfairness—fraud, duress, incapacity—under a single analytical umbrella. In an earlier paper, we summarized the doctrinal developments in the following terms:

As reflected in U.C.C. § 2-302 the unconscionability principle is largely devoid of substantive content. Some commentary has concluded that efforts to provide any analytical structure are essentially futile—that unconscionability represents the subjective reactions of the particular decision-maker to the unfairness of a particular transaction. See Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115

vehicle for limiting contract rights of termination have focused on the circumstances surrounding the exercise of the termination right rather than on the fairness of the initial bargaining process.¹¹² This is a highly unusual application of the unconscionability doctrine. Because the unconscionability rationale for judicial intervention is a response to perceived imperfections in the bargaining process, most courts have rejected the doctrine as ill-suited to a scrutiny of agreements that are suspect due to the manner of their performance rather than because of the circumstances sur-

U. PA. L. REV. 485 (1967).

The major thrust of much of the unconscionability scholarship has been to seize upon Comment 1 to U.C.C. § 2-302 proscribing "unfair surprise" and "oppression." These two factors have been described respectively as "procedural" and "substantive" unconscionability . . . and have been used by many in an effort to merge the traditional constraints identified earlier. *See generally*, Braucher, *The Unconscionable Contract or Term*, 31 U. PITT. L. REV. 337 (1970); Murray, *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1 (1969); Spanogle, *Analyzing Unconscionability Problems*, 117 U. PA. L. REV. 931 (1969); Speidel, *Unconscionable Assent and Consumer Protection*, 31 U. PITT. L. REV. 359 (1970). All of these efforts at providing analytical clarity to the unconscionability doctrine seem to founder on the problem of structuring a neutral principle by which a contract can be determined to be substantively unfair.

The problem of substantive evaluation of the utility of the bargain can be avoided by limiting the unconscionability principle to a process control—falling solely within procedural unconscionability. The doctrine can thus be viewed as a method of defining bargaining abnormalities more precisely than through the traditional doctrines of fraud and duress. . . .

. . . . Illustrations of the "unfair surprise" component of bargaining unfairness would presumptively include traditional instances of fraudulent misrepresentation, as well as attempts to obscure the nature of the exchange by disguising relevant information in extra language or contract terms. *See, e.g.*, Murray, [Unconscionability: Unconscionability], 31 U. PITT. L. REV. 1, 16-18; Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1, 11-14 (1974). The doctrine is typically applied to the paradigm "fine print" provision in a standard form contract creating a presumption that there was no consent to the bargain in fact.

Liquidated Damages, *supra* note 3, at nn.91 & 95.

¹¹² *See, e.g.*, *Pickerign v. Pasco Marketing, Inc.*, 303 Minn. 442, 228 N.W.2d 562 (1975); *Shell Oil Co. v. Marinello*, 120 N.J. Super. 357, 294 A.2d 253 (Super. Ct. Law Div. 1972), *modified and aff'd*, 63 N.J. 402, 307 A.2d 598, *cert. denied*, 415 U.S. 920 (1973); *Ashland Oil, Inc. v. Donahue*, 223 S.E.2d 433 (W. Va. 1976). *See generally* Jordan, *Unconscionability at the Gas Station*, 62 MINN. L. REV. 813, 828-36 (1978).

In *Ashland Oil, Inc. v. Donahue*, 223 S.E.2d 433 (W. Va. 1976), the court expressly rejected any suggestion that a judgment barring an oil company from exercising its reserved right of termination was based upon a perceived disparity in bargaining power. Rather, the court held that the 10-day termination clause was unconscionable and "completely absurd" in effect. *Id.* at 438-40.

rounding their creation.¹¹³ Indeed, an unconscionability limitation on unilateral rights of termination would seem justified only if such agreements fairly could be seen as invariably resulting from bargaining imperfections that would otherwise support intervention. Yet, our prior analysis suggests legitimate reasons why informed commercial parties would voluntarily assume such risks.¹¹⁴ Under the circumstances, to deny enforcement because the termination clause is per se unconscionable seems doctrinally inapposite and, more important, fails to identify any principled grounds for intervention.¹¹⁵

