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The Future of Many Contracts

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Forty years ago, my former colleague, the late Ian Macneil, published an article entitled *The Many Futures of Contracts.*[1] When I was asked to contribute to this symposium on what contract law might look like in 2025, the play on words was too good to resist. Professor Macneil developed the notion of "relational contracts," emphasizing the limits of classical contract law in dealing with long-term contractual relations. His work had a strong influence on scholarship, including my work. The notion that many contractual relationships are long-lived and require some form of adaptation as circumstances change and new information becomes available is a powerful one, one that was not well appreciated in classical contract law.

Law evolves slowly and doctrine has not changed much since Macneil wrote. And, I suspect, contract law a decade from now will not look very different from today. So, rather than predict, I will discuss some concerns I have with the doctrine as it stands today with the hope of nudging the law in a different direction.

Contract law is facilitative. As a first principle, parties should be free to define their obligations. For sophisticated parties it means that their words should be taken seriously. My first concern is with doctrines that tend to undermine the written document, for example, the watering down of the parol evidence and plain meaning rules. Other problematic doctrines include the expansive use of custom, usage, and course of performance as manifested in decisions like *Columbia Nitrogen*[2] and *Nanakuli*,[3] and the liberal application of the implied covenant of good faith and fair dealing to trump the contract language. I am not insisting on an absolutist position, but I do believe that the spirit of the Uniform Commercial Code ("UCC") and the tone of the *Restatement (Second) of Contracts* go too far in their willingness to go beyond

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1. Ian Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974).

2. Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3 (4th Cir. 1971). For a critical analysis of the case, see VICTOR GOLDBERG, FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE ch. 7 (2006).

3. Nanakuli Paving and Rock Co. v. Shell Oil Co., Inc., 664 F.2d 772 (9th Cir. 1982).

the written document. They put more faith in the role of judges and juries *ex post* than in transactional lawyers *ex ante*.

Contract performance takes place over time, and a significant question is how the obligations should be adapted as circumstances change and new information becomes available. I want to consider the implications of these realities for two doctrinal problems: remedies and quantity flexibility. It is instructive to think of these problems as exercises in contract design. Doctrine is, or should be, only about default rules, and the manner in which parties design their relationships should provide insights into how those default rules should be structured. The starting point should be recognition of the tradeoff between the parties' desire for the flexibility to adapt as new information becomes available and their desire to rely upon the continuation of the relationship. If the contract grants one party the flexibility to adapt, the counterparty might want to confront it with a price that would reflect the costs the counterparty would incur by granting that discretion.

One possible response to changed circumstances is to terminate the agreement. When designing their relationship, the parties might include an option to terminate for one or both parties. The option might be unconditional, or it might be exercisable only in certain circumstances. The counterparty might want to impose a hurdle to protect its reliance upon the continuation of their arrangement. The more it would be hurt by termination, the greater the price the counterparty would put on the option to abandon. Termination would not be a breach of the agreement; it would be an agreed-upon term.

If we treat breach as the exercise of an option to terminate, then we can view the remedy for breach as the price of that option. How should that option be priced? Framing the question in this manner has implications for how we should approach the issue of contract remedies. Farnsworth states the traditional view: "The basic principle for the measurement of those damages is that of compensation based on the injured party's expectation. One is entitled to recover an amount that will put one in as good a position as one would have been in had the contract been performed."[4] But why? Would parties typically choose to price the termination

4. E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.8,188-89 (2d ed., vol. 3 1990).

option that way?[5] The answer is probably "yes," if it only meant compensating the non-terminating party with the contract-market differential. But the "make-them-whole" remedy often goes well beyond the price differential, and in those situations, parties often opt for something other than the promisee's expectations. The exercise price for the option to terminate need not have any relationship to the legal remedies of the UCC or Restatement. To shed light on this, consider how parties explicitly price the termination option in different contexts.

Consider two classes of agreements in which the price of the option to abandon is essentially zero, despite the fact that the counterparty places considerable reliance on the continuation of the relationship. First, a venture capitalist ("VC") provides funds to an entrepreneur for a project that typically has a high risk of failure and a long period before it would yield positive profits. Typically, the contract gives the VC an option to abandon and a right of first refusal. The option to abandon is valuable to the VC, but it is costly for the entrepreneur since the VC could always use the option to rewrite the deal opportunistically in a way more favorable to it. Moreover, the first refusal right limits the entrepreneur's access to alternative funding sources. An outsider must realize that the original VC's failure to exercise the first refusal right would mean that it has overbid; therefore, the outsider would probably choose to forgo the opportunity. The entrepreneur is thus vulnerable to the possible opportunistic threat of termination. What protection does the entrepreneur include in the contract? Typically, none. The option price is zero; the entrepreneur's protection would be non-contractual, primarily the reputation concern of the VC.

