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ARTICLES

THE BUSINESS LAWYER AS TERRORIST TRANSACTION COST ENGINEER

*Royce de R. Barondes**

INTRODUCTION

Lawyers have garnered a reputation for being unreasonable and excessively contentious.¹ This popular sentiment is embedded in our culture. If lawyers cannot change that perception, a second-best outcome (from the perspective of lawyers) would be the formation of an understanding that there is a reason why they appear to act unreasonably, that it can be desirable for lawyers to act in a way that initially appears to be unreasonable. This Article attempts to build a basis for that understanding in the context of lawyers participating in large commercial transactions.

To provide a specific context for the discussion, consider a negotiation strategy occasionally adopted by counsel² in a leveraged lease of an aircraft to a large airline.³ Typically in such a transaction,

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1. See generally Robert A. Wenke, *The Art of Negotiation for Lawyers* 86 (1985) (“[M]any business people view attorneys as deal killers.”); Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 *Colum. L. Rev.* 509, 510-11 (1994) [hereinafter Gilson & Mnookin, *Disputing Through Agents*] (“Today, the dominant popular view is that lawyers magnify the inherent divisiveness of dispute resolution.”); G. Pascal Zachary, *As Asian Assets Dive, The Bargain Hunters Move in for the Killings*, *Wall St. J.*, June 22, 1998, at A1 (describing a portion of a transaction negotiation as follows: “By now, [a participant] thinks the lawyers are holding things up. ‘Just get rid of them, put me and [another participant] in a room and we’ll have a deal in an hour,’ he boasts.”).

2. This strategy was articulated to the author by an experienced Wall Street lawyer as a strategy that was, for ethical reasons, not to be emulated.

3. See Robert P. Davis, *Leveraged Leasing of Capital Equipment: A Practical Guide to Negotiating Certain Non-Tax Issues from the Lessee’s Perspective*, in *Leveraged Leasing* 1987, at 35 (PLI Commercial Law & Practice Course Handbook Series No. 423, 1987).

an airline's contractual right to purchase an aircraft is assigned to a trustee. The trustee acquires the funds to purchase the aircraft by issuing debt interests to "debt participants" and equity interests to "equity participants." Financial institutions, such as banks and insurance companies, purchase these interests.⁴ The trustee enters into a long-term lease of the aircraft with the airline. The terms of the lease are of crucial importance to both the debt and equity participants, because the lessor's rights under that lease circumscribe their rights.

One important issue addressed by the lease will be the locations to which the aircraft may be flown,⁵ because the return to the debt and equity participants may be substantially and adversely affected if the aircraft is located in certain countries. For example, the presence of the aircraft in some countries may increase the likelihood of a casualty to the aircraft. Alternatively, its location in other countries,⁶ or the registration of the aircraft in another country,⁷ may restrict the ability of the trustee to obtain possession of the aircraft after a default. Consequently, the debt and equity participants will seek to include in the lease restrictions on the locations to which the aircraft may be flown.

Paradigmatic of the type of "unreasonable" action giving rise to the popular perception of lawyers would be the insertion, by counsel for the airline, of the following facially innocuous lease provision: "The lessee may re-register the aircraft only in a 'permitted country.' For this purpose, 'permitted country' means a country that has signed the Convention on the International Recognition of Rights in Aircraft."⁸ This provision, on its face, appears appropriate. A lessor would appear to have a "right" in an aircraft under the lease. A superficial understanding of the proposal would lull counsel to the debt or equity participants into eliding the full import of the provision. However, the value of rights under a convention is ephemeral if the rights cannot be practicably realized in the country in question. For example, a

4. One describes the lease as "leveraged," because the issuance of debt leverages the equity participant's ownership of the equity interest in the aircraft.

5. See Ronald M. Bayer et al., *Lease Documentation Outline*, in *Equipment Leasing—Leveraged Leasing*, app. A at 1281, 1307 (Bruce E. Fritch et al. eds., 3d ed. 1988).

6. See generally Ian Shrank & Bruce E. Fritch, *Leveraged Leasing*, in *Equipment Leasing—Leveraged Leasing*, *supra* note 5, at 99, 274-75 (discussing the Convention for International Recognition of Rights in Aircraft).

7. See, e.g., Ian Shrank et al., *Sample Leveraged Lease Documents*, in *Equipment Leasing 1989*, app. 5 at 991, 1007 (PLI Commercial Law & Practice Course Handbook Series No. 515, 1989) (permitting re-registration of a subleased aircraft only in an "Eligible Country" in which, *inter alia*, the local laws do not provide a "disability" to the exercise of the trustee's rights under the indenture).

8. See Convention on the International Recognition of Rights in Aircraft, *opened for signature* June 19, 1948, 4 U.S.T. 1830, 310 U.N.T.S. 151.

country, such as Iraq,⁹ could be a signatory, but the convention may not afford the lessor the rights that it anticipated. Additionally, the existence of the rights does not ameliorate any risk of destruction of the aircraft.

Of course, the parties could expressly and knowingly agree that the airline would be permitted to relocate and re-register the aircraft in Iraq. But one suspects such an agreement would not be reached were the parties to negotiate explicitly about the matter.

For U.S. carriers and debt and equity participants, it seems highly likely that the “direct” benefit to the airline of having the right to take these acts would be small, relative to the cost to the debt and equity participants of agreeing to a lease that gives the airline that right.¹⁰ The proposal of a contract term that appears innocuous but has a latent impact that would not have been agreed upon had the negotiations addressed the issue more directly, is a form of negotiation that provides one basis on which lawyers can be categorized as unreasonable. This type of negotiation tactic—providing the latent allocation of rights and duties—is common and persistent,¹¹ and one reason patterns of commercial behavior persist is that they are efficient. The persistence of this type of negotiation may indicate that it provides benefits that are not obvious.¹² Perhaps this manner of negotiation increases the aggregate value to the parties of the transaction being negotiated in some indirect fashion.

This type of negotiation strategy could also persist merely because

9. *See id.* (adherence of Iraq deposited Jan. 14, 1981, 22 I.L.M. 1224 (1983)).

10. Consider, in the alternative, a major U.S. airline that owned its aircraft outright. If the airline were required to pay separately for the right to fly the aircraft to, and re-register it in, Iraq, the airline likely would be willing to pay very little, or nothing, for that right. In this sense, the right to relocate and re-register the aircraft in Iraq has little “direct” benefit to the airline.

11. Excessively vigorous negotiation techniques are particularly prevalent in the largest cities. *See* Geoffrey C. Hazard, Jr., *The Lawyer's Obligation To Be Trustworthy When Dealing with Opposing Parties*, 33 S.C. L. Rev. 181, 193 (1981) (“At one extreme lies the ‘rural God-fearing standard,’ so exacting and tedious that it often excludes the use of lawyers. At the other extreme stands ‘New York hardball,’ now played in most larger cities using the wall-to-wall indenture for a playing surface.”).

12. *Cf., e.g.*, Richard A. Posner, *Economic Analysis of the Law* 535 (4th ed. 1992) (“[T]he implicit economic content of the common law . . . may seem straightforward with regard to those areas—contracts mainly, but also large stretches of property and torts—where transaction costs are low. In such areas, inefficient rules of law will be nullified by express agreement of the parties, while persistent judicial defiance of economic logic will simply induce contracting parties to substitute private arbitration for judicial resolution of contract disputes. . . . If courts refused to enforce the efficiency criterion in [areas where there is no voluntary relationship between the disputants] . . . the likely consequence would be legislative preemption of a major sphere of judicial autonomy—the fashioning of common law rules and doctrines.”); Paul H. Rubin, *Business Firms and the Common Law* 5 (1983) (suggesting that a bias in favor of re-litigating inefficient legal rules produces efficient common law legal rules).

it results in the allocation to one party of a greater share of the transaction's aggregate value, an amount sufficient to compensate that party for a decrease in the aggregate value of the transaction as a whole. Or, more colloquially, the portion of the pie (representing the aggregate transaction value) taken by the party who benefits from that negotiation strategy increases, even if the total size of the pie is diminished.

A third possible rationale for the persistence of this negotiation strategy could be the presence of unreasonable lawyers as an artifact of path dependence.¹³ That is, even if the use of unreasonable lawyers would not be efficient if one could unilaterally impose an alternative on the relevant community, the manner in which transactional practice has developed could prevent a transition to a more efficient alternative.

If this type of negotiation were always inefficient, one would expect reputational factors to permit the achievement of a more efficient outcome. This outcome should occur particularly in the largest commercial transactions involving the best known law firms in large cities. In these transactions, the frequency of interaction should facilitate dissemination of reputations. Of course, it is not obvious that reputational factors could eliminate all substantially inefficient bargaining strategies. Opportunism may persist if there is an insufficient number of interactions to permit reputations to be adequately formed or if mechanisms to propagate reputations are inadequate.¹⁴

In summary, although the persistence of a negotiation strategy that proposes latent contractual terms that would not necessarily have been agreed upon otherwise raises the question of whether it is efficient, its persistence does not conclusively demonstrate that it is. This Article argues that contractual relationships created by this negotiation strategy can be efficient based on the concept of a

13. Recent scholarship has argued that, in some contexts, path dependence can cause inefficient outcomes to persist. See, e.g., Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 Wash. U. L.Q. 347, 348, 365-66 (1996) (describing "standardization" as "a form of path dependence"); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 Harv. L. Rev. 641, 643-44 (1996).

14. See Ronald J. Gilson & Robert H. Mnookin, *Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns*, 41 Stan. L. Rev. 567, 579 (1989) [hereinafter Gilson & Mnookin, *Coming of Age*]. David Charny notes that a firm may enhance the extent to which concerns for its reputation restrain opportunism by making investments to develop its reputation. See David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 375, 400 (1990) [hereinafter Charny, *Nonlegal Sanctions*] (discussing manufacturers). He also argues that the participation of a union in labor negotiations can cause the parties to be "repeat player[s]," increasing the significance of the employer's reputation. See *id.* at 418.

“hostage” developed by Oliver E. Williamson.¹⁵ Williamson argues that opportunistic behavior by one party to a contractual relationship can be reduced through a “credible commitment” effected by the delivery of a hostage.¹⁶ Part I briefly outlines the use of hostages in contractual relationships. This Part reviews the value provided by hostages and presents alternative solutions to opportunism, such as the use of vague contractual undertakings.

One limitation of the use of hostages to restrain opportunism is that the context of a transaction may not provide an obvious hostage. Part II examines how lawyers create hostages in the form of unreasonable contractual rights that limit future opportunistic behavior. One criterion a hostage must meet, if it is to be efficacious, is the hostage must have little value to the hostage-holder other than deterrence of the other party’s opportunism.¹⁷ If the holder of a hostage can gain value by diverting the hostage to its own use, the delivery of that hostage may reduce opportunism by the delivering party, only to increase opportunism by the party taking the hostage. Ultimately, that resolution would not provide a solution to potential opportunism, thereby eliminating the benefit derived from such an exchange. This Part argues that contract provisions that may appear to be unreasonable are, in fact, well suited to performing the function of a hostage.

Part II additionally reviews the mechanics by which commercial transactions are negotiated, noting that there are costs arising from the negotiation of hostages. These costs can arise where the taking of a hostage sends a false signal to the other party, indicating uncooperative behavior or mistrust. These signals may prevent contract formation or may otherwise increase the costs of contracting. This Part proposes taking a “hidden” contractual right (or hostage)—taking a hostage from a party who is not aware that it has provided a hostage.¹⁸ Such actions may avoid the increased negotiation costs that result from the negotiation of hostages.

Parts III, IV and V examine implications of this negotiation strategy. Part III reviews the impact of this strategy on lawyers’ reputations. This Part argues that one consequence of the adoption of

15. See Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 *Am. Econ. Rev.* 519, 522-26 (1983) [hereinafter Williamson, *Credible Commitments*] (discussing “The Hostage Model”).

16. *Id.* at 519. One example of such a hostage would be a supplier’s location of a factory close to the customer. See *id.* at 526.

17. See *infra* note 62 and accompanying text.

18. Those who unilaterally take hostages are generally labeled “terrorists.” For this reason, lawyers who seek to increase joint transaction value—those described as “transaction cost engineers”—by unilaterally seizing hostages can be identified as “terrorist transaction cost engineers.” See generally Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *Yale L.J.* 239, 255 (1984) (coining the term “transaction cost engineer”).

negotiation strategies involving the acquisition of hidden contractual hostages is a negative accretion in lawyers' reputations.

Part IV reviews selected principles of contract law and their impact on the ability to create hidden contractual rights.¹⁹ If the creation of hidden contractual hostages can increase transaction value, that fact has implications on the selection of contract construction rules.

As discussed in Part IV, certain principles of contract construction, and certain defenses to the enforcement of a contract, limit the ability of lawyers to seize hidden contractual hostages. These principles and defenses not only limit the ability of transactional lawyers who identify risks to allocate these risks by contract but also decrease the incentive for a lawyer to identify contingent risks during contract negotiations. Part V examines the implications of this decreased incentive on lawyer conduct.

I. USE OF HOSTAGES TO LIMIT OPPORTUNISM

A. *Opportunism in Contract Performance*

The potential value the granting of a hostage may provide to a commercial relationship derives from the extent to which that mechanism may restrain opportunism.²⁰ The value that may be provided by hostages thus depends on both the reasons why opportunism arises and the alternative mechanisms used to restrain it.

19. Alan Schwartz asserts that courts more frequently interpret contract terms literally in relational contexts, on the basis that an inability of the parties to have fully specified the terms that should govern their relationships is related to an inability of a court, *ex post*, to determine the appropriate risk allocations. See Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. Legal Stud. 271, 271-74 (1992) [hereinafter Schwartz, *Relational Contracts*]. Part IV does not purport to provide a theme that rationalizes decided cases, as does Schwartz; rather it is confined to articulating the impact of various rules of interpretation on the ability to take hidden contractual hostages.

20. Opportunism arises where "a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer." Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 Minn. L. Rev. 521, 521 (1981). Although this definition is sufficient for purposes of this Article, there are a number of alternative formulations. One alternative involves an expanded definition: "Contractual opportunism generally involves a party's attempt to capture a greater share of the return on a contract. Sometimes this self-aggrandizement is condemned because it reduces the joint return on a contract; other times, it is condemned because it violates contract-based expectations." Mark P. Gergen, *The Use of Open Terms in Contract*, 92 Colum. L. Rev. 997, 1002 (1992) [hereinafter Gergen, *Open Terms*]. Another provides the following discussion: "The term 'opportunism' has no precise definition but is a word often used by economists to denote what most people would call unethical or crafty behavior." G. Richard Shell, *Substituting Ethical Standards for Common Law Rules in Commercial Cases: An Emerging Statutory Trend*, 82 Nw. U. L. Rev. 1198, 1199 n.5 (1988) [hereinafter Shell, *Ethical Standards*]. Posner states, "This example shows that another name for opportunism is—monopoly." Posner, *supra* note 12, at 92.

The potential for opportunism arises in circumstances where the parties cannot feasibly envision all possible future circumstances that might have an impact on the performance to be rendered and therefore do not expressly and knowingly incorporate in their agreements practicably enforceable provisions pertaining to the rights and duties in those circumstances. The potential for opportunistic contract performance is pervasive, as commercial contracts frequently will be incomplete.²¹

A contract may be incomplete in two main ways. First, a contract may clearly assign applicable rights and duties. Nevertheless, that contract can be considered incomplete if the particular circumstances in which performance is to be rendered were not expressly contemplated by the parties during the negotiation of the contract and the circumstances that do occur are materially different from those that were contemplated when the contract was formed.²² Alternatively, a contract may not specify the rights and duties applicable in a future state that arises.²³ Both forms of incompleteness may be illustrated with simple examples.

The first type of incompleteness frequently arises in commercial leases involving percentage rent. A commercial lease may provide for rent calculated, in part, based on the tenant's income from the premises. The tenant under such a lease may take a number of actions that decrease the variable portion of the rent: it may open a competing store at a nearby location,²⁴ change the nature of the

21. See Wenke, *supra* note 1, at 92; Oliver E. Williamson, *The Economic Institutions of Capitalism* 178 (1985) [hereinafter Williamson, *Capitalism*]; Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821, 821 (1992); Edward A. Bernstein, *Law & Economics and the Structure of Value Adding Contracts: A Contract Lawyer's View of the Law & Economics Literature*, 74 Or. L. Rev. 189, 212-13 (1995) [hereinafter Bernstein, *Law & Economics*]; David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815, 1819 (1991) [hereinafter Charny, *Hypothetical Bargains*]; Gilson & Mnookin, *Disputing Through Agents*, *supra* note 1, at 517 n.23; Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 Cornell L. Rev. 608, 609 (1998); Subha Narasimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 Cal. L. Rev. 1123, 1129, 1138 (1986); Williamson, *Credible Commitments*, *supra* note 15, at 527.