The obligation of good faith has been invoked increasingly as an alternative basis for judicial intervention to limit the exercise of termination provisions.¹¹⁶ Although the precise meaning of the

¹¹³ Indeed, the overwhelming majority of cases have rejected the unconscionability rationale in termination cases. See, e.g., *Division of Triple T Serv., Inc. v. Mobil Oil Corp.*, 60 Misc. 2d 720, 304 N.Y.S.2d 191 (Sup. Ct. 1969), *aff'd mem.*, 34 App. Div. 2d 618, 311 N.Y.S. 2d 961 (1970); *Sinkoff Beverage Co. v. Jos. Schlitz Brewing Co.*, 51 Misc. 2d 446, 273 N.Y.S.2d 364 (Sup. Ct. 1966) (brewery distributorship agreement that authorized termination without cause not unconscionable because U.C.C. § 2-302 concerns the situation prevailing at the formation of the contract and not subsequent hardships suffered by one of the parties); *W.L. May Co. v. Philco-Ford Corp.*, 273 Or. 720, 543 P.2d 283 (1975).

¹¹⁴ See notes 96-106 *supra* and accompanying text.

¹¹⁵ Those courts and commentators that have advocated the use of unconscionability as an instrument for reshaping legal rights of termination have all grounded their analysis on the assumption that termination powers are used consistently and predictably to exploit strategic advantages, and assume further that unconscionability is the most effective vehicle to implement the desirable normative objective of eliminating such conduct. See generally *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 138-39 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979); Gellhorn, *supra* note 108, at 505-09; Comment, *Uniform Commercial Code § 2-302—Unilateral Right of Termination For Cause Determinable Solely by Franchisor Unconscionable*, 55 TEX. L. REV. 541, 554-55 (1977). These analyses leave two critical questions unaddressed: (1) What benign and socially beneficial explanations might account, at least partially, for the use of discretionary termination clauses?, and (2) What are the likely societal effects of a broad-gauged attack on discretionary termination clauses? A broad-based unconscionability attack on discretionary terminations is likely to be overinclusive. Assuming the normative objective of minimizing "abusive" practices, social welfare is enhanced by efforts to select instruments that are capable of isolating the disfavored behavior while not impairing mutually beneficial contractual arrangements.

¹¹⁶ Although a few courts have refused to recognize a good faith limitation on discretionary termination clauses, see, e.g., *Bushwick-Decatur Motors, Inc. v. Ford Motor Co.*, 116 F.2d 675, 676 (2d Cir. 1940); *Martin v. Ford Motor Co.*, 93 F. Supp. 920, 921 (E.D. Mich. 1950), an increasing number of cases have expressed a willingness to limit the right of termination where it appears the termination was not exercised in good faith. See, e.g., *Randolph v. New England Mut. Life Ins. Co.*, 526 F.2d 1383, 1386 (6th Cir. 1975) (distribution contract); *deTreville v. Outboard Marine Corp.*, 439 F.2d 1099, 1100 (4th Cir. 1971) (same); *McKinney v. National Dairy Council*, 491 F. Supp. 1108, 1122 (D. Mass. 1980) (employment

good faith obligation remains as ambiguous as does the unconscionability rationale, here the focus is directed toward the performance behavior of the parties rather than the bargaining process.¹¹⁷ Good faith is best conceived as a rule for policing cheating on the terms of the contract or other opportunistic behavior designed to redistribute risks already allocated by the agreement.¹¹⁸ Indeed, the risk of such opportunistic behavior is heightened measurably when relational contractors agree to a unilateral right of termination. In order for a termination provision to offer meaningful reassurances of performance efforts, the principal must be confident of his ability to invoke the clause without being required to bear the burden of proving a violation of the performance obligation. Yet, the cost of such broadly conceived termination authority is an invitation to the principal to engage in opportunistic behavior at the expense of the terminated agent. As an extreme example, a termination clause obviously would be invoked in bad faith should a franchisor terminate an agreement immediately following the receipt of the franchisee's capital contribution. Thus, in *RLM Asso-*

contract); *Baker v. Ratzlaff*, 1 Kan. App. 2d 285, 564 P.2d 153, 157 (1977) (sales contract); *Fortune v. National Cash Register Co.*, 373 Mass. 96, 364 N.E.2d 1251, 1257 (1977) (commission sales contract); *Morge v. Beebe Rubber Co.*, 114 N.H. 130, 133, 316 A.2d 549, 551 (1974).

