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PRINCIPLES OF CONTRACT DESIGN

Robert E. Scott* and George G. Triantis**

ABSTRACT

Economic contract theory postulates two obstacles to complete contracts: high transaction costs and high enforcement (or verification) costs. The literature has proposed how parties might solve these problems under a stylized litigation system, but it does not address the question of how parties design contracts under the existing adversarial system, that relies on the parties to establish relevant facts indirectly by the use of evidentiary proxies. We advance a theory of contract design in a world of costly litigation. We examine the efficiency of investment at the front-end and back-end of the contracting process, where we focus on litigation as the back-end stage. In deciding whether to express their obligations in specific or vague terms, contracting parties implicitly choose their allocation of costs between the front- and back-end. When the parties agree to vague terms (or standards), such as best efforts or commercial reasonableness, they delegate to the back-end the task of selecting proxies: e.g., the court selects market indicators that serve as benchmarks for performance. When the parties agree to specific terms (or rules), they invest more at the front-end to specify proxies in their contract and thereby leaving a smaller task for the enforcing court. In this Article, we explore the choice between rules and standards in terms of this tradeoff, and offer an explanation for why contracts in practice have a mix of vague and specific provisions. We then suggest that parties can achieve further contracting gains by varying procedural rules governing the prospective enforcement of their disputes. We illustrate by examining provisions in commercial contracts that allocate burdens and standards of proof. If the parties can improve the cost-effectiveness of litigation in this manner, they can reduce back-end costs. They thereby create opportunities to further lower contracting costs (or to improve the incentive gains from contracting) by shifting more investment to the back-end by increasing their use of vague terms. Vague terms have fallen into disfavor with contract theorists and this Article offers a justification for why they are nevertheless commonplace in commercial practice. Our analysis highlights the general and valuable lesson that the anticipated path of litigation is relevant to contract design.

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INTRODUCTION

In recent years, spurred by theoretical developments in the economics of contracting, contract law scholars have focused attention on the problems of incomplete contracting: what prevents parties from writing complete contracts that achieve the dual objectives of efficient reliance and efficient trade?¹ Contract theorists have identified two primary reasons why parties may agree to contracts that fail to provide for the optimal obligations in each contingency, or state of the world, that might materialize during the term of the contract.² First, the front-end transaction cost of writing such a complete contingent contract may exceed any resulting gains in contractual surplus. For example, the parties may not foresee all future states of the world, or they may not calculate the efficient outcome in each state, or they may not wish to incur the contracting costs of providing specifically for low-probability states.³ Second, the back-end costs of enforcing contracts may exceed any gains, owing to the difficulty of observing and verifying to a court private information known only to the parties.⁴

¹ Parties trade efficiently when the value of the exchanged performance to the buyer exceeds the cost of performance to the seller; parties rely (or invest) efficiently when their actions maximize a contract’s expected surplus. See, e.g., Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 YALE L.J. 541, 545 (2003)

² Note that a contract may be obligationally complete even though it is informationally incomplete. An obligationally complete contract might lump together various states and provide for the same obligations across the states of each lumped set. Yet, such a contract is informationally incomplete because it fails to discriminate within each set between states of the world that optimally call for different obligations. States of the world reflect both exogenous and endogenous variables. For example, different oil prices produce different states, but so does the decision of a seller to tender or not. Each event changes the state of the world and may be paired in the contract with a different obligation on the buyer.


⁴ A nonverifiable factor is one for which the information cost at trial outweighs the incentive benefit of the related contractual provision. The paradigmatic example in agency contracts is a contract that requires a minimum level of effort from the agent, where a third party (such as a court) cannot observe directly how hard the agent is working. Economists postulate that parties will not contract on factors that are nonverifiable. E.g., Oliver Hart and John Moore, Incomplete Contracts and Renegotiation, 56 ECONOMETRICA 755 (1988); Ilya Segal, Complexity and Renegotiation: A Foundation for Incomplete Contracts, 66 REV. ECON. STUD. 57, 72-3 (1999). Many legal scholars have adopted this premise as well. E.g., Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 J. LEGAL STUD. 271 (1992); Eric Posner, Economic Analysis of Contract Law After Three Decades: Success or Failure? 112 YALE L.J. 829, 857 (2003) (“The literature stipulates that transaction costs mean that the [reliance] investment is not verifiable by a court, so the parties gain nothing by putting the optimal investment in the contract).
Despite its theoretical advances, the theory of incomplete contracts has yet to yield predictions that are borne out by the realities of commercial practice. This gap between theory and practice is due to a number of limitations in the literature. First, scholars often neglect to weigh contracting costs, at either the front or back end, against the incentive gains that they produce – what we refer to as the incentive bang for the contracting cost buck. Second, scholars tend to focus on either front-end or back-end obstacles to complete contracts, and assume the absence of friction at the other end. For example, theorists concerned about back-end verification or uncertainty costs, assert that parties will tend to avoid vague contract terms such as best efforts or commercial reasonableness. Yet, these provisions are commonplace in commercial contracting because they save on front-end transaction costs. Indeed, the mix of specific and vague terms can be framed as the product of a tradeoff that the parties choose between investing in the front-end or back-end of the contracting process, based on their particular circumstances. By reaching the optimal combination of front-end and back-end costs, parties can minimize the aggregate contracting costs of achieving any given level of incentives. Conversely, for any given expenditure of contracting costs, the parties can reach the highest incentive gains by optimizing the allocation of their investment between the front and back end.

Third, contract theorists assume a highly stylized enforcement mechanism in which the court verifies information at some cost and then orders the parties to execute the trade or not to do so. As noted above, these scholars postulate that some contract provisions are too costly to verify and yield excessively uncertain enforcement outcomes. When parties enter into a legally binding contract, however, they invoke an adversarial enforcement mechanism that is governed by an elaborate set of procedural rules. The parties bear their own evidentiary costs, and a wide range of institutional features contain the cost of litigation so that the back-end costs are lower than the verification costs envisaged by contract theorists. Accordingly, parties may well find it desirable to accept these back-end costs in order to reap savings at the front-end. Moreover, although the uncertainty in judicial fact finding might undermine contract incentives, the effect is context-dependent and it is simply a factor to be taken into account in resolving the tradeoff.

5See sources cited in notes 20 and 78 infra.
Finally, contract theorists focus on substantive contract terms and not attempts by the parties to regulate the enforcement process. Yet, some of the rules governing litigation are default rules that can be varied or manipulated by the parties in their ex ante contract. By doing so, the parties can further reduce the cost of litigation and improve the ex ante incentive gains from enforcement. This has repercussions on the choice between specific and vague terms. A reduction in back-end enforcement costs should lead the parties to substitute more back-end for front-end investment by replacing specific provisions with vague terms.6

In this Article, we explore the manner by which the choice between specific and vague terms shifts investment between the front- and back-end of the contracting process, and thereby improves efficiency.7 In designing their contract, parties choose contract terms based on the expected mechanism of enforcement. We offer a theory of contract design that anticipates the enforcement of contracts by adversarial litigation. Courts do not verify facts by direct investigation, but rather rely on the self-interested evidence presented by the parties. The enforcement of vague terms entails additional layers of evidence production. For example, a promisor would first propose to the court the activities that constitutes “reasonable care” and then provide evidence that she performed them. We refer to the intermediate determination as the selection of proxies for reasonable care.8 The choice between specific terms and vague terms thus reduces to who chooses the relevant evidentiary proxies and when they are chosen: the

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7In a similar vein, Schwartz and Watson focus on the tradeoff between front-end investment in complex rules and back-end investment in renegotiating simple rules after uncertainty is resolved. Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J. L. ECON. & ORG. 2 (2004)

8We use the term “proxy” in this Article to describe what proceduralists refer to as “operative facts,” that are relevant to establishing compliance with specific and vague contract terms. A specific term narrowly confines the content of the operative facts. Indeed, in the limiting case the term directly specifies the evidentiary proxy. A vague term (or standard) defines a broader space within which a court can select the evidentiary proxy that best establishes compliance with the term.
This contrast is fairly well established in the literature on rules and standards. See generally, Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988) (referring to rules as “crystals” and standards as “mud”); Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L. J. 557 (1993). Rules purport to specify the content of an obligation ex ante, while standards leave a greater portion of the substantive provisions to be determined after the regulated behavior (e.g. breach) has occurred and, typically, by the adjudicators of disputes. The paradigmatic example in this literature contrasts the rule limiting the speed of automobiles to 55 mph with the standard that requires drivers to travel at a speed no greater than is reasonable under the circumstances. In our analysis, the distinction hinges on who chooses the proxies for “bad” driving, as well as when. In the case of the speed-limit, the legislature chooses the speed limit rule ex ante; the judge (and/or jury) fills in the content of the standard ex post by determining the relevance and weight assigned to available evidence.
present market evidence of costs and values which they then use to measure damages. The court thus chooses among more or less efficient proxies for the promisee’s expected losses from breach. Efficient proxies are those that maximize the gains in contractual incentives net of expected litigation costs. The parties may agree to liquidated damages, therefore, because they determine that their private information at the time of contracting is superior even to the court’s market information ex post.

Our analysis of the tradeoff between front-end transaction costs and back-end enforcement costs owes an intellectual debt to the work of Louis Kaplow and others who have discussed the choice between rules and standards in legal regulation. Kaplow frames the choice between rules and standards to focus on the stage at which content is given to regulation: either by promulgating a rule before the regulated behavior occurs or in the enforcement of a standard after the behavior occurs. In a very similar manner, we frame the choice between specific terms (rules) and vague terms (standards) as the decision to give content to legal obligations either on the front-end or back-end of the contracting process. We build on this analysis in several important respects, however. First, we unpack the enforcement process to represent more accurately how the content is injected at the back end. In particular, we treat the back end as an evidentiary process

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10 See e.g., Uniform Commercial Code §2-708(1) (seller’s market damages); §2-713(1) (buyer’s market damages); §2-723(2) (proof of market damages: “If evidence of a [market] price prevailing at the times or places described in this Article is not readily available the price prevailing within any reasonable time before or after the time described or at any other place which in commercial judgment or under usage of trade would serve as a reasonable substitute for the one described may be used...”) (2003).

11 See e.g., Kaplow, Rules versus Standards, supra note 9, [cite subsequent authors].

12 Kaplow, Rules versus Standards, supra note 9. Kaplow contrasts the costs of promulgation and of enforcement of regulation: standards are more likely to be preferable when the former is larger and the latter is smaller (and vice versa). Promulgation costs are larger if the regulation covers numerous heterogeneous circumstances, so that standards are more appropriate in these cases. Kaplow also distinguishes between the timing and complexity of regulation: they are distinct attributes in that rules or standards each can be more or less complex in addressing discretely the different circumstances that might arise. Id.

13 There are several interesting features of Kaplow’s analysis that we set aside for purposes of this paper. For example, he speculates that standards may be less efficient than rules (all else equal) because they impose higher learning costs on the actors being regulated. Either they must incur the costs of predicting the distribution of prospective outcomes in enforcement proceedings or they decide that the cost is not worth bearing so that the regulation has diminished effect on the actors’ incentives. Id. at 581.
in which the court chooses proxies with which to judge whether the promisor has complied with a vague contract obligation. Second, in the contractual context, the “promulgators” are the parties whose behavior will be regulated. This would seem to bias the choice in the direction of rules because the parties are better informed and have better incentives at the time of contracting than the promulgators in Kaplow’s analysis. Nevertheless, we argue that there are good reasons for the parties to let courts fill in vague terms ex post. Third, our analysis recognizes that the parties have some discretion in choosing their mode of enforcement (e.g., arbitration or litigation) or varying some of the rules (e.g. burdens of proof) in order to reduce enforcement costs. Their decisions in this regard bear on the choice between rules and standards. Finally, we draw an explicit connection between the choice between rules and standards and the complexity or “completeness” of the contract; that is, the degree to which a contract addresses separately different contingencies that call for different obligations. By efficiently choosing between vague and specific terms, the parties can lower the cost of further completing their contract. Indeed, by improving the cost-effectiveness of litigation, the parties can incorporate more standards in their contract, and reduce the cost of completing their contract even further.

This Article is organized as follows. Part I examines the determinants of front-end transaction costs and back-end enforcement costs. The choice between specific and vague terms implicitly allocates costs between the front-end and back-end of the contracting process. We focus primary attention on the back-end factors contributing to the direct costs of litigation and on the effect of uncertainty and the risk of legal error on contract incentives. The rules of evidence and procedure significantly constrain ex post litigation costs and, in some cases, may thereby expand the opportunities for parties to trade off front end and back end costs.

Part II explores the trade-off between front-end and back-end costs, and the parties use of specific and vague terms to lower contracting costs by assigning proxy choice either to the parties

14Kaplow distinguishes between the timing choice and the choice between the institutional chooser (legislator, regulator or court). Id. at 608-11.

15Kaplow treats the complexity of regulation as distinct from the choice between rules and standards. Id
on the front end or the court at the back. We set out a general theory of proxy choice and then
describe guidelines by which parties select the “chooser.” The parties use contractual rules to
specify proxies whose accuracy is less likely to be affected by the future state of the world, while
contractual standards delegate to the court the later choice of proxies that are more likely to be
state-contingent. The discussion then broadens the options available to the parties by observing
that they can design, with the aid of interpretation maxims, combinations of specific and vague
terms that define the “space” within which the court has discretion in proxy choice.

In Part III, we examine how parties can further enhance the benefits of trading off front-
end and back-end costs by varying some of the procedural rules that will govern the enforcement
of their contract. We examine various mechanisms by which the parties tailor burdens of proof to
their circumstances. By doing so, the parties reduce enforcement costs, which thereby permits
them to achieve even greater incentive gain (or lower contracting cost) by shifting more activity
to the back end. Parties shift activity to the back end by substituting vague for specific terms, or
more generally, by expanding the proxy space available to the litigation process. Finally, we
conclude that much of contract design can be explained by anticipating the effect of the course of
litigation on contract terms. In this way, commercial parties can design contracts that better
motivate incentives to perform and at lower cost than has been previously recognized. Our
analysis calls for further research into the interaction between contract and litigation, as well as
future investigation into the effect of other back-end processes, such as arbitration, renegotiation
and settlement.

I. THE FRONT-END AND BACK-END COSTS OF CONTRACTING

Contracts scholarship identifies a wide variety of obstacles that limit the completeness of
contracts. As we will describe in greater detail, these contracting costs arise mostly from the fact
that information is costly, and they can be divided between costs incurred at the front-end and
back-end of the contracting process. We will refer to the front-end costs as transaction costs and
the back-end costs as enforcement costs. The important distinction between the front and back
end is that they are separated by the resolution of uncertainty. For example, the front-end is the
drafting of the contract and the back-end is litigating disputes that arise when the contract turns
out to be a losing proposition for one party and a winning one for the other. Of course, the back-
end may entail a number of alternative possible processes, such as settlement or renegotiation. In
this paper, however, we limit our analysis to cases in which contracts end up either fully
performed or litigated.

Parties incur contracting costs to improve the efficiency of incentives in their relationship;
particularly, the incentive to perform when it is efficient to do so, and the incentive to make
efficient investments that enhance the value of their exchange. Investment in contracting costs
can increase the completeness of the contract by providing for efficient obligations in a large
number of possible states of the world. Of course, parties would wish to minimize contracting
costs if the degree of completeness is held constant. However, the parties may wish also to
increase contracting costs if that yields a greater gain in the incentives to invest and perform
efficiently. In short, the goal is to maximize the incentive bang for the contracting cost buck.
Accordingly, the parties should continue to invest in contracting costs until the marginal cost of
further investment exceeds the marginal benefit in incentive gains. If circumstances change so as
to lower contracting costs or increase the incentive gains at the margin, the parties should increase
their investment (and vice versa). For convenience, we will refer to changes in contracting cost
per incentive bang to include both changes in cost and changes in incentive effects that stem from
incremental investments in contract completeness. Later in the paper, we suggest that by shifting
investment between the front-end and back-end of the contracting process, the parties can lower
their cost of achieving incentive gains, thereby allowing them to reach additional efficiencies in
investment and performance incentives.

