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## Transactional Economics: Victor Goldberg's *Framing Contract Law*

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TRANSCRIPT OF PANEL DISCUSSION—  
TRANSACTIONAL ECONOMICS: VICTOR  
GOLDBERG'S *FRAMING CONTRACT LAW*\*

*Mark P. Gergen, Victor Goldberg,  
Stewart Macaulay, Keith A. Rowley*

***Professor Mark Gergen:***<sup>1</sup>

Thank you. It is an honor to speak to this group and to be on a panel with Stewart Macaulay, Keith Rowley, and Victor Goldberg. I have an enormous amount of respect for the three. Keith had the misfortune of being a student of mine in Federal Income Tax.

*Framing Contract Law*<sup>2</sup> offers a wealth of information about familiar cases. Victor argues that in construing contracts, courts should be attentive to how people engineer contracts to minimize transaction costs. He shows that courts often err in this regard, imposing unnecessary costs. To make his case, Victor delves deeply into the background of cases, many that will be familiar to anyone who has taught contracts, and turns up much that is new and interesting. I am going to follow Victor's lead by focusing on two cases that he discusses. I will briefly summarize what he says about the cases. I will then use the cases as a springboard to make my points, which are different from Victor's points.

The first case I want to discuss is *Parker v. Twentieth Century-Fox Film Corp.*,<sup>3</sup> a case many use to teach the duty to mitigate. Victor makes a convincing case that the mitigation issue is spurious. The contract in *Parker* had what Victor describes as a standard "pay-or-play" term that limited the studio's obligation to the minimum guarantee of \$750,000. According to Victor, the minimum guarantee

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\* This panel discussion was held at the *Third International Conference on Contracts* at South Texas College of Law in February 2007.

1. Professor Mark P. Gergen is the Fondren Foundation Centennial Chair for Faculty Excellence at the University of Texas School of Law.

2. VICTOR GOLDBERG, *FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE* (2006).

3. 474 P.2d 689 (Cal. 1970); GOLDBERG, *supra* note 2, at 277-312.

protected the talent from the opportunity cost of committing to a film while giving the studio the option to cancel. Studios need this option because they do not know if they want to proceed with a film until they are fairly deep into the project. The minimum guarantee is similar to the purchase price of an option on the actor's time or to a capacity payment. If this is correct, then the mitigation issue is spurious. When an option is not exercised, the grantor is entitled to the price paid for the option and has no duty to mitigate by making a substitute transaction. Ironically, the trial court got it right—ruling for MacLaine on this basis—and then this ground for the decision drops out of the case as it goes up on appeal all the way to the California Supreme Court.

Victor's discussion of *Parker* raises several provocative points. One point is in the spirit of Richard Danzig's book, *The Capability Problem in Contract Law*,<sup>4</sup> for *Parker* is a case study of how appellate decisions ignore and distort the facts of a case. A second point is in the spirit of Stewart Macaulay's casebook, *Contracts: Law in Action*.<sup>5</sup> In *Parker*, the studio acted opportunistically by invoking the duty to mitigate to try to welch on its obligation to pay the minimum guarantee. Studios did this in many instances, losing every time, which says a great deal about the mores of the film industry and the relative power of studios and stars. A third point, also in the spirit of the Macaulay casebook's gritty realism,<sup>6</sup> is that MacLaine's counsel did a poor job by allowing the legal issue to be improperly framed on appeal. The appellate judges appear not to have understood the basis for the trial court's opinion. Such bumbling makes one despair for the system, although in the end every court reached the correct result.

A point Victor makes in the next chapter of the book, which is about *Wasserman's Inc. v. Township of Middletown*,<sup>7</sup> lies in the background of *Parker* once the minimum guarantee is understood as an option payment. Victor makes the comparison between an alternative performance term and a liquidated damage clause. Had the contract in *Parker* required that MacLaine be paid the fee as liquidated damages in the event of breach, then the contract might have been invalidated—assuming she took comparable work in the committed time—because payment of liquidated damages would then

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4. RICHARD DANZIG, *THE CAPABILITY PROBLEM IN CONTRACT LAW* (1978).

5. STEWART MACAULAY, JOHN KIDWELL & WILLIAM WHITFORD, *CONTRACTS: LAW IN ACTION* (2d ed. 2003).

6. I use the Macaulay book because it combines realism with a nuanced understanding of legal doctrine.

7. 645 A.2d 100 (N.J. 1994); GOLDBERG, *supra* note 2, at 313–24.

plainly result in overcompensation.

This legal risk is avoided if the obligation is characterized as an option payment rather than as an obligation to pay liquidated damages. The two are often functional equivalents. Why does the law treat them differently? And why do people use liquidated damage clauses when they could use option payments to achieve the same result without legal risk? Of course, even if people use an option payment, there is a risk that a court will analyze it as a penalty clause. This happened in *Wasserman's*, and Victor argues it was a mistake (the chapter is subtitled "The Penalty Clause that Wasn't"). I gather that Victor has an article in the works on *Lake River Corp. v. Carborundum Co.*<sup>8</sup> making the same point. In that case, Judge Posner invalidated as a penalty clause what appears to be a "take-or-pay" term or a capacity payment.

Set the book aside for a moment. I use *Parker* to make a different point. I take the case on the California Supreme Court's terms and use it to make a simple point about the duty to mitigate. *Parker* is additional evidence, if you need it, that the theory of efficient breach is descriptively inaccurate. The case shows that the interest in vindicating rights and remedial simplicity trump the interest in efficient performance. Had MacLaine taken the offered role in *Big Man, Big Country*, she would have been left with an uncompensated loss, assuming she preferred the role in *Bloomer Girl* for aesthetic or political reasons. The law would not compensate her for that loss because it was too difficult to value. Instead the law allowed MacLaine to reject the role and collect the promised compensation. This gave MacLaine a windfall—pay without work—and created inefficient performance incentives. The law lives with this inefficiency, preferring to vindicate MacLaine's rights in a way that does not require litigation. Indeed, the precise holding of *Parker* is that summary judgment is appropriate even though reasonable people might disagree about the merit and weight of MacLaine's reasons for turning down the substitute role. Again, the law errs on the side of vindicating MacLaine's rights in order to avoid a jury trial. The rule I take from *Parker* is that a party may refuse substitute nonconforming performance to avoid suffering an uncompensated loss, although the refusal inflicts a disproportionate loss on the defaulter.

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8. 769 F.2d 1284 (7th Cir. 1985).

The case of *Bomberger v. McKelvey*<sup>9</sup> better illustrates my point; it is a counterpoint to *Rockingham County v. Luten Bridge Co.*,<sup>10</sup> which is in many casebooks. If you teach the duty to mitigate using *Luten Bridge*, I hope you tell your students the case is unrepresentative. The question was whether a party should halt performance when the other party repudiated and refused to perform. Usually, unlike in *Luten Bridge*, the party is allowed to complete performance and collect the contract price if he has any credible interest in doing so. So it was in *Bomberger*. Bomberger signed a contract with McKelvey to convey a lot after tearing down an existing building. After the contract was made, Bomberger entered into another contract that required he use skylights from the building he was to tear down. McKelvey repudiated before Bomberger tore down the building. Bomberger went ahead and tore down the building and sued for the contract price tendering the vacant lot. He won. The court reasoned that had he not torn down the building, he would have been in breach of the other contract, for it would have taken several months to procure substitute skylights (this was immediately after World War II). There is no suggestion in the opinion of any specific pecuniary loss to Bomberger from a delay on the other contract. The building he tore down was worth \$26,000 and was generating \$300 in monthly rent. This is a wonderful illustration of my point. In American contract law, we will tolerate a great deal of inefficiency to put somebody in the promised position while minimizing administrative costs. Or, as I said, the interest in vindicating rights and remedial simplicity trump the interest in efficient performance.

I do not think Victor would take exception to this point. A general theme of his book is that we would be better off with simple rules that define people's contractual obligations, or the lack thereof, in ways that do not vest courts with adjudicative discretion and so invite litigation. Like many others, Victor has a dim view of litigation and of courts' capacity to improve contracts.

The chapter on *Glanzer v. Shepard*<sup>11</sup> raises a related and fundamental question about the purpose of privity law. This is a famous Cardozo opinion holding a coffee bean weigher liable to a buyer who overpaid for beans as a result of a weighing error. Victor examines surveyor liability more generally. I would have said assayers or assessors—these are intermediaries who determine the value or

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9. 220 P.2d 729 (Cal. 1950).

10. 35 F.2d 301 (4th Cir. 1929).

11. 135 N.E. 275 (N.Y. 1922); GOLDBERG, *supra* note 2, at 245-78.

sufficiency of performance. Some surveyor errors merely result in overpayment or underpayment, as in *Glanzer*; others are more consequential. An example from the chapter is in ship classification societies whose error may lead to loss of life or property.

Victor makes several points in this chapter. One point is that when people bother to resolve the issue of liability for a surveyor's error by contract, they usually opt for rules of no liability. Those rules make the surveyor's decision final and binding as between the parties and exculpate the surveyor from liability to the party harmed by the error. Victor has to dig hard to find this out, for judicial decisions often do not report relevant contract terms. He also finds an interesting pattern in the cases. Courts generally point out that exculpatory terms are invalid but then absolve a surveyor of liability for consequential damages on other grounds, such as the disproportionality of the surveyor's compensation to the liability. Judges appear to want to reserve the power to police exculpatory terms. Victor explains why rules of no liability are optimal. When a bean weigher errs, there is no social loss—an over- or underpayment is merely a shift in wealth. Further, these shifts in wealth tend to be small and to even out over the long term. It is not worth expending resources to avoid such mistakes or to identify them after they occur.