¹¹⁷ Both the common law and the Uniform Commercial Code impose a mandatory obligation of good faith in the performance and enforcement of contractual obligations. See U.C.C. §§ 1-102(3), 1-203; *Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); *Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 216-19 (1968).

¹¹⁸ The critical challenge for any definition of good faith is whether it can distinguish between the normatively acceptable decision to breach and pay compensatory damages, and the kinds of strategic contracting behavior that are normatively undesirable. Focusing on the welfare effects of the behavior may provide a principled distinction. A decision to breach and allocate resources to alternative uses is efficiency-enhancing conduct so long as the breacher "buys" out of the contract by paying the appropriate quantum of damages. See *Liquidated Damages*, *supra* note 3, at 558-59. On the other hand, strategic behavior designed to exploit a contractually created monopoly position—for example, a professional athlete threatening nonperformance in order to extort a larger compensation—has no socially optimizing effects. Rather, such opportunistic behavior only redistributes portions of an already allocated contractual pie. See *Klein, Crawford & Alchian*, *supra* note 1, at 300-02. Thus, at least in this context, bad faith can be defined as intentional efforts to use contractually created discretion or other strategic opportunities to secure a larger share of the anticipated gains from an existing contract. See, e.g., *Alaska Packers Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902) (preexisting duty rule as a bar to bad faith modification); *Wolf v. Marlton Corp.*, 57 N.J. Super. 278, 154 A.2d 625 (Sup. Ct. App. Div. 1959) (duress as a bar to bad faith termination).

ciates, Inc. v. Carter Manufacturing Corp.,¹¹⁹ the court acknowledged a prima facie showing of "bad faith" termination where the evidence established that the termination was motivated by a desire to avoid paying commissions earned through the distributor's efforts.¹²⁰ Although such "red faced" cases of bad faith seem to present little difficulty, it is concern with the incidence of more subtle manifestations of this behavior that animates courts and legislators seeking to limit termination rights.

3. *Good Cause Limitations on Termination*

The desire to reduce the incidence of "cheating" behavior by principals explains some of the reluctance to enforce termination agreements fully. A number of legislatures also have imposed "good cause" limitations on the enforcement of unilateral termination privileges in franchise contracts.¹²¹ In addition, increasing numbers of relational contractors have framed their termination agreements so as to require "good cause" before a unilateral termination privilege can be exercised.¹²² On one level, the addition of a good cause gloss on termination agreements merely serves to sharpen the presumed allocation of risks under a legally mandated good faith obligation. Thus, although termination at will literally offers the principal the opportunity to terminate for any reason or no reason, including a bad reason, such discretion does not include the privilege to engage in an opportunistic exercise of termination rights. This interpretation of good cause merely mirrors the good faith limitation suggested earlier, however. Thus, a difficult question arises when the issue focuses not on opportunism, but on changed conditions that cause alternative contractual arrangements to appear more attractive to the terminating party.

¹¹⁹ 356 Mass. 718, 248 N.E.2d 646 (1969).

¹²⁰ *Id.* See also *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (fraud and bad faith found in company's threat to terminate if dealer handled competitive products); *Fortune v. National Cash Register Co.*, 373 Mass. 96, 364 N.E.2d 1251 (1977) (termination vitiated by proof that NCR had salesmen "at their mercy").

¹²¹ See, e.g., state statutes collected in STATE BUSINESS FRANCHISE DISCLOSURE AND RELATIONSHIP LAWS (CCH) ¶ 306-401.6 (1978). See also *Westfield Centre Serv., Inc. v. Cities Serv. Oil Co.*, 158 N.J. Super. 455, 386 A.2d 448 (Sup. Ct. Ch. Div. 1978) (interpreting good cause under the New Jersey Franchise Practices Act).

