Economic Reasoning and the Framing of Contract Law: Sale of an Asset of Uncertain Value

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Abstract: By analyzing two American contract law decisions, the paper illustrates the usefulness of economic analysis in framing the inquiry. The cases have a common feature, unrecognized by the courts: they both deal with the production and transfer of information regarding the sale of an asset of uncertain value. One involves the combination of an option and a lockup to encourage the buyer to produce information. The other involves contingent compensation to convey the seller’s assurance of the quality of the assets. Once this is recognized, the outcomes are straightforward.

I have been teaching the basic Contract Law course for a few years now, and have been struck by the courts’ frequent indifference to economic context. It is not so much a matter of the court arriving at the wrong answer as it is the court’s asking the wrong questions. In too many instances the court frames the problem in a way which obscures the essential features of the transaction. A little–very little–sensitivity to some elementary economic concepts can go a long way toward illuminating a number of problem areas.

In this paper, I want to illustrate this proposition by engaging in a close analysis of two American court decisions oft featured in contracts casebooks: Mattei v. Hopper\(^1\) and Bloor v. Falstaff Brewing Corp.\(^2\) This is a piece of a larger project.\(^3\) The other papers have emphasized the manner in which contracting parties allocate to one party the discretion to respond to changed circumstances, but constrain that flexibility by conveying the counterparty’s reliance interest. These decisions raise a different problem: production and transfer of information regarding the sale of an asset of uncertain value. Had the courts chosen to frame the problems this way, disposition of both cases would have been straightforward. The court’s decision in the former case remains unaffected, but the implications for similar cases would be quite different. The decision in the latter case is simply wrong.

\(^1\)51 Cal. 2d 119; 330 P.2d 625; 1958 Cal. LEXIS 213.

\(^2\) 601 F.2d 609 (2d Cir. 1979).

There are a large number of institutional responses to the information problem. I will focus on two which explain nicely the structure of the contracts in controversy. If, for example, the buyer is the most efficient provider of certain pre-sale information, then the parties might agree to give the buyer the option to buy while it collects further information. Such a lock-up provision was at the core of Mattei v. Hopper. Or, if the buyer fears that it is buying a “lemon,” the seller could alleviate that fear by making some of the compensation contingent upon the future performance of the asset. Such was the case in Bloor v. Falstaff, although neither the court nor the litigators figured it out.

I. Mattei v. Hopper

Peter Mattei, a real estate developer, entered into an agreement with Amelia Hopper to purchase a tract of land so that he might construct a shopping center on a tract adjacent to her land. The purchase price was $57,500 and Mattei was given 120 days to "examine the title and consummate the purchase." He gave a $1,000 deposit to the real estate agent. The agreement was evidenced on a form supplied by the real estate agent, commonly known as a deposit receipt. The concluding paragraph of the deposit receipt provided: "Subject to Coldwell Banker & Company obtaining leases satisfactory to the purchaser." Before the 120 day period had run, Ms. Hopper notified him that she would not sell her land under the agreed upon terms. He then informed her that satisfactory leases had been obtained and tendered the balance of the purchase price. She refused; he sued.

Her defense was that the satisfaction clause rendered the promise illusory. He had only promised to purchase if he were satisfied, which, she argued, committed him to nothing at all. There was no consideration and, therefore, no contract. The trial court agreed. On appeal, the California Supreme Court reversed. If there were no limits on Mattei’s right to claim dissatisfaction, then there would be no contract. However, the court held, Mattei was not so free. His invocation of the clause was subject to a good faith limitation. By binding himself to go forward unless he could in good faith claim dissatisfaction with the leases, Mattei provided the requisite consideration.

Real estate transactions routinely make the transaction contingent upon information that would be developed after the contract has been entered into. For example, in Omni Group, Inc.

