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When Should Contract Law Supply a Liability Rule or Term?: Framing a Principle of Unification for Contracts

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WHEN SHOULD CONTRACT LAW SUPPLY A LIABILITY RULE OR TERM?: Framing a Principle of Unification for Contracts

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I. INTRODUCTION: JUSTIFYING LAW SUPPLIED RULES AND TERMS

Nineteenth century formalism limited contract enforcement to privately negotiated terms.[1] The twentieth century has witnessed the expansion of several contracts doctrines, such as promissory estoppel and good faith, which have involved courts in supplying terms not expressly negotiated by the parties. The willingness of courts to intervene in incomplete contracts has increased with the recognition that it is difficult and costly for the parties to resolve all matters *ex ante*, particularly in long-term contracts.[2] Some

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1. Limiting enforcement to privately negotiated terms was consistent with the autonomy principle. For a discussion of the autonomy principle and its limitations, see Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 514-17 (1989).

2. As Clayton Gillette explains these transaction costs, "[t]he passage of time renders complete contracting both difficult and undesirable, for the costs of allocating risks deemed unlikely to materialize at all, or only in the distant future, tend to exceed the current value of expected losses from the remote event." Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535, 535 (1990); *see also* Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367 (1983) (detailing barriers to fully contingent contracts); James M. Malcomson, *Contracts, Hold-Up, and Labor Markets*, 35 J. ECON. LIT. 1916, 1917 (1997) (explaining that contracts are likely to "be incomplete in the sense that [the contract] cannot be conditioned on all the events that affect the payoffs to the parties" because of transaction costs and verifiability problems). Sometimes the

doctrines filling in incomplete contracts take the form of immutable or mandatory law-supplied rules;[3] others exist as default rules that supply a term unless the parties opt out of the rule.[4] Because courts (and legislatures) have assumed the role of implying terms,[5] the critical question of justification for such terms arises: when and why *should* the *law* supply a term or a liability rule[6] that the parties have not expressly agreed to?

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decision to leave gaps in the contract will be a rational one on the assumption that the likelihood of the event is remote. "Less rationally, the parties will leave out other contingencies that they simply do not anticipate." Oliver Hart & Bengt Holmström, *The Theory of Contracts*, *in* ADVANCES IN ECONOMIC THEORY 71, 132 (Truman F. Bewley ed., 1987).

There is another problem in addition to the transaction costs themselves. Even if the parties agree on specific contract language "they may be unable to do so in a way that a court can enforce their intentions because the necessary information cannot be documented in court." Malcomson, *supra* at 1917.

3. Immutable rules are not variable by the parties. There are several reasons for the law to impose immutable rules that cannot be contracted out of, as Ayres and Gertner explain. "There is surprising consensus among academics . . . on two normative bases for immutability. Put most simply, immutable rules are justifiable if society wants to protect (1) parties within the contract, or (2) parties outside the contract." Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 88 (1989). A prime example in the Uniform Commercial Code of an immutable rule, cited by Professors Ayres and Gertner, is the obligation of good faith. *Id.* at 87. *But see* GEORGE COHEN, IMPLIED TERMS AND INTERPRETATION IN CONTRACT LAW: THE LAW AND ECONOMICS APPROACH 6 (Univ. Va., Working Paper, Spring 1998) (on file with author) (suggesting good faith can also be rationalized as a default rule rather than a mandatory one).

4. Default rules are rules which the parties can choose to ignore by adopting an alternative contract. Ayres & Gertner, *supra* note 3, at 87. Courts (and other legal decision-makers) become involved in supplying default rules when the parties fail to resolve a matter by express contract *ex ante*. Questions of the legitimacy of legal intervention in such cases and the appropriate framework to use in supplying terms are examined in Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639 (1989); *see also* Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1 (1993); Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J.L. & PUB. POL'Y 783 (1992) (critiquing Jules Coleman's rational bargaining theory as a basis for choosing default rules and elevating importance of consent theory); 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 (1985) (examining the way in which the system of state-supplied terms interferes with contractual innovation); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998) (examining problem of implication of a default rule creating a bias in favor of that default rule and examining methods to overcome such bias).

5. This was a role that contracts judges had consistently avoided (at least consciously). Critics would argue that by limiting enforcement to contracts as written and by applying "a system of suprahistorical norms transcending time and space," legal decision-makers ignored the inevitable "social contingency of our thinking about the law." Robert W. Gordon, *Historicism in Legal Scholarship*, 90 YALE L.J. 1017, 1025, 1056 (1981).

6. For a thoughtful treatment of the nature of property and liability rules, see Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

This issue of justification for legal interventions taking the form of a law-supplied term or liability rule is a critical one. "Contention over how lawmakers and their coadjutors—advocates and commentators—do (and should) formulate and explain rules is rarely off the boil and never at less than a rapid simmer."[7] The expansion of judicial interventions in incomplete contracts has prompted scholars to debate the very nature of the role which courts should play in private agreements. Some scholars have viewed the doctrinal developments and the expansion of default rules as a challenge to the fundamental notion that "[c]ontractual duties are self-imposed,"[8] since by definition law-supplied default rules are "imposing" rules on the parties and thus constitute a potential infringement on private autonomy.[9] Others have portrayed the advent of these interventions as a reflection of an underlying (but seldom admitted to) truth: that courts have and will continue to function in ways that extend beyond the implementation of private agreements,[10] into a domain that polices the fairness and substance of transactions by external norms.[11]

This Article is primarily concerned with default rules which imply obligations, liability rules, in cases where none were bargained for expressly between the parties. Another type of implication that courts might engage in might relate to representational statements. The focus of this Article is on implied obligations, though the same analytical structure used to justify such implied obligations might be used to justify implied representational statements in the form of communicative torts. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (May 5, 1997 16:36:50) (on file with author).

7. Ronald J. Coffey, Methodological Perspective 1 (Feb. 4, 1992) (unpublished manuscript on file with author); *see also* COHEN, *supra* note 3, at 1 ("[W]hen courts imply, and should imply, terms to which the contracting parties have not explicitly agreed loom large in contract disputes and in the legal literature on contract law.").

8. Coleman et al., *supra* note 4, at 639.

9. "The problem of justification is complicated by the fact that the parties are being held in contract to terms to which they did not explicitly agree." *Id.* at 641.

10. Even as early as the nineteenth century good faith and other public norms were being incorporated into the case law. Letter from Robert W. Gordon, Professor of Law, Yale University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University 1 (Nov. 10, 1999) (on file with author).

11. For a discussion of communitarian and fairness norms, see David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 375, 386-89 (1990); *see also* P.S. ATYIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 167-177 (1985) (discussing elements of "fair exchange"). The insertion of fairness norms has formed what Professor Scott categorizes as the second strategy for the contract interpretation of relational contracts. As he explains this method, the courts are directed to "fill in the 'right' result or the 'right relational' result by imposing an equitable adjustment that takes all of the relational and contextual factors into account as they appear at the time of adjudication." Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 850 (2000) [hereinafter Scott, *Formalism*]; *see also* Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 NW. U. L. REV. 369 (1981).

Other scholars have viewed these doctrinal instances of judicial interventions differently and as consistent with the notion of courts acting to facilitate private agreements. Using rational choice economic analysis[12] they have justified various legal interventions in terms of the parties' projected intentions and overall efficiency.[13] To implement private intentions and promote efficiency, the law should adopt the rule that most parties would have wanted absent transaction costs.[14] This approach favors majoritarian default rules "by providing widely suitable preformulations, thus eliminating the cost (and the error) of negotiating every detail of the proposed agreement."[15]

Two recent analysts, Professors Ayres and Gertner, have diverged from an interventionist posture and argued that in some cases the promotion of efficiency dictates that the law should decline to supply a term. When incompleteness is due to strategic nondisclosure,[16] courts should diverge from what the parties would have wanted and instead adopt a "penalty default rule"[17] designed to force the disclosure of information.

12.
> If we assume rationality, then it follows that, regardless of the risk attitudes of particular parties, the dominant strategy for contractual risk allocation is to maximize the expected value of the contract for both parties. Only by allocating risks in order to maximize the joint expected benefits from their contractual relationship can the parties hope to maximize their individual utility. Any deviation from joint maximization generates an inefficient and thus an unstable contract.

Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 602 (1990) [hereinafter Scott, *Relational Theory*].

13. The connection between efficient rules and consent is a complicated one that has generated significant controversy. Judge Posner had drawn a connection between efficiency and consent in default rules by arguing that "it would be rational for all parties to consent to whatever rules were most efficient." Richard Craswell, *Efficiency and Rational Bargaining in Contractual Settings*, 15 HARV. J.L. & PUB. POL'Y 805, 805 (1992) (discussing Jules Coleman's critique of Posner's proposed connection between consent and efficiency as justifications for default rules).

14. *See* Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward A General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971-72 (1983); *see also* Coleman et al., *supra* note 4, at 641 (describing this hypothetical bargain approach to contractual gaps as "the one the parties would have made had transaction costs not made their doing so irrational"). Absent such transaction costs, of course, the view would be that the legal rule would not matter since parties could bargain to an efficient outcome regardless of the initial legal rule. *See* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15-16 (1960).

15. Scott, *Relational Theory*, *supra* note 12, at 607. The majoritarian default rule approach favors an "objective conception of rationality," and seeks to mimic "a risk allocation the majority of similarly situated rational actors would have devised were they to bargain costlessly over the question in advance." *Id.*

16. Ayres and Gertner emphasize the importance of identifying the different causes for incompleteness for devising default rules. *See* Ayres & Gertner, *supra* note 3, at 92-94 (identifying strategic reasons and transaction costs as alternative explanations for incompleteness in contracts).

17. *See id.* at 95, 97.

This Article is written in the tradition of law and economics. It accepts the basic proposition that contract formation and default gap-filling rules should be crafted to achieve efficiency goals and thereby maximize social welfare gains.[18] It argues that by using economic analysis and by identifying the discrete elements of a methodology for legal intervention[19] it may be possible to rationalize disparate pieces of Contracts and contract theories. Although such a principle will not provide a meta-theory for all of contract law, clarifying the efficiency methodology for law-supplied terms and liability default rules would help to determine whether, when and how the law should intervene in a wide variety of contexts.[20]

The failure to clarify such methodology has adversely affected the analysis of whether, absent a bargain, a liability rule should be supplied by a court to govern precontractual negotiations and if so, under what circumstances and with what terms.[21] While current analyses of precontractual liability have benefited from a shift from a doctrinal to an instrumental, economic orientation, such analyses suffer from several flaws traceable to the failure to clarify the appropriate methodology for law-supplied liability rules and thus fall short of their potential. These

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18. It recognizes that there are other plausible goals the law could choose to serve in crafting legal rules. I will not revisit the debate on the propriety of using efficiency analysis. For a discussion of criticisms of the selection of efficiency as the goal to be achieved by contract rules, see Richard Craswell, *The Relational Move: Some Questions From Law and Economics*, 3 S. CAL. INTERDISC. L.J. 91, 100 (1993).

Of course, as Professor Coffey explains so trenchantly, "the choice of values to be pursued in a goal-driven system of rule justification is well nigh an ultimacy . . .; for 'rightness' or 'goodness' of value selection cannot be verified empirically." Coffey, *supra* note 7, at 5.

19. *See infra* Part III.

20. This Article's focus on justifying law-supplied rules differs from the formalist approach which has recently surfaced in the contracts literature. Formalism "resolutely declines to fill any gaps at all. Under this *formalist* approach, courts are instructed not to create *ex ante* defaults or undertake any *ex post* adjustments, but to enforce the (facially unambiguous) express terms of the contract literalistically . . . ." Scott, *Formalism*, *supra* note 11, at 851; *see also* Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (Peter Newman ed., 1998).

This Article also diverges from the recent scholarship examining the efficacy of non-legal sanctions as a reason underlying the predilection of transactors to dispense with legally enforceable commitments. *See generally* Charny, *supra* note 11. This Article argues, using a comparative net benefit analysis, that a law-supplied rule would be justified only if it were a cheaper means of achieving social welfare benefits at less cost than private contract or other non-legal devices, including sanctions. This Article thus offers a way of rationalizing non-legal sanctions and law-supplied rules in one explanatory theory. For an elegant description of explanatory theory, see Frank I. Michelman, *Norms and Normativity in the Economic Theory of Law*, 62 MINN. L. REV. 1015 (1978).

21. For a comprehensive treatment of the topic of preliminary negotiations and the possible distinct sources of liability, see E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987).

approaches fail to take sufficient account of the behavioral realities of preliminary bargaining, including precontractual uncertainty,[22] and neglect the critical question of justification.[23] These analytical failures in turn lead to incomplete justifications for, erroneous applications of, and overly restrictive cost benefit analyses for precontractual liability rules. The failure to develop a comprehensive methodology for law-supplied liability rules and terms has obscured scholarly analysis of contract default rules in general. It has also hampered analysis of particular problems in contract law, such as the general contractor's reliance in bidding contexts, and interfered with rationalizing judicial approaches to incomplete contracts.[24]

This Article offers a comparative net benefit methodology for resolving omissions in incomplete contracts.[25] Such a methodology can assess the

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22. *See infra* Part IV.B.2.

23. *See infra* Part IV.B.4.

24. *See infra* Part VI; *see also* Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies* 21 J. LEGAL STUD. 271 (1992).

25. For an early treatment highlighting the importance of precontractual uncertainty and a comparative framework, see Juliet P. Kostritsky, *Reshaping the Precontractual Liability Debate: Beyond Short Run Economics*, 58 U. PITT. L. REV. 325, 370-85 (1997) [hereinafter Kostritsky, *Short Run Economics*]. The use of a comparative framework is reflected in Professor Jason Johnston's recent treatment of the topic of preliminary negotiation. In his article, Johnston considers whether there is a need for a law-supplied liability rule in the "courtship" process of preliminary negotiation. Jason Scott Johnston, *Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation*, 85 VA. L. REV. 385 (1999). He argues that in some instances there will be no need for legal liability (and that legal liability will be counterproductive) because the parties themselves will have a private incentive to engage in "cheap talk." *Id.* at 389. The parties will have a private incentive to truthfully and accurately engage in cheap talk about the probabilities of trade occurring because of the "parties' mutual interest in minimizing wasteful expense in investigating and negotiating when there is in fact no possibility of mutually beneficial trade." *Id.* at 390. In such cases Johnston argues that legal liability would be counterproductive because it would actually "deter the low-cost seller from informing buyers that it is low-cost." *Id.* at 416. In other instances, Johnston argues that legal liability may be warranted where the non-performing party has an incentive to be deceptive about the actual possibility of trade. In such cases, the non-performing party who wishes the performing party to invest reliance expenditures and to engage in performance to help the non-performing party decide whether a deal will be in the parties' interest, the "pretrade talk will not be informative, when one party (say the seller) will wish to encourage the buyer to continue in the courtship process even though the buyer would not continue if it were informed that the seller knows agreement is relatively unlikely." *Id.* at 491.

While this Article agrees that a comparative framework assessing private and legal responses in terms of their behavioral effects is needed, Johnston's focus on the dissembling aspect and the non-performing party's tendency to mislead the performing party about the chances for a trade diverts attention from the main issue: the potential for opportunistic exploitation of sunk costs to reduce one party's uncertainty. There may be no active intent to mislead the performing party about the chances for a trade since the non-performing party itself may be uncertain as to the chances for a trade. Nevertheless, the non-performing party solicits sunk costs to reduce the uncertainty for himself and thereby subjects the performing party to the hazard of opportunistic exploitation of sunk costs. Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard and Sunk Costs: A Default* efficiency of a law-supplied rule in the sense of achieving goals for parties at less cost than private solutions. Such methodology would improve the analysis of precontractual liability issues in the cases, rectify deficiencies in default rule approaches, and resolve subcontractor liability under the famous *Drennan* rule.[26] Articulation of the theory would unify a variety of seemingly unrelated contract doctrines as diverse as Section 45 of the Second Restatement of Contracts, promissory estoppel, implied excuse, and fiduciary obligation.

The Article takes an instrumental approach to contract formation and other doctrinal issues. It assumes that lawmakers (and parties themselves) are interested in maximizing social wealth.[27] Like all instrumental analyses, it assumes that contract law has a "regulatory role"[28] to play in crafting legal rules. It therefore assumes that liability rules will influence future bargainers' "behavior in ways that will affect social welfare."[29] Assessing a rule's capacity for maximizing social wealth requires inquiry into whether adoption of such rule will hinder or advance that goal, given the way in which people with average behavioral characteristics will respond to the rule.

To demonstrate the need for a unified instrumental framework for deciding gaps and implying liability rules, Part II of this Article will first describe the competing visions of the role of law in contract gap-filling. Although each vision has expanded the ways in which we think about contracts and has offered more realistic models of bargaining, each still fails to offer a unified framework for deciding how courts should decide

Rule for Precontractual Negotiations, 44 HASTINGS L.J. 621, 629 (1993) [hereinafter Kostritsky, *Moral Hazard*]. This risk of opportunism or strategic behavior by contracting partners provides the focus of this Article. To counteract that opportunism, this Article suggests a law-supplied liability rule, even when there is no active deception. The justification for that implied rule rests instead on a comparative net benefit approach assessing the costs and benefits of alternative strategies for controlling opportunism including a law-supplied liability rule and private mechanisms the parties could devise.

26. Drennan v. Star Paving Co., 333 P.2d 757 (Cal. 1958). The *Drennan* rule formulated by Justice Traynor implies a term of irrevocability in the subcontractor's offer once it is relied on by the general contractor in formulating the overall bid. *Id.* at 760. It is reflected in RESTATEMENT (SECOND) OF CONTRACTS § 87 (1979).

27. "Neoclassical economics maintains a maximizing orientation. That is unobjectionable, if all of the relevant costs are recognized." OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 45 (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS].