Front-end (transaction) costs are relatively straightforward and well-documented in the
literature. The parties invest in foreseeing possible future contingencies, determining the efficient
obligations that should be enforced in each contingency, bargaining over the share of the
contracting surplus, and drafting the contract language that communicates their intent to the
court.\textsuperscript{16} Contract scholars also include in the category of transaction costs the observation that information asymmetry between the parties at the front end may impede efficient contract terms.\textsuperscript{17} We set these obstacles aside in this paper by assuming that the parties are symmetrically informed. This Part focuses principally on back-end transaction costs because they are less well understood among contract theorists. The reason is that they largely stem from the process of litigation, a distinct game played between the parties under relatively complex evidentiary and procedural rules. Our article attempts to bring more detail and sophistication to the representation of back-end costs. Part II then shows how the parties can manipulate the tradeoff between back-end and front-end costs to improve the bang for their contracting cost buck.

Before the parties can decide how much to invest in the back-end, they must determine the expected net value of the incentive gain that they would secure with their back-end (enforcement) buck. This requires them to anticipate the course of their litigation and its outcome. Contracts scholars have focused on two back-end obstacles to efficiency: (a) the “verification” cost of enforcing contracts -- namely the cost of communicating information to the court -- and (b) the uncertainty of enforcement. Recognizing these obstacles, scholars postulate that parties avoid contract terms that are prohibitively costly for a court to verify or terms that are vague.\textsuperscript{18} Their predictions are at odds with commercial contracting practice that, for instance,
frequently adopts vague terms such as “best efforts” or “commercial reasonableness.” One reason for this gap between theory and practice is that the scholarly conception of verification costs is based on a highly stylized understanding of the litigation process.

A. Back-End (Enforcement) Costs

1. Direct Costs

Contract theorists identify verification costs as one of the principal obstacles to contract completeness. They postulate that parties will not condition their contract obligations on factors that are not verifiable (that is, where verification costs exceed a notional threshold). For example, they assert that parties to an agency contract would not condition payment on effort because effort is nonverifiable. In doing so, these scholars mischaracterize judicial enforcement as an investigatory rather than adversarial process. In particular, they neglect three important

19 See, University of Missouri-Columbia, Contracting and Organizations Research Institute, CORI Contracts Library, at http://cori.missouri.edu (last visited Feb. 25, 2005) (Total contracts in CORI database: 24,965. Contracts with "best efforts" terms: 4,328 (17.34%); Contracts with "reasonable expenses" terms: 2,584 (10.35%); contracts with "reasonably withheld" terms: 38 (0.0015%); contracts with "unreasonably withheld" terms: 3,525 (14.12%); contracts with "reasonable" terms: 13,281 (53.20%).

20 See e.g., OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 37-8 N.15 (1995). Hart, one of the leading figures in the economics of incomplete contracts, describes “verifiability” as follows: The contract, ‘I will pay you £1 million if you make the investment I’ is not enforceable, since no outsider knows whether it has been fulfilled. Similarly, the parties’ revenues and costs cannot be made part of a profit- or cost-sharing agreement. The quality of [my] book is observable, in the sense that anybody can read it... However, it would have been difficult for Oxford University Press and me to have written a contract making my royalties a function of quality, since if a dispute arose it would be hard for either of us to prove that the book did or did not meet some pre-specified standard. (For this reason my royalties are made to depend on some (more or less) verifiable consequences of quality, e.g., sales.) In other words, quality is not verifiable. Id. at 37-8n.15

Hart’s description contains three examples of nonverifiability that differ in the precision, or vagueness, of the contract term. Payment conditioned on the quality of his book is a much more vague term than one conditioned on a specific level of investment. Profit- or cost-based payments fall in the intermediate region because they can be interpreted in various ways by different accounting principles. Like most authors in this literature, Hart groups these three examples and suggests that parties would contract for none of these terms. It may well be true that none of these examples is directly verifiable, but the negative implication—that parties would not contract over this information at all, is at best misleading. As we show below, the relationship between the cost of enforcing terms that rely on these factors and their contribution to efficient contract incentives is far more subtle.

21 E.g., BERNARD SELANIE, THE ECONOMICS OF CONTRACTS ch. 7 (1999).
features in the judicial enforcement of contracts: (a) information comes to the court by way of self-interested and costly evidence presented by the parties, (b) the court makes its judgment based on a relative rather than absolute assessment of its confidence in fact finding (“preponderance of the evidence” or “balance of probabilities”), and ©) the parties have considerable influence, either by their contract or later agreement, over the course of the future litigation. In light of these factors, the “verifiability” of a contract obligation or contingency is context-specific and endogenous. Moreover, verification costs are likely to be substantially lower than economists implicitly assume, so that a contract might well try to regulate effort, for example.

Courts do not observe facts directly, but rather they make factual determinations by relying on proxies for the truth. The performance of a contractual obligation is proved or disproved by the presentation of evidence rather than by the court’s direct observation. Suppose, for example, that a contract requires delivery of a widget that is exactly .0025 inches wide. The promisor’s compliance with even this very precise contract term is not established directly by a court undertaking to measure the widget. Rather, compliance is proven indirectly by, for example, expert testimony of the width of the widget – testimony that is subject to cross-examination concerning the accuracy of the expert opinion. The same is true if the contract calls for a widget of merchantable quality. The court selects proxies for merchantable quality and then examines the evidence to determine whether those proxies are satisfied or not. The cost of proof therefore depends on what proxies are considered and what evidence is invoked to establish the presence or absence of the proxies.

Significant institutional forces and incentives constrain the costs of litigation, regardless of the substantive contract provisions. In the adversarial litigation system, the court chooses among the self-interested evidence presented by the parties. The parties present only the evidence that is in their respective self-interest, and the parties also bear most of the cost of their respective evidence production. Given the evidentiary and procedural rules of litigation, each party decides how much to invest in evidence production. They stop presenting when the marginal cost exceeds their marginal private benefit, which is a product of the probability of winning and the
amount at stake. A significant decrease in the probative value of evidence, for instance, might therefore result in a relatively inexpensive trial. Moreover, the parties’ evidentiary decisions are interactive, in the sense that the marginal benefit of one party’s evidence is affected by the other’s evidentiary strategy. One party’s evidence may well discourage the other party from further investing in the litigation.22

In civil cases, such as contract disputes, courts make factual determinations with substantially less than complete confidence in their fact finding. Indeed, unlike criminal cases in which the facts must establish guilt beyond a reasonable doubt, civil disputes are decided against a relative rather than absolute standard: the preponderance of evidence or the balance of probabilities. Moreover, where proof is particularly difficult, trials may be abbreviated by several well known procedural mechanisms. Even before the parties present their evidence, the court might award summary judgment to one party if the other is unable to show that there are genuinely contested issues of material fact.23

The fact-finding process in litigation is governed by burdens of proof and presumptions that tend to curtail litigation costs. The burden of proof consists of two distinct burdens -- the burden of production and the burden of persuasion – that carry distinct standards of proof. The party with the burden of production must produce sufficient evidence such that, in the eyes of the judge, a reasonable jury could infer the fact.24 If that party fails to carry that burden, the court will order a directed verdict or judgment as a matter of law in favor of the other party.25 Some or

22Avery Katz explains that an increase in one party’s evidence production may cause the other party either to advance additional evidence or to retreat by presenting less evidence. Avery Katz, Judicial Decision Making and Litigation Expenditure, 8 INT’L REV. LAW & ECON. 127 (1988). See also Chris William Sanchirico, Harnessing Adversarial Process: Proof Burdens, Affirmative Defenses, and the Complementarity Principle (Draft: February 2005).


24The application of this standard appears to be a matter for the judgment of the court. A classic treatise suggests that certain common factual groups recur and that individual judges have incentives to be consistent, and that other courts follow to produce predictable patterns or standards. JOHN W. STRONG (ED.), MCCORMICK ON EVIDENCE § 338 (5th ed. 1999).

much of the cost of a full-blown trial might thereby be avoided. The burden of persuasion follows if the burdens of production are met and both parties have presented all their evidence. The court instructs the jury that one party carries the burden of persuasion and that, unless this burden is met, the jury must return a verdict for the other party. In a civil case, such as an action for breach of contract, the burden is satisfied if it establishes the alleged fact as more likely than not to be true. This underscores the relative character of the adversarial process. One party’s evidentiary production need not be any higher than that which is necessary to pass the burden threshold, given her opponent’s evidence. At the same time, a party carrying the burden may retreat in the face of additional evidence presented by her opponent.

Legal presumptions shift burdens from one party to the other and, in so doing, might further economize on litigation costs. Under a presumption, the satisfaction of a burden with respect to fact A satisfies the burden of production on fact B, and it also shifts the burden to the other party to establish the non-existence of fact B or face a directed verdict against it. For example, when a shipper can show that it delivered goods to Carrier A in good condition and received them from Carrier B in defective condition, there is a presumption that the damage occurred while the goods were in the control of Carrier B. Such presumptions are sometimes justified on the grounds that fact B is highly correlated with fact A or that the other party has

26For a justification of the all-or-nothing feature of burdens of proof, see Chris William Sanchirico & George G. Triantis, Evidence Arbitrage: The Fabrication of Evidence and the Verifiability of Contract Performance (mimeo 2002, 2004).

27Sanchirico, Harnessing Adversarial Process, supra note 22.

28McCormick defines a presumption as “a standardized practice, under which certain facts are held to call for uniform treatment with respect to their effect as proof of other facts.” MCCORMICK, supra note 24 at §342. There is some division among courts as to the extent that the burden of persuasion (as well as the burden of proof) shifts to the other party. Id. at §342. Some courts hold that, in this case, not only does the defendant have the burden of production but that he has the burden of persuasion on the nonexistence of the presumed fact as well. Note that in criminal cases there are rules that are labeled presumptions even though they do not shift the burden of production. The Supreme Court has called these rules “permissive presumptions.” County Court of Ulster County v. Allen, 442 U.S. 140 (1979).

superior knowledge about fact B.\textsuperscript{30}

Despite these various mechanisms that curtail the evidence that is presented at trial, litigation costs may be inefficiently high because of the litigants’ incentives. Each party’s investment is a function not only of its probability of winning, but also the amount at stake— for example, the damages award being sought by the plaintiff. At the time of the trial, the parties are engaged in splitting a fixed gain or loss with little, if any, prospective efficiency value. The value of the litigation outcome derives from its effect on ex ante incentives, which are of no interest to the parties at the time of trial.\textsuperscript{31} The litigants continue to invest until the marginal cost of additional evidence exceeds the marginal increase in the expected litigation outcome, rather than in the improvement in incentives. From this perspective, the economists’ concern with verification costs may be restated as the prospect that the parties will overinvest in litigation, relative to the gains in ex ante incentives. Even in this more refined frame, however, the concern with back-end costs is overstated because it ignores the ability of the court or the parties themselves to compensate for these inefficient incentives.

Judges have self-interested motivations to take steps to abbreviate the duration and cost of trials. A judge’s prestige and influence may well be enhanced by presiding over more rather than fewer cases, holding her personal effort constant. And, within a case, the judge may reduce the demands on her time and effort by limiting the amount of evidence. In light of the public spotlight on litigation costs, some courts have enjoyed a positive reputation for putting in place

\textsuperscript{30}Id. We suggest in Part III that presumptions and shifting burdens are created by a variety of contract provisions, including conventional contract assignment restrictions, termination rights and professional certificates of performance. See text accompanying notes 160-74 infra.

\textsuperscript{31}See Steven Shavell, The Social versus the Private Incentive to Bring Suit in A Costly Legal System, 11 J. LEGAL STUD. 333 (1982)(plaintiff does not internalize the litigation cost of the defendant). Conversely, high litigation costs can undermine socially valuable incentives by discouraging the bringing of suits. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 397 (2004). See Richard A. Posner, An Economic Approach to the Law of Evidence, 51 STAN. L. REV. 1477, 1486 (1999) (discussing the possibility that parties will either underinvest or overinvest in the search for evidence, relative to the social optimum); see also Louis Kaplow, Accuracy, NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (1998). (Parties may over or under invest “because private benefits relate to the amount of damage payments ex post whereas social benefits may depend primarily on deterrent effects ex ante, which are usually of no immediate concern to the parties.” Id. at 4).
mechanisms that speed trials. The rules of procedure and evidence provide judges with tools for doing so. Accordingly, they have discretion to constrain pretrial discovery, to accelerate trial dates, to limit the length of trial, and to exclude evidence.

Several commentators assert that rules of evidence and procedure are designed to drive a wedge between the lower cost of evidence supporting the truth and the higher cost of inaccurate (or fabricated) evidence. This improves the efficiency of litigation in several ways. First, given this cost differential, Rubinfeld and Sappington suggest that the effort invested by each party in litigation may be a signal of the truth. If effort can be observed by the court, litigation may yield a second-best equilibrium in light of the court’s inability to directly verify the truth. The nonperforming defendants invest nothing in litigation and are found liable, and the

32 See e.g., the so-called “rocket docket” adopted by the United States District Court in the Eastern District of Virginia.

33 For example, Judge Posner writes that judges constrain overinvestment in evidence “not only by curtailing pretrial discovery, setting an early trial date, and limiting the length of the trial...but also by excluding evidence at trial under the authority of Rule 403 of the Federal Rules of Evidence....The relevance and hearsay rules also conduce to this end.” With respect to the hearsay rule, for example, Posner observes that it is proscribed by a cost-benefit assessment that makes exception for “those forms of hearsay that have probative value equivalent to that of first-hand evidence (for example, a statement against interest...).” Posner, supra note 31 at 1530.

34 For example, Posner states:
In general, moreover, the party having the objectively stronger case will be able to obtain evidence favorable to it at lower cost than the opposing party can obtain evidence favorable to itself. So the competitive system of gathering evidence will tend to favor the party who would win in an error-free world...[M]ost cases, civil or criminal, are resolved correctly [because]... it is usually cheaper to obtain persuasive evidence on the side of truth.”

Posner, supra note 31 at 1492-3, 1507.

See also, Hyun Song Shin, Adversarial and Inquisitorial Procedures in Arbitration, 29 RAND. J. ECON. 378, 380 (1998); Antonio Bernardo, Eric Talley & Ivo Welch, A Theory of Legal Presumptions, 16 J. L. ECON. & ORG. 1 (2000). In Bernardo et al’s model, the marginal cost of evidence is higher for a shirking agent than for a high-effort agent. “[T]his cost differential implies that shirking agents will rationally choose to present less evidence than their non-shirking counterparts in equilibrium. Consequently, the litigation effort expended by the agent may be an efficiency-enhancing signal of her type – a signal that is only possible when litigation occurs along the equilibrium path.” Id. at 10-11:Chris William Sanchirico, Evidence Tampering, 53 DUKE L.J. 1215 (2004); Chris William Sanchirico, Evidence, Procedure, and the Upside of Cognitive Error, 57 STAN. L. REV. 291 (2004)(cognitive shortcomings make it more difficult to provide consistent and detailed testimony that is false than true).

35 Litigation effort by an innocent defendant should be more effective than equal expenditure by the guilty, suggesting that the innocent defendant would spend more effort in her defense. “If this were not the case, litigation would serve no purpose, since it would not enable the court to distinguish more accurately the innocent from the guilty.” Daniel L. Rubinfeld & David E.M. Sappington, Efficient Awards and Standards of Proof in Judicial Proceedings, 18 RAND J. ECON. 308 (1987).
performing defendants spend until their private marginal benefit of investment (in reducing their expected liability) equals the marginal cost of additional evidence. Despite judicial pronouncements to the contrary, courts often do draw inferences in civil cases from the failure of a party to present evidence that might exonerate them. This separation ameliorates the concern with excessive litigation cost.

Second, if parties can reduce their evidentiary costs by performing their contractual obligations, this saving may have an ex ante incentive effect by inducing performance. Therefore, contracting parties may wish to contract over factors that might entail prospectively high litigation cost, if there is a very significant discrepancy between the evidentiary cost that would be incurred by the performing party (who would tell the truth at trial) and that of the nonperforming party (who would lie). The adversary’s evidentiary costs, in contrast, have no beneficial effect on performance incentives other than by raising the likelihood of a finding of liability. Nevertheless, as before, our point is simply to suggest that the focus on verification costs alone is far too simplistic to explain contract design.

Finally, the parties themselves may further reduce litigation costs by consent. They can do so narrowly, by stipulating facts or agreeing to limited discovery, or, more broadly, by settling the case altogether. Indeed, the prospect of settlement provides another illustration of how the concern with verification costs is misleading. Settlement is more likely, all other things equal, the higher the anticipated litigation costs. For any given difference in the parties’ expectation regarding the likely judgment, the likelihood of settlement increases with the expected aggregate cost of trial.