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5Mattei could have been held to an objective (reasonable person) standard or a subjective (good faith) standard; the court chose the latter because of the difficulties in determining objectively the qualities of a satisfactory lease.
v. Seattle-First National Bank, 6 another casebook favorite, the purchaser’s obligation depended on its satisfaction with an engineer’s and architect’s feasibility report. 7 In a number of disputes, the seller has argued that the conditions rendered the promise illusory. And, as in Mattei, the courts have often rescued the deal by reading a good faith requirement into the promisor’s satisfaction condition. Indeed, in some instances they have done so in the face of contract language making the satisfaction a matter of the buyer’s “sole judgment and discretion.” 8

Had the deal been structured a bit differently, there would have been no question of consideration or good faith. The transaction could have been conditional on the satisfaction of some independent third party, perhaps a lender or appraiser. 9 Mattei could have taken an option on Hopper’s land, for, say $1,000. The $1,000 would provide consideration, hence there would be a contract, and Mattei could choose not to exercise the option for any reason at all. 10 Or Mattei could have made the $1,000 deposit non-refundable. If that were an exclusive remedy, then the situation would be identical to the option. There are two differences between the actual transaction and the $1,000 option. One is the language describing the conditions that would influence Mattei’s decision to exercise the option. The other is the price. Hopper granted Mattei


7“This transaction is subject to purchaser receiving an engineer’s and architect’s feasibility report prepared by an engineer and architect of the purchaser’s choice. Purchaser agrees to pay all costs of said report. If said report is satisfactory to purchaser, purchaser shall so notify seller in writing within fifteen (15) days of seller’s acceptance of this offer. If no such notice is sent to seller, this transaction shall be considered null and void.” At 3-4. See also, Horizon Corporation v. Westcor, Inc. 142 Ariz. 129; 688 P.2d 1021; 1984 Ariz. App. LEXIS 461 (approval of zoning, leases of major retail tenants, and financing); Rodriguez v. Barnett, 52 Cal.2d 154, 338 P.2d 907 (1959) (satisfaction with and approval of a subdivision map); Larwin-Southern Cal, Inc. v. J.G.B. Investment Company, Inc., et al., 101 Cal.App.3d 626, 162 Cal.Rptr. 52 (1979) (“buyer's approval of a preliminary title report, its approval of its engineering report as to soil conditions, dirt balance, drainage, utility requirements and its economic feasibility study, and the approval of a tentative map”)


9The only good faith issue would be whether the third party’s independence had been compromised by a side deal with the buyer.

10If the contract gives a false recital of the payment of nominal consideration (“in consideration of buyer’s payment of $20, . . .), the majority position in the United States is that there is no contract. See Lewis v. Fletcher, 101 Idaho 530 for majority position and Smith v. Wheeler, 210 S.E.2d 702 for the minority position.
a four month option with an exercise price of $57,500 and a price of $0. Is this by itself sufficient to find consideration, without resort to an implied duty to exercise his discretion in good faith?

The answer should be Yes. Properly understood, the buyer’s promise is valuable to the seller, even if the buyer reserved the right not to go through with the deal if he so chose. The agreement facilitates the production of information which can result in an enhanced price for the seller’s asset.\textsuperscript{11} The apparent paradox of the sale of a valuable option at a price of zero disappears upon recognition that the agreement is in reality two intertwined transactions. In the first, the buyer purchases an option: he pays a positive price to induce the seller to take the property off the market for a period of time. In the second, the seller pays the buyer to develop some information about the commercial prospects of the property. The seller believes that if the buyer had better information, the sales price would be higher and that the buyer is the most cost-effective producer of that information. The netting of these two transactions could easily result in the buyer paying nothing. Indeed, we need not stop at nothing. The seller could agree to a negative price—the seller could pay the potential buyer up front or could agree to pay if the deal falls through, either because it or the buyer decided not to consummate the transaction.

The first half of the transaction—the option—is straightforward. The second—the lockup—is less so. The seller faces two information problems. First, there is a possible information asymmetry with potential buyers fearing that the seller might take advantage of the information she developed while the property was in her possession. Potential buyers might discount their bid because of their fear that they might be buying a lemon.\textsuperscript{12} The seller has a number of devices, none of them free, for providing quality assurance to purchasers. She might collect and publish information; she might provide specific representations and warranties; she might make some of the sale price contingent on the future earnings from the property.\textsuperscript{13} Or she might choose to subsidize the production of information by one (or possibly more) potential buyer(s). Straight cash payments would not be the best way of accomplishing this, but let us put that aside for the moment. The simple point is that if the new information sufficiently enhanced the seller’s credibility, the seller could receive more from the enhanced sale price of the land than it would lose from the payment to the prospective buyer. That is, the exercise price of the option is higher because the buyer and seller both know that if the property turns out to be less desirable, the buyer can walk away.

