2000

Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith

Victor P. Goldberg
Columbia Law School, vpg@law.columbia.edu

Columbia Law School
The Center for Law and Economic Studies
435 West 116th St.
New York, NY 10027-7201

Working Paper No. 176

Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith

Victor P. Goldberg
Columbia University
School of Law

August, 2000

Discretion in Long-Term Open Quantity Contracts: **Reining in Good Faith**
Victor P. Goldberg

Long-term contracts often promise to deliver the seller's full output, the buyer's requirements, or some variation on these. For example, an electric utility might enter into a thirty year contract with a coal mine promising that it will take all the coal needed to supply a particular generating plant. These open quantity contracts have raised two issues. The first has been whether the promise was illusory. If the utility had no duty to take any coal, a court could have found that there was no consideration and, therefore, no contract. While there was a time when full output and requirements contracts did not fare well on this ground,[1] nowadays their validity is rarely challenged with success.[2]

The second and more interesting question today concerns the interpretation of the quantity term. What, if anything, limits the buyer's discretion? The answer, both at common law and in UCC §2-306(1), has been "good faith."[3] The Code's Official Comment claims that §2-306 entails "the reading of commercial background and intent into the language of any agreement."[4] In fact, it does nothing of the sort. Rather, it often involves supplanting the parties' careful balancing of various concerns in the initial contract with a wooden, uninformed reading of the

---

[1]See, for example, Bailey v. Austrian 19 Minn. 535 (1873) and Crane et al. v. C. Crane & Co., 105 F. 869 (7th Cir. 1901). American Trading Co. v. National Fiber & Insulation Co. 111 A. 290 (1920) provides an extensive list of early cases finding contracts void for want of mutuality; that case is discussed below, at note ?. For a more inclusive listing, see Mutuality and Enforceability of Contract to Furnish Another With His Needs, Wants, Desires, Requirements and the Like, of Certain Commodities, 26 A.L.R. 2d 1139. See also, Havighurst & Berman, Requirements and Output Contracts, 27 Ill. L. Rev. 1, 23-24. (1932). For a suggestion that the judicial hostility was overstated, see See Walter F. Pratt, Jr., American Contract Law at the Turn of the Century, 39 S.C. L. Rev. 415 (1988) and Stacy A. Silkworth, Quantity Variation in Open Quantity Contracts, 51 U. Pitt. L. Rev. 235 (1990).

[2]For one of the few successful challenges, see Propane Industrial, Inc. v. General Motors Corporation, 429 F.Supp. 214 (1977) (discussed below at note 43).

[3]§2-306(1). The UCC already imposes an implied, nonwaivable covenant of good faith and fair dealing. So, the explicit mention of good faith in §2-306 would seem redundant. It likely reflects the importance of "good faith" in resolving the illusory promise problem of an earlier era. In the May 1999 proposed revision, the provision is renumbered as §2-304 with some minor changes in wording that do not help. The American Law Institute approved the draft in May 1999. However, the National Conference of Commissioners on Uniform State Laws (NCCUSL) tabled it in July 1999. The Discussion Draft of April 14, 2000 restores the original number and makes no revisions.

[4]UCC §2-306, Comment 1.

agreement. With no theory to guide them, courts have held that good faith required that producers behave in most peculiar ways–for example, running a plant at below full capacity for the life of the contract, or running the plant to satisfy the needs of its waste remover rather than its customers.

This second question is the focus of the present paper (although I will give some attention to the first as well). The paper is part of a larger project, the intent of which is to make contract interpretation more transactionally sensitive.[5] It is the most ambitious of the papers thus far, as it examines a much broader set of cases than had its predecessors. Here, the central concern is the allocation of discretion to one party to respond to changing circumstances and the constraints placed on that flexibility to protect the counterparty's reliance interest.

Long-term contracts cannot completely specify in advance all the obligations of both parties over the life of the agreement.[6] In order to adapt their relationship to changing circumstances they will find it necessary to give one, or both, parties the discretion to respond as new information becomes available. In particular, they might find that shifting supply and demand conditions would be better met by giving one party the discretion to vary quantity. Suppose that the party with discretion is the buyer, as in a requirements contract. The seller would have two concerns. First, the buyer could use its discretion opportunistically to rewrite the contract.[7] Second, if the seller intended to make decisions in reliance on the continued performance of the buyer, it would want a means of conveying the extent of that reliance, perhaps by setting a minimum quantity or establishing a multi-part pricing regime. In effect, it wants to confront the buyer with a price reflecting the extent of its reliance. If that price is set too high, both parties lose. It is in their joint interest to fine-tune the protection of the reliance; and as we shall see below, they can be quite good at it. The generous interpretation of good faith parallels the expansion of liability under §90 of the Restatements.[8] The courts have used good faith as a blunt

---

[5]See Victor P. Goldberg, Bloomer Girl Revisited or How to Frame an Unmade Picture, 1998 Wis. L. Rev. 1051; Victor P. Goldberg, In Search of Best Efforts: Reinterpreting *Bloor v. Falstaff*, __ St. Louis University Law Journal __(2000); and Victor P. Goldberg, Economic Reasoning and the Framing of Contract Law: Sale of an Asset of Uncertain Value, 92 Revue d'Economie Industrielle 111 (2000).

[6]Complex contracts could have more than two parties, but the contracts of concern in this paper will be two-party contracts.

[7]This is the central theme of Steven J. Burton & Eric G. Andersen, Contractual Good Faith. "[I]n commercial cases . . . discretion in performance may not be used to recapture opportunities foregone when contracting." (At 127)

[8]See Farnsworth on Contracts at §2.19. A recent survey of the case law suggests that the judicial acceptance of reliance as a basis for enforcing contracts has been overstated; see Robert A. Hillman, Questioning the "New Consensus" on Promissory Estoppel: An Empirical and

instrument for providing protection to one party's reliance without asking whether that party would have been willing to pay for such protection in the first place.

A contract grants one party discretion for a reason. The reason might not always be obvious, and it might not be a very good reason, but, as in most other areas of contract law, the courts should defer to the judgment of the parties. If it turns out that the buyer has no requirements or the seller chooses to produce no output, so be it. Such a rule would encourage the parties to determine at the time of contracting how they would constrain the discretion. The invocation of good faith should be unnecessary or at worst it should be read narrowly to recognize one exception.[9] If the contract linked the buyer's requirements to the needs of a particular plant, sale of the plant or the firm would terminate the requirements of the *buyer*, although the *plant* would continue to have requirements. The buyer could attempt to avoid the consequences of a bad bargain by such an opportunistic sale. Even in these situations, parties can (and do) contract to deal with just such behavior, so at most the exception would serve as a default rule to protect casual or careless contractors from themselves. Ironically, the UCC does not preclude this form of opportunism.[10] As we shall see below, the courts have had difficulty distinguishing the buyer who no longer has requirements because it had sold its plant from the buyer who had closed the plant.[11]

Commentators have converged on the implications of the good faith standard for open quantity contracts. According to Silkworth, "[c]ourts consider two related factors in deciding these cases. First, courts will uphold quantity variations if they find a valid business reason that justifies the variation. Second, courts will disallow a quantity variation and award damages where

---

Theoretical Study, 98 *Columbia Law Review* 580 (1998).

[9]The discretion/reliance problem has traditionally been lumped with two other classes of cases involving open quantity terms. In some contexts, quantity discretion is, in effect, an implicit excuse clause. A grower agrees to sell its entire cotton crop before it is harvested; see, for example, Riegel Fiber Corporation v. Anderson Gin Company, 512 F.2d 784 (5th Cir. 1975). Or, relatedly, the variability might be meant to accommodate the discretion of a third party, as in Atlantic Track and Turnout Company v. Perini Corporation 989 F.2d 541 (1st Cir. 1993). If bad weather results in a small crop or if the third party chooses not to go forward, the promisor's obligation is pared back. The second class involves jobbers who purchase large quantities of goods when the market price exceeds the contract price; see, for example, the textbook favorite, Oscar Schlegel Manufacturing Company v. Peter Cooper's Glue Factory 231 N.Y. 459; 132 N.E. 148 (1921). These cases are analytically different and are beyond the scope of this article.

[10]"When an enterprise is sold, the question may arise whether the buyer is bound by an existing output or requirements contract. That question is outside the scope of this Article, and is to be determined by other principles of law." UCC §2-306, Comment 4.

[11]See Section III.

they find that the quantity determining party has attempted to manipulate the contract in light of a contract price and market price disparity."[12] Similarly, in their treatise on *Contractual Good Faith*, Burton and Andersen state: "Most cases involving the obligation to perform in good faith can be synthesized using the following principle: a party performs in bad faith by using discretion in performance for reasons outside the justified expectations of the parties arising from their agreement."[13] The problem with both formulations is that they do not provide a framework for inferring the valid business reasons (Silkworth) and reasonable expectations (Burton & Andersen) that would define the contours of good faith. Indeed, once the analytical framework is understood, it is clear that "good faith" does no work.

What follows is a tour through the case law with three different concerns in mind. First is an analysis of the decisions on the merits. Second, the decisions provide some evidence on how the parties cope with the problem of harnessing discretion. The evidence, however, is often not very good, which leads to my third concern: The quality of the evidence is poor because the courts ask the wrong questions and adduce the wrong evidence. The exercise will, I hope, provide further support for framing contract law questions with more attention to the underlying economics of the transaction. Paradoxically, while I look more deeply at the economics than the courts have done, the moral of the exercise is that courts should look even less. With the possible exception of the sale-of-plant cases, courts should just say Yes.

I begin by drawing upon an earlier study of mine of petroleum coke contracts[14] to illustrate the nuanced allocation of discretion regarding quantity determination. Section II analyzes some cases involving long-term contracts in which the contract's validity was questioned for want of mutuality. Sections III and IV analyze contracts in which the requirements were reduced to zero (or nearly so). The first of these focuses on the problem of the buyer transferring the underlying asset, and the second analyzes a set of cases in which the promisor found a drastic cutback to be the best course of action. Section V concerns contracts in which an attractive contract price induced the buyer to increase its requirements (or a seller its output). Section VI concludes.

I. Quantity Variation in Long Term Contracts: An Illustrative Example

---

[12]Silkworth, note 1 at 236. See also Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 J. Legal Studies, 271, 298 (1992) and Mark P. Gergen, The Use of Open Terms in Contract, **92** Colum. L. Rev. **997**, 1070.

[13]Burton & Andersen, note 7, at 57.

[14]Victor P. Goldberg and John Erickson, Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke, 30 J. of Law & Econ. 369 (1987).

To facilitate adaptation to changed circumstances, long-term contracts typically allow one party some discretion regarding quantity, requirements and output contracts being extreme forms. Even in these, the discretion will not be unbounded. One limitation on discretion is physical. A contract, for example, would not require the seller to provide whatever quantity of widgets the buyer desires. Rather the seller would commit to providing widgets the buyer needs for a particular purpose or to supply a particular plant. The capacity of the buyer's plant would place an outer limit on the buyer's discretion. There are numerous devices for constraining discretion. The contract could set up a mechanism, requiring, for example, that changes be ratified by both parties. Or it could give one party the power to determine output, confronting that party with a cost if it were to change the quantity in a way that would affect adversely the counterparty. If Y is the party with discretion, other things equal, the greater X's reliance, the greater the price Y must pay for quantity adjustments adversely affecting X. The law, as currently embodied in §2-306(2), provides a set of default rules and barriers to surmounting them. The Code exhibits a lack of faith in the ability of the contracting parties to fine-tune the protection of the counterparty's reliance. In fact, their ability to fine-tune is quite impressive, much better, I would assert, than courts invoking good faith after the fact. In this Section, I will illustrate how the reliance-flexibility tradeoff varies with the context, analyzing quantity variation in contracts for a particular product—petroleum coke in a particular period (pre-1970).[15]

Petroleum coking is a process that takes the heavy residual oils left over from the initial distillation of crude oil, producing gas oil (which can be further processed into lighter, higher valued, fuels like gasoline) and petroleum coke. In 1970 there were 53 cokers in operation at refineries in the United States. About 15% of the crude oil refined in the United States was coked. The coke was a waste product of the refining process, bulky and a source of pollution. However, it had some value, particularly to the aluminum industry. Calcining the coke made it an excellent conductor of electricity and the calcined coke was used to make anodes for the electrolytic cell reduction of alumina to aluminum. Its value in this use was enough so that owners of calciners were willing to pay the refineries a positive price to take the coke off their hands.[16]

Great Lakes Carbon Corporation (GLC) owned a dozen calciners, selling the calcined coke to end users. GLC had storage capacity at ten different locations which could hold about an eighteen month supply of raw coke. In the late 1950's end users, primarily aluminum companies, began building their own calciners. Most, but not all, the aluminum companies' output was for internal use; some, however, was sold to other end users. These calciners were, for the most part, built in conjunction with new cokers.

---

[15]This Section is based on Goldberg and Erickson (note 14).

[16]Only high quality (low sulphur) coke was calcined. Low quality (high sulphur) coke also usually sold at a positive price, albeit a much lower one. It was used primarily for fuel in utility boilers and cement kilns.

The contracts between the refineries (cokers) and the calciners varied considerably in the way they allocated responsibility for the quantity decision, the variation reflecting the concerns of the parties. When, for example, a refinery added a new coker, it wanted some assurance that the accumulation of coke would not unreasonably interfere with the operation of the refinery. But assurance is costly, so the refinery would have to weigh the benefits of additional assurance against the costs. For the GLC contracts this weighing generally resulted in granting the coker complete discretion to produce any quantity of coke (including zero). However, the results were dramatically different for the end user contracts.

GLC entered into ten long-term contracts with refineries building new cokers in 1946-61.[17] The cokers' capacity was less than that of GLC's calciners which, typically, were supplied by half a dozen or more cokers. The refineries had little storage capacity, so if the coke were not removed promptly, the refinery might have to shut down its coking (and perhaps its refining) operation entirely. GLC, on the other hand, had considerable storage capacity so that it could immediately remove coke from the refinery and store it rather than processing it immediately. Its ample storage capacity enabled GLC to adapt with ease to fluctuations in the quantity of coke produced at individual refineries. As a result, almost all the GLC contracts were full output/immediate removal contracts with GLC bearing all the risks of quantity variation. The coker was obligated to sell only if it produced, but the decision as to whether it should produce (and if so, how much) was entirely in the hands of the refinery. A failure to remove the coke rapidly enough would constitute a breach of GLC's obligations.

It is tempting to claim that this allocation of discretion is obvious. The seller is, in effect, contracting for removal of a waste product, one accounting for less than three percent of the value of the refinery's product; it seems logical that its production decisions would be based on the market for its product, not for its waste. Examination of the contracts with the aluminum companies shows that this is too simple. The aluminum contracts concerned the simultaneous construction of a new coker and new calciner. The calciners were located near the cokers, often sharing the inventory pile. Unlike GLC, the aluminum companies could not rely on multiple sources (including inventories) of coke. They were dependent upon a particular refinery, just as the refineries were dependent on them for removing coke. In none of the contracts did the buyer promise to take all the coker's output. Nor did the contracts go to the opposite extreme by obligating the cokers to meet the calciner's requirements. Rather the contracts specified a minimum quantity, granted the buyer (calciner) some discretion in varying that quantity (up or down), and provided some mechanism to convey to the calciner the extent of the coker's reliance. Thus did the parties fine-tune the protection of their respective reliance interests.

The contracts accomplished this in different ways. In one instance the buyer agreed to pay a "standby" charge of $75,000 per month, which obligated it to pay for about 40% of the coke,

[17]Nine of the ten were for at least ten years.

whether it took any or not. In effect, if not in name, this amounted to a "take-or-pay" clause.[18] In other contracts, the price per ton was higher for the first, say, 35% of the contract quantity than for the remainder. The low marginal price encouraged the buyer to take more, thereby giving some protection to the seller's reliance. One contract allowed the buyer to reduce its take if there were external evidence of a decline in the demand for its aluminum, the reduction being shared by the parties by formula. The buyer in that contract did, however, agree to pay fifty percent of the contract price whether or not any coke was produced (take-or-pay, again). While the mechanism varied, the basic format was the same. The calciner determined the quantity, but the coker's interest was conveyed by confronting the calciner with a cost if it were to take less than the contract quantity.

Two contracts between Union Oil and Collier illustrate how the availability of storage capacity could influence the allocation of decision making with regard to quantity. Both were for the construction of an adjacent coker and calciner. Both were for full output and gave the refinery the option of suspending, reducing, or discontinuing the production of coke. The storage capacity at the two sites differed considerably, however, with one having a two-year capacity, while the other was able to store less than six months production of coke,. At the former, the stockpile was the calciner's only protection from supply disruptions. It bore the risk that in the early years Union Oil would not find it worth its while to produce enough coke to maintain the inventory stockpile. The latter contract gave the buyer more assurance of continued supply and also provided less assurance of removal. The contract called for a minimum quantity over the ten year life of the agreement of roughly forty percent of the coker's capacity. If the seller discontinued producing coke, it agreed to make up the deficiency with coke of similar quality from other sources at the contract price. If the coke at the refinery accumulated beyond a certain point and Union desired to continue coking, it could solicit outside offers. Collier had a right of first refusal. If there were no outside offers, then Union could force Collier to remove the coke; however, Collier would only have to pay fifty percent of the contract price. Thus, when deciding whether to produce additional coke, Union had some incentive to take into account the buyer's difficulties of disposal.

So, although the contracts were all for the same product, petroleum coke, the allocation of discretion was dictated by the context. Where the calciners had ample storage capacity, the quantity decision was in the hands of the cokers (the pure full output contracts). Where calciners had little storage capacity and alternative suppliers were problematic, the cokers relinquished their discretion, giving the calciner the final say. However, none of the agreements gave the buyer unbridled discretion (as would a requirements contract). The calciner's freedom to alter the quantity taken was typically circumscribed to take into account the coker's reliance. Of course, the law, by reading good faith into the contract, would have placed some limits on the buyer's discretion under a requirements contract. The negotiated limits on buyer discretion were different from, and far more nuanced than, those arising from the good faith standard.