36 An agent’s “evidentiary expenditures are part of her effective litigation penalty as much as any payments she must make to her opponent by virtue of verdict and remedy.” Sanchirico, Harnessing Adversarial Process, supra note 22 at 11.

37 Id.

38 As Steven Shavell observes, “a mutually beneficial settlement exists as long as the plaintiff’s estimate of the expected judgment does not exceed the defendant’s estimate by more than the sum of their costs of trial.” He also states that “[t]he larger are the legal expenses of either party, the greater are the chances of settlement, clearly, since the sum of legal costs will rise, and thus the greater will be the likelihood that the sum of legal costs will
2. Uncertainty and Error Costs

In light of the various constraints on evidence production and the modest confidence threshold for judicial fact-finding (balance of probabilities), there is uncertainty and the prospect of judicial error in contract enforcement. Some contracts scholars argue that uncertainty undermines performance incentives. Other scholars, however, suggest that the effect on incentives depends on the nature of the uncertainty, which in turn is a function of context-specific variables. In particular, the prospect of legal error is more likely to undermine incentives if the fact-finding lies within a discrete rather than continuous set of possible alternatives. Consider a contract that requires an agent to make a specific investment in a venture. Suppose that the agent’s share of profits from the venture and her reputational concerns are such that her self-interested strategy would be to invest $30, which the parties know will be suboptimal. They agree, therefore, to a clause requiring the agent to invest $60 and impose a penalty if the agent fails to do so. Yet, the actual investment of the agent is not verifiable: the court observes only a noisy signal of her investment and therefore may assess it incorrectly. Under these conditions, if the agent’s choice is binary (she can invest either $30 or $60), then the risk of error exceed any excess of the plaintiff’s expectation over the defendant’s expectation. One would expect legal expenses to rise with the size of the potential judgment.” SHAVELL, FOUNDATIONS, supra note 31 at 403, 406. See Albert Choi & George G. Triantis, Contractual Choice Between Arbitration and Litigation (mimeo 2004). Although outside the scope of this paper, we would expect that the terms of a contract would differ depending on whether the parties anticipated that disputes would be resolved by litigation or by settlement. Settlement and litigation outcomes are likely to differ, leading to divergent incentives when the contract terms are not adjusted. Albert Choi & George Triantis, The Effect of Settlement on Contract Design (mimeo 2005). Shavell speculates that settlement increases deterrence by raising the likelihood of plaintiffs bringing suit. SHAVELL, FOUNDATIONS, supra note 31 at 412.

39See infra note 78.


For the most part, competence has been treated as an either/or proposition: courts either can or cannot verify a potential contracting variable...[But] verifiability is a matter of degree not dichotomy; judicial competence is more or less limited because courts make errors more or less frequently in “observing” a contract variable or translating an observation into a conclusion about efficiency...The dichotomous verifiability approach to contract enforcement is somewhat surprising in light of the extensive literature examining the implications of varying degrees of imperfection in the enforcement of tort and criminal law.

Id. at 162.
will undermine incentives by raising the possibilities that an agent investing $60 may nevertheless be found liable (Type 1 error) and that an agent investing $30 may not (Type II error). But as long as the probability of liability is higher if the seller breaches in fact by investing $30 than if she invests $60, the enforcement of the obligation will improve her incentive somewhat. The important question is whether the gain warrants the enforcement cost.

Suppose now that the contract specifies performance that lies on a continuous set of decision points. In this case, the effect on incentives is less clear and depends on the distribution of error. The risk of inaccurate assessment may ameliorate the degree of underinvestment in effort (a good thing) or it may overshoot and cause excessive effort (which may be either a good or a bad thing relative to the agent’s contractual incentives in the absence of the contract term requiring additional effort). Assume again that the contract requires the agent to invest $60 and that the agent would invest $30 in the absence of the investment clause in the contract. The parties do not have sufficient incentive to produce evidence at trial that leads the court to pinpoint the agent’s effort in fact (e.g., because the marginal cost of evidence rises steeply beyond some point). This risk of legal error creates a wedge between the social and private return from investment above $30. The social return in this case is the value created within the venture, while the private return to the agent is the incremental reduction in expected liability caused by additional investment. The expected liability would fall because of the lower probability that the court would find a breach.

Unless the court declines to adjudicate this dispute, it will arrive at an assessment of the agent’s investment. At the time the agent makes her investment decision, however, the court’s prospective determination is a probability distribution. If the court is extremely uninformed, the distribution may be uniform across effort levels regardless of the actual effort expended. The agent would then enjoy no private return (in the way of lower expected liability) from increasing her investment and it will remain at $30. If, however, the distribution is normal and peaks at the

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Where the variance is especially high, underdeterrence is more likely. In the extreme case, the actor’s expected liability is unaffected by his investment choice. Craswell & Calfee, supra note 41. A standard of proof threshold is unlikely to mitigate this result because it does not help the court discriminate between complying and noncomplying agents.

A more comprehensive analysis would also factor the effect on the plaintiff’s incentive to bring suit and present evidence. For example, the extra dollar in investment may lead to more than a dollar in saving on litigation costs because the plaintiff might not litigate or litigate with less enthusiasm.

This is Gillian Hadfield’s important contribution in Hadfield, supra note 40. Moreover, she demonstrates that the agent’s cost of effort acts as a brake against the incentive to reduce expected liability by investing more effort: to raise effort, the expected liability reduction must exceed the cost of the incremental effort. Id.

To be sure, a complete analysis of the effect of fact finding error needs to incorporate the incentive of the principal to bring suit against the agent. In light of the fact that litigating parties bear their own costs, legal error can induce the principal to bring suit against a complying agent or to hesitate to bring suit against a noncomplying agent. Polinsky and Shavell demonstrate that plaintiffs are discouraged by the prospect that guilty defendants will not be held liable (false negatives) and encouraged by the chance that even an innocent defendant may be found liable (false positives). But if the principal cannot discern the actual effort level, the effect of legal error on the incentive to
contract design to predetermine the distribution of fact finding, but that we leave that inquiry for future research.\(^46\)

**B. Trade-offs Between Front-End and Back-End Costs: The Use of Vague Contract Terms**

Contract scholars have a split view of vague terms, depending on their perspective. When contracts scholarship is concerned with front-end (transaction) costs, such as the cost of negotiating and writing contracts, vague terms serve to reduce these costs by letting the enforcing court complete the contract.\(^47\) This argument, however, assumes costless enforcement. When contract scholarship is concerned with back-end costs, including verification costs and uncertainty, the authors prefer specific to vague terms. They argue that courts should refrain from enforcing vague terms that entail prohibitively high verification costs.\(^48\) These arguments tend to

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\(^46\) Hadfield, supra note 40 at 162 (parties can anticipate and adjust for legal errors in their initial contract, and the concern with legal error should also guide gap filling). We touch on this possibility in discussing the contractual assignment of burdens and standards of proof, in Part III.


\(^48\) Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. Legal Stud. 271 (1992); Robert E. Scott, *The Case for Formalism in Relational Contracts*, 94 NW. U. L. Rev. 847 (2000). Alan Schwartz predicted that courts would decline to apply best efforts provisions when the relevant facts are uncertain. “Courts passively permit the distributor to provide whatever quantity she deems best.” Schwartz, *Contracts in the Courts*, supra at 304. In a sample of cases where the best efforts obligation had been directly litigated, he found, consistent with his prediction, that the courts interpreted best efforts obligations to generally permit a distributor “to supply any quantity of efforts greater than zero.”Id. At 302.
set aside the front-end costs of specific provisions.

In fact, however, contracts include both specific and vague terms, and the courts seem to actively interpret and enforce vague terms.\textsuperscript{49} Commercial contracts regularly invoke factors such as “best efforts,” “reasonable expenses,” and “reasonable withholding of consent.”\textsuperscript{50} Not only are explicit best efforts obligations common, they are also the subject of extended negotiations, including negotiation over seemingly minor linguistic variations. Indeed, many contracts reflect a highly nuanced approach to the specification of vague clauses. For example, best efforts may be replaced by “commercially reasonable efforts,” “reasonable efforts” or “reasonable best efforts.” While some courts interpret best efforts as the equivalent of good faith,\textsuperscript{52} others impose a higher standard of reasonable diligence\textsuperscript{53} and some even require the level of effort that would be exerted by a similarly situated integrated firm.\textsuperscript{54}

Contract scholarship therefore needs a theory to explain the common use of both vague

\textsuperscript{49} Kenneth A. Adams, \textit{Understanding “Best Efforts” and Its Variants (Including Drafting Recommendations)},” 50 \textit{PRAC. LAW.} 11 (2004).

\textsuperscript{50} See franchise and distribution contracts cited in notes 86-919 infra; \textit{See also, CORI Contracts Library}, supra note 19.

\textsuperscript{51} Adams, supra note 49 at 12 (reviewing contracts of public companies filed with the SEC and finding “best efforts” used 627 times, “commercially reasonable efforts” used 425 times, “reasonable best efforts” used 345 times and “reasonable efforts” used 307 times). See also the Taco Bell contract discussed at text accompanying notes 89-97 infra.

\textsuperscript{52} See e.g., Triple A Baseball Club Assocs. v. Northeastern Baseball, Inc., 832 F.2d 214, 225 (1st Cir. 1987) (“We have been unable to find any case in which a court found...that a party acted in good faith but did not use best efforts.”); W. Geophysical Co. of Am. v. Bolt Assocs., Inc., 584 F.2d 1164, 1171(2d Cir. 1978) (best efforts obligation is met by “active exploitation in good faith”).


\textsuperscript{54} Petroleum Mktg. Corp. v. Metropolitan Petroleum Corp., 151 A. 2d 616, 619 (Pa. 1959) (buyers had the duty to “use such efforts as it would have been prudent for the [sellers] to use in their own behalf if they had owned the receivables....”).
and specific terms, as well as to predict when each type is more likely to be used. This paper addresses these questions by examining the important but neglected trade-off between front-end and back-end costs. The resolution of this trade-off in each contracting instance determines the parties’ optimal choice between specific and vague terms. For those readers who think in terms of indifference curves, we would draw a graph with front-end and back-end costs on each axis and iso-incentive curves, each of which trades off the costs while maintaining the same level of contract completeness or incentive efficiency. The point on the curve that hits the lowest 45 degree budget line is the optimal combination of front-end and back-end investments that will achieve the incentive efficiency of the curve. Conversely, the point on the curve that hits the lowest budget line represents the cheapest combination of front-end and back-end costs for the curve’s incentive efficiency.

The tradeoff between front-end and back-end costs is never an all-or-nothing choice. The parties will make some effort to describe their obligations on the front-end; indeed, the courts require this as a precondition to an enforceable contract and will decline enforcement on account of excessive vagueness.\textsuperscript{55} At the other extreme, it is prohibitively costly to draft a contract that entails no back-end costs and entails no enforcement uncertainty. Therefore, it is analytically helpful to invoke a concept that represents what is being traded between the front- and back-ends (for example, as one moves along the iso-incentive curve described above). We draw on the fact, mentioned earlier, that courts do not directly observe the materialization of contingencies or the performance of obligations, but rely on evidence or proxies. Parties can constrain the space from which these proxies may be drawn in litigation by agreeing to more or less specific terms. The more vague the term, the broader the space, and the more work the parties leave for the back-end. Conversely, the parties can invest in defining proxies at the front-end and identifying them through specific terms.

Contracts essentially provide for pairs of contingencies and performance obligations– for

\textsuperscript{55}For discussion, see Robert E. Scott, \textit{A Theory of Self-Enforcing Indefinite Agreements}, 103 COLUM. L. REV. 1641 (2003).
example, when X occurs, the promisor must pay $Y. For our expositional purposes, the parties might define X at any of three levels. First, X might be the production of a specific bit of evidence, such as a signed document or testimony by a specific witness. Second, X may be a relatively specific event, such as the delivery of a widget with a specified weight. In this category, the parties delegate to the court the determination of which bits of evidence are sufficient to satisfy X and trigger the promisor’s payment obligation. Third, X may be a vague term, such as the delivery of a widget in excellent or merchantable condition. In this category, the court must determine not only what evidence is sufficient to establish the weight of the widget but also the degree to which the weight is relevant in the determination of whether the standard has been met. For convenience, we refer to this latter determination as the choice of proxy for the vague term or standard. Although there are factual bases for choosing among proxies, the selection is generally regarded as a question of law for the judge. In some cases, the proxy choice becomes fixed as a legal default rule. This is the case with expectation damages, for example, where market damages are regarded as the default mechanism for establishing the promisor’s contractual expectancy in the case of goods or services traded in established markets. But in any event, the judge cannot simply leave the standard to be specified by the jury without identifying appropriate proxies. Thus, for example, in Empire Gas Corp. v. American Bakeries Co., Judge Posner ruled that the trial judge had failed to give appropriate instructions to the jury when he did not specify what evidence would support a finding of bad faith, a widely used standard.

Thus, specific and vague contract terms (or rules and standards) may be distinguished by the manner in which proxies for a particular contingency or obligation are chosen. The parties may either choose the proxy directly by a rule in their contract or delegate the choice to the court.

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56 Sanchirico & Triantis, supra note 26.

57 See e.g., Uniform Commercial Code §§ 2-703(d),(e), 2-706, 2-708(1) (seller’s market damages), and §§ 2-711(a),(b), 2-712, 2-713 (buyer’s market damages) (2003).


59 “It is not true that the law is what a jury might make out of [the obligation of good faith]. The law is the [obligation of good faith] as interpreted. The duty of interpretation is the judge’s. Having interpreted the [obligation of good faith] he must then convey [its] meaning, as interpreted, in words the jury can understand.” Id at 1336.
by a contractual standard. In either case, the court determines whether the relevant proxies have been satisfied by screening bits of evidence presented by the parties. If the proxy is determined by contract, the parties incur front-end (transaction) costs to do so. If the parties agree to a vague term (standard), they accept higher expected back-end (enforcement) costs in return for lower front-end costs.

As an example of a court-selected proxy under a vague term, consider the familiar contracts case of Bloor v. Falstaff Brewing Corp. Falstaff purchased most of the distribution network and related assets of a brewer named Ballantine. Part of the compensation consisted of royalty payments of $.50 per barrel of beer sold during the six years following the sale. The parties designed this component of the sale price to reflect the value of the Ballantine distribution assets to Falstaff. However, the royalty threatened to induce sub-optimal effort by Falstaff by effectively taxing the marginal product from sales of beer. To deal with this problem of underinvestment, the parties included a provision requiring Falstaff to “use its best efforts to promote and maintain a high volume of sales.” When the seller sued and claimed that Falstaff had breached its best efforts obligation, the trial judge faced the dual task of verifying whether the defendant had breached and determining the appropriate measure of damages. Judge Brieant chose a market proxy for the performance of best efforts: the sales of two integrated firms (Rheingold and Schaefer) that both produced and distributed the same product and that were roughly comparable in size and locale to the contract product. The integrated firms provided an

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60 Admittedly, this analysis somewhat oversimplifies for the purpose of exposition the distinction between contingencies and proxies because even the narrowest proxies can be further broken down into evidentiary units. Thus, the distinction between the two approaches (standards and rules) may more appropriately be viewed as one of degree.


63 Goetz & Scott, Relational Contracts, supra note 16.

64 454 F. Supp. at —.

65 Id. at 277-81. Goetz & Scott, Relational Contracts, supra note 16 at 1122-23.
appropriate benchmark for efficient best efforts because they did not suffer from the skewed incentives of sharing revenues with separate organizations and because the relevant sales data was readily available. The parties no doubt incurred litigation costs in proposing and arguing over the appropriate proxy. Nevertheless, they avoided front-end costs by contracting for “best efforts” instead of specifying proxies at that stage.