¹²² See, e.g., *J & S Home Realty, Inc. v. Anaconda Co.*, 172 Mont. 236, 563 P.2d 566 (1977).

In *J & S Home Realty, Inc. v. Anaconda Co.*,¹²³ the court explicitly considered whether a manufacturer's decision to go out of the building materials business in good faith and for business reasons was "cause" sufficient to terminate the distributor's contract. The court concluded that a good cause limitation in the contract must contain meaning beyond mere good faith. Although a termination based on changed business conditions might well be consistent with the obligation of good faith, the good cause limitation imposed additional restrictions on termination. Absent evidence of failure of performance by the distributor, changed conditions making alternative arrangements more advantageous to the manufacturer did not justify termination under the good cause limitation.¹²⁴

The preceding analysis confirms that the precise meaning and reach of the various limitations on contractually specified rights of termination remains unclear. The uncertain effect of such limitations on unilateral termination agreements jeopardizes the ability of parties to use termination as a means of reassurance where performance standards are difficult to police. The uncertainty costs of limitations on termination are a product of the failure to isolate and define adequately the relative risks embraced in a termination provision. In the following section, we propose a model for allocating the different risks that induce a decision to terminate.

C. A Termination Model

Assume that, in our initial hypothetical case, manufacturer and distributor negotiate a ten-year distribution contract providing that either party may terminate the agreement on ten-day notice "for any reason with or without cause." The agreement is terminated by the manufacturer after six years because the distributor was "unable to sustain a continuing pattern of growth."¹²⁵ The distributor appeals the termination, arguing that exercise of the termination clause should be limited on grounds of unconscionability, good faith, or good cause. How would such a termination issue be resolved?

¹²³ 172 Mont. 236, 563 P.2d 566 (1977).

¹²⁴ *Id.* at 239-40, 563 P.2d at 567-68.

¹²⁵ The facts of the hypothetical are based loosely on those in *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979).

Three distinct risks are encompassed in the manufacturer's unilateral option to terminate the contract. The first risk inherent in an unqualified right of termination is the vulnerability of the distributor to cheating or strategic attempts by the manufacturer to extort additional compensation. A second risk is the possibility that contingencies may materialize that cause the manufacturer to regret having entered into the relationship, thus precipitating termination. The third and final risk is the inherent possibility that termination may be induced by the distributor's failure to achieve the required standard of performance. Because the allocation of these risks will influence the behavior of relational bargainers, it is useful to examine the legal treatment of termination agreements in terms of the risk-bearing consequences of the legal rule.

1. Allocation of Termination Risks in a Friction-Free Environment

In order to assess the effects of any particular termination rule, we first assume that, although future events may be uncertain, accurate retrospective information is accessible for purposes of adjudication. We assume also that legal process costs are negligible, so that the theoretical gains from an otherwise beneficial regulatory rule are never counterbalanced by implementation costs. We relax these assumptions below when we discuss the practical compromises that may be dictated in a more realistic setting.

The risks of opportunistic termination and best efforts failure can be allocated without great theoretical difficulty. Because cheating and efforts to prevent cheating represent a dead-weight social loss, limitations on intentional bad faith behavior are always optimal when enforcement costs are negligible.¹²⁶ In order to maintain the appropriate disincentives to engage in socially disfavored activity, the risk of cheating or other opportunistic behavior must be borne, therefore, by the party with the discretionary power to terminate the contract. On the other hand, the distributor is the optimal bearer of the risk of a failure to achieve a best efforts standard of performance. The distributor can exercise some control over the level of efforts invested in his business activities, and thus is the efficient bearer of the risk that his distribution efforts will

¹²⁶ See note 27 *supra* and accompanying text.

not achieve the joint-maximizing output.¹²⁷ Indeed, we suggest that the decision to bargain for a termination clause is motivated largely by the opportunity to reduce expected agency costs through minimizing the risk of a failure of best efforts.