Second, given that the value of the land is uncertain and information about the value is costly to produce, the owner might not be in the best position to develop the information. The


\textsuperscript{13}See Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L. J. 239.
information might be on general matters of interest to most potential buyers, for example, soil conditions, traffic patterns, or the availability of potential anchor tenants. Or the information might be more specific to particular potential purchasers, for example, financing conditions or the availability of particular anchor tenants closely linked with a specific potential purchaser. If the buyer is the most efficient producer of this information, then, again, the seller might be willing to pay some of the buyer’s expenses if doing so would increase the sale price by enough.

Why might sellers choose to make the payment indirectly, linking it to the option to buy, rather than simply paying cash? If the buyer’s information costs are high, then the buyer must consider the real possibility that the expenditures would be for nought if the seller subsequently refused to sell. Even if the information were valuable only to the first buyer (say, the architectural plans and economic feasibility study for a unique structure), the buyer might be reluctant to incur the costs if the seller could sell to someone else or could take advantage of the buyer’s sunk cost when negotiating the sale price. Potential buyers will balance the expected costs of additional information production against the expected benefits. If the seller can subsidize information production by certain buyers or otherwise increase the likelihood that the buyer would reap the rewards of its investment, it can influence the quantity and quality of the information produced. In particular, the seller must decide whether it prefers a large number of potential buyers each spending a small amount on information or a small number (perhaps one) studying the asset more intensively.

The seller might be able to use some of the information developed by the prospective buyer to its advantage in dealing with subsequent potential purchasers—in effect free riding on the first prospective buyer’s efforts. If, for example, Mattei had identified some retailers with a strong interest in being anchor tenants, Ms. Hopper or a third party could approach those retailers directly. Later buyers could either use the information or draw some inferences about the content of the information from the first party’s behavior. The potential purchaser must fear that others would free ride upon the information it produced, and without assurances or subsidies would likely produce too little information. Again, by providing those assurances or subsidies, the seller can influence the buyer’s production of information.

Direct cash payments to the buyer would, in general, not work. Such payments would create two obvious moral hazard problems. If the seller pays for information while buyers determine how much to produce, the buyers will not bear the financial responsibility for their investment decisions; they will have an incentive to overspend. Moreover, the buyers would be reluctant to share the information with others; they would also be more inclined to tilt their information production toward information that would be of more value to them than to other possible buyers. A seller might be able to police this behavior by monitoring or by separating the production of information from the use of it (perhaps by insisting upon fire walls or by hiring information specialists who cannot benefit directly from the information generated). But if the potential buyers are indeed the best producers of information, the separation of ownership from use can be costly.
The lockup provides an opportunity for a buyer to develop the information secure in the knowledge that if the information is positive, he will be able to reap the rewards. Mattei is free to explore the matter for 120 days and, if satisfied, he can buy Hopper’s property for $57,500. The option means that if the value exceeds the strike price, all the benefits go to the buyer. If the information is negative, the buyer can refuse to exercise the option. It will, however, be out of pocket the information costs. Thus, the first moral hazard problem is resolved. The seller bears some of the information cost in the negotiated exercise price, but the buyer bears all the direct costs of information production and, therefore, has the incentive to economize. The cost of the option to the buyer is its expected expenditure on information. True, he does not promise to spend a dime on information production or to act upon any information produced. The seller’s reward comes not from the buyer’s explicit promise to produce information, but from the reward structure established by the bargain. This moral hazard problem explains why the net price of the two transactions often ends up being zero. Sellers do not want to overpay for the information. In effect, the net price of zero sets a limit on the amount of effort the buyer should put into the search.