Other parties shift contracting costs and proxy selection to the front-end. Many commercial contracts include explicitly benchmarks similar to the ones in Bloor v. Falstaff. Franchisors promote sales efforts by their franchisees by requiring them to maintain sales volume comparable to other similarly situated franchisees or franchisor-owned outlets. These proxies are established by evidentiary bits at a back-end cost that is significantly lower than if the parties were to argue in court about the appropriate proxy. Thus, some contracting parties elect to incur front-end costs in specifying proxies by contract while others leave the proxy choice to the back-end process. More generally, the choice is not simply between specifying proxies or not. Rather, contracts define a broader or narrower space within which the court selects proxies. The size of the space determines the discretion over proxy choice that is assigned to the court instead of the parties, as well as the extent to which the proxies are chosen at trial rather than the time of the contract. Accordingly, the determination of proxy choice implicitly allocates costs between the front-end and back-end of the contracting process. We now turn to examining more closely the factors governing the parties’ strategies in making this allocation.


67 Drahozal and Hylton, supra note 6 at 556.

68 See examples text accompanying notes 90-97 infra.

69 Indeed, many contracts reflect a highly nuanced approach to the specification of vague clauses. For example, best efforts can be replaced by “commercially reasonable efforts,” “reasonable efforts” or “reasonable best efforts.” Adams, supra note 49 at 12 (reviewing contracts of public companies filed with the SEC and finding “best efforts” used 627 times, “commercially reasonable efforts” used 425 times, “reasonable best efforts” used 345 times and “reasonable efforts” used 307 times). See also the Taco Bell contract discussed at text accompanying notes 90-97infra.
II. THE CHOICE BETWEEN RULES AND STANDARDS IN CONTRACTS

In this Part, we explore how parties choose their mix of specific and vague contract terms (or rules and standards) to optimize the selection of efficient evidentiary proxies over two dimensions: when the choice of proxy is made and who makes the choice. We describe the means by which the parties define the domain or the “space” within which the court selects proxies at litigation. A specific term defines a very narrow space – at the limit, a single proxy. It therefore entails larger front-end transaction costs, but lower back-end enforcement costs than a vague term that leaves the court with a broader space. Contracts that combine rules and standards in defining a contingency or obligation offer additional flexibility in setting boundaries for the court’s discretion, but respond to the same tradeoff.

A. Efficient Proxies and Efficient Choosers: Rules or Standards in Contracts

1. Determinants of an Efficient Proxy.

It is helpful to briefly describe the features of an efficient proxy before turning to examine how contracting parties would choose between contracting directly on proxies and delegating the choice of proxies to the court. An efficient proxy contributes a larger incentive bang than its expected cost in being litigated.70 We can illustrate this point with the following simplified example. Suppose a seller and buyer enter into a contract for the sale of a widget that may be produced either with an ordinary veneer or a premium polished veneer. The buyer values the widget at $1000 with the premium veneer and $600 with the ordinary veneer. The seller’s corresponding production cost are $700 for the premium veneer and $500 for the ordinary veneer. Thus, the surplus from trade is $300 if the widget has a premium veneer and $100 if it does not. The seller would produce an ordinary widget unless otherwise obligated under the contract. The parties consider whether to contract for the premium veneer, in which case they would provide for liquidated damages of $400, a sum equal to the expectation loss of the buyer. If the buyer would

70The notion of incentive bang for expected litigation buck is formalized in Sanchirico &Triantis, supra note26.
be confident of the seller’s performance, the parties would set a contract price of $800 for the premium widget.

Enforcement, however, might be costly and it might be uncertain. Specifically, the condition of the veneer might be different at trial than at the time of delivery because of the buyer’s use of the widget. The parties are likely to offer conflicting expert testimony at significant combined cost. To illustrate the bang for the buck concept, suppose that the parties would invest a total of $X in litigation but that the court would thereby detect without error whether the veneer was premium or ordinary at the time of delivery. Would it be efficient for the parties to contract for premium veneer? The gain in surplus from the premium veneer is $200. So, as long as X is less than $200, the term yields a net bang for the buck if the enforcement induces the seller to perform. And it does in this example, because the incremental production cost to the seller of premium veneer is $200, which is less than the damages liability (not to mention the litigation costs). To incorporate a further element of uncertainty, suppose instead that the parties invest a combined $100 in evidence, but the probability that the seller will be found liable is 75% if she has produced an ordinary widget. As long as the probability of liability is lower than 25% when she produces the premium widget, the seller has the incentive to perform the contract. And, the contract achieves an incentive gain greater than its enforcement cost.

2. Determinants of an Efficient Chooser

The parties in the foregoing example have the choice between specifying the obligation to provide premium veneer at the time of contracting or contracting for a widget of “high quality,” or similar vague term, under the expectation that the court will require premium veneer if appropriate in the circumstances. By assigning the proxy selection to the better chooser, the parties can either reduce their contracting costs or improve the efficiency of the proxy, or both. Of course, the best information as to proxy choice is held by the parties themselves after the resolution of uncertainty. The parties have divergent private interests in the choice of proxies at trial. In selecting a chooser, therefore, the parties have only two options: the choice of proxies will be made either at the time of the contract by the parties who enjoy private information, or
after the resolution of uncertainty by the court who enjoys the benefit of hindsight. The superior decision maker is a function of the relative incentives and information of the parties and courts; rarely are either the parties or the court ideally situated. Barring significant asymmetries in sophistication and information, the parties should have superior incentives at the time of contracting; after all, they share in the benefits of efficient contracting. A court presumably has no bias in favor of one party over another in a dispute, but it also does not have much of a stake in the efficient \textit{ex ante} outcome. As noted earlier, the court may have incentives to contain litigation costs, but its ex post perspective is likely to weigh litigation costs against accuracy in fact finding, rather than against ex ante efficiency.

The comparison of informational advantages is a closer call and this is what leads to the diversity in the use of specific and vague contract terms. At any given time, the parties have information superior to that which they can communicate to the court. Yet, as we have seen, the selection of the proxy-chooser is between the parties at the time of the contract and the court at the later time of litigation. The efficiency of proxies (their incentive bang and enforcement buck) is often determined by the surrounding circumstances. Therefore, front-end proxy choice must contemplate the operation of the proxy in various possible future states of the world either by identifying pairs of proxies and states or by more crudely lumping states in groups. In contrast, back-end proxy selection can be fine-tuned to the materialized state, albeit at the cost of identifying which state has in fact occurred.\footnote{See Kaplow, \textit{Rules versus Standards}, supra note 9. Ian Ayres observes that the argument for muddy (vague) default rules in corporate law “stems from a prediction that some firms would want courts to implement more fully contingent rules than the firms themselves can practicably contract for \textit{ex ante}”. Ian Ayres, \textit{Making a Difference: The Contractual Contributions of Easterbrook and Fischel}, 59 U. CHI. L. REV. 1391, 1418-19 (1992).} In other words, the court has the benefit of hindsight.

The parties may view the court’s hindsight as an advantage or disadvantage depending on how much uncertainty has resolved by the time contract performance is due. Where the enforcement cost of proxies varies with the materialized state of the world (for example, the availability of a market indicator), the court has a systematic advantage. However, the incentive
benefit of a proxy depends on whether the relevant contingencies have occurred by the time that performance is due, not at the time of trial. Thus, if uncertainty is resolved before performance is due, the court’s proxy-selection may be predictable so as to influence the promisor’s behavior. Conversely, if the promisor must perform before much uncertainty has dissipated – for example, by investing early in the relationship – then the court’s hindsight may in fact be a liability.

In sum, the parties will choose a specific proxy when the parties’ private information is more important than the effect of contingencies on the choice of proxy. When the efficient proxies are highly state-contingent and less dependent on private information of the parties, the parties will be more inclined to use standards to delegate proxy choice to the courts, particularly if uncertainty is expected to resolve itself by the time the relevant performance is due.

The case of Eastern Air Lines v. Gulf Oil Corp.\textsuperscript{72} provides an instructive example. The parties entered into a long term contract for the sale of jet fuel at designated locations. They wished to set a price for the jet fuel in order to allocate the risk of exogenous changes in the input price of crude oil to Eastern Airlines and the risk of fluctuations in production cost to Gulf. They selected a contract proxy that adjusted the contract price according to an easily verifiable indicator of crude oil price--West Texas Sour crude “as listed...in Platts Oilgram Service.”\textsuperscript{73} Subsequently, as a result of governmental regulation following the oil crisis in the 1970s, this proxy failed. The court declined to choose a substitute proxy. The parties might have anticipated the failure of the indicator by stating explicitly in the contract that the price either would be adjusted to the price of crude oil (a standard) or that it would be tied to Platt’s or “any other appropriate index.” In general, a contract might adopt a blended strategy by providing for a specific proxy and delegating to the court the choice of a replacement if the specific proxy should fail. As we discuss in the next section, the inclusion of such a standard is an invitation to the court

\textsuperscript{72} 415 F. Supp. 429 (1975).

\textsuperscript{73} Id. at —. For discussion, see Robert E. Scott & Jody S. Kraus, Contract Law and Theory 864-69 (Rev. 3d ed. 2003).
to choose a new proxy.\textsuperscript{74}

The classic contrast to the conservative approach of the court in \textit{Eastern Air Lines} is the decision in \textit{Aluminum Co. of America v. Essex Group, Inc.}\textsuperscript{75} where the court reformed the parties’ price adjustment proxy in the absence of an explicit delegation by the parties. The usual critique of this opinion is not that parties would never choose to delegate proxy choice to the courts, but rather that there was no evidence in the contract or otherwise of the parties’ intention to do so. Indeed, the fact that they had invested a great deal of resources up front to provide a specific proxy might have been evidence to the contrary. \textit{Alcoa} is also unique because the contract reformation was the court’s initiative, in that neither party suggested a proxy even at the time of trial. One party asked for enforcement, the other argued that performance was excused.\textsuperscript{76}

Parties thus delegate proxy choice to the courts through the language of the standard and its combination with the specific rules in the contract. In some cases, the parties might rely exclusively on specific rules and forego standards. In hindsight, a court may be tempted in these cases (perhaps with the encouragement of one of the parties) to see gaps between the discrete rules and therefore to read into the contract implied standards, such as best efforts or commercial reasonableness. Yet, commercial parties can include standards in their contract at relatively low cost and they enjoy superior knowledge of the context of their contractual relationship to determine the optimal allocation of proxy choice. The courts, therefore, are wise to interpret the absence of vague standards in commercial contracts as instructions from the parties to abstain from proxy choice and to limit their construction to the specific terms of the contract.\textsuperscript{77}

\textsuperscript{74}See the discussion of liquidated damages in II.B.3 infra.

\textsuperscript{75} 499 F. Supp. 53 (1980).

\textsuperscript{76} See \textit{SCOTT & KRAUS}, supra note 73 at 830-33, 864-67.

\textsuperscript{77} It is conceivable that parties may elect either polar alternative of 100% standards or 100% rules. In the former case, a contract with only a vague standard risks being found unenforceable on the grounds of indefiniteness. See, e.g., Kraftco Corp. v. Kolbus, 274 N.E. 2d 153, 156,(Ill. App. Ct. 1971). In such a case, the parties are likely motivating self-enforcement by using deliberately indefinite terms to harness norms of reciprocity. \textit{Self-Enforcing Agreements}, supra note 53. In the latter case, the parties might craft a contract consisting of 100% rules and wish those rules to be applied literally and strictly with no attention to any contractual purpose. As we

In Part I, we identified the potential effects of uncertainty and the risk of error in fact finding on performance incentives. Where the promisor’s decisions are binary in nature, Type I and II errors undermine her incentives to perform. The prospect of legal error is compounded when a court enforces a vague term instead of a specific provision because the court’s task is broader: it must choose proxies as well as the evidentiary bits that support each proxy. Indeed, some contract scholars indicate that specific terms should be preferred to vague terms for this reason.78 The danger is that the promisor may exploit the uncertainty as to the correct proxy by shirking her obligations and then proposing an alternative proxy. To the degree that the court might adopt the promisor’s opportunistic suggestion, the vague term compromises the efficiency of her incentives.

This concern loses sight of the nature of the adversarial enforcement process and the consequent nature of the uncertainty in proxy selection. Both parties propose proxies to the court and there is no compelling reason why promisors would be systematically more likely to prevail in litigation than proxy selection at the time of contract. Moreover, the important question is not whether vague terms are perfect, but whether there are conditions under which they are superior to a contract with a corresponding specific obligation or even no obligation at all. Suppose that the court has superior information at the time of trial but there is uncertainty as to which proxy it will choose between two alternatives, such as the relevance of weight and of color to the merchantability of a widget. Given the court’s superior information, the parties can expect that one or both of the proxies will be less noisy under the circumstances than the one that the parties would pick ex ante. Therefore, even when discounted by the relevant probabilities of judicial

78Schwartz and Scott, Contract Theory, supra note 1; Schwartz, Contracts in the Courts, supra note 48.
choice, either alternative would improve performance incentives over a certain but inferior specific contract proxy.\textsuperscript{79}

A further virtue of delegating the proxy choice to the court via a vague standard is that the uncertainty as to which proxy will be selected might help to reduce the incentives of promisors to game specific rules once an adverse risk has materialized (a problem familiar to the design of tax rules).\textsuperscript{80} The uncertainty in judicial fact finding discussed in Part I.A.2 concerned the court’s error in determining the dollar amount of investment by the promisor, a unidimensional variable. In contrast, vague terms are often used when the performance in question is multi-dimensional, such as effort, and uncertainty raises different considerations in this case. Compare the incentives of an agent faced with a specific proxy for effort (in the form of a contract rule) and another agent whose behavior is governed by a standard of effort. The first agent has the incentive to direct her attention to satisfying the proxy alone and ignore all other dimensions of the desired performance.\textsuperscript{81} When faced with a standard, the agent has many proxies that might bear probabilistically on litigation outcomes. Its optimal strategy may therefore be to focus on effort rather than any single proxy, and thereby improve its position vis-a-vis all proxies.

Consider the following example offered by Canice Pendergast:

[i]t is difficult to imagine an occupation for which there are more measures of performance [than baseball]. Despite this, it is not common for players to have contracts where pay is directly related to specific performance measures. Part of the reason for this is that teams are reluctant to offer a contract that rewards a

\textsuperscript{79}See Hadfield, supra note 40.


\textsuperscript{81}This is a version of the well-known agency problem of multi-tasking. Bengt Holmstrom & Paul Milgrom, Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership and Job Design, 7 J. L. ECON. & ORG. 24 (1991); George Baker, Incentive Contracts and Performance Measurement, 100 J. POL. ECON. 598 (1992).
player for home runs, say, because the player may have an incentive to hit home runs even when it is not in the interest of the team for him to do so. By contrast, the more common cases where players are offered explicit bonuses are for aggregate measures of performance, such as making the All Star Team or being the league’s Most Valuable Player. Since these are more holistic measures of performance, they suffer less from the multi-tasking dilemma.\textsuperscript{82}

The parties to such a contract are using a standard in order to delegate to a third party the evaluation of the player’s performance. Part of the motivation is the challenge of specifying all the relevant facets of a player’s contribution to his team. But as discussed in the excerpt above, a distinct difficulty is the problem of specifying the desirable state-contingent proxies as they differ among possible future states of the world. Hitting or fielding may be relatively more important depending on the course of the season. A retrospective determination of performance can economize on having to specify state-contingent performance measures and compensate for the parties’ bounded rationality. Of course, the baseball contract contemplated above delegates the proxy choice to experts in the industry.\textsuperscript{83} If experts are not available, however, one can imagine that even a delegation to a court may be superior to the parties’ attempting to list the relevant proxies ex ante. Moreover, the passage quoted above also suggests that aggregate measures mitigate multi-tasking problems. Our argument is that vague standards can achieve the same effect probabilistically, as long as the range of individual proxies are correlated with the desired performance.

A similar, more cynical, argument may be made about the agent’s incentives under a specific proxy.\textsuperscript{84} As an alternative to performance, an agent has the option to invest in persuading the court that she has satisfied a specific proxy. For example, she may tamper with a testing

\textsuperscript{82}Canice Pendergast, \textit{The Provision of Incentives in Firms}, 37 J. ECON. LIT. 7, 22 (1999) (italics in original).

\textsuperscript{83}In a similar vein, we later discuss the delegation of proxy choice in construction contracts to architects. See text accompanying notes 156-160 infra.