---

[18]Take-or-pay clauses are misnamed. The buyer agrees to pay for a fixed quantity regardless of whether he in fact takes it.

II. Mutuality

Economic actors often attempt to arrange their affairs so that there is no enforceable promise. For example, early automobile franchise agreements were held unenforceable for want of mutuality. The auto manufacturers could have redrafted to resolve the technical problem but chose not to do so since they preferred that their arrangements be terminable at will.[19] It is important to remember that one, or both, parties will often desire that their relationship not be treated as an enforceable contract, although it is doubtful that constructing the relationship so that a court would find a lack of mutuality is a sensible way to achieve that goal.

Mutuality is often invoked strategically by a party who was quite content to have the contract enforceable at the time of formation, but was looking for a rationale for not performing when things turned out not to her liking. Such opportunistic challenges against long-term contracts on the ground that mutuality is lacking seldom succeed anymore.[20] For an egregious (and venerable) example of a court validating such an opportunistic ploy, consider *Northern Iowa Gas & Electric Co. v. Incorporated Town of Luverne, Iowa*.[21] A power company entered into a twenty-year contract to provide electricity in an amount "to answer the needs of the town and its said patrons" with the town having the option to renew for an additional twenty year term. The town would build, maintain, and own transmission lines from a connecting point to the town. The contract explicitly recognized the town's reliance: "It is further understood that the town is about to expend approximately $11,000 in order to secure electric lights and power for its use and for the use of its citizens and patrons, and that it does and must rely upon the company . . . to provide such electricity; and the company therefore agrees that it will furnish the town a good and sufficient bond in the sum of $5,000, upon which the company and a solvent surety company shall at all times be liable, conditioned for the faithful performance of this contract, and for the payment of any damages, stipulated or otherwise, which the town may suffer by reason of a breach in

[19]See Bushwick-Decatur Motors, Inc. v. Ford Motor co. 116 F.2d 675 (2d Cir. 1940). Friedrich Kessler, Automobile Dealer Franchises: Vertical Integration by Contract 66 Yale Law Journal 1135, 1149 (1957), noted:

> An initial block confronting dealers lay in the argument that a franchise, marked by the absence or indefiniteness of obligations, was not a valid and enforceable contract. Until recently, the validity issue was continuously raised in franchise litigation, the defendant manufacturer almost invariably arguing that the agreement lacked mutuality. . . .
>
> For many decades, the invalidity argument may have been the most powerful weapon available to manufacturers in defending damage suits by dealers. It was honored by most courts, provided the manufacturer engaged in careful draftsmanship.

[20]Farnsworth on Contracts, §3.2.

[21]257 F. 818 (1919).

whole or in part of any of the conditions of this agreement."[22] The contract price was 3.5¢ per kilowatt hour (the opinion is unclear as to whether this would have been fixed in nominal terms for the entire forty years). As a result of the First World War, the price was "confiscatory," and the power company wanted out. It sought an injunction restraining the town from connecting to its transmission lines. And the court granted it: "As the [town] under the contract in question never assumed any obligation on its part, nor agreed to purchase any definite amount of electricity for lighting or other purposes, the contract between the plaintiff and the defendant is lacking in mutuality, and therefore void."[23]

The decision is an aberration even in its day. Most courts would have been capable of overcoming the court's lack-of-mutuality argument. Surely, the parties thought they had a contract. The court does not say whether the power company did indeed furnish the $5,000 bond, but it is reasonable to presume that it did so. According to the court, the power company furnished a bond against the breach of a non-contract and was kind enough to grant an option to renew the non-contract. It does not require a very fertile imagination to find ample consideration in the town's promise to build and maintain the transmission line; nor should the uncertain quantity create a problem. Demand projections for electricity twenty (or forty) years down the road will be highly uncertain, especially in the early days of electrification. That sort of uncertainty is precisely why both parties would opt for a variable quantity contract.

The decision provides an illustration both of how a court's framing of the issue can lead to foolish results (although this court seemed more intent than necessary on winding up in the wrong place), and of how parties can tailor their protection of reliance to their needs. The power company has numerous customers, the town only one (most likely) supplier. The power company could have insisted upon a minimum payment, but apparently did not do so. The town would have to spend some money to prepare to receive the electricity and insisted upon some protection against the seller's failure to meet its needs. The $5,000 bond seems relatively modest given the initial expenditure, but since the town would bear the cost of a larger bond indirectly, the magnitude reflects a judgment as to how much protection its reliance warranted.

The court came to a very different result in *Van Horn et al v. Ericson Lake Co. et al*.[24] Ericson (the company) built a dam and agreed to provide to Ericson (the town) all the electric power needs of its residents for fifteen years. It built the dam and the transmission lines, and performed under the contract for some period of time. High water washed away the dam and the company was unable to rebuild. Indeed, its property was sold after the mortgage had been foreclosed. The town's reliance was such that it had required that the company post a bond. Moreover, there was no force majeure clause; if an act of God washed away the dam, the

[22]At 819.

[23]At 822.

[24]203 N.W. 553, 113 Neb. 332 (1925).

company was still responsible. The court rejected without comment the lack-of-mutuality defense. It concluded that the bond was for liquidated damages, not a penalty, and enforced the contract against the surety.

In the remainder of this Section I will discuss three relatively recent cases in which a disappointed party attempted to avoid a contract by invoking the lack of mutuality.[25] All three disputes followed fuel price increases in the early 1970's, although the first, *Laclede Gas Company v. Amoco Oil Company*,[26] preceded the October 1973 oil shock.

Laclede was a distributor of natural gas and propane. The developers of new residential developments would negotiate with Laclede to provide an assured supply of gas or propane. In the long run, the efficient fuel would be gas, but because the capital costs of connecting to a gas distribution system were likely high and the delays long, propane served as the interim fuel of choice. Amoco agreed to supply Laclede with all its propane requirements for specific developments at a price 4¢ per gallon above the price posted at Amoco's refinery. A developer would first request that Laclede supply it. If Laclede determined that provision would be appropriate, then it could request that Amoco agree to supply the propane to that development. If Amoco agreed to do so, it would sign a supplemental form to this effect. So, Laclede had the responsibility for recommending that a development be served, but Amoco reserved the right to refuse. Once it had agreed, however, it was obligated to provide the development's propane requirements.

---

[25]See also Portland Gasoline Co. v. Superior Mktg. Co. Inc, 150 Tex. 533, 243 S.W.2d 823 (1951). Portland promised to deliver to Superior "all of the net butane and propane mixture that it produces." Superior wanted out of the contract for reasons unstated. One clause of the contract provided that, although the parties expected the daily production to exceed 10,000 gallons, Portland would not be in default if it delivered less than that amount so long as what it delivered was its total production. Superior argued that because Portland could cease production entirely and thereby avoid any obligation, the contract was illusory. Rejecting this argument, the court held that the implied promise to manufacture and deliver was sufficient to provide mutuality. The Texas Supreme Court has subsequently held that it was not necessary to rely on the implied promise to find the existence of a contract "and to the extent Portland Gasoline found that such an implied obligation was necessary for the contract to be enforceable, we overrule it." Northern Natural Gas Co. v. Conoco, Inc., 986 S.W.2d 603, 36 U.C.C. Rep.Serv.2d 1011, 42 Tex. Sup. J. 75 (1997).

[26]385 F.Supp. 1332 (1974) district court; reversed and remanded, 522 F.2d 33, 8th Cir (1975). I will consider two other pre-oil shock cases in Section V: City of Lakeland, Florida v. Union Oil Company of California 352 F.Supp. 758 (1973); and Orange and Rockland Utilities, Inc. v. Amerada Hess Corporation 59 A.D.2d 110; 397 N.Y.S.2d 814; 96 A.L.R.3d 1263; 22 U.C.C. Rep. Serv. (Callaghan) 310 (1977).

Laclede was to install, maintain, and operate all distribution facilities from the point of delivery, Amoco's header piping. It appears from the court's description that Laclede would have to make some investment in storage equipment and other facilities in attaching to Amoco's distribution lines.[27] Substitution of other suppliers would therefore be expensive. The Court of Appeals probably overstated Laclede's vulnerability:

> Laclede thus bound itself to buy all its requirements from Amoco by agreeing to attach its distribution lines to Amoco's header piping; and even if a change of suppliers could be made under the contract, Laclede could not own and operate a separate distribution system hooked up to some other supplier's propane storage tanks without substantially altering the supply route to its distribution system or making a very substantial investment in its own storage equipment and site. As a practical matter, then, Laclede is bound to buy all the propane it distributes from Amoco in any subdivision to which the supplemental agreement applies and for which the distribution system has been established.[28]

The investments could not have been too onerous since they were meant to be transitional. In the three years the parties operated under the agreement, seventeen developments were signed up, but only eight remained. (All eight were mobile home parks.) The flexibility afforded Laclede (discussed below) is another indicator of the modest level of relation-specific investment. Moreover, while the parties were in dispute, Laclede began supplying the subdivisions by truck with propane from Phillips procured under a separate supply contract.[29] Laclede's contract with Phillips allowed it to buy up to 45 million gallons of propane annually. The maximum amount of propane it purchased for the subdivisions was 400,000 gallons, less than one percent of the

---

[27]The trial court suggested that both parties had to make some relation-specific investments:

> It was Amoco's obligation, upon acceptance of a subdivision by this supplemental letter agreement, to acquire the sites suitable to both parties for the location of the required storage and vaporization facilities. Amoco was to install, own, maintain and operate those and any other facilities necessary and 'adequate to provide a continuous supply' of propane, which included the delivery of propane into the storage tanks in volumes sufficient to meet the needs of the customers within the subdivision. Laclede was obliged to acquire easements and other rights at the installation of its distribution facilities, and to install, own, maintain and operate said distribution facilities within the subdivision. The title to the gas would pass from Amoco to Laclede at the outlet of the Amoco header piping. (At 1334)

[28]522 F.2d 33 at 38.

[29]385 F.Supp. 1332, 1334.

Phillips' contract.[30] So, while it could easily meet the demands of the subdivisions by general purchases of propane and delivering it to its own storage tanks by truck, the agreement allowed it to save money by putting in some relation-specific investment and eliminating the costs of truck distribution.

The agreement allowed Laclede to fine-tune protection for its reliance. If Amoco accepted a particular subdivision, it was required to meet that subdivision's propane needs for life. It could not terminate the agreement. Both parties expected, however, that the systems would eventually be converted to natural gas. Upon conversion, Laclede would give Amoco thirty days written notice and that would terminate its responsibility to the subdivision. In addition, Laclede had the right to terminate each year even if the subdivision continued to use propane.[31] Amoco had no right to terminate. Laclede could, therefore, rely on Amoco's continued supply; however, its right to terminate allowed it to substitute fuel from an alternative supplier if the contract price became so far out of line with the market price that it would pay to replace Amoco with trucked-in propane (or to construct alternative distribution facilities for piped-in propane). Amoco, with a large number of customers and little relation-specific investment needed no protection and was therefore willing to forego the right to terminate, especially since the contract price was indexed to the price it would be charging others (the posted price).

Nonetheless, a conflict arose when Amoco notified Laclede of a 3¢ per gallon increase in April 1973. Laclede objected and demanded an explanation. Amoco refused to give one, instead sending a letter informing Laclede that it was terminating the agreement and that it had a right to do so since the agreement lacked mutuality.

The trial judge agreed with Amoco. Laclede's right to cancel arbitrarily without Amoco having a similar right made the agreement void for lack of mutuality. The consideration was "not of sufficient quality nor quantity to act as a palliative for Amoco to swallow the bitter pill of Laclede's arbitrary and unbridled right of cancellation."[32] The Court of Appeals reversed, citing Corbin for the notion that so long as Laclede could only exercise the power to cancel with notice, the contract should not be rendered invalid for lack of consideration. The contract was a

[30]At 1335.

[31]"This Agreement shall remain in effect for one (1) year following the first delivery of gas by (Amoco) to (Laclede) hereunder. . . . this Agreement shall automatically continue in effect for additional periods of one (1) year each unless (Laclede) shall, not less than 30 days prior to the expiration of the initial one (1) year period or any subsequent one (1) year period, give (Amoco) written notice of termination." 522 F.2d 33, at 36.

[32]385 F.Supp. 1332, 1336.

requirements contract and such contracts are routinely enforced where "the needs of the purchaser are reasonably foreseeable and the time of performance is reasonably limited."[33]

The notice rationale, which is widely accepted, is really quite bizarre. Navigating the somewhat tricky terrain of the doctrine of consideration, Corbin forwarded this distinction which is now standard doctrine:

> (1) A promises to pay $100 a week for service and B promises to serve for one year beginning June 1 if he then so pleases. There is no contract; B's promise is no promise. The same is true if B promises "I promise to serve for one year beginning June 1, but I reserve the privilege of not serving."
>
> (2) Is the case materially different if B's promise is, "I promise to serve for one year beginning June 1, but I reserve the option to cancel by giving notice before that date"? Both technically and practically there is a difference, because the terms of B's promise no longer leave his option unlimited. His option is between serving and giving notice, and not as in the first case above between serving and not serving. The cost to B of one of these alternatives—the giving of notice—may be slight. Nevertheless, it is sufficient to satisfy the requirement of a consideration if agreed upon as such. The writing and the mailing of a letter is more than a peppercorn.[34]

So, and the treatises agree, a slight constraint on the promisor's right to cancel would constitute sufficient legal detriment to provide consideration.[35] In effect, instead of paying $0 for the option (not enforceable), or a nominal amount (perhaps not enforceable because the payment is a sham),[36] the promisor agrees to make a contingent payment of 33 ¢ (the price of a postage stamp) to a third party—the Post Office (enforceable).[37] Rather artificial.

The district court was bothered by the lack of symmetry in the termination mechanism. Such asymmetries are to be expected and are a natural consequence of the underlying purpose of

---

[33]522 F.2d 33, 38.

[34]Arthur L. Corbin, The Effect of Options on Consideration, 34 Yale L. J. 571, 587-588 (1925).

[35]*Laclede* (at 37) cites both Williston and Corbin for the proposition. See Farnsworth on Contracts at §2.14, n.3.

[36]See Farnsworth on Contracts at §2.11, §3.23.

[37]If the promisor terminates with notice, the damages would be the same as for the $0 option, namely zero. If the promisor neglected to give notice, however, the damages could be substantial.

the transaction. Laclede has the right to propose the connection of a particular subdivision; Amoco has the right to veto it. But once Amoco chooses not to exercise the veto, the decision on whether service should continue is put exclusively in Laclede's hands since Laclede has some relation-specific investment at risk and because Laclede must determine when the transition to gas should be made. The agreement reflects a plausible allocation of decision rights between the parties. It is not the only plausible allocation; one could imagine situations in which Amoco would insist upon more protection of its reliance. Still, the value both parties anticipated from entering into the deal stemmed from the carefully structured allocation of decision rights, not from the fact that Laclede had to give notice.

In *Eastern Air Lines, Inc. v. Gulf Oil Corporation*,[38] a glitch in the price index resulted in the contract price of aviation fuel being substantially below the market price. The contract was a straightforward requirements contract with Gulf agreeing to sell all of Eastern's requirements of jet fuel at specified locations. Eastern had been buying jet fuel from Gulf under similar contracts for over a decade (and non-jet fuel for years before that). Indeed, the court suggests that the contract was in most respects similar to contracts in general use in the business.[39] Eastern purchased 100% of its requirements at particular locations, but only about ten percent of its total jet fuel requirements, from Gulf under this contract. The contract price was indexed to a posted price quoted in Platt's Oilgram, but after the 1973 oil shock, the index failed to track the market price of oil. Platt's reflected the regulated price of domestic oil, not the unregulated price of foreign oil; by January 1974 the former was $5 per barrel while the latter had soared to $11. The seller attempted to avoid the consequences by arguing that commercial impracticability warranted excusing performance, that the contract was not binding for want of mutuality, and that, even if it were binding, the buyer had breached the contract by unreasonably varying its demands. The court rejected all three defenses.

The impracticability issue is beyond the scope of this paper, although the court was surely right in rejecting the claim.[40] The court had little trouble with the mutuality defense, noting that under the UCC Eastern's discretion was limited by good faith. It could not, in good faith, cut its requirements to zero, so the contract was binding. And, finally, Eastern's actual performance

[38]415 F.Supp. 429 (1975).

[39]"The contract is Gulf's standard form aviation fuel contract and is identical in all material particulars with the first contract for jet fuel, dated 1959, between Eastern and Gulf and, indeed, with aviation fuel contracts antedating the jet age. It is similar to contracts in general use in the aviation fuel trade. The contract was drafted by Gulf after substantial arm's length negotiation between the parties." (At 432).

[40]See, Victor P. Goldberg, Impossibility and Related Excuses, 144 J. of Inst. and Theoretical Economics 100 (1988); and Victor P. Goldberg, Price Adjustment in Long-Term Contracts,1985 Wis. L. Rev., 527, 543.

under the contract was consistent with the good faith standard. It did not substantially increase its requirements to take advantage of the favorable contract price.