28. For a lucid explanation of the differences between instrumental analyses of legal rules and the "traditional dominance of the interpretive approach" geared to ascertaining "what inferences the parties are justified in making about each other's intentions," see Avery Katz, *When Should An Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249, 1250-52 (1996).

29. Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1264 (1980).

incomplete contracts. Part III of the Article outlines the methodological framework for unifying judicial approaches to law-supplied terms or rules. The framework will incorporate a: (1) realistic model of human behavior; and (2) a comparative net benefit framework to assess law-supplied interventions. Part IV traces the origin of the unifying comparative net benefit method to new institutional economics. Part IV analyzes how the failure to advert to the problems of uncertainty (and other bargaining impediments) has impaired the development of a complete comparative cost structure outlined in this Article and hampered the analysis of precontractual liability. Commentators compound these problems by employing overly restrictive cost/benefit analyses which fail to provide promisees with the optimal incentives to rely. Current analyses of reliance ignore the important issues of the problem of opportunistic expropriation of reliance investments. Accounting for these issues and applying the suggested methodology to reliance issues would improve results. Part IV applies the theory to several prototypical reliance cases. Part V explores two frameworks for dealing with incomplete contracts: a hypothetical bargain and penalty default rules. Since both approaches lack a comparative cost framework, neither can fully justify a law-supplied liability rule or term. Part VI applies the unified comparative net benefit framework to determine whether and in what fashion the law should intervene to protect the general contractor's reliance on a subcontractor's offer and concludes that the protections of *Drennan* should be modified using the framework outlined here. Part VII uses the unified framework to rationalize a myriad of cases of law-supplied interventions in contract. The section will address Professor Alan Schwartz's theory for explaining judicial strategies of intervention in incomplete contracts.[30] Part VIII offers a final assessment of why a comparative net benefit framework matters and outlines its advantages.

II. UNITY THROUGH CLASSICAL LIBERAL THEORY FOLLOWED BY NEOCLASSICAL, RELATIONAL, FAIRNESS, AND EXTRACONTRACTUAL THEORIES

The development of a well-articulated methodology for justifying legal interventions has not yet been fully realized. Because the classical nineteenth century contract writers disavowed any role for law-supplied liability rules or terms, that liberal theory of contract[31] hindered the development of a theory

30. *See supra* note 24.
31. *See* GRANT GILMORE, THE DEATH OF CONTRACT 14-17 (1974) (describing Willistonian and Holmsian Classical thought).

of legal intervention, insisting that parties choose their own terms. Various doctrines in contracts[32] reinforced that non-interventionist stance, thus rendering questions about legal intervention unnecessary. The theory emphasized freedom from contract and abstract rules, as well as the "fundamental dichotomy . . . between the individual and the community."[33] Courts advanced an individualistic focus by narrowly limiting their role to the enforcement of voluntary, consensual obligations.[34] Consequently, they generally declined (at least consciously) to interfere with voluntary agreements or to supply terms for the parties.[35]

That unified vision of contract law has disappeared (or seemed to) as at least some courts and scholars recognized the unrealistic nature of a model which assumed that all problems could be solved by the parties *ex ante* by express contract. Proponents of neoclassical[36] and relational contract theory[37] recognized the inevitability of contractual gaps and the concomitant need for judicially supplied rules to govern omissions. These newer theories of contract reflected greater realism in the vision of contracting relationships and an increased recognition of the impossibility of achieving the complete "presentiation"[38] ideal of classical theory under which all possible problems were resolved *ex ante* by contract.[39] The neoclassical recognition of deficiencies in the original contract caused its proponents to accede that "courts had to interpret, fill gaps, and even impose precontractual and quasi-contractual liability."[40] Neoclassicists also recognized that parties themselves

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32. These doctrines included requirements of certainty as a precondition for enforcement. *See* E. ALLAN FARNSWORTH, CONTRACTS § 3.27 (3d ed. 1999). For an interesting discussion of the common law certainty requirement as an example of a penalty default rule, see Ayres & Gertner, *supra* note 3, at 97.

33. Jay M. Feinman, *The Significance of Contract Theory*, 58 U. CIN. L. REV. 1283, 1286 (1990).

34. Jay M. Feinman, *Critical Approaches to Contract Law*, 30 UCLA L. REV. 829, 831-32 (1983).

35. But as Robert Gordon notes, the classical theory of nineteenth century formalism may have been belied by the reality of the case law since "in the actual case law, there was plenty of estoppel, good faith and unconscionability even in the 1880s and 90s, the supposed high point of classical theory." Gordon, *supra* note 10.

36. *See* Feinman, *supra* note 33, at 1285-89 (describing parameters of neoclassical contract theory).

37. Ian Macneil championed the idea of relational contracts to demonstrate the complexity of and conflicts inherent in such relationships and to explore the limits on the cognitive abilities of the parties to "presentiate" and deal with all future contingencies *ex ante*. *See* Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978); *see also* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

38. Macneil, *supra* note 37, at 863.

39. Feinman, *supra* note 33, at 1287.

40. *Id.* at 1287.

could solve some of the gaps by "[t]hird party assistance in resolving disputes and evaluating performance"[41] in the form of arbitration.

Despite the agreement on the need for courts to play a greater role in incomplete contracts, there was disagreement on the nature of that role. Some viewed the expanded role to reflect a view that courts should police contracts by applying substantive standards external to the parties' individual agreements. Some neoclassicists questioned the perceived paradigm of a fully contingent contract negotiated by two "atomistic individuals;"[42] they tempered the autonomy and individualistic focus of classical contract law by embracing the application of "communal standards of responsibility to others."[43]

Other courts exercised this expanded role by embracing standards over rules[44] and by engaging in particularized fact-based contextual inquiries.[45] Courts demonstrated an increased willingness to fill in gaps in incomplete contracts, often rationalizing the intervention in terms of the parties' projected private intentions.[46]

Relational visionaries like Professor Ian Macneil, who followed the Neoclassicists, continued to chip away at the perceived paradigm underlying liberal theory. They stressed the unreality of liberal theory's assumption that the archetypal contract relationship was a discrete one-shot spot sale when in actual fact, many contract relationships were complex, continuing, and interwoven.[47] Relationalists stressed the importance of that complex relation and directed the decision-maker to confront the inevitable need to make adjustments not by reference to the contract itself but by reference to the "entire relation" as a reference point for contract adjustments.[48]

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41. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 70.

42. *See* Robert W. Gordon, *Unfreezing Legal Reality: Critical Approaches to Law*, 15 FLA. ST. U. L. REV. 195, 207 (1987).

43. Feinman, *supra* note 33, at 1287-88.

44. For an important treatment of this shift, see Richard E. Speidel, *Restatement Second: Omitted Terms and Contract Method*, 67 CORNELL L. REV. 785, 786 (1982). Professor Kaplow "offers an economic analysis of the extent to which legal commands should be promulgated as rules or standards." Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 557 (1992).

45. Speidel, *supra* note 44, at 789 ("Consequently, standards rather than rules were essential, for standards both permitted and required the particular dispute to be set in context.")

46. The effort to rationalize interventions in terms of the parties' projected intentions took the form of courts formulating default rules that would be hypothetically preferred by the parties. Justifications for the default rule strategy rest on instrumental considerations. *See* Scott, *Formalism*, *supra* note 11, at 2-8 (explaining instrumental cost saving justification for default rules).

47. Ian R. Macneil, *Restatement (Second) of Contracts and Presentiation*, 60 VA. L. REV. 589, 594 (1974).

48. Macneil, *supra* note 37, at 890; *see also* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 72.

While the neoclassical and relational approaches to contract law have advanced a more realistic model of bargaining than the mythical completely contingent contract, they still lacked a framework to guide judges and other legal decision-makers confronting the great issue of contracts: when the law should intervene with a term or liability rule when the parties have failed to decide a matter by express private arrangement. The failure to offer such a detailed framework can be explained in part because of the neoclassical orientation to "techniques used by contract planners"[49] themselves as a means of resolving gaps rather than to law-supplied interventions. Moreover, to the extent neoclassicists recognized a role for courts for gap-filling, directing decision-makers to use "policy analysis, empirical inquiry, and practical reason,"[50] they failed to provide a detailed and close analysis of the justification for legal interventions. Relational visionaries (championed by Ian Macneil) centered one inward to the "relation" with its "minisociety with a vast array of norms."[51] Such relational theory thus suffered from a flaw similar to the neoclassicists: of failing to address precisely how decision-makers should decide whether and how to fill gaps in incomplete contracts. While the reader of Macneil's work is directed to the organic nature of contractual relationships and advised to give less "deference" to the contract[52] and more deference to the relational norms, a framework for using relational concepts to resolve incomplete contracts remains undeveloped.

Other visions of contract law have argued that fairness or distributional concerns are increasingly important in modern doctrines (such as unconscionability) and should guide contract gap-filling and interpretation.[53] Fairness theorists focus on bargaining impediments arising from a special deficiency of one of the parties which might justify judicial interference in the form of a refusal to enforce all or part of a contract.[54]

There are, however, several difficulties with the fairness vision as a means of guiding courts confronted with the need to fill in gaps. "[U]nless highly specified, [fairness] is amenable to widely variegated interpretations,"[55] and therefore the concept remains a problematic foundation for rule justification. Because fairness is such an open-ended

49. Macneil, *supra* note 37, at 865; *see also* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 70.

50. Feinman, *supra* note 33, at 1288.

51. Macneil, *supra* note 37, at 901.

52. *Id.* at 890; *see also* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 72.

53. *E.g.*, Charny, *supra* note 11, at 386 ("This communitarian approach purportedly accommodates a range of community interests rather than simply enforcing choices made by the contracting parties.").

54. *See, e.g.*, U.C.C. § 2-302.

55. Coffey, *supra* note 7, at 9.

term susceptible of many meanings, by itself, the vision provides no means of differentiating when supplying a liability rule or term will or will not advance fairness goals. Moreover, because it focuses on the (extreme) case where one party suffers from a particular, individualized impediment, it is difficult to abstract from that case a theory of how contracts cases involving omitted terms should be decided when parties are equal as to endowment and the barriers to complete contracts involve informational or structural problems including: asymmetric information, sunk costs, and bounded rationality which are likely to recur over many transactions and affect all bargainers.

Moreover, because there are conflicting visions of fairness,[56] it is difficult to justify intervention in terms of facilitating a particular fairness goal.[57] As Professor Ronald Coffey explains "fairness . . . unless highly specified is amenable to widely variegated interpretations and therefore is not, in its undifferentiated form, susceptible of application in rule justifications."[58] Finally, because the fairness vision contains an incomplete framework as to assumptions about behavioral reality, it is of limited usefulness in predicting whether parties will be able to achieve their goals by contract (or whether structural barriers will prevent that) or in predicting how parties subject to a rule will react to it.

Another vision of contract, exemplified by the noncontractual theorists like Marc Galanter[59] and Stewart Macaulay,[60] poses a different difficulty for courts filling incomplete contracts. By stressing the importance of private noncontractual arrangements, these theorists have called into question whether it is necessary at all for courts to fill incomplete contracts. They have explored private arrangements that exist as a palliative to the deficiencies inherent in law-supplied default rules.[61]

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56. *See* Kostritsky, *Moral Hazard, supra* note 25, at 637.

57. Of course, as Professor Gordon notes, "the fact that there's lots of disagreement [about fairness] has never stopped courts from policing for fairness." Gordon, *supra* note 10.

58. Coffey, *supra* note 7, at 9.

59. *See* Marc Galanter, *Justice in Many Rooms: Courts, Private Ordering and Indigenous Law*, 19 J. LEGAL PLURALISM & UNOFFICIAL L. 1 (1981).

60. *See* Stewart J. Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract*, 11 LAW & SOC'Y REV. 507, 523-25 (1977). Stewart Macaulay's pioneering work on the role contract law played in the conduct of actual businessmen documented the surprising extent to which contract law was marginalized by businessmen. Stewart J. Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55-69 (1963).

61. Lisa Bernstein continued the work of the non-contractual theorists and has stressed the importance of these private arrangements in her studies of the diamond and cotton industries. She has shown how parties may prefer in some instances to opt out of the law-supplied default rules and substitute their own private arrangements. *See generally* Lisa Bernstein, *Opting Out of the*

This non-contractual vision challenges the premise of this Article: that it is important to develop a principle to unify contractual approaches to law-supplied terms. By stressing the relative unimportance of formal contract law, noncontractualists suggest that unifying certain subjects within the boundaries of contract law may be an increasingly arcane exercise as the focus shifts to private extra-contractual arrangements. It may therefore be difficult to unify a subject whose boundaries have exploded to include private law propounded by trade associations since "sophisticated transactors might allocate some aspects of their transacting relationship to the legal realm and some to the extralegal realm."[62] However, there is a real and significant question that is still unanswered by the mere identification of the extra-contractual arrangements: when should the law intervene to fill gaps when neither the formal nor extra-contractual arrangement resolves a matter.

Despite limitations, each of these visions has expanded, in some way, the possibilities of rationalizing the role of courts in incomplete contracts. The fairness advocates[63] have directed our attention to what to do when there is a particularized bargaining deficiency.[64] The question of when the law should intervene in the cases where endowments are equal, but there are recurring informational problems of bounded rationality, opportunism and sunk costs, and a failure to contract expressly on all matters, remains unanswered. Neoclassical and Relational models have directed our attention to the importance of a more realistic paradigm than the impossible to achieve complete "presentiation" model of classical liberalism. Yet, the refinement of a more realistic view of the nature of the bargaining process does not, in itself, provide a framework to use in filling in contractual gaps.

Galanter, Macaulay, and Bernstein have directed our attention to the reality that parties will sometimes opt out of the formal contract system and

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Legal System: Extra Legal Contractual Relations in the Diamond Industry, 21 J. LEGAL STUD. 115 (1992).

62. Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1770 (1996).

63. *See generally* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1777 (1976) (discussing the "element of real nobility" in using altruism in judging cases).

64. Thus, this Article is not actually concerned with cognitive deficiencies of particular bargaining parties. It focuses instead on structural impediments such as bounded rationality, opportunism, and sunk costs which may affect all transactors. The importance of integrating such bargaining impediments into a framework justifying legal interventions cannot be underestimated. With an understanding of the structural recurrent impediments to bargaining, it becomes possible to explain why intervention in the form of a law-supplied rule or term with a particular content may be needed to promote efficiency. The legal decision-maker can reach that conclusion by comparing the costs of controlling contractual hazards by law-supplied rules and private devices in light of the structural impediments which exist.

prefer private arrangements.[65] Such theorists, focusing on the importance and nature of these arrangements, leave us with the question of when and why a court should intervene if such arrangements leave a matter unresolved.

The question that remains unresolved with each of these competing visions of contracts is how should courts decide cases of gaps, omissions, and incomplete contracts, taking it as a given that contract law is concerned with the enforcement of private assent-based arrangements, between parties of average behavioral characteristics who share certain goals, including the maximization of joint surplus. The approach outlined here assumes that it is possible to identify improvement-producing solutions that increase social welfare between the parties in assent-originated (contractual) relationships. The prior failure in the academic literature to articulate a framework for identifying solutions that can improve social welfare in cases of omissions stems, in part, from a failure to accept increasing social welfare as the justification for legal intervention. Some neoclassicists have adopted a different strategy of pursuing equitable adjustments out of a concern for fairness and wealth distribution outcomes rather than the maximization of social welfare.[66] And among those, the new Formalists,[67] who have accepted the instrumental goals of efficiency, have nevertheless placed an increased emphasis on the difficulties[68] courts may have in filling gaps, as in cases where there is "information that is either unobservable to one or both of the parties or unverifiable to the courts."[69] Formalists have, therefore, opted for an approach, "resolutely declin[ing] to fill any gaps at all."[70]

III. A UNIFIED FRAMEWORK FOR JUSTIFYING LAW-SUPPLIED INTERVENTIONS

A. *The Framework: A Comparative Net Benefit Approach*

To remedy the deficiencies in these competing visions, to unify disparate pieces of the Contracts course and to respond to recent criticisms of law-supplied rules,[71] this Article suggests a framework to resolve when law-

65. *See supra* note 62.

66. Scott, *Formalism*, *supra* note 11, at 851.

67. *See, e.g.*, *id.*; Jay M. Feinman, *Relational Contract Theory in Context*, 94 NW. U. L. REV. 737 (2000).

68. Scott, *Formalism*, *supra* note 11, at 851.

69. *Id.* at 863.

70. *Id.* at 851.

71. *See generally id.* (describing reluctance of new formalists to fill contractual gaps).

supplied interventions are needed and when private arrangements may suffice. The framework adopts a comparative net benefit approach to determine if legal intervention could achieve certain goals at less cost than private mechanisms. It accepts the traditional assumption of law and economics scholars that it is possible to use an instrumental framework to identify default rules that will achieve "*ex ante* efficiency."[72] Thus, it rejects the effort of a second strand of scholars to promote "*ex post* efficient result[s]"[73] by imposing "fair" results. At the same time, although recognizing that there may be certain disadvantages of intervening, such as "heightened risks of misinterpretation,"[74] and recognizing that there may be some instances where it would be imprudent for the court to intervene when doing so would have to be based on "information that is unobservable to one or both of the parties or unverifiable to the courts,"[75] there are nevertheless instances where a court-supplied liability rule will lead to welfare improvements.