Victor also finds that coffee weighers do not try to resolve their legal liability by contract (with the exception of coffee traded on one exchange). When they do resolve mistakes, often it is without reference to their contract or to the law. In the petroleum industry, surveyors disclaim liability on their price list, while oil traders oppose this limitation in their acknowledgement forms. Victor thinks oil traders would win in the battle of the forms if the issue was ever litigated. My impression is that people are willing to do business with this issue unresolved, even though it invites litigation.

This raises a provocative question. What if the liability rule in *Glanzer* has no material effect on people's primary behavior? It does not seem to affect how they write contracts. Therefore, one suspects it does not affect their performance, for if it did, they would rewrite the contracts to ensure no liability for the reasons Victor gives. I am fairly confident that Victor would say this is an additional reason for a no liability rule. Litigation to resolve liability for an accident is a deadweight loss if the prospect of liability does not reduce the incidence of accidents. I am assuming there is no distributive justification for the liability, such as loss-spreading. This conclusion implicitly denies any value to doing what seems fair. While this may be right as a matter of policy, it is deeply unrealistic. It is difficult for

judges, in particular trial judges who deal directly with the parties, to suppress the instinct to do what seems fair as between the parties in a particular case. Much of contract law consists of judges saving people from drafting mistakes, particularly when enforcing a contract as written would give one party a windfall at the other's expense. The law on penalty clauses illustrates this fact. After reviewing a decade of cases, I found that in the majority of cases that invalidated a liquidated damage clause, the courts saved the parties from the effect of a poorly drafted clause that, if enforced, would give a windfall to one party at the other's expense.<sup>12</sup> This same scenario comes into play across much of the Dawson, Harvey, and Henderson casebook.<sup>13</sup> Jack Dawson understood as well as anyone in the twentieth century that much of contract law (and, of course, restitution law) is explained by this instinct to fairness.

Victor urges judges to resist the instinct to fairness. Victor's view is that if adults want to make mistakes, they should be allowed. The deadweight loss of litigation is not worth cleaning up afterwards. When I was younger, I wrote an article arguing that some interventions may be efficient because the prospect of intervention reduces the cost of contracting and sometimes eliminates an incentive for inefficient behavior in contract performance.<sup>14</sup> I conceded that the argument was not very compelling. Whether intervention is efficient depends on courts' capacity to identify mistakes, the likelihood that people make errors in drafting contracts, and the sensitivity to the law while drafting and executing contracts. At best, the efficiency argument is a wash. If, like Victor, you think of drafting contracts as "transaction cost engineering," and you have a low opinion of the litigation system, then the efficiency argument is a non-starter.

Victor joins Bob Scott in advocating a radical simplification of contract law. I expect Victor would restore something like the "plain meaning" and "four corners" rules in contract interpretation. He would rip out much of the law of waiver and estoppel, vitiate the duties of good faith and best efforts, and enforce liquidated damage clauses as written. I expect he would eliminate many of the doctrines invoked to avoid forfeiture.<sup>15</sup> These changes may seem right if we

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12. See Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 *IND. L.J.* 45, 55 (1995).

13. JOHN P. DAWSON, WILLIAM BURNETT HARVEY & STANLEY D. HENDERSON, *CASES AND COMMENT ON CONTRACTS* (4th ed. 1982).

14. Gergen, *supra* note 12, at 45-46.

15. The battle of the forms is one exception. In Chapter 8, Victor recommends that judges opt for the least obnoxious term. GOLDBERG, *supra* note 2, at 196.

accept Victor's normative and factual premises. Even accepting these premises, these changes are right only if we can count on judges and juries to stay with the program and suppress this instinct to fairness. If we make these changes and judges and juries continue to do what they have always done, then we will return to something similar to contract law when the realists found it. A body of law would exist consisting of rules that appear to constrain judges and juries and occasional outcomes that bend the rules to do what is fair. Perhaps this would be an improvement over a body of law that openly vests judges with discretion. But I have not seen anyone make this case.

Again, *Framing Contract Law* is an important and interesting book. You will learn much from reading it. I turn the proceedings over to Stewart Macaulay.

***Professor Stewart Macaulay:***<sup>16</sup>

I am pleased to be here. I see a lot of old friends. My role as discussant means that I will really pay attention to this important book. You will notice that I have put a number of text flags to mark passages, and I have underlined many things in my copy. I think that Victor's book should be read, and Contracts teachers must confront its arguments. We have to look at it, and we are sure to learn a lot.

I may come advertised as a person whose work is opposed to Victor's positions. I have a reprint of one of my articles from January of 2003, and it bears the title *The Real and the Paper Deal*.<sup>17</sup> My subtitle says that I see that empirical pictures of relationships work against the urge to fashion transparent simple rules. I often find myself defending Article 2 of the Uniform Commercial Code (UCC) while recognizing many of its problems. However, despite my reputation, I like Victor's book. We may come to different conclusions here or there, but I think that Victor and I are arguing about the right things. We agree that the more we know about a transaction, the better we can fashion a solution to its problems. An empirical approach does not guarantee agreement, but it usually means that we will be debating what matters. And I should emphasize that I totally agree with much, if not most, of what Victor says.

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16. Professor Stewart Macaulay is the Malcolm Pitman Sharp Hilldale Professor and Theodore W. Brazeau Professor of Law at the University of Wisconsin.

17. Stewart Macaulay, *The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules*, 66 MOD. L. REV. 44 (2003).



I fell down the rabbit hole to the land of empiricism because I talked to my father-in-law, Jack Ramsey. He was the retired CEO of S.C. Johnson & Sons in Racine, Wisconsin. I was a 27-year-old beginning Contracts teacher, and Jack asked me about my Contracts course. I was teaching out of *Fuller on Contracts*.<sup>18</sup> This seemed a safe move because so many other Contracts teachers were using it, and it had the reputation of being a serious book by a famous scholar. When I described my course, Jack laughed. That was not the reaction that a 27-year-old beginner wanted from a man with so much experience in national and international business. He described a business world where long-term continuing relationships provided their own norms and sanctions. Contract law was either unnecessary or something far at the margins of the way things worked. He pushed me to talk to others, and they confirmed his view that contract law applied to but a limited subset of situations.

At a panel on Contracts at the Association of American Law Schools meeting in 2005, I used an analogy to the story of the U.S.S. San Francisco.<sup>19</sup> This nuclear submarine was cruising at about 500 feet below the surface near Guam. It was running at top speed and ran into an underwater mountain that was not shown on its navigational charts. I fear that too much contracts scholarship is like cruising without an accurate chart. We are told that a certain rule or approach will lead to efficiency. Too often, however, the analysis fails to take into account the way contract law is delivered. It is easy to talk about efficiency, but it is hard to know whether any particular rule or approach will produce an efficient result in the real world.

I really like Victor's work, although I do not always come out at the same place. Essentially, Victor comes out of transaction planning, and he wants courts to pay close attention to formal contract documents fashioned by those planning a deal. I think he wants the lawyers' and economists' work to control the sales people, and he wants the engineers to try to perform the contract. There are some places where I would at least suggest qualifications. The qualifications may not be fair because I will pick up some marginal ones from Victor's text; however, they are the ones I know. Victor talks about the firm offer and looks at the opposite approaches of Learned Hand and Roger Traynor.<sup>20</sup> Hand was the great formalist commercial lawyer

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18. LON L. FULLER, *BASIC CONTRACT LAW* (1947).

19. See Stewart Macaulay, *Contracts, New Legal Realism, and Improving the Navigation of The Yellow Submarine*, 80 TUL. L. REV. 1161 (2006).

20. GOLDBERG, *supra* note 2, at 377.

who would not let reliance on an offer alone serve to make it enforceable.<sup>21</sup> Traynor was the legal realist who loved to fashion new legal rules. Traynor would protect a general contractor or an owner who relied on a bid.<sup>22</sup>

Fred Konefsky dug into the background of the two famous opinions, *James Baird Co. v. Gimbel Bros., Inc.* and *Drennan v. Star Paving Co.* Konefsky tells us that it is crystal clear that Traynor set out to write an opinion rejecting Hand's approach.<sup>23</sup> Traynor found a case he could use as a vehicle and twisted the facts—at least a little—to fashion a new rule protecting reliance on bids. According to Victor, it does not make much difference whether you go with Hand or Traynor. If a bidder does not stand behind his mistaken bid and absorb the loss, he will be in great trouble in future transactions. Most of the time this is true, but occasionally it is not. In our casebook, we use a federal decision that raises the problem, *Janke Construction Co. v. Vulcan Materials Co.*<sup>24</sup>

The University of Wisconsin at Milwaukee wanted to install an air conditioning system. As part of the job, bidders had to pipe the waste water some distance out into Lake Michigan. The state engineers required that a certain kind of pipe be used to withstand the water pressure of the lake. The request for bids stated that this particular pipe must be used, but the bid added the phrase “or equal.” A general contractor talked with a pipe supplier seeking a price for what the university job required. The supplier quoted a price but failed to inform the general contractor that he planned to supply pipe that fell within the “or equal” clause. This price was significantly lower than the price most suppliers had quoted for the state-specified pipe. The general contractor put in a bid based on the supplier's price and won the award. However, the state engineers would not accept the supplier's pipe as “equal” to the specified pipe. The court followed the Traynor rule and found that the general contractor's reliance was reasonable. The supplier was liable for the increased cost of getting pipe that complied with the state's demands. This general contractor was a smaller firm that did not buy much from the pipe supplier.