The satisfaction clause suggests an all-or-nothing outcome. Either the buyer is satisfied and the option exercised, or he is not and the option expires. Good faith is obviously irrelevant in the former case; what about the latter? If we unpack that, it becomes clear that good faith adds almost nothing. Suppose that in the 120 day period after Mattei’s deposit, the real estate market crashed and Mattei then chose not to exercise his option. One could argue that the non-exercise of the option because of adverse market conditions was bad faith, but that is a flimsy argument. After all, if the value of the property falls, the quality of the leases (that is, their economic value) falls too. Unless we insist that the contract meant that Mattei must be satisfied with the leases with rents determined on the date he and Hopper entered into their agreement, Mattei should be able to take into account changed market conditions when deciding whether or not to go forward with the sale.

If the information were only moderately disappointing, the buyer could make an alternative offer (perhaps waiting for the official expiration of the option). Nothing in the nature of the option precludes a subsequent sale to Mattei (or another buyer) at a new price below the exercise price. Of course, if Mattei’s research gives him an informational advantage, he could exploit this advantage by acting strategically. Suppose that he finds the property worth a bit more than the exercise price. He could feign disappointment, telling Hopper that he cannot exercise his option, but that he would be willing to purchase the property at a new, lower price. Such strategic behavior might be less than admirable, but it is hard to imagine that it could trigger good

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14One line of argument, developed in Kenneth French & Robert E. McCormick, Sealed Bids, Sunk Costs, and the Process of Competition, 57 Journal of Business 417 (1984), suggests that sellers invariably bear all the costs of pre-sale information production. As I show elsewhere (Goldberg, Gold Ring, n. 11, at 475-481), they overstate the case. Nonetheless, it is correct to say that sellers will often find it in their interest to help potential buyers economize on their pre-sale information expenditures.
faith concerns. The questionable behavior occurs only in the renegotiation of the contract and the seller is hardly without recourse. If the seller were suspicious, after all, she maintains the right to refuse to sell to this buyer at any price below the initial contract price; she could shop the second offer to other potential buyers who might be able to draw some inferences from the original buyer’s behavior.

In both cases, Mattei’s decision not to go forward with the purchase would be the result of his having already performed his part of the agreement; that is, he would have acquired information on the value of the leases and acted upon the information by choosing not to exercise his option. What if Mattei had produced no information at all? If a better offer came along, the fact that Mattei had not yet spent anything searching for information about the parcel should not destroy Mattei’s option. Surely, the buyer had bought the option to act on good news and the external offer is simply a manifestation of that good news. The only concern would be that Mattei for some reason wanted the property off the market and had no intention to either acquire information or consummate the deal. Perhaps Mattei entered into similar agreements on a number of parcels but only intended to purchase one. Even then, there was some likelihood that he would choose this particular parcel, so it would be unreasonable to characterize this as merely an attempt to put a parcel off the market for a period of time. It is difficult to imagine a plausible scenario in which a buyer would simply tie up a property with no intention of moving forward. Yet that class of cases is the only one in which even a plausible case can be made for holding that the buyer’s discretion undercut consideration. And then the legal response should not be “no contract;” rather, if anything, there should be a claim by the seller for fraud.

The foregoing is a somewhat convoluted path to a simple point. The seller and buyer both benefitted from the agreement, regardless of whether the buyer’s discretion was limited by good faith. It was limited by a more significant, practical constraint, self-interest. The lock-up benefitted Hopper by increasing both the probability that the land would be sold by a certain date and the expected price of the asset. It benefitted Mattei by giving him a pure option and by giving him assurance that if he chose to expend resources on evaluating the property (as he most likely would, else why bother?), then he could purchase the land at the preset price if the information turned out positive. There is a bargain; both sides benefit and the seller suffers a detriment (her property is temporarily tied up). The buyer does not directly suffer a detriment, since he has the discretion to do nothing, even though exercising that discretion would almost certainly not be in the buyer’s interest.