The framework of intervention must begin with a study of contracting behavior built on recognition of how "contractual man" behaves.[76] A primary characteristic is "bounded rationality," which limits contractual man's ability to foresee future contingencies. Contractual man also acts opportunistically, using "self-interest seeking with guile."[77] Asset specificity in transactions in which parties' investments are particularized and non-salvageable is an important factor in positing a framework for intervention since it limits the parties' ability to solve inevitable disruptions in the contract by simply exiting to the market.[78] That bargaining model of the average behavioral characteristics of parties and transactions, together with a model of contracting parties' average goals, will help the legal decision-maker determine whether barriers to the parties privately achieving their objectives through express contracts exist. The framework then considers whether the parties would be able to achieve their goals through other private non-contractual strategies. The model directs the decision-maker to ascertain whether law-supplied rules and/or terms or other private strategies the parties might employ to reach the parties' goal (such as the "mitigation of all forms

72. *Id.* at 849.
73. *Id.* at 850-51.
74. *Id.* at 862.
75. *Id.* at 863.
76. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 43.
77. *Id.* at 47.
78. The absence of transaction-specific assets renders the need to craft mechanisms for controlling disruptions unnecessary since in such cases "discrete market contracting is efficacious." *Id.* at 31.

of contractual hazards")[79] given the barriers blocking private contractual solutions, would be more cost effective.

An understanding of this model—borrowed from the new institutional economics—would go beyond the neoclassical and relational visions of contract outlined here by providing a more complete model of bargaining behavior that admits not only bounded rationality problems but also problems of strategizing and in some cases asset specificity. Most importantly, it suggests the usefulness of a comparative net benefit framework for assessing the efficiency of law-supplied rules or terms in a wide variety of cases.

B. Applications

The usefulness of a framework premised on a realistic model of behaviored reality and a comparative net benefit test can best be understood by focusing on principal/agent theory.[80] It provides an example of a law-supplied obligation in the form of fiduciary obligation.[81] The importance of fiduciary obligation applicable to agents for determining law-supplied obligations in contract may, at first glance, be obscure. Yet, close analysis reveals a useful framework.

First, principal/agent relationships involve parties who have had the opportunity to bargain for a variety of terms, but who have failed to choose or contract for a precise standard to govern the agent's behavior. Thus, the principal/agent context raises the precise question at issue in incomplete contracts contexts—namely when, if ever, should the law intervene with a law-supplied term not expressly negotiated. In the principal/agent context the law-supplied term is the fiduciary obligation which would impose a "performance obligation"[82] on the agent.

To resolve whether the law should imply such a performance obligation, the law then focuses on whether the parties would have a joint interest in controlling the agent's moral hazard problem in order to maximize joint gains. The hazard in the principal/agent relationship arises because of a

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79. OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 5 (1996) [hereinafter WILLIAMSON, MECHANISMS].

80. *See generally* David E. M. Sappington, *Incentives in Principal Agent Relationships*, 5 J. ECON. PERSP., Spring 1991, at 45 (examining the paradigm problem of the agent shirking and causing loss to the principal).

81. *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426 (1993) (suggesting that the "duty of loyalty is a response to the impossibility of writing contracts completely specifying the parties' obligations").

82. Ronald J. Coffey, *Firm Opportunities: Property Right Assignments, Firm Detriment, and the Agent's Performance Obligation*, 13 CAN.-U.S. L.J. 155, 155 n.3 (1988).

basic fact: the agent has a tendency to shirk and to promote her own interests over those of her principal.[83] It is in the parties' mutual interests to control such hazards because a failure to negotiate a safeguard to control the hazard will result in the terms of the agent's compensation being reduced to account for the inevitable shirking or cheating in which the agent will engage. An effective safeguard for control of the potential opportunism of the agent will, thus, be a "source of mutual gain."[84]

Having established the benefits of controlling agent shirking, the question for the legal decision-maker is why the parties did not privately negotiate a safeguard. Here the decision-maker confronts the reality of a variety of barriers that the parties confront, including the hidden action[85] and information problems. First, the principal cannot actually observe the agent's actions. Second, the principal will have a hard time determining how much of a particular outcome is due to the agent's good or bad efforts or to extraneous causes. Third, since agents will face many possible decisions over time, even if there were no problems of hidden action and hidden information,[86] the unforeseeability of future events would make it difficult to draft a contract to govern the agent's conduct. The final question for the legal decision-maker becomes whether a law-supplied rule would actually control the propensity to shirk at lower cost than other private mechanisms including incentive schemes. If so, then "[w]e interject such an implied term (that is, the performance obligation) for justifications that lead us to conclude that some selected ultimate objective (goal, end, purpose, consequence) will be achieved at a higher level with the interjection (intervention) than without

83. Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1048 (1991) ("Once a consensual relationship in which the principal relinquishes control or management or her assets to the agent is formed, the resulting separation of ownership from control or management creates opportunities for the agent to appropriate the asset or some of its value.").

84. WILLIAMSON, MECHANISMS, *supra* note 79, at 60; *see also* Oliver E. Williamson, *Kenneth Arrow and the New Institutional Economics*, *in* ARROW AND THE FOUNDATIONS OF THE THEORY OF ECONOMIC POLICY 584, 592 (George R. Feiwel ed., 1987) (citing "real economic value" in friction reduction).

85. "The most typical hidden action is the effort of the agent. Effort is a disutility to the agent, but it has a value to the principal in the sense that it increases the likelihood of a favorable outcome." Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 38 (John W. Pratt & Richard J. Zeckhauser eds., 1985); *see also* Oliver Hart & Bengt Holmström, *The Theory of Contracts*, *in* ADVANCES IN ECONOMIC THEORY FIFTH WORLD CONGRESS 79-83 (Truman F. Bewley ed., 1987) (discussing model of hidden action in principal/agent theory).

86. Arrow, *supra* note 85, at 39 ("In the hidden information problems, the agent has made some observation that the principal has not made.").

it all things . . . considered."[87] The law would then compare private strategies such as screening, bonding, and incentive alignment schemes to determine whether a law-supplied term or private device would be most cost-effective.

IV. UNIFIED THEORY AS A WAY TO REORIENT THE ANALYSIS OF PROMISSORY ESTOPPEL RELIANCE ISSUES, INSTRUMENTAL ANALYSIS AND PROMISSORY ESTOPPEL: A SHIFT IN THE RIGHT DIRECTION WHICH STILL FALLS SHORT

A. Derivation of Theory: An Extension of the New Institutional Economics

The unified comparative net benefit framework used in explaining or rationalizing why the law might supply a fiduciary obligation should also guide courts for filling in gaps in contracts. This approach derives from the framework developed by the new institutional economics ("NIE") and Professor Oliver Williamson for assessing, on a comparative net benefit basis,[88] the private governance structures developed by parties as means of minimizing such problems as opportunism and other forms of moral hazard.

The relevance of the NIE bringing unity to the study of contracts and for resolving questions of law-supplied rules and terms may seem problematic. After all, new institutional economics, by its own terms, downplays the importance of legal rules. It elevates the importance of private orderings that exist apart from legal rules and may provide superior solutions to common problems. NIE rejects "legal centralism"—the idea that "disputes require 'access' to a forum external to the original social setting of the dispute" where "[r]emedies will be provided as prescribed in some body of authoritative learning and dispensed by experts who operate under the auspices of the state"[89]—and redirects attention instead to "private ordering"[90] and other private governance structures. While it is true that

87. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Kenneth B. Davis, Dean, University of Wisconsin Law School (May 2, 1996, 02:42 EST) (on file with author).

88. The comparative framework assessing public and private frameworks is perhaps traceable to Ronald Coase. As Williamson explains, "Ronald Coase's classic 1937 article expressly posed the issue of economic organization in comparative institutional terms." WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 3-4.

89. Galanter, *supra* note 59, at 1; *see also* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 20.

90. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 21.

NIE focuses on the emergence of certain private governance structures, explaining them in terms of their superior ability to "effect economizing outcomes,"[91] the comparative cost structure should be relevant to courts assessing their roles in incomplete contracting contexts.

Application of a comparative cost structure developed by Williamson to the issue of justifying a law-supplied rule requires an understanding of the methodology of institutional economics. First, NIE requires a model of behavior. It starts with the confluence of behavioral characteristics of bounded rationality, sunk costs, and opportunism to explain why parties might have difficulty adopting express contracts to attenuate the central problem of opportunism.[92]

Using this orientation, Williamson then looks at and explains governance structures as an alternative device to contract that parties may employ to achieve "mitigation of hazards," thereby promoting "mutual gain."[93] In looking at how parties can increase joint gain from the control of contractual hazard, Williamson develops an important formula. This formula posits "that technology (k), contractual governance / safeguards (s) and price (p) are fully interactive and are determined simultaneously."[94] In this formula, technology refers to the level of transaction-specific assets. Thus, $k > 0$ when transaction-specific investments are substantial. If a party has invested transaction-specific assets and there is no safeguard negotiated by the parties to prevent expropriation of such assets, the "breakeven" price will be higher,[95] presumably because the seller who has invested assets will price the transaction higher to reflect the greater risk associated with the absence of a safeguard. On the other hand, a transaction with safeguards to guard against expropriation will have a comparative cost advantage.

Franchising illustrates the importance of how specific asset investments and negotiated safeguards may affect pricing. In a franchise, the franchisor takes a risk that the franchisee will engage in "quality debasement."[96] A McDonald's franchisee might substitute inferior meat and thus hurt the public perceptions of McDonald's meat quality. To counter such franchisee cheating, the franchisor requires short-term rentals and other devices that would cause the franchisee a capital loss from his specific investments. These transaction specific investments by the franchisee, in effect, act as a kind of negotiated safeguard. Were such safeguards not in place,

91. WILLIAMSON, MECHANISMS, *supra* note 79, at 5.
92. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 64-67.
93. WILLIAMSON, MECHANISMS, *supra* note 79, at 60.
94. *Id.* at 62.
95. *See id.*
96. *See id.* at 63-64.

presumably, the franchisor would charge the franchisee a higher price for the franchise privilege to cover the cost of potential cheating.

The cost advantage of transactions with safeguards designed to curtail opportunism has been used primarily to explain the prevalence of governance structures.[97] Those structures that best succeed in mitigating hazards by economizing on transaction costs, enjoy a comparative net benefit advantage and, therefore, prevail over others.[98] Comparative cost concerns have been used to explain a variety of corporate arrangements such as vertical integration as a governing structure.[99] "A comparative institutional orientation was employed to assess when and for what reasons market procurement gives way to internal organization."[100]

This comparative cost approach to hazard mitigation should provide a useful structure for unifying judicial approaches to incomplete contracts. It would recognize that because of bounded rationality, contracts will necessarily be incomplete and that such contracts will therefore fail to expressly control opportunism and may therefore resort to other more cost-effective private devices to effectuate control of hazard. The comparative cost approach also suggests, at least by implication, that in deciding what, if anything, the law should do when such contracts are incomplete, the relevant inquiry should assess the relative costs of private and law-supplied mechanisms to deal with and control contractual hazards as a way of maximizing joint gain.[101]

The courts and other legal decision-makers should use a comparative cost/benefit structure to decide whether legal intervention is cost-justified. That structure should examine: (1) the parties' objectives (such as maximization of surplus through control of hazards), (2) the parties' average behavioral characteristics, (3) structural impediments to parties expressly bargaining for control of hazards, (4) parties' private strategies which they might use (as an alternative to private contract) to control such hazards, and (5) the costs of a law-supplied rule or term and the costs of the private

97. *Id.* at 14.

98. *Id.* at 47.

99. *Id.* at 67.

100. *Id.* at 66.

101. There is admittedly a major difference in the method suggested here from its prior use in the corporate context to explain on a comparative cost basis which bargained for structures or mechanisms have prevailed, as contractarians would do. *See, e.g.*, Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 79 (1989) ("[T]he most important implication of the contractual theory of the corporation is that, whatever the source or nature of individual terms, they should be enforced.").

This Article seeks to use the comparative cost structure to suggest a means of identifying the appropriateness of law-supplied terms or liability rules.

alternatives. The law should intervene only if the law-supplied rule or term would be the least costly alternative means of attenuating a hazard and therefore result in transaction cost economies.

B. Reorienting Reliance Theories

1. The Shift to an Instrumental View of Reliance

The parties' drive to develop cost effective structures for attenuating hazards, and subsequent drive to maximize gain in a contractual relationship, helps to explain why courts concerned with instrumental goals should use a similar structure in assessing the justification for law-supplied terms and liability rules. At least initially, the importance of developing such an instrumental efficiency assessment for justifying legal rules in contracts remained unrealized in many areas, including promissory estoppel.[102] Recently commentators have embraced an instrumental efficiency analysis as a basis for assessing precontractual liability issues; however, such instrumental analyses still fall short as a basis for determining when legal intervention is justified.

Traditional doctrinal analysis of section 90 of the Second Restatement of Contracts and preliminary negotiation utilized a "convention maintenance"[103] perspective to analyze liability issues, an approach which remained outwardly indifferent to instrumental considerations.

Under a "convention maintenance approach" the law protects reliance and imposes liability on the promisor if it regards the reliance as "reasonable." It measures reasonableness by prevailing conventions; "reliance is reasonable if it is customarily expected under the circumstances."[104] The difficulty with such an approach is, of course, one of circularity: what is usual is in turn affected by what the legal rule is, and it may not be possible to identify conventions or expectations which exist apart from the legal rule.[105]

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102. *See* Katz, *supra* note 28, at 1250 (describing neglect of the economic components of preliminary negotiation and seeking to remedy that neglect by examining "estoppel and related legal doctrines . . . as economic regulations"); *see also* Johnston, *supra* note 25, at 388 (asserting "there has as yet been no attempt to analyze systematically the general economic incentives" in preliminary negotiation).

103. Katz, *supra* note 28, at 1251.

104. *Id.* at 1254. For that reason, as Katz explains, convention maintenance theory only "makes sense if [the] parties' expectations are largely independent of legal practices." *Id.* at 1251.

105. If the conventions are affected by changes in the law, then there is no particular reason to choose the prevailing convention as a source for the law; they "cannot tell us which legal rule is

Recent scholars of Section 90 have helpfully used an instrumental, economic analysis to assess the merits of precontractual liability.[106] The instrumental, economic analysis of promissory estoppel differs markedly from "conventional" approaches; it takes a "regulatory" perspective.[107] "[T]he direction of the analysis is top-down rather than bottom-up. The central question is not which legal rule is consistent with the parties expectations,"[108] but rather which legal rule, if any, ought to be adopted to promote "efficient reliance."[109] Under that approach "expenditures should be made based on the actual probability of agreement."[110] The promissory estoppel issue becomes one of deciding at what point liability should attach to maximize social wealth and to assess the rules in light of how "advance planning increases the gains from trade by allowing the parties to rely."[111]

The shift to instrumental analysis marks a significant development in promissory estoppel analysis. It encourages legal decision-makers to determine if intervention in the form of a promissory estoppel liability rule will advance or promote certain ultimate goals, such as the maximization of wealth and the promotion of efficiency.

However, despite the general agreement on the overall benefits of an instrumental, efficiency analysis for assessing whether the law should intervene with a liability rule, its application to the particular context of precontractual liability suffers from several flaws that prevent the theory from fully justifying whether a liability rule is optimal. These flaws are traceable to the failure to advert to all of the elements of the justificative framework discussed earlier. For example, instrumental analyses of promissory estoppel have neglected the key role reliance plays in reducing precontractual uncertainty.[112] This neglect has resulted in overly narrow

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best." *Id.*; *see also* Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 275 (1986) (detailing the circularity problem in tests based on reasonableness of reliance).

106. *E.g.*, Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV. 481 (1996); Johnston, *supra* note 25; Katz, *supra* note 28; Kostritsky, *Short Run Economics*, *supra* note 25; J. P. Kostritsky, *"Why Infer?" What the New Institutional Economics Has to Say About Law-Supplied Rules*, 73 TUL. L. REV. 497 (1998) [hereinafter Kostritsky, *Why Infer?*]. Earlier instrumental analyses of reliance include Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. CHI. L. REV. 903 (1985); Goetz & Scott, *supra* note 29; G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221 (1991).

107. Katz, *supra* note 28, at 1253-54.

108. *Id.* at 1253.

109. Craswell, *supra* note 106, at 491.

110. Johnston, *supra* note 25, at 392.

111. Katz, *supra* note 28, at 1267.

112. Economists have identified the importance of decision-making under uncertainty. *See, e.g.*, JACK HIRSHLEIFER & JOHN G. RILEY, THE ANALYTICS OF UNCERTAINTY AND INFORMATION

efficiency assessments of reliance that judge efficiency solely by comparing the gain from the investment if the trade succeeds with the possible loss if it fails. Such an efficiency analysis neglects the separate and significant value the reliance may have in reducing uncertainty for the nonrelying party. This value is not captured by the loss/gain formula, which looks only at the relying party's loss and gain.[113] Even recent commentators like Johnston, who recognize the uncertainty problem, misconstrue the central problem to be one of dissembling, and discouraging overly optimistic talk "by actual pessimists who might otherwise prefer to pretend to be optimistic."[114]

Finally, some efficiency analysis of promissory estoppel has obscured the problem of opportunism, which besets precontractual bargainers who have invested sunk costs.[115] A failure to grasp that central problem has resulted in a failure to compare private strategies with the law-supplied rule as an alternative means of mitigating the hazard and thereby obfuscating the justification question. Without an understanding of the moral hazard problem endemic to precontractual negotiation, and the central problem of opportunism posed by the promisee's reliance on sunk costs, the law cannot begin to craft a rule to optimally mitigate that hazard.[116]

The law needs to look at the dynamics of precontractual bargaining in an entirely different way and to focus on a cost/benefit analyses of law-supplied

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(1992). For a discussion of the neglect of this concept in the context of promissory estoppel see generally Johnston, *supra* note 25, and Kostritsky, *Short Run Economics*, *supra* note 25.

113. Johnston, *supra* note 25, at 392.

114. *Id.* at 499. This characterization of promisors exploiting sunk costs invested by promisees ignores the possibility raised by Dean Robert Scott that after all the "promisee has control over his reliance [and] can exit to find other promisors." Comments from Robert E. Scott, Dean, University of Virginia School of Law, to Juliet Kostritsky, Professor of Law, Case Western Reserve University Law School 1 (Feb. 23, 2000) (on file with author) (commenting on presentation at the University of Virginia Student Colloquium on Contracts and Commercial Law) [hereinafter Scott, Comments].