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21. See generally *James Baird Co. v. Gimbel Bros., Inc.*, 64 F.2d 344 (2d Cir. 1933) (holding that offer was withdrawn before it was accepted, therefore the contract was not enforceable).

22. See generally *Drennan v. Star Paving Co.*, 333 P.2d 757 (Cal. 1958) (affirming judgment for Plaintiff when Plaintiff relied on a subcontractor's mistaken bid).

23. Alfred S. Konefsky, *Freedom and Interdependence in Twentieth-Century Contract Law: Traynor and Hand and Promissory Estoppel*, 65 U. CIN. L. REV. 1169, 1169 (1997).

24. 386 F. Supp. 687 (W.D. Wis. 1974), *aff'd*, 527 F.2d 772 (7th Cir. 1976).

Relational norms and sanctions were not enough to get the supplier to stand behind its mistaken bid.

I like this result. Of course, the court did not need to adopt the Traynor view of Restatement section 90. The court could have worked with ideas such as negligent misrepresentation or a duty to disclose that would show that the bid was based on an interpretation of the “or equal” clause in the state’s request for bids. A number of tools were available to get the result I want.

Victor shows us how parties could structure their transactions to avoid these problems. Of course, he is right—they could do this. However, construction people are rather casual about writing detailed contracts and holding to them. Some wonderful Dilbert cartoons reflect engineers’ views of lawyers planning transactions, mocking the lawyers’ tendency to plan for improbable events. I think the chance that courts might find liability puts just a little more pressure on the parties to work out a settlement. In the *Janke* case, the pipe supplier was held liable. In the future, other suppliers in this position will have an incentive to stand behind their mistake or find a way to settle.

Victor also talks about one of my favorite cases, *Nanakuli Paving & Rock Co. v. Shell Oil Co., Inc.*<sup>25</sup> Victor calls the case one of the “Terrible Twosome.” He mentions the case in a chapter called, “Do as They Say, Not as They Do.”<sup>26</sup> Here Victor and I disagree. *Nanakuli* involved a long-term requirements contract between Shell and its Hawaii distributor. Shell’s Hawaii representative worked closely with the distributor and knew about paving industry practices. Nanakuli’s officials acted, in many ways, as if their firm was part of Shell Oil. Legally they were separate entities, but practically, they were one operation. The language of the written requirements contract stated that the price would be Shell’s posted price at the time of delivery. However, the distributor had to bid on state highway paving contracts and use Shell’s price at the time it made the bid. The distributor could be bound to a losing contract if Shell raised the price significantly between the time the distributor submitted the bid and the time the state awarded the contract. Clearly, Shell Oil wanted its distributor to bid on highway paving contracts. This was Shell’s primary way of selling asphalt.

An industry practice called “price protection” allowed the asphalt supplier to give its distributor the price at the time it made its bid, despite the literal term of their contract. Sand and gravel suppliers

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25. 664 F.2d 772 (9th Cir. 1981); GOLDBERG, *supra* note 2, at 162–88.

26. GOLDBERG, *supra* note 2, at 162–88.

also followed this practice in highway construction. Shell price protected Nanakuli on the only two occasions when it had raised prices during the time that Nanakuli was awaiting the results of a bid to the state. However, asphalt sales were moved from one division within Shell to another, and new executives took over. They decided the practice of price protection would no longer be followed. Their decision reflected the impact of the increases in the prices of petroleum products and the reaction of the United States government, which imposed price controls on most petroleum products but not on asphalt. As a result, the posted price increase was much greater than it had been in the past when Shell price protected. However, Shell's notice to their distributors was not clear. Shell did not say it would no longer offer price protection. Nanakuli entered a bid for a state paving job based on Shell's price when the bid was calculated. Shell raised the price of asphalt drastically after the bid was submitted but before it was accepted by the state. The state then accepted Nanakuli's bid, binding it to a highly disadvantageous contract, which was a factor in Nanakuli's later bankruptcy.

The Ninth Circuit found that Shell's failure to price protect Nanakuli constituted a breach of contract. First, the court relied on usage of trade. Under the UCC, this is "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question."<sup>27</sup> The court found that Shell was bound by the practices of Chevron, the other supplier of asphalt in the Hawaiian Islands, and by the practices of sand and gravel companies. Second, the court found that there was a course of dealing between the parties. This is "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct."<sup>28</sup> Although Shell had price protected Nanakuli on only two prior occasions, these were the only two times when the problem arose. A course of dealing and any usage of trade "supplement or qualify terms of an agreement."<sup>29</sup>

As I understand Victor's objection to the court's opinion, he thinks that the document that allowed Shell to increase its posted prices should control. If it did, then those running Shell could read the contract and know what they could and could not do. If trade usage

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27. U.C.C. § 1-205(2) (2004).

28. *Id.* § 1-205(1).

29. *Id.* § 1-205(3).

and course of dealing “supplement or qualify terms,” then those who run large business bureaucracies cannot be sure of their rights and duties. Those at the home office in San Francisco cannot be sure just what had been going on in the field. Often, of course, the problem turns into one of authority under agency law. We have to ask whether firms in Nanakuli’s place should rely on anything but the literal text of a contract regardless of what other firms in Shell’s place or other firms in the industry say or do. The problem is a common one. I call it the conflict between the paper deal and the real deal. Or we can view it as the conflict between the lawyers and other transaction planners and the people in the field who perform the contract. Mix agency law with the parol evidence rule and waiver and you have a fine mess.

I am less sympathetic to the home office in the *Nanakuli* case because Shell’s new executives knew about price protection and wanted to reject the practice. Victor might say that the amount of the price increase was so much greater than ever before that earlier practices should not establish that Shell would go this far in maintaining its old price. He could object to the court’s consideration of practices in the rock and gravel industries along with the asphalt industry. Yet why would Nanakuli take the risk of bidding on state paving contracts if Shell would not price protect? Remember, Shell wanted Nanakuli to bid on these contracts. Nanakuli had to be the low bidder fairly often, otherwise Shell would only sell trivial quantities of asphalt in Hawaii.

Indeed, the Shell executives’ position does not seem to be in Shell’s own long-run interest. I have speculated that these executives wanted to post highly favorable numbers, get promoted, and leave the consequences to the executives who followed them. If Shell were to continue to do asphalt business in Hawaii, it would have to find a replacement for Nanakuli because the executives’ actions destroyed Nanakuli by pushing it into bankruptcy. You might see the case as one where Shell waived its written contract provision and then tried to withdraw its waiver. However, the court found that Shell’s attempt to do away with price protection was ambiguous and perhaps even designed to not be read or understood. I confess that I have some sympathy for reasonable reliance on practices by the people in the field. And I must confess that I have never been a transaction planner trying to get personnel to go by the book.

We can now turn to Victor’s analysis of *Aluminum Co. of America v. Essex Group, Inc.*<sup>30</sup> I find his analysis totally convincing.

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30. 499 F. Supp. 53 (W.D. Pa. 1980); GOLDBERG, *supra* note 2, at 348–69.

The court gets the math wrong and rewrites a contract based on faulty assumptions. Moreover, this involves protecting a highly skilled and well-represented major corporation against the mistakes of its transaction planners—an odd expression of paternalism. Nonetheless, I see the case as reflecting the old saying, “All’s well that ends well.”

As I read the facts, the parties wanted a requirements contract. ALCOA was to supply the aluminum that Essex needed to make aluminum wire products. Moreover, the plants were close enough to each other so that ALCOA could deliver aluminum in liquid form and cut a step out of the manufacturing process. However, Essex wanted a price much lower than the price others had to pay for this aluminum. This took place in the 1960s when transaction planners worried about price discrimination under the Robinson-Patman Act.<sup>31</sup> Perhaps a lower price to Essex could have been cost justified, but the transaction planners decided to sidestep the problem by manipulating the form of the transaction. The parties created a “toll conversion” contract. ALCOA was not selling aluminum to Essex. It was only selling the service of converting Essex’s bauxite into aluminum. Thus, one could not compare the price that Essex paid with the price paid by other customers that bought aluminum from ALCOA. Of course, this was a triumph of form over substance. Where did Essex get its bauxite? It bought it from one of ALCOA’s subsidiaries and transported it on ALCOA’s ships.

Then the world changed. The Organization of the Petroleum Exporting Countries (OPEC) raised energy prices greatly, and the production of aluminum (or the converting of bauxite into aluminum) required large amounts of electrical energy. The demand for aluminum increased greatly and prices went up. Essex found that it had a very good deal. Instead of using the product, Essex paid \$0.36 a pound and resold it at \$0.73, in other words, at a \$0.37 per pound profit. Had this been written as a requirements contract, Essex could not have done this. Under section 2-306(1) of the UCC, a buyer may demand only the “actual . . . requirements as may occur in good faith.”<sup>32</sup> Essex was not buying its requirements for making things from aluminum wire. Essex had gone into the metal business. I do not think that ALCOA had considered this risk.