The court says little about why the parties (and apparently most other buyers and sellers of jet fuel) used a requirements contract. The only reference was to Gulf finding an outlet for jet fuel coming from a newly completed refinery. That cannot be right. The claim that requirements contracts were widely used by other refineries and were used by Gulf at other refineries and at earlier times is inconsistent with this explanation. More likely, airlines were concerned with maintaining an adequate inventory at various locations and refineries were better able to hold that inventory and adapt to fluctuations in local demand. The court provided a cataloging of reasons why fuel liftings at any particular location might vary either because of external factors or business decisions by the buyer:

> Throughout the history of commercial aviation, including 30 years of dealing between Gulf and Eastern, airlines' liftings of fuel by nature have been subject to substantial daily, weekly, monthly and seasonal variations, as they are affected by weather, schedule changes, size of aircraft, aircraft load, local airport conditions, ground time, availability of fueling facilities, whether the flight is on time or late, passenger convenience, economy and efficiency of operation, fuel taxes, into-plane fuel service charges, fuel price, and, ultimately, the judgment of the flight captain as to how much fuel he wants to take.[41]

Gulf claimed that Eastern had manipulated its requirements by engaging in a practice referred to as "fuel freighting." Eastern could vary its requirements in response to contract versus market price differentials by filling up at the low-priced airports. Fuel freighting was, the court argued, an established industry practice, well-known to both parties. The parties had agreed, in effect, that Eastern would be able to respond to changed circumstances to economize on its fuel costs. The court suggested that the opportunities for freighting were very few, but did not say whether the practical limits on Eastern's discretion were critical to resolving the breach question. It does not seem to matter to the court that the opportunities for fuel freighting might be much greater than in the past three decades because of the unprecedented contract-market price differential. Of course, if most of the remainder of Eastern's fuel supply was procured under similar contracts with a similar indexing failure, there would be little incentive to engage in fuel freighting. On that fact the opinion is silent.

Despite a huge contract-market price differential, the variation in quantity appears to have been rather modest. That does not mean that Eastern did not try to take advantage of the relative price shift; most likely its response was limited by technological realities. The court relied upon the practical limits to fuel freighting in finding that Eastern’s behavior was acceptable under the unreasonably disproportionate standard of §2-306. The technological limits on quantity variation are hardly inevitable, however. Contracting parties might rationally choose to allow one party

[41]415 F.Supp. 429, 436.

considerable leeway in adapting to relative price changes even if that would result in huge swings in requirements.[42] The *Eastern* outcome is surely correct, but if the requirements were indeed sensitive to relative prices, then the parties, not the court, were in the best position to determine whether to interpose limits on Eastern's discretion.

In *Propane Industrial, Inc. v. General Motors Corporation*[43] the court did actually find a contract void for want of mutuality when the buyer's requirements were very sensitive to relative prices (up to a quantity ceiling). General Motors' assembly plant in Kansas City used natural gas for heating during the winter. However, it had an interruptible contract with the public utility, the Gas Service Company. In such a contract, the buyer gets a reduced unit price, but agrees that the utility can interrupt supply from time to time. This variable quantity contract (not the subject of the dispute) allows the utility to adjust to demand surges and temporary supply shortages by allocating the risks to a particular subset of customers. General Motors was willing to accept the risk of supply interruptions because it maintained a standby supply of propane gas at the plant. It contracted with various propane companies to assure supplies of the standby propane. The disputed contract was with one of these suppliers and covered the 1973-74 heating season. In the previous year there had been three suppliers (including Propane Industrial); in 1973-74 there were two.

The Propane Industrial contract was on a General Motors purchase order. General Motors agreed to pay 17¢ per gallon for up to 500,000 gallons:

> To cover a possible requirement of (500,000) gallons of propane to be used as standby fuel at this Plant during the Heating Season from September 1, 1973 through April 30, 1974. . . . By the acceptance and acknowledgment of this Purchase Order, Vendor guarantees standby propane availability of the above quantity during the heating season to be delivered in accordance with [maximum deliveries for month, week, and day].[44]

It was the backup standby contract for most of the period. GM's other contract was with Enterprise Products Company for propane requirements from November 1, 1973 through March 31, 1974. GM agreed to "purchase 1,600,000 gallons at $0.15463 per gallon, with an option to be relieved of the obligation to purchase by payment of $0.035 per gallon or to delay delivery until the 1974-1975 heating season by payment of an additional $0.045 per gallon, plus freight charges."[45] Thus, if GM took less than the contract quantity, Enterprise would be paid 3.5¢ per

---

[42]See Section VII.

[43]429 F. Supp. 214 (1977).

[44]At 216.

[45]At 217.

gallon and an extra penny if GM carried the obligation over to the next heating season. PI would be paid nothing for standing ready to deliver propane on 24 hour notice.

So, PI was to be the exclusive supplier for the cusp months and Enterprise the primary supplier in the peak months. The Propane Industrial contract did not, however, state how many firms might be standby providers. Conceivably, after receipt of the PI purchase order, GM could have entered into additional agreements with others, perhaps at more favorable prices.

It is important to recognize, as the court did not, that the contract in dispute was only one piece of a larger package. General Motors wanted an assured supply of fuel for heating for the winter months. It could have obtained all its fuel from a single supplier—the gas company—if it were willing to pay the price. But it could do better by patching together a set of flexible agreements which assured it a lower net price. The primary contract with the gas company gave the seller the discretion to cut off supplies under certain conditions. Its secondary contract with Enterprise was for a fixed quantity. However, GM could reduce the quantity if it wanted to and was willing to pay a per unit fee. In effect, it promised to pay a flat fee (3.5 cents per gallon) for the option to take up to 1.6 million gallons of propane in the peak months at a fixed price of roughly 12 cents[46] and had the option to pay an additional penny per gallon to carry over untaken propane to the next heating season. This could be recharacterized as a take-or-pay contract with a make-up clause in which GM agreed to pay for about 22% of the contract amount regardless of whether or not it took anything. The tertiary contract with PI provided additional assurance at a price premium, but gave GM complete discretion as to whether it would use PI's propane or someone else's. GM did not foreclose its ability to search for lower prices; if the market price had fallen, GM could have gone elsewhere or insisted that PI revise the agreement.

It could have achieved almost the same thing by promising that it would buy propane from no one other than PI and Enterprise and by giving PI a right of first refusal vis a vis other potential propane suppliers. Such an arrangement would likely be less attractive to GM since the first refusal right discourages bidding by outsiders and would limit GM's flexibility by forcing subsequent bids into the same form as the PI agreement. For example, GM might be willing to entertain an offer to supply propane for September only, but that would be precluded by a first refusal clause. The arrangement also gave it the flexibility to respond to a price increase. If circumstances changed so that it appeared that prices would be higher in the following heating year, GM could increase its take of the PI propane up to the ceiling and roll the Enterprise propane over to the next year.

Propane prices began rising in mid-1973 and PI wrote that it would be unable to fulfill the contract unless the price were increased. The dispute is complicated by the fact that the federal government instituted a mandatory Propane Allocation Program in October 1973. The essential element is that, at the request of the Federal Energy Administration, Propane Industrial delivered

---

[46]This is the incremental price, the full price of about 15.5 cents less the 3.5 cent fixed payment.

75,000 gallons to GM's Fairfax plant at the very end of 1973. GM paid at the contract price of 17¢. Propane Industrial billed at 40.5¢ per gallon[47] and sued for the difference. If the delivery had been made under an existing contract, General Motors would win; if not, then the federal statute provided that the price be a reasonable price at the time of delivery and GM conceded that the price billed by the plaintiff would be reasonable.

The question, according to the court, was whether the buyer had promised to purchase exclusively from the seller and it concluded that it had not.

> Plaintiff could not expect defendant to purchase any propane from it during the 1973-1974 season if defendant obtained more favorable terms under purchase orders with other suppliers. Stated conversely, the plaintiff could not have enforced against defendant an obligation to purchase from plaintiff all propane required by defendant at its Fairfax plant during the 1973-1974 season.
>
> Therefore, it is concluded that defendant made no express or implied promise to purchase any propane from plaintiff during the 1973-1974 season. In the absence of such a promise, [the] purchase order . . . lacks the mutuality of obligations and consideration required for a binding requirements contract because defendant gave no consideration and incurred no legal detriment in exchange for the promise of plaintiff. The purchase order constituted merely an offer or invitation for orders which could be revoked by plaintiff at any time prior to acceptance by receipt of an order for a specific amount from defendant.[48]

If the court posed the proper question, then its answer is surely correct. GM had not bound itself to do anything at all. It could take its propane requirements from Enterprise or anybody else and not breach its promise. But, so what? PI had granted GM an option at a price of zero. This was not a gift. PI did it because doing so was valuable, ex ante. Having a standby supply contract in place meant that there was a reasonable probability that it would sell propane to GM; the contract price appeared to reflect the risks of holding inventory, since it was ten per cent higher than Enterprise's full price and forty percent over its incremental price. There was a bargain and each side received a benefit. That GM's discretion on the downside was unbounded should be irrelevant. The deal was valuable to PI, at least ex ante, not because of General Motors' good faith, but because of GM's self-interest.

The *Propane Industrial* decision is one of the rare modern cases in which the lack-of-mutuality defense has succeeded. The more significant cases today concern the interpretation of variable quantity agreements. The case law has distinguished between cases in which there has been a significant decrease in requirements and those in which there has been a significant increase. In the former category, it has lumped together cases in which a firm ceased to have

---

[47]The weighted cost of the propane to it was about 35¢.

[48]At 221.

requirements because it shut down a facility and those in which it ceased to have requirements because it sold the facility to someone else who continued to operate it. In the following Section, I begin the discussion of the interpretation issue by disaggregating the former category.

III. Zero Requirements Because of Transfer

If the buyer in a requirements contract has no requirements, it should, the UCC notwithstanding, not be liable and an inquiry into the buyer's good faith should be irrelevant. There is one plausible exception to this rule. The basic problem is simple enough. X agrees to provide Y's requirements at a particular plant. Y then sells, leases, or otherwise disposes of the plant to Z who continues to run the plant. Y claims to have no requirements and Z says it is not bound by Y's contract.

In the nineteenth and early twentieth century both English and American courts allowed that a requirements contract could be undone by a change of control. In *Drake v. Vorse*,[49] the defendant in a requirements contract ceased doing business as an individual and entered into a partnership. The court held that he was under no obligation as an individual to take any more castings since he needed none for his business as an individual. Nor did the partnership have an obligation to take since it was not a party to the contract.[50] Similarly, in *Rhodes v. Forwood,*[51] Lord Cairns noted that a buyer could take zero requirements if the principal's colliery closed on account of low prices, strikes, etc..

> . . . if . . . it could not be contended that there is any provision in this contract against any of those risks, why is it to be assumed with regard to the . . . risk of the colliery owner, not selling his coal elsewhere piecemeal but selling the colliery itself to a purchaser, that there is an implied undertaking against that one risk,

---

[49]3 N. W. 465. 52 Iowa, 417 (1879). For a more recent case holding that if a contract did not preclude the buyer from selling his business, then the sale would effectively eliminate his duty to have requirements, see Langenberg v. Guy, 77 Cal. App. 664; 247 P. 621; 1926 Cal. App. LEXIS 433.

[50]"But, conceding that it [the contract] bound him [the defendant] to order and take of the plaintiff all the castings he should want, it could not, we think, have the effect to preclude him from entering into a partnership, nor could it become obligatory upon the firm. It was certainly the defendant's privilege to discontinue business at any time when it should appear to him that his interest demanded it, and that, too, without becoming liable to the plaintiff in damages. He did discontinue business upon his individual account. After that he did not individually want or need any castings, and as the firm was not bound to take any we do not think that the defendant became liable." (At ___)

[51] 47 L.J.Q.B. 396 (1898).

> although it is admitted that there is no undertaking at all against any of the other risks? . . . The simple point here appears to me to be, as it is admitted that there is no express contract which has been violated, can your Lordships say that there is any implied contract which has been violated? I can find none. I cannot find any implied contract that the colliery owner would not sell his colliery entire.[52]

An ALR annotation circa 1920 suggested that the application of the rule was symmetrical: ". . . where the buyer disposes of the business with reference to which he has purchased a commodity to the extent of his requirements, the seller is under no obligation to furnish such commodity to the purchaser of the business, nor is he under any obligation to furnish the same to the original buyer."[53]

These decisions can be contrasted with another nineteenth century case, *Wells v. Alexandre*.[54] There, the seller agreed to furnish all the buyer's coal requirements for three steamships for one year. It did so for six months, whereupon the buyer sold the steamships, which continued to ply the same route for the remainder of the year. The new owners apparently purchased their coal elsewhere (the decision is vague on this) and the coal supplier sued the original owner.[55] The court held for the plaintiff:

> The fact that the defendants deemed it best to sell the steamers, cannot be permitted to operate to relieve them from the obligation to take the coal which the ordinary and accustomed use of the steamers required, for the provisions of the agreement do not admit of a construction that it was to terminate in the event of a sale or other disposition of them by the defendants.[56]

In effect, the court hints at what appears to be a sensible default rule: the obligation is not terminated by transfer of the property. Whether that really is an appropriate rule has nothing to do with variable quantity contract questions. In any event, as we shall see, parties can, and do, contract on this question. The significant point is that one can easily distinguish between the

---

[52] At 401. See also Hamlyn & Co. v. Wood & Co. [1891], 2 Q. B. 488. Defendant, a brewer, agreed to sell all the grain that was a waste product of the brewing process for ten years. It sold the business to another brewer who refused to adopt the contract. The court refused to recognize an implied term that the defendant not sell the business for the life of the contract.

[53] 7 ALR 498, 507.

[54] 130 N.Y. 642, 29 N.E. 142, 15 L.R.A. 218. (1891)

[55] The opinion is silent on whether they could, or did, sue the new owners.

[56] At 646.

buyer who has no requirements because it had transferred the business to a successor (which does still have requirements) and the buyer who simply closes down its plant.

The courts took a wrong turn in *Diamond Alkali Company v. P.C. Tomson & Company*.[57] Diamond was an Ohio manufacturer of soda ash, caustic soda and other related products which were used by Tomson in its Philadelphia factory. The parties decided that it would make sense to relocate Tomson's factory adjacent to Diamond's. Diamond loaned Tomson $100,000 and sold it the land for the factory. Tomson agreed to build a plant on the site capable of taking care of its entire present business, the plant to cost not less than $100,000. Diamond agreed to sell Tomson all its requirements for five years. Tomson's president testified as to its reliance on the agreement:

> I think the reason for fixing a period of five years during which the Diamond Alkali Company would furnish us with our requirements, was that if we only made a yearly agreement, we would invest in a factory there, and have several hundred thousand dollars invested in it, and if anything should happen, we couldn't get our raw material, why, there would be no advantage to it. I think that was one of the reasons for it. We wanted to be sure of the supply for our manufacturing during the period of five years operating our new building.[58]

The seller also relied upon the contract, expanding its capacity after entering into the contract.

Tomson erected the plant in Ohio, but before it had moved its operations to Ohio it sold its Philadelphia plant, including good will, to a third party and agreed not to enter into the business again for five years. It then refused to open and operate the Ohio plant. Diamond sued for equitable relief which was denied, but the Court of Appeals concluded that Tomson had breached and the case was remanded to determine damages.

The agreement explicitly stated that Tomson was "not to sell, lease or enter into any contract for the operation of its manufacturing plant at Fairport without the consent of the Alkali Company during the continuance of this agreement."[59] This term would almost certainly have prevented someone from operating the Ohio plant without using Diamond's products. The harder question is what to do in the situation in which the new factory is abandoned. The court does not tell us why the sale price of the Philadelphia facility was so attractive that the parties would be willing to turn their back on a brand new facility that had cost over $100,000 (in pre-Depression dollars) to build. It must have been a heck of a deal. The court, citing *Wells v. Alexandre*, held that the mutual intentions of the parties were that they would continue in business for five years and that Tomson, by accepting the covenant not to compete, had breached this contract.

---

[57] 35 F.2d 117 (1929).

[58] At 119.

[59] At 118.

It seems odd that a third party would offer to pay Tomson enough so that in effect it would be dynamiting its expensive new factory. I suspect that this was not the case and that the court, confused by its framing of the matter, left out a significant piece of the story. It is silent on whether anything in the contract with the third party precluded Tomson's sale of the new plant to either Diamond or another firm. Since it is likely that such a deal would be a Pareto improvement over demolition of the new factory, one suspects that resale was the likely outcome. Had it sold to another (with Diamond's approval), the requirements contract should remain alive; had it sold to Diamond, the contract would be moot. The court's resolution was probably not the final step. It most likely merely defined the starting point for bargaining over the disposition of the new plant.

That is all speculation on my part. The significant points are two. First, there is a huge distinction between the case in which the requirements of the physical facility cease and the case in which the buyer transfers ownership of the facility, but the facility continues in operation. Second, the contract gave Tomson the discretion to adapt to changed circumstances; had Diamond wanted more protection of its reliance, it could have insisted upon minimum payments (for example, a take-or-pay provision). It chose not, because it believed that Tomson's self-interest provided adequate protection for its reliance. The likelihood was very low that Tomson would find that the most profitable use of a brand new factory would be to close it. There is no reason to rewrite that contract to give Diamond more protection than it had bargained for.[60]

The issues in *Diamond Alkali* were somewhat obscured by the lack of information regarding the future use of the new plant. *Central States Power & Light Corporation v. United States Zinc Co.,*[61] which concerned a three-year contract supplying natural gas to a smelter, presented a simpler problem. The gas supplier would have to construct a pipeline to the smelter; it appears from the decision that the costs of that pipeline would be covered by the expected future gas sales. The smelter required about 6.5 million cubic feet of gas per day. The contract called for a fixed quantity of 3 million cubic feet, but if the buyer's total requirements did not reach 3 million, its obligation would be capped by its total requirements.[62] The buyer had no

---

[60]The district court (which had found for Tomson) had asked rhetorically; "How can it be found that the defendant had in mind and may be assumed to have agreed to continue a losing business for a term of five years or to forego an advantageous sale?" Diamond Alkali Co. v. P. C. Tomson 23 F. 2d 515, 516 (1928). It also noted that the agreement had placed a number of restrictions on Tomson: "the defendant shall neither mortgage nor in any manner pledge its assets without the consent of the plaintiff. Why was not a sale included, if contemplated?" (At 516)

[61]60 F.2d 832 (1932).