\textsuperscript{84}Triantis, \textit{Efficiency of Vague Terms}, supra note 80 at 1076-8.
mechanism or misrepresent accounting results. In light of opportunities to manipulate or “manage” evidence, contractual sanctions for nonperformance might increase the incentives to perform, but they may also raise the payoffs from investing in evidence management. Where the cost of successfully fabricating evidence is lower than the cost of performance, the agent has the incentive to invest in socially wasteful evidence management rather than in performance. Given that evidence management is socially unproductive, the parties have a joint interest at the time of contracting to deter this activity by delegating the proxy choice to a court under a vague standard. If the proxy is uncertain because it is within the discretion of a future court, the uncertainty discourages evidence management by blurring the target. The agent must discount the benefit from evidence investment with respect to any given proxy by the probability that the court will choose that proxy. As a result, the expected benefit from evidence management with respect to that proxy is lower under a standard than a rule. Thus, within some margin, the agent may be better off simply performing under the standard, given that performance is correlated with all the possible proxies.

B. Rules-Standards Combinations

The choice between party-selected proxies (rules) and court-selected proxies (standards) is not an exclusive binary choice based on relative informational advantages and cost-efficiency of proxy choice. The parties can, and regularly do, include both types in their contract. The combination of vague and specific terms is widely used in commercial contracting. One conventional explanation for vague terms in this context is that they act as “catch-alls” that compensate for the under-inclusiveness of specific terms. Yet, this raises the question of why parties do not simply agree to a broad standard alone (the catch-all without the specific terms)

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85 Other examples of evidence manipulation are the creation of records or the sponsoring of research that will support future expert testimony. It might also entail the destruction of prejudicial evidence that the other party might find on discovery. Id. An alternative strategy might be to not perform and invest in evidence persuading the court to give weight to a more rather than less favorable proxy.

86 Cf., Sanchirico and Triantis, Evidence Arbitrage, supra note 26 (describing conditions under which the prospect of fabrication might improve contract incentives).
that invites the court to choose the proxies invoked by the contract rules. We reframe this explanation in terms of the efficient delegation of proxy choice. The parties may choose to give the court a defined space within which to select proxies, but specify other proxies in contract rules. Although specific and vague terms provide useful benchmarks for narrow and broad spaces, the parties have the range of intermediate options to choose from. In this section, we provide and explain various common illustrations in which the contract’s use of combinations of specific and vague terms, that serve to guide the court’s future interpretation of the standard itself, as well as the accompanying rules.

1. Acceleration rights in loan agreements

Loan agreements provide a useful example of an effective combination of rules with a standard. The lender is entitled to accelerate the maturity of the loan and enforce collection of the principal and accrued interest upon an event of default. Failure to make a scheduled payment is an event of default, but so are the violations of covenants such as the debtor’s promise to maintain insurance on important assets or to refrain from issuing future secured debt. In addition, many agreements provide that the lender may accelerate if it deems itself insecure or believes in good faith that the prospect of repayment is impaired. These acceleration rights are designed to permit the lender to exit upon evidence of borrower misbehavior or a higher risk of such misbehavior. At the same time, the parties wish to limit the ability of the lender to trigger default for ulterior purposes: for example, to exploit higher market rates of interest by calling back and re-lending the funds.

The parties thus find it desirable to list specific proxies for inefficient debtor behavior but front-end costs prevent them from including a comprehensive list. So, they agree to a vague good faith standard that would catch the residual behavior not covered by the specific covenants. Why then do the parties not cover all suspect behavior with the insecurity standard alone? After all, the specific concerns of the failure to insure or the issuance of more debt all fall within the scope

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87 Uniform Commercial Code §1-309 imposes the requirement that the lender must believe in good faith that the prospect of payment is impaired, and this is often explicitly incorporated in loan agreements.
of events that would impair the prospect of repayment. The reason is that the parties wish to contain the proxy-choosing discretion of the court.

In this insecurity standard (as well as elsewhere in commercial law), “good faith” is interpreted by the law as meaning honesty in fact and the observance of reasonable commercial standards of fair dealing. A contracts scholar concerned with enforcement costs might observe, therefore, that a lender’s good faith belief that the prospect of repayment is impaired is not verifiable or is too uncertain. We have observed, however, that verification costs may be less than the incentive gains and also less than the corresponding front-end cost saving that the parties enjoy by substituting this vague term for more specific alternatives. In particular, the parties choose specific proxies whose appropriateness is not significantly context dependent and not a determination that benefits from the ex post information advantage of a court. Conversely, the parties agree to a standard when they wish to harness the benefit of a court’s hindsight and to address the risk that the debtor will game specific events of default. The parties combine their description of the standard with specific rules so as to define the constraints or space within which the court can choose proxies ex post.

2. Franchisee obligations

Similar combinations of rules and standards are commonly found in franchise and distributorship contracts. These contracts typically provide both that an agent satisfy specific requirements and generally exercise best efforts. The Taco Bell franchise contract is a good illustration. It provides that “[t]he Franchisee shall devote his or her full time, best efforts and constant personal attention to the day to day operation of the Restaurant” and “[i]n addition, and without limiting the generality of the foregoing... [the Franchisee shall] [d]iligently promote and

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88 See Uniform Commercial Code §1-201(20); §2-103(1)(b) (2003).

make every reasonable effort to increase the business of the Restaurant.”\textsuperscript{90} The same section also states that the franchisee may not have any financial stake or contractual relationship with any similar business (a non-competition covenant).\textsuperscript{91} The agreement also requires that the manager of the franchisee attend a training course and refresher courses offered by the franchisor, comply with the methods, techniques and material taught at these courses, and instruct employees in the same material. The franchisee must keep the restaurant open for the business hours specified in the company manual.\textsuperscript{92} And, as a final illustration, the agreement requires the franchisee to maintain and repair the restaurant, including signage and landscaping.\textsuperscript{93}

The performance obligations in these franchise and distributorship agreements address two distinct incentive problems. The first stems from the distortion in incentives caused by the sharing of the profits of the franchise outlet. We noted this effect in our earlier discussion of the court’s opinion in \textit{Bloor v. Falstaff Brewing}. In the Taco Bell Agreement, the monthly franchise fee is a percentage (5.5\%) of gross restaurant sales.\textsuperscript{94} The franchisee must deliver annual reports to the franchisor that are prepared in accordance with specified accounting standards and accompanied by the signed opinion of a certified public accountant.\textsuperscript{95} The combination of a “best efforts” standard and associated specific terms are intended to address the incentive distortion caused by this marginal tax on receipts.

The second incentive concern addressed by best efforts is that, despite the tax on sales, the

\textsuperscript{90}Taco Bell Corp. Franchise Agreement Sample Copy, section 3.1, http://library.consusgroup.com/library_sbn/146/146107.asp.

\textsuperscript{91}Id. at §3.8.

\textsuperscript{92}Id. at §3.1.

\textsuperscript{93}Id.

\textsuperscript{94}Id. at §7.0(b)

\textsuperscript{95}Id. at §8.2. The report must comply with the Statement on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants (AICPA). The franchisor has broad rights of inspection of books and the restaurant. If there are discrepancies in the reported and actual sales figures, the franchisee agrees to pay interest, administrative charges and inspection expenses.(§8.5)
The franchisee has an incentive to take actions that would raise its own profits but impair the value of the Taco Bell trademark and reputation (a cost that the franchisee externalizes to the franchisor and other franchisees). The agreement appears to address this concern within the best efforts provision because the best efforts standard is followed by: “without limiting the generality of the foregoing [best efforts],” the franchisee shall operate the restaurant in a clean, safe and orderly manner, providing courteous, first-class service to the public. Later, the agreement provides that the franchisee must also sell only products authorized in the company manual and it must prevent the use of the restaurant for any immoral or illegal purpose or for any other use not expressly authorized in the agreement or in the company manual.

3. Force majeure and liquidated damages

Force majeure clauses typically provide that performance is excused in the event of specific contingencies (such as war, labor strikes, supply shortages, and government regulation that hinders performance). But these clauses also identify excusing contingencies that fall within a vaguely stated category of factors beyond the control of the parties. Another common example concerns liquidated damages clauses that provide for a calculation of damages based on a laundry list of specific market factors together with a general reference to “any similar valuation.” For instance, a recent gas and power supply agreement provided that liquidated damages should be determined by comparing the contract price to the relevant market prices either quoted by a bona fide third-party offer or which were reasonably expected to be available in the market under a replacement contract. To ascertain the market prices of a replacement contract, the contract permitted the promisee to consider, “among other valuations, any or all of the settlement prices of NYMEX energy futures contracts, quotations from leading dealers in energy and gas swap contracts and other bona fide third party offers, all adjusted for the length of

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96 Id. at §3.1(a)

97 Id. at §3.5, §3.1(d).

the remaining contract term and differences in locational basis.\(^{99}\)

The preceding examples show how parties to commercial contracts deploy specific terms alongside a standard. These combinations have several effects on proxy choice. The existence of specific terms constrains the court’s choice of proxies under the standard. In addition, the existence of the vague term affects the application of the specific contractual proxies. First, consider the court’s choice of proxy under a mixed rules/standards contract. In the adversarial system, the choice of proxy is likely to be a choice between the proxies offered by the litigating parties. The court’s task is (a) to ensure that the selected proxy falls within the space contemplated by the parties in their agreement and (b) within this space, to choose the appropriate proxy or proxies. The former is a matter of contract interpretation and, in this task, the courts are guided by interpretation maxims. These principles are followed with sufficient regularity that the parties can anticipate them at the time of contracting. In the following section, we outline the most relevant principles and then demonstrate how they are reflected in the patterns of rules and standards in commercial contracts.

C. Maxims of Interpretation and The Scope of the Proxy Space.

As a general matter, the canons and maxims of contract interpretation do not depend on a finding that a contract term is ambiguous. Rather, they are used both in determining what meanings are reasonably possible as well as in choosing among divergent interpretations.\(^{100}\) These maxims first instruct the court to view the agreement ex ante: that is, to put itself in the

\(^{99}\)See Tolling Agreement by and among Liberty Electric Power, LLC and PG&E Energy Trading - Power, L.P., § 14.2(a) (April 14, 2000) (on file with the authors)[emphasis added].

\(^{100}\)Restatement (Second) of Contracts §202 comment a (1979). The maxims and rules of interpretation have evolved in the common law as a product of general assumptions as to how words are used. These maxims are not limited to contract interpretation but extend to any inquiry into the legal meaning of language, including statutory interpretation. For discussion, see E. ALLAN FARNSWORTH, CONTRACTS §7.11 (4TH ED. 2004).
position the parties occupied at the time of contracting,\textsuperscript{101} and to interpret provisions in light of the purpose of the contract.\textsuperscript{102} Consistent with the notion of purposive interpretation, a contract must be read as a whole and each part must be interpreted in light of all provisions.\textsuperscript{103}

For this paper, it is useful to examine the interpretive effect of the choice of combined rules and standards, as compared to stand-alone rules or standards. Three well-known maxims are particularly relevant: \textit{ejusdem generis}, \textit{noscitur a sociis} and \textit{expressio unis est exclusio alterius}. If a contract through its exclusive use of precise terms provides only for specific proxies, the maxims of interpretation caution the court against considering other proxies at the time of trial. Under the \textit{expressio unis} maxim, the expression in the contract of one or more things of a class implies exclusion of all that is not expressed.\textsuperscript{104} The inference is that all omissions should be understood as exclusions, and the specification of particular items impliedly excludes other items relating to the same general matter.\textsuperscript{105} Moreover, when a contract provides that a thing should be done in a certain way, it is presumed to be exclusive.\textsuperscript{106}

A standard on its own gives the court a relatively large space within which to choose proxies. Where the parties combine standards and rules that relate to the same subject matter, the \textit{ejusdem generis} canon applies, whether the general language is preceded or followed by the

\begin{itemize}
\item \textsuperscript{101} Id. at comment b
\item \textsuperscript{102} Bourke v. Dun & Bradstreet Corp., 159 F.3d 1032, 1039 (7th Cir. 1998) (“purpose” is given great weight). Restatement (Second) of Contract §202(1).
\item \textsuperscript{103} Restatement (Second) of Contracts §202(2). “[A] word changes meaning when it becomes part of a sentence, the sentence when it becomes part of a paragraph.” Id. comment d. Because of the force of the principle of purposive interpretation, parties sometimes signal their purpose in a preamble or in recitals (such as a “whereas clause”).
\item \textsuperscript{104} See Smart v. Gillette Co. Long-Term Disability Plan, 70 F.3d 173, 179 (1st Cir. 1995) (where contract listed specific benefits, any other benefit not so listed is excluded); Eden Music Corp. v. Times Square Music Publications Co., 514 N.Y.S. 2d 3 (1987); United States v. First Nat’l Bank of Crestview, 513 So. 2d 179 (Fla. App. 1987).
\item \textsuperscript{105} See, e.g., Tate v. Ogg, 170 Va. 95 (1938) (enumeration which included “any horse, mule, cattle, hog, sheep or goat” excluded turkeys).
\item \textsuperscript{106} Norman J. Singer, Sutherland on Statutes and Statutory Construction §47.26 (6th ed. 2000).
\end{itemize}
enumerated specific terms. The meaning of the general language is then limited to matters similar in kind or classification to the enumerated specific terms. But the parties must be careful when using combinations of standards and rules to use words that signal to the court a desire to have new proxies created at trial. In a recent case, a lease contract provided that the lessor could terminate “for good cause” and this general language was then followed by enumerated items such as nonpayment of rent, serious or repeated damage to the premises, or the creation of physical hazards. The appeals court held that the general phrase “for good cause” did not include other violations of the lease, such as keeping a dog on the property. Contracting parties can avoid a restrictive interpretation under the *ejusdem* rule by providing that the general language includes *but is not limited to* the specific enumerated items that either precede or follow it.

Under *noscitur a sociis*, the meaning of vague phrases may be determined by reference to their relationship with other associated words and phrases. Under this maxim, the coupling of words or phrases indicates that they should be understood in the same general sense. As noted above, where the parties provide for specific proxies but no standard, *expressio unis* might prevent the court from reading a general purpose. Moreover, even under *noscitur a sociis*, a

107 See Liberty Mutual Ins. Co. v. East Cent. Okla. Elec. Coop., 97 F. 3d 383, 390 (10th Cir. 1996) (when interpreting a general word that follows a series of specific words, the specific words restrict the meaning of the general—encompassing only action of the same general type). As an example of the limiting effect of the *ejusdem* maxim, in the gas and power supply agreement discussed in text accompanying note 95 above, one of the parties in litigation sought to introduce, as evidence of a replacement contract, expert testimony based on an economic model of projected prices for electrical power over the remaining term of the contract. The other party objected to the evidence on the grounds that an economic model was not properly included within the general provision “among other valuations” because it was not in the same family as “the settlement prices of NYMEX energy futures contracts, quotations from leading dealers in energy and gas swap contracts and other bona fide third party offers....” See pre-trial brief of Liberty Electric Power LLC in Liberty Electric Power, LLC, Claimants v. NEG Energy Trading - Power, L.P., Respondents, AAA Case No. 70 198Y 0028 04 (on file with the authors).

108 Housing Auth. of Mansfield v. Rovig, 676 S.W. 2d 314 (Mo. 1984).

109 Cooper Distrib. Co. v. Amana Refrigeration, Inc. 63 F. 2d 262, 280 (3d Cir. 1995); Eastern Airlines v. McDonnell Douglas Corp., 532 F. 2d 957 (5th Cir. 1976) (delays in performance due to causes beyond seller’s control, including but not limited to enumerated events). This has been called a common drafting technique designed to save the drafters from spelling out in advance every contingency in which the specific factors could apply. Moore v. California State Bd. of Accountancy, 831 P. 2d 798 (1992).

110 *noscitur a sociis* means “it is known by its associates”.

series of specific proxies may not have enough in common to indicate to the court the general objective that associates them. But when a broad standard is added to a listing of specific terms, it communicates the underlying objective and helps the court interpret the specific terms in light of the general purpose. The *noscitur* maxim requires that the general and the specific words must be considered together in determining the contract’s meaning, so as to “give effect to both the particular and the general words.” Thus, the general term informs the interpretation of the specific proxies as well, and might allow the court to fine-tune a specific proxy in light of its information advantage in hindsight.

A contract standard thus presents the court with two tasks. The first is to define the space for proxies allowed by the standard, in light also of the specific proxies specified in rules of the contract. This application of the interpretative maxims is a question of law. The second is to choose the most appropriate proxy, or set of proxies, within that space. The court will weigh the incentive gains from the proxy, and the verification costs. The goal, as we have previously noted, is to find the proxy with the biggest incentive bang for verification buck. Both the bang and the buck are likely to depend somewhat on extrinsic facts. At least with respect to evidentiary costs, however, the judge would seem to have an advantage over the jury in comparing alternative proxies as to verification costs.