In many of these cases, it is precisely the presence of reliance investments that makes an exit by the promisee an impracticable solution. Unlike situations in which asset investments are "general purpose investments" where difficulties "can be solved . . . by each party going his way," asset specific investments pose the special problem of "strategic hazards that arise as a consequence of their nonsalvageable character." WILLIAMSON, ECONOMIC INSTITUTIONS *supra* note 27, at 54.

115. *See infra* note 170.

116. Exploring the implications of the opportunistic exploitation of sunk costs has proved useful in analyzing liability issues and contract doctrines. *See, e.g.*, WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 30-31 (exploring the difficulties inherent in controlling for opportunism where bounded rationality and sunk costs are present); George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 958 (1992) (arguing "that opportunism does and should play a much broader role in understanding and developing contract doctrine from an economic perspective than the legal economists have so far recognized"); Kostritsky, *Moral Hazard*, *supra* note 25, at 651; Shell, *supra* note 106, at 221 (suggesting a new cause of action to guard against opportunism).

rules and private approaches designed to encourage investments to reduce overall precontractual uncertainty, while at the same time curbing the moral hazards associated with the exploitation of those investments.[117] Finally, the analyses should directly confront the methodological issue of whether legal intervention is justified.

2. Neglecting the Uncertainty Problem Leads to Overly Restrictive Cost/Benefit Analyses

Neglect of the uncertainty in precontractual negotiation has caused commentators assessing efficient reliance to embrace an overly narrow cost/benefit analysis oriented exclusively to the ultimate transaction.[118] The embrace of such a cost/benefit analysis measuring possible losses and gains from a reliance investment adversely impacts the analysis of promissory liability issues in several ways, as explored below.

The tradition of judging the efficiency of reliance by a cost/benefit analysis of the reliance investment measured against the probability of the transaction being consummated derives from the groundbreaking work of Professor Charles Goetz and Dean Robert Scott. In their seminal 1980 article,[119] they explain that every investment of reliance has a possible benefit of early investment, which may be valuable if the deal materializes, as well as a possible detriment if the reliance is lost because the deal fails.[120] To determine whether to invest, the promisee will weigh the "prospective gain" if the promisee relies early and adapts to the forthcoming promise ("beneficial reliance"),[121] as well as the potential loss from the reliance investment ("detrimental reliance") should the trade fail, and the "probabilities of performance and nonperformance."[122]

In a recent article, Professor Craswell utilizes a similar cost/benefit analysis to measure the efficiency of reliance by looking at possible gains or losses in terms of the probabilities of an ultimate trade.[123] His suggested formula for judging efficient reliance illustrates the approach of judging the

117. The control of hazard is a central recommendation presented in WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 63.

118. *See* Johnston, *supra* note 25, at 391-92.

119. *See* Goetz & Scott, *supra* note 29.

120. *Id.* at 1286.

121. *Id.* at 1267. Ideally, beneficial reliance will result as a consequence of a promise as "advance knowledge of a future transfer will increase the benefit to the promisee because he can more perfectly adapt his consumption decisions to the impending change in wealth." *Id.*

122. *Id.* at 1270 n.26.

123. Craswell, *supra* note 106, at 489-91, 501-07.

efficiency of reliance investments solely in terms of the ultimate transaction.[124] "Since reliance involves both potential losses and potential gains, the efficient level of reliance—that is, the level of reliance that will maximize the total expected value of the proposed transaction—can be defined by the balance of potential gains and losses."[125] Moreover, he asserts that it is "the efficiency of B[uyer]'s reliance [which] can provide a principled basis for justifying a court's application of . . . contract formation doctrines."[126] Thus:

> [T]he efficient level of reliance depends on (1) the potential upside from the reliance, or the amount by which the reliance will increase B[uyer]'s gains if S[eller] does perform; (2) the potential downside from the reliance, or the amount by which the reliance increases B[uyer]'s losses if S[eller] fails to perform; and (3) the probability of each of these two outcomes (i.e., the probability that S[eller] will or will not perform).[127]

Thus, Professors Goetz and Scott and Professor Craswell all utilize a cost/benefit analysis for calculating the efficiency of reliance, which is in some sense comparable to the "'Learned Hand' test for defining the efficient level of precautions in a negligence case."[128] Presumably, the efficiency of reliance depends on a comparison of "potential gains and losses" from the reliance, with a probability being attached to the gain or loss based on the chances for a trade or no trade.

Professor Katz uses a similar cost/benefit analysis in which he considers the "advantages of beneficial reliance and the disadvantages of detrimental reliance."[129] Under Katz's approach, one weighs when it is optimal or efficient to rely by multiplying the potential lost reliance by the probability of breach and by multiplying the potential profits by a percentage representing a discount for the possibility of no trade.[130] In this case, as in the Goetz and Scott, and Craswell approaches, the efficiency of reliance is measured by balancing the gain and loss by attaching a probability to achieving the gain or

124. *Id.* at 491.
125. *Id.*
126. *Id.* at 507 (emphasis omitted).
127. *Id.* at 491.
128. *Id.*; *see also* Goetz & Scott, *supra* note 29, at 1275.
129. Katz, *supra* note 28, at 1268.
130. Thus, according to an example posited by Professor Katz, if the potential profits are $20,000, but there is only an 80% chance of a trade, the discounted profits are $16,000. *Id.* at 1269. The lost reliance is calculated by multiplying the amount of the investment by the chance of breach. *Id.* If the investment is equal to $60,000, and the chance of breach is 20%, the discounted reliance would equal $12,000. *Id.* According to Katz, expected net profits in such a case would equal $4,000 ($16,000 - $12,000). *Id.*

loss. Under the Katz scenario, the "optimal time" to invest occurs when the "expected net profits are highest . . . ."[131] Presumably, that point would occur when some of the uncertainty regarding the trade has been resolved by the passage of time, yet, the delay has not been so long as to make the reliance too costly because it was made at the last minute.

These cost/benefit formulations have been accepted as a means of judging whether, on a net basis, a reliance investment is efficient.[132] Yet, they falter as a complete method for determining whether a law-supplied liability rule (making a promisor liable for another party's precontractual reliance) would be justifiable and promote efficiency. The basic deficiency in current cost/benefit analysis of reliance is that to the extent that the formulae judge the beneficial aspects of reliance exclusively by how much the reliance will "enhance the value of the relationship"[133] for the relying party from ultimate performance, they downplay the separate and important value of reliance in reducing the informational uncertainty. They neglect the role "reliance plays in reducing uncertainties for putative offerors."[134]

That neglect of the uncertainty problem adversely affects the analysis of promissory liability issues.[135] Such formulae "fail to consider how the uncertainties affecting the party deciding to contract may be mitigated by early reliance . . . ."[136] The neglect of uncertainty, together with an efficiency calculus geared exclusively to a cost/benefit analysis based on probabilities of trade, mistakenly suggest that early investments of reliance would necessarily be inefficient because at an early point, the probability attached to consummation of the ultimate trade would be relatively low.

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131. *Id.* at 1270.

132. A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 32 (1983).

133. Johnston, *supra* note 25, at 392 (citation omitted).

134. Kostritsky, *Short Run Economics*, *supra* note 25, at 371-72.

135. In a thoughtful comment, Dean Robert Scott queried whether in fact my comparative net benefit approach would really have any advantages over the current approaches to precontractual reliance liability. "Doesn't the comparative cost approach actually push in the opposite direction—toward less legal liability, not more?" Scott, Comments, *supra* note 114, at 2.

This Article argues that a comparative cost approach would lead to liability whenever the court deems a liability rule to be a more cost effective means of constraining opportunism in the precontractual negotiations occasioned by the promisee's sunk costs. Since the problem reoccurs in a variety of factual contexts whenever promisee investments have been solicited by the promisor as a means of reducing uncertainty for the promisor, courts may find that a generalized performance obligation and liability rule might, in fact, lead to liability in a broad number of cases. It would lead to more liability, presumably, than a rule that deemed most early reliance as inefficient because it was made at a time when the probabilities of consummation were low. Even early investments of precontractual reliance can present the potential for opportunistic behavior occasioned by a need by the promisor to gather more information from the promisee, thereby making liability appropriate in such cases.

136. Kostritsky, *Short Run Economics*, *supra* note 25, at 371-72.

Moreover, the neglect of uncertainty causes analysts like Goetz and Scott to underestimate the need for precontractual promissory liability. As they explain, "if promises are unenforceable, the promisee has the correct incentives to protect himself to the optimal level against risks. Because the promisee bears all risks of breach . . . he will rely on a promise only to the extent that the prospective cost of the reliance is outweighed by prospective benefits."[137]

This projected scenario assumes that the promisee's reliance will be optimal when he or she weighs the costs and benefits, taking into account the probabilities of an ultimate trade. However, Goetz and Scott's confidence in the promisee's optimal self-protection with a non-enforcement rule may be unrealistic. Under a rule denying enforcement, the promisee may not have the correct incentives to rely and may under-invest where the reliance investment is useful in reducing promisor uncertainty but does not actually result in any beneficial reliance to the investing party, as explained below.

The promisee weighs his beneficial reliance against possible loss from the investment. Katz's example illustrates this adaptive effect: "[B]uyers can increase the utility of their purchases by investing beforehand in complementary inputs such as specialized storage facilities, or in such services as training workers to use the goods."[138] As Goetz and Scott explain, the dilemma is one of "intertemporal allocation"[139] in which the promisee must choose how soon to invest. There are risks and benefits to investing early when uncertainty is greatest, but there are also costs to waiting because, as Professor Katz explains, "[a]s time passes, the incremental cost of delay will begin to exceed the incremental benefits of waiting."[140]

In many cases, however, this ideal picture of how investment decisions are made, which will result in optimal reliance, is inaccurate. The reliance investment made by the promisee may not actually result in any beneficial reliance to him, and he may therefore lack the correct private incentive to

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137. Goetz & Scott, *supra* note 29, at 1279. In part, Goetz and Scott's confidence in a legal regime allocating the risk of precontractual reliance may depend on the law and economics view that "liability should be placed on the party who is best able to estimate and control the risk." Johnston, *supra* note 25, at 489. *See generally* GUIDO CALABRESI, THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970) (developing a law and economics approach to liability). One objection held by attorneys and economists to a liability rule is that by insulating the promisee from the risk inherent in the reliance investment, the promisee may be tempted to over-rely. This temptation is known as the moral hazard problem and "effectively puts each party at risk of becoming an insurer of the other party's cost of premature performance." Johnston, *supra* note 25, at 490.

138. Katz, *supra* note 28, at 1267.

139. Goetz & Scott, *supra* note 29, at 1267.

140. Katz, *supra* note 28, at 1268.

invest. In some cases, if the promisee weighs these benefits and costs of investing early, taking into account the probabilities of ultimate consummation of trade as well as the risks from too early an investment "when the level of uncertainty is high," as well as the "cost of delay," optimal investment will result.[141] In other cases, however, this may not be so where the reliance actually benefits not the promisee but the promisor by reducing the promisor's uncertainty.[142] In such cases the promisee will lack the proper incentives to rely optimally. He will be unlikely to invest at all because he will consider only the possible detrimental reliance since the benefit ("reduced promisor uncertainty") will actually be external to him and thus not accounted for in his calculations. Thus, a cost/benefit analysis, which measures efficiency only by reference to the probabilities of an ultimate trade, will potentially underestimate the need for, and efficiency of, promisee investment.[143]

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141. *Id.*

142. In his remarks to the University of Virginia Colloquium Dean Scott queried, "Aren't reductions in promisor uncertainty reflected in a higher probability of promise being performed and thus an increase in net beneficial reliance (i.e., aren't these feedback effects in the precontractual negotiations that are reflected in a net reliance focus?)." Scott, Comments, *supra* note 114, at 1. Dean Scott was asking whether it was really necessary to focus separately on the uncertainty problem in precontractual negotiations because of an assumption that the Goetz and Scott formulation already captures an element of promisor uncertainty. The argument is that in weighing the benefits from investing, the promisee will weigh the cost if the trade materializes and the loss if the trade fails. According to Scott, promisee investment that will result in a reduction of promisory uncertainty will necessarily be reflected in a "higher probability of the promise being performed." *Id.* at 1. Scott's argument is that promisees will, in fact, make correct decisions on reliance since a reliance investment that reduces promisor uncertainty will mean that the promise has a higher probability of being performed. *Id.*

However, the reduction in promisor uncertainty may not, in fact, lead to a higher probability of the promise being performed. In fact, the information gleaned may lead to the deal failing quickly as the promisor learns some devastating information about the promisee. For that reason, the current formulations, by failing to highlight the importance of the reduction of uncertainty, may result in promisees weighing too heavily the cost associated with the deal failing since such promisees would not be taking into account the external benefit to the promisor from the reduction of uncertainty.

143. The neglect of the uncertainty problem as well as a static view of how parties act in the face of uncertainty should affect the analysis of precontractual liability. Professor Katz, for example, explains that "[i]n the presence of uncertainty, parties faced with investment decisions generally find it profitable to take an intermediate position—that is, to hedge." Katz, *supra* note 28, at 1270-71.

In fact, a putative promisor faced with a decision about whether to commit, and on what terms to commit, often does something much more proactive to solve the uncertainty problem: such promisor actively solicits sunk costs from the promisee to reduce that uncertainty. Once those costs have been sunk by one party primarily to reduce the other party's (the promisor's) uncertainty, the prime issue in determining if the law should intervene with a term is not that of bargaining power, as Katz asserts, *id.* at 1273, but of the opportunities for the expropriation of the sunk costs of the investing party by the non-investing party.

Because a promisee, weighing the costs and benefits of making a reliance investment by calculating its gain and loss based on the probability of a trade, may ignore benefits to the promisor in the form of reduced uncertainty, this Article argues that the current orientation in the Katz, Craswell, and Goetz and Scott formulations for judging efficient reliance neglects an important externality[144]—the possible benefit to the promisor from the promisee taking certain steps or investing sunk costs.[145] This exclusion means that even if the investment would not be justifiable if the costs and benefits for the promisee alone were weighed, the investment might nevertheless be an important one for helping the promisor decide if trade is possible and if so on what terms. However, because that benefit is an externality, the promisee may fail to take the benefit into account as he or she weighs costs and benefits.

The neglect of the uncertainty problem also causes Goetz and Scott to misconstrue the consequences of enforcing nonbargained-for promises. They assume that enforcement may cause promisors to make fewer promises or to further qualify the promises that they do make to avoid liability.[146] They refer to these reactions by promisors as "precautionary adjustments."[147] In this conceptualization, a promisor's primary goal would be to optimize the "volume of exposure to regret contingencies"[148] from enforcement of promises, and enforcement of nonbargained promises would merely prompt promisors to do everything possible to limit liability exposure. Goetz and Scott are convinced that "[a] rational promisor will pursue precautionary adjustments up to the point at which marginal precautionary costs are exactly balanced by marginal reductions in regret costs."[149]

Once the issue is framed as opportunistic behavior of appropriating the sunk costs of the other party, it becomes incumbent on the decision-maker to determine if the parties or the law will control it more effectively.

144. As Harold Demsetz explains: "[w]hat converts a harmful or beneficial effect into an externality is that the cost of bringing the effect to bear on the decisions of one or more of the interacting persons is too high to make it worthwhile . . . ." Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV., May 1967, at 347-48.

145. Arguably, a payment by the promisor could solve this externality problem. *See* Comments from Clayton P. Gillette, Professor of Law, University of Virginia Law School, to Juliet Kostritsky, Professor of Law, Case Western Reserve University Law School 3 (Feb. 23, 2000) (on file with author) (commenting on presentation at the University of Virginia Student Colloquium on Contracts and Commercial Law). *But see* Kostritsky, *Short Run Economics*, *supra* note 25, at 367-70 (detailing costs of such payments designed to take care of the externality problem).

146. Goetz & Scott, *supra* note 29, at 1273-74.

147. *Id.* at 1274.

148. *Id.* at 1273, n.31.

149. *Id.* at 1274.

The difficulty with this projected "precautionary adjustment" response to enforcement is that it would not solve, but rather hinder, solutions to the basic informational problem that promisors face: the need for promisees to invest in ways that will allow promisors to determine the terms of a possible trade. The making of precautionary adjustments by promisors would seem counterproductive and would not encourage promisees to invest sunk costs.

Finally, the cost/benefit analysis oriented toward gains and losses on the ultimate trade with its neglect of uncertainty also causes scholars to circumscribe liability too narrowly. Professor Craswell concludes, for example, that "if the probability of successful consummation is extremely low—the efficient level of reliance might be zero, so an enforceable commitment would be unnecessary."[150] By focusing on the probabilities of ultimate consummation of the transaction, one is led to conclude that "B[uyer] should rely whenever the potential benefits of reliance (weighted by the probability that S[eller] will in fact perform) exceed the potential losses from reliance (weighted by the probability that S[eller] will not perform)."[151]

However, even in cases where the probabilities of consummation are low (or at least uncertain), the possible investment of reliance can be expropriated by an opportunistic putative promisor who will use the reliance investment to decide whether to proceed and, if so, on what terms. Since the possible expropriation is a contractual hazard, and both parties can be expected to want to reduce contractual hazards in order to increase mutual gain,[152] decisions on precontractual reliance issues must consider not merely how likely the deal is to be consummated, but also what, if anything, the law should do to control opportunistic expropriation of the sunk costs invested by promisees. The court should weigh the cost of private strategies and express contracts that the parties could use to effect control.