Judge Teitelbaum used an expansive view of mistake, impossibility, and frustration to excuse ALCOA from performing the contract as written. Teitelbaum thought that a complete excuse would

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31. Robinson-Patman Antidiscrimination Act, 15 U.S.C. § 13 (2000).

32. U.C.C. § 2-306(1) (2004).

be unfair. As a result, he rewrote the escalator clause in the contract. Victor raises major questions about the judge's assumptions and conclusions. Other writers on Contracts have debated this case almost endlessly. In our casebook, we sample much of this debate about rewriting contracts so that the written deal reflects what a judge sees as the real deal.<sup>33</sup> Then we ask, what happened next? Judge Teitelbaum's revised escalator clause never went into effect. Essex appealed the case to the Third Circuit, and that court unsuccessfully tried to push the parties to settle before oral arguments. After oral arguments, we report: "ALCOA indicated an interest in settling the case. The parties conferred at length, with ALCOA giving ground in its demands. It appears that the case was settled on the basis that the original contract would continue in effect until December 31, 1981; that during the balance of the original time of the contract, ALCOA would sell at a more favorable price; and that ALCOA would extend the time of the contract for a period of five years on a favorable price basis, albeit not as favorable as during the contract period." In essence, they enlarged the pie and cut it a little differently. Essex got a good price, but not the "you-can't-believe-it good price" it had under a literal reading of the original escalator clause.

A cynic or a realist might argue that Judge Teitelbaum's rewriting of the contract was the best of all possible solutions. He produced a result that ALCOA liked, but ALCOA did not feel confident that it had defended successfully on appeal. Essex was moved away from its unreasonably favorable reading of the deal. As a result, the world changed so that the parties had a reason to work out a settlement that continued their relationship on a basis that each could see as better for it. Samuel Gross and Kent Syverud argue that the function of trials in the American legal system is not dispute resolution; rather, trials serve to deter other trials, and they carry out this function most successfully.<sup>34</sup> Trials, or the threat of them, provoke settlement in many cases.

Perhaps all is well because it ended well in the ALCOA case. But there was no necessary reason that the judge's reworking of the express term of the contract would produce a good settlement. Settlements can be good, bad, or indifferent. The court could have just taken a hard line approach. ALCOA was a major corporation that could afford the best transaction planners. They wrote a contract price

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33. MACAULAY, KIDWELL & WHITFORD, *supra* note 5, at 695-701.

34. Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 63 (1996).

for an unlimited quantity that proved to be very unfavorable and that may not have reflected the parties' actual assumptions of risks. If the court had refused to rework the contract, ALCOA and all other transactors would have a powerful incentive to plan better in the future.

We might prefer a variation on this approach. In the *Westinghouse Electric Corp. Uranium Contracts Litigation*,<sup>35</sup> Judge Merhige read the contract very literally so that Westinghouse could not escape liability for its promise to remove spent uranium rods from a nuclear power plant. However, he then attempted to coerce the parties into a settlement. As part of the process, he required the parties to appoint a panel of nuclear engineers to assist in finding a resolution. This panel found a technical solution. The cooling ponds could be reworked so that all of the rods produced during the life of the plant could be stored there while awaiting a governmental solution to the problem of nuclear waste. Merhige was famous, or infamous, as a judge who settled big cases rather than tries them.<sup>36</sup> It was said that he gathered the CEO's of utilities and Westinghouse on his sun porch and fed them mint juleps. He forced executives to confer without their lawyers and appointed the dean of a law school to act as a mediator so that executives of one utility could be sure that they were not settling for less than what another utility gained.

Do we want hard, cold, and pure rules so that contract litigation becomes as predictable as possible? It is far easier to propose that we have such rules than to draft them. Do we want a measure of uncertainty so that parties will have incentives to avoid the risks of judges rewriting their deals or twisting their arms to do what they could have done before litigation? These questions face those of us worried about contract law. Victor's work moves us toward thinking about the law in action rather than systems that please scholars. His book is a must for everyone in this field.

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35. *Florida Power & Light Co. v. Westinghouse Elec. Corp.*, 517 F. Supp. 440 (E.D. Va. 1981), *rev'd in part*, 826 F.2d 239 (4th Cir. 1987).

36. Ronald J. Bacigal, *An Empirical Case Study of Informal Alternative Dispute Resolution*, 4 OHIO ST. J. ON DISP. RESOL. 1, 2-3 (1988).



**Professor Keith Rowley:**<sup>37</sup>

Good morning. I am delighted to be here and pleased to be on my second panel with Stewart Macaulay. Stewart moderated a panel I was on at the Law and Society Association in Las Vegas last year. As for Mark Gergen, many of you have heard me say that I teach Contracts in spite of my Contracts professor, not because of him. Let me reiterate that Mark was *not* my Contracts professor. I took Tax from Mark, not Contracts. I wanted to go last both out of deference to two people who I felt had much more depth of experience and insight to bring to bear and because it let me cherry pick what I wanted to say.

I want to address three chapters from Victor's book. First, I want to talk about the opening chapter, which deals with something that Victor refers to as the "net profits puzzle."<sup>38</sup> He laid this trap for me by making the whole chapter about the movie industry, and I love the movie industry. Then I want to talk about the second chapter, which deals with *Wood v. Lucy, Lady Duff-Gordon*.<sup>39</sup> And then I would like to address Chapter Six, which deals with *Bloor v. Falstaff Brewing Corp.*<sup>40</sup> So I am just taking the two "best effort" cases that Victor addresses at some length and will have some questions and general comments. Let me make a few general comments first.

One of the things about this book that makes it highly accessible to any reader is that, while it is based on an economic framework, it is not heavy on economics. There are not a lot of quadrilateral equations, charts, or results for regression analyses running through this. What Victor really seems to be talking about, certainly in these chapters and in others as well, is understanding the little economics; the economics of everyday life. Then you have a context in which these cases arise. It really is, more than anything else, an exercise in economic anthropology. He really digs into cases and chooses to illustrate some of his broader points by focused discussion of cases—oftentimes calling on factual material that apparently was either overlooked or unavailable to the judges who decided the case. I think that is fascinating. It is an interesting way of getting into various contract stories. There are plenty of other interesting cases out there

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38. GOLDBERG, *supra* note 2, at 13–41.

39. 118 N.E. 214 (N.Y. 1917); GOLDBERG, *supra* note 2, at 43–73.

40. 601 F.2d 609 (2d Cir. 1979); GOLDBERG, *supra* note 2, at 142–61.

that have not been written about but are ripe for the same kind of analysis.

A second general comment is with respect to economics. I feel somewhat comfortable talking about this because I was an Economics professor before I went to law school. Victor didn't drink the Kool-Aid; nor have I. We see economics as a very useful tool in understanding, explaining, or at least rationalizing a lot of things. In fact, there is a wonderful little quote in the introduction where Victor says, "[A] little economics can go a long way in helping to decide contract disputes."<sup>41</sup> To Victor's quote I would add, "to understand each side of a contract dispute and, perhaps, to criticize the parties and the resolution of their dispute." This is not "Chicago School" economics; this is not any particular brand of economics. Rather, it is just the small "e" economic analysis of the law, which is something that I enjoy doing and teaching.

Mark and Stewart alluded to context. Context is certainly the motive force behind much of Victor's discussion of the cases. As any good, latter-day legal realist would agree, you have to understand the context in which the parties entered into the contract in order to understand the contract, and in order to adjudicate, arbitrate, or mediate any dispute that might arise between or among them. And yet, there may be tension between, on the one hand, paying attention to subjective context—including things like trade usage, course of dealing, and course of performance—and, on the other hand, focusing on what a reasonable person in the position of the buyer or seller would have understood when they were entering into this contract.

In his chapters on *Wood v. Lucy* and *Bloor v. Falstaff*, Victor argues that we should look at the language of the contract and what these parties agreed to. If it is clear by reading the contract what the parties agreed to, we should ignore the context. (As an aside, terminology Victor deploys in these discussions is probably as "economic" as anything in the book, writing about asymmetric information, transaction costs, and timing issues.) So, look at what the parties wrote and enforce what they wrote unless what they wrote is not really clear. In that case put it in context. But, how do we tell whether it is clear? The UCC and the Second Restatement take the position that you judge clarity by looking at the context.<sup>42</sup> Victor seems to suggest judging clarity without looking at the context and

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41. GOLDBERG, *supra* note 2, at 6.

42. See U.C.C. §§ 1-303, 2-202 (2004); RESTATEMENT (SECOND) OF CONTRACTS § 202 (1979).

only going to the context afterwards.

This really is a nice book, and it is an excellent read. The book raises a lot of questions that it does not answer, not intentionally. And in many of the questions that it does answer, the answers are not given as if edicts from on high. The chapters are a thought exercise.

With that lengthy introduction out of the way, the first thing I want to scrutinize more closely is a chapter that, in some respects, is very different from the others. It is certainly different from the other two that I will address. It is the very first chapter in the book, where Victor discusses the “net profits problem” in the context of motion picture contracts, and the idea that there are multiple types of compensation.<sup>43</sup> There are development fees, which are paid whether the project gets made or not. And there are fixed fees, which are paid only if the project actually gets made. So they are really not fixed; they are contingent on the movie going forward.

The chapter discusses the value of the net profit participation when the vast majority of films never show any profit because of the peculiar ways that Hollywood does accounting. It seems only fitting to illustrate this discussion with a film clip. But rather than use a more “contemporary” example, such as Robert Altman’s studio backlot drama *The Player*,<sup>44</sup> I want to transport you back about 400 years or so to a memorable scene from *Shakespeare in Love*:<sup>45</sup>

Fennyman: Henslowe, do you know what happens to a man who doesn't pay his debts? His boots catch fire!