### III. Harnessing Litigation by Contract

#### A. The Linkage Between Litigation Rules and Contract Design

In some respects, contracting parties can agree to the procedural rules that will govern the enforcement of their contract. It is now common for parties to agree to have disputes resolved by

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113Restatement (Second) Contracts §212(2) (1979) (the judge should not defer to the jury unless the interpretation “depends on the credibility of extrinsic evidence or on a choice among reasonable interefences to be drawn from extrinsic evidence”).
arbitration rather than litigation or by the court of a specified venue.\textsuperscript{114} In many of these cases, the parties’ ex ante agreement as to procedure improves the cost-effectiveness of their prospective enforcement mechanism.\textsuperscript{115} In other words, the procedural provisions may increase the incentive bang for the enforcement buck (or lower the enforcement buck per bang). The ability of the parties to effect such improvement has further repercussions in our analysis. If the parties reduce the back-end cost per incentive effect, they should then substitute more back-end for front-end contracting investment. This substitution leads to further reduction in the cost per incentive effect, and allows the parties to achieve even more efficient contract incentives. As noted above, the parties can substitute back-end for front-end costs by including more vague terms and leaving proxy choice to the enforcement process.

Although arbitration and venue clauses are common in contracts and widely discussed in the literature, the fact that parties can vary the rules of litigation in their ex ante contract is relatively unexplored. We have been hard pressed, for instance, to find scholarly treatises on procedure or evidence that identify the set of rules that are default rather than mandatory provisions. And, as we have already noted, contracts scholars focus principally on the substantive terms and not on the ability of the parties to regulate the procedural course of their future enforcement. This is a rich avenue for future research and we take a preliminary step in this Part by examining the ways in which the parties can vary one important feature of judicial fact finding: the allocation of burdens of proof and the standards of proof. A threshold question is whether burdens and standards of proof are regarded as mandatory background rules or as defaults subject to alteration by individual parties. While we have not found written authority, the considered judgment of experts in the field is that express terms allocating burdens and standards of proof would be enforceable by most courts.\textsuperscript{116} We do have ample evidence that many

\textsuperscript{114}This is a component of what Judith Resnick refers as the emergence of “contract procedure”, although her focus is more on arbitration and the provisions such as venue choice that facilitate settlement. Judith Resnick, \textit{Procedure As Contract}, 80 \textit{Notre Dame L. Rev.} 593, 627 (2004).

\textsuperscript{115}See Drahozal & Hylton, supra note 6 at 558 (arbitration permits vague terms to be enforced by industry experts rather than courts).

\textsuperscript{116}E-mail from Professor Caleb Nelson 2/23/05; e-mail from Professor John Harrison 2/27/05 [copies on file].

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contracts in fact contain such provisions.117

Burdens of proof illustrate the important connection identified above between the rules governing litigation and the rule/standard choice. When the parties delegate proxy choice to the court, the court typically chooses among the conflicting and self-interested proxies that the parties propose at trial. The lower the cost of resolving this dispute over competing proxies and the more efficient the expected outcome, the more likely the parties are to use vague terms ex ante. To illustrate, suppose that an agent such as a fast-food franchisee is bound by a vague contractual promise not to injure the reputation of the franchise. The agent coaches little league baseball but is also known to have a drinking problem. Each is a candidate proxy that might be selected under the contract standard. In many (if not most) cases, the factual issues are not whether the proxy is or is not satisfied (e.g., did the agent coach little league and drink), but rather the choice of (and weight assigned) to the proxy. Under the default rules of litigation, a principal (or franchisor) who seeks to prove a breach of promise by its agent typically will be allocated both the burden of production and the burden of persuasion. Unless the principal satisfies its burden, the result will be as if the agent's proxy were chosen because the agent will be found not to have breached its promise. As a formal matter, the court determines the proxy, but the burden effectively assigns the advantage to the agent by reducing her evidentiary costs and raising the likelihood that her proxy (coaching) will be adopted over the franchisor's proxy (drinking). As we suggest below, it may be efficient in some circumstances to place the burden on the agent, and favor the principal’s proxy. The parties can shift the burden by contract, and thereby enhance the incentive bang for

117For as sampling of contracts that contain express provisions respecting burdens and standards of proof, see CORI Contracts Library, supra note19 at http://cori.missouri.edu (last visited Feb. 25, 2005). Sample provisions include (a) employment agreements: “(iii) in all cases both the burden of production of evidence and the ultimate burden of persuasion with respect to any allegations or claims that this Section 10.2 has been breached or violated by the Executive shall be borne by AAI and the Corporation.” (contract dated January 10, 2003, between Ascent Assurance, Inc., and (“AAI”), Ascent Management, Inc.); (b) securities purchase agreements: “Any Person asserting that such Guarantor’s obligations are so avoidable shall have the burden (including the burden of production and of persuasion) of proving (I) that, without giving effect to this Section 10.8, such Guarantor’s obligations hereunder would be avoidable and (ii) the extent to which such obligations are reduced by operation of this Section 10.8.” (Securities purchase agreement by and among Overhill Farms, Inc., and Levine Leichtman Capital Partners II, L.P., Dated as of April 16, 2003); (c) Technology License Agreements: “Company and Licensee shall bear the burden of proof with respect to establishing that any of its claimed confidential information falls within any of the foregoing exceptions.” (License Agreement entered into as of October 23, 1998, by and between SurgiJet, Inc., a (“Company”) and VisiJet, Inc. (“Licensee”)); and (d) most, commonly, indemnity agreements (see notes 152-3 infra).
buck extracted from the vague reference to the protection of the franchise’s reputation.

The contrast between two classic contracts cases illustrates the significance of burden allocation. Consider *Raffles v. Wickelhaus* and *Frigaliment Importing v. B.N.S. International Sales*. In *Raffles*, the parties entered into a contract to buy and sell cotton. Their contract called for the delivery of cotton by way of a ship named “Peerless” sailing from Bombay to Liverpool, when in fact there turned out to be two ships named “Peerless” sailing from Bombay to Liverpool within three months of each other. The buyer believed “Peerless” referred to a ship departing Bombay in October, while the seller believed “Peerless” referred to a ship departing Bombay in December. The defendant buyer refused to accept and pay for that cotton and the court agreed, holding that “there was no consensus and therefore no binding contract.” In *Frigaliment*, the buyer sued the seller for selling it “fowl” (lower grade chicken) instead of “broiler” (higher grade chicken). The seller argued that the term “chicken” in the contract included all types of chickens, while the plaintiff contended it meant only broiler chicken. The court found that the meaning of “chicken” was vague and found for the seller on the grounds that the buyer, as plaintiff, had not carried its burden of proving which of the two plausible meanings the parties intended.

Alan Farnsworth explains the importance of the burden allocation in both *Raffles* and *Frigaliment*:

For the seller to prevail in a suit against the buyer [in Peerless], it would seem that the seller would have to sustain ‘the burden’ – as the court in *Frigaliment* put it – of showing that the word Peerless was used to refer to the ship that sailed in December. This the seller did not do. But if the buyer had sued the seller, it would seem that the buyer would have had to sustain the burden of showing that the word

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118 FARNSWORTH, supra note 100 at 451.
121 159 Eng. Rep. at —. For discussion, see SCOTT & KRAUS, supra note 73 at 789-807.
122 190 F. Supp. at —.
Peerless was used to refer to the ship that sailed in October. This presumably, the buyer could not do. The explanation, then, for the judgment for the seller is not that there is no contract, but that neither party can sustain the burden of showing that its meaning should prevail.... If the buyer in Frigaliment had rejected the chickens and the seller had sued for the price, the same court might have found for the buyer on the ground that the seller had not sustained the burden of showing that chicken was used in the broader sense.”  

In sum, because the buyer in *Raffles* had rejected the goods, the seller had the burden of establishing that the parties had agreed to the delivery of cotton via the December “Peerless” and was unable to do so. In *Frigaliment*, the buyer had the burden (of establishing a narrower interpretation of “chicken”) because it had accepted the goods, but failed to satisfy that burden. The contrasting effects of burden allocation raise two questions that have yet to be addressed in contracts scholarship. First, which is the more efficient allocation? Second, if the common law does not provide for such efficient allocation, how might the parties themselves do so by contract? The first question is complex and context-dependent. We set out below some of the factors that may affect the optimal allocation in any given case, without attempting to resolve the conditions. Indeed, we do not exclude the possibility that contracts vary procedural rules for ulterior, inefficient purposes that favor one party over the other. Our contribution instead is to draw attention to the contractual mechanisms by which parties might assign burdens in their ex ante agreement.

**B. Efficiency Considerations for Allocation of Burdens of Proof.**

The nascent scholarship on the efficiency of burdens of proof falls into two groups: one is

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123 Farnsworth, supra note 100 at §7.9

124 Id.

125 For example, in our discussion of burdens in indemnification contracts, we speculate that the allocation of burden to the firm may be a veiled attempt to undermine the exclusion for acts committed in bad faith. Note –, infra.
concerned with the cost-effectiveness of truth-finding and the other with the deterrence effect on the primary behavior being regulated.\textsuperscript{126} The first approach examines the effect of burden allocation on the cost of communicating information to the court. This scholarship is in the spirit of the seminal work of Landes and Posner, who evaluated rules of procedure as devices for minimizing the sum of the direct costs of litigation and of the costs of erroneous fact finding.\textsuperscript{127} The advantage of the adversarial system is that the process can choose between two sources of information with different cost schedules. Bruce Hay and Kathy Spier suggest that the burden of proof ought to be assigned to the party with superior knowledge of the facts in dispute or the party asserting the more unusual version of the facts.\textsuperscript{128} This allocation reduces the expected evidentiary costs of trial. In a similar vein, several authors suggest that burden allocation enhances the informativeness of negative evidence -- the failure of a party to present evidence favorable to its case.\textsuperscript{129} Such negative evidence is costless. However, negative evidence is also noisy when a party might be uninformed, because the court cannot infer whether the failure to present favorable positive evidence is due to the fact that it does not exist or simply that the party is unaware of it. Thus, the burden should be placed on the more informed party, or the party more likely to have access to the evidence if it is available.\textsuperscript{130} Finally, we note that the party with superior access to information often can misrepresent the truth at lower cost than her opponent. As we observed

\begin{footnotesize}
\begin{enumerate}
\item See notes 128-131 infra.
\item Bruce L. Hay & Kathryn E. Spier, \textit{Burdens of Proof in Civil Litigation: An Economic Perspective}, 26 J. LEGAL STUD. 413 (1997). Hay and Spier state that the burden should fall on the plaintiff when the probability that the plaintiff’s version is true multiplied by the plaintiff’s cost of producing the evidence is less than the probability that the defendant’s version is true multiplied by the defendant’s cost. They assume that the parties have access, perhaps at different cost, to the same pool of evidence, and that neither can lie or otherwise fabricate evidence.
\item Hyun Song Shin, \textit{Adversarial and Inquisitorial Procedures in Arbitration}, 29 RAND. J. ECON. 378, 389 (1998)(“the absence of a report from the well-informed party makes it likely that the well-informed party knows the true circumstances but that the news is unfavorable to him. The greater the disparity of information, the more informative is the absence of any announcement.”) See also, Jesse Bull & Joel Watson, \textit{Evidence Disclosure and Verifiability}, 118 J. ECON. THEORY 1 (2004).
\item Bull and Watson provide an example in which one party has access to a documentary bit of evidence of a state A, if such state has materialized. If this party benefits from the court finding that state A has occurred, the burden is appropriately placed on that party (to exploit the informational benefit of negative evidence). Otherwise, the negative evidence stemming from the failure of the document to be presented in court is not informative. Bull & Watson, supra note 129.
\end{enumerate}
\end{footnotesize}
earlier, commentators have argued that evidentiary rules pry a wedge between the costs of telling the truth and lying. Placing the burden on the party with the best information may magnify the effect of the wedge by forcing that party to present more evidence.

These theories, however, do not predict well the allocation of burdens in practice. For example, plaintiffs tend to bear the burden of establishing the facts necessary to plead their case, even though these facts are typically more accessible to the defendant. As Chris Sanchirico points out in this respect, tort plaintiffs carry the burden of proving their defendant’s negligence, while the defendant has the burden of proving that the plaintiff was contributorily negligent. Modern discovery practices may be one explanation for the insensitivity of burdens to presumed informational advantages. Discovery attenuates the informational advantages that one party might have over the other. In this light, Hay and Spier suggest that the reason for placing burdens on plaintiffs is that they typically assert the more unusual facts because people tend to comply with the law. But this claim does not account for an important selection effect: the fact that the plaintiff has decided to bear the cost of initiating a law suit, suggesting that the defendant is more likely than average to have done wrong. Yet another theory proposes that burdens of proof follow pleading burdens by falling on the party with the more specific allegation: for example, the plaintiff pleads a specific type of negligence while a defendant asserts the absence of any negligence. While that approach may justify the pleading responsibility, it does not explain the burden of proof. Once the plaintiff has alleged the facts necessary to support its claim, the burden of proof can fall on the defendant to show that those allegations are untrue.

The second line of scholarly analysis of burdens focuses on the effect of burden allocation on deterrence—in our analysis, on contract performance. Burdens affect the evidentiary strategies and costs of plaintiffs and defendants. Each effect bears on ex ante incentives in two respects. First, as the expected evidentiary cost of the plaintiff rises, plaintiffs are less likely to sue, all other things equal. However, the lower incidence of litigation may lead to a string of consequences that

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132 Hay & Spier, supra note 128.

complicates the analysis. The reduction in law suits may undermine the performance incentives of the defendant, causing a rise in nonperformance and a consequent increase in the expected recovery of plaintiffs.\textsuperscript{134} It might thereby result in an offsetting increase in the number of cases filed, which might restore the performance incentive. The ultimate effect on incentives is unclear and context-dependent.\textsuperscript{135}

Second, the evidentiary costs of defendants have a direct impact on incentives because, like the ultimate determination of liability, they impose a sanction. This sanction improves deterrence (or contract performance) if the evidentiary-cost sanction on complying defendants is lower than that on noncomplying defendants. At first blush, it may appear that the allocation of burdens does not affect this process because burdens assigned to defendants fall indiscriminately on complying and noncomplying actors alike. However, the following simple example suggests otherwise by taking into account the plaintiff’s incentive to sue.\textsuperscript{136} Suppose that a principal-agent contract requires an action that will cost the agent $100 and provides that the agent must pay liquidated damages of $105 if she fails to perform. In order for the principal to enforce the provision, the court must determine whether the agent performed or not. Suppose that the evidentiary cost to the agent of proving performance is $10. The net gain to the agent from performance is $105 - $100 = $5, less whatever evidence cost the agent would have to pay to exonerate itself. If the burden is on the principal, the principal simply will not sue if the agent performs, and the agent would enjoy the full gain of $5 from performing. If the burden is on the agent, however, the agent would suffer a net loss of $5 compared to nonperformance because of the $10 it would have to pay to satisfy the evidentiary burden. Thus, the litigation burden imposes a prospective tax on the defendant agent that discourages performance. In this example, therefore, the burden is more appropriately placed on the principal, the potential plaintiff.\textsuperscript{137}

\textsuperscript{134}This assumes that judicial determinations are somewhat accurate.

\textsuperscript{135}Bernardo, et al., supra note 34. The authors explain that the only equilibrium in this example is in mixed strategies.

\textsuperscript{136}Again, we are assuming in this discussion that fact finding is accurate, but at a cost. We also assume that the plaintiff bears a positive cost in bringing suit.

\textsuperscript{137}The parties would share the cost ex ante in the price of the contract.
For the purposes of this paper, it is particularly important to note that whether the objective is to reduce evidentiary costs or to improve contractual incentives, the effects of burden allocation are highly context-dependent. These advantages are not very susceptible to general rules of allocation; at best, the law can provide default allocations from which the parties may contract away if they wish. Thus, parties may tailor burdens to accommodate their particular circumstances. For example, the contract might shift the burden to the defendant if the defendant has access to a key exculpatory document and if discovery is costly or imperfect in enabling the other party to obtain the document. In a similar vein, parties who seek to use burdens to sanction non-performance and reward performance must also be sensitive to such context-specific factors. Harnessing burdens by contract, however, requires first an appreciation of the default rules by which the law allocates burdens of proof.