22. See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261, 270 (1985) ("When a contract fails to provide for a contingency, unintended results may occur. . . . Note that contractual instructions, although incomplete, may nonetheless specify a perfectly well-defined and clear result for each contingency. . . ."); cf. Schwartz, *Relational Contracts*, *supra* note 19, at 272 (asserting that courts occasionally supply additional terms to contracts that appear facially complete).

23. See, e.g., Schwartz, *Relational Contracts*, *supra* note 19, at 272 (articulating a similar dichotomy by describing a contract as being incomplete where either it "has a true gap—for example, no price term—or . . . partitions future states or potential contracting partners 'too coarsely'").

24. See *id.* at 275.

business activities undertaken at the demised premises,²⁵ or vacate the premises.²⁶ For example, in *Bastian v. Albertson's, Inc.*,²⁷ a firm operating a supermarket vacated its leased premises, for which it was obligated to pay rent equal to the greater of a fixed amount or 1.5% of gross sales, and moved to a nearby location.²⁸ The tenant refused to terminate the lease, and the premises remained vacant.²⁹ The tenant, in refusing to terminate the lease, may have sought to limit its competition by preventing the location of a competing business in its former premises.

No express contractual provisions afforded the landlord a remedy; the actions of the tenant conformed with the literal terms of the contract.³⁰ The landlord, however, successfully argued the existence of an implied covenant to pay a "reasonable and adequate rent to the lessors during the time the lessee chose not to operate its supermarket on the premises."³¹ Thus, a contract may be considered incomplete where it provides for rights and duties but does not expressly modify those rights and duties (or reaffirm their application) in unforeseen circumstances, or circumstances that were foreseen but disregarded, that subsequently arise.

A contract also may be incomplete by failing to provide for the rights and duties applicable in a circumstance that does arise. An example of such a contract would be one calling for the payment, at a future time, in a currency of a government not in existence at the time performance becomes due.³²

25. See, e.g., *Lippman v. Sears, Roebuck & Co.*, 280 P.2d 775, 778, 781 (Cal. 1955) (stating, in a case where the tenant changed the use of the property from a sales location to a storage location, a trial court finding that the minimum rental "was not a substantial and adequate minimum rent to be paid in lieu of a percentage of the sales is a sufficient basis for a determination that Sears[, the tenant,] impliedly covenanted to use the demised premises for the sale of merchandise").

26. See, e.g., *College Block v. Atlantic Richfield Co.*, 206 Cal. App. 3d 1376, 1379, 1383 (1988) (holding, in a case in which the tenant ceased operating a gas station on the premises, that a covenant of continued operation will be implied only if the guaranteed minimum is "not substantial" and does not "provide [the landlord] with a fair return on its investment").

27. 643 P.2d 1079 (Idaho 1982).

28. See *id.* at 1080-81.

29. See *id.* at 1080.

30. See *id.*

31. *Id.* at 1085. *Brown v. Safeway Stores, Inc.*, 617 P.2d 704, 706-07 (Wash. 1980) (en banc), involved a similar pattern in which a tenant vacated premises formerly used for a supermarket and moved to a nearby location. The lease provided for rent equal to the greater of a fixed amount or 1.5% of gross sales and granted the tenant the unconditional right to sublease the premises. See *id.* at 706, 710. The tenant subleased the property to an Asian grocery and import business. See *id.* at 707. The court held that there was no implied limitation on the tenant's right to sublease the premises, and therefore, the tenant was not required to sublease the property only to a sublessee generating comparable gross sales. See *id.* at 710-11.

32. See, e.g., *Thorington v. Smith*, 75 U.S. 1, 14 (1868) (holding a party "entitled to be paid in . . . Confederate dollars can recover their actual value at the time and place of the contract, in lawful money of the United States").

The factors that result in incomplete contracts, even in highly negotiated transactions, are familiar. The limitations of language permit the plausible assertion that any but the most simple contract is ambiguous in some regard.³³ Different language conventions within particular groups can introduce more ambiguity. Additionally, an incomplete contract may be knowingly accepted in order to cut costs.³⁴ In many contracts, particularly those calling for performance to be rendered a material amount of time in the future, the costs of negotiating the express allocation of all possible material risks, including remote risks, may be prohibitive.³⁵ Moreover, the contracting parties may be unaware of many of the events that may materially affect the nature and value of the performance of a contract.

When parties to highly negotiated commercial transactions are negotiating contracts, it is understood that circumstances not adequately addressed in their contracts may arise. In such cases, a variety of mechanisms are used by parties at the contract formation stage to limit opportunistic conduct during contract performance. If both parties are in a position to act opportunistically, they could attempt to require simultaneous performance.³⁶ The possibility that opportunistic behavior would be met with opportunistic behavior could, in such circumstances, result in cooperative behavior. For transactions not conducive to simultaneous performance, the parties may segment the performance of each into smaller increments, creating a transaction-specific reputation that could limit

33. See, e.g., *Frigalment Importing Co. v. B.N.S. Int'l Sales Corp.*, 190 F. Supp. 116, 117 (S.D.N.Y. 1960), cited in Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 Mich. L. Rev. 215, 222 n.21 (1990) (detailing a dispute over whether a contract for the sale of "chicken" included "stewing chicken"); Shell, *Ethical Standards*, supra note 20, at 1227 (discussing *Homsi v. C. H. Babb Co.*, 409 N.E.2d 219, 223 (Mass. 1980), in which a seller of an oven agreed to provide the purchaser with the "necessary gas"). The appellate court in *Homsi* affirmed a trial court's finding that the seller's failure to disclose in the contract that the term "gas" meant propane gas was actionable as a deceptive practice under Massachusetts law, where the seller knew that the term would be interpreted by the buyer to mean natural gas, which was significantly less expensive. See *Homsi*, 409 N.E.2d at 223-24.

34. See, e.g., Charles B. Craver, *Effective Legal Negotiation and Settlement* 155-56 (3d ed. 1997) (discussing the benefits of "constructive ambiguity"); Wenke, supra note 1, at 92-93 (indicating that ambiguity may be necessary if an agreement is to be reached).

35. See, e.g., Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 Ind. L.J. 45, 52 n.51 (1995) [hereinafter Gergen, *Defense*]; Schwartz, *Relational Contracts*, supra note 19, at 278-80 ("In sum, contracts can be incomplete because of (1) the inevitable limitations of language, (2) party inadvertence, (3) the costs of creating contract terms, (4) asymmetric information, and (5) a preference on one side of the transaction for anonymity (that is, pooling).").

36. See G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 Vand. L. Rev. 221, 253 (1991) [hereinafter Shell, *Opportunism*].

opportunism. The parties also can attempt to build into the contract a mechanism by which their performance is monitored on an ongoing basis.

Where these solutions are not available, the parties can instead agree to a vague standard limiting opportunism. For example, one party could agree to use its "best efforts" or "reasonable best efforts" in performing a specified contractual obligation. Or a party may merely rely on an appropriate resolution to be provided by a generally applicable principle of contract law,³⁷ such as the implied covenant of good faith³⁸ or a defense such as impracticability³⁹ or mistake.⁴⁰

This approach to restricting opportunism also has limitations. The application of such provisions to a specific factual pattern can be uncertain.⁴¹ Even if the parties can detect opportunistic behavior that should be proscribed by one of these nebulous contractual provisions, the victim may be unable to produce evidence adequate to cause a judicial determination in its favor in any resulting litigation.⁴² This uncertainty can increase costs by producing increased litigation arising from the indeterminacy of the application of deliberately ambiguous language to a specific factual pattern.⁴³

B. *Value of Hostages in Restraining Opportunism*

An alternative mechanism used to restrain one party's opportunism in the performance of an incomplete contract involves the delivery of

37. Cf. Gergen, *Defense*, *supra* note 35, at 93 (identifying a similarity between nebulous contractual undertakings, such as one calling for "best efforts", and doctrines that excuse performance).

38. See U.C.C. § 1-203, 1 U.L.A. 109 (master ed. 1989); Restatement (Second) of Contracts § 205 (1981).

39. See U.C.C. § 2-615, 1B U.L.A. 195; Restatement (Second) of Contracts § 261. A party to a highly negotiated and documented transaction is unlikely to rely on doctrines of contract interpretation and enforcement to provide a suitable risk allocation, and omit an express contractual allocation, where the risk is material and not remote, and the application of the doctrine to the particular factual pattern is uncertain. See Gergen, *Defense*, *supra* note 35, at 54-55 (discussing impracticability).

40. See Restatement (Second) of Contracts §§ 151-158.

41. See Gilson & Mnookin, *Disputing Through Agents*, *supra* note 1, at 518-19 (discussing nebulous contract provisions); cf. Steven J. Burton, *Default Principles, Legitimacy, and the Authority of a Contract*, 3 S. Cal. Interdisc. L.J. 115, 136 (1993) (stating, concerning the principle that contractual gaps should be filled with the provisions the parties would have supplied, that "[a] growing consensus among economic analysts suggests that finding the efficient market-mimicking default rule is a great deal more difficult than Posner had imagined when he developed his theory").

42. Cf. Roland Kirstein & Dieter Schmidtchen, *Judicial Detection Skill and Contractual Compliance*, 17 Int'l Rev. L. & Econ. 509, 512-19 (1997) (providing a model of contracting in an environment incorporating incomplete judicial detection skills).

43. For similar reasons, uncertainty as to the content of legal rules can prevent efficient business planning. See Shell, *Ethical Standards*, *supra* note 20, at 1242 ("Clear rules allow businesspeople to better plan future economic activity.").

a hostage by that party.⁴⁴ Parties to commercial relationships have adopted this mechanism to restrain opportunism in a variety of contexts.⁴⁵

In one view of secured lending arrangements, the granting of rights to repossess collateral provides the lender with the ability to disrupt all or a portion of the debtor's business, and this arrangement deters opportunistic behavior by the debtor.⁴⁶ Excessively stringent bank loan covenants can perform a similar function.⁴⁷

The examples are not limited to commercial lending, however. A provision in a franchise agreement permitting the franchisor to terminate the agreement at will constitutes another example of such a hostage.⁴⁸ The possibility that the franchisor may terminate the franchise, and the resulting loss to the franchisee of its investments in building goodwill for the franchise, imposes incentives on the franchisee to operate the franchise in a fashion that contributes to the positive reputation of the franchisor and other franchisees.

Margaret F. Brinig identified a particularly memorable example of hostage delivery that involves the historical development of the custom of delivering engagement rings.⁴⁹ She notes that this custom became more prevalent in the period between the two world wars at a time when states were abolishing the cause of action for breach of a contract to marry.⁵⁰ She states that during the period,

[A] woman was expected to remain chaste until the time of her engagement. Once she was betrothed, however, sexual intimacy with her fiancé reportedly occurred nearly half the time. All this was well and good, but if the marriage never came about, she was irretrievably barred from offering an unblemished self to a new suitor and suffered a loss in "market value."⁵¹

Thus, in her view, the delivery of the ring served as an extra-legal substitute for the disappearing contract-based cause of action.⁵²

Other examples include "earnest money" deposits, such as deposits in typical contracts for the sale of real estate;⁵³ excessive liquidated

44. See Williamson, *Credible Commitments*, *supra* note 15, at 527.

45. See *supra* notes 27-30 and accompanying text (detailing how a decision about plant location can be used to restrain opportunism).

46. See Robert E. Scott, *The Truth About Secured Financing*, 82 Cornell L. Rev. 1436, 1448-52 (1997).

47. Cf. Bernstein, *Law & Economics*, *supra* note 21, at 223 (describing these covenants as being accompanied by an unenforceable undertaking by the lender not to enforce the covenants unreasonably).

48. See *id.* at 218-20; Muris, *supra* note 20, at 576-77; Williamson, *Credible Commitments*, *supra* note 15, at 529.

49. See Margaret F. Brinig, *Rings and Promises*, 6 J.L. Econ. & Org. 203, 203-04 (1990).

50. See *id.* at 205.

51. *Id.* (citations and footnote omitted).

52. See *id.* at 211.

53. See Carol M. Rose, *Trust in the Mirror of Betrayal*, 75 B.U. L. Rev. 531, 537

damages,⁵⁴ lower wages paid to employees in the early years of employment, accompanied by higher levels in later years;⁵⁵ and provisions in commercial leases obligating tenants to pay for improvements.⁵⁶

Yet there is an important distinction to be drawn among these hostages. The retention of a hostage may not be a zero sum event. The benefit to the holder of the hostage from not returning the hostage may not be equal to the detriment suffered by the party who relinquished the hostage, and, in fact, varies according to the type of hostage involved. It is not novel to note that, on this basis, one can distinguish, for example, the hostage inherent in secured lending from the hostage elements of deposits in real estate contracts, excessive liquidated damages and, in some contexts, the termination of a franchise. Additionally, one can distinguish hostages whose seizure requires judicial process,⁵⁷ such as excessive liquidated damages provisions.⁵⁸

For example, the value to a creditor of the assets seized upon exercise of a security interest frequently will be less than the value of the assets to the debtor.⁵⁹ It will be costly for a bank to sell assets seized upon exercise of a security interest. And a debtor's loss of its tangible assets may divest it of goodwill that cannot be realized by the secured party in a subsequent sale of the collateral. Thus, the value to a creditor realized by exercising a security interest may be less, sometimes substantially less, than the diminution in value incurred by the debtor. A lender's exercise of its rights in the collateral may be a "negative sum" event. One might call such a hostage, in which the direct value of the hostage to the hostage-taker is less than the value of the hostage to the other party, a "negative sum" hostage.

Hostages in the form of cash do not have this negative sum characteristic. The hostage-taker essentially acquires the value that the party granting the hostage has relinquished. One could

(1995).

54. See Gergen, *Defense*, *supra* note 35, at 61-62 (questioning the efficacy of this form of hostage).

55. See Charny, *Nonlegal Sanctions*, *supra* note 14, at 396 ("[T]he worker in his early years posts a bond—in the form of 'uncompensated' labor—that the employer returns to him if he holds his job into later years.").

56. See Bernstein, *Law & Economics*, *supra* note 21, at 219.

57. Cf. Gergen, *Defense*, *supra* note 35, at 62 (noting the decreased effectiveness of bonds, the realization of which requires resort to judicial process).

58. Cf. *id.* (arguing that excessive liquidated damages are "poor security for performance").

59. See Scott, *supra* note 46, at 1457-58; cf. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 964-65 (1997) (valuing collateral in a cram down under 11 U.S.C. § 1325(a)(5)(B) as the "cost the debtor would incur to obtain a like asset for the same 'proposed . . . use,'" as opposed to the value that would be obtained in a foreclosure sale); Charny, *Nonlegal Sanctions*, *supra* note 14, at 407, 420-22 (discussing consumer credit).

characterize such a hostage as a “zero sum” hostage. Zero sum hostages are not uncommon. A franchisor’s right to terminate a franchise at will could be a zero sum hostage if the franchisor can capture the goodwill forfeited by the franchisee on termination of the franchise.⁶⁰ Similarly, a long-term lender’s right to accelerate a loan could be essentially zero sum, or could become less negative sum, if interest rates were to rise after a loan had been extended. In that case, the lender’s realization of less than the outstanding principal amount could be offset, in whole or in part, by the ability to extend a loan at a higher interest rate.⁶¹

This distinction between negative sum and zero sum hostages is important in determining whether the taking of a hostage, to deter opportunistic behavior by one party, creates incentives for the hostage-taker to act opportunistically by improperly retaining the hostage. The preferred type of hostage is significantly negative sum, deterring opportunism by the party who grants the hostage while providing no direct incentive for the hostage-taker to divert the hostage to its own purposes.⁶²

Even with hostages that have no direct value when appropriated for the purposes of the hostage-taker, there is some risk that the delivery of a hostage will increase opportunism by the holder of the hostage. For example, a lender could seek to extract a fee from a debtor in exchange for not accelerating indebtedness, even if there were no opportunity for the lender to extend credit to other potential borrowers at a higher interest rate. But the sequence of “play” can undermine the credibility of the threat.⁶³ Frequently, after the lender makes the threat, there is no compelling reason to follow the threatened course if the borrower does not pay the requested fee. For the threat to be most effective, the lender would have to bind itself to accelerating the loan—to killing the hostage—if the fee were not paid, at a time when the borrower had not irrevocably determined whether to pay the fee.⁶⁴

60. See Bernstein, *Law & Economics*, *supra* note 21, at 220 n.87 (describing this type of hostage as a “beautiful prince(ss)” (alteration in original)).