[62]"Vendee agrees to receive, purchase and pay for said gas at said price and on the basis above stated, and to take during the first year of the contract at least two million cubic feet of gas per day, and during the second and third year of the contract at least three million cubic feet of gas per day; provided, that, if the total requirements of vendee for gas fuel does not equal or

obligation to resell (or store) gas it could not use. If it operated at more than 50% capacity it either had to find other suppliers or buy gas from Central States at a price (and other terms) to be negotiated.

Nine months after signing the contract the buyer, after failing to renegotiate a more favorable price, dismantled the plant and discontinued its operation. The gas supplier sued, claiming that the buyer had implicitly promised to stay in business and to continue to have requirements. The majority, relying in part on *Wells* and *Diamond Alkali*, agreed. The buyer "owning an established business had the implied obligation to continue it in the usual manner, and accept during the time fixed the gas required to so conduct it."[63] The court in effect took a contract in which the parties had limited the buyer's discretion in a way that protected it from having to be a reseller of gas it could not use, to a take-or-pay contract in which the buyer promised to pay whether it took the gas or not. The dissent highlighted the distinction between this case and *Wells*:

> I think the [buyer] was entitled to a directed verdict. The parties agreed upon a partial supply of gas needed for a particular smelter described in the contract. If that smelter burned any gas, appellee must purchase it of appellant, up to the specified amount. That is a fair and valid contract. Vendee could not escape its obligation by selling the smelter; so long as the smelter required gas, the obligation remained. But does the obligation remain if the smelter is destroyed by fire, or is razed by a tornado, or is dismantled because of the collapse of business? In such events, no gas is required for the smelter, and there was no agreement to buy gas not required. It matters not whether the dismantling occurred in a year, or a month, or a day. That is the contract the parties made.[64]

Texas Industries, Inc., v. R. P. Brown et al.,[65] a simple variation on *Wells*, involved a requirements contract for "aggregate" (an input into the manufacture of concrete masonry units) to supply three of buyer's plants. The seller built a new plant at a cost of $500,000 to serve the three plants. The buyer then leased its plants to a group of lessees and thereafter argued that the leasing arrangement extinguished the contractual obligation, despite the fact that the plants continued to operate and to have requirements. The court held for the seller, but lumped this case with others in which the plant's requirements were zero (as in the previous two cases).

---

exceed the two or three million per day that vendee shall be required to take only the amount of its total requirements." At 832.

[63]At 834.

[64]At 836.

[65]218 F.2d 510 (1955)

> In these circumstances, the law of Texas imposes an implied obligation upon the buyers to keep the plants in operation lest, by disposing of them or shutting them down, the buyers be permitted to destroy the subject matter of the contract, the requirements of the plants, in violation of the intention of the parties that sales and purchases under it would continue for the full term thereof. This rule was recognized in a decision of the Supreme Court of Texas in 1951, *Portland Gasoline Co. v. Superior Marketing Co., Inc., 150 Tex. 533, 243 S.W.2d 823, 825,* wherein was cited Williston on Contracts, Rev.Ed., Vol. 1, pp. 357-358, which refers to a class of cases that finds from the business situation, from the conduct of the parties, and from the startlingly disproportionate burden cast upon one of them, a promise implied in fact by the seller to continue in good faith sales or production, or on the part of the buyer to maintain his business or plant as a going concern, and to take its bona fide requirements. "In other words, this view implies an obligation to carry out the contract in the way anticipated, and not for purposes of speculation to the injury of the other party."[66]

The agreement itself made clear that it would not terminate because of sale, assignment, and so forth.[67] The buyer invoked the contract language, apparently because leasing was not specifically mentioned. The court, however, rejected this argument, holding that the language made it clear "that the contracting parties took pains to anticipate and provide against contingencies such as are now being put forward as reasons for terminating the contract."[68] That should have been the dispositive issue–did the contract survive the substitution of parties. Invocation of good faith and disproportionate burdens is quite beside the point.

Tri-state Generation and Transmission Association, Inc. v. Shoshone River Power, Inc.[69] illustrates how a party might opportunistically sell its business in an effort to get out from under an onerous requirements contract. Tri-state, a generation and transmission (G&T) cooperative, provided electricity to 25 distribution cooperatives including Shoshone. Part of Tri-state's financing came from the Rural Electrification Administration (the REA) which required as a

---

[66] At 512-513.

[67] "Nothing in this agreement contained shall prevent any party hereto from consolidating or merging its operation into another operation, or from changing the form of organization, or from selling, conveying, or exchanging its property as an entirety or substantially as an entirety, but any and all such mergers, consolidations, organizational changes, sales, conveyances, or exchanges shall be binding upon the organization resulting from or succeeding to the ownership of the property as an entirety or substantially as an entirety, to the intent that the terms and provisions of this contract shall inure to the benefit of and be binding upon the parties hereto, and upon the heirs, executors, administrators, successors and assigns of each party hereto." At 513.

[68] At 513.

[69] 874 F.2d 1346 (1989).

condition of its loans that its G&T borrowers get requirements contracts of matching maturity. Shoshone's original contract was of 33 years duration, and the most recent modification had extended the life to 43 years. The requirements contracts between Tri-state and its member distribution cooperatives were meant to be security for the loans; however, there was no minimum payment. Shoshone had over 1,000 members to whom it supplied electricity. The arrangement worked fine for decades, but in the mid-1980's when fuel prices collapsed, Tri-state's prices remained high. Pacific Power & Light Company offered to supply Shoshone and other distribution cooperatives at prices substantially below Tri-state's.[70] To take advantage of Pacific's low prices, Shoshone agreed to sell to Pacific its assets, which consisted of the power-delivery subscriptions of its members and, to a lesser extent, its poles and power lines. That is, Shoshone's members would continue to have electricity requirements, but these would be supplied by Pacific, not Tri-state.

Tri-state attempted to enjoin the merger. The court denied specific performance, but found that Shoshone's action was a breach of the contract and awarded damages. The majority held that "as a matter of law, . . . when there are sufficient members in Shoshone's system requiring electric power, a sale of Shoshone's assets or member subscriptions to Pacific cannot qualify as a good faith reduction or elimination of requirements."[71] The dissent, which would have remanded for a new trial on liability, noted that the seller could have achieved greater protection of its reliance by including a take-or-pay clause in the contract. It also remarked on the lack of provisions preventing the sale of the business or making the contract binding on the buyer's successors or assigns. In effect, the court came up with a plausible default rule—the requirements are defined by the physical assets, not by the identity of the contracting party. The moral is blurred, however, by a convoluted opinion which relies extensively on *Diamond Alkali* and *Central States*, failing to recognize that in both these cases the facilities would not remain in operation.

For a decision suggesting that the default rule be that the agreement should survive the sale of the asset, see *Proctor v. Union Coal Co.*.[72] "... the construction [of the contract] that the defendant could terminate the plaintiff's rights at any time by a sale of the premises, would leave the plaintiff wholly at the mercy [of the defendant].... It is not to be presumed that the parties intended so unreasonable an agreement, in the absence of language expressing such intention."[73] I am not insisting that this default rule is the right one. So long as the barriers to contracting around this default rule are low, it should not much matter. My point is that the cases in which the party sells the underlying asset are analytically different from those in which the party closes

---

[70]805 F.2d 351, 353 (1986).

[71]874 F.2d 1346, 1360.

[72]243 Mass. 428, 137 N.E. 659.

[73]At ___.

down the plant or drastically reduces its requirements. Those cases are the subject of the next Section.

IV. Reduced Requirements

Most commentators agree that the law, both pre- and post-Code, treated increases and decreases asymmetrically.[74] A dispute continues over whether the "unreasonably disproportionate" language of the UCC applies on the down side; the 1999 revised draft of the UCC suggests that the drafters desire symmetry.[75] The preference for asymmetric treatment stems from the recognition that there is less opportunity for the quantity-determining party to take advantage of price variations by decreasing its requirements. A requirements buyer could increase its purchases without limit (if the contract placed no limit) to take advantage of a rising market, but it could only cut its requirements to zero to take advantage of a market price decline.

The Code puts considerable emphasis on the role of quantity estimates and prior dealings between the parties in imposing extra-contractual limits on the quantity-determining party's discretion. Even under the Code, however, a buyer could, in "good faith" substantially cut back, or even eliminate, its requirements. But "good faith" is interpreted, heaven knows why, to mean that the firm can shut down for lack of orders, but not to curtail losses.[76] No attempt is made to relate this standard to any economic context. Why would businesses want this default rule, especially if it is difficult to contract around? A simpler starting point would be a default rule which gives complete flexibility on the down side with the only concern being avoidance by change of title (as discussed in the previous section).

In this Section I will consider eight quantity-reduction cases. In the first three, the court upheld the reduction, although the last decision was most likely incorrect. In the next three the court invoked good faith to undo a perfectly sensible allocation of discretion. I then analyze

---

[74]Silkworth (note 1) suggests that the case law does not distinguish between increase and decrease cases, nor should it.

[75]"The question is whether the lack of output or requirements occurred in good faith, not whether the lack of actual output or requirements was 'unreasonably disproportionate.' This follows the interpretation of prior 2-306(1) in Empire Gas Corp. v. American Bakeries Co., 840 F.2d 1333 (7th Cir. 1988), but rejects the court's dictum that the unreasonably disproportionate limitation is not applicable to any decrease in quantity or requirements." American Law Institute, Proposed Final Draft Uniform Commercial Code Revised Article 2. Sales, §2-304, Comment 4. The most recent draft of the Code omits this comment. Both Easterbrook and Posner accept the asymmetric interpretation; see the discussion below.

[76]Comment 2.

Empire Gas Corporation v. American Bakeries,[77] in which a watered down version of the good faith standard is still potent enough to subject a buyer to millions in damages for a failure to have any requirements. I conclude with a brief description of a recent decision which illustrates the futility of relying on a good faith standard absent a coherent framework for understanding the transaction.

The case cited in the UCC comments for the proposition that a firm can drastically reduce its requirements in good faith is *Southwest Natural Gas Co. v. Oklahoma Portland Cement Co.*.[78] A cement company had a fifteen year requirements contract for provision of all its natural gas needs.[79] It subsequently redesigned its boilers so that they would utilize the waste heat of the kilns and this resulted in a substantial decrease in the amount of gas needed to power the boilers. The gas company's attempt to enjoin the use of waste heat as a violation of the contract was denied. The result was surely correct, but it was softened by the court's language.

> The term of the contract here involved was 15 years. That was longer than the ordinary life of certain of the appliances and equipment in the cement plant. It is a reasonable assumption that the parties contemplated whenever it became necessary to renew worn-out equipment, the Cement Company would install modern equipment in its place. Certainly, the parties did not contemplate that the contract should obligate the Cement Company to replace worn-out equipment with a like type of equipment that had become obsolete in the cement manufacturing industry, or not to utilize fully, modern equipment when installed. We are of the opinion that the Cement Company had the right to install modern equipment whenever it was necessary to replace worn-out equipment so long as in so doing it acted bona fide.
>
> The boiler plant of the Cement Company became worn out in 1933. To replace it the Cement Company installed a modern boiler system similar to the types generally used in other cement manufacturing plants. In the improved plant a new or different fuel was not substituted for gas, but a more efficient and economical utilization of gas was effected, so that the heat resulting from the combustion of the gas in the kilns was used both to heat the product in the kilns, and the boilers. . . . In so improving its plant, the Cement Company acted in good faith and in the exercise of prudent business judgment. That it had the right to do.[80]

---

[77]840 F.2d 1333 (1988).

[78]102 F. 2d 630 (10th Circ. 1939).

[79]There were some modifications which allowed it to use other natural gas which can be ignored.

[80]At 633.

"Bona fide," "good faith," and "prudent business judgment" presumably impose some constraints on the buyer, but what? If the relative price of an alternative fuel fell, could the Cement Company switch? Would that be “imprudent?”

The most plausible explanation for the structure of the fifteen-year contract is that the cement company needed assurance of a continued supply and that replacement of Southwest by another supplier would have been difficult. Southwest, on the other hand, likely supplied a number of customers and had only modest relation-specific investments. If that is indeed the case, then we would expect that the contract would give the buyer considerable assurance of supply and the flexibility to alter the amount taken as circumstances change. That does not, of course, mean that the gas company need grant it unlimited discretion. Possibly, it might want to confront the cement company with an additional cost when it contemplated a change to a less gas-intensive technology if relative prices or technology changed. But why rely on an after-the-fact review by a court or jury guided by such loose language as "good faith" or "prudent business judgment?" The parties could fine-tune the gas company's protection in a number of ways. The simplest would be to impose a minimum quantity, perhaps in the form of a take-or-pay arrangement. Or the gas company could be given a right to revise or terminate following the occurrence of certain events (a change in relative prices of a certain magnitude, a reduction in quantity beyond a certain point, a finding by an arbitrator that the technology has changed). Such protection was likely unnecessary, since I doubt that the gas company had any need to protect its reliance. But why, absent explicit language, should there be any presumption that the buyer was promising to adapt inefficiently as new information became available?

In *Northern Indiana Public Service Company v. Colorado Westmoreland, Inc.*[81] Judge Easterbrook, sitting by designation, held in favor of a public utility purchaser which had substantially reduced its coal requirements. NIPSCO entered into long-term contracts with Colorado Westmoreland in 1977 which were renegotiated in 1980 and again in 1982. The dispute concerned its performance under the last contract. That contract was for its requirements at a particular generating facility. The contract included both estimated requirements (about one million tons per year) and a maximum annual obligation by the seller (1.25 million tons).[82] In finding for the utility, Judge Easterbrook provided elaborate detail on the nature of the transaction and its negotiating history.

The contract was one of two NIPSCO contracts for low-sulphur western coal. The other was with Carbon County Coal Company. After fuel prices collapsed in the early 1980's NIPSCO

[81]667 F.Supp. 613 (1987).

[82]The seller also agreed to use best efforts to meet requirements in excess of 1.25 million tons; it is not clear whether the contract price would carry over to the additional output. The contract also placed a limit on the seller's total commitment. It could not enter into contracts with others which when added to the coal it was obliged to deliver to NIPSCO would exceed the capacity of the mine.

sought declaratory judgments regarding both contracts. It sought, and failed, to be excused from the Carbon County contract, a fixed quantity contract with an indexed price well above the current market price.[83] In the CWI contract, NIPSCO wanted a judgment that, despite a substantial reduction in requirements, the contract was still in force. In addition to these two contracts, NIPSCO was supplied by an unspecified number of high-sulphur Midwestern coal companies with less expensive coal. NIPSCO had eleven coal-fired generating units. The CWI contract was for the requirements of one particular unit, Schahfer 15. To simplify the story somewhat, when determining which units to operate, NIPSCO had to balance the costs of generating at those units and the reliability of the system; it also had to take into account directives from the regulatory commission (economy purchase orders) and the possibility that the commission would not allow it to recover all its costs. As a consequence, NIPSCO started using more high-sulphur and less low-sulphur coal. In addition, hard times in the steel industry—a major determinant of the demand for NIPSCO's power—led to a scaling back of power needs. So, despite the contract estimate of approximately one million tons of coal per year, requirements in 1983-1985 ranged from 573,000 tons to 713,000.[84]

CWI argued that a quantity reduction of this magnitude was not in good faith, citing Comment 3 of §2-306.[85] Judge Easterbrook rejected the argument on four grounds: (a) NIPSCO acted in commercial good faith; (b) the variance from the estimate was only 45%; (c) the parties dickered over the boundaries on the requirements and the court should not read language into the agreement which the parties explicitly chose not to include; and (d) the restrictions in the statute are asymmetric, applying only to the buyer who attempts to unduly increase his requirements.[86]

The most interesting aspect of the opinion for my purposes is the rich description of the contractual alternatives considered by the parties before they settled on the final language. CWI initially proposed a minimum-take contract. Alternatively, CWI suggested a 900,000-ton "walk

[83]Northern Indiana Public Service Co. v. Carbon County Coal Co., 799 F.2d 265 (7th Cir. 1986). Carbon County won a judgment of $181 million, but was denied specific performance.

[84]667 F.Supp. 613, 615. Requirements in 1986 were only 315,000 tons, but the parties concede that was an aberration because of a fire in the mine and a steel strike.

[85]"If an estimate of output or requirements is included in the agreement, no quantity unreasonably disproportionate to it may be tendered or demanded. Any minimum or maximum set by the agreement shows a clear limit on the intended elasticity. In similar fashion, the agreed estimate is to be regarded as a center around which the parties intend the variation to occur."

[86]At 636. "Otherwise a requirements contract at a price that becomes advantageous to the buyer would allow the buyer to become the middleman to the world, suddenly deciding to sell the product in bulk or building new plants and 'requiring' vast quantities. This has been a problem in the electricity business." He then cites two of the cases discussed in the next section (which I will argue were wrongly decided).

away" provision. If NIPSCO ordered less than 900,000 tons in any year, CWI would have the option of declining to fill the orders and canceling the contract.[87] If NIPSCO were concerned about protecting its long-term supply of coal, then it might place orders just to keep the agreement alive. In effect, by purchasing coal that it did not need today, NIPSCO would be renewing its option to purchase coal tomorrow. If NIPSCO did not exercise the option, then CWI could choose to terminate the deal. The risk of termination would have been one of the costs that NIPSCO would have to consider when deciding whether it should order coal that it did not need today. All this was moot as NIPSCO rejected both the minimum-take and the walk away provision. In a proposed draft, NIPSCO proposed a clause that would define the parameters of its discretion:

> [1] Nothing contained in this Agreement shall be construed to require the use of coal for generation of electrical energy or to prohibit Buyer from utilizing any and all other or substitute sources of energy as may become available; [2] nor shall anything in this Agreement be construed to require the purchase of more coal than needed for the operation of Buyer's Schahfer Unit 15; [3] nor shall anything in this Agreement be construed to cause Buyer to operate Schahfer Unit 15 to any greater extent than Buyer in its sole discretion deems prudent, either as to hours of operation or as to load carried on said Schahfer Unit 15; [4] nor shall anything in this Agreement be construed to prevent Buyer from operating any and all of its generating stations, including Schahfer Unit 15, and utilizing other sources of power supply in the most efficient, economical, and prudent manner for the production and supply of electrical energy for Buyer's Customers. . .[88]

In the course of the negotiations both the first and third clause were eliminated. The first deletion means that the generating unit could not be shifted to an alternative fuel without CWI's permission. The other deletion is harder to explain since the language of the next clause seems to allow NIPSCO to justify its decisions on roughly the same grounds. Judge Easterbrook concluded that deleting the clause allowed CWI to protect itself against irrational changes in requirements.[89] Nonetheless, it is clear that the contract would, with one exception, allow the buyer to adapt to changed circumstances by varying its requirements in a way that it reasonably perceived to be in its long-term economic interest without having to get the permission of, consult with, or pay CWI. The exception, as noted, was a change in the relative price of fuels.