Recognition of the central problem of precontractual uncertainty would make it possible to understand that rather than making precautionary adjustments to the "costs of promising"[153] as a way of lessening exposure to the possibility that the deal might turn out to be less desirable than expected (a "regret contingency"),[154] a promisor would instead solicit actions from a promisee to reduce the precontractual uncertainty. For that reason, it might make sense to focus, not on how liability might cause promisors to rein in their promises, but rather on whether a liability rule that fell short of enforcement of the ultimate promise could encourage promisees to invest

150. Craswell, *supra* note 106, at 493.
151. *Id.* at 491.
152. *See supra* note 84.
153. Goetz & Scott, *supra* note 29, at 1271.
154. *Id.* at 1273.

enough to reduce a promisor's uncertainty. Calculations of whether the law should impose a liability rule to precontractual negotiations must not depend solely on traditional calculations of efficiency geared only to the probabilities of a trade. Traditional efficiency calculations will significantly underestimate the need for a liability rule. The comparative net benefit framework suggested here would provide a better framework for determining if a liability rule would solve problems parties want solved (such as the alleviation of opportunism) at less cost than other alternatives. The traditional efficiency calculations are static because they ignore the fact that reliance investments are often being made to reduce the other party's uncertainty and, once made, leave the investing party vulnerable to expropriation—a problem that must be controlled to maximize joint gain for the parties.

3. Solicitations of Pretrade Reliance to Reduce Promisor Uncertainty: A Larger Problem than Dissembling

Explicit neglect of the importance of precontractual uncertainty has been mitigated by some recent analyses.[155] However, even commentators such as Professor Jason Johnston, who explicitly recognize the problem of precontractual uncertainty, rationalize liability in terms of achieving the goal of "informative pretrade talk."[156] Johnston argues that a party soliciting sunk costs may pretend to be more optimistic about the chance for a trade in order to encourage the relying party to rely when, in fact, the soliciting party is actually a pessimist.[157]

Professor Johnston has made an important contribution in highlighting the importance of the uncertainty problem in his recent Virginia Law Review

155. *E.g.*, Johnston, *supra* note 25; Kostritsky, *Short Run Economics*, *supra* note 25; Kostritsky, *Why Infer?*, *supra* note 106.

156. Johnston, *supra* note 25, at 391.

157. *Id.* at 499. Professor Johnston's approach of subjecting the non-performing party to liability if he fails to speak and to discourage the performing party from performing further is directed at "forc[ing] informative communication by actual pessimists." *Id.* In some ways, this approach can be rationalized and explained as a type of penalty default directed at forcing the revelation of communication that a party would prefer not to reveal, such as his actual degree of optimism or pessimism about the chances for a trade. For a general discussion of penalty defaults, see Ayres & Gertner, *supra* note 3. The liability rule operates indirectly to force the revelation of information about the actual state of mind of the non-performing party. Johnston prefers this approach to a legal rule which would impose liability "if and only if the literal content of the assurance—that agreement was quite likely—was concealing." Johnston, *supra* note 25, at 492-93. The difficulty in an approach which directly aims to deter concealing content is one of judicial capability. The courts will have difficulty "determin[ing] *ex post* whether a party's *ex ante* statement was true in this sense." *Id.* at 493.

article.[158] He recognizes the important role of reliance, whose "primary function is not to enhance the value of performance, but rather, to determine whether there will be a relationship at all, and if so, upon what terms."[159] His recent article explicitly highlights the unique importance of reliance in reducing uncertainties in precontractual negotiation.[160]

As Johnston explains, part of the "economic significance"[161] of reliance lies in the fact that beginning performance may, in fact, allow sellers to distinguish themselves to the buyer. Before performance, the "buyer may well view sellers as essentially indistinguishable until they somehow demonstrate the capacity to perform this particular job."[162] That unique ability of performance to distinguish sellers, as well as market conditions, such as "high seller response costs,"[163] makes it likely, according to Johnston, that buyers will conceal their types and pretend to be optimistic buyers (low cost) who have a high probability of trading when in fact they are pessimistic buyers (high cost with a low probability of trade).[164] If the buyers do not conceal their types, it is unlikely that the sellers would engage in the partial performance that is so useful in distinguishing amongst sellers and reducing the buyers' uncertainties about the sellers.[165]

For this reason, Johnston suggests a liability rule to make a party liable if he remains silent after the performing party starts to engage in partial performance without telling the performing party to stop.[166] Johnston supports a liability rule since it will foster efficiency by smoking out pessimistic buyers and saddling them with large liability if they remain silent, pretending that they are low cost buyers with a high probability of trade when in fact that is not the case. The buyer will, in effect, be encouraged to reveal himself for what he is--a pessimistic high cost buyer whose probability of trading with the seller is low. Forcing the disclosure "by actual pessimists who might otherwise prefer to pretend to be optimistic . . .

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158. *See* Johnston, *supra* note 25.

159. *Id.* at 392.

160. "The provision of a complex, customized good or service therefore both makes partial performance the only effective means for the seller to reduce uncertainty about its cost . . . ." *Id.* at 494.

161. *Id.* at 493.

162. *Id.* at 494.

163. *Id.*

164. *Id.* at 408.

165. "Because partial performance is so costly, it may be that no seller type, not even the most efficient and experienced, would begin to perform if it were informed that the buyer was a relative pessimist. . . ." *Id.*

166. *Id.* at 498-500.

is apt to be the only workable approach to the problem of deterring concealing pretrade talk."[167]

Johnston's approach creates liability "triggered" by optimistic speech that caused pretrade performance. The notion is that because the "pessimistic high-cost seller has lower chance of ultimately trading, . . . and therefore faces higher expected liability when liability is determined solely by the buyer/receiver's response"[168] in the form of partial performance, the pessimistic seller will speak up to discourage buyers from further performing to avoid further liability.

Approaching the uncertainty problem from the vantage point of discouraging dissembling, and forcing a revelation of one's true view of the probabilities of a deal occurring, misconceives how uncertainty is likely to affect the bargaining process. In the beginning of negotiations, a party attempting to decide the terms of the putative trade often does not know enough to enter into a bargain and desperately needs the other party to rely. Doing so will furnish the information to determine whether a trade is even desirable and if so what the terms should be. Johnston recognizes that need, but he argues that the party only becomes liable by remaining silent after a party has relied.[169] Thus, one can immunize oneself from liability simply by telling the other person to cease and desist from any further reliance. In that way Johnston is confident that the rule will flush out pessimists who have a low opinion of the probability of an ultimate trade.

This Article argues that Johnston's focus on the dissembling problem unfortunately diverts analysis away from the real problem of sunk costs being solicited to reduce uncertainty for one party. The party who solicits the sunk costs from the other party in order to reduce uncertainty for himself should be liable on that ground alone, at least if one is convinced that a liability rule will be the most cost-effective way of deterring opportunism and increasing joint gain. The chance for opportunism occurs because one party is sinking non-salvageable sunk costs,[170] which is true regardless of the state of mind of the putative offeror. Under that view, the state of mind of the soliciting party is not of great importance and the soliciting party should be liable for the initial sunk cost and should not be able to absolve himself of liability merely by saying "cease and desist and rely no further."[171] An

167. *Id.* at 499.

168. *Id.* at 492.

169. *Id.* at 488.

170. "Sunk costs are like spilt milk: They are past and irreversible outflows." RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 95 (3d ed. 1988); *see also* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 29-32.

171. *See supra* note 166.

overemphasis on dissembling interferes with an understanding of the full dimensions of the uncertainty problem. Without that understanding, one cannot surmise why it would be important for the law to supply a liability rule for precontractual assurances designed to solicit reliance without regard to whether the party soliciting or encouraging the reliance investments was overstating the likelihood of a trade.[172]

Ultimately, Johnston seems most concerned with imposing liability to flush out pessimists who pretend there is a high chance for trade when in fact there is not. That approach fails to fully grasp that the problem is often not one of promisors misleading promisees, but instead, the general uncertainty problem afflicting all precontractual bargainers. An approach that encourages pessimistic promisors to be discouraging once the promisee has begun to perform in order to escape liability does not solve informational uncertainty problems for the vast majority of promisors who are still uncertain about a possible trade. The difficulty with Johnston's approach is that the non-performing party who solicits reliance investments is forced to decide whether he thinks there is a high or low probability of trade and to take steps to discourage performance by promisees to avoid liability. Yet, the very reason that the putative promisor solicited sunk costs or part

172. Johnston's approach, which creates liability based on the pre-trade performance by a promisee who has not been discouraged by the party sending a message, suggests that it is the failure to discourage further reliance investment that creates the liability. Johnston, *supra* note 25, at 488-89. Yet, the initial investment of reliance which was solicited by the party sending a message or assurance, was solicited to reduce the non-performing party's uncertainty. *Id.* at 392. The solicitation of the sunk cost to hedge should be actionable on that basis and the non-performing party should not be able to shield himself from liability simply by further discouraging such reliance investments. *Cf. id.* at 488-89. The initial solicitation of the sunk costs creates the possibility of the expropriation of sunk costs. *See* Tom K. Lee & I.P.L. Png, *The Role of Installment Payments in Contracts for Services*, 21 RAND J. ECON. 83 (1990). Unless that potential for opportunism is curbed at the initial stages, the promisee ("the receiver of the message" in Johnston's terminology) may invest less or not at all or insist on costly safeguards that require individual negotiation. *See* Kostritsky, *Moral Hazard*, *supra* note 25, at 682-83. To reduce those costs and thereby increase joint gain, the potential for opportunism should be curbed.

The advantage of grounding the precontractual liability rule in the opportunistic exploitation of sunk costs, rather than in the tendency to engage in deceptive talk, is that it helps to explain why the parties themselves would have an interest in curbing the potential for opportunistic exploitation of sunk costs: to increase joint gain by curbing a contractual hazard. It also helps to explain the willingness of courts in other contexts in which courts intervene in the form of an implied term or liability rule. Thus, in section 45 cases once part performance begins, the offeror may not revoke an offer. RESTATEMENT (SECOND) OF CONTRACTS § 45 (1981). There is really no deception going on and Johnston's theory would therefore not be instructive about providing a theoretical basis for an implied term. In addition, the particular rule which he suggests for courtship—of discouraging further investment to escape liability—would not really help resolve the section 45 cases. That the law implies a subsidiary promise not to revoke can be better explained in terms of the theory outlined here of implying a term or liability rule in cases where the presence of the sunk costs by the performing party gives the offeror the opportunity for exploiting sunk costs.

performance from the promisee was to reduce uncertainties about the performing party's type. If the promisor is unsure as to the probability of an ultimate trade, he or she will need further investments, but might discourage further investment to avoid liability.

While this Article agrees on the important role sunk costs play in reducing uncertainty in the contract formation process, there is a broader basis for imposing liability than merely flushing out "pessimists," and the law should recognize that basis for liability. Although there may be some percentage of buyers who are known pessimists and pretending to be optimistic in order to induce the sellers to separate themselves, in other cases buyers are neither pessimists nor optimists, but merely learners whose expectations about the probabilities of trade will be determined by what they learn from reliance investing promisees in the "courtship" process rather than fixed *ex ante*. In each case, regardless of whether the promisor is an actual pessimist or not, he or she is using the sunk costs invested by the promisee to reduce uncertainty.

The buyer has a high amount of uncertainty regarding the possible value of the object that he will be buying. A primary means of reducing uncertainty is by having the seller engage in certain performance steps. That then raises the potential for the buyer to exploit the sunk costs and use them to decide whether to deal, what value to offer, and what the terms of trade will be—a type of hedge.[173] In such cases, there may be no "actual pessimists," only those seeking to learn more about the other party. When the issue is framed in that way, the inquiry then becomes how to develop a framework to guide the law in dealing with the opportunities for exploitation by one party who solicits sunk costs from the other party to reduce its own uncertainty.

4. Obscuring the Framework Justifying Legal Intervention

Another failing in current promissory estoppel scholarship—which is related to the neglect of the uncertainty problem and the use of cost/benefit analyses oriented to trade probabilities—is the obscuring of the legal intervention issue. A cost/benefit analysis that examines whether a party would calculate its own reliance investment to be an efficient one at a particular point in time, given the probability of ultimate agreement being

173. This is different from the "hedge" discussed by Katz, *supra* note 28, at 1267. Katz contemplates a hedge by someone who is actually "making some transaction-specific investments." *Id.* This Article assumes that the party investing is not the party hedging—rather it is the non-performing party who is hedging by soliciting sunk costs from the other party.

reached, does not fully resolve whether legal intervention is justified. The cost/benefit analysis used to analyze the issue of whether the *law* should intervene should be conceptualized differently. A suggested analysis to justify intervention follows.

Justifying legal intervention in the form of a liability rule applicable to preliminary negotiation requires one to recognize the central moral hazard problem posed by the problem of opportunistic exploitation of sunk costs of the promisee. When the problem of precontractual reliance is conceptualized in that way, then the exclusive focus becomes "maximizing social wealth"[174] by optimizing the "moment at which it is optimal to begin investing"[175] or becomes a weighing of prospective gain and loss from the reliance investment based on the relative probabilities of the trade or no trade. Either of these means of identifying the efficient reliance represent incomplete approaches to maximizing gains from trade.

It will not be possible to ascertain an efficient solution unless one also finds a means of directly addressing the danger of opportunism and "minimizing the deadweight costs of transacting imposed by the natural barriers (uncertainty, opportunism, and sunk costs) as a means to increasing the gain from trade."[176] To determine how such deadweight loss should be minimized in preliminary negotiations, one should use the unifying comparative net benefit framework (outlined above) to assess whether a law-supplied liability rule could control such hazard and thereby increase the gain from trade, given the natural barriers which do exist. It is incumbent on a legal decision-maker who recognizes that parties will try to control such opportunism in order to increase the parties' mutual gain to: (1) determine the possibility of private contracts to control such behavior; and (2) to compare the relative costs of other private strategies with law-supplied rules for controlling such hazards. Focusing exclusively on possible gain and loss will neglect the contractual hazard inherent in reliance investment as well as the structural impediments to express contractual controls. A failure to advert to a comparative cost/benefit analysis of efforts to control opportunistic hazards will interfere with a theory's "capacity to fully resolve the question of why a legal liability rule of an *implied commitment* is required"[177] and obscure the relevant analysis to use.

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174. *Id.* at 1268.

175. *Id.*

176. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University (July 16, 1996, 13:37:09 EST) (on file with author).

177. Kostritsky, *Short Run Economics*, *supra* note 25, at 343 (emphasis added).

The traditional formula for cost/benefit analysis, which focuses exclusively on the potential gains and losses from investing a particular reliance sunk cost, not only interferes with an assessment of how gains from trade can be maximized by controlling contractual hazards, but also fosters confusion of another sort: confusion on the nature of default rules themselves.[178] By focusing on a cost/benefit analysis a party might use to calculate its own risks of investing, the traditional analyses of efficient reliance have obscured the methodological justification for *legal intervention.* An analysis of when reliance by one party is likely to be efficient (given the probability of trade) and of the fact that in such cases it might actually be in the other party's interest "to agree to such a commitment,"[179] obscures the central question facing courts: namely when should the law, if ever, supply terms or liability rules when the parties have not agreed *ex ante* to such commitments even when it might be in their mutual interests to have such a commitment. Moreover, by focusing on the mutual benefits to the parties from "advance commitment[s],"[180] the legal decisionmaker is discouraged from carefully assessing when legal intervention is needed to promote such mutual interests. Asserting that a rule would be in the parties' mutual interests does not explain why the *law* should intervene to advance such interests.[181] If the parties did not agree to what was arguably in their mutual interests, then what is the reason they failed to agree on such terms explicitly?[182] Such an analysis must confront the importance of structural and informational barriers, including uncertainty, which interfere with the achievement of fully contingent contracts to control contractual hazards in order to develop a justificative framework for legal intervention.

The failure to advert to the structure suggested here causes Professor Katz (who has helpfully directed us to the crafting of precontractual rules to promote economic efficiency), to avoid "address[ing] the interaction between default rules chosen by the state or private associations, on the one hand, and rules actually selected by individual contracting parties on the other."[183] Yet,

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178. *See id.* at 344.

179. Craswell, *supra* note 106, at 495.

180. *Id.*

181. Jules Coleman and others highlight this problem as requiring "an account of why it is that something to which individuals would have agreed (though they did not in fact) provides a civil authority with grounds for imposing those conditions upon them now." Coleman et al., *supra* note 4, at 645.

182. Some commentators explain cases in which courts must decide whether to imply a term, such as in *Drennan v. Star Paving Co.*, 333 P.2d 757 (Cal. 1958), by reference to expressly negotiated option contracts, but the true justification for law-supplied terms (as in an implied option) must lie elsewhere. *See* Craswell, *supra* note 106, at 498.

183. Katz, *supra* note 28, at 1257.

that "formulation obscures the central issue[s]"[184] of legal intervention. The law must necessarily focus on such interactions because the court must examine the "rules actually selected" by the parties along with a determination of any structural barriers and must at the same time examine and compare state law-supplied default rules with other "private associations" and with other private strategies. An examination of the interactions is needed for a comparative cost analysis.

Commentators approaching the issue of precontractual liability to date thus fail to advert (at least expressly) to the legal intervention question. Recognition of the centrality of the legal intervention question would be beneficial. It would force legal decision-makers to develop a framework for assessing whether legal intervention would improve efficiency. A comparative cost/benefit analysis should analyze: (1) the goals likely to be sought on average by the parties; (2) the barriers which interfere with the achievement; (3) the private devices or strategies parties could use to overcome barriers and achieve the goals as well as their costs; (4) the cost of a law-supplied rule; and (5) a comparison of the costs of a law-supplied rule with private strategies. Adverting to this structure would help to more fully justify rules of implied commitment in the precontractual context and in other doctrinal areas as well.[185]

C. Real World Scenarios: Or How Modified Promissory Estoppel Would Affect Analysis and Case Outcomes

The advantage of an approach that makes the uncertainty problem primary, unlinks promissory estoppel protection from overly narrow cost/benefit analyses tied to the ultimate transaction probability, and highlights the methodology underlying legal intervention, is that it would actually render decisions in many promissory estoppel cases easier.