61. See Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 *Geo. Mason L. Rev.* 45, 51-59 (1998).

62. See Charny, *Nonlegal Sanctions*, *supra* note 14, at 406-07; Williamson, *Credible Commitments*, *supra* note 15, at 526-27. This type of hostage poses the potential for a net resource loss if the hostage is retained by the hostage-taker. See Charny, *Nonlegal Sanctions*, *supra* note 14, at 406. Thus, a significantly negative sum hostage could be problematic if there were also a direct benefit to the hostage-taker from retaining the hostage for its own purposes.

63. See generally Katz, *supra* note 33, at 235-37 (discussing rationality of subgames).

64. *But cf.* David C. Croson & Robert H. Mnookin, *Scaling the Stonewall: Retaining Lawyers to Bolster Credibility*, 1 *Harv. Negotiation L. Rev.* 65, 65-66, 74-75 (1996) (arguing that a non-refundable retainer can bind a prospective plaintiff to bringing a lawsuit and induce a settlement of a claim worth less than the cost to

In this circumstance, the importance of a lender's reputation can increase the likelihood of opportunism. A party who possesses a hostage that provides no direct benefit upon its exercise could nevertheless exercise the hostage to develop a reputation for doing so, in order to extract gains in future transactions.⁶⁵ One expects, however, that activity would be tempered by the impact of that reputation on the frequency of future transactions. Although those already in contracts with that party may believe threats to retain hostages, others contemplating entering into future transactions could decide to avoid entering into a contract with such an unreasonable party.⁶⁶ Alternatively, if the potential loss to the party who relinquished the hostage were very large, one could envision that a not otherwise credible threat to retain the hostage could nevertheless influence that party's actions.

Thus, for a variety of reasons, even a substantially negative sum hostage could give rise to opportunism by the party holding the hostage. These various possible outcomes do not permit the formulation of universally applicable conclusions. Hostages will increase the joint value of a transaction in some circumstances, and the consequential increase in the value of opportunism to the hostage-taker in other circumstances will cause the delivery of a hostage to decrease a transaction's joint value.

II. IMPLICATIONS FOR TRANSACTIONAL LAWYERS

Part I discussed the value hostages can add to commercial relationships by deterring opportunism. Negative sum hostages are particularly useful, because they restrict opportunism by one party but do not encourage, or encourage to a diminished extent, opportunism by the other party. Part II reviews the environment of the negotiation of substantial commercial transactions between sophisticated parties represented by counsel. This Part also reviews the method by which transactional lawyers in such a context further their clients' interests by providing for the delivery of alternative forms of hostages.⁶⁷

litigate the claim and that "[b]y sending some signal that she is aware of the tactic . . . the plaintiff should be able to convince a rational defendant that settling before the retainer is paid could be mutually beneficial").

65. Cf. Charny, *Nonlegal Sanctions*, *supra* note 14, at 407 (noting that lenders to consumers may seize collateral to develop a "reputation for 'toughness' among borrowers who might be tempted to default").

66. It is unlikely that a party who retains a hostage can limit the dissemination of its reputation for retaining hostages to firms with which it already has business, while preventing its transmission to mere potential contracting partners.

67. Excluded from this discussion are other transactions, such as those memorialized in contracts of adhesion and transactions in which not all parties are represented by counsel. These transactions raise other issues. See, e.g., Rex R. Perschbacher, *Regulating Lawyers' Negotiations*, 27 *Ariz. L. Rev.* 75, 91 (1985) (indicating an unrepresented party may rely on the expertise of counsel representing an opposing party).

A. Elements of Negotiation

The use of hostages can add value in transactions that otherwise could be infected by opportunism. But the nature of commercial relationships restricts parties' abilities to negotiate for the provision of hostages in transactions that could benefit from the delivery of hostages.

A party's posture in negotiating a commercial contract can disclose information concerning the manner in which that party will perform its obligations. A confrontational posture during the negotiation may signal that confrontation will also arise during the course of contract performance. For example, some have argued that raising non-financial issues during the bargaining process may signal a tendency towards uncooperative action during contract performance.⁶⁸ In this view, a concern for the language used to address non-financial issues may indicate a party will seek to rely on the express terms of the contract, as opposed to referencing the actions that maximize collective welfare, to resolve issues arising during performance of the contract.

Because complex commercial contracts generally cannot expressly articulate the rights and duties that should pertain in all possible future states,⁶⁹ this signal can be of particular importance during the negotiation of complex commercial contracts. Until a definitive agreement is executed, parties negotiating a commercial contract are frequently free to terminate pursuit of the prospective relationship.⁷⁰

68. See Bernstein, *Law & Economics*, *supra* note 21, at 229-30; Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. Cal. Interdisc. L.J. 59, 70-71 (1993) [hereinafter Bernstein, *Social Norms*]; Charny, *Nonlegal Sanctions*, *supra* note 14, at 405 ("Negotiation may also create or intensify an adversarial atmosphere by raising the specter of litigation for transactors who wish to view themselves as friends or partners."); Korobkin, *supra* note 21, at 621; *cf.* Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 Or. L. Rev. 239, 249-50 (1995) [hereinafter Bernstein, *Silicon Valley*] ("[A Silicon Valley] lawyer noted, '[w]hen I deal with lawyers in other parts of the country, they . . . will go crazy over a lot of stuff that would just draw a yawn from a Silicon Valley law firm.' Because the post-deal relationship between the entrepreneur and the fund is like a partnership, contentious or prolonged pre-transaction negotiations that erode trust and goodwill may impose particularly high costs on the parties. . . . [R]educing these types of 'attitudinal' negotiating costs may also reduce the likelihood of transaction breakdown. . . ." (third alteration in original)(footnotes omitted)); Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 Yale L.J. 369, 397 (1990) [hereinafter Schwartz, *The Myth*] (arguing that parties may not seek to include contract provisions providing for the reimbursement of the legal fees of the prevailing party in subsequent litigation, because the request for such a provision sends a bad signal).

69. See generally *supra* notes 21-23 and accompanying text (discussing how failing to consider potential future consequences can result in incomplete contracts).

70. See generally E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum. L. Rev. 217 (1987) (discussing the extent to which actions prior to execution of a definitive agreement can result in contractual obligations).

Consequently, signals indicating one party's performance will not be cooperative may cause the other party to terminate the negotiations.⁷¹ Alternatively, a party receiving those signals may decide to continue the negotiations but document the relationship more completely, increasing the costs of negotiation for both parties.

Other commentators have noted the importance of building trust in complex commercial negotiations.⁷² The process of building trust during the negotiation of commercial contracts does not simply involve avoiding the conveyance of certain signals addressing one's own future actions. One party's negotiation of a commercial contract also can signal the extent to which it trusts the other party. And the two types of signals are interrelated.⁷³ It is difficult for a party to build trust while simultaneously taking actions that indicate mistrust of the other party.

B. *Impact of Seeking Hostages on Negotiations; Alternative Forms of Hostages*

The importance of trust in the negotiation of commercial contracts affects a party's ability to negotiate expressly for the delivery of a hostage, as a request for the delivery of a hostage signals an absence of trust. This fact will affect the manner in which parties seek to negotiate for hostages.

One common element in the negotiation of complex commercial relationships is the discussion of the reasons underlying a party's request for certain contractual rights. If a proposed term in a contract adversely affects one party, it is natural for that party to seek to identify the rationale underlying the term. An understanding of the rationale can permit an alternative resolution to be reached, achieving the same benefits at a lesser cost for the adversely affected party.

This understanding of the process of negotiation exposes a problem with attempts to take hostages. A party seeking to take a hostage must be prepared to provide a rationale for the requested provision. Consider, for example, a secured lender providing the borrower with a rationale for requesting a security interest.⁷⁴ The lender could identify

71. See Bernstein, *Law & Economics*, *supra* note 21, at 230; Bernstein, *Social Norms*, *supra* note 68, at 71; cf. *Lippo v. Mobil Oil Corp.*, 776 F.2d 706, 725 (7th Cir. 1985) (Posner, J., dissenting in part) (stating, in criticizing Lippo's interpretation of its contract with Mobil, which Judge Posner found unreasonable: "It seems to me pretty obvious that Mobil would never have agreed to such an application and that for Lippo to have pressed for it would just have convinced Mobil of Lippo's unreliability and have made the negotiations collapse.").

72. See Shell, *Opportunism*, *supra* note 36, at 252-53; Rose, *supra* note 53, at 531-32.

73. Rose argues that parties who are monitored because they are not trusted may behave less cooperatively by virtue of that monitoring. See Rose, *supra* note 53, at 540.

74. See *supra* note 46 and accompanying text.

its mistrust of the borrower and its desire to punish the debtor if the debtor misbehaves by either investing in excessively risky projects or engaging in self-dealing, for example. But the articulation of this rationale does not foster the building of trust in the relationship. That response may result in the termination of the negotiations or an increase in negotiation costs.⁷⁵

A transactional lawyer has two methods by which he can seek to diminish the adverse impact of a hostage request on the tenor of the relationship between the parties. First, a transactional lawyer who knows his client seeks to take a hostage can obfuscate the reason underlying the request for the relevant contractual provision. For example, he could indicate the provision in question is "standard" or "customary," without articulating the intent to take a hostage. The advantage of this reply is that, if true, it eliminates the secondary signal inherent in the request for a particular contractual provision. If all parties in the lender's position seek a particular contractual provision, any lender's request for that provision provides no information about the lender to the borrower.

A second method for diminishing the strength of the adverse signal arising from seeking a hostage is more controversial. The lawyer may seek to take a "latent" or "hidden" hostage. In this case, the lawyer seizes the hostage without the knowledge of the party who has relinquished it. Frequently, these hostages can be created by providing an overinclusive contract provision. In such a case, counsel drafts a provision that addresses one issue in a "reasonable" way but expands the language so that it also addresses and allocates to the other party, in an unreasonable, latent fashion, the risk of a second contingency.

This method of seeking a hostage can tax the skill of a transactional lawyer. The skillful drafting of the clause in question may cause opposing counsel immediately to identify the issue that is addressed reasonably and to overlook the other implications. Yet opposing counsel may inquire as to the consequences of the provision. In that circumstance, the lawyer seeking to seize the hidden hostage may identify the benign rationale without raising the second consequence, with the hope that the other counsel will not grasp the second meaning.⁷⁶ Artfulness frequently is required for success, because

75. In commercial loans, the borrower generally agrees to pay the counsel fees of the lender. See, e.g., Jonathan R. Harris, *Loan Agreement Among Specialty Steel Company, Inc., Groveland International Distributions, Inc., Wesley-Harding, Inc. and Megabank, N.A.* § 12.04, in *Drafting Commercial Documents Series 1996*, at 159, 278 (Massachusetts Continuing Legal Educ., Inc., No. 96-04.15, 1996). Consequently, in this case, the increased cost would be borne to a great extent by the borrower itself.

76. See generally Craver, *supra* note 34 at 411 ("In most instances . . . selective disclosures are expected by opponents and are considered an inherent aspect of negotiation interactions."). If litigation arises concerning the process by which contractual provisions were negotiated, the parties frequently will be unable to

direct misstatements may provide a fraud defense to the enforcement of the contract,⁷⁷ while the provision of a convoluted response, in order to avoid making a fraudulent statement, may alert opposing counsel to the need for greater review of the provision in question.

The methods by which counsel can seize a hidden contractual hostage limit the range of possible hostages. For example, it would be difficult for a lender to obtain an enforceable security interest without the knowing assent of the borrower. The documentation requirements are too stringent.

One example of such a hostage, however, is the provision that refers to an international convention in defining the jurisdictions in which a lessee may register an aircraft.⁷⁸ This contractual provision could operate as a "hidden" hostage. For example, an aircraft lease will address various aspects of the lessee's use of the aircraft, including maintenance requirements.⁷⁹ During the term of the lease, technological developments may obviate the need to perform certain maintenance. Suppose that one such development during the term of a lease could decrease maintenance costs by \$500,000 without adversely affecting the value of the aircraft at the end of the lease term. Prudent debt and equity participants would not want the trust agreement and the lease to authorize the trustee to agree to such a modification without their consent.⁸⁰ On the other hand, the trustee

recreate the history of the negotiations, although written comments delivered during the negotiations sometimes are available. *Blue Cross & Blue Shield Mutual v. Blue Cross & Blue Shield Ass'n*, 110 F.3d 318 (6th Cir. 1997), presented a case where some written comments delivered during negotiations were available to construe the meaning of a contract provision and one party used the tactic of partial articulation of the rationale for a provision. That case involved the interpretation of a provision that terminated a license agreement. *See id.* at 321-22. The licensee sought to continue the license and limit the scope of the termination provision on the following basis: A prior license agreement had, in the licensee's view, a more limited termination provision that would have been triggered only upon a party's bankruptcy or insolvency. *See id.* at 328. When the license agreement was renewed, the licensor, in discussing a revised termination provision, indicated in written comments that the new termination provision was "'an updated version' of the old provision, 'with an express reference to reversion of the [licensed service] Marks to the [licensee] in the event of [licensor's] bankruptcy. It should be noted that federal bankruptcy laws may override the automatic termination provisions hereof.'" *Id.* It appears that these comments were of the drafting party; the opinion references the comments as being "on the proposed replacement provision." *Id.* The licensee unsuccessfully sought to use these comments, made in the negotiation of the controlling provision, to limit the application of the termination provision to the types of activities contemplated by the licensor's comments—circumstances involving bankruptcy or insolvency of a party. *See id.*

77. *See generally infra* notes 161-66 and accompanying text (discussing the fraud defense to enforcement of contracts).

78. *See supra* notes 8-9 and accompanying text.

79. *See Shrank & Fritch, supra* note 6, at 157.

80. *See Davis, supra* note 3, at 66 (stating, about the lease documentation, "a . . . 'document-freezing' provision will be contained in the Indenture for the benefit of the Lenders").

would not want to incur the potential liability for not having exercised the applicable standard of care in agreeing to such a modification. In any case, the modification would not occur without the consent of the debt and equity participants. The debt and equity participants could condition their agreement to a modification in the maintenance requirements on delivery of a side payment of almost the entire \$500,000. To restrain this uncooperative behavior, the lessee could threaten to take the aircraft to a location disfavored by the debt and equity participants, for example.⁸¹

This hostage is somewhat different from the more traditional hostage, such as the delivery of a security interest. It is a contractual resolution that is hypothesized to be unusual—most contracts produced by express bargaining about the subject matter do not reach the particular resolution. Both parties may know of and bargain about the language, but it is hypothesized that the adversely affected party or parties (in this case, the debt and equity participants) do not understand the import of the language at the time the contract is negotiated. In this sense, one could refer to this hostage as “hidden.”

The language of a particular contract may not afford a lawyer the opportunity to secure a single “hidden” hostage that could be used by his client to restrain opportunism in all contexts. Yet an equivalent result could be reached through an array of “contingent” hostages. Each of these hostages could be of effect only in a subset of the possible future states in which opportunism could arise. An array of contractual hostages could deter opportunism, if at least one in the array would be effective in each potential future state. These hostages can be entirely unrelated to the opportunism to be prevented, and they can concern entirely different contract provisions.

An example based on *GTE Mobilnet Ltd. Partnership v. Telecell Cellular, Inc.*⁸² can illustrate the value of such a hidden hostage. GTE Mobilnet (“Mobilnet”) provided cellular telephone service. It used agents to solicit customers.⁸³ The terms of one agency agreement

81. In particular cases, there may be benefits to the airline from strategic exercise of these particular hostage rights. Subleasing the aircraft to a firm in a foreign country that did not afford the original mortgagee practically exercisable remedies would effectively deprive the mortgagee of its security interest. If the original mortgage did not attach to the payments from the sublessee, the airline could acquire additional financing from a third party secured by the payment stream due from the sublessee. Although divesting the original mortgagee of a method to realize on its security would not release the airline from its obligation under the lease, it would permit the airline to alter the relative priorities among its creditors. That alteration could benefit the airline by producing a lower aggregate cost of capital. The effect is similar to the impact of an LBO on existing creditors. See generally *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1507, 1526 (S.D.N.Y. 1989) (granting summary judgment in favor of a defendant issuer on a claim that an LBO contemplated by the defendant violated the implied covenant of good faith).

82. 955 S.W.2d 286 (Tex. 1997).

83. See *id.* at 288.

provided, in part, "In the event any other GTE Mobilnet agent signs an Agency Agreement containing a Schedule 2, Agent Commission Plan, with substantially and materially better terms, Agent shall be presented with an opportunity to have said Schedule 2 substituted for the Schedule 2 contained herein."⁸⁴ This type of provision is colloquially referred to as a "most favored nation" provision.