The contract could have left Mattei’s decision to his sole discretion thereby making it a pure option. What purpose could be served by adding the satisfactory lease clause (or satisfaction with engineering studies, approval of subdivision maps, etc.)? Such clauses can be viewed as a device for conveying information to the seller about the buyer’s intentions. If the seller knows

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15 For a case in which the plaintiff alleged that the defendant entered into an option-like agreement with no intention of going forward, see Locke v. Warner Bros. 57 Cal. App. 4th 354, 66 Cal Rptr. 2d 921 (1997).
that the buyer’s intended use is a shopping center, that information will affect the strike price of the option. The clause’s effect is similar to a buyer’s representation. Suppose, however, that Mattei had no intention of building a shopping center and that his real intent was to drill for oil (and that the land was much more valuable in that use). It could be argued that this deception should be actionable, perhaps as fraud, misrepresentation, or a breach of the implied covenant of good faith. But that is a far cry from concluding that there was no contract.

The option terminology suggests that the discretion be unbounded, but that need not be the case. The parties can, if they so choose, limit that discretion in various dimensions. They could even contract into a good faith standard, however nebulous that might be. Indeed, the default rule could be that the discretion is constrained by good faith so that the parties would have to contract around it. My concern is twofold: (a) by making the buyer’s good faith a necessary element of the contract (else no consideration), the doctrine needlessly raises good faith from a default rule to a mandatory rule, waivable only by concocting an alternative basis for enforceability (cash consideration or, that great wild card, reliance); and (b) absent an understanding of the context, good faith does not provide a coherent constraint on the buyer’s discretion.

II. Bloor v. Falstaff

The owners of Ballantine beer (IFC) sold Ballantine’s brand name and distribution network (but not the brewery) to Falstaff, another brewer, for $4 million plus a 50¢ per barrel royalty for beer sold with the Ballantine brand name for a six year period. Had Falstaff maintained Ballantine’s sales volume the royalty payment would have been over $1,000,000 per year. Falstaff agreed to use “best efforts” to promote and maintain a high volume of sales and further agreed to pay liquidated damages in the event of a substantial discontinuance of distribution under the Ballantine brand name. The seller subsequently went bankrupt and the bankruptcy trustee sued Falstaff under the contract claiming that Falstaff had not used “best efforts” in promoting Ballantine and that it had substantially discontinued production, thereby triggering the liquidated damages clause. The court found for the plaintiff on the first point, but not the second. The opinion has been well-received, with commentators generally agreeing that Falstaff’s breach was so egregious as to not provide much of a test of the boundaries of “best efforts.” Farnsworth, for example, says: “Unfortunately, its decision did relatively little to add precision to the meaning of 'best efforts,' since Kalmanovitz [of Falstaff] fell so far short of the mark.”

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Judge Friendly held that the “best efforts” clause required Falstaff to generate sales of Ballantine beer even if that came at the expense of Falstaff’s profits.

While [the best efforts] clause clearly required Falstaff to treat the Ballantine brands 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 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. . . . Clause 8 imposed an added obligation to use “best efforts to promote and maintain a high volume of sales. . . .” Although we agree that even this did not require Falstaff to spend itself into bankruptcy to promote the sales of Ballantine products, it did prevent the application to them of Kalmanovitz’ philosophy of emphasizing profit uber alles without fair consideration of the effect on Ballantine volume. Plaintiff was not obliged to show just what steps Falstaff could reasonably have taken to maintain a high volume for Ballantine products. It was sufficient to show that Falstaff simply didn’t care about Ballantine’s volume and was content to allow this to plummet so long as that course was best for Falstaff’s overall profit picture, an inference which the judge permissibly drew. The burden then shifted to Falstaff to prove there was nothing significant it could have done to promote Ballantine sales that would not have been financially disastrous.18

The evidence was sufficient to convince the court that Falstaff had not tried hard enough to generate sales of Ballantine beer.

Judge Friendly takes it as axiomatic that the contract required Falstaff to trade off its profits for Ballantine’s sales. Conspicuous by its absence in the decision is any analysis of why the contract included the royalty arrangement and the best efforts covenant. That is not entirely his fault, as the record was completely silent on this point. So, we are left with the somewhat peculiar spectacle of a court giving meaning to a context-sensitive phrase with no guidance as to the context. Had the court recognized that the royalty was, in effect, an “earnout,” ancillary to the one-shot sale of some of Ballantine’s assets to Falstaff, the outcome would have (or, at least, should have) been different.