Recently, some commentators examining a full range of promissory estoppel cases have begun to argue that courts are evincing a hostility to promissory estoppel liability.[186] In part these projections of promissory estoppel's demise in the case law are premature and stem from a failure to understand the importance of factors that help to determine whether courts

184. Kostritsky, *Short Run Economics*, *supra* note 25, at 347.

185. *But see infra* Part IV.D for a discussion of the critique based on possible judicial error costs.

186. *See, e.g.*, Sidney W. DeLong, *The New Requirement of Enforcement Reliance in Commercial Promissory Estoppel: Section 90 as Catch-22*, 1997 WIS. L. REV. 943, 949-50. *See also* Robert A. Hillman, *Questioning the 'New Consensus' on Promissory Estoppel: An Empirical and Theoretical Study*, 98 COLUM. L. REV. 580, 588-96 (1998).

should supply a precontractual liability rule. An understanding of those factors suggests that when opportunism, sunk costs and bounded rationality are present and the promisor is using sunk costs from the promisee to solicit sunk costs to hedge and reduce uncertainty, a liability rule making the promisor responsible for the promisee's sunk costs should apply, at least where the court is convinced that private alternative strategies for reducing the opportunism would be more costly. An understanding of those factors suggests that, in those cases in which promissory estoppel claimants lose, those factors are not present; therefore, the claimants should lose. Conversely, when those factors are present, the success rate of promissory estoppel claimants is high.[187]

A class of cases which might benefit from a comparative net benefit approach involves cases in which promises or assurances are made and followed by one party investing sunk costs at the behest of the promisor.[188] The promisee invests sunk costs and they are of such a nature that they reduce uncertainty for the putative promisor. The sunk costs help to determine if a deal with the promisee would be beneficial or not. In this class of cases the danger for the promisee is the same in each case: the potential opportunistic exploitation of the promisee's sunk costs to reduce uncertainty for the promisor. In such cases, the theory suggested here would posit that parties jointly would have an interest in reducing or controlling the moral hazard since a failure to do so would have caused the promisee to invest less or impose harsher terms.[189] The question then would become one of comparing costs and efficiency of a law-supplied liability rule to discourage opportunism with other private mechanisms, including a bargained-for contract a party might use to control hazard or other devices such as screening the promisor's trustworthiness *ex ante*, reputational controls, or option contracts.

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187. Juliet P. Kostritsky, The Rise and Fall of Promissory Estoppel or Is Promissory Estoppel Really as Insignificant as the Critics Say It Is (11/29/00) (unpublished draft manuscript, on file with author).

188. *E.g.*, Cyberchron Corp. v. Calldata Sys. Dev., 47 F.3d 39 (2d Cir. 1995); Esquire Radio & Elec. Inc. v. Montgomery Ward & Co., 804 F.2d 787 (2d Cir. 1986); Computer Sys. of Am., Inc. v. IBM Corp., 795 F.2d 1086 (1st Cir. 1986); Werner v. Xerox Corp., 732 F.2d 580 (7th Cir. 1984); V'Soske v. Barwick, 404 F.2d 495 (2nd Cir. 1968); OAO Corp. v. United States, 17 Ct. Cl. 91 (1989); Christensen v. Intelligent Sys. Master, Ltd., 399 S.E.2d 495 (Ga. Ct. App. 1990).

189. *See supra* notes 93-94 (explaining that transactions without contractual safeguards will be priced less competitively than those with contractual safeguards). *See also* Lee & Png, *supra* note 172, at 95 (explaining that installment payments may be implied in English law to encourage greater efforts on the part of contractors who would otherwise be subject to the problem of "moral hazard and in which there are large sunk costs").

If one can conclude that a generalized law-supplied performance obligation requiring the promisor to disclose changes or a willingness to compensate the promisee for expenses was a more cost-effective means of encouraging promisee investment than other mechanisms including pricing and bargaining for each interim investment, and less expensive than screening promisors *ex ante* to assess their trustworthiness, then the law-supplied rule should be adopted as the most efficient solution to a recurrent problem.[190]

Despite the theoretical appeal of a theory based on the comparative net benefit standard for curbing opportunism by promisors who use sunk costs invested by promisees to reduce their own uncertainties, the lurking question might be: Will the theory have any practical usefulness? The theory is useful because it helps to explain, better than the language of the promissory estoppel doctrine itself, the results in the cases. In those cases where the promisors have actively solicited sunk costs by the promisees and those sunk costs are useful in helping the promisor to hedge or to determine whether and on what terms to proceed with the transaction, the promisee will likely succeed in a promissory estoppel action.

Certainly the *Hoffman v. Red Owl Stores, Inc.*[191] case, one of the most famous in the contracts course, illustrates how the incremental investment of sunk costs by a potential franchisee helped the potential franchisor determine whether to grant the promisee a franchise. The potential franchisee took a number of steps including the acquisition and sale of a small grocery store at Red Owl's suggestion.[192] The franchisee's acquisition and operation of a small grocery store provided invaluable information in advance about his potential for success in a business enterprise, information that the franchisor would probably be unable to obtain in any other manner.[193]

Yet, if one were to apply the efficiency formulas conceived by Goetz and Scott for weighing the investment and its possible loss if the trade fails with the possible success if the enterprise succeeds by taking into account the relative probabilities of trade and no trade, Hoffman's investment in the small grocery store may well have been inefficient because the probabilities of a trade were too remote at that point. At the same time, the investment provided valuable information to the franchisor about Hoffman's ability to operate a small grocery store and thus had value in screening Hoffman's

190. "[T]he one time state creation cost [of a state-supplied liability rule for precontractual liability] is less than the sum of the total costs private parties would otherwise have incurred to solve the problem for themselves." Schwartz, *supra* note 20, at 279.

191. 133 N.W.2d 267, 268-71 (Wis. 1965).

192. *Id.* at 269.

193. *Id.*

capabilities. If putative promisors were able opportunistically to exploit the sunk costs of potential franchisees without legal liability, then the likely effect would be that promisees would invest less in future transactions and promisors would be deprived of valuable information that would enable them to determine whether to proceed and on what terms.

The question for the legal decision-maker is whether the implication of a liability rule would mitigate the hazard of expropriating sunk costs in a less expensive manner than privately negotiated safeguards. As an alternative promisees could invest in screening potential promisors, in bargaining over each incremental act or sunk cost, or in negotiating bonding mechanisms designed to guard against opportunism. Yet, these private protective actions by promisees could be quite costly, at least when the costs of such devices are aggregated over many transactions.

Since the problem of the opportunistic exploitation of sunk costs invested by a putative promisee to reduce uncertainty for a putative promisor is a recurring one, it seems that the situation is an ideal one for the implication of a law-supplied liability rule, since average parties would want to reduce the hazard in such situations in order to maximize joint gain by saving the parties from having to incur the costs of private protective safeguards.

Other fact situations are similar to *Hoffman* in that the putative promisors faced with uncertainties made promises to induce promisee reliance and reduce uncertainty.[194] Those similarities in typology help to explain the success rate of the plaintiff. At the same time, in a large number of instances plaintiffs in promissory estoppel cases are likely to fail where the plaintiff's investment of sunk costs seems slight or nonexistent or the costs were invested before the promises were made or the promisee is himself acting in bad faith.[195] In this latter group of cases, the danger of opportunistic exploitation by the promisor of promisee sunk costs to reduce his own uncertainty lessens, thereby obviating the need for a law-supplied liability rule.

The famous (or perhaps famous only to the promissory estoppel aficionado) case, *Esquire Radio & Electric Inc. v. Montgomery Ward & Co.*,[196] illustrates another case of a plaintiff victory which can be explained by the fact that the putative promisor was using the sunk costs of the plaintiff to hedge. In *Esquire* the defendant ordered goods from overseas vendors and paid for the goods but used the plaintiff as a middleman who would stockpile

194. *See supra* note 188.

195. Some of these factors and their correlation with failure rates in promissory estoppel cases are discussed in DeLong, *supra* note 186, at 997-99.

196. 804 F.2d 787 (2d Cir. 1986).

the goods and make immediate payment for the goods on behalf of the defendant. When and if the defendant needed the goods, it would repurchase the goods from the plaintiff.[197] Only at the point of repurchase would the plaintiff actually recoup its costs.[198] The understanding between the parties was that the defendant would buy back all of the inventory so that the plaintiff did not get stuck with inventory for which it received no compensation.[199] At one point as inventories accumulated, the plaintiff became increasingly nervous and sought a formalization of the buy-back understanding.[200] The defendant said "[y]ou ought to carry more and not be so tight on the quantities," and offered reassurance that it would buy back the inventory.[201] When the defendant reneged, the plaintiff sued and recovered on promissory estoppel grounds.[202]

The *Esquire* case is an easy case to understand if one grasps that the defendant was in effect soliciting sunk costs by the plaintiff to hedge its own bets. The defendant could not be sure of its ultimate needs for the goods and thus was unable or unwilling to commit to a fully contingent buy-back arrangement.[203] Yet, the informal buy-back arrangement allowed it to hedge and gain the full benefits of an available inventory when needed without shouldering any of the downside risk. The arrangement also allowed the defendant, for successive points in time, to hedge and to resolve the current need for the inventory to help determine whether a commitment of a formal enforceable buy-back arrangement would be justified. The accumulating inventories suggests that the defendant was learning that perhaps the demand for the products was not as great as anticipated and that such a buy-back arrangement would not be in its interest. Thus, the continued investment by the plaintiff in the inventory allowed the defendant to postpone the decision about whether to commit to a formal buy-back arrangement until the defendant had more information about the desirability of such an arrangement based on the demand for its products. The plaintiff's investment in the form of sunk costs of inventory purchases thus provided a valuable benefit to the defendant.

The pattern of the defendant soliciting sunk costs to reduce his own uncertainty can help to explain a pattern in the employment cases such as the

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197. *Id.* at 791.
198. *Id.*
199. *Id.* at 792.
200. *Id.* at 791-92.
201. *Id.* at 792.
202. *Id.*
203. *Id.* at 794.

famous case of *Grouse* v. *Group Health Plan.*[204] In *Grouse*, an employer offered Grouse, a pharmacist, a job.[205] That job offer caused Grouse to terminate his current employment and to turn down another offer.[206] Subsequently, the potential employer indicated that a favorable job reference would be needed.[207] Because Grouse failed to deliver a reference, the employer hired someone else.[208] Grouse then brought an action and prevailed on promissory estoppel.[209]

In many employment cases the potential employer discusses with a potential employee an undertaking that the employer might be willing to take in the future. Terms of the contract cannot be presently agreed to in part because of many uncertainties. The employer is often soliciting sunk costs by an employee in order to reduce risks or uncertainties connected with the hiring of a certain employee. In *Grouse* the employer was interested in the employee's termination from his prior job because that step was in some sense valuable to the defendant.[210] It increased the certainty that the potential employee would be ready and available to work for the defendant. The defendant was also uncertain about the employee's capabilities and was in some sense hedging to acquire further information about the employee, even after making an offer.[211] Because the plaintiff had taken some steps in reliance, by terminating his prior employment and turning down alternative employment, the defendant should pay for the reasonable value of whatever steps the putative employee has taken prior to the defendant's warning that his willingness to reach the expected agreement has changed.

In employment cases in which promissory estoppel often succeeds, the putative defendant has sought certain initial steps from the putative employee. These often include the act of moving to the defendant's location. This action by the employee gives the defendant employer a further opportunity to reduce uncertainties about the employee.[212] The very act of

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204. 306 N.W.2d 114 (Minn. 1981).

205. *Id.* at 115.

206. *Id.* at 115-16.

207. *Id.*

208. *Id.*

209. *Id.* at 116.

210. *Id.*

211. *Id.*

212. Protection for beginning workers is consistent with Professor Schwab's view that such protection may be implied by courts through just cause terms designed to protect against "[t]he danger of employer opportunism [which] is greatest for late-career workers, and it is also a problem for some beginning career employees." Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 MICH. L. REV. 8, 11 (1993). *But see* Andrew P. Morriss, *Bad Data, Bad Economics, and Bad Policy: Time to Fire Wrongful Discharge Law*, 74 TEX. L. REV. 1901, 1901-03 (1996) (suggesting rationale for retaining at-will rule since it "suits the

moving is a valuable signal of the employee's commitment. The employee's act of moving and starting work also helps to provide better information about the employee's worth than could be obtained in mere negotiations. That information is valuable to the employer in reducing the risks of hiring an unknown quantity.

Because the information provided by the employee helps the employer to determine whether to proceed with a fully contingent employment contract and to screen the employee's capabilities, but at the same time leaves the employee vulnerable to opportunistic exploitation of his sunk costs, a liability rule is appropriate if other mechanisms for the employee to self-protect would be more costly.

D. *Postscript to Case Law: Is the Methodology Practicable?*

Certainly one plausible response to the argument that courts should adopt the comparative net benefit methodology as a framework for deciding when courts should supply liability terms or rules is that the approach is too costly in terms of "the risk of judicial error."[213] Professor Clayton Gillette has argued that the methodology may be too difficult to implement given the disagreements that are possible over basic components of the test, such as the factor requiring an assessment of the parties' objectives. As Professor Gillette explains: "When contractual disputes arise in long-term contracts, it is highly likely that the parties will disagree, at least publicly, about their original intent."[214]

Yet, it is important to remember several things. First, the courts are aided in this process by the fact that "[t]here is also something taken to be more or less common and durable—again, without ruling out chronically gradual or episodically drastic shifts—in the behavior of individuals, acting alone or collectively: what they seek, how they pursue objectives, and how they react to interventions."[215] Thus, the parties' objectives here are fundamental ones on which there is common agreement, such as, a desire to maximize welfare, rather than on the particular objectives the parties held in entering a specific contract.

institutional competence of courts" and provides an appropriate "allocation of decisionmaking authority between the public and private sectors which serves the needs of both employers and employees").

213. Gillette, *supra* note 145, at 4.

214. *Id.*

215. Coffey, *supra* note 7, at 3.

Second, the liability rule is designed to cover a recurring situation in which the investment of sunk costs by a promisee at the behest of a promisor gives the promisor the potential to act opportunistically to exploit those sunk costs for the purpose of hedging. The recurrent nature of that phenomenon seems to indicate that it would lend itself to the creation of a state supplied rule to control the hazard because it is a case where "the one time state creation cost is less than the sum of the total costs private parties would otherwise have incurred to solve the problem for themselves."[216]

Moreover, the development of an articulated methodology would help, rather than hinder, courts. While the methodology would require the court to make a number of determinations—assessing the barriers to contractual solutions, identifying behavioral characteristics of the parties, and comparing the relative costs of private contracts and other incentive schemes—the methodology is necessary if courts are ever going to be able to fully justify the adoption of a liability rule. Without it, courts specifying obligations are simply adopting rules without being able to fully justify them. Courts and legislatures in many contexts make determinations as to whether the adoption of a particular rule will help or achieve certain goals—whether it be the projected effects of an implied warranty of habitability, a liability rule for precontractual negotiation, or the implication of a subsidiary promise not to revoke an offer of a reward once performance has begun.[217] In each case, these projected effects regarding intervention "as a means of achieving chosen goals can be verified to the extent that we can test the accuracy of assumptions about the workings of natural phenomena, both inanimate and living"[218] and "assumptions take the form of hypotheses and of extensions therefrom reached through processes of necessary inference."[219] Thus, the fact that the framework could even be somewhat difficult to implement does not justify dispensing with it if adoption of such methodology would better promote goal achievement.

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216. Schwartz, *supra* note 20, at 279. The recurring nature of the problem of opportunism and the potential diminution in total gain that results from such behavior may help to mitigate a current objection to a judicial role in filling in incomplete contracts. This objection is voiced by critics who are urging a reduced role for courts formulating terms or default rules for the parties and embracing a new formalism. They point out that in some instances courts are ill equipped to fill in terms where "any contract term selected by a court to fill the gap would have to be based upon information that is either unobservable to one or both of the parties or unverifiable to the courts." Scott, *Formalism*, *supra* note 11, at 863. In cases, however, where one party opportunistically exploits sunk costs to reduce its own uncertainty, the implication of a law-supplied liability rule to control such behavior does not pose difficulties of hidden information or verifiability problems and, therefore, seems more amenable to a court-supplied term or rule.

217. *See* RESTATEMENT (SECOND) OF CONTRACTS § 45 (1979).

218. Coffey, *supra* note 7, at 5.

219. *Id.* at 6.

Moreover, the alternative to not adopting the structure or methodology might involve courts in continuing to impose or deny liability in precontractual negotiations without an adequate justification for doing so.

Finally, since a major alternative to a court-supplied liability rule would be a negotiated option or side payment, the methodology of a law-supplied liability rule may be quite practicable in light of the cost of the alternative of requiring each party to negotiate such a side payment.[220] Requiring each promisor and promisee to reach private contractual solutions "ignores the real barriers that exist to subdividing performance into parcels that have equal economic value to each side to facilitate a trade at prices acceptable to both."[221] Thus, a law-supplied liability rule may well be the most cost-effective solution to solving problems of opportunism.

V. DEFAULT THEORY RECONSIDERED

Although there is agreement on the need for default rules to govern when the "agreement of the parties does not resolve the dispute that has arisen"[222] and the "situation is a recurring one,"[223] there has been a wide ranging debate about the appropriate method for legal decision-makers to use in selecting the governing default rules. In the earlier part of this Article, I suggested the adoption of a comparative net benefit framework. Some scholars have embraced a methodology which seeks to fill gaps using hypothetical bargaining as a justification for legal intervention. Others have embraced, as an alternative, a penalty default rule "purposefully set at what the parties would not want."[224] For different reasons (explored below), both methodologies fail to provide adequate justification for law-supplied intervention.