This case arose from a dispute between Mobilnet and two of these agents, Telecell Cellular, Inc., and Feingersh Young Interests, Inc. (the "complaining agents").⁸⁵ Mobilnet believed the agents had not been fulfilling their contractual obligations, and, in particular, that they "had improperly used . . . confidential information."⁸⁶ On the other hand, the agents had objections regarding the extent to which Mobilnet fulfilled its contractual obligations; Mobilnet offered certain promotions to another agent that it did not offer to the complaining agents. The complaining agents claimed the provision of the agency agreement quoted above⁸⁷ required Mobilnet to offer them promotions offered to other agents, in addition to better commission schedules.⁸⁸ The appellate court held that the quoted language was (i) not ambiguous and (ii) did not require Mobilnet to offer the complaining agents promotions offered others.⁸⁹

The precise nature of these promotions is not reported. They in some way benefited the favored agent. Promotional benefits can be of various forms. One example would be the delivery of a free phone to customers who signed up with the favored agent. Alternatively, the promotions could consist of the provision by Mobilnet of a service that the favored agent previously had to supply on its own. Some form of targeted advertising would be an example.

Either of these types of discriminatory promotions has an economic effect equivalent to charging a different fee schedule. Money is fungible. The profit available to the disfavored agent is based on the revenues from its commissions less expenses. An increase in selling expenses has the same effect on the agent's profit as a decrease in the commission schedule. If the disfavored agent has the same commission schedule but is selling a product worth less than that sold by the favored agent, the disfavored agent has to make up the difference, if it is to get business. For example, if Mobilnet provided free phones to customers who signed up with the favored agent, the disfavored agent, to compete, would have to do so as well (or provide

84. *Id.*

85. *See id.* at 288-89.

86. *GTE Mobilnet Says Ruling Reversed by Texas Court, Favoring GTE's Defense*, Radio Comm. Rep., Sept. 18, 1995, at 42, available in LEXIS, News Library, Allnews File.

87. *See supra* note 84 and accompanying text.

88. *See GTE Mobilnet*, 955 S.W.2d at 288-89.

89. *See id.* at 289.

some other benefit), but bear the cost on its own. That is equivalent to (i) having the same promotions available in all sales but (ii) giving the disfavored agent a commission rate lower per customer by the cost of a phone.

This ruling may seem harsh. But a consideration of the context suggests the power to evade the most favored nation obligation, inherent in the language drafted by Mobilnet,⁹⁰ was being used as a hostage to deter misconduct.

Although the opinion does not address the issue, it appears the complaining agents were in direct competition with the agent who received more favorable terms. That raises a question—why did Mobilnet seek preferred terms for a competing agent for performing agency duties in the same area, and risk liability to the complaining agents for doing so? The complaining agents' rationale for these acts was articulated by their counsel in a newspaper article: "'GTE had a pet agent that it paid more per activation.' This undercut her clients and gave the other agent an unfair business advantage"⁹¹

A desire to pay a "pet agent" more is not a sensible rationale. It was in Mobilnet's own economic interest not to pay a third party more for performing services identical to those being provided by the complaining agents. The rationale articulated on behalf of the complaining agents is that Mobilnet was essentially making a gift to the other agents. A much more plausible reason is that the complaining agents were not providing services of the same quality as the other agents, and Mobilnet was forced to pay the other agents more to induce the delivery of the higher level of performance that Mobilnet desired.⁹² The subject matter of the contract—solicitation of customers—did not allow precise monitoring of the effort expended

90. *See id.* at 291 ("There was much specific testimony that Mobilnet drafted [the] paragraph . . .").

91. Margaret Cronin Fisk, *GTE Mobilnet Loses on Fraud Claim*, Nat'l L.J., Feb. 28, 1994, at 16.

92. Not all cases in which a party seeks to avoid fulfilling a contractual obligation to provide equal treatment among various parties will be benign. There may have been other, inappropriate, reasons why Mobilnet sought to pay the third party a greater commission, although the fact that counsel for the complaining agents articulated a "pet agent" theory suggests the absence of a factual basis for such an alternative in that case. *Miller v. LeSea Broadcasting, Inc.*, 87 F.3d 224 (7th Cir. 1996), however, provides an illustration of a case where a party, for improper reasons, sought to avoid compliance with a contractual provision mandating equal treatment of various other parties. In *Miller*, a firm owned various television stations, of which approximately one-half of the programming was of a religious character. *See id.* at 225. The owner had granted the manager of one station a right of first refusal on any sale of that station. *See id.* There was a suggestion that the owner, in subsequently negotiating a sale of the station, structured a contract with terms designed to frustrate any attempt by the station manager to exercise his right of first refusal, for the reason that the prospective purchaser would have been more likely to continue the religious theme of the station. *See id.* at 228.

by the agent. And, as noted above,⁹³ Mobilnet had concerns that the complaining agents were improperly using confidential information, which also could be difficult to prove. So it would seem that Mobilnet sought to exercise a latent contractual right in order to punish the complaining agents for improper performance that Mobilnet could identify but thought would be difficult to prove.

In summary, this Part argues that the seizure of latent contractual hostages can increase joint transaction value in particular cases. In some cases, there may not be a natural hostage, such as those available to lenders. Additionally, express requests for hostages can derail the negotiation of an otherwise profitable transaction. These factors can cause parties to seek latent contractual hostages that increase joint transaction value.

III. LAWYERS' REPUTATIONS

The best hostages are "negative sum" hostages that limit the hostage-taker's ability to act opportunistically. Unfortunately, however, it is the provisions that provide these types of hostages that appear the most unreasonable and seem to grant the beneficiary of the provision little direct benefit while significantly punishing the other party. Two implications of this fact merit discussion. First, this method of advancing clients' interests, by taking hidden contractual hostages, affects the public perception of lawyers. This Part addresses that issue. Second, the ability to realize the benefits from this method of creating hostages is dependent on judicial contract construction that enforces these hidden hostages. Part IV discusses selected applicable principles of contract construction and selected applicable defenses to the enforcement of contracts.

A. *Consequences of the Identification of a Hidden Hostage*

Joint transaction value can be increased by the seizure of hidden hostages, but crafting hidden contractual rights requires skill. Some attempts to create hidden contractual rights are identified by the opposing counsel before definitive documentation is executed. These occasions, and the resulting client responses, affect lawyers' reputations.

When a hidden hostage is identified during the course of negotiations, it is in the interest of the potential hostage-taker to be able to disassociate itself from the attempt. The rationale for attempting to acquire a hidden hostage is that a patent request to take a hostage can signal mistrust by the hostage-taker, which can prevent a transaction from being negotiated to fruition. That a contracting

93. See *supra* note 86 and accompanying text.

party sought to acquire a hostage "silently" could well strengthen the signal.

A client can diffuse the signal by imputing responsibility to its counsel. Others have argued that lawyers can add value by lending their reputations to their clients,⁹⁴ much as investment bankers are said to lend their reputations to companies in initial public offerings in order to enhance the marketability of stock sold in an initial public offering.⁹⁵ In this context, however, counsel can act as a negative reputation "sink." Counsel, by taking responsibility for having included the offensive language, can deflect the negative reputation that otherwise would accrue to the client were the client directly responsible for the attempt to take a hidden hostage.⁹⁶

The structure of the most prestigious corporate law firms facilitates the operation of this mechanism.⁹⁷ For the negative reputation to be

94. See Gilson & Mnookin, *Disputing Through Agents*, *supra* note 1, at 512-13; Gilson, *supra* note 18, at 290-93 (discussing, *inter alia*, the importance of lawyers' reputations to the process of rendering legal opinions and accountants' reputations to the process of delivering comfort letters); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53, 61 n.20 (1986); Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. Cal. L. Rev. 507, 512-13, 574 (1994); Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 Va. L. Rev. 1707, 1739-40 (1998); cf. Walter W. Steele, Jr., *Deceptive Negotiating and High-Toned Morality*, 39 Vand. L. Rev. 1387, 1389 (1986) (indicating clients may hire lawyers to benefit from the reputations of their lawyers).

95. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 620 (1984).

96. Cf. Melvin Aron Eisenberg, *Private Ordering Through Negotiation: Dispute-Settlement and Rulemaking*, 89 Harv. L. Rev. 637, 660-62 (1976) (arguing that lawyers can facilitate dispute resolution because their presence interposes in the negotiations participants not bearing personal culpability for the acts of the clients).

A related argument concerns the reasons why clients engage outside counsel to assist in the negotiation of transactions. See Edward A. Bernstein, *Blaming the Lawyer: The Role of the Lawyer in Reducing Agency Costs 7-10* (May 21, 1998) (unpublished manuscript, on file with author) [hereinafter Bernstein, *Blaming the Lawyer*]. Certain outcomes in transactions in which an employee of a firm participates may adversely affect the employee's career. Bernstein argues that employees' risk aversion may undermine their ability to promote their employers' interests. See *id.* at 1-2. Bernstein notes that clients engage outside counsel to insulate employees from adverse professional consequences and thus eliminate the adverse impact of employees' risk aversion from two of those outcomes: transaction breakdown arising from overly aggressive negotiation and an unwise assumption of a contingent risk that subsequently comes to fruition. See *id.* at 1-3, 7-10. He argues, however, that the manner in which counsel are engaged and the organizational structure of law firms may create agency problems that limit the ability of outside counsel to realize the goals sought by clients. See *id.* at 3, 13-14; cf. Gilson & Mnookin, *Disputing Through Agents*, *supra* note 1, at 530-33 (discussing similar agency issues within a law firm).

97. Organizational structure also can affect other aspects of a law firm's performance. The fact that large law and accounting firms may have many clients will decrease the ability of a particular client to compel firm malfeasance by threatening to withdraw business. See Kraakman, *supra* note 94, at 71; see also Gilson & Mnookin, *Disputing Through Agents*, *supra* note 1, at 531 (discussing that the potential loss of

attributable solely to counsel, the structure of the relationship between lawyers and their clients must permit separation of their respective reputations. An intimate relationship between a client and its counsel would suggest that the negative acts of the lawyer should taint the reputations of both. In this context, additional bureaucratic layers between the client and the person ultimately responsible for drafting the contract would facilitate a client's ability to divorce its reputation from the actions of counsel.⁹⁸

Particularly suited to promoting this separation is a law firm structure in which the person responsible for drafting the hidden hostage is not the person directly engaged by the client. That relationship is, in fact, created in many of the most prestigious law firms in large cities. While a client may have an ongoing relationship with a partner at a prestigious law firm, substantial drafting roles are played by senior associates, and under the firms' promotion policies, the vast majority of these senior associates will have limited tenures at their firms.⁹⁹

Part of the role of an outside transactional counsel is to negotiate some provisions without involving the client in the details. In some cases, however, a client may intentionally seek to transfer responsibility for a particular negotiation posture to outside counsel. That is, a client may instruct its counsel: "Include these provisions in the next draft. I want you to say that these provisions should be included on some legal basis, and that you, the lawyer, want them

one client probably will not affect the total revenue of a large firm).

For an alternative aspect of the impact of law firm structure on law firm performance, see Ribstein, *supra* note 94, at 1715-16. He notes that larger firms may have developed reputational capital that creates incentives for those firms to restrain final period problems that would otherwise affect the performance of individual lawyers. *See id.* at 1715-19.

98. Cf. Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 Vand. L. Rev. 75, 112 (1993) (arguing that reputational factors do not restrain over-aggressive activity by lawyers, because "individual personnel can be scapegoated"); Shell, *Opportunism*, *supra* note 36, at 270 (arguing that reputational sanctions, i.e., sanctions against a firm arising from its having acquired a negative reputation, can be diminished in large organizations that "often can explain to prospective business partners that a particular instance of opportunism was caused by a corporate agent who no longer influences decisions or who exceeded company policies").

99. *See, e.g.*, Gilson & Mnookin, *Coming of Age*, *supra* note 14, at 571 n.14, 583 n.44, 585 n.51 (noting that only 8.6% of the lawyers who were associated with "one of the . . . most prestigious law firms in the United States" during 1964 to 1974 were partners at the firm in 1987, and only 22.8% were promoted to partnership at "large New York City firms").

For an alternative consequence of the limited tenure of associates, see Bernstein, *Blaming the Lawyer*, *supra* note 96, at 18-19. The consequences of inadequate legal advice in a transaction may not manifest themselves until long after the inadequate advice has been rendered. Bernstein indicates that where a lawyer's tenure with his firm is limited, there are diminished incentives for him to provide adequate legal advice. *See id.*

included for some legal reason.” Although applicable rules of professional conduct limit public disclosure of such a request,¹⁰⁰ the request can facilitate the consummation of a transaction, with the result that lawyers’ reputations are diminished.

Thus, both as to technical legal issues and as to larger business issues, outside counsel can facilitate the consummation of transactions by allowing participants to deny responsibility for acts that, if attributed to the participants themselves, would diminish mutual trust and increase the likelihood of transaction breakdown.

B. *Inadvertent Hostage Takers*

This discussion has not yet addressed whether transactional lawyers *must* knowingly take hostages. One could plausibly object to the assertion that lawyers add value by taking hidden hostages if there is no evidence that lawyers who take hidden hostages understand the concept.¹⁰¹ As no empirical data is being presented to support the proposition that lawyers consciously attempt to take hidden hostages, this Part argues that transactional lawyers need not be aware of the value of hostages in order for this form of negotiation to persist.

Modern commercial litigation complements the process of taking hidden hostages. Just as a party may obtain an array of contingent hidden contractual rights, only some of which may be exercisable in particular future states, federal civil litigation practice permits a defendant to assert counterclaims not arising out of the transaction that is the subject of the plaintiff’s claims.¹⁰²

The commencement of litigation concerning a contract signals a decrease in cooperation that will attend performance under the contract. Even if a dispute that results in litigation concerns only part of the contractual relationship, mistrust can permeate the entire relationship.

Decreasing marginal costs of litigation compound the deleterious impact from litigation pertaining to a part of the relationship. Some litigation costs are not claim-specific. For example, some discovery activities necessary to pursue or defend one claim can produce

100. The Model Rules of Professional Conduct restrict disclosure of “information relating to representation of a client.” Model Rules of Professional Conduct Rule 1.6 (1998). Between sophisticated parties, the Model Rules prohibit a lawyer from assisting a client’s fraudulent conduct. *See id.* Rule 1.2(d). This rule should not prevent lawyers from furthering a client’s interests through negotiation tactics the clients themselves can lawfully adopt.

101. *See generally* Jay M. Feinman, *Relational Contract and Default Rules*, 3 S. Cal. Interdisc. L.J. 43, 52 (1993) (criticizing rationalizations of individuals’ failure to bargain “to the last dollar” on the following basis: “[I]t takes remarkable modesty for scholars to assume that ordinary people can intuitively arrive at the analysis that yields optimal results, when scholars can do so only after much sophisticated training and work.”).

102. *See* Fed. R. Civ. P. 13(b).

information useful to litigate other claims. Thus, commencing litigation on one claim may cause the assertion of other claims that could not have been profitably asserted otherwise.¹⁰³

The possibility of litigation can cause lawyers to scrutinize the language of relevant contracts in search of ambiguity or rights of which the principals were not previously aware, in order to form the basis of a new "litigation position."¹⁰⁴ But the identification of a possible counterclaim, or a right of the defendant not previously asserted, can redirect the parties to cooperative behavior. A plaintiff who has nothing to lose from litigation has less incentive to act cooperatively than one who faces a material counterclaim. A hidden contractual hostage can be such a previously unasserted right.

While negotiating a commercial contract, a lawyer need not consciously seek to obtain an unreasonable, latent right with the purpose of returning cooperation to the parties' relationship at some time in the future. Consider the stereotypical lawyer who derives personal satisfaction from securing latent, unreasonable rights for his client; the lawyer who likes to "slide things by" opposing counsel. Lawyers who have that personality trait and who are accomplished in securing latent rights will secure benefits for their clients. Clients served by such lawyers will realize benefits when those with whom the clients deal attempt to act opportunistically. The onerous provisions negotiated by their counsel can facilitate returning a relationship to one based on cooperative performance. The motives underlying the lawyers' choices to seek unreasonable, latent contract rights are irrelevant to the value of the rights they have secured for their clients. These lawyers should garner reputations for negotiating documents that produce desirable results for their clients when cooperation between parties breaks down. Market forces cause lawyers who are less willing to seek, or less able to obtain, unreasonable terms to be less successful in retaining clients, *ceteris paribus*.¹⁰⁵

Thus, it should not be surprising that popular culture views lawyers as being unreasonable. However, lawyers may be "reasonably unreasonable," and it is precisely those characteristics that appear to be unreasonable that can promote aggregate transaction value and are thus "reasonable."