An earnout makes part of the payment for an asset contingent upon some measure of future performance. Often it is a function of profits; here it is a function of sales. Most corporate acquisitions do not involve earnouts. In 1998, of the over 9,000 acquisitions only 153 included an

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18At 614-5.
Earnouts rarely show up in appellate litigation—a Lexis search found only 42 cases. That might not adequately indicate the frequency with which they generate disputes. I suspect, based in part on my consulting experience, that the disputes are far more common, but that they arise in arbitrations, not litigation.

IFC was, essentially, selling two assets—Ballantine’s brand name and its distribution network. Its purpose was simple. It wanted to sell at the highest price. Other things equal, the fewer post-sale restrictions on Falstaff’s exploitation of the assets, the more Falstaff would be willing to pay. That should be obvious, but the court’s failure to recognize this basic point is the core of the problem. Falstaff’s pursuit of “profit uber alles,” ex post, redounds to IFC’s benefit, ex ante. So, any restriction, like the best efforts clause, immediately raises a red flag: how might the particular restriction raise the value of the Ballantine assets, ex ante?

The earnout was a response to the problem of asymmetric information. In some earnouts, the managers of the seller are expected to provide services to the buyer—the earnout serves a role similar to a covenant not to compete. That was not the case here, as the IFC managers were real estate people with no useful knowledge about the beer industry and no intent to stay in the business. IFC was certifying the quality of the Ballantine assets. In sales of complex assets the seller typically has more information than the prospective buyer. If buyers cannot distinguish good assets from bad, then they are likely to be suspicious of any particular asset and to reduce their offer price accordingly. Sellers can get a better price if they can convince buyers of the quality of the asset. There are myriad ways of providing assurance. The seller can provide extensive representations and warranties; the buyer can engage in extensive due diligence investigation. The parties have an incentive to economize on the joint production of information. By accepting some of its compensation in a contingent form, the seller provides some assurance to the buyer of the quality of the asset.

The parties want an arrangement which maximizes the value to the buyer ex ante. But producing information and assurance is not costless. The process of maximizing the value of the asset can reduce the size of the joint pie. That would obviously be true if the parties had spent months negotiating elaborate representations and warranties and/or engaging in a due diligence investigation. In this instance the parties avoided all these costs using the royalty payment

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19 For the number of deals, see 1998 M&A Profile 33 Mergers & Acquisitions 42 (March/April 1999). For the number including earnouts, see Deal Structuring: Earn-Outs Get Into More Deals, 33 Mergers & Acquisitions 35 (March/April 1999).


21 In the last year I was involved, briefly, as a potential expert witness in two arbitrations concerning the interpretation of an earnout clause.

22 See Gilson, note 13, 262-4.
instead. It, too, is not costless. Earnouts in general have a number of value-reducing features. They do not track value perfectly; they can distort incentives; and they are not strategy-proof—that is, the buyer can operate the business in a way which exploits the mechanism. For example, if an earnout based on profits in the first three years, the buyer can make investment decisions which shift profits from the third to the fourth year. Anticipation of these costs will influence the final price of the asset.

The Ballantine royalty had the potential to alter Falstaff’s incentives in two ways. First, the royalty acts as a tax (roughly 2%) on sales which could induce Falstaff to market a somewhat smaller amount of Ballantine product than it would have, but for the royalty. So “best efforts” might possibly mean that Falstaff should push its sales effort a bit beyond the point that would otherwise be optimal, ex post. The distortion of incentives (which in this instance is quite minor) is a common problem in contingent compensation arrangements (franchise fees, percentage leases, oil and gas royalties, and so forth) and “best efforts” is just one of the devices for dealing with the problem.

The relatively low “tax” suggests that this was not the concern of the parties. The more likely concern was diversion: there were two assets being sold and the earnout only tracked one of them. If Falstaff could use the distribution network to sell Falstaff rather than Ballantine, the royalty would not track the value of the asset. The “best efforts” requirement could be viewed as one contractual device for protecting against this sort of diversion. But the context suggests how the clause should be read. “Best efforts” in this context means that Falstaff agreed that in its pursuit of “profit uber alles” it would not opportunistically divert sales from Ballantine (the sales of which were to track asset quality) to Falstaff. And that poses the central question: Did Falstaff use the network to divert more sales than the parties should reasonably have expected? That might be a difficult question to answer for some fact patterns, but for the facts of this case the answer is easy and negative. When Kalmanovitz took charge he dismantled the distribution system. Falstaff did not divert resources to the more profitable brand, it simply terminated (or at least drastically pared) a project that did not work.