*Cut to playhouse interior where the proprietor, Henslowe, is trussed up with his boots being held to a burning brazier by Lambert, one of Fennyman's associates. Fennyman, to whom Henslowe is indebted, interrogates Henslowe and instructs Lambert while Fennyman's clerk, Frees, watches. Henslowe moans in agony.*

Fennyman: Why do you howl when it is I who am bitten? What am I, Mr. Lambert?

Lambert: Bitten, Mr. Fennyman.

Fennyman: How badly bitten, Mr. Frees?

Frees: Twelve pounds, one shilling, and four pence, Mr. Fennyman, including interest.

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43. GOLDBERG, *supra* note 2, at 13–36.

44. THE PLAYER (Fine Line Features 1992).

45. SHAKESPEARE IN LOVE (Miramax Films 1998).

Henslowe: (moan) I can pay you.

Fennyman: When?

Henslowe: (moan) Two weeks. Three weeks at the most. Oh, for pity's sake.

Fennyman (to Lambert): Take them out.

*Lambert pulls a rope lifting Henslowe's boots away from the brazier. Henslowe sighs with relief.*

Fennyman (to Henslowe): Where will you find . . .

Frees: . . . Sixteen pounds, five shillings, and nine pence . . .

Fennyman: . . . including interest, in three weeks?

Henslowe: I have a wonderful new play.

Fennyman (to Lambert): Put them back in.

*Lambert looses the rope, moving Henslowe's boots back toward the fire.*

Henslowe: (moan) It's a comedy.

Fennyman: Cut off his nose . . .

*Lambert brandishes a knife and holds it under Henslowe's nose.*

Henslowe: It's a new comedy by William Shakespeare . . .

Fennyman: . . . and his ears.

*Lambert retrains the knife to the base of Henslowe's right ear.*

Henslowe: . . . and a share. We will be partners, Mr. Fennyman.

Fennyman: Partners?

*Fennyman motions for Lambert to desist. Lambert does so grudgingly, then pulls the rope again to lift Henslowe's boots from the fire.*

Henslowe: It's a crowd-tickler: mistaken identities, shipwreck, Pirate King, a bit with a dog, and love triumphant.

Lambert: I think I've seen it. I didn't like it.

Henslowe: But this time it is by Shakespeare.

Fennyman: What's it called?

Henslowe: *Romeo and Ethel, the Pirate's Daughter.*

Fennyman: Good title.

*Fennyman motions for Lambert to untie Henslowe.*

Fennyman: A play takes time. Find the actors. Rehearsals. Let's say we open in two weeks.

*Fennyman throws open the stage curtain and walks toward where the audience would stand and sit.*

Fennyman: That's what, 500 groundlings at two pence a head; in addition, 400 backsides at three pence – a penny extra for cushions. Call it 200 hundred cushions. Say, two performances for safety. How much is that, Mr. Frees?

Frees: Twenty pounds to the penny, Mr. Fennyman.

Fennyman: Correct.

Henslowe: But I have to pay the actors and the author.

Fennyman: Share of the profits.

Henslowe: There's never any . . .

Fennyman: Of course not.

Henslowe: Oh, Mr. Fennyman. I think you might have hit upon something.

Fennyman: Sign there.

*Fennyman gestures to a piece of parchment that Frees has prepared. Henslowe, his hands still bound, does his best to make his mark while Frees tries to assist by moving the parchment around the stationary quill.*

Fennyman: So, *Romeo and Ethel, the Pirate's Daughter*. Almost finished?

Henslowe: Oh, without doubt he's completing it at this very moment.

That part of this chapter is fun to read. In some ways, it sets the table for the whole book; in other ways, it is a bit of a teaser because it does not follow quite the same path as most of the book: it does not focus on a landmark case as the launching off point. But, it is probably the chapter in which Victor does the most economic heavy lifting, realizing that the heavy lifting here is nothing like the heavy lifting that he would do in an economics journal article. The idea is that you have superstars, whether they are actors, directors, producers, or other forms of talent. Then you have the other people that get involved in taking an idea and ultimately making it into a movie. And, of course, you have the studio, in most cases, that wants to dip its beak into the money trough as well.

Interestingly, because of the way net profits work, the medium-talent people, besides getting a salary or fixed payment, get a share of net profits. But the net profits are calculated after the Tom Cruises, John Travoltas, Nicole Kidmans, and Halle Berrys of the world take

their share of the gross profits. The net profits quite often end up being negative. Fortunately, none of the net profit participants have to pay back the studio. Victor makes a convincing case for why talent in Hollywood—talent that is not at the level where it can command gross profit participation—is willing to take a net profit deal. When someone talks about hitting different points on a movie, they are talking about gross profits. Two different stories are there, not at all in conflict with one another. One story deals with relational contracting. If I want to work with this studio or with these actors again, or if I want them to make my next movie, I will agree to take net profits. Even though I may not actually see any direct financial compensation in the form of a net profits payment for this film, if we do a good job on this film, they will want to make another film with me. If that one is successful as well, I will become someone who commands gross profits rather than net profits.

The other interesting point concerning the so-called “fixed payment” that most talent receives is that the payment is not really fixed at all. It is paid when the movie is actually made. You get a development fee if you are a producer, a writer, or perhaps a director who comes in early on, but that fee is very small. Then there is some fixed compensation, which is certainly nontrivial to a room full of law professors. After that, there is profit participation, which is good if it is gross and not so good if it is net. Victor makes the argument that net profit participants are willing to cede their right to receive net profits to allow gross profit participants to come into the movie later in the process. The gross profit participants essentially squeeze out the net profit participants because those gross profit participants make it more likely that the movie will actually be made. Therefore, the net profit participants will get their fixed fee. So, I get \$2,500 for an option to make a movie out of my script. I get another \$250,000 if they actually make a movie out of my script. I get ten percent of all net profits if the movie goes to distribution. If the movie is not made, I do not get my \$250,000, much less my net profit. If giving up my net profits means bringing John Travolta, Charlize Theron, Martin Lawrence, or whoever will make this movie go, I have an incentive to do that; that incentive probably only makes sense when considered in economic terms.

Let me shift to *Wood v. Lucy*,<sup>46</sup> a case with which I am going to assume a high degree of familiarity. If you read the book though, you will find that your high degree of familiarity is wrong, or not nearly as

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46. 118 N.E. 214 (N.Y. 1917).

complete as you thought. Do not feel too badly, because Cardozo did not really know what he was talking about either—or at least, that is what Victor would have us believe. Lucile, Lady Duff-Gordon entered into a contract to allow Otis Wood to be her exclusive agent. Wood was to place endorsements for her and arrange other contracts for her. In return, Wood promised to pay Lucy fifty percent of the revenues from whatever he arranged for her.

After a year or so, Lucy went behind Wood's back and made a deal directly with Sears Roebuck and with an automobile company. Wood argued that Lucy could not do that because she made him her exclusive agent; therefore, Lucy would have to pay him the money that would be due to him had she let him make those arrangements for her. Wood had to show that he gave valuable consideration to Lucy in exchange for her promise to let him keep fifty percent of the revenues. The problem is that, looking at the express terms of the contract, nothing in the contract required Wood to do anything. Was there an obligation to go forth on a weekly or monthly basis, make a certain number of phone calls, or pursue so many leads? Wood was not, by the terms of the contact, obligated to do anything other than pay Lucy fifty percent of whatever revenues he attracted from using Lucy's name. To make this contract enforceable, Judge Cardozo implied a duty of reasonable efforts.

This reminds me of a discussion I was having the other day in class about *Alaska Packers' Ass'n v. Domenico*,<sup>47</sup> where the court basically decides that a company that is sending people to Alaska to fish for, catch, and process salmon would not put defective fishing nets on the ship. Therefore, the court rejects the sailors' argument that the nets on the ship were defective. Apparently, the court made that decision without ever actually doing any discovery to see whether there was proof that the nets were defective.

In *Lucy*, Wood surely would not have promised to pay Lucy fifty percent of any revenues he generated by using her name if he had not implicitly promised to actually use her name. Cardozo implied an obligation on Wood to make this a bilateral contract, where one party promises to seek ways to market the other's name, and the other party promises to let the first party keep fifty percent of whatever he earns off of the other's name. Cardozo went a step further and imposed this implied duty of reasonable efforts because of the exclusivity of the arrangement. Accordingly, Wood had to use reasonable efforts to try and place Lucy's name on things in order to generate income for him

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47. 117 F. 99 (9th Cir. 1902).

and for her.

This exercise in economic and legal anthropology unveils for us another case involving Wood, only this time with Rosie O'Neill, the creator of the Kewpie doll.<sup>48</sup> The case arose in close proximity to *Wood v. Lucy*. The contract between O'Neill and Wood, unlike the contract between Lucy and Wood, had an express "best efforts" clause in it and had language discussing what the exclusivity meant. As Victor explains it, the contract basically provided that O'Neill would not use any other agent to represent her, but reserved the right to make deals on her own. However, if she did, she had to share the revenues from those deals with Wood. These cases were both filed in the same court. But the files on both cases are what Victor calls "slim records."<sup>49</sup> Victor also says that Cardozo clearly did not have access to the contract between O'Neill and Wood when he was deciding Lucy. Why not? The files were in the courthouse. All Cardozo had to do was send the clerk to get it.