A. *Problems With Hypothetical Bargain Theory*

The traditional preferred methodology for filling in contractual gaps was the hypothetical bargain.[225] Hypothetical bargaining seeks to supply terms that the parties would have bargained for, *had there been no transaction*

220. *See, e.g.*, Wouter P.J. Wils, *Who Should Bear the Costs of Failed Negotiations? A Functional Inquiry Into Precontractual Liability*, 4 J. DES ECONOMISTES ET DES ETUDES HUMAINES 93 (1993).

221. Kostritsky, *Short Run Economics*, *supra* note 25, at 368.

222. FARNSWORTH, *supra* note 32, § 7.16, at 497.

223. *Id.* at 501.

224. Ayres & Gertner, *supra* note 3, at 91.

225. *Id.* at 89-91.

costs. The theory was that by supplying such rules or terms, the legislature or court could save the parties the costs of contracting for terms preferred by the majority.[226] Idiosyncratic parties could opt out of the rules. These formulations of hypothetical bargain theory suffer from several shortcomings which impair their usefulness as a model for crafting default rules. First, hypothetical bargain theory assumes a frictionless world, and thus, cannot provide guidance for a world beset by frictions of opportunism, sunk costs, and bounded rationality. Because a second-best world of frictions does exist, it is important to assess default rules in terms of their ability "to solve the barriers problems that the parties would want, given a second-best world."[227]

By incorrectly focusing on *lowering* the "absolute magnitude of transaction costs"[228] as an end in itself without a comparative assessment,[229] hypothetical bargain methodology leads scholars to weigh only the "costs [of transacting] against the benefits of contractually addressing a particular contingency."[230]

In fact, in determining if intervention in the form of a law-supplied default rule is justified, the decision-maker must account for the reality of frictions, and assess not only the transaction costs of negotiating a specific provision, and the benefits from the provision (such as lowered opportunism, for example), but also alternative private incentives which might achieve the parties' goals and the costs of law-supplied rules as well as the relative costs of each. For that reason, the comparative net benefit approach is a more nuanced version of the majoritarian default rule. It also provides more specific content to the majoritarian default rule by expressly recognizing that judging the optimality of judge made rules and private arrangements requires reference to the fact that such interventions or arrangements take "place under the influence of such barriers (because the very meaning of a first-best world is the absence of such barriers)."[231]

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226. There is a contrary approach to default rules which seeks to supply tailored default geared to the particular parties. *See, e.g.*, Gillette, *supra* note 2, at 541-46; *see also* Scott, *Relational Theory*, *supra* note 12, at 600-01 ("Each of these arguments for more particularized default rules is driven by the claim that individual attitudes toward risk influence the nature of particular contractual relationships in systematic and predictable ways.").

227. Kostritsky, *Why Infer?*, *supra* note 106, at 512 (quoting Coffey, *supra* note 176, at 2).

228. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 27, at 22.

229. "[I]t is the difference between rather than the absolute magnitude of transaction costs that matters." *Id.*

230. Ayres & Gertner, *supra* note 3, at 93.

231. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University (April 5, 1997 22:44:54) (on file with author).

B. Rethinking Penalty Default Rules

Shortcomings in hypothetical bargain theory led to an effort to develop an alternative structure for implied default rules known as "penalty default rule" methodology.[232] Yet, as seen below, because of Ayres and Gertner's focus on the aspect of the *Hadley v. Baxendale*[233] case, which declined to supply a liability rule, the comparative cost structure which should be central to a court's determination of whether a law-supplied rule would be appropriate, gets obscured in their analysis. The penalty default rule approach was formulated by Professors Ayres and Gertner in one of the most influential articles in contracts scholarship.[234] It argues that at least in some contexts, legal decision-makers should utilize "penalty defaults . . . purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other or to third parties (especially the courts)."[235]

Ayres and Gertner developed this theory of penalty defaults in a close analysis of the *Hadley* case.[236] In a sense, the *Hadley* court was faced with a question of whether to intervene with a law-supplied term of consequential damages which was not agreed to expressly by the parties. In that sense, the case does involve a question of legal intervention. However, the *Hadley* case is a complex example of judicial intervention and non-intervention. Because of these complexities, it may be incorrect to use *Hadley* as a basis for justifying default rules which take the form of a law-supplied term or liability rule. Moreover, while the penalty default rule has the appealing quality of being able to offer "an apparently plausible rationale"[237] for the particular result in the *Hadley* case, it cannot—by itself—form the basis for assessing whether a court should intervene with a law-supplied liability rule or term in other contexts. Such interventions must depend instead on the adoption of a comparative net benefit standard. That approach would "explain, with more robust explanatory power than the penalty default rule, a variety of other gap-filling default rules" in contract law.[238]

To understand the limited usefulness of the *Hadley* rule as a paradigm for assessing whether legal intervention is justified, it is first necessary to parse the *Hadley* ruling. The *Hadley* ruling really has three components: (1) a law-supplied implied term of foreseeable (in the ordinary course) damages;

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232. Ayres & Gertner, *supra* note 3, at 87-91.
233. 156 Eng. Rep. 145 (1854).
234. *See* Ayres & Gertner, *supra* note 3.
235. *See id.* at 91.
236. 156 Eng. Rep. 145 (1854).
237. Kostritsky, *Why Infer?*, *supra* note 106, at 518.
238. *Id.* at 527.

(2) a law-supplied term of implied consequential damages (if prior disclosure); and (3) a refusal to supply consequential damages (absent prior disclosure).[239]

In effect, the *Hadley* rule in its third (and most influential) aspect actually represented a *refusal* to intervene with an implied term of consequential damages. Thus, it is not a particularly good paradigm to use for judging generally the appropriateness and efficiency of law-supplied interventions which take the form of a law-supplied liability rule or term.

If one focuses on the third prong of the *Hadley* ruling, which refused to imply consequential damages absent prior disclosure as to type, then Ayres and Gertner might argue that it is still a good paradigm to use in deciding default rules and that *Hadley* stands for a generalized framework to use in deciding whether to intervene. They might argue that whenever a party has strategically withheld information, it may be necessary for the court to refuse to intervene to punish that withholding of information and thereby encourage the parties to disclose the information in future contracts to increase efficiency. The normative argument is that efficiencies will be achieved if the parties disclose their true types, including their potential for damages. Such disclosure will permit the shipper in *Hadley* for example, to take cost-effective precautions.[240] Inefficiencies will result if one's true type is not disclosed because the shipper will not take cost-effective precautions. By penalizing the nondisclosure of one's true type, the *Hadley* rule will encourage the disclosure of information and thereby permit the shipper to take cost-effective precautions. Ayres and Gertner conclude that the penalty default rule will promote efficient separation of parties by type, and thus, efficiency, whenever the costs associated with contracting around the *Hadley* rule, the low damage default, are less than the inefficiencies associated with failing to contract around the default (what Ayres and Gertner term the "cost of pooling equilibria").[241] "The efficient default minimizes the sum of these two costs . . . ."[242]

Although Ayres and Gertner helpfully highlight "[t]he tension between 'pooling' and 'separating'"[243] and emphasize the need to compare the costs of separating against the costs associated with "the inefficiency cost when high-

239. *Hadley*, 156 Eng. Rep. at 151; *see also* Kostritsky, *Why Infer?*, *supra* note 106, at 518-19.

240. Ayres & Gertner, *supra* note 3, at 101 ("Informing the carrier creates value because if the carrier foresees the loss, he will be able to prevent it more efficiently.").

241. *Id.* at 112.

242. *Id.* at 114.

243. *Id.* at 112.

damage mills fail to contract for greater precaution,"[244] their formulation still begs the question of whether legal intervention is justified. It seems to suggest that the high cost millers will themselves "contract for the efficient amount of insurance"[245] without confronting the question of whether, when and how the law should intervene when the parties' own actions fail to achieve the efficient result.

The difficulty with the Ayres/Gertner approach, which focuses on the *Hadley* rule's *refusal* to intervene, is that it does not form an appropriate basis on which to justify a legal intervention. Ordinarily the central issue should be a comparative one: Would the suggested law-supplied liability rule or term maximize the gains from trade by reducing the losses from pooling (or not being able to separate) at less cost than the private strategies parties could employ to reduce pooling? The important point a legal decision-maker should consider is whether the suggested law-supplied liability rule or term will achieve the parties' goals (such as a reduction in loss due to opportunistic behavior) at comparatively less cost than private strategies. If one poses the question in that way, then it seems fairly obvious that the court should not adopt a non-*Hadley* rule which would grant consequential damages to all parties regardless of disclosure. Doing so would not achieve reductions in the losses from pooling because parties would all have an incentive to pool, and losses from pooling would remain. In other cases, however, the answer may not seem all that obvious, and focusing the question in comparative cost reduction terms may help the court to resolve the issue of intervention.

By focusing on its "penalty" aspects designed to force disclosure of information, the Ayres/Gertner discussion of *Hadley* fails to focus on the comparative cost framework outlined above which should underlie any decision on legal intervention, and thus, fails to provide a framework for legal decision-makers to use in implying a variety of terms and liability rules:

> Without an understanding of these interventionist and noninterventionist aspects of the *Hadley* ruling [and without an understanding of that comparative cost framework], it becomes difficult to assess the importance of *Hadley* for resolving the critical question of when and why it is ever appropriate for the law to intervene with a term or liability rule if the parties have failed to negotiate one.[246]

244. *Id.* at 109.
245. *Id.* at 110.
246. Kostritsky, *Why Infer?*, *supra* note 106, at 519.

Even the second aspect of *Hadley*, which did represent a law-supplied term of consequential damages, was premised on the *prior disclosure* of special circumstances by the party with the information.[247] Thus, the court's hypothetical willingness to intervene with an implied term of consequential damages was premised on the absence of opportunism. Thus, this second prong of *Hadley* is not an example of a court deciding to intervene with a law-supplied rule or term to control opportunistic behavior as the most cost effective means of controlling potential hazards and thereby maximizing mutual gain (as in the case of the court implying a fiduciary performance obligation to control agent shirking).

The first prong of the *Hadley* rule, which was not the focus of the Ayres and Gertner discussion and which represents a willingness of the *Hadley* court to intervene with an implied ordinary and foreseeable damages term, is the one that actually yields the greatest insights into when a court should intervene with an implied term in order to minimize the losses from pooling—thereby maximizing the mutual gains from trade.[248]

The level of intervention in the first prong of *Hadley*, which implies consequentials for all ordinary and foreseeable losses, in effect, intervenes to give ordinary damages without disclosure. The result of this implied damage term, in effect, gives the lower cost miller the ability to identify itself as worthier (with less costly damages) than the others (who must opt out to get higher consequential damages)—it "permits them better to separate themselves than would private strategies"[249] which, after all, are subject to a "budget constraint."[250] The rule, intervening to give all parties an implied term of all ordinary and foreseeable damages allows the party with lower damages to separate himself out at a lower cost than would private constraints, and forces the high cost miller to undertake the costs of identifying his type to get the higher damages.

Viewed in this way, the *Hadley* rule can even be viewed as a rule that may be preferred by both parties because it would: (1) permit the lower cost millers to be immediately identified as worthier (because they do not opt out); and (2) be preferred by the higher cost millers because the pooling that would allow the high cost millers to disguise themselves and that would otherwise occur under a non-*Hadley* rule actually would be "transitory at best, because the worthies keep dropping out."[251]

247. *Hadley v. Baxendale*, 151 Eng. Rep. 145, 151 (1854).

248. *See supra* note 84.

249. Coffey, *supra* note 176, at 2.

250. *Id.*

251. *Id.* Ayres and Gertner focus on the third prong of *Hadley* (no consequentials absent prior disclosure) and find that even if the rule would be efficient to penalize non-disclosure, it would not

What is obscured in the Ayres and Gertner discussion of the *Hadley* case is whether, in a case in which a court is faced with the prospect that parties will act opportunistically by non-disclosure of type, the court should actually intervene to control that opportunism with a liability rule or term when there are large structural barriers interfering with private contractual arrangements to control opportunism. Normally a court should only intervene in such cases if it is convinced that the costs of doing so are less than the private strategies parties might employ to overcome the structural barriers. The *Hadley* rule emphasized by Ayres and Gertner actually involves that aspect of the case in which the court declined to intervene, and therefore, does not present a case involving the question of a justification for legal intervention. If, however, one focuses on the first aspect of *Hadley*, in which the court does intervene with implied damages to give damages that are ordinary and foreseeable, it may be because the legal decision-maker determined that the rule implying such ordinary damages would actually be preferred by low cost millers as one that would "achieve the greatest reductions in the loss from pooling and the greatest increase in joint gains from trade and net benefits."[252] The rule would even be preferred by high cost millers because the temporary nature of a pooling phenomenon under a non-*Hadley* rule would be short-lived.

Thus, the aspect of *Hadley* representing an implied term of ordinary damages can actually be justified on a comparative net benefit basis. It will achieve the greatest reductions in the loss from pooling because it will be cheaper than other private devices the low cost millers could use to signal their worthiness (low cost damage status). The high cost miller would not object because the reductions in pooling loss would increase the joint gains from trade. If that comparative methodology is employed, to assess whether a particular law-supplied rule or term is justified, it might be advantageous in explaining a greater variety of contract default rules than the penalty default rule theory.

To assess the relative advantages of the comparative benefit methodology and the penalty default rule in terms of their explanatory power for rationalizing disparate rules of contract law, it might be useful to examine the

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be preferred by the high cost millers who would prefer to remain anonymous. *See* Ayres & Gertner, *supra* note 3, at 101-04. As pointed out in the text, however, even high cost millers may regard themselves as no worse off under the *Hadley* rule since the non-*Hadley* rule under which they could earn rents from subsidized shipping prices would be "transitory." *See* Coffey, *supra* note 176, at 2. Morever, since millers themselves may be subject to strategic withholding of information by other contractual parties in the future, they may prefer the *Hadley* rule implying damages only if they are foreseeable or disclosed to minimize future losses from pooling. *Id.*

252. Kostritsky, *Why Infer?*, *supra* note 106, at 526.

"zero-quantity" penalty default rule[253] discussed by Ayres and Gertner. Ayres and Gertner assert that the "zero quantity" default "cannot be explained by, 'what the parties would have wanted' principle."[254] Instead, they see the default rule declining to supply a quantity where the parties have not done so as a perfect example of a penalty default.[255] They see the default as an effort by courts to force the party with the information about quantity to disclose it, since it may be cheaper for the parties to do so "than for the courts to determine after the fact what the parties would have wanted."[256]

However, if one looks more fully at a complete range of cases involving indefinite quantity, then the results are more variegated and hard to explain by the penalty default rule alone. There are certainly cases where courts *refuse to intervene* with a definite quantity term, but there are also cases involving indefinite quantity in which courts do intervene by supplying a good faith term limiting the quantity that may be demanded (as in an output or supply contract).[257] In such cases the penalty default rule alone does not explain the range of cases. If a desire to penalize parties for failing to disclose information were the principal concern, then courts should be inclined to deny relief in all cases which lack a quantity term, but that is not the case. A complete rationale must, therefore, lie elsewhere.

> The true rationale for such refusal, however, does not lie within the penalty default/information forcing rationale. The true reason for courts refusing the supply quantity, at least in one-shot spot trades is that there is no particular reason for courts to intervene . . . when there are no persuasive barriers to the parties reaching a fully contingent contract.[258]

Where the quantity is not specified, however, and structural impediments (including bounded rationality) interfere with negotiating a quantity and there is the possibility of opportunism, the courts willingly imply a term of good faith by which to limit output and requirements, especially where the implication of such a good faith term may be useful in constraining opportunistic behavior. Thus, the motive of courts can perhaps best be explained, not in terms of a desire to penalize nondisclosure of information, as by a calculation that a court should decline to intervene unless the law-supplied term would be the least costly alternative. In ordinary short-term

253. Ayres & Gertner, *supra* note 3, at 95-97.
254. *Id.* at 96.
255. *Id.* at 96-97.
256. *Id.*
257. *See* U.C.C. § 2-306.
258. Kostritsky, *Why Infer?*, *supra* note 106, at 529.

contracts where the parties face no insuperable obstacles to the specification of quantity but the parties decline to provide a quantity term, the court will decline to intervene because the costs of implying a quantity term are great due to the unverifiability of that information.[259] In other cases where the parties do face large obstacles (in terms of bounded rationality) to the specification of quantity in long term contracts, and the parties leave the quantity term indefinite but merely agree, for example, to purchase all one's "requirements," the court will readily intervene with an implied good faith term to limit a party's discretion.[260] That implied term will operate to enforce what would otherwise be an indefinite contract that might be unenforceable because of the illusory nature of the promise. This result can be explained in part by: (1) the courts' desire to curb opportunistic behavior by the party with the discretion over quantity, and (2) a determination that a law-supplied generalized commitment to curb such opportunism would be less costly than private contractual arrangements or other private strategies.[261]

VI. OTHER APPLICATIONS: SUBCONTRACTING

In subcontracting cases, courts face the determination of whether to imply a term, but the issue is the universal one of determining whether legal interventions in the form of an implied term of irrevocability can be justified on a comparative cost basis.[262] Once the issue is framed in that manner, then it becomes incumbent on the legal decision-maker to analyze the impediments impeding an express contract or option, the objectives of the parties, the potential problem of opportunism due to sunk costs of one party, as well as possible solutions.

In the context of subcontracting, general contractors rely on subcontractors' bids in computing their overall bids. Courts addressing this issue have liberally followed *Drennan* and implied a term of irrevocability for the subcontractor's offer once it has been relied upon.[263] The question in subcontracting cases is whether the circumstances merit the law intervening with an implied term of irrevocability for the subcontractor's offer.