C. The Default Rules for Allocating Burdens of Proof.

The default scheme of proof burdens allocates burdens of production and burden of proof, and is overlaid by the operation of presumptions that shift burdens between the parties as they present their evidence. As noted above, the default burdens of proof track the pleading burdens. The general rule is that the pleading responsibility rests on the party who invokes the intervention of the court to change the status quo.\textsuperscript{138} There are exceptions, however, for “affirmative defenses”. In contract breach actions, the claim of nonperformance must be plead and proved by the plaintiff. The plaintiff must allege and prove the making of the contract, its consideration, and the satisfaction of all conditions precedent (whether express or implied) to the defendant’s reciprocal obligation to perform.\textsuperscript{139} The defendant may respond that the obligation to perform has been discharged on any of a number of substantive grounds, including novation, accord and satisfaction, cancellation and termination, impossibility, mutual mistake, release, alteration, merger, and the failure of a condition subsequent to performance. As affirmative defenses, all of

\begin{footnotes}
\item[138]McCormick, supra note 24 at §336.
\end{footnotes}
these must be plead and the burden of production carried by the defendant. Once all the burdens of production are met, the overall burden of persuasion, however, remains on the plaintiff. Thus, the burdens with respect to most facts in contract breach cases – particularly performance standards with which we are mostly concerned – fall on the plaintiff, the party who is seeking to change the status quo.

A doctrinal explanation of the general allocation to the plaintiff and the exception of affirmative defenses eludes commentators. Courts and commentators typically offer three justifications for what constitute affirmative defenses. First, the defendant may have the comparative advantage in information production. Second, the defendant may be assigned the burden with respect to a fact that is particularly unusual. Third, commentators sometimes mention a category comprising defenses that are normatively disfavored, such as contributory negligence or statutes of limitations. Unhappily, however, given their generality and the

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140 Note that it is commonly said that once a party offers evidence sufficient to avoid a directed verdict, that the burden of production shifts to the adversary. But that is not strictly true if the burden is defined as the quantum of evidence needed to avoid an adverse verdict. McCormick suggests, therefore, that in this instance the better view is that neither party has the burden of production. McCormick, supra note 24 at §338.

141 Id.

142 Fleming James, Jr., et al., Civil Procedure §7.8 at 322 (5th ed. 2001); Lee, supra note 127 at 3 (“The indeterminacy of the conventional doctrine has led both courts and commentators to throw up their hands and give up on deriving any sort of coherent analytical framework for assigning burdens of pleading and burdens of proof.”)


145 McCormick, supra note 24 at §337; Cleary, supra note 143 at 11. Allocating burdens based on the finding of “unusual” facts begs the question about the factual basis for finding a fact "unusual." There must be some background fact, either established before the court or of which the court takes judicial notice, before the court can say that fact Z is "unusual." One way to frame this policy choice is as equivalent to a presumption that if X, then the court presumes not-Z, thus placing on the party pleading Z the burden of showing that it occurred despite X.

146 Cleary, supra note 143 at 11.
inconsistency of their application, none of these supposed policies are reliable as a working rule.\textsuperscript{147} In particular, we noted in the previous section that the comparative advantage in information production fails to predict the allocation of burdens in practice.\textsuperscript{148} For example, in breach of contract claims the plaintiff has the burden of proving that the defendant’s conduct constituted a breach notwithstanding the fact that the defendant has better access to the facts in question.\textsuperscript{149}

Substantive contract law often determines which party will be the plaintiff in disputes: for example, the identity of the plaintiff may depend on the course of the parties actions. Consider § 2-607(4) of the Uniform Commercial Code noted earlier. This provision assigns the burden of proving that a delivered good does not comply with the contract to the buyer if the buyer accepts the good. If instead the buyer simply rejects the good, the burden falls on the seller who sues for breach of contract. This burden includes the burden of establishing facts as to the condition of the goods upon delivery.\textsuperscript{150} The identity of the plaintiff in any dispute—and the consequent allocation of the burden of proof—thus may rest on factors having little to do either with informational advantages or self-interested behavior.\textsuperscript{151} In the case of an allegedly defective good, the burden hinges on whether the plaintiff has accepted or rejected delivery. In short, the parties’ ex post actions can affect the burdens in litigation. Consequently, the default allocation of burdens is neither predictable at the time of contracting nor based on factors that seem to have clear efficiency consequences. More pertinent to our project, therefore, is the ability of the parties to determine burden allocation (and the proof standards) by their ex ante contract, to which we now

\footnotesize{\textsuperscript{147} See e.g., JAMES ET AL., supra note 142 at §7.16 (“There is no a priori test for allocating the burden of persuasion or the burden of producing evidence”). Cf., Hay & Spier, Burdens of Proof, supra note 128. Hay and Spier’s analysis concerns the desirable burden of proof given the objective to reduce litigation costs and does not address efficient incentives in primary activity. See Hyun Song Shin, Adversarial and Inquisitorial Procedures in Arbitration, 29 Rand. J. Econ. 378, 380 (1998).}

\footnotesize{\textsuperscript{148} JAMES, JR., ET AL, supra note 142 at §7.16. (“The burden of proof traditionally is placed on the party having the readier access to knowledge about the fact in question. This consideration, however, has never been controlling”); Sanchirico, Harnessing Adversarial Process, supra note 22.}

\footnotesize{\textsuperscript{149} JAMES, JR., ET AL, supra note 142 at §7.16.}

\footnotesize{\textsuperscript{150} For an analysis, see ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 263-72 (2d ed. 1991).}

\footnotesize{\textsuperscript{151} We concede that there is some information explanation for this contrast: it induces the buyer to examine the goods earlier rather than later. Id.
D. Allocating Burdens and Standards of Proof by Contract

Like other commentators, we are hard pressed to rationalize the procedural rules for burdens of proof. It is therefore not surprising that contracting parties might wish to fashion their own. Even if the legal scheme can be justified, it is highly unlikely that it yields the efficient burden allocation for each contract. The parties may therefore wish to clarify, reverse or fine-tune the default allocation in their contract. We identify in this section three ways by which the parties might do so, and provide examples from commercial practice: The first approach is by direct allocation of burden; the second is by pre-designating who will be the plaintiff in the event of a dispute; and the third is by the framing of substantive provisions governing, for example, the right to assign or terminate a contract. We also observe that the parties’ flexibility extends beyond simple binary burden allocation between the parties. They may also provide for shifting burdens based on explicit or implied presumptions.

1. Direct Burden Allocation.

The most straightforward way for parties to reallocate burdens and/or alter the standard of proof is for them to do so directly through an explicit term in the contract. Indemnity agreements, for example, commonly reallocate burdens and elevate standards of proof. Consider the standard indemnification agreement between DAOU Systems, Inc., and its directors and officers. The contract provides in relevant part:

Presumptions and Effect of Certain Proceedings.

(a) Upon making a request for indemnification, Indemnitee shall be presumed to be entitled to indemnification under this Agreement and the Company shall have the burden of proof to overcome that presumption in reaching any contrary determination.

134 contracts in the CORI data base contain indemnity contracts that elevate the burden of proof from preponderance of the evidence to a clear and convincing standard; 25 contracts create a presumption that the indemnitee is entitled to indemnification; 51 contracts create a presumption that the indemnitee acted in good faith; and 38 contracts allocate to the indemnitor the burden of proof on the issue. See CORI Contracts Library, supra note 19.
(b) Indemnitee shall be deemed to have acted in good faith if Indemnitee's action is based on the records or books of account of the Company, including financial statements, or on information supplied to Indemnitee by the officers of the Company in the course of their duties, or on the advice of legal counsel for the Company or on information or records given or reports made to the Company by an independent certified public accountant or by an appraiser or other expert selected with reasonable care by the Company. In addition, the knowledge and/or actions, or failure to act, of any director, officer, agent or employee of the Company shall not be imputed to Indemnitee for purposes of determining the right to indemnification under this Agreement. Whether or not the foregoing provisions of this Section 7(b) are satisfied, it shall in any event be presumed that Indemnitee has at all times acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Company. Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence [emphasis added].\textsuperscript{153}

Consistent with common practice, the firm’s obligation to indemnify is discharged if the director or officer has not acted in good faith. Litigation over this provision is likely to be brought by the director or officer seeking indemnification. In the absence of a contract term to the contrary, this party would carry the burden of showing that she acted throughout in good faith, by introducing proxies supporting this claim. Yet, the DAOU Systems standard form (like most agreements of its kind) shifts the burden to the firm, who is typically the defendant, and also elevates the standard of proof from the default “balance of probabilities” to “clear and convincing evidence.” It shifts the burden by way of presumption that is triggered when the agent presents the minimal evidence that her actions were based on the company’s records or books, or on the advice of legal counsel or on information supplied by an independent certified public accountant.

The parties had the following three options, among others, in drafting their indemnification agreement. The agent might have enjoyed (a) a blanket entitlement to indemnification, (b) an

\textsuperscript{153} CORI Contracts Library, note 19 supra.
entitlement conditional on a finding of good faith (without varying the default burden of proof), or ©) an entitlement conditional on good faith, together with a presumption of good faith. The first option would protect a risk-averse agent from liability if the firm should fail, but would also insulate the agent from bearing the cost of her negligence or self-dealing. The second option would deter the agent from such misbehavior, but leave her open to the firm’s opportunistic claims that she had not acted in good faith (even though untrue). Although the firm might ultimately fail in court, the agent would bear litigation costs and the risk of legal error. As a result, she would be reluctant to make risky decisions on behalf of the firm, even if they are profitable. This is particularly true if the agent were to bear the burdens of proof, as she would under the default procedure. The parties might choose between these first two options by weighing the severity of the risk of agent and firm opportunism. If the risk of firm opportunism were relatively more severe, the parties would omit the good faith exception.

The third option permits them to use the procedural tool of burdens and standards of proof to reach an intermediate solution that fine-tunes the trade-off between setting efficient incentives for each party. We can also see how the use of a vague term such as good faith is more likely when the parties can manipulate procedural rules such as burdens of proof. If the parties might have eschewed good faith when limited to the binary choice between the first two options, they might include it if they could fine-tune with the aid of burden allocation. The example in the next section provides another illustration where contracting over burden allocation broadens the range of available incentive schemes.

2. Pre-Designation of Plaintiff.

Parties can harness burdens indirectly, without an explicit contract term. As an example, consider once again a simple sales contract between buyer and seller. Recall that under §2-607(4) of the Uniform Commercial Code, the default burden of proving whether a good is defective or not depends on whether the buyer has accepted or rejected the good. The rejecting buyer sues the

154 Bernardo, Talley and Welch make a similar point in observing that the business judgment rule protects corporate officers from claims of negligence (but not from allegations of self-dealing) and thereby distorts managers’ decisions less. See Bernardo, et. al., supra note 34 at 2.
seller for damages and carries the burden; the seller sues the accepting buyer for the price and carries the burden. As in the indemnification contract in the previous section, parties to a sales contract could contract directly over which party, the seller or the buyer, would bear the burden of proof as to the condition of the goods in all cases. As an alternative to an explicit contract term, however, the parties can harness the efficiency benefits of burdens indirectly. Although there are default rules defining acceptance and rejection, they may be varied by contract to implicitly assign the burden of proof to the seller or the buyer, depending on the parties’ preferences.\footnote{Uniform Commercial Code §§2-602(1), 2-606(1), 2-513(4), 1-204 (2003).} Deposits are another mechanism by which commercial parties may structure substantive provisions to influence the likely identity of the plaintiff.\footnote{This is reminiscent of Aaron Edlin’s use of deposits to determine ex ante the identity of the party who would make the breach decision. In his case, the goal is to induce efficient specific (reliance) investments. See Aaron S. Edlin, Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages, 12 J. L. ECON. & ORG. 98 (1996) (up-front payments give the promisor the ability to hold up the promisee in renegotiation and thus discourage excessive reliance).} When the buyer has prepaid or made a deposit, the seller has less to gain by suing for the price. Thus, the buyer is more likely to be the plaintiff whether she has accepted or rejected the goods.

Construction contracts present a variation of this approach. Like the “good faith” requirement of directors and officers in the indemnification contract, the default threshold for contractor performance is also a standard, “substantial performance.”\footnote{For discussion, see Charles J. Goetz & Robert E. Scott, The Mitigation Principle: Toward a General Theory of Contractual Obligation, 69 VA. L. REV. 967, 995-97, 1009-11 (1983).} And, as a vague term, it raises the prospect of high verification costs, uncertainty and opportunistic claims by either side that undermine the efficiency of incentives. The owner may introduce evidence that apparent defects in construction (such as noncomplying piping material) reduce her value substantially, whether or not this is true. Conversely, the builder’s opportunistic strategy is to shirk on performance but claim that it nevertheless complied with the standard, by offering an alternative proxy (such as aesthetic appearance).

A construction contract typically requires the property owner to make progress payments to

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\[156\] This is reminiscent of Aaron Edlin’s use of deposits to determine ex ante the identity of the party who would make the breach decision. In his case, the goal is to induce efficient specific (reliance) investments. See Aaron S. Edlin, Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages, 12 J. L. ECON. & ORG. 98 (1996) (up-front payments give the promisor the ability to hold up the promisee in renegotiation and thus discourage excessive reliance).

a builder during construction. An important contract design choice, therefore, is whether each payment is made before or after the builder completes the construction to which the payment relates. One might think of this as choosing which party gives value first -- essentially, a deposit for each stage. As we now know, this decision determines the party who bears the burden of proof and whose opportunistic arguments at litigation are correspondingly constrained. Assume initially that payments are made in advance, and particularly that the final payment is made prior to the completion of construction. This provision places the default burden on the owner (as plaintiff suing to recover its payments) in litigation over whether the builder has substantially performed its obligation. The burden deters opportunistic suits by the owner and might reduce litigation costs. Yet, a reduction in the likelihood of litigation might also undermine the builder’s incentives by enabling him to point to self-serving proxies for “substantial performance”. If this is the net effect of the burden allocation, then the parties must trade off the litigation cost savings against the adverse effect on performance incentives. This is a similar tradeoff to that described above in the context of suits by corporate officers for indemnification. The parties have a procedural as well as substantive decision variable with which they can fine-tune the balance: they can contract for the standard of proof as well as the burden of proof. Shifting the burden to the owner is less significant when the standard remains the preponderance of the evidence than when it is raised to clear and convincing evidence, as in the indemnification agreement.

In sum, the contracted order of performance – whether the construction occurs before or after the corresponding payment from the owner – determines who is more likely to be the plaintiff and, accordingly, who will carry the burdens of proof. Given the standard of proof, the burdens may be significant because of the relative costs they impose on the litigants and their relative likelihood of victory. Thus, the alternative burden allocations have contrasting effects on incentives. Yet, the simple choice of placing the burden on one party or the other is unlikely to achieve the first-best incentives for builder performance.

In the construction contract in the famous case of *Jacob & Youngs v. Kent*¹⁵⁸ the parties

adopted a more intricate burden-shifting solution that is common in construction contracts. Their contract provided that final payment was due upon the issuance of the architect’s certificate. Effectively, this provision assigned the choice of proxy to the architect, presumably on the grounds that she enjoys the advantage over the court of industry expertise. Like an arbitrator, the architect’s discretion is disciplined by her reputational stake in not appearing to be biased in favor of builders or owners. After all, she would like to be chosen in subsequent similar arrangements. Yet, in most such contracts, the architect’s certificate operates as a presumption of substantial performance that can be rebutted by evidence that its issuance was influenced by fraud, bias or mistake.

3. Framing of substantive rights: contract assignment and termination

The following set of examples differ from the foregoing in that the burden allocation results from the manner in which substantive rights are framed. In addition, the examples are interesting because the parties’ dispute is not simply over the division of the spoils from a completed relationship. Rather, it occurs in the midst of a potentially on-going relationship, such as a distributorship or franchise. This is an important difference because it complicates the weighing of possible opportunistic behavior by each party. In the construction or indemnification examples discussed above, the parties generally assess the relative concerns that a promisor would shirk or the promisee would sue opportunistically. In the cases that follow (as in the earlier example of the loan agreement), the parties are also concerned with the parties’ opportunistic attempts to terminate or continue (or assign) the relationship for self-interested rather than efficient reason.

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159 230 N.Y. 239, 240 129 N.E. 889, 890 (1921).