A more complex analysis is required in evaluating the risk that changed circumstances may cause either party—in this case the manufacturer—to regret the arrangement. In conventional contracts, the risk of such a “regret contingency” typically is allocated to the party seeking to terminate; he presumably enjoys the comparative advantage in bearing the risk of his own disappointment. In relational contexts, however, it is often impractical for the parties to specify and allocate such risks accurately in advance. Absent an ability to identify systematically which party is better able to bear the risk of regret, how is the risk to be assigned?

The critically important variable in determining the optimal assignment of the risk of regret contingencies is whether the parties select an indefinite duration or a fixed term contract. As we suggest above, parties to relational exchange may in some cases elect to use sequential or indefinite duration contracts. Assume that, rather than a ten-year fixed term, the manufacturer and distributor agree to an indefinite duration distribution contract. In this case, the risk of regret is assigned to the distributor because it represents the most plausible explanation for the selection of this particular method of economizing on transactions costs. A sequential or indefinite term contract permits either party to adjust to events that may cause regret over the original compensation arrangement. Additional covenants by the distributor not to compete and by the manufacturer to buy back tangible assets are methods of retaining some capacity to encourage, within this flexible environment, transaction-specific investments by both parties. In order to retain the presumed risk allocation of the parties, a manufacturer would, therefore, be entitled to terminate an indefinite duration contract in order to pursue a change in marketing strategy. If termination in fact does not represent the joint-maximizing outcome considering the interests of both parties, the terminated distributor would be free to bargain for a redivision of the joint contractual product in order to induce the disappointed manufacturer not to terminate.

The risk consequences associated with negotiating a fixed term

¹²⁷ See note 59 *supra* and accompanying text.

contract such as the one proposed above are simple: the risk of the manufacturer's regret is shifted from the distributor to the disappointed manufacturer. The decision to assume voluntarily the risk of uncertain or unforeseeable events presumably is motivated by the corresponding gains that the fixed term agreement offers in terms of fostering asymmetrical investments in transaction-specific assets. By providing the vulnerable party with the right to prevent a termination, such an agreement requires the disappointed party to buy out the other's difficult-to-value specific investments in order to secure a release from a now-regretted arrangement.

In sum, optimal risk allocation requires that in all cases the risk of bad faith termination be borne by the manufacturer and the risk of a failure of best efforts be borne by the distributor. Because the risk of the manufacturer's regret can be assigned only by specific agreement, the risk is assigned to either party depending on whether they negotiate a fixed term or an indefinite duration agreement. This analysis suggests that in the case of indefinite term contracts, the right of termination should be constrained only where necessary to discourage strategic behavior. Where the agreement calls for a fixed term, however, even a broadly discretionary termination clause should optimally be subject to additional limitations—whether based on unconscionability, good faith, or “good cause”—whenever the terminating party also attempts to shift the risk of regret contingencies.

The model formulated above is incomplete, however. Even in indefinite term contracts, an additional limitation arises when a relationship necessitates highly transaction-specific investments by a party subject to termination, thus increasing that party's vulnerability. The view that this vulnerability supports the use of recoupment limitations is not accepted universally. If one regards the threat of termination to be exclusively a device to motivate the performance of an agent, then a recoupment guarantee limits the penalty for nonperformance and inefficiently attenuates the impact of a useful enforcement device.¹²⁸ One simple response is to observe that there is an optimal amount of *ex ante* sanction for any activity, and the threat of loss of large transaction-specific investments may constitute inefficient over sanctioning. There are,

¹²⁸ See Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356 (1980).

however, at least two additional reasons why we are not persuaded that recoupment guarantees must be regarded as economically inefficient. First, if the objective is merely to increase the size of the nonperformance penalty, there are many alternative ways of doing so. More important, however, is the fact that the recoupment limitation must be analyzed as a device affecting the behavior of the terminator as much as of the terminated. Bad faith termination will be an especially strong risk where the agent's legitimate profits reach a level unanticipated at the time of contracting. Hence, it may be sensible for the party subject to termination to regard the recoupment feature as, in effect, a "penalty" intended to deter a potential bad faith terminator.