Second, the automobile franchise relationship, before it was enshrouded in legislative protections for franchisees, gave the manufacturers a cancellation option at a nominal price, or, in some instances, at a zero price. The Ford franchise contract pre-1940 was legally unenforceable, which, in effect, meant that either party could walk away costlessly. In *Bushwick-Decatur Motors, Inc. v. Ford Motor Co.*,[6] the Court of Appeals for the Second Circuit found the franchise agreement to be illusory, despite the claimed reli-

5. Scott and Triantis have written an important paper arguing against the compensation principle as the appropriate remedy for breach of contract. *See* Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004).

6. 116 F.2d 675 (2d. Cir. 1940).

ance of the dealer on alleged oral statements by Ford representatives:

> [D]efendant's settled policy was 'Once a Ford dealer, always a Ford dealer'; that by the dealership contract 'the plaintiff had become a member of the great Ford family; that the plaintiff would remain a Ford dealer as long as it wanted to'; that the Ford policy, settled for many years, 'was a guarantee of this; and that the plaintiff need have no hesitation whatever in investing all available funds in the promotion of the sale and servicing of Ford products as such investments would be perfectly safe.' . . . [P]laintiff was encouraged to enlarge its facilities, increase its sales force and expand its business, in reliance on the assurances given by the defendant that plaintiff was 'in' as a Ford dealer as long as it wanted and should have no concern over the wisdom of making long term commitments and long term plans.'[7]

Ford wanted its dealers to make investments in reliance on continuation of the relationship, and, by and large, dealers did so. The dealers could not rely on the contract language since it was unenforceable; they relied instead on the expectation that their satisfactory performance would assure the renewal of their franchise. Dealers wanted more, but, absent legislative intervention, they could not get the producers to give explicit protection to their reliance.[8]

In other contexts, the option price can be substantial. The contract between the movie studio and the actor, for example, includes a "pay-or-play" clause.[9] If it were to receive new information between the time the contract is signed and the time the movie is completed, the studio could terminate. In effect, the pay-or-play clause fixes a price for this termination option. For major talent, it would be the so-called "fixed fee," which might be in the $20 million range. For lesser talent, the fee would be smaller, and the right to compensation might not be triggered until the occurrence of some subsequent event, perhaps the receipt of a bona fide outside offer. The option price would reflect the fact that the actor

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7. *Id.* at 678.

8. Since passage of the Dealers Day in Court Act of 1956, automobile franchise agreements that were not enforceable or were terminable on short notice have been prohibited; *see* STEWART MACAULAY, LAW AND THE BALANCE OF POWER: THE AUTOMOBILE MANUFACTURERS AND THEIR DEALERS, 61-71 (1966).

9. *See* GOLDBERG, *supra* note 2, at ch. 15.

has set aside a particular time period in which it can no longer accept alternative projects. The more attractive these alternatives, the greater the option price.

In corporate acquisitions the agreements often include options to walk away, sometimes with the option price being made explicit. Sellers of public corporations typically have the right to reject the deal by paying a breakup fee, usually around 3% of the deal price.[10] Buyers will usually have a right to walk away from the deal if there is a material breach of the seller's representations and warranties or if there is a material adverse change ("MAC"). Some agreements also allow the buyer to terminate by paying a breakup fee. The fee could be made contingent upon specific facts. For example, in one recently litigated case, the contract allowed the buyer to pay a breakup fee of $325 million if the deal could not close despite the buyer's best efforts.[11] If, however, the deal failed to close because of a "knowing and intentional breach of any covenant," the damages would be uncapped.[12] The vice chancellor found that the buyer and its lawyers had committed a number of bad acts and that the breach of the covenant was intentional.[13] The buyer settled for $1 billion, roughly three times the breakup fee.[14]

The option perspective on breach of contract was set out over a century ago by Oliver Wendell Holmes: the "duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else."[15] If the contract were silent on what should happen if one party were to terminate, the option price would be set by the default remedy. This characterization is sometimes referred to as "efficient breach," terminology that I find to be unfortunate. The more general statement is "efficient adaptation to changed conditions," with one subset of adaptations being termination. The notion that a party has an option to perform or terminate does not sit well with many commentators who regard breach as immoral. Daniel Friedmann has been a particularly vocal proponent of this position.[16] There is

10. *See* David Fox, *Breakup Fees -Picking Your Number*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Sept. 11, 2012, 9:03 AM), https://blogs.law.harvard.edu/corpgov/2012/09/11/breakup-fees-picking-your-number/.