160 As any student of contracts knows, the contractual solution to the standard moral hazard problem in construction cases did not work perfectly in Jacob & Youngs. The architect refused to certify that the builder had fully complied, though the defect appeared trivial. The seeming disjunct between the size of the withheld final payment and the nature of the noncompliance suggested possible fraud or mistake by the architect. The builder, however, did not attempt to impeach the architect’s decision. Rather, the builder asked the court to hold that perfect compliance was not a condition to receiving the entire last payment. The court agreed. It believed that forfeiture of the entire last payment would have been unfair, and that the parties could not have intended this result. 230 N.Y. 239, 129 N.E. 889 (1921). For a critique of the court’s opinion, see Schwartz & Scott, Contract Theory, supra note 1 at 614-16.
a. Assignment clauses. Assignments of contract rights have mixed efficiency consequences. On the one hand, they can move contract rights from lower to higher valued uses. On the other hand, leaving the assignment decision to the promisor may lead to inefficient transfers because she does not internalize the cost of the assignment to the promisee. So, for example, franchise agreements restrict the ability of the franchisee to assign its rights under the contract because the franchisee is interested only in maximizing the proceeds from a purchaser, without regard to the effect of the new franchisee on the franchise’s reputation and value. Thus, agreements do not permit assignment but, recognizing that transfers may be efficient, the contracts also do not prohibit all transfers. Banning assignments completely would prevent the exploitation of the franchisee’s private knowledge of higher-value franchisees. It is difficult, however, to distinguish between the benign and malign scenarios by specific rules. So, the parties rarely attempt to list requirements that must be met. Instead, they invoke a “reasonableness” standard under which the franchisor’s consent to any assignment is required but will not be “unreasonably withheld.” The reasonableness requirement is intended to have bite.\(^{161}\) The parties guide the courts by combining the standard with specific rules or by explicitly stating the objective of the standard. The Taco Bell franchise agreement, for example, states that “[t]he Franchisee acknowledges that the purpose of the aforesaid restriction is to protect the Company’s trademarks, service makers, trade secrets and operating procedures as well as the Company’s general, high reputation and image, and is for the mutual benefit of the Company, the Franchisee and other franchisees of the Company.”\(^{162}\) The contract further provides that “[i]n considering a request for a transfer, the Company will consider, among other things, the qualifications, apparent ability and credit standing of the proposed transferee as if the same were a prospective, direct franchisee of the Company.”\(^{163}\)

\(^{161}\)E.g., “Except where this Agreement expressly obligates the Company reasonably to approve or not unreasonably to withhold its approval of any action or request by Distributor, the Company has the absolute right to refuse any request by Distributor or to withhold its approval…” Ace Hardware Corporation National Supply Network, Distributor Franchise Agreement §§13(b)(ii), 16(b), http://library.consusgroup.com/library_sbn/144/144968.asp.

\(^{162}\)See Taco Bell Contract, supra note 90 at §13.3.

\(^{163}\)Id. at §13.0.
Consider two alternative ways of framing the reasonableness condition that illustrate the parties’ anticipation of burdens of proof. Under either alternative, litigation addresses the issue of whether the assignment is “reasonable” and the parties present alternative proxies. The first approach permits the franchisee to assign its rights only if reasonable. The second permits the franchisee to assign its rights only with consent of the franchisor and provides that such consent will not be unreasonably withheld. Commercial agreements tend to adopt the latter approach to regulating assignments. The choice of the latter version anticipates the assignment of burdens of proof in litigation. In the former case, the franchisor, suing for damages and to prevent the continued use of its trademark, would be required to prove that the transfer was not reasonable. Under the latter version, the franchisor would initially establish that it withheld consent. Then, the burden would shift to the franchisee to show that the franchisor’s consent was unreasonably withheld. One might speculate that this allocation may be efficient on grounds of comparative information advantages: the person in contact with the intended transferee is likely to have better information about the qualifications of the new franchisee.

b. Contract Termination. Explicit termination clauses are common in many different categories of commercial contracts, including employment agreements, service contracts, merger and acquisition agreements, loans, and franchise and distributorship arrangements. Their role is puzzling because even in their absence, either party to an on-going relationship can terminate by declaring that the other party materially breached its obligations. Under the common law of contracts, material breach entitles the nonbreaching party to withhold performance and seek damages for breach. One reason for explicit termination clauses is to provide for the conditions that trigger termination, rather than relying on the common law requirements for material breach.

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164 See e.g., the following sample contracts in the CORI Contract Library, supra note 19: Cruikshank & Associates Consulting Agreement; National Penn Bankshares Share Purchase and Merger Plan; Northwest Bancorp Merger Agreement; Pak Mail Centers Franchise Agreement; Rexnard Corp. Employment Agreement; Sears License Agreement; Smart Serv Online Product License and Services Agreement. CORI Contract Library, supra note 18. The phrase “termination” appears in 15,343 contracts (or 60.95% of the total) in the CORI Contracts Library. Of the 25,172 total documents in the data base, the phrase "right to terminate" appears 2,263 times; "termination with cause" appears 1,747 times; "terminated with cause" appears 1,139 times; "termination without cause" appears 673 times; and "terminated without cause" appears 365 times. Id.

165 See e.g., Restatement (Second) of Contracts §§ 235, 237, 243 (1979).
We suggest in this section that termination clauses also tailor burden allocation. Indeed, we present evidence that the burden design under termination rights may entail burden shifting similar to that invoked by the provision for the architect’s certificate in construction contracts.

Consider in general terms the benign and malign reasons why a party to a long-term contract – such as a lender, employer or franchisor – might wish to terminate the relationship. For convenience, we refer to that party as the principal and the counterparty as the agent. First, a principal may wish to terminate the contract because the agent failed to exert the level of effort required in the contract (i.e. shirked) and thereby jeopardized the value of the relationship. Shirking may be an efficient justification for termination: it both arrests a relationship that is no longer valuable because of the dealer’s shirking and yields an ex ante discipline that might deter shirking.\textsuperscript{166} Second, the principal may terminate because the materialization of an exogenous risk, such as changed market conditions, has rendered the contract unprofitable to the principal (but not to the agent). Cancellation for this reason alone would lead to the loss of the relationship’s future value and would also undermine the contract’s allocation of risks. The principal’s incentive to guard against exogenous risks that make its own performance more costly or that make the return performance less valuable is undermined by its ability to escape adverse changes by terminating.\textsuperscript{167} Third, the principal may threaten termination in order to force a renegotiation of its terms so as to secure a larger share of the contract surplus. This opportunism is an attempt to appropriate the agent’s contract-specific investments in the on-going relationship. The prospect of renegotiation deters the agent from investing in the relationship. As with the second reason, the principal’s termination is opportunistic and contrary to the ex ante interests of the parties.

In light of the mixed motivations for termination, the parties might seek to regulate in their

\textsuperscript{166}The same may be said of events of default in debt instruments, such a loan contracts. See George G. Triantis, \textit{The Interplay Between Liquidation and Reorganization in Bankruptcy}, 16 INT’L REV. LAW & ECON. 101, 104-7 (1996).

\textsuperscript{167}See e.g., Paradine v. Jane, Aleyn 26, 82 Eng. Rep. 897 (K.B. 1647) (“When a party by his own contract creates a duty or charge upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract.”) For discussion of the principle of “promisor’s risk” see SCOTT & KRAUS, supra note 73 at 77-88.
Explicit termination clauses often have graduated termination rights. At the first level, there is a right, most often granted to both parties, to terminate the agreement without cause upon appropriate notification. In the license agreement used by Sears Roebuck, for example, §20.1 provides for ‘No Fault Termination’ under which either party “without cost, penalty or damages for any reason whatsoever” has the right to terminate the agreement upon providing the other party with at least 180 days written notice. Sears License Agreement made on January 1, 2003 between Sears Canada, Inc. and Sears Roebuck & Co. and CPI Corp., at CORI Contracts Library, supra note 18. Second, the termination clause grants the parties a right to terminate immediately for any among a list of specified causes. For example, §20.7 of the Sears License Agreement provides for “Termination With Cause Immediately.” This clause lists a number of specific grounds for termination by the licensor: e.g., insolvency or bankruptcy of the licensee, sales of assets not in the ordinary course of business, a failure to operate and conduct business for more than three consecutive days, misappropriation of funds of the licensor, disclosure of confidential information, a change of control, and implementation of a change of practice without prior approval. §20.7(a) through (x). The list of precise terms authorizing termination is followed by a single broad standard that grants Sears the right to terminate for the “licensee’s refusal to co-operate... in the performance of the Agreement, or for the “licensee’s failure or refusal, within 3 business days after receipt of written notice from Sears, to comply with any material provision or condition” of the contract. §20.7(y)(emphasis added). This is consistent with the usual pattern of requiring notice and opportunity to cure before permitting termination on the basis of the violation of a standard rather than rule. The notice informs the licensee of the proxy that the licensor intends to rely on in declaring the termination of the contract.

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Unfortunately, the parties are unlikely to be any more successful than the default scheme in conditioning the allocation of the burden of proof on the principal’s motivation for terminating. After all, the principal’s motivation lies at or at least near the core of the fact finding operation. Assigning the burden of proof in the contract to the principal would deter inefficient termination but also efficient cancellation in response to shirking by the agent. Therefore, if burden allocation is a binary choice, the best available arrangement depends on a comparison of the prospects of efficient and opportunistic cancellation. For example, to the extent that the agent’s incentive to shirk is disciplined by reputational constraints, the burden of proof is more appropriately placed on the principal. We encountered a similarly rough determination in the context of the indemnification agreement and the construction contract. To give an example more specific to the termination context, if the principal’s exposure to exogenous risks is small or if the agent’s specific investment are minor, then the parties might be more likely to allocate the burden to the agent. In any event, our main observation is that the allocation of burdens provides a procedural lever that complements the substantive termination right.

The case of International Harvester v. Calvin demonstrates how a termination clause might yield a more complex shifting burden of proof. International Harvester concerned a long-term franchise contract for the sale of heavy duty trucks within a designated region. The contract contained a combination of rules and standards governing the distributor’s performance under the contract. These provisions committed the distributor, inter alia, to exercise its best efforts to promote the sales of the manufacturer’s product, to “provide and maintain physical facilities commensurate with the sales possibilities and service needs in the distributor’s sales area,” and to “achieve a reasonable share of the market for the goods covered by the agreement in the normal trade area served by the dealer’s location.” Two years after the contract was concluded, the manufacturer notified the dealer that it was in violation of its obligations, including its commitment to maintain a reasonable market share. The manufacturer warned that it would terminate unless the dealer corrected the violations. Subsequently, the manufacturer notified the

169353 So. 2d 144 (Fla. 1978).

170 The facts are drawn from Id. at —.
dealer that the agreement was terminated, effective in 90 days. 171 A state regulatory body set aside the termination, however, and the manufacturer sued to reverse that administrative order.

The court interpreted the termination provision to include a tailored allocation of burdens similar to that raised by the architect’s certificate in the construction contract discussed earlier. The court effectively treated the termination provision as if it were a delegation of proxy choice to the manufacturer itself. The manufacturer enjoyed a presumption that the termination was justified if it could satisfy two easy requirements at trial: to establish by simple affidavit that the dealer had failed to comply with the reasonable market share requirement and that the manufacturer had delivered the required termination notice. 172 The burden then fell to the dealer to prove that it had in fact complied with its contractual obligations.

As in the case of the architect’s certificate, however, the court was also receptive to claims of process abuse. The dealer could avoid the burden of proving compliance by showing that the manufacturer had an ulterior motive in terminating: for example, that the manufacturer sought to install another dealership in the adjoining county. Indeed, in International Harvester, the dealer had filed a formal protest with the agency charged with jurisdiction over claims of unfair treatment of dealers. Only then, the dealer contended, did the manufacturer’s evaluations of the dealer’s sales performance begin to deteriorate. The dealer also testified that the manufacturer attempted to coerce the dealer to expand its facilities and greatly increase its investment in inventory and fixed costs. The notice of termination, the dealer argued, was the result of its reasonable refusal to comply with these demands. The court held that this prima facie showing of bad faith shifted the burden to the manufacturer to show by a preponderance of the evidence that the termination was not motivated by strategic considerations – that it would have terminated even in the absence of

171 Id. at —.

172 Recall the Jacob & Youngs presumption based on the architect’s certificate, text accompanying note 160 supra.
the alleged bad faith purpose.\textsuperscript{173}

This example of shifting burdens (or presumptions) suggests that the parties have more flexibility in burden design than all-or-nothing allocations to each party. The court in \textit{International Harvester} adapted the scheme of presumptions and shifting burdens from civil rights case law.\textsuperscript{174} Yet, we should not miss the important lesson for contract design. The discussion underscores the importance, but also the complexity, of the contracting task of efficient burden assignment, whether by explicit or implicit provisions. On the one hand, the parties must identify and evaluate the relative severity of the agent’s incentives to shirk and the principal’s incentives to make opportunistic claims of breach, both in terms of their likelihood and their efficiency consequences. On the other hand, the parties must anticipate the future litigation, particularly, who is more likely to be suing and for what. Although the parties can undoubtedly improve on the default burden allocations, the tailoring task is likely to involve substantial up-front transaction costs.

\textbf{CONCLUSION}

In this Article, we analyze the relationship between the front-end and back-end stages of contracting by examining (1) the choice between specific and vague terms and (2) the interaction between substantive and procedural contract provisions. We offer a preliminary theory explaining the feedback effect of the adversarial litigation system –and especially the process of proxy selection and proof-- on contract terms. In doing so, we hope to set a research agenda for further

\textsuperscript{173}Id. at 148. In fact, the manufacturer presented evidence that the dealer’s sales were only 70% of its estimated sales potential. Moreover, the dealer’s market penetration was only 6% when the other franchise dealers in the area averaged 15.3%. Finally, the national advertising budget for all dealers averaged .5% of total operating budget, while this dealer only spent .1% on advertising. The court in \textit{International Harvester} held on these facts that the objective data introduced by the manufacturer and substantially uncontradicted by the dealer was “so overwhelming” as to carry its burden of proving an independent reason for termination of the contract.

\textsuperscript{174}The court cited the Supreme Court’s burden scheme in \textit{Mt. Healthy City School District Board of Education v. Doyle}, 429 U.S. 274, 284-7 (1977). The school board had refused to rehire a teacher at least partly because of statements he made on the radio. Once the teacher established in court that his constitutionally protected speech was a motivating factor in the decision not to rehire, the burden fell on the Board to show by a preponderance of evidence that it would have reached the same decision even on the basis of the teacher’s other actions.
integrating the litigation mechanism with the theory of contract design. Much can be gained by a sharing of knowledge and insights between procedure and contracts scholars and, in the world of practice, between litigators and transaction lawyers. Indeed, contract design can anticipate not only the effect of litigation, but also other possible back-end processes, such as arbitration, renegotiation or settlement.

We conclude that commercial parties can (and do) design contracts that motivate better contractual performance incentives and at lower cost than has been previously understood. By examining how contracts can harness the litigation process, we breathe new life into the scholarly acceptance of vague terms by rebutting a persistent skepticism in contract scholarship about their cost-effectiveness. Vague terms can be valuable by deferring proxy selection to the enforcement stage, particularly when the parties can also improve the efficiency of litigation by, for example, manipulating the assignment of burdens of proof. The use of deposits or termination rights in combination with vague terms illustrates this strategy.

The claim that party-created standards can enhance efficiency in harnessing the ex post informational advantage available at litigation does not justify the promulgation by legislatures or courts of default standards instead of default rules. After all, the cost to the parties of writing such vague terms is low. Moreover, we have shown that standards such as “reasonableness” or “best efforts” are rarely invoked in isolation. The combinations of rules and standards that we have examined reveal a complex contractual design that public law makers are often unable fully to comprehend. Thus, there are several normative implications that might be drawn from the analysis. First, parties are better able to write constrained efficient contracts that optimize resource expenditures and incentive gains than has generally been believed. Therefore, the justification for filling gaps in incomplete contracts with legally supplied default terms is weakened. Second, the task of combining rules and standards is both complex and context-specific. Therefore, the courts would be wise to interpret the absence of vague terms or standards in commercial contracts as instructions from the parties to limit their construction to the specific terms of the contract.

Cf. Ayres, supra note 71 at 1405-6.