Again, it should be emphasized, this allocation of decision making was hardly inevitable. Indeed, in its contract with Carbon County NIPSCO opted for a very different arrangement in

---

[87]At 631.

[88]At 633.

[89]The revised contract also tacked on a somewhat cryptic clause requiring that the buyer treat the seller no less fairly than its other producers of coal. (At 615)

which it sacrificed its quantity flexibility. Carbon County had only one customer and the mine was developed only after the contract had been entered into, so there was an obvious interest in protecting the seller's reliance. On the other hand, CWI's mine was already developed and the Schahfer unit built when the parties entered into this requirements contract. It is not clear from the opinion whether CWI had other customers (although its proposed "walk away" term suggests strongly that it did). CWI needed less protection of its reliance than did Carbon County and therefore was more willing to give NIPSCO control of the quantity decision. Judge Easterbrook did not allow the fine-tuning of the parties to be trumped by the wooden standards of the UCC.

In an earlier case, *Willapa Electric Company, v. S. L. Dennis Construction Company et al*[90] the Washington Supreme Court gave a very narrow reading to a minimum payment clause, finding in favor of a buyer who ceased to have requirements. An electric company entered into a five-year contract to provide all the electricity needs at the site of a rock crusher. Service required construction of two miles of new pole and wire line at a cost of about $4,000 pre-Depression dollars.[91] The costs of those poles would be amortized over the life of the agreement. To protect itself against the buyer's reducing its purchases, the contract established a minimum monthly payment. In the event that the buyer violated the contract and no longer had any requirements, the minimum payment would become due immediately.[92] The buyer disconnected from the power system and refused to make the minimum payment. The Supreme Court of Washington overturned a trial court verdict for the power company, giving what appears to be a very strained reading to the contract language. The minimum monthly charge, it suggested, "means only that, when the consumer maintains a connected load, or wholly disconnects the connected load and fails to notify the electric company of such disconnection, the consumer must pay for the load up to the time of notice of disconnection thereof, whether 'used or not.'"[93] It dismissed evidence of the power company's reliance expenditures on the two miles of lines it built to serve this customer by noting that "there is no language in the power contract pointing to that expenditure on the part of the electric company as furnishing any consideration for the obligation

---

[90]168 Wash. 416, 12 P.2d 609; 1932 Wash. LEXIS 866.

[91]The court noted that the utility "did not have such prospective use for that new line to warrant its construction, apart from the prospective service under its contract with the construction company; though it had prospect for, and did serve over that line, some other consumers." (At 418-19)

[92] "If the Consumer violates this contract there shall immediately become due and payable as damages, not as a penalty, the minimum payment named herein for the unexpired term of the contract, or extension thereof." (At 418)

[93]At 421.

assumed by the construction company of taking or paying for 'power to be required or used by consumer on said premises.'"[94]

The opinion is short on detail, so it is possible, I suppose, that the court's interpretation of the language is correct. But unlikely. The dissent pointed out that in the contract between the initial customer and its assignee, they had agreed that if the power contract were canceled, they would split the cancellation fee fifty-fifty, with the assignee's liability capped at $1,500. That is, the buyer (and the assignee) presumed that the minimum payment was take-or-pay. Moreover, the seller's substantial reliance expenditure is consistent with this interpretation. So, the case was, most likely, wrongly decided. It stands out in stark contrast to other cases which overshoot in the other direction, in particular the three that follow.

Feld v. Henry S. Levy & Sons, Inc.,[95] the leading New York case, illustrates how the good faith implication makes a simple case hard and undoes a sensible allocation of decision making. Levy & Sons operated a wholesale bread baking business. As part of its operations it generated considerable waste product in the form of stale or imperfectly appearing loaves. One option for disposing of this material was to convert it into "bread crumbs" by removing the labels, processing the loaves through two grinders, toasting the product in an oven and bagging it. It purchased the oven and entered into a one year evergreen (automatically renewed) contract with the Crushed Toast Company which agreed to purchase "all bread crumbs produced by the Seller in its factory at 115 Thames Street, Brooklyn, New York"[96] at a price of 6¢ a pound. Either party could cancel on six months notice. The Crushed Toast Company was required to deliver a "faithful performance bond," presumably to provide assurance to Levy of timely removal of the waste. In the first eleven months, Levy delivered about $30,000 worth of bread crumbs. Apparently the operation was not profitable for Levy. It attempted to renegotiate the contract price up to 7¢, but was rebuffed. One month before the end of the first year Levy ceased production of bread crumbs and dismantled the toasting oven. The waste was then sold to animal food manufacturers. Feld sued for breach.

Supreme Court denied both parties' motion for summary judgment. Appellate Division affirmed over a strong dissent which would have (properly) granted Levy's motion for summary judgment. The Court of Appeals affirmed unanimously, rejecting the dissenters' argument that the language was clear and unambiguous and that there could be no inference that Levy had promised to continue to produce bread crumbs to sell to plaintiff. The court first noted that output contracts were not unenforceable because the seller was required to conduct his business in good faith. The seller was not free to decide whether he should produce any bread crumbs. "The

[94]At 424-25.

[95]37 N.Y.2d 466, 373 N.Y.S.2d 102, 335 N.E.2d 320 (N.Y. 1975).

[96]At 468.

seller's duty to remain in crumb production is a matter calling for close scrutiny of its motives."[97] That scrutiny would require data on "the actual cost of the finished bread crumbs to defendant, statements as to the profits derived or the losses sustained, or data specifying the net or gross return realized from the animal food transactions."[98] Moreover, "[s]ince bread crumbs were but a part of defendant's enterprise and since there was a contractual right of cancellation, good faith requires continued production until cancellation, even if there be no profit. In circumstances such as these and without more, defendant would be justified, in good faith, in ceasing production of the single item prior to cancellation only if its losses from continuance would be more than trivial, which, overall, is a question of fact."[99]

The court failed to recognize that, in its own statement of the facts, it had already provided the relevant economic data. The contract price was six cents per pound and Levy's actions (dismantling the oven) indicate that this amount would not even cover the variable costs; it was cheaper to shut the project down. However, Levy indicated that a price of seven cents per pound would have been sufficient to warrant its continued operation of the toaster oven. So, the fight is over one penny. The court gives no hint as to how that information would help answer the question it has posed. Further, it glosses over the question of why Levy's termination of an operation that does not cover variable costs would be in bad faith. Given the incoherence of the question, the elusiveness of the answer is hardly surprising.

That this was an output contract rather than a requirements contract matters not. It can be viewed as a requirements contract for a service—waste removal.[100] The deformed loaves and day old bread were waste products that happened, by chance, to have a positive market value for various uses. Suppose, instead that they were of no value and that Levy had entered into a contract to have all its trash hauled away at a price of, say, 3¢ a pound. The only difference is that the net flow of cash now would be from Levy to Feld. Can one seriously argue that Levy has a duty to stay in business to produce garbage for Feld to haul away? Yet that is precisely what the court has done.

It is conceivable that a producer would under certain circumstances promise to produce a specific level of a waste product. That, recall, was what the oil refineries promised to the aluminum companies who were building calciners in reliance upon the refineries' coke output.[101]

---

[97]At 471.

[98]At 471.

[99]At 472.

[100]That would presumably get it out of the UCC's scope.

[101]See text at note 14. In some instances state and local governments have built capital intensive waste treatment facilities, set high prices for waste removal, and imposed "flow

The contrast between the GLC and aluminum contracts suggests the conditions in which the parties might want to give substantial protection to the trash remover's reliance interest. Those conditions are certainly not met in *Feld v. Levy*. The facts are spotty, but a reasonable inference is that the Crushed Toast Company was in existence prior to the formation of this contract, that it had other suppliers, and that toasted bread crumbs could be held in inventory at less expense and for a greater period of time than unsold loaves of bread. Hence its willingness to subject itself both to Levy's discretion in determining the bread crumb production and to post a faithful performance bond. The fact that Levy, the party that had carefully protected its reliance because it had purchased an oven for making bread crumbs and had a clear need to assure the removal of unsold loaves, dismantled the oven should have been sufficient to end the inquiry. Instead the court, under the banner of good faith, encouraged a fruitless inquiry into the costs and revenues associated with the two alternative ways of disposing of the waste.[102]

A half century earlier, the New York Court of Appeals mishandled a similar case. In *Wigand v. Bachmann-Bechtel Brewing Company,*[103] the defendant, a brewer, entered into an agreement in which it agreed to sell to the plaintiff all the "wet grains" produced at its brewery for a five year period, or until 500,000 barrels of beer had been brewed. Wet grains were a waste product of the brewing process which would then be dried and sold as cattle feed. Wigand would, under the contract, install a plant for drying the grains in Bachmann-Bechtel's brewery. It had in previous years installed such plants in other breweries. The cost of installation was $6,050, borne entirely by Wigand. At the end of the five years (or after the 500,000 barrels had been

---

controls" limiting the ability of clients to dispose of their waste outside the jurisdiction. These fencing-garbage-in ordinances have generated a considerable amount of litigation. In C & A Carbone, Inc. v. Town Of Clarkstown, New York,114 S.Ct. 1677 (1994), the Supreme Court found one such ordinance a violation of the dormant commerce clause. For a sampling of post-*Carbone* flow control cases, many of which turn back challenges to the ordinances, see, Houlton Citizens' Coalition v. Town Of Houlton, 175 F.3d 178 (1999); Automated Salvage Transport, Inc. v. Wheelabrator Environmental Systems, Inc., 155 F.3d 59 (1998); National Solid Waste Management Association v. Williams, 146 F.3d 595 (1998); Ben Oehrleins and Sons and Daughter, Inc. v. Hennepin County, 115 F.3d 1372 (8th Cir.); and Sal Tinnerello & Sons, Inc. v. Town of Stonington, 141 F.3d 46 (2d Cir.1998).

[102]In another case involving sale of a waste product, Neofotistos v. Harvard Brewing Co.341 Mass. 684, 171 N.E.2d 865 (1961), a brewery promised to sell all its waste grain to the plaintiff. Plaintiff promised daily removal. As in *Feld*, plaintiff was required to furnish a surety company performance bond. After sustaining substantial losses, the brewer closed the brewery. Plaintiff's claim that the brewery should have continued to produce grains was rejected. The case is easily distinguishable from *Feld*. For my purposes, the similar protection of the seller's reliance–the importance of removal and the requirement that the buyer post a bond–is of more interest.

[103]222 N.Y. 272; 118 N.E. 618 (1918).

produced), title to the drying plant would be transferred to the brewer. Wigand's compensation would come entirely in the form of a favorable price for the wet grains of six cents per barrel of beer.[104] The contract included an excuse clause broader than the typical *force majeure* clause:

> Should the party of the first part hereto be prevented from operating its brewery by reason of strikes, break-downs in machinery, or for any reason whether beyond its control or otherwise, then and in that event this contract and the performance thereof by the party of the first part shall stand in abeyance until the brewery of the party of the first part shall again be in operation.[105]

In the first 21 months the brewery produced 158,000 barrels of beer and both parties complied with the contract. Then the brewer sold its beer business (but not the physical plant) to another brewer. It covenanted with the purchaser that it would not operate its brewery for two years. It complied with the covenant and, for reasons unstated, did not reopen the brewery even after the two years had expired. Wigand sued and ultimately prevailed, although the Court of Appeals rejected the jury verdict of $8,500 and remanded for a new trial.[106]

The court put great weight on Wigand's reliance on the brewery's continued operation in concluding that the brewery had breached the implied covenant of good faith and fair dealing.

> The mutual promises in the contract, many of which we have stated, are such that a voluntary and intentional failure to perform by the defendant would be inequitable and unjust. The large expenditure by the plaintiff for machinery which he placed in the defendant's plant for which pay could only be obtained by him through a continuance of the business; the furnishing by him of $5,000 to the defendant, only to be returned by deductions from the purchase price of the wet grains received; the necessity of expenditures to keep the plant in repair and for insurance as stated for the full period of five years, are important facts to be considered in determining what was meant by the defendant when it promised to sell to the plaintiff "all of the wet brewery grains produced from the brewing at its brewery" as in the contract provided.[107]

---

[104]In addition, Wigand advanced about $5,000 to the brewer for modifications of the brewery so that the drying plant could be installed. That was to be paid back at $250 per month to be offset against Wigand's payments for wet grain.

[105]At 276.

[106]Wigand won at trial; that verdict was reversed by Appellate Division (169 A.D. 285; 154 N.Y.S. 840 (1915)).

[107]At 277.

In *Feld,* the seller had made the significant relation-specific investment—the toasting oven. Here, the relation-specific investments (over $6,000 in pre-WWI dollars) were made by the buyer. Recoupment depended on the continued operation of the brewery. Wigand could have reduced its reliance by phasing its compensation differently. Failing that, it might have forced the brewery to take this reliance into account when making decisions on how much beer to produce or whether to produce beer at all. It could, for example, have insisted that if the brewery were shut down, the brewer would have to purchase the drying plant for a fraction of the $6,050 related to the length of time the drying plant had operated. Instead it relied, not unreasonably, on the seller's self-interest. Under most circumstances the brewer would find operating the brewery more attractive than moth-balling or destroying it.[108] But in those rare cases (as the present) where the brewery seems to be worth more dead than alive, Wigand's reliance remains unprotected, at least until the court comes in and trumps the agreement. It is possible that the brewery might agree ex ante that it would have to pay a fee to the waste removal firm if it chose to go out of business to cover at least some of Wigand's reliance costs. But is it likely? Other suppliers, notably workers, also relied on continued operation of the brewery and presumably received nothing. The court simply found an implausible duty to produce waste, imposing a particular vision of the balance between discretion and reliance other than the one designed by the parties.[109]

In yet another tail-wags-dog opinion, the New York Court of Appeals held that a Manhattan hotel should remain in operation for the benefit of a parking garage (or pay the consequences).[110] The Savoy Hilton entered into a five year contract with the parking garage, promising to use reasonable efforts to enable the garage to have "the exclusive right and privilege of storing the motor vehicles of [the hotel's] guests, tenants and patrons."[111] The garage agreed to pay the hotel ten percent of the transient storage charges incurred by the hotel guests. Thus, the garage paid a fee for the hotel's encouraging patronage. The garage was about one-half mile from the hotel. (Only in New York!) Savoy purchased the hotel (which was over thirty years old) shortly before it entered into the contract. Less than two years after entering into the

---

[108]Recall the discussion of *Diamond Alkali* and *Central States* above at notes 57-61. The decision does not discuss whether the brewery was reopened by someone else or simply closed down.

[109]Contrast *Wigand* with *Hamlyn*, note 52, which also involved removal of the waste grains from the brewery. There, the court held that the brewery's discontinuance did not create liability, even though production continued, albeit under different ownership.

[110]407 East 61st Garage, Inc. v. Savoy Fifth Avenue Corporation 23 N.Y.2d 275; 244 N.E.2d 37; 296 N.Y.S.2d 338 (1968). I have incorporated additional facts from the (skimpy) record. In addition to affidavits by the principals, each side introduced an article from the *New York Times*.

[111]At 278.

agreement, Savoy demolished the hotel. There was some dispute over the reason. The owner claimed that it was losing money on the hotel and that there was no hope of making it profitable. The plaintiff claimed that the real reason for demolition was that the land had a higher and better use—namely construction of a fifty-story office building (the General Motors Building just south of Central Park). The plaintiff made much of the motive in his affidavit and briefs, but the claims of both sides come down to the same point: the hotel was worth more dead than alive.

The parking garage sued for damages for lost profits during the last three years of the agreement.[112] Judge Breitel, speaking for a unanimous Court of Appeals, reversed summary judgment for the hotel and remanded.[113] The court framed the question in a neutral way: "The real issue in this case is . . . whether this agreement imports an implication that Savoy was obligated to remain in the hotel business, or, better, had undertaken indefeasible obligations for the full term."[114] It recognized "the incongruity of an enterprise, as large as a metropolitan hotel, being obligated to 'continue in the hotel business' merely because of various relatively minor incidental service contracts, such as that involved here."[115] Nonetheless, the court asserted a default rule: when the promisee relies upon the promisor's continued activity, a promise to remain in business will be implied. Savoy could avoid this result in two ways. Ex ante, Savoy could have included an express term in the contract that would terminate the agreement if the hotel went out of business. Ex post, Savoy could invoke custom or usage in the industry to show that incidental service contracts are terminable on the hotel's going out of business.

So, the net result is a default rule which could be overcome by explicit contract language or by demonstrating that people in the industry knew (or should have known) that the default rule

---

[112]The garage did not attempt to obtain an injunction that would have given it the right to hold out for a piece of the increased value of the office building. A *New York Times* article, introduced by the plaintiff, identified two tenants who did have the right to throw a monkey wrench into the planned conversion. The two threatened to remain in business if their terms were not met, and Savoy, in turn, threatened to raze the hotel around them and construct the office building on the remainder of the site. See William Robbins, "New G.M. Building May Rise Around 2 Tenants; Coffee House and Flower Shop Owners May Stay Till Leases Expire," *New York Times*, Dec. 12, 1965, Section 8, Page 1, Column 2. In fact, [what happened?]