Victor discusses another "best efforts" case, *Bloor v. Falstaff*, in Chapter Six.<sup>50</sup> In *Bloor*, IFC, the company that bought Ballantine when Ballantine was in financial distress, sold the Ballantine brewing business, distribution network, trademarks, and other intellectual property to Falstaff. The contract contained seven or eight "best efforts" clauses. Some of you are probably old enough to remember Falstaff beer. I do not know whether it is still out there or not, but I remember the ads when I was young.

The court looked at one of many express "best efforts" clauses to make sure that Falstaff still marketed Ballantine beer, which interestingly, according to Victor and the court, was precisely the same beer that was in the Falstaff can. But Ballantine was a budget beer and Falstaff a premium beer. So Falstaff sold for more than Ballantine even though it was the same product. I have heard that after the second can, all beers are the same. That argument apparently was not played up enough in the court to make it into the court's decision.

Another general point I want to make, and one that Stewart and Mark both alluded to in one way or another, is that there seems to be a strong sentiment in this book in favor of express terms. That is consistent with what I tell my students in Contracts every year. The

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48. *Wood v. Wilson*, 151 N.Y.S. 853 (App. Div. 1915); GOLDBERG, *supra* note 2, at 43–73.

49. GOLDBERG, *supra* note 2, at 50.

50. 601 F.2d 609 (2d Cir. 1979); GOLDBERG, *supra* note 2, at 142–61.



offeror is the master of the offer. You can put whatever you want in that contract. If the other party decides they do not want to sign it, that is fine. But if you had the opportunity to put something in the contract but did not, and the other party signed it and you signed it, sometimes that will work against you. Then the court will say, “It is not really clear exactly what best efforts means, but you could have spelled it out better and you did not. Therefore, if you were the drafter of the contract, we are going to essentially *contra proferentem* you<sup>51</sup>—we are going to decide that you left it out and that it is not part of the deal as a result.”

Victor’s take on *Bloor* is that there were so many “best efforts” provisions in the contract that it is not entirely clear what the buyer undertook, and the court never really seemed to care what the nature of the transaction was. This was not Wood agreeing to market Lucy’s ongoing apparel lines and continue getting her endorsements. This was not a coal plant buying its requirement of coal from a coal producer. This was Ballantine getting out of the beer business completely and selling its intellectual property and distribution network to Falstaff. The delayed compensation part of the deal that had the “best efforts” clause attached to it was not so Ballantine could make a lot more money and continue to be a prosperous brand. It was merely a way of financing Falstaff’s purchase of Ballantine, rather than paying cash. It was also a way of indicating to the buyer that the seller thought it was selling something useful and valuable. Ballantine agreed to take deferred compensation because it thought the deal would make plenty of money; therefore, Ballantine was happy to take a percent per barrel.

Another case near and dear to my heart involves the Black Sox scandal. I have been working on a project over the last few years, and I have talked with Victor at some length about it. During the 1919 World Series, several Chicago White Sox players decided to throw the World Series in exchange for payments from gamblers.<sup>52</sup> Based on the research that I have done and the benefit of having grown up in a house where baseball was second only to religion, the scam would never have worked if the conspirators had not convinced the two Hall of Fame caliber pitchers at the top of the White Sox pitching rotation—Eddie Cicotte, who to this date holds one of the lowest

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51. See Keith A. Rowley, *Contract Construction and Interpretation: From the “Four Corners” to Parol Evidence (and Everything in Between)*, 69 MISS. L.J. 73, 151 (1999).

52. See generally ELIOT ASINOF, *EIGHT MEN OUT: THE BLACK SOX AND THE 1919 WORLD SERIES* (1963).

career earned run averages for a starting pitcher in the history of major league baseball, and Claude “Lefty” Williams, who would not do anything unless Cicotte was going to do it too—to participate in the scandal. Cicotte had previously told Arnold “Chick” Gandil, who was trying to organize the fix, that he was not interested and was going to see Charlie Comiskey, the owner of the team, to try to collect on the \$10,000 bonus that was in his contract if he won thirty games—a \$10,000 bonus over his \$5,000 base salary.

So this is an extraordinarily one-sided exclusive dealing arrangement where, because of the nature of baseball contracts in the 19-teens, there is no such thing as free agency. Every player signed a standard form contract provided by the league—either the American League or the National League—in which his team played. Cicotte basically was a highly paid serf of Comiskey and was paid \$5,000 a year—not so high. Comiskey, when the pennant was wrapped up and the Sox were sure of playing in the World Series, ordered manager Kid Gleason to sit Cicotte down so that he would be unable to earn his thirtieth win and his \$10,000 bonus. When Cicotte asked Comiskey for his bonus, the Old Roman purportedly said “29 is not 30,” whereupon Cicotte told Gandil that he would join the fix.

Now we all know that, today, an employer cannot fire someone before the end of year in order to avoid paying them a year-end bonus. But that is analogous to what Comiskey did to Cicotte. And so it opens up an area of inquiry for “best efforts.” Did the team owe Cicotte a good faith duty to use best or even reasonable efforts to allow him to earn the bonus that he so richly deserved?

I will stop there because I want Victor to have a chance to talk about any or all of the things that Mark, Stewart, and I have said. Thank you very much.

***Professor Victor Goldberg:***<sup>53</sup>

I want to thank you all for your comments. Let me just respond in an unstructured way here. Let me start with *Nanakuli*, which is mentioned as one of the Terrible Twosome.<sup>54</sup> I do not actually analyze it at all in the book. I spend most of my time on the other terrible one, *Columbia Nitrogen Corp. v. Royster Co.*<sup>55</sup> I actually read *Nanakuli* last

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54. *Nanakuli Paving & Rock Co. v. Shell Oil Co., Inc.*, 664 F.2d 772 (9th Cir. 1981); GOLDBERG, *supra* note 2, at 162–88.

55. 451 F.2d 3 (4th Cir. 1971); GOLDBERG, *supra* note 2, at 162–88.

night again—it is a long opinion with virtually no facts. Actually the one set of facts given are the facts in *Columbia Nitrogen*. And those they clearly get wrong.

The problem I have with *Nanakuli* is that it would have been so easy to write price protection into the contract if the parties so desired. And the fact that it was not there suggests that there was a problem that gave Shell the opportunity to waive the price, if they wanted, by giving price protection or not. This is an easy way to understand the case. One thing that is quite remarkable is that the court looked at what the aggregate (that is, rock) suppliers were doing; those contracts looked extremely different. There is no reason to believe that the aggregate contracts look anything like the asphalt contracts.

This was actually a five-year contract; it was quite unique. The notion that you can decide what others in the industry do without looking at what anybody has written strikes me as quite bizarre. *Columbia Nitrogen*, which I did examine, involved the only three-year contract in the entire business. The court did not bother to look at what any other contracts looked like. In fact, a lot of the decision, at least in the case itself, concerned what the parties could have included in the written contract but had failed to do so. Well, if they had included the terms in the contract, would that matter given the alleged customs and practices? The implication is that written contracts, in that case at least, appear to be meaningless. Clearly what the court found is not an enforceable contract. This does not really help you much, but that is where the case ends up.

Let me talk about *Wood v. Lucy* briefly. The thing I found interesting and that surprised me was to find the Kewpie doll contract, which—just to get the timing straight—was actually entered into before *Wood v. Lucy* and was in litigation before the contract in *Wood v. Lucy* was signed. What I could not find in my research—since I am not an historian or a very good archeologist—was who the lawyers were that drafted those contracts and whether Wood had the same lawyer in both contracts. One possible story is that Wood's lawyer, realizing that his "best efforts" clause was now in litigation with O'Neill and that she was going to raise his failure to use best efforts as a counterclaim, deliberately left it out of the *Lucy* contract. This I do not know; it is only speculation. What I think is interesting though, once we get past that, is that Cardozo did not have to find consideration in this contract. Wood could have lost here, and it would have been very easy for anybody in the future who wanted contracts like this to be enforceable to give it some explicit

consideration.

The real problem I have with the opinion is that what was reasonable efforts, or a peppercorn worth of efforts, which is all Cardozo needed to find for consideration, became “best efforts” in section 2-306 of the UCC. All of a sudden we now have a duty being imposed only because we had to try to find a way to trump up consideration. But we have no idea what this duty actually is. There are some states that actually have ruled that “best efforts” clauses as such are not enforceable because they are too vague, but implied “best efforts” are enforceable. This has been one of the great mysteries to me.

Let me turn to *Bloor v. Falstaff Brewing Co.*,<sup>56</sup> the “best efforts” case. One of the problems—and this comes back to everybody’s points—is what to do about context. I am wishy-washy in some sense about it. I do not like to look at trade usage, etc. I think that can really lead us into *Columbia Nitrogen* sort of problems. On the other hand, when you have terms like “best efforts,” which are inherently vague, you have to do something to give them content. I think that the only way to give them content is to look at the context in which they are used.

When I teach the Deals course that Val alluded to earlier, we often look at merger agreements; these are typically fifty pages, single-spaced, and probably say “best efforts” or “reasonable best efforts” or some variation of that phrase fifty or seventy-five times within the agreement. The agreement will say “material adverse” effect seventy times. What does “best efforts” mean there? What does “material” mean? At best you have to determine what it could possibly mean in the context.