103. Conversely, increasing litigation costs can encourage settlement. *See, e.g.*, Bernstein, *Social Norms*, *supra* note 68, at 78 n.67 ("Consequently, as the litigation costs that the defendant can threaten to impose on the plaintiff increase, the minimum amount he will have to pay to induce the plaintiff to settle the claim at the outset will decrease. Since relational standards increase the cost of litigation, they may enable defendants with superior bargaining power to pay less in settlement.").

104. *See generally* Blinderman Constr. Co. v. United States, 39 Fed. Cl. 529, 554 n.21 (1997) ("Plaintiff's ill-conceived interpretation [of the contract] strikes the court far more as a belatedly-conceived litigation position than as a plausible justification for plaintiff's [actions] . . .").

105. Other factors also can affect the extent to which a lawyer retains clients.

IV. PRINCIPLES OF CONTRACT CONSTRUCTION AND DEFENSES TO CONTRACT ENFORCEMENT

Part III argued that the use of hidden hostages may increase the value realized by transacting parties by increasing extra-judicial resolution of disputes, thereby returning the parties to cooperative performance of their obligations. For these hostages to be effective, the parties whose opportunism is to be restrained must perceive some possibility that a court would enforce the terms of the hidden hostages as written.¹⁰⁶ Therefore, the effectiveness of these hostages in deterring opportunism extra-judicially is critically dependent on certain legal principles of contract construction and defenses to contract enforcement.

Enforcing a hidden contractual hostage in a particular context could appear to require an excessively literal approach to contract construction. A recent controversial opinion by Judge Easterbrook colorfully identified the issues:

We do not doubt the force of the proverb that the letter killeth, while the spirit giveth life. Literal implementation of unadorned language may destroy the essence of the venture. Few people pass out of childhood without learning fables about genies, whose wickedly literal interpretation of their "masters'" wishes always leads to calamity. Yet knowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of "kindness" in performance, or of judicial oversight into whether a party had "good cause" to act as it did.¹⁰⁷

Although some principles of contract interpretation and some defenses to the enforcement of a contract limit the ability to take hidden hostages, various elements of those principles may facilitate the creation of hidden hostages. This Part reviews the implications of selected principles of contract construction and selected contract enforcement defenses on the ability of lawyers to take hidden hostages.¹⁰⁸

A. *Reasonable Construction of Contract Language*

The Restatement (Second) of Contracts states, "[A]n interpretation which gives a reasonable, lawful, and effective meaning to all the terms is preferred to an interpretation which leaves a part

106. The precise probability will vary depending on the circumstances—the value to be gained from opportunistic behavior, etc.

107. *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990).

108. This discussion continues to assume that the contractual hostage in question is the product of negotiation between sophisticated parties represented by counsel.

unreasonable, unlawful, or of no effect."¹⁰⁹ The comments provide the following example:

A licenses B to manufacture pipes under A's patents, and B agrees to pay "a royalty of 50 cents per 1,000 feet for an output of 5,000,000 or less feet per year, and for an output of over 5,000,000 feet per year at the rate of 30 cents per thousand feet." The 50 cent rate is payable on the first 5,000,000 feet, the 30 cent rate only on the excess. The more literal reading is unreasonable, since it would involve a smaller payment for 6,000,000 feet than for 4,000,000 feet.¹¹⁰

Commentators have argued that courts should fill gaps in contracts by providing the terms that reasonable, informed parties would have provided in the circumstances had they bargained expressly about the matters in question.¹¹¹ That approach is an extension of the principle that methods of contract construction should provide a reasonable meaning to contract terms.

The essential character of a "reasonable" interpretation is that it reflects an outcome that would be reached by informed parties who

109. Restatement (Second) of Contracts § 203(a) (1981); *accord* 5 Margaret N. Kniffin, Corbin on Contracts § 24.22, at 239 (Joseph M. Perillo ed., 1998).

110. Restatement (Second) of Contracts § 203 cmt. c, illus. 1. "Reasonableness" in this context may be in the eye of the beholder. Consider an advertisement of a sale to the effect of 20% off for all persons who purchase, in the aggregate, over \$200 of goods and 25% for aggregate purchases over \$300. Assume that the advertisement was sufficiently definite, e.g., it was limited to items in stock, so that it would be treated as an offer. I suspect that most individuals would be surprised if, upon presenting merchandise with an aggregate pre-sale price of \$350, they were advised that the total sales price would be \$317.50 ($\$200.00 + 0.8(\$300.00 - \$200.00) + 0.75(\$350.00 - \$300.00)$), and not \$262.50 ($0.75 \times \350.00). The interpretation of the advertisement indicating a price of \$317.50 would be similar to the interpretation favored by the Restatement in the quoted example. I also suspect persons purchasing merchandise with an aggregate pre-sale price less than \$300, if they thought about it, would expect to pay no more than \$225.01 ($0.75 \times \300.01).

111. See Jules L. Coleman, Risks and Wrongs 165 (1992); Posner, *supra* note 12, at 93; *cf.* Market St. Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 596 (7th Cir. 1991) (Posner, J.) ("But whether we say that a contract shall be deemed to contain such implied conditions as are necessary to make sense of the contract, or that a contract obligates the parties to cooperate in its performance in 'good faith' to the extent necessary to carry out the purposes of the contract, comes to much the same thing. They are different ways of formulating the overriding purpose of contract law, which is to give the parties what they would have stipulated for expressly if at the time of making the contract they had had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero."); Barnett, *supra* note 21, at 906 (arguing in favor of a slightly different approach: "default rules that reflect the commonsense expectations of persons in the relevant community of discourse"); Charny, *Hypothetical Bargains*, *supra* note 21, at 1878 ("[C]areful analysis requires that courts adopt the simple hypothetical bargain conception in a number of important respects."); Charny, *Nonlegal Sanctions*, *supra* note 14, at 433 ("[L]egal intervention improves transactors' welfare by enforcing certain terms that the transactors would have placed into a legal contract were it not for high drafting costs." (footnote omitted)). See generally *infra* Part IV.E (discussing cases construing the implied covenant of good faith to a similar effect).

had bargained expressly about the matter. One might characterize the drafting of a provision having an unreasonable, latent, literal meaning as “sharp dealing.” A first order analysis, one disregarding consequential effects of hostages, would indicate this type of sharp dealing is not efficient¹¹² and should be discouraged.¹¹³ But those elements that optimize the joint value of a contract by “creating a hostage” make the term itself appear unreasonable.

An optimal hostage creates a right that directly benefits the holder of the right to a negligible extent while imposing material costs on the other party. It is only the “indirect,” “consequential” or “second order” impact of the hostage, the decreased opportunism produced by threats to exercise the hostage rights, that increases the joint value of a transaction. It is the “unreasonableness” that makes a hostage desirable and that causes the use of hostages to persist.

Consequently, in contexts where a provision could restrain opportunism, a court is unable to determine whether a contract provision is “reasonable.” Whether a hostage increases joint value depends on three factors: (1) the likelihood that the party relinquishing the hostage otherwise would act opportunistically, (2) the impact the hostage has on restraining opportunistic behavior, and (3) the extent to which the hostage increases the hostage-holder’s likelihood of acting opportunistically. The participants’ ethical viewpoints and the values they place on their reputations will affect the extent to which delivery of a hostage increases joint value. These factors are participant-specific in that in identical transactions, the measures are dependent on the identities of the participants. Reference to objective criteria, such as the provision most frequently resulting from express negotiations about a particular issue, cannot reflect these crucial subjective factors.

The requirement that contract terms be construed to produce a result that is “reasonable” thus impedes the ability of parties to provide by contract for the delivery of hostages that can increase joint transaction value. This discussion is not intended to argue for the converse of the traditional rule by saying that all ambiguous contract terms should be interpreted so as to provide an unreasonable result. Rather, the point is more limited. Although the traditional rule on its face appears irrefutable, it will produce inferior results in some cases.

B. *Contra Proferentem*

The principle of *contra proferentem* is a second rule of contract

112. See generally Shell, *Ethical Standards*, *supra* note 20, at 1206 n.40 (“If laws increase honesty and reduce sharp dealing without producing offsetting losses, they promote efficiency.”).

113. Cf. Barnett, *supra* note 21, at 883 n.164 (arguing that a duty of good faith should be implied in contracts, because it is unlikely that a party to a contract would knowingly grant the other party the power to perform the contract in bad faith).

construction that impinges on the ability of a party to acquire a hidden hostage. This principle provides that ambiguous language in a contract is to be construed against the party who provided the language.¹¹⁴ Recognition of hidden hostages would appear to violate the core of this principle. Yet two refinements of the principle adopted by some courts are consistent with the recognition of hidden hostages.

First, some courts restrict the application of *contra proferentem* to contracts between parties of unequal bargaining power.¹¹⁵ This modified rule of *contra proferentem* is in harmony with allowing beneficial hidden hostages. Parties having the power to impose non-financial terms on those with whom they contract may be more likely to act opportunistically and exercise a hidden hostage. Those same factors that afford a party the power to dictate non-financial terms may eliminate restraints that otherwise would prevent its opportunism. For example, factors limiting the dissemination of information and facilitating one party's imposition of inappropriate non-financial terms may limit the reputational costs accruing to a dominant party from acting opportunistically.

Furthermore, there are insignificant benefits to enforcing hidden hostages in contracts of adhesion. Absent a mistake, the hidden hostage generally would benefit the dominant party. Where the dominant party has the power to include a wide range of terms in a contract, there is no need for that party to seize a hidden hostage. Thus, this modified principle of *contra proferentem*, limiting its application to contracts of adhesion, appropriately demarcates circumstances in which the taking of a hidden hostage should be proscribed.

A second, independent refinement of the principle of *contra proferentem* addresses contracts negotiated in circumstances with no significant imbalance in the parties' power. The negotiation of a

114. See *Newman & Schwartz v. Asplundh Tree Expert Co.*, 102 F.3d 660, 663 (2d Cir. 1996) (“[U]nder the principle of *contra proferentem*, courts are to construe ambiguous contract terms against the drafter.”); *Mesa Air Group, Inc. v. Department of Transp.*, 87 F.3d 498, 506 (D.C. Cir. 1996); Restatement (Second) of Contracts § 206; Kniffin, *supra* note 109, § 24.27, at 282-83.

115. See, e.g., *Nunn v. Chemical Waste Management, Inc.*, 856 F.2d 1464, 1469 (10th Cir. 1988) (refusing to apply canon when parties are of equal bargaining power); *Little Susitna Constr. Co. v. Soil Processing, Inc.*, 944 P.2d 20, 25 n.7 (Alaska 1997) (stating that a contract is not construed against the drafter when negotiated between “equally situated parties”); Kniffin, *supra* note 109, § 24.27, at 292 (noting that *contra proferentem* may be inappropriate “if both parties are equally sophisticated”). *But see* *United States v. Ready*, 82 F.3d 551, 559 (2d Cir. 1996) (“[C]ommon’ rule that terms are construed against drafter ‘often operates against a party that is at a distinct advantage in bargaining . . . [but] may be invoked even if the parties bargained as equals.’” (quoting E. Allan Farnsworth, *Farnsworth on Contracts* § 7.11, at 518 (1990))). See generally Charny, *Hypothetical Bargains*, *supra* note 21, at 1854 n.133 (arguing against the application of the principle to cases involving sophisticated participants).

complex commercial contract can involve multiple iterations, with the final contract consisting of the synthesis of a series of comments on various provisions. One could attempt to apply the principle of *contra proferentem* on a clause-by-clause basis, and in that view, contract interpretation would depend on an examination of the drafting history of each provision. Drafting responsibility for some provisions would be attributed to one party, and responsibility for other provisions would be attributed to the other party.

However, some courts refuse to apply this doctrine to the interpretation of such a contract.¹¹⁶ For example, the court in *RCI Northeast Services Division v. Boston Edison Co.*¹¹⁷ addressed a dispute concerning a contract prepared by Boston Edison that incorporated, by reference, a bid prepared by RCI.¹¹⁸ The dispute addressed the meaning of a provision from that bid. In response to Boston Edison's argument that the provision should be construed against RCI, the court stated: "Though RCI proposed the... language initially, it was Edison that decided to employ the

116. See *Consumers Ice Co. v. United States*, 475 F.2d 1161, 1165 (Ct. Cl. 1973) ("[S]ince the contract language was the product of negotiation, neither party may be called to task for failing to seek clarification of what seems to be language that is ambiguous on its face."); *Homac, Inc. v. DSA Fin. Corp.*, 661 F. Supp. 776, 788 (E.D. Mich. 1987) ("[T]he justification for applying such rule pales in a situation, like the instant one, where the terms of an agreement resulted from a series of negotiations between experienced drafters." (quoting *E.I. duPont de Nemours v. Shell Oil Co.*, 498 A.2d 1108, 1114 (Del. 1985))); *Spatz v. Nascone*, 368 F. Supp. 352, 354 (W.D. Pa. 1973) ("[W]here a contract is the result of the joint efforts of attorneys or negotiators, then it is not to be construed against either party."); *United States v. Continental Oil Co.*, 237 F. Supp. 294, 298 (W.D. Okla. 1964) (citing an "exception to the general rule that a writing is construed most strongly against the draftsman when the words involved are the common language of both parties or the contract is the joint effort of the attorneys and technicians for both sides"), *aff'd*, 364 F.2d 516 (10th Cir. 1966); *Beck v. F. W. Woolworth Co.*, 111 F. Supp. 824, 828 (N.D. Iowa 1953) ("It is held that such rule of construction is not applicable where the contract is prepared with the aid and approval of and under the scrutiny of legal counsel for each of the parties thereto."); *Centennial Enters., Inc. v. Mansfield Dev. Co.*, 568 P.2d 50, 52 (Colo. 1977) ("The evidence clearly indicated that the agreement was the product of several negotiating sessions and that [the party seeking benefit from the rule of *contra proferentem*] was responsible for at least one draft of the contract. The rule... therefore, has no applicability."); *Schultz v. Kneidl*, 153 A.2d 779, 782 (N.J. 1959) ("Although plaintiffs' brief suggests that the lease was drawn by the landlord's attorney and therefore that 'the construction of the lease should tend to favor the tenant rather than the landlord,' it developed at oral argument that although the original draft of the lease was prepared by the landlord's attorney, that draft was substantially revised at conferences held between the parties and their respective attorneys, so that the present lease, 16 pages long and containing 29 articles, is the product of the joint efforts of the attorney for the lessor and the attorney for the lessees. There is no basis for the application of the quoted rule of construction." (citation omitted)), *aff'd*, 157 A.2d 861 (N.J. 1960); Kniffin, *supra* note 109, § 24.27, at 291 (citing *RCI Northeast Svcs. Div. v. Boston Edison Co.*, 822 F.2d 199 (1st Cir. 1987)).

117. 822 F.2d 199 (1st Cir. 1987).

118. See *id.* at 200.

phraseology in the final contract. Thus, if RCI was the natural mother of the clause, Edison was equally its adoptive father—and both of these worldly-wise litigants must share the responsibility for the clause's upbringing."¹¹⁹

This modification to the rule of *contra proferentem* also is consistent with the beneficial use of hidden hostages. The point of a beneficial hidden hostage is that it decreases the extent to which a contract must address possible future states. Simple contracts, in which there is little or no back and forth negotiation of the provisions, are less likely to be complex enough to warrant the creation of hidden hostages. The creation of hidden contractual rights in those simple contractual relationships may inordinately reflect attempts by the draftsman to facilitate his client's own opportunism. Thus, there is a rough similarity between those contracts to which this modified rule of *contra proferentem* would apply and those contracts simple enough not to justify the creation of hidden hostages.

C. Extrinsic Evidence and State Laws Regulating Deceptive Practices

The ability of parties to take hidden hostages is also restrained in those jurisdictions that have rejected the plain meaning rule. Under the plain meaning rule, evidence of prior negotiations cannot be introduced to show that a written contract is ambiguous.¹²⁰ Courts rejecting, or relaxing, the plain meaning rule allow evidence of the negotiations to be introduced for purposes of demonstrating ambiguity. This position, in turn, increases the extent to which extrinsic evidence can be used to shape the understanding of the terms of the relationship.¹²¹ A defining characteristic of a hidden hostage is that its function was not discussed during the negotiation of the contract. The benefit of recognizing hidden hostages derives from the ability to muffle signals during contract formation that would prevent consummation of otherwise value-increasing transactions. The "hidden hostage" impact of the contract provision necessarily will not have been discussed during contract negotiation.

119. *Id.* at 203 n.3.