So, we are left with two plausible meanings of “best efforts” in the context of this transaction. First, it could be aimed at correcting Falstaff’s incentives which were a bit distorted by the royalty “tax.” Second, and more plausible, it could have been an attempt to limit diversion of revenue away from the device chosen to provide assurance of that value. Neither of these provides a basis for concluding that Falstaff’s pursuit of profit uber alles by revising its Ballantine marketing strategy and dismantling much of the Ballantine distribution network violated its obligation to Ballantine.

How to explain the liquidated damages of $1.1 million per year in the event of Falstaff’s substantial discontinuance of Ballantine? If this proviso was included as part of the quality

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23Ballantine’s 1970 price was $26.60 per barrel (PX 9 at 1618) and the royalty rate was 50 cents per barrel.
assurance mechanism, as I first thought, it makes no sense. In effect, it says: if the assets are really terrible so that they are unusable, then Falstaff pays Ballantine $1.1 million per year for the duration; if on the other hand, they are only pretty bad, Falstaff pays less. That is a perverse result, which I thought, could only be explained by poor drafting.

However, the clause makes more sense if it is viewed as being independent of the quality of the brand name and instead concerns diversion of revenues from the exploitation of Ballantine’s distribution network. With this reading Falstaff says, in effect: We agree that we will not cheat you by diverting receipts from the metering device (Ballantine sales) and profiting by the use of the other valuable asset we have purchased, your distribution network; if we have done too much diversion, we agree to pay a penalty (although the law does not permit us to call it that). The trigger for the penalty would not be the quantity of Ballantine sold nationally, which is what the court focused on in ruling that there has not been a substantial discontinuance. Rather, it would be the percentage of Ballantine being sold through the old Ballantine network.

But this mechanism had one big hole. What if the network itself turned out to be of little or no value, as was in fact the case? Falstaff essentially abandoned the network, but continued to exploit the brand name as best it could. If the proviso’s purpose was to thwart massive diversion of revenues, there was no diversion. Falstaff bore the direct risk of the distribution network being a lemon; it seems unlikely that ex ante the parties would have wanted Falstaff to post an additional bond against that prospect. But, and this must be emphasized, it is most likely that neither party expected the distribution network to be worth so little, and the contract reflected their failure to anticipate this possibility.

III. Concluding Remarks

Two anecdotes do not a theory make. The analysis of these cases is only meant to illustrate the value of adopting a more transactionally sensitive perspective in contract litigation. I am not advocating that we try to ascertain the parties’ true intent, a process Judge Easterbrook once characterized as inviting “a tour through Walters’ cranium with Walters as the guide.”

Certainly, in Mattei the parties were using forms and were largely unaware of the implications. And the lawyers drafting the Ballantine contract no doubt gave little attention to the possible meaning of “best efforts,” a phrase they threw around liberally, using it six other times in the agreement. The point is that the context of the transactions should constrain the court in interpreting what reasonable parties could (and should) have meant. An interpretation of a contract which begins with the presumption that the seller intended to restrict the buyer’s subsequent use of the asset is bound to fail unless there is an understanding of the possible gains from tying the buyer’s hands. Had Judge Friendly understood that—and I must emphasize that the litigators gave him no help whatsoever—then Falstaff would have been an easy case, but for the

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24Skycom Corp. v. Telstar Corp., 813 F.2d 810, 814 (7th Cir. 1987).

other side.

The case law is American, but the problem is universal. And the solutions—the option/lockup and the earnout/royalty—are sufficiently obvious that I would be most surprised if they were not in common use outside the United States. I would speculate that the fit between what the parties do and the legal system’s accommodation of their needs will be no better in the non-American legal systems; Falstaff would probably have fared no better elsewhere. I hope that this brief essay will encourage a comparative analysis confirming my expectations on both fronts, and that such research might help nudge the doctrine in the proper direction.