The subcontracting context is subject to bargaining constraints, which might interfere with the negotiation of an express contract which would fully

259. *See* Schwartz, *supra* note 24, at 294.
260. *See* U.C.C. § 2-306.
261. Kostritsky, *Why Infer?*, *supra* note 106, at 541-53.
262. *Id.* at 541-43.
263. *Id.* at 542.

protect any reliance by either party. The general contractor cannot unconditionally promise to use the subcontractor because he does not know if he will be awarded the overall contract—a major uncertainty.[264] The general contractor can only commit based on a probability distribution and such a limited commitment may be insufficient to compensate the subcontractor for an unconditional commitment. These uncertainties will interfere with the negotiation of a fully contingent contract. Yet, despite the absence of a bargain, the general contractor may need to rely on the subcontractor's figures and its offer.[265] The question for the law is: Should the law imply a generalized performance obligation to govern the subcontractor's behavior and protect the general contractor's reliance? The subcontractor might make a limited commitment to perform so long as intervening events create no additional burdens on her ability to perform. That conditional commitment might be sufficient to offset the general contractor's costs.

"A default rule imposing such a conditional commitment on the general contractor to use the subcontractor [if awarded the overall bid] and a conditional commitment by the subcontractor to perform according to her bid (becoming unconditional if no intervening events cause additional burdens)" would represent a departure from current law.[266] *Drennan* and section 87(2) make the subcontractor's offer irrevocable—an unconditional commitment—and do not bind the general contractor to any commitment at all.[267] The rule proposed here "would satisfy the parties' rational expectations and would save them the costs of explicitly contracting over every change in the value of their respective positions prior to the point at which specification of a complete and explicit bargain is possible."[268]

VII. UNIFIED THEORY *VIS À VIS* ALAN SCHWARTZ

Perhaps the theory of a comparative net benefit methodology outlined here offers another advantage: tying together and explaining when courts will and when they will not intervene with implied terms or liability rules.

Professor Alan Schwartz has offered a theory to explain and unify the variegated approach of courts to incomplete contracts. His theory is based

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264. *Id.* at 543.

265. Comment, *The Subcontractor's Bid: An Option Contract Arising Through Promissory Estoppel*, 34 EMORY L.J. 421, 421 (1985) (discussing need for general contractor to rely by submitting its own overall bid).

266. Kostritsky, *Moral Hazard*, *supra* note 25, at 692.

267. Drennan v. Star Paving Co., 333 P.2d 757 (Cal. 1958); RESTATEMENT (SECOND) OF CONTRACTS § 87(2) (1981).

268. Kostritsky, *Moral Hazard*, *supra* note 25, at 692.

on the notion that "courts would rather be passive than active when faced with problems that they cannot solve."[269] As one example, Schwartz addresses the excuse doctrine. If parties ask for court intervention in the form of an implied excuse, courts are likely to intervene only when the factors allegedly giving rise to an excuse are easily verifiable by courts.[270]

Schwartz argues that a court's willingness to intervene to fill gaps in contracts will depend largely on whether the court is capable of supplying a term.[271] Judicial capability, in turn, depends on whether the omission relates to a matter which is easily verifiable by a court.

According to Schwartz, the courts will readily grant excuse in the case of "exogenous events [which] may affect a performing party's physical ability to perform" since "[t]he occurrence and effect of major exogenous events ordinarily is verifiable."[272] Where a party asks for excuse based on increased cost of performance, on the other hand, courts will deny relief because deciding that case would require courts to scrutinize the performer's costs, matters which are not easily verifiable by a court.[273] Schwartz's verifiability theory has obvious appeal since it seems to explain the split between cases granting excuse (physical destruction, governmental regulation) and cases denying relief (partial frustration) and, in addition, is simple to implement.

The theory also makes sense in terms of the cost benefit theory discussed earlier because it suggests that courts will decline to intervene when doing so is too costly. Under the unified comparative net benefit framework theory, legal intervention ordinarily would not be justified unless the law-supplied rule would be a less costly alternative than private devices that the parties might employ to overcome structural barriers to private express contracts, and thereby, achieve shared goals such as curbing opportunism and maximizing surplus. That comparative cost theory might suggest a similar result of non-intervention in cases where information is unverifiable or not accessible to courts. In such cases, it would be hard to see how one would conclude that legal intervention would be cost-justified.

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269. Schwartz, *supra* note 24, at 274. In effect, Schwartz is addressing the judicial capability or monitoring problem.

270. *Id.* at 290-94, 314.

271. *Id.* at 298, 313.

272. *Id.* at 286. "Examples include floods, fires, wars, embargoes, strikes and government regulations. The risk that such events will occur is contractible; asymmetric information helps explain how the risk is allocated. The occurrence and effect of major exogenous events ordinarily is verifiable . . . ." *Id.*

273. *Id.* at 283, 292.

Yet, Schwartz's focus on the verifiability issue as the key factor that explains a court's willingness or unwillingness to intervene represents only a partial explanation for the court's behavior. A more complete explanation rationalizing court intervention should start with the goals the parties have set (such as maximization of surplus, recognizing that parties seek to control opportunism and other contractual hazards to achieve greater surplus). Then, one should take account of the serious obstacles parties face in controlling contractual hazards by express contract and examine thereafter whether private devices or strategies parties might employ to overcome such obstacles would be more or less costly than law-supplied rules or interventions.[274]

Although the verifiability issue certainly may be part of the cost/benefit calculus of legal intervention, the focus on the parties' goals, such as controlling for contractual hazards, together with a comparative net benefit approach, offers a broader rationale that could be used to better justify and explain legal intervention in a wider variety of cases.

For example, in the indefinite quantity scenario with cases arising with output and requirements contracts, the court implies a term of good faith to constrain the behavior or party with discretion to produce output or declare requirements.[275] In requirements contracts, the courts readily apply that standard to find opportunism when a buyer vastly increases its "requirements" to take advantage of a low fixed purchase price in a rising market to propel itself into the position as a wholesaler.[276] Schwartz explains that these cases turn on the fact that the court can easily verify whether there are "systemic factors [that] cause the market price to rise substantially above the contract price."[277] Other matters similarly involve verifiable issues. If one, for example, suddenly becomes a wholesaler, that issue is in a sense verifiable by reference to past purchases for internally generated needs and excess present purchases for non-internally generated needs.

In these cases therefore, a court willingly intervenes with a term of good faith and then applies that term to ban the discretion exercised. On the other

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274. The comparative benefit approach, which looks at structural impediments to express contractual solutions to curb opportunism as a precondition for determining whether a law-supplied rule would produce efficiency improvements, can be utilized in a variety of contexts. Professors Stanley Longhofer and Stephen Peters use such a framework to assess the welfare improving effects of law supplied coordination rules in bankruptcy. *See* Stanley D. Longhofer & Stephen R. Peters, Protection for Whom? Creditor Conflicts in Bankruptcy (March 1997) (unpublished manuscript on file with author).

275. U.C.C. § 2-306 (1997).

276. Schwartz, *supra* note 24, at 296; *see, e.g.*, Orange and Rockland Utils., Inc. v. Amerada Hess Corp., 397 N.Y.S.2d 814 (N.Y. App. Div. 1977).

277. Schwartz, *supra* note 24, at 296.

hand, where there are "factors that affect [the party with discretion] much more than they affect otherwise similarly situated firms,"[278] and are thus *not systemic*, the information is not readily verifiable and so a court declines to intervene. If a seller, for example, because of internal restructuring, curtails its output because of those factors peculiar to the seller, the court declines to intervene and permits the seller to curtail output without being found to violate the good faith component of performance.[279] Schwartz argues that the non-intervention is explicable by the difficulty of verifying whether these factors peculiar to the seller, and not systemic, are legitimate.[280]

However, in the case of the seller curtailing output because of individualized non-systemic factors, the analysis to use in deciding whether the courts should intervene should begin with an analysis of the parties' goals (such as the reduction of contractual hazards). The court should then proceed to a comparative net benefit assessment of whether intervention is cost-justified. In the case of the seller reducing output due to individualized factors, such as the loss of an employee, the conduct involved does not seem to present a case of opportunistic behavior (or if it does involve opportunism, a court's intervention to assess it would be so costly as to outweigh any benefit to be derived from curbing the opportunism). The case of the buyer propelling itself into a new wholesaler status seems to involve a buyer manipulating its requirements to take advantage of a rising market, a clear case of opportunistic behavior. The court intervenes in the latter case because it assumes that parties have a shared goal of curbing opportunistic behavior, and because of sunk costs, bounded rationality and opportunism they will not effectively control such opportunistic hazards by contract.[281] Thus, the court intervenes with an implied term of good faith where it is convinced that such law-supplied term will more effectively curb opportunism at a lower cost than the private devices parties might employ (such as screening, bonding, etc.)[282] to curb opportunism.

Professor Schwartz's verifiability analysis may enter into a determination of how costly it would be for the court to intervene but it is not the determinative factor.

Another example Professor Schwartz uses to illustrate the importance of verifiability as a factor determining whether a court will intervene involves claims excuse for partial frustration.[283] As Professor Schwartz explains, a

278. *Id.*
279. *Id.* at 297-98.
280. *Id.* at 296-98.
281. Kostritsky, *Moral Hazard*, *supra* note 25, at 651-53.
282. *Id.* at 654-57 (discussing screening and bonding techniques).
283. Schwartz, *supra* note 24, at 290-91.

paying party may claim such an excuse whenever "performance is worth less to him than he originally thought it would be."[284] Because it may be difficult for a court to ascertain "a paying party's profits,"[285] a court will simply decline to intervene by denying the excuse claim.[286]

Although verifiability seems to be a factor, arguably there are other factors involved as well. One must begin with an analysis of whether crafting an implied excuse in such a case would maximize gains from trade or not. Arguably, implying such an excuse for a paying party simply because he is making less than anticipated would be sanctioning opportunistic behavior by the party claiming excuse particularly where "[t]he performing party has made relation-specific investments in many long-term contract situations."[287]

The difficulty with sanctioning "an out" with an implied excuse in the case described above, which might foster opportunism, is that there would actually be no reason to intervene. Doing so would actually increase a contractual hazard for the performing party and thereby lessen the overall gains from trade. The most cost-effective solution to the hazard might, therefore, be to decline to imply an excuse where implying an excuse would actually foster opportunism. Schwartz, however, would argue that the unwillingness to intervene in the case of the party claiming excuse (because he will make less on the deal than anticipated)[288] is explained by the fact that intervention would involve the court in ascertaining matters that are unverifiable by the court.[289] Schwartz contrasts the results in claimed excuses by paying parties who will make less than anticipated[290] (in which the excuse claims fail) with those excuses based on physical destruction of the property or governmental regulation (in which excuse claims regularly succeed). Schwartz posits that the difference in such cases is that of verifiability.[291] A court can easily verify whether physical destruction has occurred, or whether a governmental regulation affecting the contract has been implemented.[292]

While it is possible to rationalize the differing results in the cases according to Professor Schwartz's verifiability factor, doing so provides only

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284. *Id.* at 291.
285. *Id.* at 292.
286. *Id.*
287. *Id.* at 291; *see also* FARNSWORTH, *supra* note 32, at 497.
288. Schwartz, *supra* note 24, at 291.
289. *Id.* at 292.
290. *Id.* at 291-92.
291. *Id.* at 292.
292. *Id.*

an incomplete explanation of the courts' actions. While verifiability may factor into the cost/benefit analysis of the court's intervention, it does not by itself provide a rationale for intervention. The question should be how judicial intervention would achieve certain social welfare goals, including the maximization of joint gain. In the case of an excuse based on partial frustration by a party making less than anticipated, the claimed excuse might well have the potential for fostering opportunism, particularly where the performing party has invested sunk costs. Courts hesitate to grant excuse in such cases and thereby mitigate the danger of opportunism. In the case of a claimed excuse based on the total destruction of property, the party claiming excuse is not acting opportunistically and granting an excuse will not promote such behavior in the future.[293]

While it is possible to point to a difference in the verifiability of information that forms the basis for the excuse, it cannot provide a comprehensive explanation for the behavior of courts in incomplete contracts. In some instances, courts are willing to supply certain terms such as good faith to constrain demands under requirements contracts even though a court's decision to intervene in the first place with the term of good faith is not by itself "verifiable." A court interpreting the term of good faith may, of course, by guided by verifiable information such as "the contract price, the market price, and the party's total sales . . . under the contract and on the market,"[294] but supplying the implied term of good faith *ab initio* is neither verifiable nor observable. Thus, the true reason for courts intervening with an implied term of good faith is to constrain opportunistic behavior by parties to a long-term supply contract.[295] Decisions about whether intervention is justified will involve a cost benefit analysis of intervention, and such costs may include the verifiability or non-verifiability of information, but the verifiability of the information does not explain the intervention itself. One must formulate the intervention in terms of achieving social welfare goals. The court must ask: how would the adoption of an excuse, or of a term of good faith, or some other form of completing an incomplete contract achieve joint wealth maximization?

A final example that Schwartz uses to illustrate the central role of the verifiability factor is the court's ready willingness to imply excuse in the

293. *Id.* at 286 (noting that "[p]erforming parties cannot affect the probability or impact of the exogenous events.").

294. *Id.* at 298.

295. Steven Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 522 (1981).

cases of physical destruction or supervening governmental regulation.[296] In both cases, courts readily grant excuse because it involves "action . . . easy to verify."[297]

Yet, if one looks closely at the range of impracticability cases, including examples where a party claiming excuse is denied relief, it seems that verifiability alone is not the determinative factor in a court's intervention decision.

Focusing on verifiability as the focal point of intervention erroneously suggests the reason for the court's intervention lies in the verifiability of certain factors. In fact, an explanation for a court's intervention should begin with an assessment of certain goals—such as the maximization of surplus, for example. The court should then proceed to determine whether a law-supplied term would advance or hinder the achievement of that goal. Finally, the court should assess whether the law-supplied good faith term would be able to achieve those goals at a lesser cost than private contractual arrangements or other private strategies.

In the case of the requirements contract, a court faced with whether to intervene with a law-supplied term of good faith may determine that the law-supplied term would be preferred on a comparative net benefit basis because it will be the most cost-effective means of controlling cases of recurring opportunism. However, in cases where the court assessing a quantity variation to see whether it comports with good faith would have to assess non-contractible or non-verifiable factors, it might determine that the cost of intervention would be too high or that no opportunism is involved.

The robust explanatory power of a comparative net benefit approach can easily be seen by applying it to numerous examples in contracts where the court may imply terms or liability rules to constrain recurring problems of opportunistic behavior, particularly where one party has invested or would have to invest sunk costs in a way that would make it vulnerable to expropriation.[298] Courts imply a term of irrevocability in subcontractor bidding cases to protect the sunk costs of general contractors.[299] Decision-makers utilize section 90 to protect against the opportunistic exploitation of sunk costs invested by promisees. Courts regularly imply constructive conditions of exchange so that performances are construed as due simultaneously. They are in that fashion protected against the risk of having to sink costs when the other party is not ready and willing to perform.

296. Schwartz, *supra* note 24, at 292.
297. *Id.*
298. Kostritsky, *Why Infer?*, *supra* note 106, at 552.
299. *Id.* at 542.

In Section 45 contracts, where an offeror may, for example, offer a reward for the offeree performing a specified act, courts had to decide whether to imply a term of irrevocability based on an offeree's performance.[300] Through Section 45, courts implied a subsidiary promise not to revoke the offer once part performance had begun.[301] In determining whether to imply such a promise of irrevocability, the court, a decision-maker, should consider whether there are barriers which might interfere with private contractual solutions to the problem of opportunistic exploitation of an offeree's sunk costs. It may be difficult for the offeror to make the offer irrevocable in return for a certain number of interim steps because the offeror does not know in advance which steps to bargain for because she does not know which interim steps will yield successful results, and so, be worth bargaining for. Even if one were to focus on subsidiary arrangements in which the putative offeror fractionalized performance into a series of divisible steps and expressly bargained for each interim step, that could be quite a costly process. A legal decision-maker should consider the costs of such contractual arrangements as well as the costs of private strategies parties might employ to deter opportunism, such as screening all possible putative offerors in advance for their trustworthiness.

In all of these cases, the rationale of a comparative net benefit analysis helps to explain the results more fully than a verifiability theory alone.

VIII. CONCLUSION: ADVANTAGES OF THIS UNIFIED FRAMEWORK

The framework provided by this Article, with its behavioral assumptions of bounded rationality and opportunism, transactional characteristics of asset specificity, as well as a comparative assessment of costs, would: (1) give better insights into the justification for legal intervention across different subject areas; (2) provide insights into the deficiencies of the hypothetical bargain theory—the traditional method for justifying many judicially-supplied terms and default rules in contracts; (3) demarcate the scope of penalty default rule methodology originated by Ayres and Gertner, and illustrate its limitations at least as a general means of resolving questions of law-supplied rules or terms; (4) provide a better structure for explaining and modifying certain doctrines in contract law including the *Drennan* rule; and (5) provide a unifying theory for judicial intervention and non-intervention which uses some of Alan Schwartz's factors, but which also challenges his conclusion that there are only "few cases in which the state can intervene optimally

300. Kostritsky, *Why Infer?*, *supra* note 106, at 537.
301. *Id.*

when transaction costs are the culprit."[302] This Article posits that indeed there are many cases of recurring problems of opportunism for which a law-supplied rule appears cost-justified. Many apparently unrelated rules of contract law can be explained as a legal intervention designed to curb opportunistic behavior, a recurring problem in ongoing contractual relations, which may be difficult or costly to solve on a transaction-by-transaction basis.

302. Schwartz, *supra* note 20, at 282.