11. Hexion Specialty Chem., Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008).

12. *Id.* at 724.

13. *Id.*

14. *Id.* at 746.

15. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

16. Daniel Friedmann, *The Efficient Breach Fallacy*, 16 J. LEGAL STUD. 1 (1989).

nothing immoral, however, about a voluntary agreement that would allow one party to terminate, perhaps for a price, if certain circumstances arose. Indeed, even Professor Friedmann would be comfortable with parties contracting over a termination remedy; his moral indignation only goes as far as the default rule.[17]

The fundamental point is that the default contract law remedy is, in effect, the implied termination clause, and it should be viewed as just another contract term from which parties are free to vary. The remedy default rule, however, is stickier than others. The stickiness of the expectation damage remedy has great rhetorical power. If a breacher is perceived as having wronged the promisee, then corrective justice would seem to require that, like a tort victim, the promisee should be made whole. "The fundamental principle that the law's goal on breach of contract is not to deter breach by compelling the promisor to perform, but rather to redress breach by compensating the promisee."[18] That provides an anchor for doctrinal argument and friction for moving away from the default remedies. I am suggesting that it is time to lift that anchor.

Reframing the problem as a matter of transaction design and recognizing the reliance-flexibility tradeoff shows why the benefit of the bargain remedy is too simplistic. Holmes's framing as the promisor having a choice between performing or paying damages was, in large part, a response to the notion that default rules should be derived from ethical norms rather than commercial needs. Reviving Holmes's aphorism would at least nudge the rhetoric in a more useful direction. The evidence from the design decisions of contracting parties indicates that the price of termination often bears no resemblance to the redress remedy. Decoupling the pricing of the termination option from the question of compensation can lead to a more nuanced approach to contract remedies.

I will give one illustration of a remedy doctrine that makes no economic sense and which could plausibly disappear within the next decade: the lost volume seller remedy embodied in UCC § 2-708(2). The problem in the retailing context is a simple one. A customer orders a consumer durable, such as a car. Before delivery, the customer cancels the order (a breach). The retailer sells the same car to another customer at the same price. The retailer

17. *Id.* at 23.
18. FARNSWORTH, *supra* note 4, at §12.18.

then sues the customer for breach. The customer argues that since the contract price and cover price were the same, the retailer's damages were zero. The retailer responds by claiming that it would have sold the second car anyway, so it would have made the profit on each of the cars. The profit would be the difference between the contract price and the but-for cost, which, in the retail context, is the difference between the retail and wholesale price—the gross margin.

That is the solution embodied in UCC § 2-708(2). The resolution gets more complicated as various difficulties are considered. Would the second buyer have bought only *this* car? Would the retailer be able to sell additional cars at the same cost? All of these complications are irrelevant if the problem is reframed in terms of the option price. This remedy in effect sets the customer's option price at the gross margin—roughly 12-15%of the retail price. That is, the customer agrees to pay $3,000 for the option to pay an additional $17,000 to buy a car with a retail price of $20,000. Even assuming customers are aware of this, is there any reason to believe that they would agree to such a bargain? The possibility that a customer might order a car and then change her mind is a cost of doing business for the retailer. Moreover, the retailer can influence the likelihood of a cancellation. In particular, it could set an explicit option price in the form of a non-refundable deposit. The higher the deposit, the less likely the cancellation. Under what conditions would a consumer agree to a substantial deposit? If, for example, the car model is a hot seller, manufacturers might have to allocate the cars amongst their dealers; even if a dealer had potential buyers for more than, say, twenty cars a month, it could not sell to all of them. The option price as reckoned by the lost volume formula would be zero—the dealer could not have sold another car. That, however, is precisely the situation in which the customer might rationally choose to pay a substantial option price. Conversely, if demand were slack, the formula would result in an option price equal to the gross margin, whereas the contract would likely set an option price at, or near, zero. UCC § 2-708(2) gets it backward.

Termination is an extreme form of adaptation to change. Less extreme would be variation of quantity. That raises a second set of concerns about doctrine. UCC § 2-306(1) purports to deal with the problem by using "good faith" to define obligations. This, I would suggest, is a big mistake. It again reflects the Code drafters' failure to understand basic economics and their lack of faith in transactional lawyers. The basic problem, simply put, is that in a long-term contractual relationship, supply and demand conditions are likely to change and the parties will want to adapt as new information becomes available. In some instances, the adaptation mechanism would entail an elaborate governance system. In others, it would entail giving one party control. As with the analysis of termination, the parties' discretion need not be unbounded. The party with discretion can be confronted with a price reflecting the counterparty's reliance.