120. See generally 2 E. Allan Farnsworth, *Contracts* § 7.12 (3d ed. 1999) (indicating that the "overwhelming majority" of jurisdictions have retained some form of the plain meaning rule).

121. See, e.g., *Trident Ctr. v. Connecticut Gen. Life Ins. Co.*, 847 F.2d 564, 568-69 (9th Cir. 1988) (analyzing the role of extrinsic evidence in discerning parties' original intentions as compared to the plain meaning of the contract); *Pacific Gas & Elec. Co. v. G. W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 644-46 (Cal. 1968) (en banc) (admitting extrinsic evidence to determine the intentions of the parties); *Morey v. Vannucci*, 64 Cal. App. 4th 904, 912 (1998) (allowing extrinsic evidence to be admitted so long as the evidence does not lend itself to an unreasonable interpretation of the contract); see generally 2 Farnsworth, *supra* note 120, § 7.12 (discussing courts' relaxation of the plain meaning rule by allowing evidence of prior negotiations in interpreting contract language).

As suggested above,¹²² one method by which lawyers take hidden hostages involves articulating to opposing counsel a truthful but innocuous reason for a contract provision. For example, the lawyer could explain that the provision remedies a specific problem all would agree should be addressed, while not disclosing a second impact of the provision that constitutes a hidden hostage. The rejection of the plain meaning rule could permit introduction of evidence of the negotiations, limiting the impact of the provision to the articulated, i.e., innocuous, impact. This approach thus substantially restrains the ability to take hidden hostages.¹²³

The ability to take these hostages is further impeded by some state laws, modeled on the Federal Trade Commission Act ("FTC Act"), that regulate unfair and deceptive trade practices.¹²⁴ Businesses are given a cause of action under some of these statutes.¹²⁵ Just as the rejection of the plain meaning rule diminishes the impact written contractual terms have on the controlling terms of a judicially-defined contractual relationship, these state laws de-emphasize the importance of written contracts in business relationships.¹²⁶ The case law under those acts indicates a risk that the exercise of a contract right designed as a hidden hostage would be considered part of a proscribed plan of deception.

G. Richard Shell indicates the leading definition of deception actionable under such state statutes requires that the "practice must have a 'tendency or capacity' to mislead . . . in a material way."¹²⁷ One

122. See *supra* notes 76-77 and accompanying text.

123. In a related context, Judge Kozinski has noted that costs are attendant to the use of equitable principles to avoid literal enforcement of a contract: "When parties are allowed to undermine the finality of written instruments, every transaction can be held hostage to competing claims as to what might have been said or believed by any of the participants. . . . In any event, litigating such claims, no matter how legitimate, is expensive, time-consuming and nerve-racking." *Ryan v. Corey (In re Corey)*, 892 F.2d 829, 838 n.6 (9th Cir. 1989) (discussing equitable principles under Hawaii law that permit recharacterization of deeds as mortgages not intended to convey equitable title).

124. See generally Shell, *Ethical Standards*, *supra* note 20, at 1200 (stating that all 50 states have adopted laws modeled directly or indirectly on § 5 of the FTC Act, 15 U.S.C. § 45(a)(1) (1982)).

125. See *id.* at 1215. Shell asserts that Massachusetts "appears" to have been the first jurisdiction that extended to businesses the right to assert a cause of action under a state version of the FTC Act. *Id.* at 1214. It is for this reason that Massachusetts cases are prominent in extending the reach of these statutes to customary business disputes.

126. See *id.* at 1235 ("Contracts are important in state FTC Act analysis only to the extent they describe the explicit commercial relationship between the parties. If the conduct of one of the parties falls short of the implicit behavioral assumptions underlying the relationship, the court may ignore the contract and regulate the underlying conduct by applying contextually based standards of unfairness and deception.").

127. *Id.* at 1218-19.

example is an "insistence on a 'bad faith' interpretation of an ambiguous contract term."¹²⁸

Shell discusses *Pepsi-Cola Metropolitan Bottling Co. v. Checkers, Inc.*,¹²⁹ in which a soft drink distributor refused to pay its supplier \$61,000, an amount not in dispute, to enhance the distributor's bargaining power in resolving a dispute concerning the amount of product to which the distributor was entitled.¹³⁰ The court upheld a judgment in favor of the supplier, in an amount equal to three times the amount of the debt plus attorneys' fees,¹³¹ noting, "There was no relation between [the supplier's] fully liquidated claim for product it had delivered in the past, and [the distributor's] desire to persuade [the supplier] to sell more product to [the distributor]."¹³²

This type of statute has been held to apply to one party's erroneous interpretation of a contract. *F. Ray Moore Oil Co. v. State*¹³³ involves a contract requiring a state supplier to disclose the source of its inventory.¹³⁴ The supplier changed sources, reducing its costs, and neither reduced the price charged the State nor advised the State of the change.¹³⁵ The appellate court affirmed the trial court's finding that the supplier's acts were unlawfully deceptive, which decision was accompanied by an award of treble damages.¹³⁶

The supplier alleged that it believed it was properly interpreting the contract by neither adjusting the rate paid to the State nor advising the State of its new source.¹³⁷ The court relied on extrinsic evidence to prove that the terms of the contract required the supplier to advise the State of any change in source, and thus the supplier violated the contract terms by failing to do so.¹³⁸

The principle underlying the *Checkers* and *F. Ray Moore Oil Co.* decisions can significantly affect the efficacy of hidden hostages in certain jurisdictions, particularly those that consider failure to perform a contract an actionable deceptive trade practice. Hostages are useful when one party can identify, but cannot prove in court, that the other party has acted opportunistically.¹³⁹ The only hostage restraining opportunism in such a context may well be unrelated to the contract provision governing the performance that is being rendered in an

128. *Id.* at 1225.

129. 754 F.2d 10 (1st Cir. 1985).

130. *See id.* at 18.

131. *See id.* at 12.

132. *Id.* at 18.

133. 341 S.E.2d 371 (N.C. 1986).

134. *See id.* at 373.

135. *See id.*

136. *See id.*

137. *See id.*

138. *See id.* at 374.

139. *See generally* Gilson & Mnookin, *Disputing Through Agents*, *supra* note 1, at 517-18 (noting that the parties may be able to identify opportunism that cannot be proved in court).

opportunistic fashion. But the existence of a hidden hostage often will be in doubt. Gauging the likelihood that a contract will be interpreted in accordance with its terms is an art, not a science. A party who seeks to restrain opportunism by threatening to exercise a hidden hostage may be uncertain as to whether a court would enforce the hostage rights. The power of the threat in such a context is substantially diminished if a judicial decision to "release" the hostage is accompanied by the imposition of a penalty on the party that threatened to exercise hostage rights. These state statutes, in fact, frequently provide for treble or other extra-compensatory (i.e., punitive) damage awards.¹⁴⁰ Thus, in jurisdictions with this type of statute, the efficacy of contingent hidden hostages in restraining opportunism may be limited to the extremely narrow circumstances where the hostage is related to the opportunism sought to be restrained.¹⁴¹ Any other threat could subject the party holding the hostage to a claim of a bad-faith assertion of an unrelated claim, subjecting the hostage-holder to potential extra-compensatory liability.

D. *Fraud and Hidden Contractual Hostages*

As noted above,¹⁴² one method by which hidden contractual hostages can be obtained involves a lawyer identifying only one of two possible implications of a contract provision. This negotiation strategy could be regarded as fraudulent.¹⁴³ Were this method of

140. See Shell, *Ethical Standards*, *supra* note 20, at 1219.

141. Cf. *id.* at 1242 n.245 (arguing that extra-compensatory damages, coupled with legal rules requiring compliance with vague legal standards, can "overdeter" undesirable conduct).

142. See *supra* notes 76-77 and accompanying text.

143. This negotiation strategy also could be considered unethical. The ethics of negotiation have been the subject of significant commentary. See, e.g., Hazard, *supra* note 11, at 188-93 (considering the "problem of trustworthiness in negotiations"); Langevoort, *supra* note 98, at 81-83 (discussing a lawyer's obligation to be truthful in negotiations); Perschbacher, *supra* note 67, at 97 n.119 (noting that a draft of the Model Rules of Professional Conduct attempted to give specific guidelines for general duties of fairness to others in negotiations); Alvin B. Rubin, *A Causerie on Lawyers' Ethics in Negotiation*, 35 La. L. Rev. 577, 578 (1975) (noting that ethical conduct in negotiations is not specifically addressed by most writings about lawyers' ethics); Murray L. Schwartz, *The Professionalism and Accountability of Lawyers*, 66 Cal. L. Rev. 669, 685-88 (1978) [hereinafter Schwartz, *Professionalism*] (arguing, *inter alia*, that a lawyer should not assist a client entering into a contract that, based on facts known to the lawyer, would not be enforceable against his client, where the other party is unaware of the contract's unenforceability); Steele, *supra* note 94, at 1403-04 (proposing a rule obligating "fairness and candor" in negotiations); Alan Strudler, *On the Ethics of Deception in Negotiation*, 5 Bus. Ethics Q. 805, 818-19 (1995) (arguing in favor of permitting deception where allowing deception is "potentially mutually advantageous"); Gerald B. Wetlaufer, *The Ethics of Lying in Negotiations*, 75 Iowa L. Rev. 1219, 1272 (1990) (arguing that although lying may be effective in negotiations, many lies are "ethically impermissible"); James J. White, *Machiavelli and the Bar: Ethical Limitations on Lying in Negotiation*, 4 Am. B. Found. Res. J. 926, 927 (1980)

negotiation fraudulent, the ability of sophisticated commercial parties to take latent contractual hostages would be substantially diminished. Although there are theories under which a sophisticated commercial party could challenge as fraudulent the enforceability of a latent contractual hostage obtained through such a studied omission, case law suggests that such a challenge would be unsuccessful.

Case law in some jurisdictions indicates that, between sophisticated parties, misstatements of the legal consequences of a contract will not

("[A] careful examination of the behavior of even the most forthright, honest, and trustworthy negotiators will show them actively engaged in misleading their opponents about their true positions.").

This negotiation strategy does not easily fit within the frameworks of typical ethical dictates. Steele, for example, argues that transactional lawyers should seek to negotiate agreements that are "fair." Steele, *supra* note 94, at 1403 ("[W]hen serving as a negotiator lawyers should strive for a result that is objectively fair."). In contexts where this negotiation tactic is used to prevent opportunistic behavior, ethical criticisms of this mode of negotiation in highly negotiated transactions with parties represented by counsel, on the basis that it produces "unfair" results, are inapposite. The best hidden contractual hostages are, by definition, "unfair" at some level. The characteristics that make them "unfair" are those that also make them most useful.

Moreover, this mechanism for restraining opportunism is useful where the circumstances creating the incentives for opportunistic behavior were not foreseen at the time the original bargain was reached. If, at the time a contract is formed, the parties cannot accurately ascertain whether the contract will fairly allocate the risks that actually arise, it becomes substantially problematic to determine whether the taking of a hidden hostage will produce an "unfair" result. An assessment of the ethical propriety of this mode of negotiation on that basis would therefore be complex.

Wetlauffer concludes that a party to a negotiation may ethically lie in response to a question seeking information that there is no obligation to disclose, where the questioned party could either disclose such information or lie. *See* Wetlauffer, *supra*, at 1269-70. Because, in the transactions discussed in this Article, neither party has an obligation to provide legal advice to the other, Wetlauffer's view would suggest approval of lying in this context, absent other responses that do not result in the disclosure sought to be avoided.

Alternatively, one could conclude that this strategy is ethical if used against a party believed to be seizing hidden contractual hostages. Wetlauffer concludes that dishonesty of one's contracting party, by itself, does not excuse lying. *See id.* at 1267; *cf.* Strudler, *supra*, at 819 (asserting that a "mutual advantage" rationalization for mendacity "shows more promise" than self-defense). Wetlauffer discounts the argument that lying by the recipient of a lie is justified to eliminate the advantage otherwise gained by the first party to lie, on the basis that identifying the original lie necessarily eliminates its effectiveness. *See* Wetlauffer, *supra*, at 1267. This reasoning suggests that one is not justified in attempting to seize a hidden contractual hostage if the other party has sought to do so. Yet, that one party has attempted to seize a hidden contractual hostage increases the likelihood that there are other hidden contractual hostages as yet undiscovered, suggesting that the propriety of the reciprocal taking of hidden contractual hostages in such a context is more easily defended.

Were this negotiation strategy considered fraudulent, its use would, of course, be unethical. *See* Model Rules of Professional Conduct Rule 8.4 (1998); *cf. id.* Rule 4.1 (proscribing a lawyer's "mak[ing] a false statement of material fact or law to a third person"). *But cf.* Craver, *supra* note 34, at 405 ("[A]dvocate prevarication during legal negotiations rarely results in bar disciplinary action . . ."); Schwartz, *Professionalism*, *supra*, at 682 (asserting that lawyers are rarely disciplined for fraudulent conduct).

be actionable as fraud.¹⁴⁴ *Doctor's Associates, Inc. v. Stuart*,¹⁴⁵ involves a challenge to the enforceability of a provision in franchise agreements for Subway sandwich shops. The provision required arbitration of any disputed breach of the franchise agreements.¹⁴⁶ Under each agreement, the franchisees were required to lease the shop premises from an affiliate of the franchisor under a separate lease, which did not contain an arbitration provision.¹⁴⁷ The form of lease had a cross-default, under which a default by the franchisee under the franchise agreement constituted a breach of the lease, entitling the franchisor to evict the franchisees.¹⁴⁸

After a dispute arose concerning compliance with the franchise agreements, the franchisees initiated a lawsuit in state court, seeking a declaration that the arbitration agreements were unenforceable on the basis of fraud, *inter alia*.¹⁴⁹ The franchisor then initiated a suit in federal court, seeking an order compelling arbitration.¹⁵⁰ On appeal to the Second Circuit, the franchisees reiterated their claim of fraud. They alleged the franchisor "fraudulently induced them into executing the franchise agreements by falsely representing that arbitration was a condition precedent to the institution of legal action by *either* party to the franchise agreement."¹⁵¹

The allegedly fraudulent acts in that case are more extreme than the method discussed above to take a hidden contractual hostage. The quoted allegation in *Doctor's Associates* involves a false affirmative statement of the legal import of the contract, as opposed to an omission. That act corresponds to a party seeking to take a hidden contractual hostage by falsely stating that an identified consequence of a contract provision represents its sole effect, knowing that there is a second, less benign implication.

The fact pattern in *Doctor's Associates* does not seem to involve the taking of a negative sum hostage but rather an attempt to create latent provisions that divest the franchisees of a right for a corresponding benefit for the franchisor. The documents appear to have provided generally for arbitration but selected out, and allowed judicial procedures in, a subset of disputes in which resort to judicial process would benefit only the franchisor.

144. Cf. Wetlaufer, *supra* note 143, at 1242 n.74 (stating, "misrepresentations of law are not cognizable for purposes of fraud," on the basis that reliance thereon is unreasonable).

145. 85 F.3d 975 (2d Cir. 1996).

146. *See id.* at 977-78.

147. *See id.*

148. *See id.* at 978.

149. *See id.*

150. *See id.*

151. *Id.* at 979.

Nevertheless, the court held in *Doctor's Associates* that, as a matter of law, the franchisees' allegations did not provide a basis for a fraud defense:

Defendants[, the franchisees,] have utterly failed to allege, much less prove, sufficient facts indicating that they were defrauded into agreeing to arbitrate. Before purchasing their franchises, Defendants received a Uniform Franchise Offering Circular ("UFOC") from [the franchisor]. The UFOC included copies of both the standard franchise agreement and the sublease. Although the franchise agreement contains an arbitration clause, the sublease does not; rather, it provides that if the sublessee breaches the franchise agreement, the lessor may terminate the sublease and bring an eviction action. These clauses were not camouflaged, and Defendants cannot now complain that they failed to read or inquire into the meaning of those documents.¹⁵²

As is the case with many of the relevant opinions in this area, the court's language seems somewhat at odds with the facts. The court indicates that the prominence of the provisions prevents the franchisees from asserting a defense on the basis that they "failed to read or inquire into"¹⁵³ the meaning of the terms. Yet the franchisees' claim was not merely that the provision was buried, but that there was a false statement concerning its impact.¹⁵⁴ Nevertheless, the court concluded no fraud defense was available.¹⁵⁵

Doctor's Associates reflects a very restrictive application of fraud to misstatements made in the course of contract negotiations. It may be that the drafting gambit at issue in the case is familiar to counsel who frequently work in the franchise area, but I suspect many transactional lawyers, including those with significant experience, would not spot the implications of these provisions. The reference to "camouflaged"¹⁵⁶ clauses must then be taken to refer to the location of the actual clauses and not their import. Thus, at least in that court, where the text of the provision in question has not been placed in an obscure location, a false statement between sophisticated parties about the legal consequences of the document will not give rise to fraud liability. In the context of a fraud claim, a latent contractual hostage negotiated through a conscious omission of one of various consequences of a contractual provision is enforceable; there can be no complaint that the language in question was located in an obscure place. If the parties actually discuss a contract provision, no party can plausibly claim that it was not aware the contract provision was in the documents signed.