The preceding analytical model provides useful insights about existing patterns of legal enforcement. Contracts for an indefinite duration may be terminated at will except in gross instances of bad faith¹²⁹ or cases in which the terminated party has yet to recoup a specialized capital investment in the enterprise.¹³⁰ The model also provides a useful framework for analysis of the judicial treatment of unilateral termination under fixed term agreements. A significant number of recent cases involve termination of dealerships by oil companies, reflecting the change in marketing strategies motivated by the unanticipated rise in crude oil prices during the 1970's.¹³¹ In these and analogous circumstances, termination limi-

¹²⁹ See, e.g., *Shell Oil Co. v. Marinello*, 120 N.J. Super. 357, 294 A.2d 253 (Super. Ct. Law Div. 1972), *modified and aff'd*, 63 N.J. 402, 307 A.2d 598, *cert. denied*, 415 U.S. 920 (1973); notes 120-21 *supra* and accompanying text.

¹³⁰ See note 108 *supra* and accompanying text.

¹³¹ The spectacular increase in the retail price of gasoline following the 1973 oil embargo altered the pre-embargo marketing strategy in which sales of associated products and repair services were promoted and gasoline sold as an ancillary service. This strategy was based on the assumption that the demand for gasoline was inelastic over the relevant range. Price increases produced by the embargo revealed consumer sensitivity to price and, in turn, encouraged the development of low-cost sales methods, such as self-service purchases. Existing dealers, meanwhile, had substantial investments in automobile servicing and repair facilities and were reluctant to shift to the cheaper self-serve format. Hence, the stage was set for a substantial number of terminations, resulting, in turn, in a significant amount of litigation. See, e.g., *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980); *Pickering v. Pasco Marketing, Inc.*, 303 Minn. 442, 228 N.W.2d 562 (1975); *Westfield Centre Serv. Inc. v. Cities Serv. Oil Co.*, 158 N.J. Super. 455, 386 A.2d 448 (Sup. Ct. Ch. Div. 1978); *Shell Oil Co. v. Marinello*, 120 N.J. Super. 357, 294 A.2d 253 (Super. Ct. Law Div. 1972), *modified and aff'd*, 63 N.J. 402, 307 A.2d 598, *cert. denied*, 415 U.S. 920 (1973); *Atlantic Richfield Co. v. Razumic*, 480 Pa. 366, 390 A.2d 736 (1978); *Ashland Oil, Inc. v. Donahue*, 223 S.E.2d 433 (W. Va. 1976).

tations have been imposed consistently on fixed term contracts when manufacturers or producers have attempted to disenfranchise dealers in order to pursue new marketing strategies.¹³² At the same time, courts consistently have enforced such termination agreements where a best efforts or other performance failure has been shown clearly.¹³³

If the risk of performance failure is the only risk allocated to the distributor by a unilateral termination clause in a fixed term contract, why would the parties negotiate such an overly broad provision, thereby inviting improper attempts to terminate? The answer, of course, is that the assumption of negligible enforcement costs necessarily distorts the outcome. In a friction-free environment, the terminating manufacturer would be able to allege and establish at no cost the appropriate best efforts failure in order to justify the decision to terminate. In this environment, the parties would never agree to the clause specified above. In order to appreciate the true significance of such provisions, therefore, it is necessary to examine the effects of enforcement costs on the optimal allocation of termination risks.

2. *Problems of Proof, Process, and Error Costs*

By relaxing the assumptions of perfect measurement and zero process costs, we are able to evaluate the efficiency of limitations

¹³² See cases cited note 131 *supra*. See also *Michael Todd & Co. v. Lecal Co.*, 583 F.2d 1056 (8th Cir. 1978) (distributor entitled to damages where manufacturer terminated in order to deal directly with consumers); *Whiteis v. Yamaha Int'l Corp.*, 531 F.2d 968 (10th Cir. 1976), *cert. denied*, 429 U.S. 858 (1977) (attempt by manufacturer to terminate dealer in order to change from exclusive distribution scheme to competitive site franchises barred by obligation of good faith); *Junikki Imports, Inc. v. Toyota Motor Co.*, 335 F. Supp. 593 (N.D. Ill. 1971) (automobile manufacturer who wished to change marketing strategies prevented by obligation of good faith from using termination as means of eliminating dealer from the market).