[113]While this was not a variable quantity contract, Supreme Court classified it as a requirements contract and granted summary judgment to the hotel because there had been no evidence of bad faith. The Court of Appeals held that "the agreement between the garage and Savoy is not a 'requirements' contract, but is akin to the grant of a license or franchise by Savoy to the garage." (At 278) The court then went on to note that categorization was not particularly helpful in analyzing the case.

[114]At 279-80.

[115]At 280-81.

does not apply here. The court gave no reason why the default rule should give complete protection to the garage's reliance with no concern for the hotel's discretion. Nor does it indicate how one should give content to the custom and usage standard. Whose custom and usage? Hotels? Parking garages? Hotels dealing with parking garages? In Manhattan? Would the custom and usage depend on whether the garage owner relied upon the contract in building the garage, whether the hotel customers constituted 100% (or 50% or 5%) of the expected revenues of the garage? The garage's interest in protecting its reliance depends crucially on these matters. Under most circumstances, the garage would require only modest (if any) protection of its reliance; indeed, the most plausible scenario is that the multi-year agreement was designed to protect the reliance of the hotel which was concerned about the consequences of not having a convenient parking garage nearby.

Suppose that instead of closing, the Savoy had changed its business strategy. Perhaps it chose to remodel and offer fewer, and larger, rooms. Would it have to compensate the garage during the remodeling period or for the lower number of potential patrons? Could it introduce a subsidized airport shuttle service which would result in a smaller number of patrons with cars to be parked? Could it close the hotel restaurant for lunches or on Monday evenings? Would it have to clear its advertising budgets with the parking garage? Would we expect a hotel to require approval from (or to promise payment to) a parking garage as it adapts its business decisions to changing circumstances? If the court does not mean to hold the hotel responsible for these decisions, how does one draw the line between these and the decision to tear the hotel down? Must these all be fact questions relying on proof of custom and usage? It makes little sense to have a fact-sensitive default rule where the fact is so elusive.

The three preceding cases are like shooting fish in a barrel, at least when one is armed with the right tools. *Empire Gas Corporation v. American Bakeries Company*[116] presents a more difficult problem. After entering into a requirements contract, the buyer changed his mind and had no requirements for the life of the contract. The seller sued and won a jury verdict in excess of $3 million. On appeal, Judge Posner upheld the verdict. Although the contract concerned potential sales of more than $5 million and was between firms with combined sales in 1980 of around $1 billion, the agreement was prepared by two laymen without, it appears, any assistance from counsel.[117]

American Bakeries was a distributor of bakery goods in different parts of the country, operating a large fleet of trucks. Concern over the energy crisis of the late 1970's sparked interest in the possibility of converting part of its fleet to the use of propane gas. It entered into a four-year requirements contract with Empire for provision of conversion units (approximately 3,000

---

[116]840 F.2d 1333 (7th Cir. 1988).

[117]646 F. Supp. 269, 271 (1986).

"more or less, depending upon requirements of Buyer"[118]) and propane motor fuel. The units would give the trucks the capability of running on either fuel. Empire did not manufacture conversion units; it would purchase them elsewhere and supply them to American. The contract fixed the price for the conversion units ($750 a piece), but did not give the brand or specifications. Empire had at least five brands of conversion equipment in inventory and the court opinions suggest that delivery of any of these would have been appropriate at the contract price. Empire was not in the business of marketing conversion equipment;[119] its primary concern was sale of propane. American agreed to take its requirements of propane from Empire at (roughly) the market price. The pricing term was a loosely worded "meeting competition" clause:

> In consideration of providing propane dispensing equipment, American Bakeries Company agrees to purchase propane motor fuel solely from Empire Gas Corporation at all locations where Empire Gas has supplied carburetion and dispensing equipment as long as Empire Gas Corporation remains in a reasonably competitive price posture with other major suppliers. Buyer may elect to call for price negotiations at which time seller will have the opportunity to alter buyer's price to buyer's satisfaction. . . .[120]

In addition, Empire promised to provide American with propane dispensing equipment, including a 1,000 gallon tank, at no charge at all locations where Empire supplied dispensing services.[121]

After the agreement was signed, American advised Empire that it was having financial difficulties. For over a year American failed to take any conversion units or propane, but informed Empire that it intended to honor the contract. Finally, Empire sent an invoice for the purchase of 3,000 conversion units which it claimed to be holding in inventory. American refused to accept conversion units or pay for them and Empire sued for lost profits both on the conversion units and the propane. The jury concluded that, but for the breach, Empire would have sold 2242 conversion units (an exactitude suggesting capriciousness) to American; that it had lost profits on these sales of about $600,000, roughly 36% per unit; and that the lost profits from the foregone propane sales were $2.6 million.

Judge Posner suggested that, on the basis of the negotiating history, the contract could have been interpreted as one for a fixed quantity of conversion units. The reason for this conclusion is unclear since he also noted that American rejected Empire's standard contract which

---

[118]840 F.2d 1333, 1335.

[119]"Empire Gas does not manufacture conversion equipment, but supplies it essentially as an accommodation to the customers for its propane, the major part of its business." At 1336.

[120]1987 U.S. Dist. LEXIS 1324, at 2. The courts ignored the open-ended nature of the price term, focusing only on the quantity term.

[121]1987 U.S. Dist. LEXIS 1324, at 8.

called for a minimum number of conversion units per month.[122] Regardless, the parties agreed that the agreement should be classified as a requirements contract and therefore that it fell under UCC §2-306.

In interpreting UCC §2-306 he adopted the majority position holding that a reduction in requirements was constrained only by the buyer's good faith, not by the "unreasonably disproportionate" proviso. American would have been acting in bad faith had it purchased conversion units or propane from competitors;[123] and it would not have been acting in bad faith "if it had a business reason for deciding not to convert that was independent of the terms of the contract or any other aspect of its relationship with Empire Gas, such as a drop in the demand for its bakery products that led it to reduce or abandon its fleet of delivery trucks."[124] If American simply changed its mind without a reason, this presented a more difficult case. The requirements contract could plausibly be characterized as giving American an option, but that, Posner concluded, was not the law.[125]

> The essential ingredient of good faith in the case of the buyer's reducing his estimated requirements is that he not merely have had second thoughts about the terms of the contract and want to get out of it. Whether the buyer has any greater obligation is unclear, . . . but need not be decided here. Once it is decided (as we have) that a buyer cannot arbitrarily declare his requirements to be zero, this becomes an easy case, because American Bakeries has never given any reason for its change of heart.[126]

---

[122] 840 F.2d 1333, 1338-1339.

[123] It is not clear why one would choose to characterize this as "bad faith" rather than as a flat-out breach.

[124] At 1339.

[125] "If no reason at all need be given for scaling back one's requirements even to zero, then a requirements contract is from the buyer's standpoint just an option to purchase up to (or slightly beyond, i.e., within the limits of reasonable proportionality) the stated estimate on the terms specified in the contract, except that the buyer cannot refuse to exercise the option because someone offers him better terms. This is not an unreasonable position, but it is not the law." (At 1339.)

[126] At 1340-41.

Good faith, according to Judge Posner, puts a burden on the buyer to give a valid business reason (other than "I changed my mind") for the failure to take any goods. American did not give any reason and, apparently, could not. Ergo, its action must have been in bad faith.[127]

The contract differs from others discussed in this paper in that it was a two-stage requirements contract. American agreed to buy all its propane requirements from Empire; it would only have propane requirements if it had conversion units and these too it promised to buy only from Empire. It is useful to analyze the contract in two stages, beginning first with the propane stage. Had American installed the conversion units, then its requirements would have depended on overall fuel needs (the demand for its products) and on the relative cost of fuels. If gasoline prices had fallen relative to propane, American could have reduced its requirements to zero. That was precisely the flexibility it had bargained for. It was crystal clear to both parties that the only reason to go through with this contract was to have vehicles that could use either fuel and to allow Empire to choose the most efficient. If the two fuels were very close substitutes, we should anticipate that fairly minor fluctuations in relative prices would have resulted in dramatic shifts in American's requirements. That is how Judge Posner interpreted the agreement.[128] Empire could have demanded some limits on American's discretion to protect its reliance. It is hard to imagine that much protection would have been necessary, given the meeting competition clause and the fact that Empire had a large number of propane customers at most locations. Not surprisingly, the contract provided no explicit protection (e.g., minimum purchases of propane); Empire bore the risk that the relative price of propane would rise and that American would purchase gasoline instead.

Of course, since American never took any of the conversion units, the propane requirements were never an issue. The requirements for conversion units would also be sensitive to the relative prices of propane and gasoline—not the day-to-day fluctuations that would have

---

[127]The dissent disagreed: "The majority thus transforms the seller's theoretical burden of proof on bad faith (unarticulated to the jury) into an actual presumption of the buyer's bad faith (articulated post-trial)." (At 1343). He would have reversed and remanded because Empire had not met the burden of proving bad faith, or, alternatively, because, if an unreasonably disproportionate reduction in requirements creates a presumption of bad faith to be rebutted by buyer's proof of good faith, this was not the rule under which the trial was conducted.

[128]"American Bakeries objects violently to the assumption made by Empire Gas's expert witness that the vehicles converted by American Bakeries, had it honored what Empire Gas contends were its obligations under the contract, would have run 100 percent on propane. The conversion units would have been dual units, which permit the driver by a flick of a switch in the engine to run his vehicle on either gasoline or propane. But since the parties agree that the price of propane was lower than that of gasoline throughout the entire contract period, a driver would have switched his conversion unit to gasoline only when he was low on propane and too far away from a propane station to reach it before he ran out. This factor was not big enough to upset the expert witness's calculations significantly." (At 1341-1342)

determined propane requirements, but the long-term expected costs of the alternative fuels. If, in time, American learned that the future price of propane was expected to be relatively high, then the requirements contract would give it the flexibility to adapt to the new information by discontinuing installation of the conversion units. The seller could have constrained the buyer's discretion by, in effect, imposing a cost if buyer were to reduce its purchases. It could have done so by providing for a specific minimum, or an installation schedule, or a flat payment to be offset against future purchases. American had, recall, rejected Empire's initial proposal which would have required installation of a minimum number of units.[129] The parties' failure to include protection of Empire's reliance in their agreement was no accident; it reflected the low value of that protection.

If, because of a shift in relative prices, American concluded that it would no longer be profitable to purchase additional conversion units, then it could cut back or eliminate its requirements. That is the efficient response and, unless an aggressive definition of good faith were interposed, that would be the outcome. The point is twofold. The parties could have explicitly limited the buyer's discretion to adapt to changed circumstances, but chose not to. Further, it is doubtful that the courts, using an open-ended standard like good faith, could provide a default rule better than the zero-protection rule—if the contract is silent, the seller imposes no fee to protect its reliance and the buyer has absolute discretion to cut back or eliminate requirements.

There was no evidence that relative prices had changed; indeed, Judge Posner noted that propane prices stayed below those of gasoline for the entire period.[130] The facts are unclear, but the only changed circumstances appear to be either that American's financial condition deteriorated or that it simply got cold feet. Posner's opinion holds that cold feet are not enough, although the relative price change most likely would have been. In that sense, his interpretation is far more respective of the contract language than the *Feld* or *Wigand* courts. But that does present a puzzle. Why would the seller be willing to bear the risk of relative price changes, but not the lesser risk of the buyer changing his mind?

Unlike most of the other contracts discussed in this paper, the underlying business sense of the contract is not clear. American did not enter into this agreement to assure a supply of conversion units. The units were produced by a number of suppliers with Empire only an intermediary. It could easily have found such units on the open market. That part of the agreement was most likely ancillary to the fuel requirements contract. It is not obvious why American would want to take all its fuel requirements from Empire.[131] Perhaps it was desperate

---

[129]See above at note 122.

[130]At 1342.

[131]Perhaps empire used the tied sale to circumvent price controls, charging an above market price on the conversion units. There is no evidence of this in the opinion.

to line up any fuel sources in that era of shortages and rationing; perhaps it would have been vulnerable to short-term inventory fluctuations and it was buying assurance of a continuous supply of propane. On this Judge Posner is silent. Indeed, his only invocation of reliance is with regard to the *seller's reliance* on the estimated requirements.[132] Given that Empire sold propane to a large number of accounts, its reliance on any particular one was likely trivial; its failure to protect its reliance in the contract is consistent with this.

The lost profits remedy provided a ludicrously high level of protection for Empire's reliance. The damages are the markups on commodities that Empire bought and sold in competitive markets. Empire stocked and resold conversion units made by others. The contract was for sale of a commodity, propane, at roughly the market price (given the meeting competition clause). The jury found, in effect, that American agreed to pay for 30% of the estimated 3,000 conversion units whether it took them or not. That outcome, as Judge Posner observed, was due at least in part to American's litigation strategy. American attacked Empire's damage estimates but did not present its own. "American Bakeries gambled . . . [;] we will not relieve it of the consequences of its risky strategy." [133] The court was unwilling to use the damage assessment to make any inferences about the plausible contract structure. The seller could not have wanted nearly so much protection of its reliance.[134]

Ironically, in an earlier decision, *Lake River Corporation v. Carborundum Company,*[135] Judge Posner held a minimum guarantee clause to be an unenforceable penalty although the penalty was no worse than the one imposed by the *Empire Gas* jury. Lake River had installed a bagging system for $89,000, in reliance on the contract; had the buyer breached immediately, it would have owed $533,000, which Posner found an unreasonably high penalty. In *Empire Gas,* Empire's reliance expenditures were $0 and the damages in the millions thanks to the "lost profits" formulation. Illinois law might well require both outcomes; I think one could come to the

[132]"The statement of an estimate invites the seller to begin making preparations to satisfy the contract, and although no reliance expense was incurred by the seller in this case, a seller is entitled to expect that the buyer will buy something like the estimated requirements unless it has a valid business reason for buying less. More important than the estimate . . . is the fact that ordinarily a requirements contract is terminated after performance has begun, rather than before as in the present case. Whether or not the seller can prove reliance damages, the sudden termination of the contract midway through performance is bound to disrupt his operations somewhat." At 1340.

[133]At 1342.

[134]The high measured damages could conceivably arise from the tie-in alluded to in note 131. Again, there is no evidence of this.

[135] 769 F.2d 1284 (7th Cir. 1985).

opposite (and preferable) result under existing law,[136] but it would certainly require fewer contortions if the Code were revised to deal with the problems cleanly.

I will conclude this Section with one more illustration of the importance of proper framing. In *Indiana-American Water Company, Inc. v. Town of Seelyville*,[137] the court held that a buyer under a requirements contract to take up to one million gallons per day of water for 25 years from the water company did not breach the agreement when, fifteen years into the contract, it decided to develop a wellfield that it already owned to meet part of its water demands, thereby eliminating its requirements. It distinguished an earlier decision[138] in which a golf course which had agreed to buy water under a requirements contract was held to have breached that contract by purchasing a wellfield in order to obtain its own supply of water. On what ground was it distinguished? The buyer in the present case had owned the (undeveloped) wellfield for many years before the present contract was executed; it had not purchased or otherwise acquired its wellfield during the term of the contract. Purchasing and developing a wellfield after the contract was entered into is "bad faith," but developing a wellfield already owned is "good faith." It is easy to imagine contract language that would have preserved the buyer's option to develop its own property; it is even conceivable that parol evidence would indicate that the water company was aware of the buyer's ownership of the field. It is even plausible that the contract was designed to protect the buyer's reliance, since the water company likely had a portfolio of customers and the buyer a dearth of alternative suppliers of water. The blinders of faith, good or otherwise, led the court to hinge the decision on an irrelevancy and obscured the questions that ultimately mattered.

V. Large Quantity Increases in Long-Term Contracts

The notion that one party might take undue advantage of a favorable market-contract price differential in a requirements or output contract is at the core of the Code's concern about unreasonably disproportionate demands.[139] In long-term contracts, the parties generally include boundaries on the quantity-determining party's discretion, boundaries which are sometimes disregarded by courts invoking good faith. In this Section, I will first discuss four cases in which

---

[136] Judge Posner's lengthy discussion in *Lake River* of the merits of a penalty and the questionable wisdom of enforcing the rule against penalties in a contract between sophisticated commercial entities indicates that he is not happy with the outcome.

[137] 698 N.E.2d 1255

[138] Andersen v. La Rinconada Country Club, 4 Cal.App.2d 197, 40 P.2d 571 (1935)

[139] A buyer might attempt to increase its requirements in a particular year if the price were favorable by accumulating inventory. For an early example of a buyer attempting to do so (and the court rejecting that attempt), see Manhattan Oil Co. v. Richardson Lubricating Co., 113 F. 923 (1902).

the court pared back the buyer's requirements. I conclude with an analysis of a case in which the court found for a seller in an output contract despite a huge increase in output.

In *Utah International, Inc. v. Colorado-Ute Electric Association, Inc*[140] the seller desperately wanted out of a bad contract. In April 1973, after three years of negotiation, the parties entered into a 35-year coal supply contract. Seller agreed to provide the coal requirements for two new generating units, each with a capacity of 350,000 kilowatts. The court did not say, but it appears that the contract required that the seller develop a new mine. The buyer's discretion was limited in two ways. First, the seller's total obligation over the 35 years was limited to 1830 trillion Btu's. Second, the buyer's annual obligation was to pay for 85% of the expected coal consumption of the two generators, regardless of whether it actually took the coal. The contract included a schedule of expected consumption for the entire period. That is, the contract appears to have been a take-or-pay contract with an annual maximum set by the buyer's requirements and a total maximum amount for the 35 year period. There is no mention in the decision of any other restrictions (e.g., makeups) on the timing of the buyer's taking of the 1830 trillion Btu's. The oil price shock of 1973 caused coal prices to go up well beyond the contract rate and, as in many other fuel disputes of the era, the seller wanted to either renegotiate or abrogate the contract. The buyer, it claimed, had ordered generators with a capacity of 410,000 kilowatts without informing the seller. The size, it contended, was an essential condition of the contract and by building units of this size the buyer had abrogated the contract.