*Bloor* is one of those peculiar cases where you can figure out what they should have meant by the context. I prefer to look at what reasonable, sophisticated people in this position would have meant when they put “best efforts” in the contract. In that context, it is easy to see that Judge Friendly got it wrong. If you recall, the “best efforts” clause litigated in that case involved the royalty payments that Ballantine was to receive as part of its compensation for the sale of the distribution network and its brand name. The royalty was fifty cents per barrel; the royalty clause had a “best efforts” clause in which Falstaff agreed that it would use best efforts to increase Ballantine’s sales. Now, the first question is, what was that royalty doing in the contract? Judge Friendly did not ask. The answer Keith alluded to is

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56. 601 F.2d 609 (2d Cir. 1979).

information asymmetry, the so-called lemons problem. When you are selling a complicated asset like a firm or a big hunk of a firm, there are real questions as to what you are selling. How do you deal with that? Often what we see are representations, warranties, conditions, and due diligence. These are normal ways of dealing with this information asymmetry—the fact that the seller knows something about what he is selling that the buyer does not.

In this case, they deliberately did none of that. Ballantine sold the assets “as is.” That is pretty scary. You are going to spend millions and all you are getting is “as is.” In order to assure Falstaff that the assets were worth something, Ballantine made the bulk of its compensation contingent upon the quality of the assets. That is essentially what this royalty did. If they had sold what they had been selling over the previous years, the royalty would have been about \$5 to \$6 million over and above the \$4 million sale price. So roughly half of the value of the deal was essentially in this royalty.

Now, that is the context. So then the question is: Given that this amounted to an earnout transaction, what is the role of the “best efforts” clause? What I argue is that the problem that the parties had was that Ballantine was really selling two assets; it was selling the Ballantine brand name, and it was selling its distribution network, which could be used for other things such as selling Falstaff beer. The royalty was essentially a meter on the quality of the Ballantine brand name. However, it would not have been too hard for Falstaff to decide they no longer wanted to sell Ballantine beer and instead sell Falstaff beer through the Ballantine distribution network. Basically, Falstaff could cheat Ballantine by diverting business away from the meter (the royalty). The “best efforts” clause, I suggest, was there to try to prevent that cheating. Now, that would still be difficult to litigate in principle. Suppose we found out that forty percent of the beer being sold to the network was Ballantine and sixty percent was Falstaff. Is that “best efforts”? You can see how there would be many problems litigating this.

The facts of the case make it easy. Paul Kalmanovitz purchased Ballantine and dismantled its entire distribution network. Falstaff was not diverting anything. So there was no diversion, and therefore there was no violation of the “best efforts” clause, at least as I interpret it. The problem was that Falstaff had bought two lemons. The nice thing about that case, in one sense, is that you can actually come to a fairly clean result. The unfortunate part is that it does not generalize. You will see very few other “best efforts” cases like this. However, “best efforts” is something that is inherent in many cases. While the *Bloor*

analysis does not generalize, the approach does. The contract Judge Friendly constructed for the parties had Falstaff promise that it would use the assets it purchased suboptimally. Since restrictions on future use should make the asset less attractive to the buyer, the question that should have arisen is: why would a rational seller impose such a restriction? When the question is properly framed, the answer comes into focus: the royalty dealt with the lemons problem and the best efforts clause was to police cheating.

Mark mentioned *Lake River Corp. v. Carborundum Co.*<sup>57</sup> I actually drafted something on this a few months ago and sent it to Dick Posner, the judge who wrote the *Lake River* opinion. Posner responded and we had a brief e-mail correspondence on it. Strangely enough, he still thinks he is right. My argument turn on one of the facts, left out of the opinion and buried in the contract in an obscure clause. The clause says that Lake River essentially agrees to bag up to 400 tons a week of Carborundum's product. Most of you probably have only a vague recollection of this case, so I will back up. This was a three-year contract in which Lake River agreed to bag at least 22,500 tons of Carborundum's product and Carborundum agreed to pay Lake River for those 22,500 tons. Carborundum only sent 12,000 tons of product. Lake River sued claiming Carborundum owed Lake River for the other 10,500 tons that Carborundum did not send. Carborundum argued that the clause was a penalty clause. Posner reluctantly agreed that it was a penalty clause and, therefore, was unenforceable.

Posner also argued that this does not mean that "take-or-pay" contracts are unenforceable, because "take-or-pay" contracts are different. But as Mark and I certainly agree, they are not different. So what is going on here? What Lake River promised to do was to stand ready for a three-year period to bag whatever was sent, up to the 400 tons per week. Carborundum was getting something valuable—flexibility—and was willing to pay for it. On the other side, providing that flexibility was costly for Lake River. It had to forego other opportunities and remain ready, willing, and able to perform.

The real deal is a bargain over this flexibility where one party values it, and it is costly for the other party to provide. They managed to find a mutually agreeable price ex ante, but this was undone by the court. I think it is important to realize—and this really is a central theme of the book, particularly Chapter Five—flexibility is often valuable to one party and costly to provide for the other. Contracts

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57. 769 F.2d 1284 (7th Cir. 1985).

will reflect that by granting discretion to one party, but confronting that party with consequences (a price) for the exercise of that discretion.

Now, I have one other disagreement with Posner on this case. According to Posner's analysis, if Carborundum breached on the first day, it would have owed Lake River the full amount of the contract, \$533,000. I tried to tell him that I do not think that is right. If Carborundum breached on the first day, then there would be a duty to mitigate. Lake River had this capacity freed up to do other things, and the revenue they get from doing those other things should be subtracted from that \$533,000. Posner disagrees. Because it is a stipulated damage clause, even though it does not say that, Carborundum would have to pay \$533,000 regardless, and there would be no mitigation. But I think once you recognize that anticipatory repudiation of a three-year contract or a "take-or-pay" contract is different from not taking the amount after the contract has been performed, you have a very different analysis of the case and get a different outcome.

In conclusion, I want to emphasize the basic theme of the book, namely that an understanding of the economics of transactions will be valuable for analyzing contract disputes and doctrine.

I think I have used up my time. We will leave the rest of the time for open discussion.

***Professor Stephen A. Smith:***

I am Professor Stephen Smith from McGill University. I have an observation that is prompted by the extent to which the different commentators were in agreement with the book's arguments. The observation is that this agreement is not surprising. Whether you care about vindicating individual rights, efficiency, or fairness, you will care about giving effect to the intentions of contracting parties.

Whatever normative perspective on contract law is adopted, the first step in determining what contracting parties should do is to interpret what the parties have agreed to. Furthermore, I do not think there is any disagreement, even between authors with very different normative perspectives, about what interpretation means. At first blush it may look like there is a debate between authors who say you need to take context into account when interpreting contracts and those who say you should not do this. However, I do not think this is a real debate. Everybody accepts that we should take context into account. The only question is what that context is. The need to take

context into account in understanding words is a basic feature of language. No one believes that you can understand words in isolation.

Let me give an example. Authors who argue that judges should read a particular contract or type of contract literally and strictly, not filling or adding any terms, are basically saying that the context in which such contracts were made is one in which the drafters assumed, quite reasonably, that the contract's words would be read literally, strictly, etc. By contrast, authors who argue for a more expansive interpretation generally assume that the context is one in which the drafters assumed that their words would be understood more expansively. This is a point I stress when I teach French and German lawyers about English contract law. I explain that apparent differences in how contracts are interpreted in common and civil law are often not a consequence of different views on interpretation, but arise from the different cultural contexts in which contracts are traditionally drafted in these jurisdictions. To illustrate this point, I often give students two copies of contracts for the purchase of shares, one written in Germany by a German lawyer, the other written in England by an English lawyer. Both lawyers belong to the same multinational law firm. The German contract is 30 pages long; the English contract is 160 pages long.

Neither of these lawyers has made a mistake or done a bad job drafting. Nor did they have different theories about the meaning of interpretation. Each reasonably expected that judges would take into account the context in which their contract was drafted. The contexts did, however, differ. Each lawyer reasonably had different expectations about how much was going to be filled in by a judge or anyone else reading the contract. Coincidentally, the English practice supports Victor's point about how commercial agreements should be interpreted. The context in which most commercial agreements are made, at least in England, is one in which it is assumed that the words in the contract will be read literally and strictly. This is why the last thing that English lawyers in major commercial practices usually do before signing a contract, even a 160 page contract, is to get the firm's lawyers who have worked on the transaction together in a conference room to read out loud the entire contract, word by word. The lawyers want to make sure that they mean every single word in the contract. This does not mean that context is irrelevant when interpreting an English contract. English judges should and do take context into account. But the context in which the English contract is drafted is different from the context in which the German contract is drafted. Thank you.



***Professor Val Ricks:***<sup>58</sup>

I wonder how the lawyers were getting paid in each of those societies.

***Professor Smith:***

At one point, English lawyers were paid by the word when they drafted contracts. No doubt that is one reason for the length of English contracts.

***Professor Rowley:***

One of the things that interests me about Victor's approach to context is found in the chapter on *Bloor v. Falstaff*. Victor comes to the conclusion that, when terms of a contract are ambiguous, it is important to look at context—including trade usage, course of performance, and course of dealing. But if the terms of the contract are crystal clear, then you should not look at things like course of dealing, course of performance, or usage of trade.