¹³³ See, e.g., *Excello Wine Co. v. Monsieur Henri Wines, Ltd.*, 474 F. Supp. 203, 209 (S.D. Ohio 1979) ("Monsieur Henri's best interests were no longer being served by the distributorship with Excello."); *International Harvester Co. v. Calvin*, 353 So. 2d 144 (Fla. Dist. Ct. App. 1977) (assuming that the dealer made its required showing of rebuttable bad faith with an assertion that the reason for termination was its protest of a neighboring dealership, this was overcome by the supplier's evidence of inadequate "market penetration" as an independent reason for termination); *Randall v. Peerless Motor Car Co.*, 212 Mass. 352, 99 N.E. 221 (1912) (agent denied recovery of damages for wrongful termination where evidence indicated a failure to use "best energies"); *Freeman v. Danal Jewelry Co.*, 397 A.2d 1323 (R.I. 1979) (employment contract properly terminable where employees' performance was unsatisfactory).

on termination rights from a more practical standpoint. Under a legal regime limiting the right of termination, the terminating party must determine how to establish that the termination option is being exercised for a risk that has been allocated to the terminated party. Given the enormously difficult problems of proving a violation of the performance obligation,¹³⁴ the issue in termination cases inevitably turns on the allocation of presumptions and burdens of proof.

One resolution of our hypothetical termination case would be for the court to adopt the procedural mechanism suggested by the recent decision in *International Harvester Co. v. Calvin*.¹³⁵ In *International Harvester*, the manufacturer exercised a unilateral termination privilege, alleging that the distributor failed to achieve satisfactory sales performance. The agent successfully challenged the termination before a state agency, but the appeals court reversed. In sustaining the termination, the court explicitly allocated to the distributor the burden of establishing that International Harvester's termination was motivated either by opportunism or regret rather than because of the alleged performance failure. Once a *prima facie* claim of improper termination was presented, the burden shifted to International Harvester to establish a failure of performance as an independent and sufficient reason to terminate.¹³⁶ Presumably, the power of termination would have been limited by the court only where the distributor was able to establish either an inference of bad faith or evidence of changed circumstances that suggested that International Harvester was seeking alternative distribution arrangements, and where International Harvester, in turn, was unable to prove its allegations of unsatisfactory performance.¹³⁷

As a theoretical proposition, it is impossible to predict whether such an allocation of presumptions and burdens of proof is socially optimal. The relevant empirical question, however, is clear. It is efficient for the legal system to regulate unilateral termination

¹³⁴ See notes 65-74 *supra* and accompanying text.

¹³⁵ 353 So. 2d 144 (Fla. Dist. Ct. App. 1977).

¹³⁶ *Id.* at 147-48.

¹³⁷ A similar procedural framework was suggested implicitly in *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979), where the court sustained a termination based on Amana's allegations of poor sales volume and the distributor failed to suggest any "improper" reasons underlying the termination.

where the reduction in the social costs of improper terminations is not overbalanced by concomitant increases in agency costs that result from the diminished efficacy of termination provisions as a form of contractual bonding.

Although there are no data suggesting how this question is to be resolved, some plausible empirical assumptions can be advanced. First, instances of bad faith terminations are likely to be infrequent due to the existence of extralegal sanctions against strategic behavior in continuing relationships. Thus, manufacturers with established commercial distribution contracts will incur substantial "goodwill" losses if they attempt to exploit a discretionary termination authority. Furthermore, in many distribution contexts, anti-trust claims, carrying treble damages liability, are routinely filed against producers as a "penal" sanction for disfavored terminations. Second, these distribution and franchise contracts often require asymmetrical specialized investment and consequently are frequently characterized by fixed term agreements under which the manufacturer implicitly assumes the risk of regret over changed conditions.