The court had no difficulty in finding that the contract should be enforced. More problematic was the integration of the quantity terms. Colorado-Ute's construction of larger generators was, the court ruled, a breach of the contract, but that did not require a forfeiture.[141] The buyer was required to pay for the first 85% of its estimated coal consumption (the minimum annual amount) regardless of whether or not it could use the coal at the new generators. What if it needed less? The court held that it could (but was not obliged to) take coal below the minimum quantity and resell that coal on the open market. What if it needed more? The court split the baby. The court simply eliminated the requirements element. The seller had no obligation to sell coal beyond the minimum annual amount. If it did so, the sale would be pursuant to a new agreement, with terms, including price, to be negotiated. Given the huge post-1973 increase in coal prices, that was a significant victory for the seller.

The court did not reproduce the contract language which is unfortunate, since there seems to be a conflict between the stated capacity of the two generating plants and the total quantity. The contract specified the estimated sales for each of the 35 years. That sum was only about 80% of the maximum obligation (the 1830 trillion Btu's). If the larger generators were used with the

---

[140] 425 F.Supp. 1093 (1976).

[141] My guess is that if the contract price had not diverged from the market price the seller would have been delighted by the "breach," since it would have resulted in the seller receiving its revenue sooner.

same rate of capacity utilization that was used in determining the annual estimates, the 1830 trillion BTU ceiling would not have been reached. It is reasonable to assume that if the smaller generators had been operated at capacity, they would have bumped into the 1830 trillion Btu ceiling before the end of the 35 years; otherwise the ceiling would have been completely irrelevant. The only effect of installing the larger generators, therefore, would be a change in the timing of the buyer's requirements so that the contract maximum could be reached sooner. (If they could not have reached that ceiling with the smaller generators, then one would be hard-pressed to explain why the parties included two apparently inconsistent terms in the agreement.) Given the huge increase in coal prices, the change in timing mattered to the parties, ex post. But, ex ante, when they entered into the contract and when Colorado-Ute changed the size of the generators (pre-oil shock), the change in timing was likely unimportant; prices could as easily have fallen (as they did in the 1980's).

The seller had agreed to make enough coal available to produce 1830 trillion Btu's over 35 years, and to be paid for about 2/3 of it, even if the buyer decided to take none. At most, the generator size placed limits on the timing. If the capacity of the two units was indeed a term of the contract, then the ceiling on the buyer's annual requirements would be defined thereby. The buyer should not be allowed to insist upon delivery of coal beyond the capacity of the smaller units. That, rather than the court's baby-splitting, would have been the resolution consistent with the terms of the agreement.

Assuming, as we must, that the smaller generators had sufficient capacity to yield the 1830 trillion Btu maximum within the 35 year time frame, we can calculate backward to determine Colorado-Ute's maximum annual requirements for running those generators. (This gives only an approximation–had the court understood the case better, it could have obtained a more precise figure.) That would set a ceiling for the seller's annual responsibility. A little fiddling with the numbers yields a maximum take about 50% greater than the contractually defined minimum take, the precise number depending on how much the potential output of the smaller generators would have exceeded the 1830 Btu ceiling over the life of the agreement.[142] While the seller's maximum annual obligation was not so well-defined as the minimum annual take, it was certainly ascertainable by reference to the plant's capacity; and the seller's total obligation over the 35 years was precisely defined. The court just chose to disregard this in rewriting the deal. Perhaps

[142]Suppose that the 350 kilowatt plant operating at full capacity exactly exhausted the 1830 trillion Btu ceiling. Then the annual schedule of expected consumption would have them producing at 80% of capacity. Their minimum take was 85% of the expected consumption, or 68% of capacity (.80x.85). Since 100/68=1.47, the contract maximum would be 47% greater than the contract minimum. If the capacity of the smaller plants were greater (so that the 1830 trillion Btu constraint mattered), then the annual schedule would yield a lower level of capacity utilization. The ratio of the maximum the buyer could have demanded to the minimum the buyer had agreed to take would therefore be larger. If, for example, the annual schedule assumed operation at only 75% of capacity, then the minimum take would be 64% of capacity (.75x.85) and the ratio of the maximum to the minimum take would be 1.56.

the court's paring back of the seller's obligation was an informal attempt to share the wealth. The court did not explicitly take the price history of coal into account, but the outcome might reflect its discomfort with the buyer receiving so large a share of the windfall, especially when it apparently behaved in a less than exemplary manner.[143]

In both *City of Lakeland, Florida, v. Union Oil Company of California*[144] and *Orange and Rockland Utilities, Inc. v. Amerada Hess Corporation*[145] the purchaser of fuel oil substantially increased its requirements following an increase in the market price. The increased requirements were due both to substitution of oil for gas and increased wholesale sales. In both instances the courts disallowed the full increase, although the courts differed in their treatment of the two. In each case the buyer's requirements were limited by the capacity of its plant and the court held, implicitly, that good faith required that the buyer run its plant at below full capacity.[146]

The City of Lakeland, Florida owned power plants that could be fired by burning either natural gas, Bunker "C" oil, or a mixture of the two. It entered into a ten-year contract for the primary fuel, natural gas, in 1960. That contract, not at issue here, specified a minimum amount

---

[143]Havighurst and Berman, note 1, noted long ago: "No court will admit that price fluctuation is a factor of legal significance. This is a risk supposedly anticipated and assumed by the seller when the contract is made. However, . . . it may have its effect in making the court reluctant to allow recovery or at least anxious to find means to cut down the measure of damages." (At 5)

[144]352 F. Supp. 758; 1973 U.S. Dist. LEXIS 15435.

[145]59 A.D.2d 110; 397 N.Y.S.2d 814; 96 A.L.R.3d 1263; 22 U.C.C. Rep. Serv. (Callaghan) 310 (1977).

[146]It is hard to make sense of the stated facts in T.B. Walker Mfg. Co. v. Swift & Co., 200 F. 529 (1912). Swift agreed to sell to a canner 175,000 to 225,000 pounds of beef for 1909 with the following clause tacked on: "We take care of buyer's needs this year." The market price rose and the buyer asked for more; Swift, having already delivered in excess of 225,000 pounds refused and the court found that Swift had met its obligation. What is remarkable about the case is that Walker's plant capacity was said to be three million pounds–more than ten times the expected requirements. It is doubtful that Walker planned on running its factory at less than ten percent of capacity or that it had been doing so for four to five years. (The court noted that Swift had been selling to Walker for four or five years and implies that the quantities were in the same ballpark.) Perhaps supply was seasonal so that the annual capacity figure was misleading. Or perhaps the capacity was used for packing the beef of others (it wasn't really a requirements contract) or non-beef products. Or perhaps Walker acquired new capacity in the contract year or just managed to flim-flam Swift. My guess is that the court got the outcome right, but just garbled the facts.

of gas the City must take. However, it also gave the City a right to terminate if Bunker “C” oil became available at a more favorable price which the gas company refused to match. The fuels were interchangeable, but they differed in their method of delivery. Oil is transported by carrier and stored in on-site tanks; gas is received from transmission lines with no on-site storage. Difficulties in transmission or increased consumption might result in interruption of gas supply, particularly in cold weather.

In 1968 the City entered into a contract with Union Oil for provision of Bunker “C” as a stand-by or alternate fuel. The contract price was $2.28 or the going market price plus specified transportation costs (which at the time of first delivery was $2.16) whichever was smaller. It was a five-year contract with Lakeland having the option to terminate every year. If the supply of natural gas were interrupted, the City could take all its fuel requirements from Union Oil. Moreover, if the contract price of oil fell below that of natural gas, the buyer could take 100% of its fuel requirements from Union Oil.

In the first three years, the share of oil increased from 20% to 40% to 56%. In the third year, in May 1970, the City entered into a new gas contract which set a fixed price for gas of 3.3¢ per therm (equivalent to about $2.08 per barrel of oil) plus an escalation factor based on the market price of oil. So long as the market price of oil was less than $2.47, gas remained the cheaper fuel. Rising oil prices in late 1970 brought the adjusted gas price above that and the City shifted a substantial amount of its purchases to oil. When the City notified Union in June 1971 that it elected to continue the agreement for the fourth year, Union responded that it would no longer be willing to sell at the contract price. The City sued for injunctive relief and damages.

Union Oil argued that the agreement was not valid because the City’s promise was illusory. Natural gas and oil are, Union argued, the same commodity, so the City was at liberty to buy the same commodity from others (the gas company) if it so desired.

> There can be no doubt, under the literal terms of the contract . . . that the City is free to purchase as much or as little Bunker "C" oil as it may want from Union, i.e., "capriciously desire." Hence, the prime question is whether the City is also at liberty to purchase the same article or commodity from other suppliers as well. Union insists that it is, arguing that gas and oil are "apples and apples," that both are fuels subject to interchangeable or even simultaneous use. As a result, since the agreement also permits the City to purchase natural gas in any amount it desires, Union would conclude that the contract contains no promise at all sufficient to supply a valid consideration.[147]

The court dismissed this argument noting that the agreement “expressly contemplated the possibility of a conversion from gas to oil as the primary fuel,” and denying that interchangeability

[147] At 764.

rendered gas and oil the same commodity.[148] Because oil was a different commodity, if the City elected to take any oil at all, it was bound to take it from Union. That was sufficient to dispel the illusory nature of the promise and permit the court to find consideration.

That reasoning suggests that, had both contracts been for oil, the court would have found for Union. The promise was given substance, the court reasoned, not by good faith, but by the exclusivity—if the buyer chose to take oil, it could only take from Union Oil. Suppose, however, that both suppliers were supplying Bunker "C" oil. Union Oil had granted the buyer a zero-price option to take any quantity of oil up to a maximum (set by the buyer's capacity) at a contractually determined price. The buyer received assurance of supply continuity and an option to take fuel at the lower net price; the contract price and the seller's expected sales were high enough to make the deal appear attractive to the seller, as indeed it was for most of the first three years of the agreement. The benefit to both parties should provide the consideration, not the exclusivity.[149]

Union Oil also argued that if this were a valid contract, the City had abused its discretion by increasing its purchases in a matter not contemplated by the parties. It had converted fuel oil from a standby fuel to the primary fuel and had increased its overall demand for fuel oil by increasing its wholesale sales to Tampa Electric, a public utility. The court dismissed the former argument, noting that the contract was quite specific in allowing the buyer to do so. It accepted the latter, however, pointing out that initial sales to Tampa had been less than one per cent of electricity production, but that they had grown to over 13% by 1971.

> The simple fact is that Union entered into an agreement which later proved to be improvident, from its point of view, when the market price of oil advanced to unforeseen heights. The City, on the other hand, realized a concomitant advantage; and that is precisely what the business and the law of contracts is all about. This is not to say, however, that the City may add insult to injury by taking undue advantage of its favorable contract and increase its wholesale exchange of energy with a neighboring system. Such increases must be regarded as beyond the contemplation of the parties and the scope of the contract, and must be taken into account as a limiting factor in determining the damages to be awarded to the City.[150]

The only contractual limit on Lakeland's requirements was its generating capacity, known to both parties at the time of contracting. If Lakeland had shifted to using fuel oil for 100% of its needs that would have been acceptable, according to the court. Apparently, Lakeland's capacity had not been fully utilized. The court appears to conclude that the existing level of

---

[148]At 765.

[149]Recall the discussion of *Propane Industrial* (following note 43).

[150]At 768.

underutilization was an implied term in the contract; increased utilization in response to the favorable price somehow "added insult to injury." The court provides no hint as to why, in the absence of any explicit language, the requirements should be bounded by the existing level of capacity utilization rather than the more natural actual generating capacity.

Amerada Hess is oft-cited as an example of a buyer unreasonably expanding its requirements in response to an increase in the market price. Properly framed, this is an easy case which the court bungled (with the approval of most commentators).[151] The parties entered into a ten-year contract in December 1969 in which Amerada Hess agreed to supply O&R's requirements for fuel oil No. 6 for its Lovett generating plant in Tompkin's Cove, New York.[152] The contract required Hess to lease a parcel of land from O&R and erect storage facilities to which it would deliver the fuel oil. The price for the first five years was $2.14 per barrel, subject to escalation for cost-related factors.[153] The quantity clause specified estimated annual sales for the five years. It was expected that the primary fuel at the plant would be gas; projections were for gas to account for about 60% of the BTU's generated by the plant. However, the contract stated: "[nothing] herein shall preclude the use by Buyer of . . . natural gas in such quantities as may be or become available."[154]

Five months after the contract was signed, the price of fuel oil began to rise. By March of 1971 it had more than doubled. O&R increased its fuel oil requirements by over 60% in 1970 and continued to order quantities that were more than double the contractual estimates. In April, 1971, Hess unilaterally attempted to raise the price by 97.7 cents per barrel and threatened to terminate deliveries if O&R declined. O&R obtained a preliminary injunction enjoining Hess from ceasing delivery of the fuel oil.[155] Apparently, this did not prevent Hess from limiting its sales to the contract estimates. O&R purchased additional fuel oil at the market price and sued Hess for

---

[151]See, for example, Silkworth, note 1, at 235; Burton & Andersen, note 7, at 129; and Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 *J. Legal Studies*, 271, 298 (1992).

[152]The facts are taken from this decision and a prior dispute between the parties in which Hess was enjoined from terminating the contract, Orange and Rockland Utilities, Inc. v. Amerada Hess Corporation, 67 Misc.2d 560, 324 N.Y.S.2d 494 (1971).

[153]The price for the second term would be renegotiated. If the parties failed to reach agreement, the contract would terminate.

[154]59 A.D.2d 110, 112.

[155]67 Misc.2d 560, 564.

the difference for fuel oil purchased through September 1973.[156] Its complaint was dismissed by the trial court and that dismissal was affirmed by Appellate Division. O&R's requirements, said both courts, were not incurred in good faith. They were, as a matter of law, unreasonably disproportionate.

O&R could not (and did not) take oil under the contract and resell it at the higher market price. It could only demand fuel oil to supply the needs of the Lovett plant. Its requirements increased over the estimated needs for two reasons. First, it increased its sales to the New York Power Pool, in effect sharing with other utilities the benefits of its below-market price. Second, it substituted oil for gas at the Lovett plant.

> The former factor is tantamount to making the other utilities in the state silent partners to the contract, . . . while the latter factor amounts to a unilateral and arbitrary change in the conditions prevailing at the time of the contract so as to take advantage of market conditions at the seller's expense. . . . Hess was therefore justified in 1970 in refusing to meet plaintiff's demands, by reason of the fact that plaintiff's "requirements" were not incurred in good faith.[157]

Again, the court uses “good faith” to impose a quantity ceiling short of the plant’s capacity. The contract placed a clear limit on O&R's maximum demand—the capacity of the Lovett generating plant. It should surprise no one in the industry that if the relative prices of oil and gas change, the buyer would react in the appropriate manner. Nor was the existence of the New York Power Pool a deep secret. O&R's requirements depended only in part on the electricity demand of their direct customers. The contract gave O&R flexibility both in its choice of fuel and its dealings with the power pool. If Hess wanted to place tighter limits on O&R's discretion it would have been easy to do so, either by including a quantity maximum short of the plant's capacity or by tying its supply obligation to the market price. To be sure, Hess did not anticipate the price increase in 1970 (let alone the much larger increase after October 1973), but that risk was allocated to Hess in the contract. By interposing the "unreasonably disproportionate" standard, the courts deprived O&R of the flexibility it had bargained for, converting the contract into a (nearly) fixed quantity contract. As in *Lakeland*, the court implicitly ruled that the seller had promised to run its plant at less than full capacity for the life of the agreement, never asking why on earth a party would make such an odd promise.

---

[156]Hess' obligation terminated prematurely because of an environmental regulation that went into effect in October 1973. Ironically, the huge run up in oil prices began almost exactly when the contract terminated.

[157]59 A.D.2d 110, 117-118.

In neither *Lakeland* nor *Amerada Hess* did the seller increase its requirements by expanding its plant. Nor, under the contracts, could they.[158] The physical limits of the plant were the only constraints on their discretion. The contracts could have imposed further limits on interfuel substitution, sales to non-end users (Tampa Electric and the New York Power Pool), or on total sales. Or they could have set price as a function of annual power sales (perhaps allowing for renegotiation of the price for all sales above a certain level.) Apparently, they felt these additional constraints unnecessary; in fact, the *Lakeland* contract explicitly rejected limits on interfuel substitution. In both instances the court rewrote the contract placing additional constraints on the seller's discretion.[159]

A much earlier case, *Loudenback Fertilizer Co. v. Tennessee Phosphate Co.,*[160] posed a slight variation on these cases. Loudenback entered into a five-year requirements contract to purchase rocks in order to make fertilizer, with a 3,000 ton annual maximum. In the first two years it ordered none; after a doubling of the market price of rocks in the third year it ordered 3,000 tons which the seller refused to deliver. The court sustained the seller's demurrer, saying that the buyer's failure to take any rocks in the first two years was a breach of the agreement. Burton and Andersen argue that the court's decision in favor of seller was based on buyer's opportunistic demand for the maximum, not it's failure to take in the first two years.[161]

Why did the buyer take no rocks in the first two years? The rocks were an input into an intermediate product, namely acidulated rocks. In the first two years it was cheaper to buy acidulated rocks directly rather than to make by combining seller's rocks with sulphuric acid, because, the buyer claimed, there had been a large increase in the price of sulphuric acid. In the third year, however, with acidulated rock prices up and sulphuric acid prices down, it was cheaper to make. In both *Lakeland* and *Hess* the increased quantity demand was in response to a fall in

---

[158]Judge Easterbrook missed this point in his implicit approval of the two decisions in his *NIPSCO* decision; see note 86.