152. *Id.* at 980. The court further held that no reliance had been shown. *See id.*

153. *Id.*

154. *See id.* at 979-80.

155. *See id.*

156. *Id.* at 980.

Doctor's Associates is not unique in restricting the assertion of a fraud defense against one who made a false statement concerning the legal consequences of a document. For example, in *Cohen v. Wedbush, Noble, Cooke, Inc.*,¹⁵⁷ the court held that allegations brought by customers of a stock brokerage firm were insufficient to create a defense of fraud.¹⁵⁸ The customers had signed a margin agreement provided by the brokerage firm which required arbitration of disputes. The customers subsequently alleged that an agent of the brokerage firm had advised them that the agreement would "not compromise any of [their] rights."¹⁵⁹ *Cohen* is stronger than necessary for purposes of understanding the enforceability of latent contractual hostages against a sophisticated party and suggests an imbalance in bargaining power and an absence of negotiation.

A series of cases construing Texas law articulates a developed analysis of the issue,¹⁶⁰ which parallels the issues as framed by the Restatement (Second) of Contracts.¹⁶¹ These cases generally deny relief on the basis of fraud where there were affirmative misstatements. It follows that no fraud defense would prevent the enforcement of hidden contractual hostages negotiated with the strategy of omissions contemplated here.

A seminal Texas case is *Fina Supply, Inc. v. Abilene National Bank*.¹⁶² The court in *Fina Supply* identified two traditional theories under which false statements about the legal consequences of a document could be fraudulent. First, "[a] party having superior knowledge, who takes advantage of another's ignorance of the law to deceive him by studied concealment or misrepresentation, can be held responsible for this conduct."¹⁶³ Second, the court stated, "[M]isrepresentations involving a point of law will be considered misrepresentations of fact if they were intended and understood as such."¹⁶⁴ These theories parallel the relevant provisions of the Restatement.

157. 841 F.2d 282 (9th Cir. 1988).

158. *See id.* at 287-88.

159. *Id.* at 286-87 (discussing the proposition that "[t]he [plaintiffs] cannot use their failure to inquire about the ramifications of that clause to avoid the consequences of agreed-to arbitration" (quoting *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334, 339 (7th Cir. 1984))). *But cf.* *Chamberlin v. Fuller*, 9 A. 832, 836 (Vt. 1887) ("No rogue should enjoy his ill-gotten plunder for the simple reason that his victim is by chance a fool.").

160. *See Boggan v. Data Sys. Network Corp.*, 969 F.2d 149 (5th Cir. 1992); *Gold Kist, Inc. v. Carr*, 886 S.W.2d 425 (Tex. 1994); *Fina Supply, Inc. v. Abilene Nat'l Bank*, 726 S.W.2d 537 (Tex. 1987).

161. *See* Restatement (Second) of Contracts §§ 169(b), 170 (1981).

162. 726 S.W.2d 537 (Tex. 1987).

163. *Id.* at 540.

164. *Id.* The court also identified a third traditional theory, not relevant to this discussion, where fraud arises by virtue of a relationship of trust and confidence. *See id.*

Under the Restatement, a statement of opinion, as opposed to a statement of fact, can be the basis of a fraud defense only in limited circumstances, such as where the victim "reasonably believes that, as compared with himself, the person whose opinion is asserted has special skill . . . with respect to the subject matter."¹⁶⁵ This test is similar to the first theory articulated in *Fina Supply*. The Restatement, however, also recognizes that statements of law can be statements of fact and can be actionable on that basis.¹⁶⁶ The second theory identified in *Fina Supply* addresses circumstances in which misrepresentations of the legal consequences of a document made in the course of negotiations could be considered misrepresentations of fact.

A literal reading of both these theories would seem to indicate that the seizure of latent contractual hostages would give rise to a fraud defense. But these theories, as they have been construed, would not render latent contractual hostages obtained in negotiated transactions between sophisticated parties unenforceable through a failure to disclose the full impact of the provision creating the hostage.

The first theory has two elements: the wrongdoer had "superior knowledge" and there was "studied concealment or misrepresentation."¹⁶⁷ The second element seems to be met in virtually any circumstance where fraud was alleged, including cases where one party takes a latent contractual hostage. The first element seems to be satisfied almost by definition, as long as the victim can prove the reliance element of fraud. These allegations of fraud arise where the victim alleges that the wrongdoer believed a contract would have a particular legal consequence but caused the victim to believe that there would be an alternative legal consequence. For the victim to complain successfully, the interpretation believed by the victim during negotiations must be proved wrong, and the wrongdoer's unexpressed interpretations proved correct. Thus, by definition, the wrongdoer was better informed of the consequences of the relevant contract provisions.

However, the court in *Fina Supply* construed this "superior knowledge" element of the first theory of fraud in a different fashion. Rather than inquiring into whether the alleged wrongdoer was correct in its assessment, the court instead focused on the sophistication of the parties. The court read the "superior knowledge" requirement as addressing access to knowledge¹⁶⁸ and held that an alleged wrongdoer does not have "superior knowledge" where the parties are equally sophisticated and both have access to legal counsel.¹⁶⁹

165. Restatement (Second) of Contracts § 169(b).

166. *See id.* § 170 cmt. a.

167. *Fina Supply*, 726 S.W.2d at 540.

168. *See id.*

169. *See id.*

Furthermore, the court narrowly construed the element of deception. The court indicated that as between sophisticated parties, the deception requirement is satisfied only where the alleged wrongdoer prevented the victim from examining the implications of the contract term in question.¹⁷⁰ This view suggests a requirement for malfeasance at the level of tampering with the copy of the document sent to opposing counsel or falsely advising opposing counsel that all changes had been marked in some fashion. The court stated, "No artifice or fraud was employed which prevented [the victim] from making an examination of the [contract] amendments to determine whether they accomplished the desired [results]"¹⁷¹

The court in *Fina Supply* similarly construed the second theory under which misrepresentations of the legal consequences of a contract provision can be fraudulent. This construction would render the theory generally inapplicable to commercial transactions between sophisticated parties. As to the alternative theory, under which these misrepresentations will be actionable as misrepresentations of fact "if they were intended and understood as such,"¹⁷² the court stated:

[W]here the parties are in an equal bargaining position with equal access to legal advice, there is no room for application of the doctrine that misrepresentations of points of law will be considered misrepresentations of fact if they were so intended and understood. This is so because in such a situation the parties enjoy the opportunity of making their own investigation and determination of the legal effect of their actions.¹⁷³

These principles were subsequently applied in *Boggan v. Data Systems Network Corp.*¹⁷⁴ and *Gold Kist, Inc. v. Carr.*¹⁷⁵ *Boggan* involves a dispute arising from a sale of a business, in which both the buyer and the seller were represented by counsel.¹⁷⁶ The purchase agreement, as executed, allowed the purchaser to deduct from the purchase price all inventory not sold or returned to vendors within 120 days of the closing.¹⁷⁷ Prior drafts of the purchase agreement would have allowed the purchaser to deduct only "obsolete" inventory.¹⁷⁸

After the closing, the purchaser sought to deduct from the purchase price all inventory not sold within 120 days following the closing, including inventory not formerly listed as "non-current" on the target's financial statements.¹⁷⁹ The seller alleged that, based on the

170. *See id.*

171. *Id.*

172. *Id.*

173. *Id.*

174. 969 F.2d 149 (5th Cir. 1992) (construing Texas law).

175. 886 S.W.2d 425 (Tex. 1994).

176. *See Boggan*, 969 F.2d at 150-51.

177. *See id.* at 151.

178. *See id.* at 150-51.

179. *See id.* at 151.

negotiations that resulted in the purchase agreement, the seller had understood this purchase price adjustment to apply only to inventory reflected on the financial statements of the target as "non-current" inventory.¹⁸⁰ On this basis, among others, the seller alleged that the buyer had committed fraud.¹⁸¹

The theory on which the case was submitted to the jury was limited to one in which the buyer's statements were fraudulent, affirmative statements of fact.¹⁸² The case was not submitted on a theory that the buyer made actionable statements of opinion.¹⁸³ The appellate court reversed a verdict in favor of the seller, limiting its analysis of the fraud issue to theories under which the buyer's statements could be construed as facts.¹⁸⁴ As to the statements allegedly made by the buyer's representatives during negotiations, the court cited two cases categorizing statements regarding the legal effect of a document as mere statements of opinion.¹⁸⁵ In this context, the court stated:

To the extent that [the seller] understood, based on his discussions with [the representative of the buyer], that the set-off would only apply to 'non-current' inventory, his reliance on [the representative of the buyer's] comments [was] misplaced: if anything, [those] statements amounted to expressions of opinion, perhaps intent, but certainly not fact.¹⁸⁶

A similar result was reached in *Gold Kist*.¹⁸⁷ The dispute giving rise to the lawsuit arose from the sale of trucks and equipment for hauling peanuts.¹⁸⁸ One component of the seller's business, Gold Kist, Inc. ("Gold Kist"), consisted of peanut shelling.¹⁸⁹ Gold Kist contracted for third parties to transport peanuts from various "buying points" to its peanut shelling plant.¹⁹⁰

The original draft of the agreement for the truck and equipment sale contemplated a collateral agreement that the purchaser would have an exclusive right to transport peanuts for the seller within Texas.¹⁹¹ After a preliminary understanding, subject to approval by the seller's corporate headquarters, had been reached, it was reviewed by more senior personnel at the seller's distant corporate headquarters, who rejected the ancillary exclusivity provision.¹⁹² A

180. *See id.* at 151, 153.

181. *See id.* at 151.

182. *See id.* at 152.

183. *See id.* at 154 n.4.

184. *See id.* at 150, 152, 154 n.4.

185. *See id.* at 154 n.4.

186. *Id.* at 154.

187. 886 S.W.2d 425 (Tex. 1994).

188. *See id.* at 428.

189. *See id.*

190. *See id.*

191. *See id.*

192. *See id.*

revised form of the agreement was drafted at the corporate headquarters, signed, and sent to the purchaser for signature, providing in pertinent part, "Gold Kist, from time to time, may, but shall be under no obligation to, engage you to haul commodities on its behalf."¹⁹³

Carr, the purchaser, testified that before he signed the agreement, a representative of the seller described this provision as meaning that the seller "did not have to use Carr if his performance did not meet Gold Kist' [sic] expectations."¹⁹⁴ The purchaser subsequently sued the seller, alleging fraud, in addition to other claims. As to the fraud claim, the court stated:

Carr did not contend that Gold Kist misrepresented the terms of the written agreement. . . . There was no evidence that Carr was induced by fraud to agree to the provision in the contract. At most, the record establishes that [an employee of Gold Kist] made a representation regarding the legal effect or interpretation of a document which did not constitute fraud.¹⁹⁵

The court ultimately reversed a jury verdict in favor of the purchaser.¹⁹⁶

The court's explanation of its holding in *Gold Kist* is not entirely clear. The reference to there being no evidence of fraudulent inducement suggests that the court's decision was merely a product of the plaintiff's failure to introduce adequate evidence to support his case. But, considering this sentence together with the accompanying language, the fair import of this part of the court's opinion is that misrepresentations concerning the legal effect or interpretation of a document cannot be the basis for a fraud claim. The purchaser, in the court's view, failed to introduce evidence of fraudulent inducement, because the evidence proved the existence of a fact pattern that is not, as a matter of law, fraudulent inducement.

When contractual hostages are taken by the use of outright lies about a contract provision's consequences, courts may resolve the legal issues involved as they did in *Boggan* and *Gold Kist*. These two cases address clear misstatements concerning the legal consequences of the relevant documents and foreshadow the types of holdings that can be expected of courts in these situations. The seizure of latent contractual hostages will often involve a more subtle lie, such as one of omission. Even in jurisdictions that do not follow *Boggan* and *Gold Kist*, jurisdictions that would allow a claim of fraud in these factual patterns, latent contractual hostages could nevertheless be enforceable in many situations. Latent contractual hostages

193. *Id.* at 429.

194. *Id.* (summarizing the alleged statement of a Gold Kist employee).

195. *Id.* at 430.

196. *See id.* at 428.

frequently can be obtained without an outright lie concerning the impact of the provision that creates the hostage. In some cases, the impact of the provision may not be discussed at all. In other cases, counsel seeking to take the hostage may identify a benign rationale for the provision creating the hostage while failing to mention the second impact, the one that actually creates the hostage. These patterns of negotiation would be actionable in the courts that do not follow *Boggan* and *Gold Kist*, or *Doctor's Associates*, only if these omissions were considered fraudulent, and it would be difficult to characterize them as such.

If the omission concerned a "basic assumption," the drafting lawyer making this type of omission would have committed fraud if he knew that opposing counsel was unaware of the second implication of the contract provision.¹⁹⁷ Hidden contractual hostages, however, are unlikely to implicate "basic assumptions." Moreover, actual knowledge, and not mere reason to believe, is required,¹⁹⁸ and careful counsel seeking to seize a latent contractual hostage may not have the requisite actual knowledge.

The Restatement also provides for reformation of a contract where the drafter "knows that disclosure of the fact would correct a mistake of the other party as to the contents or effect of a writing, evidencing or embodying an agreement in whole or in part."¹⁹⁹ The accompanying illustration, however, identifies a substantial mistake: a seller mistakenly believes that a contract for the sale of property incorporates the buyer's assumption of a mortgage.²⁰⁰ The relative importance of the mistake addressed by the example suggests that the type of contingencies frequently addressed latently by hidden hostages are not covered by this provision.

The Restatement's categorization of "half-truths" as misrepresentations is perhaps most on point.²⁰¹ It provides:

A statement may be true with respect to the facts stated, but may fail to include qualifying matter necessary to prevent the implication of an assertion that is false with respect to other facts. For example, a true statement that an event has recently occurred may carry the false implication that the situation has not changed since its occurrence. Such a half-truth may be as misleading as an assertion that is wholly false.²⁰²

The illustrations, however, address circumstances where the

197. See Restatement (Second) of Contracts § 161(b) (1981). Whether the omission concerns a "fact" also could be disputed.

198. See *id.* § 161 cmts. d & e (identifying the potential availability of the defense of mistake where the wrongdoer merely had reason to know of the mistake).

199. *Id.* § 161(c).

200. See *id.* § 161 cmt. e, illus. 12.

201. See *id.* § 159 cmt. b.

202. *Id.*

omitted information undercuts the information conveyed.²⁰³ The seizure of a hidden contractual hostage need not necessarily involve such a statement. For example, the drafting lawyer could, in response to an inquiry concerning proposed language, describe one of the possible implications of the language after saying, "Consider the following fact pattern." The drafting lawyer could then identify the application of the provision in question to that fact pattern. Any complaint concerning the omission of other implications does not undercut the truth of the statement asserted and thus is unlike the illustrations.

These cases evidence a strong bias against granting a sophisticated party relief from contractual provisions, under a theory of fraud, on the basis that the other party failed to identify all the legal consequences of the provisions. The above discussion identifies significant authority upholding, in the face of fraud challenges, negotiation tactics that are substantially more misleading, involving outright falsehoods. The theory of fraud, then, does not present substantial obstacles to the enforcement of latent contractual hostages against sophisticated parties.²⁰⁴

E. *Good Faith, Impracticability and Similar Defenses*

A variety of additional doctrines afford courts the power to alter the bargain expressly struck by the parties. They include defenses, such as impracticability, mistake, and frustration, as well as the doctrine of good faith.²⁰⁵ E. Allan Farnsworth has noted, "The cases in which an adversely affected party has been allowed to avoid the contract on this ground [of mutual mistake] are not marked by their consistency in either reasoning or result."²⁰⁶ Application of the other three principles to a fact pattern involving a hidden contractual hostage is similarly murky.²⁰⁷

The historical application of these doctrines has been fundamentally inconsistent, so an exhaustive review of the case law and literature cannot accurately predict the extent to which these

203. See *id.* § 159 cmt. b, illus. 3, 4.

204. The result could substantially differ were the victim unsophisticated.

205. See Gergen, *Defense*, *supra* note 35, at 50 ("The impracticability, mistake, and frustration doctrines permit courts to ignore contractual terms, but it commands them to respect bargained-for allocations of risk.").