UCC § 2-306(1) explicitly addresses "full output" and "requirements" contracts. In the former, the quantity decision is at the discretion of the seller. The buyer agrees to take whatever the seller chooses to produce. In the latter, the quantity decision is at the discretion of the buyer. The seller agrees to provide whatever the buyer chooses to order. If the discretion were completely unbounded, such an agreement could be disastrous. If the market price rose even one cent above the contract price, the buyer could claim requirements thousands of times its normal needs. Fear of this possibility led the drafters of the Code to cap the discretion by imposing a good faith limitation. The poster-child case for extreme quantity variation is *Oscar Schlegel Manufacturing Co. v. Peter Cooper's Glue Factory*.[19] When the market price more than doubled the contract price, the buyer increased its purchases more than tenfold.[20] The parties might be quite eager to constrain such opportunistic behavior.

Unfortunately, the UCC throws out the baby with the bathwater. It purports to operationalize the good faith standard without regard to why parties might want to allocate quantity discretion to one of them. The Official Comments provide some indication of what is meant by good faith: the amount demanded in a requirements contract cannot be disproportionate to estimates.[21] There is some dispute as to whether the disproportion rule applies only to increased demands or whether it is symmetrical. The asymmetry of the rule in some jurisdictions is justified by the simple arithmetic fact that the downward discretion is bounded by zero.[22] The second aspect of good faith memorialized in the Offi-

19. 132 N.E. 148 (N.Y. 1921).

20. As I have shown elsewhere, the contract did actually put limits on the buyer's discretion, but the seller failed to invoke the limits. *See* GOLDBERG, *supra* note 2, at ch. 3.

21. U.C.C. § 2-306 cmt. 3 (1972).

22. *See* Empire Gas Corp. v. Am. Bakeries Co., 840 F.2d 1333, 1343 (7th Cir. 1988). The court found that the buyer's cutting its requirements to zero could be in good faith, but

cial Comments is the notion that a buyer cannot reduce or eliminate its requirements merely because it would otherwise lose money.[23]

Parties do not, however, get unbounded discretion. The requirements are normally tied to a particular purpose. For example, a buyer might take all the coal necessary to run a particular power plant. Or a buyer might limit its requirements to a particular purpose. The limits could be made tighter by incorporating a maximum and/or a minimum. Those limits could be further defined over various time periods. The buyer might agree, for example, to take a maximum of 400 tons per week and a minimum of 25,000 tons over three years.[24] Within those constraints, discretion can be further limited so that the counterparty's reliance can be accounted for. The contract allocates flexibility to the party that values it most. If the value of that flexibility exceeds the counterparty's cost of providing it, there is room for a deal. The counterparty bears the cost of providing that flexibility, and the contract can convey that information to the seller by, in effect, imposing a price. The price need not be explicit.

There are many ways to price flexibility. There are, for example, a number of variations on a "take-or-pay" contract. The party with discretion might have to pay a stand-by fee, or it might promise to pay for a minimum quantity—either 100% of the contract price or some fraction thereof. In a take-or-pay contract, the buyer agrees to pay for a certain percentage of the specified quantity,

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that the burden of proving that its decision was in good faith was on the defendant and that it had failed to do so. *Id.*

23. Comment 2 reads:

> Under this Article, a contract for output or requirements is not too indefinite since it is held to mean the actual good faith output or requirements of the particular party. Nor does such a contract lack mutuality of obligation since, under this section, the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his output or requirements will approximate a reasonably foreseeable figure. Reasonable elasticity in the requirements is expressly envisaged by this section and good faith variations from prior requirements are permitted even when the variation may be such as to result in discontinuance. A shut-down by a requirements buyer for lack of orders might be permissible when a shut-down merely to curtail losses would not. The essential test is whether the party is acting in good faith. Similarly, a sudden expansion of the plant by which requirements are to be measured would not be included within the scope of the contract as made but normal expansion undertaken in good faith would be within the scope of this section.

U.C.C. § 2-306 cmt. 2 (1972).

24. Those limitations were included in Lake River's contract with Carborundum. *See* Lake River Corp. v. Carborundum Co., 769 F.2d 1284 (7th Cir. 1985); *see also* Victor P. Goldberg, *Cleaning Up Lake River*, 3 VA. L. & BUS. REV., 427-45 (2008).

regardless of whether or not the buyer actually takes it. The price for the first, say, 20% of the product in any given month is, in effect, zero. If the value of the seller's plant is contingent on the continued purchases by the buyer, the guaranteed "take" is one way to protect the seller's reliance. The greater the reliance, other things equal, the higher the guaranteed payment will be. The seller's reliance need not, in general, be fully protected—that is, the parties can share the risk of a bad outcome by setting the sum of the guaranteed payments below the seller's costs if the buyer were to order less than the minimum. Parties could include liquidated damages if the buyer were to fail to take a minimum amount; there would be, of course, the risk that a court would find that the liquidated damages were a penalty and would refuse to enforce the clause (that is another doctrine that has outlasted its sell-by date).