Given the assumed effectiveness of extralegal sanctions, termination for reasons other than a failure of best efforts will be a cost-effective strategy for such a manufacturer only where changed conditions producing regret create the prospect of substantial and continuing losses. This suggests that the evidence of such exogenous conditions will be accessible to a terminated dealer seeking to establish a wrongful termination. These generalizations would support, in turn, a presumption of best efforts failure that the distributor must rebut by establishing that termination was motivated either by opportunism or by regret over changed conditions.

The difficult proof problem associated with termination clauses does suggest that courts will be more inclined to regulate termination where alternative forms of monitoring or bonding are available at low incremental cost. The existence of close substitutes reduces the relative value of unilateral termination as a device to police best efforts agreements. This hypothesis appears confirmed by casual analysis of the cases. For example, the most rigorous limitations on termination have occurred in the franchising context. These forms of relational contracting offer more and closer substitutes for minimizing agency costs than do those other relationships where the common law presumption that termination clauses

are fully enforceable has been retained.

The fact that only crude observations are possible from the cases indicates the failure of current legal rules to encourage parties to specify and isolate more carefully the various risks that are encompassed in termination cases. Carefully developed procedural rules can reduce the risks of "improper" termination while preserving some ability to terminate for best efforts failure even though proof of such failure is unavailable.

Isolating the relevance of the burden of proof permits the identification of a final question. Although the parties may be unable to specify the risks in advance, they may well be able to allocate the burden of proof. Should individually tailored allocations be sanctioned? If the preceding analysis is plausible, the answer is clearly an affirmative one. The parties obviously are better able to identify comparative advantages in establishing the causes for termination behavior. Unless such an arrangement represents an obvious effort to cheat, such an allocation of burdens enhances efficiency.

IV. CONCLUSION

Executory contracts allocate the risk of various contingencies whose occurrence would influence the costs or benefits of a contemplated activity. By in effect selling a risk to the other party, who presumably anticipates a lower cost of bearing that risk, each bargainer reduces the costs of his own risk portfolio. This article has examined the behavior of contracting parties when the relevant contingencies are deemed too uncertain or too complex to permit the associated risks to be identified, described, and assigned appropriately at the time of contracting. Although such circumstances render relational contractors unable to exchange risks in precise, conventional ways, the process of negotiating such an executory contract is nonetheless motivated by cost-minimizing incentives.

This cost-minimizing hypothesis is confirmed by examining two terms commonly found in relational contracts: a broadly defined "best efforts" standard of performance and a discretionary termination privilege. The vague concept of best efforts can most sensibly be construed as requiring the level of effort necessary to maximize the joint net product flowing from the contractual relationship. This joint-maximization criterion is a plausible norm for all cooperative contractual relationships where the parties have not

specified a precise standard of required performance; it produces the largest possible net product for ultimate division between the parties. Unfortunately, the gains from this cooperative objective can be realized fully only if the parties are able to provide an appropriate monitoring/bonding package—perhaps incorporating a discretionary termination provision—that induces the optimal output. Although such provisions often appear to give one party an unfettered opportunity to exploit the other, they also serve as a risk-allocating mechanism designed to reduce the agency costs of relational exchange. The tension between the monitoring function and the exploitation opportunity is an inevitable consequence of many business environments.

The decisions reached by courts interpreting best efforts and termination agreements are generally consistent with the kinds of tradeoffs that we ascribe to parties motivated by cost-minimization. Standard legal doctrine, however, has failed to articulate any explicit rationalization or explanation of these intuitively plausible outcomes. The consequence has been a level of uncertainty and ambiguity in the case law that blunts the social utility of the legal rules involved. A reconciliation of doctrine and result in these cases may serve two purposes: to facilitate the understanding of those legal counsel who attempt to craft appropriate mechanisms for allocating risks under exceptionally complex and uncertain conditions, and also to sharpen the courts' perception of the tensions inherent in the mechanisms chosen and the policies designed to regulate them.