206. 2 Farnsworth, *supra* note 120, § 9.3.

207. Compare Gergen, *Defense*, *supra* note 35, at 46 (arguing these doctrines are manifestations of a principle of "loss alignment" under which a party is relieved from "a significant and unexpected loss under a contract when such relief would leave the other party in a position no worse than she would have been in had the contract not been made") with Andrew Kull, *Mistake, Frustration, and the Windfall Principle of Contract Remedies*, 43 *Hastings L.J.* 1, 5-6 (1991) (arguing that the cases suggest a judicial principle of "inertia," in which courts leave the parties in their respective positions).

doctrines will prevent the realization of hidden contractual hostage rights. Nevertheless, a review of a series of cases decided by the United States Court of Appeals for the Seventh Circuit discloses some relevant nuances in these doctrines.

The first case in the series is the controversial decision in *Kham & Nate's Shoes No. 2, Inc. v. First Bank*.²⁰⁸ This case involves a bankruptcy court's equitable subordination of obligations under a credit facility provided by First Bank of Whiting to Kham & Nate's Shoes.²⁰⁹ First Bank of Whiting first loaned funds to the debtor in 1981.²¹⁰ By late 1983, the debtor had developed serious liquidity problems and owed the bank \$42,000.²¹¹ Additionally, the bank bore contingent liability under letters of credit in favor of certain creditors of Kham & Nate's Shoes.²¹²

The bank and the debtor formulated a two-part solution to the debtor's liquidity problems.²¹³ The parties contemplated that a long-term solution to the debtor's liquidity problems would be realized by the debtor's obtaining a \$1.2 million loan guaranteed by the Small Business Administration.²¹⁴ To address the debtor's financial difficulties in the interim, pending resolution of the debtor's negotiations with the Small Business Administration, the debtor obtained a new \$300,000 line of credit from the bank.²¹⁵ The bank's obligation to extend credit under this new line was conditioned on the debtor's filing a bankruptcy petition and granting the bank a "superpriority" lien, under 11 U.S.C. § 364(c)(1), on essentially all the debtor's assets.²¹⁶ The line of credit was subject to cancellation on five days' notice.²¹⁷

The debtor subsequently drew funds under the new line of credit.²¹⁸ However, it did not secure the permanent, SBA-guaranteed

208. 908 F.2d 1351 (7th Cir. 1990). In addition to the issues discussed in this Article, *Kham & Nate's Shoes* also involved the "new value" principle under federal bankruptcy law. This principle was the basis on which the district court confirmed a plan of reorganization that allowed the debtor's principals to retain equity interests in the debtor. *See id.* at 1353. The ongoing vitality of the "new value" principle is in question. *See generally* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. Partnership, 526 U.S. 434, 443 (1999) (reserving the question of whether there is a new value exception).

209. *See* 908 F.2d at 1354.

210. *See id.* at 1353.

211. *See id.*

212. *See id.*

213. *See id.*

214. *See* First Bank v. Kham & Nate's Shoes, No. 2, Inc., 104 B.R. 909, 910 (N.D. Ill. 1989) (affirming the bankruptcy court's order to subordinate obligations of Kham & Nate's Shoes), *order vacated*, 908 F.2d 1351 (7th Cir. 1990).

215. *See* First Bank, 104 B.R. at 910.

216. *See id.*

217. *See* Kham & Nate's Shoes, 908 F.2d at 1353.

218. *See id.* at 1354.

financing.²¹⁹ Approximately one month after the \$300,000 line of credit was signed, the bank notified the debtor that the line of credit was being terminated.²²⁰ The debtor subsequently proposed a new plan of reorganization under which obligations to the bank would be treated as unsecured.²²¹ The bankruptcy court equitably subordinated obligations owed to the bank and confirmed the plan.²²²

On appeal, the United States Court of Appeals for the Seventh Circuit examined whether the obligations owed to the bank should be equitably subordinated, on the basis that the bank had either engaged in "inequitable conduct" or violated its obligation to act in good faith.²²³ The court, in an opinion written by Judge Easterbrook, vacated the order confirming the plan of reorganization, which equitably subordinated extensions of credit under the \$300,000 line of credit.²²⁴ The court noted that the obligation to act in good faith "do[es] not block [the] use of terms that actually appear in the contract."²²⁵

This fact pattern is similar to those in which parties may properly seek to exercise latent hostage rights. The bankruptcy court found that the bank would have been secure in making additional advances.²²⁶ When the bank decided to terminate the line of credit, however, the debtor ultimately incurred substantial losses.²²⁷ If one believes these findings,²²⁸ the bank's actions in terminating the line of credit resulted in little direct benefit to the bank while causing substantial harm to the debtor, an outcome similar to the hallmarks of an optimal hostage scenario.

This particular dispute did not involve a latent contractual hostage. The debtor did not argue on appeal that it had been unaware of the import of the contractual language allowing the bank to terminate the line of credit. In fact, the court noted that the documents made the bank's termination rights manifest; the contract stated, "[N]othing provided herein shall constitute a waiver of the right of the Bank to

219. See *First Bank*, 104 B.R. at 911.

220. See *Kham & Nate's Shoes*, 908 F.2d at 1354.

221. See *id.*

222. See *id.*

223. See *id.* at 1357.

224. See *id.* at 1363.

225. *Id.* at 1357.

226. See *id.* at 1358.

227. See *First Bank v. Kham & Nate's Shoes, No. 2, Inc.*, 104 B.R. 909, 911 (N.D. Ill. 1989).

228. The discussion in the appellate court's opinion of the absence of bad faith or inequitable conduct suggests that some of the bankruptcy court's findings of fact are not credible. The bankruptcy court found that the bank "would have been secure in making additional advances." *Kham & Nate's Shoes*, 908 F.2d at 1358. The opinion at the appellate level, however, states that the inability of the debtor to obtain financing from any other source supports the view that the bank would *not* have been secure in making additional advances. See *id.*

terminate financing at any time."²²⁹ Nor does the opinion suggest that the bank sought to terminate the line of credit because the debtor was engaging in improper conduct.²³⁰ Although this factual pattern did not involve a latent contractual hostage, the court's discussion of the principles of good faith is consistent with a more narrow understanding of the implied covenant of good faith. Such an understanding would be more accommodating of latent contractual hostages. It discredits the view that the implied covenant of good faith prevents one party from taking actions that seriously disadvantage the other party but do not benefit itself.

The second case in the series, *Market Street Associates Ltd. Partnership v. Frey*,²³¹ involves a dispute concerning the terms of a commercial lease. A provision in the lease entitled the tenant to "request Lessor . . . to finance the costs and expenses of construction of additional Improvements upon the Premises" in the amount of \$250,000 or more.²³² The lease further provided that if the parties could not reach an agreement on the landlord's financing of the improvements, the tenant would have the option to purchase the property at a price specified by a formula set forth in the lease.²³³ The tenant requested financing for \$2 million in improvements with an oblique reference to the lease provisions addressing financing of improvements.²³⁴ The landlord declined to provide financing without entering into negotiations, and the tenant subsequently sought to exercise the purchase option set forth in the lease.²³⁵ The district court granted summary judgment in favor of the landlord on the basis, *inter alia*, that the tenant violated the duty of good faith. The tenant appealed.²³⁶

The opinion issued by the court of appeals quotes *Kham & Nate's Shoes* for the proposition that the covenant of good faith prevents opportunism in contract performance that could not have been contemplated when the contract was formed.²³⁷ In reversing the district court's award of summary judgment in favor of the landlord, the court said:

We do not usually excuse contracting parties from failing to read and understand the contents of their contract; and in the end what

229. *Id.* at 1353.

230. The bank's President indicated that the bank terminated the line of credit as a result of a conflict between himself and the bank employee who arranged the line of credit. *See First Bank*, 104 B.R. at 911.

231. 941 F.2d 588 (7th Cir. 1991).

232. *Id.* at 591.

233. *See id.*

234. *See id.* (indicating that one of two letters from the tenant requested a discussion of "financing pursuant to the lease").

235. *See id.* at 591-92.

236. *See id.* at 592.

237. *See id.* at 595.

this case comes down to... is that an immensely sophisticated enterprise simply failed to read the contract. On the other hand, such enterprises make mistakes just like the rest of us, and deliberately to take advantage of your contracting partner's mistake during the performance stage (for we are not talking about taking advantage of superior knowledge at the formation stage) is a breach of good faith. To be able to correct your contract partner's mistake at zero cost to yourself, and decide not to do so, is a species of opportunistic behavior that the parties would have expressly forbidden in the contract had they foreseen it.²³⁸

The court further distinguished actions taken during the negotiation of a contract, noting, "The formation or negotiation stage is precontractual, and here the duty is minimized. It is greater not only at the performance but also at the enforcement stage, which is also postcontractual."²³⁹

The United States Court of Appeals for the Seventh Circuit subsequently addressed the duty of good faith in *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*²⁴⁰ This case arose from a dispute between a franchisor and a franchisee over the operation of a cookie store.²⁴¹ The franchisor terminated the franchise on the basis, *inter alia*, that the franchisee had been delinquent in making payments.²⁴² In a discussion regarding the franchisee's failure to demonstrate the franchisor's violation of the covenant of good faith, the court noted that the franchisor had offered to allow the franchisee to assign the franchise. That offer could indicate that the franchisor was not seeking to appropriate value properly belonging to the franchisee.²⁴³

These later cases also reflect a construction of the implied covenant of good faith that is more favorably inclined toward enforcing latent contractual hostages. The emphasis noted above²⁴⁴ in *Market Street Associates* on the increase in the scope of the obligation to act in good faith, arising as the parties pass from the contract negotiation phase to the performance phase, suggests a greater willingness to enforce hidden contractual hostages, which are created before the duty of good faith increases. In *Great American Cookie Co.*, the reference to the franchisor's lack of direct benefit from terminating the franchise supports the conclusion that the franchisor did not violate its obligation to act in good faith.²⁴⁵ This reference suggests a sensitivity to issues relevant to enforcing the preferred types of hostages—those

238. *Id.* at 597.

239. *Id.* at 595.

240. 970 F.2d 273 (7th Cir. 1992).

241. *See id.* at 275.

242. *See id.* at 278.

243. *See id.* at 280.

244. *See supra* notes 231-36 and accompanying text.

245. *See* 970 F.2d at 280.

that do not create incentives for the holder of the hostage to act opportunistically.

It should be noted, however, that none of these cases directly addresses the enforceability of a latent contractual hostage. Moreover, the hostage may be used to restrain opportunism in a situation entirely unrelated to the contract term giving rise to the hostage.²⁴⁶ There is some support for the position that it is bad faith to exercise a contractual right for a purpose entirely divorced from the putative purpose of the right.²⁴⁷ In jurisdictions following that principle, there would be substantial limits on the enforceability of hidden contractual hostages.

F. Conclusions

Some of the doctrines discussed in this Part have nuances that facilitate the creation of latent contractual hostages. The impact of other doctrines is to prevent the creation of latent contractual hostages, particularly the preferred latent contractual hostages that do not induce second order or consequential opportunism by the hostage taker. It is not easy to assess quantitatively the efficiency of these preventative doctrines, as applied to highly negotiated and documented commercial transactions, compared with the alternative doctrines that increase the enforceability of latent contractual hostages.

In other contexts, a similar assessment can be made if one of the two alternatives can be shown to have a negative or zero value and the other alternative is shown to have a positive value. A principle that contracts should be construed "reasonably" seems defensible in that fashion. A cursory inspection yields no benefits to construing contracts unreasonably. In some contexts, there are certainly benefits to adopting a reasonable construction of a contract, even if the construction is not as consistent with the actual language used as an "unreasonable" alternative construction. But if a closer inspection indicates that there are some circumstances where the "unreasonable" construction produces superior results, identifying the more efficient legal principle becomes much more complex. Because the judiciary is not well-equipped to make the requisite empirical inquiry, even if the question could be practicably resolved, the determination is more an

246. See *supra* text accompanying notes 76-81.

247. See Robert A. Hillman, *An Analysis of the Cessation of Contractual Relations*, 68 Cornell L. Rev. 617, 622 (1983) ("[C]ourts may find bad faith where a party that is unharmed by the breach of an express clause uses the breach as a pretext for ceasing performance and entering into a more attractive alternate deal."). But see *Oak Mill Enters. 2000, Inc. v. Knopfler (In re Schraiber)*, 141 B.R. 1000, 1005-06 (holding, in a case citing *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351 (7th Cir. 1990), and *Market St. Assocs. Ltd. Partnership v. Frey*, 941 F.2d 588 (7th Cir. 1991), that such an exercise of a condition does not constitute bad faith).

exercise in judgment, i.e. decisionmaking in the absence of sufficient data or a rigorous decisionmaking algorithm.²⁴⁸

V. IMPACT ON LAWYER COMPETENCE

Part IV discussed the impact of various principles of contract law on the ability of lawyers to take hidden hostages. The failure to adopt principles of contract law that allow lawyers representing sophisticated parties in negotiated transactions to take hidden hostages can have a perverse impact on the type of representation ultimately obtained by clients. This Part discusses that impact.

Transactional lawyers use contract provisions to allocate risks. One way in which lawyers add value is by identifying potential risks. For example, a lawyer negotiating the terms of senior debt on behalf of the senior creditor can add value by pointing out that the value of the senior debt can be adversely affected if the debtor can incur subordinated indebtedness maturing before the senior debt.

Of course, a lawyer can bring excessive zeal to this activity, ensnaring the negotiations with an overwhelming array of issues to be resolved. One of the obligations of counsel in a transaction is to exercise judgment in limiting the points that need to be addressed in negotiations. But the fact that transactional lawyers are not perfect in their exercise of this judgment does not eliminate the value arising from the identification and discussion of proper issues.²⁴⁹

Just as a transactional lawyer will exercise discretion in raising legal issues, a transactional lawyer will exercise discretion in taking hidden hostages as well. Attempts to take excessive numbers of hidden hostages may result in the identification of the hostages and an adverse effect on the tenor of negotiations. A prudent lawyer will assess the likelihood of potential problems and respond with a balanced strategy, addressing some issues directly in negotiations and others with hidden hostages, as the context requires.

But if the hostages are not enforceable, there is no incentive for a client to hire a lawyer who can properly make that assessment. A diminution of the value that can be realized from identifying issues decreases the extent to which market forces will reward lawyers who are able to identify potential risks in advance. A natural consequence of that result is a decrease in the extent to which clients are apprised of risks that should cause transactions not to proceed.

248. Cf. Gergen, *Defense*, *supra* note 35, at 98 (stating that the relative costs and benefits of defenses excusing performance cannot be assessed).

249. See Painter, *supra* note 94, at 544 (quoting Benjamin Cardozo, describing the transactional lawyer as a "creative agent" crafting contracts "with privileges or safeguards till then unknown to the business world" (quoting Sullivan & Cromwell, *A Century at Law* 15 (1979))).

CONCLUSION

Lawyers add value to transactions by creating relationships that minimize transaction costs.²⁵⁰ At times, actions that appear “unreasonable” in the negotiation of commercial relationships, such as the taking of hidden hostages, can actually be reasonable. Those apparently unreasonable actions can increase joint transaction value by decreasing opportunism.

One natural consequence of this value-adding method is that lawyers incur reputations for being unreasonable. They act as a reputation “sink,” deflecting reputational consequences for certain actions from their clients.

Marc Galanter has identified four categories of complaints against lawyers: “[L]awyers are (1) corrupters of discourse; (2) fomenters of strife; (3) betrayers of trust; or (4) economic predators.”²⁵¹ Although this Article has not attempted to address all the bases for the adverse reputation that lawyers have garnered, for example lawyers’ betrayals of clients’ trust, it does address a significant source of the adverse reputation of lawyers.

In addition to articulating an intellectual salve for the wound to the collective self-image of lawyers inflicted by popular perceptions, this Article provides some modest insights into principles of contract construction and principles providing defenses to the enforcement of contracts. The actions that result in lawyers taking hidden hostages can produce contractual rights, not knowingly assented to by all the parties, that increase the possibility of opportunism. It is not at all clear that a court could apply the relevant defenses to contract enforcement and principles of contract construction in a fashion that would limit enforcement of latent contractual hostages to those that are beneficial. However, the possible joint benefit arising from hidden contractual hostages suggests that greater circumspection is required before a court should decline to enforce facially unreasonable, highly negotiated contract provisions against a sophisticated party.

250. See Gilson, *supra* note 18, at 312-13.

251. See Marc Galanter, *Predators and Parasites: Lawyer-Bashing and Civil Justice*, 28 Ga. L. Rev. 633, 634 (1994).