To illustrate the confusion caused by UCC § 2-306(1), consider the leading case in New York, *Feld v. Henry S. Levy & Sons, Inc.*[25] Levy baked and sold rye bread.[26] Inevitably, there would be some waste product—imperfect loaves and unsold bread—which Levy had to dispose of. The bakery decided to install an oven to convert these into breadcrumbs, which had some commercial value.[27] To ensure prompt removal, it entered into a one-year, full-output contract with Feld, a seller of breadcrumbs.[28] To protect its reliance interest, Levy required that Feld obtain a "faithful performance" bond.[29] Because Feld had other sources of breadcrumbs, the contract put no constraints on Levy's discretion. Levy was concerned with producing bread and, not surprisingly, did not want the tail of its waste product determining how much it should produce. That is, if Levy decided to produce no breadcrumbs, nothing in the written agreement prevented it from doing so. Levy was disappointed with the results and, after failing to renegotiate the contract price, dismantled the oven and ceased producing breadcrumbs.[30] Dismantling the oven did not amount to termination of the agreement since Levy was required to give six months notice; had it reinstalled the oven, it would still have been obliged to de-

25. 335 N.E.2d 320 (N.Y. 1975).
26. *Id.* at 321.
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*

liver the crumbs to Feld. Feld sued for breach, arguing that Levy could not in good faith reduce its output to zero.[31]

The Court of Appeals held that, despite the contract language, the seller was not free to decide whether it should produce any breadcrumbs at all.[32] The implied duty of good faith required that it continue to produce breadcrumbs "even if there be no profit. In circumstances such as these and without more, defendant would be justified, in good faith, in ceasing production of the single item prior to cancellation only if its losses from continuance would be more than trivial, which, overall, is a question of fact."[33] The court gave no indication as to how a jury could determine that fact. More significantly, it gave no reason for making the outcome depend upon that fact. The court failed to recognize that Levy was the one making an investment—the toaster oven—in reliance upon the contract. The cost to Feld of granting the discretion was zero. The court, in effect, held that Levy promised that it would be willing to lose some money—but not too much—in order to protect Feld's non-existent reliance. The contract priced Levy's discretion at zero; the court trumped it for no good reason.

The essential point is that good faith, unguided by any understanding of the business sense of the transaction, is too blunt an instrument. Courts should start with the presumption that commercial parties are capable of balancing the quantity discretion against the counterparty's reliance. The role of good faith can be limited to cases involving opportunistic behavior. I recognize that there would be disputes as to what constitutes opportunistic behavior, but at least it suggests a broader range of acceptable behavior than that embodied in the Code and its Comments.

There remain a few other items on my wish list. I would like to see a more sensible resolution of the battle of the forms[34] than the knockout rule; I have proposed what I believe to be a more sensible rule—the "best shot" rule.[35] That would at least force parties, when drafting their forms, to take account of the concerns of their counterparties. I would also like to see the resurrection of the "tacit assumption" approach to the question of the recovery of consequential damages. I take some solace from the fact that the House of Lords did finally recognize the tacit allocation of risks in

31. *Id.*
32. *Id.* at 323.
33. *Id.*
34. U.C.C. § 2-207 (2002).
35. *See* GOLDBERG, *supra* note 2, at ch. 8.

rejecting a claim for consequential damages in *The Achilleas*.[36] Further down the wish list, I would like to see that, in the event that contract performance is excused (impossibility, impracticability, frustration), the default rule should be that the parties are left where they were at the moment the excusing event occurred. The current default rule of restitution of prepayments possibly offset by reliance expenditures "if necessary to avoid injustice"[37] has little to recommend it. Since parties almost always contract out of the default, it does not do much harm. But the rule's emphasis on justice and fairness is out of step with the commercial needs of parties.

36. Transfield Shipping Inc. v. Mercator Shipping Inc. (The Achilleas), [2008] UKHL 48, [2009] 1 A.C. (H.L.) [61] (appeal taken from Eng.). For analysis of the decision and the tacit assumption approach, see Victor P. Goldberg, *The Achilleas: Forsaking Foreseeability*, 66 CURRENT LEGAL PROBLEMS 107, 130 (2013).

37. RESTATEMENT (SECOND) OF CONTRACTS §§ 272, 377 (1974).