[159]In Cullinan et al v. Standard Light & Power Co., 65 S.W. 689 (1901), the buyer agreed to take "oil sufficient to run their . . . plant in Dallas, Texas," maintaining the option to cancel the contract if oil fuel was not satisfactory as compared to coal. When the price of oil rose by forty percent, the buyer (according to the seller's complaint) ordered "immense quantities of oil, ostensibly for use in running its plant in Dallas, but really for the purpose of speculation, and of cheating and defrauding [seller] out of the 20 cents per barrel advance in price." The district court's sustaining of the buyer's demurrer was, quite properly, reversed. Diversion of the oil for resale would be a clear breach of the agreement. There was no allegation of such a breach in either *Lakeland* or *Hess*.

[160]121 F. 298 (1903).

[161]Burton and Andersen (note 7)

the relative price vis a vis a substitute. In *Loudenback*, it was in response to a fall in the relative cost of a product produced internally versus that same product already "assembled." Perhaps the parties did not mean to give the buyer the discretion to respond to such price changes. Or perhaps one could argue that the requirements contract covered both the raw material and the assembled product (although the court does not come close to saying that). The minimal statement of the facts gives no indication of why either party would want a multi-year contract, nor why the quantity discretion was given to the buyer. Absent any facts, the most natural interpretation would seem to be that the buyer agreed to buy between zero and 3,000 tons per year with the actual quantity depending on the overall demand for its fertilizer and the relative costs of make versus buy. Rather than sustaining seller's demurrer, the court should have granted summary judgment to the buyer (perhaps leaving the window open for some narrow defenses).

In *The Lenape Resources Corporation v. Tennessee Gas Pipeline Company*,[162] a closely divided court upheld a buyer's claim despite a huge increase in the quantity it demanded. The dispute involved a long-term take-or-pay contract—the Gas Purchase Agreement (GPA)—entered into in 1979. It was typical of contracts entered into at that time by pipelines in general and Tennessee in particular in both the length and the commitment to a high take-or-pay option. It did have one unusual feature, as we shall soon see. Market conditions changed dramatically shortly afterward leading to industry wide renegotiation and litigation. One court noted:

> In the 1980s, . . . conflicting forces increased the gas supply, yet decreased demand, thereby leading to a sharp decline in sales and market price. Thus, pursuant to their long term take-or-pay contracts, pipelines were required to buy gas at a cost significantly above the market price at which they could later sell it. Confronted with the prospect of bankruptcy, many pipelines refused to either take or pay for gas, despite their contractual commitments. Producers recognized that instability among the pipelines would ultimately be detrimental to their own interests by causing massive dislocation within the industry. Resultingly, most pipelines and producers agreed to reform their contracts and settle their disputes.[163]

In 1983 and again in 1985-1986 Tennessee informed its producers that it would refuse to honor its take-or-pay obligations. Not all the producers caved in graciously. Settlements of some of Tennessee's litigation are described in *Mandell v. Hamman Oil & Refining Co.*[164] and

[162]925 S.W.2d 565 (1996).

[163]Williamson v. Elf Aquitaine, Inc. 925 F.Supp. 1163, 1166 (1996).

[164]822 S.W. 2d 153, 156-57 (Tex. App.--Houston [1st Dist.] 1991). Tennessee settled by paying Hamman $8 million. Hamman was a lessee who had to pay royalties to the landowners. The lessors argued that they were entitled to a share of the $8 million; the court held that the lessors were not entitled to royalties on gas not produced.

Williamson v. Elf Aquitaine, Inc..[165] Lenape did acquiesce initially,[166] but in response to a 1989 suit against it by its lessors for breach of the implied covenant to develop its leases, Lenape developed new wells, dramatically increasing its production, thereby precipitating this litigation.

The GPA reflected Tennessee's weak bargaining position in 1979.[167] It agreed to take, on a take-or-pay basis, 85% of Lenape's delivery capacity (defined as the amount of gas that could efficiently be withdrawn from the wells) of the defined gas reserves in a particular field. The decision as to the development of the fields was left exclusively in Lenape's hands. The contract specifically reserved the seller's right

> [t]o operate its property free from any control by Buyer in such a manner as Seller, in its sole discretion, may deem advisable, including without limitation, the right, but never the obligation, to drill new wells, to repair and rework old wells, and to plug any well or surrender any lease or portion thereof . . . .[168]

Production in the first twelve years was modest, with annual payments never exceeding $300,000. Following the development of the new wells, there was a huge increase in production. In 1993 Tennessee paid, under protest, $89 million. It sought a declaratory judgment that the increased production was in bad faith and unreasonably disproportionate to prior production. Alternatively, it argued that if the contract were not governed by §2-306, then the agreement was void and unenforceable for lack of mutuality.

---

[165] 138 F.3d 546 (5th Cir. 1998) Tennessee entered into a confidential settlement in 1985 revising the terms and paying a flat fee of about $600,000. After further hassles the parties entered into a second settlement in 1987, again revising the terms with Tennessee paying an additional $6 million. The litigation, as in *Mandell*, involved unsuccessful claims by the lessors against the producer for royalties on the side payment.

[166] The Court of Appeals noted that "Lenape recognized as early as 1983 that it could file suit against Tennessee for breach of the GPA, but that it made a business decision 'to let the big boys fight that battle' rather than to file suit." Tennessee Gas Pipeline Company v. The Lenape Resources Corporation, 870 S.W. 2d 286, 304 (1993).

[167] The trial court found, and both the majority and dissent agreed, that "[w]hen the parties negotiated the GPA in 1978 and 1979, and executed it on January 16, 1979, Buyer needed and wanted to obtain under long term commitment or dedication as much gas as possible, and the parties intended that the GPA not limit, for any reason, the volume of the committed reserves or amount of gas to be delivered therefrom to Buyer by Seller(s) over the 20-year term of the GPA." (At 580).

[168] Tennessee Gas Pipeline Company v. The Lenape Resources Corporation, 870 S.W. 2d 286, 293 (1993).

The trial court's decision for Lenape was reversed by the Court of Appeals; that decision, in turn, was reversed by the Texas Supreme Court in a 5-4 vote. There was considerable disagreement as to whether the GPA was an output contract subject to §2-306. The majority's ostensible ground for concluding that it was outside §2-306 was that the Section applies "only when a contract does not unambiguously specify the quantity of the output of the seller or the requirements of the buyer."[169] This, however, fails to distinguish the GPA from other carefully crafted agreements delineating the limits of the quantity-determining party's discretion. More to the point, the majority noted that §2-306 is a gap filler and the contract language clearly filled the gap.[170] The real question should have been whether the clear language of the GPA could be trumped by the imposition of a fact finder's notion of good faith.

It is illuminating to compare the differing views of what a good faith test would entail. The majority catalogued the difficulties:

> Instead of defining Tennessee's take-or-pay obligations in terms of a fixed percentage of Sellers' delivery capacity, Tennessee would have us read the GPA as requiring Tennessee to purchase only a portion of gas that may be tendered as reasonably proportionate to any normal or otherwise comparable prior output. The quantity of gas which Tennessee must either take or pay for would depend on a number of indeterminate variables: prior output; normal prior output; comparable prior output; proportionality to either normal or comparable prior output; and reasonableness of the proportionality. Reading these factors into Tennessee's take-or-pay obligations, any increase in production and delivery capacity would be measured after the fact by these variables, thus injecting uncertainty into the parties' obligations under the GPA.[171]

[169] 925 S.W.2d 565, 570. Comment 1 of the 1999 revised draft of the UCC repeats the dubious claim that the "contested quantity term was not a requirements or output contract." Had they simply said that explicit language defining the parameters of the variable quantity was enough to avoid the Code's default rule, that would have made some sense. Instead we end up with the notion that some variable quantity contracts are subject to §2-306 (§2-304 in the revised version) and some are subject to another, apparently less restrictive, standard.

[170] "Regardless of whether the take-or-pay contract is an output contract, section 2.306 does not apply to this gas purchase agreement because the parties agreed to quantity obligations that differ from those imposed by section 2.306. Section 2.306, like many other provisions of Article 2 of the UCC, is a gap-filler and may be varied by the parties' agreement." (At 570) The 1999 Code revision did not mention this more sensible piece of the decision.

[171] At 571.

According to the dissent, “The basic test for good faith here is whether and to what extent the Sellers would have increased the quantity of gas proffered had the contract price equaled the market price, i.e., was there a valid business reason for the increased quantity independent of price?”[172] That is, the seller enters into a long-term agreement giving it complete flexibility to develop its business in response to all new circumstances save the inability of the contract price to track market conditions. It is hard to understand why that should be a mandatory rule, especially since there are so many devices available for linking the contract and market price.[173] The dissent goes on to link the “unreasonable disproportion” standard to the parties’ expectations at the time of contracting:

> But whether the magnitude of the disproportion here is unreasonable under section 2.306 depends on the expectations of the parties when the contract was executed and whether such an increase in output could have been reasonably forecast or anticipated. *Orange and Rockland, 397 N.Y.S.2d at 822.* Objective indicia of the parties' reasonable expectations at that time may also be considered, including the size and capabilities of the pipe lines and other facilities, the history of the area, the nature of the formation, local industry practices, reserve and deliverability estimates and so forth.[174]

The evidence on expectations and trade practice would be confined to conditions in 1979 at the time of contract execution. There is no question that when the contract was executed Tennessee was not concerned about the possibility that Lenape would have too much delivery capacity. Tennessee might not have anticipated an expansion of this magnitude, but it surely hoped for one. It was scrambling for gas sources and the more the merrier. Granting Lenape complete discretion in this dimension seemed costless at the time. That turned out to be a big mistake. But that mutual misjudgment should not empower the court to rewrite the contract.

Tennessee compounded its mistake by failing to renegotiate limits on Lenape’s discretion in the six-year window before the suit by Lenape’s lessors forced it to expand its capacity. Lenape did not take full advantage of its windfall for years and it would not have been very expensive for Tennessee to buy its way out. It chose not to do so, and as a result the price of a buyout rose dramatically. It is conceivable that had the parties engineered a buyout, Lenape could still have been sued successfully by its lessors for its failure to develop the leases. If so, it, not Tennessee, would have been the big loser.

---

[172]At 582.

[173]See Goldberg (Price Adjustment) at note 40.

[174]At 583.

Lenape's relationship with its lessors was likely the proximate cause of the huge expansion of delivery capacity. However, that should not matter. Suppose that Lenape owned the properties outright. When the gas market collapsed, the contract gave Lenape a valuable right. It could threaten to develop a gas field for which it was assured above-market prices. If the market conditions did not warrant the development, this was at least a threat point in its dealings with Tennessee. Lenape's taking a hard line might be less appealing than if it could say credibly "the lessors made me do it." Still, there is no reason for the courts to take sides in the renegotiation between two sophisticated hard-nosed bargainers.

In *Lenape*, the seller of gas dramatically increased its output. *Northern Natural Gas Co. v. Conoco, Inc.*,[175] presented an interesting twist. Northern, a pipeline, had contracts to purchase natural gas from a number of suppliers of natural gas and a contract to supply all of that gas to Conoco.[176] However, after the deregulation of the gas market Northern managed to buy itself out of all its contracts to buy gas so that its gas purchases and sales dropped from 3 billion cubic feet per day in the mid-1980s to zero in 1994. Hence, it had no gas under contract and, therefore, had no obligation to deliver to Conoco. Conoco sued, arguing that Northern could not avoid its obligation by canceling contracts with its suppliers and a jury awarded it $20 million for lost processing profits. That result was overturned, however, with the court finding that the contract did not require that Northern buy any gas and, therefore, that it had no obligation to deliver any gas to Conoco. Still, Conoco won half a loaf, with a unanimous supreme court remanding on the question of whether Northern's cancellation of its contracts was in good faith.

> Nothing requires the seller in an output contract to have any output, and nothing requires the buyer in a requirements contract to have requirements. On the other hand, parties to output/requirements contracts are required to exercise good faith in determining outputs or requirements, as well as accept the concomitant risk that their counterparts to the contract may make good faith variations, even to the extent of liquidating or discontinuing the business. . . . We agree with Conoco that a party who seeks to avoid performance of an output contract by having no output–or of a requirements contract by having no requirements–may not do so in bad faith. Accordingly, we affirm the court of appeals' judgment remanding this cause for a new trial for Conoco to attempt to prove that Northern canceled its gas purchase contracts without a valid business reason and in bad faith.[177]

---

[175] 986 S.W.2d 603, 36 UCC Rep.Serv.2d 1011, 42 Tex. Sup. Ct. J. 75 (1999).

[176] Northern was to deliver gas "in keeping with all the quantity and other provisions of the various gas purchase contracts in effect from time to time." (At 604-5)

[177] At 608-609.

The *Lenape* majority's skepticism about defining a good faith response to the dramatic changes in the natural gas market seems to have evaporated in the three years between the two decisions. If Northern's closing out its unprofitable contracts with suppliers was a valid business reason for having no gas to deliver to Conoco, as the court held, what could be bad faith? That, apparently, is a jury question, although there is no hint as to how a juror could possibly answer the question.

VI. Conclusion

One might object to the preceding discussion by invoking the circularity problem. The backdrop against which these contracts were written, either the common law or the Code, included "good faith." If the parties drafted their agreements against that backdrop, then, it could be argued, they have incorporated the present understanding of the law into the contract. If the parties expected courts to apply the Code's good faith standard, then a failure to do so would amount to a rewriting of the agreement. Putting a "rational expectations" spin on things, when they entered into the agreement, the parties could have anticipated what the courts ultimately did. The implied limitation, the argument goes, was part of the deal. Without a theoretical framework there is no particular reason to prefer one interpretation to another. The theoretical framework proposed here allows us to break the circle and to reject the notion that the parties intended to incorporate the Code's good faith standard.

The relevant theory is hardly esoteric. The core notion is that in long-term agreements, adaptation to changed circumstances is often best achieved by granting to one party considerable discretion in determining quantity. The discretion will not be unbounded; the contracts will typically relate the quantity to a physical constraint, like the capacity of a particular plant of the buyer or seller. Moreover, the contracts will often go further than that. If the opposite party is vulnerable to quantity variation, it will want to convey the contours of its reliance by, in effect, confronting the decision maker with a price reflecting the extent of its reliance.

In some instances, like the Great Lakes Carbon (GLC) petroleum coke contracts,[178] the contract allows the seller to operate the plant at any level at all without taking into account any adverse effects on the counterparty. This is not an accident, since GLC's ability to hold a large inventory meant that its reliance costs would be very low. Similarly, Propane International provided General Motors the flexibility to put together a web of agreements to assure a low-cost supply of standby gas, giving it an option to take gas at a price above the market price at the time of contracting.[179] PI's reliance was nil. It agreed to stand ready to deliver gas at the premium price (although that premium price turned out to be well below the market price), and if GM did not need the gas, PI would simply hold it in inventory. Likewise, Levy relied on Feld to remove the day-old bread, but Feld, who apparently was selling bread crumbs long before Levy bought his toaster oven, did not need a promise that Levy would continue to produce bread crumbs; Levy's

[178] See Section I.
[179] See text at note 43.

self-interest (it had bought a toaster oven that appeared to have no other economic use) provided sufficient protection of Feld's reliance. The buyer's reliance in *Wigand* and *Diamond Alkali* was considerably greater than in *Levy,* since the buyer owned capital assets the value of which depended crucially on the continued operation of the plant. In both instances, the buyer's protection was the penalty (lost revenue) that the seller would incur from closing an otherwise viable facility—an entire factory, rather than a mere toaster oven.

The other guy's self-interest is not always enough. The preceding discussion has provided numerous examples of devices that constrain the exercise of discretion. For one, by incorporating flexible pricing, the contracts could decrease the rewards to opportunistic behavior by the quantity-determining party. Eastern's incentive to engage in fuel freighting, for example, would normally have been constrained by tying the contract price to current market conditions; however, the breakdown of the price adjustment mechanism meant that in this instance the constraint failed.[180] The meeting competition clause in the Empire Gas contract is another example.[181]

Two-part pricing is another example. If the per unit price for small quantities is high, then, so long as the buyer is likely to require an amount above that minimum, the seller will have some assurance that it will receive enough compensation to make its initial investment worth while. This device was common in the petroleum coke contracts of the aluminum companies.[182] General Motors also used two-part pricing with Enterprise, its primary propane supplier.

Alternatively, the seller could be required to make a fixed payment. Two-part pricing would mean that if the buyer's demand fell off dramatically, the seller could end up bearing all the risk. The seller might insist upon more assurance so that even if the buyer took nothing, the seller would still receive some compensation. There are numerous devices for reaching this outcome: take-or-pay, minimum quantity, standby charges, or liquidated damages (and variations on these) all set the marginal price at zero for low quantities. The options considered in the NIPSCO-CWI negotiations, as described above, indicate the range of choices and the ability of serious commercial parties to tailor them to their own needs.[183]

The tailoring need not always be wise, either ex ante or ex post. But the important point is that the parties have an incentive to take their reliance interest into account, and, since protecting reliance can be costly, they have a further incentive to economize by not insisting upon

---

[180]The Laclede-Amoco contract (see text at note 26) also was indexed to the posted price; the opinion does not indicate why Amoco was dissatisfied.

[181]Many of the petroleum coke contracts had indexed prices and maximum-minimum prices, so that if the contract price were too far out of line, it would have to be renegotiated; see Goldberg and Erickson (at note 14), pp. 389, 394.

[182]See Section I.

[183]The contrast between NIPSCO's contract with CWI and Carbon County (see note 83) is another indication of the ability of parties to tailor the contracts.

too much protection. There is no reason to believe that a court, using a theoretically ungrounded good faith standard, could do better.