That raises for me the question of against which background to assume that sophisticated parties are contracting. Do we assume they are contracting against a *tabula rasa* where there are no rules and the parties are setting them all for themselves? Or, are they assuming that things like trade usage, course of performance, and prior dealings among themselves will be part of the contract unless they expressly contract out of them? I think that promotes a more efficient use of negotiating and drafting resources by making contracts of the thirty-page variety rather than the fifty-page variety.

***Professor Gergen:***

Leon Green made an apt point in this regard in *Judge and Jury*.<sup>59</sup> While he is speaking about the law of misrepresentation, the same applies to the parol evidence rule. Green wrote:

[T]he elaborate formula with its multitude of sub-formulas . . . permit[s] the judge to range as freely as his judgment dictates. . . .

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58. Professor Val D. Ricks is the Vinson & Elkins Research Professor and a Professor of Law at South Texas College of Law.

59. LEON GREEN, *JUDGE AND JURY* (1930).

. . . [T]he point to be stressed here is that whatever sort of judgment is desired, the formulas which have been evolved and their coteries of attendant phrases provide the most flexible accommodation without in the least impairing their own integrity or that of the judicial process. A science of law could ask little better by way of intellectual machinery for handling these varied and difficult cases.<sup>60</sup>

Green differs from Victor in that he trusts trial judges to get it right while Victor does not. I tell my students that the parole evidence rule does not constrain judges. Rather it enables judges to take the issue of interpretation away from the jury, even when interpretation turns on contestable issues of fact.

***Professor Goldberg:***

Let me make two quick responses. First, on the *Nanakuli* point, I think it is quite interesting that in the previous two waivers, the price difference was not quite so high—\$2 to \$5 difference—whereas this waiver was going to be for about \$30. A second point is about “best efforts.” Professor Linzer said that parties should draft “reasonable efforts” contracts. What does that mean? When Allen Farnsworth was my colleague, I asked him what the difference was. Allen said, “Best efforts, reasonable efforts, reasonable commercial, best efforts all mean the same thing. Good faith means something different.” I asked him why. Lawyers like nuances, why are there no nuances here? He could not answer that. If you look just at section 2-306 of the UCC, Cardozo’s “reasonable efforts” have become “best efforts.”<sup>61</sup> They are treated as synonyms a lot of the time. I do not understand how the drafting change is going to help you with that.

***Professor Macaulay:***

The only thing that I wanted to add is that the lawyer’s opportunity to draft and plan varies in different situations. We cannot assume that the parties could have done a great job drafting in every case. I know a lawyer who has worked for dot-coms for about ten years. The computer engineers generally think that law and formal contracts are worthless. Often they have to run their sales past the general counsel’s office. The lawyers are often called “Dr. No”

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60. *Id.* at 311–13 (emphasis omitted).

61. U.C.C. § 2-306 (2004).

because it seems that all they are good for is ruining sales when they raise intellectual property issues. The fact that Microsoft might sue us because our license to use a Microsoft product probably does not cover the use that the sales engineer wants to make does not impress the engineer. Lawyers always think of the improbable “what ifs.” Lawyers also want to define the “deliverables.” Computer engineers really mean that they are going to come up with a program that will do cool things, and they will work out just what those cool things are as they go along. Many of them are not very interested in making money for the firm; they just want to get on with the project defined only in the most general terms because they do not want to be pinned down before they get into the project. At best, the lawyers get a very short time to review contracts proposed by the engineers, which can produce some less than perfect language. The lawyers will grab the language that they have used in the past and tinker with what they see as they read. Of course, there are situations where the document is beautifully crafted and every comma has been debated. But we cannot expect this in every case.

***Professor Annette Burkeen:***

My name is Annette Burkeen from Salmon P. Chase College of Law. One of the comments I had when Professor Gergen was talking about how to constrain judges when interpreting “best efforts” or “reasonable efforts” clauses is that you do not seem to allow for strategic vagueness. A “best efforts” or “reasonable efforts” term might be strategic—that is, the parties may use such term as an acceptable form of an agreement to agree. As circumstances change over the course of a contract, the parties may negotiate or renegotiate whether unforeseen or contingent circumstances justify a reconceptualization of what conduct complies with the agreement. The use of such terms may also impliedly signal the parties’ willingness to allow the court to resolve the issue when the parties are unable to do so. I have not really heard anyone speak to that end.

***Professor Rowley:***

Victor made a quick allusion to this in his response. One of his views of *Wood v. Lucy*—given the prior contract between Wood and O’Neill and the pending litigation—was that Wood might very well have drafted a contract to use with Lucy that was intentionally unenforceable on the theory that most people do what they say they

are going to do in contracts and it does not end up in litigation; or, if the parties do not do what they say they are going to do, the dispute is so small that it is not worth going to court over it. It is not exactly what you are talking about, but it is along the same vein: that you might draft in such a way that you can back out. The funny thing in *Wood v. Lucy* is that the parties were reversed. It was Wood who wanted to enforce the contract that he drafted to be unenforceable and Lucy who argued it was not enforceable because it was for no consideration.

***Professor Goldberg:***

I think that you are right. A lot of the times people draft contracts knowing that there are holes and that they are going to work things out. Look, for instance, at a basketball contract; you cannot say, "I'm going to work really hard, honest." Look at Vince Carter when he was with Toronto; that was clearly a violation of any best efforts. The other side of that coin is that when you draft a contract really precisely, when it gets into litigation people will look at it with a microscope and try to find an ambiguity when before there was none. That is a more common problem. But you are absolutely right that people do leave holes, and sometimes they just have to.

***Professor Daniel Kleinberger:***

My name is Daniel Kleinberger from William Mitchell College of Law. The law school at which I teach is named after a justice of the state supreme court who had very much a "four corner" approach. He was also given to succinct opinions, a fact I found out with great pleasure when I was asked to prepare remarks on his approach to the parol evidence rule. He certainly was not paid by the word. His opinions in this area run about two-pages long.

I wanted to offer just a few observations. One is with regard to bad drafting. The Delaware Chancery Court recently talked about the duty to "scriven carefully" while drafting agreements under entity statutes that give maximum effect to freedom of contract. In essence, the Court warned the lawyer that it would interpret the contract just the way he had written it.

In my experience as a commercial lawyer, a lot of drafting problems come up from very bad lawyering, where the attorney forces a disconnect between the process of developing a contract and the process of thinking about the deal. A careful drafting process

necessarily involves recurrently making sure that the client understands the document. The document is, after all, describing the client's deal. I question whether client understanding is possible with a 100-page contract, which is somewhat beyond the bounds of my comprehension.

The other thing I want to include is that possibly what is happening in the debate between strict construction and not-so-strict construction is something comparable to what goes on in the fancy realm of constitutional adjudication, in particular the allocation of power between the government and the people. The common law issue of contractual interpretation implicates the same question. That is, a more liberal standard of interpretation reallocates power from the private sector to an arm of the government—the judiciary.

I tell my students that one of the best ways to convert a get-the-government-out-of-the-economy conservative into a liberal Democrat is to have the conservative make a deal that he later decides he does not want. Then, the duty of good faith and fair dealing is invoked, and he will not see this as an invocation of government power over the economy. The broader a court's view of good faith, the more power the government has to reconstruct private deals.

Another thing, which I am going to talk about later in my presentation, is the statutory approach in business entity law to the concept of good faith and fair dealing. Over a period of years, the Uniform Law Commissioners have debated what that actually means. RUPA says, in effect, "It is a very broad construction. But we do not really know what this thing is so we leave it to the courts to decide." Later uniform acts suggest a very narrow construction. What has shifted—basically—is the philosophy of how much power goes to the courts.

***Mr. Andrew Oh-Willeke:***

My name is Andrew Oh-Willeke from McGihon & Associates, L.L.C. in Denver, Colorado. Professor Gergen was talking about the notion that we are balancing two kinds of deadweight loss—in the litigation system, which could be avoided with simpler contract rules, and in the contracting process, which is invisible but might be just as much of a bad thing, and that the empirical side of that really matters. Well, doesn't the experience of Israel really give us a test of how much deadweight loss the complexity of contract and discovery rules provide? Israel is doing a real-life experiment. It got rid of its parole evidence rule and has run its world of contract law without it for quite

a long time. The remarkable thing is that while everyone argued that it would clog the courts when that change in the law was made, in practice it has had almost no impact on litigation cost, which would suggest the nature of the contract rules are not contributing a lot to the amount of deadweight loss that goes on in the court. If that is the case, does having simpler contract rules really make sense?

***Professor Gergen:***

Israel is fascinating because its supreme court has the capacity to review every case. The supreme court can adopt rules that vest judges with enormous discretion, knowing they will have the final say in every case. In the United States it is very different. This is particularly true in states like Texas, where the supreme court does not trust some lower courts.

I do disagree with Professor Kleinberger's claim that this is all about power. It is about whether we empower people by rules that bound the discretion of trial judges to do what they thought the parties meant but did not quite say. Or we empower people by giving trial judges ex-post discretion to do what they thought the parties wanted. What is more empowering to people is an empirical question that turns on judicial competence, people's competence in drafting contracts, and the like. But Steve nailed it. It is all about trying to effectuate the parties' intent.

***Professor Goldberg:***

I just want to make one more point. You talk about writing long contracts because we have to spell everything out. The other side of that coin is that if the judges are continually intervening by not honoring what is in the contracts, you have to write a lot more elaborate contracts to try to constrain the judges. So it is not quite clear which is going to end with the longer and more elaborate contracts.