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HYPOTHETICAL BARGAINS: THE NORMATIVE STRUCTURE OF CONTRACT INTERPRETATION

*David Charny**

A construction company promises to indemnify the property owner "against all loss . . . in any way connected with the performance of this contract."[1] Must the construction company reimburse the property owner for the owner's liabilities to third parties, incurred as a result of the construction?

After performing a tubal ligation, a physician tells his patient that "it [is] impossible for her . . . to have any more children."[2] Is the physician liable for breach of promise when the patient becomes pregnant again?

A car rental contract extends insurance for accidents that occur when the car is driven by the lessee of the car or by his "immediate family, his employer, his employee . . . or his partner."[3] Does the policy cover an accident suffered while the car is being driven by a restaurant valet?

A corporation's shareholder-employee is contractually obligated to sell his shares back to the corporation when he quits his job.[4] Must the corporation disclose to the employee circumstances that indicate that the shares are much more valuable than the current buy-back price?

In resolving these cases, some of our most distinguished jurists have adopted positions that are incorrect, perhaps even incoherent.[5] They have, under the influence of modern contract theory, relied upon an analytic framework that is fundamentally flawed.

To interpret contracts, lawyers ask: what would the parties have agreed to had they explicitly adverted to the issue? That is, the interpreter constructs a "hypothetical bargain": he determines how the parties would have bargained to treat the situation that has arisen had

* Professor of Law, Harvard University. — Ed. Thanks to Phil Areeda, Lisa Bernstein, Lucian Bebchuk, Clark Byse, Bob Clark, Terry Fisher, Kathleen Flynn, Jerry Frug, Mort Horwitz, Louis Kaplow, Duncan Kennedy, Reinier Kraakman, Saul Levmore, Jerri Lynn-Scofield, Frank Michelman, Todd Rakoff, Arthur von Mehren, and Lloyd Weinreb. The Harvard Law School and the Olin Foundation Program in Law and Economics provided financial support.

1. Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 69 Cal. 2d 33, 36, 442 P.2d 641, 642, 69 Cal. Rptr. 561, 562 (1968).

2. Garcia v. Von Micsky, 602 F.2d 51, 52 (2d Cir. 1979).

3. Travelers Ins. Co. v. Budget Rent-A-Car Sys., 901 F.2d 765, 766 (9th Cir. 1990).

4. Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 432 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

5. The jurists in question for the examples here are, respectively, Justice Traynor and Judges Oakes, Kozinski, and Easterbrook. The cases are analyzed in the course of the discussion below.

it been directly presented to them at the time they were forming the contract.[6]

In particular, the hypothetical bargain framework is invoked to resolve two types of issues. First, courts use it to interpret "ambiguous" language; that is, to apply the language of a contract to a particular contingency which subsequently arises, "the court [ ] construe[s] the language . . . so as to give effect to what would have been the intention and agreement of the parties had their attention been drawn to events as they actually were to occur."[7] Second, courts use the rule as one of "construction": to supply "implied duties" in the face of a contingency that no language in the contract addresses. For example, in construing the scope of the implied duty of good faith, courts ask whether the parties "would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith — had they thought to negotiate with respect to that matter."[8] Similarly, "when supplying terms of an effective but incomplete contract a court properly picks those for which the parties probably would have bargained, had they anticipated the problem."[9]

Yet fundamental issues of method and justification remain unresolved. First, there is disagreement — and some confusion — about the ways in which the hypothetical bargain test should be applied. A simple example illustrates the range of issues. Consider the question whether to imply a good faith term in an employment contract. The

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6. By contracts, I refer generally to agreements that govern consensual transactions, including the legally implied terms for transactions that are provided by corporate and commercial law, bankruptcy law, and tort.

For scholarly use of the hypothetical bargain paradigm, see, *e.g.*, Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1824 (statement of framework), 1835-58 (analysis) (1989); Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN L. REV. 271, 271-79, 283-99 (1986) (hypothetical contract among venturers in a close corporation) [hereinafter Easterbrook & Fischel, *Close Corporations*]; Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702 (1982) (hypothetical contract between investors and managers); Jackson & Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989) (bankruptcy); Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 210-11 (1989) (article 9 of the U.C.C.).

Treatments, from an instrumental perspective, of some of the issues raised in the present article, can be found in Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); Coleman, Heckathorn & Maser, *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. PUB. POLY. 639 (1989); Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215 (1990).

7. Harcourt Brace Jovanovich, Inc. v. Sun Bank Natl. Assn., No. 87-3985 (Fla. Cir. Ct. June 25, 1987), *available in* Harcourt Brace Jovanovich schedule 13D (filed July 9, 1987) at 13.

8. Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986) (opinion by Chancellor Allen).

9. Wisconsin Real Estate Inv. Trust v. Weinstein, 781 F.2d 589, 593 (7th Cir. 1986).

adjudicator can construct the "hypothetical bargain" in many different ways. He could ask: would this particular worker and firm have bargained for this term? Or he could ask: would workers and firms of this "type," however defined, generally bargain for such a term? The adjudicator then would have to decide how general or widespread the purported outcome must be before it is taken as authoritative: all transactions, most transactions, a preponderance of transactions? Similarly, the adjudicator must decide what characteristics to ascribe to hypothetical bargainers. Should one imagine the outcome for workers and firms as currently informed? — or for workers and firms with all information that is now available to the adjudicator, even if the transactors do not have that information when they actually bargain? Should we take workers and firms with their extant preferences and modes of thinking, or should we posit some "ideally rational" worker or firm? Such questions as these complicate contract interpretation.

Second, the difficulties in method arise from fundamental problems of justification. Why are we bound by obligations to which we did not assent *explicitly*, but only hypothetically? It is by no means clear that individuals should be bound to hypothetical — as contrasted to actual — contracts, or even that it is appropriate to call such hypothetical contracts "contracts" at all.[10] The autonomy- or rights-based arguments for promissory obligation do not readily extend to merely hypothetical agreements.[11] Nor is it clear — from a consequentialist perspective — that a rule implying obligations to which transactors "would have assented" generally will reduce, rather than increase, the costs of transacting.[12]

I address these issues of method and justification here. My argument proceeds in four Parts. Part I defines the problem of interpretation more rigorously and identifies the methodological choices facing an interpreter. Part II presents the justifications for enforcing hypothetical bargains. The argument proceeds from the three justificatory principles generally accepted for enforcing contracts: fostering indi-

10. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985), and Clark, *Agency Costs versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 59-71 (J. Pratt & R. Zeckhauser eds. 1985), provide definitive critiques of the claim that the "hypothetical contract" among shareholders should have the binding force of actual — explicitly and consciously assented to — bargains.

11. *E.g.*, Dworkin, *Why Efficiency?*, 8 HOFSTRA L. REV. 563, 574-79 (1980) (objection in context of hypothetical bargains in the law); *see also* Kronman, *Comment on Dean Clark*, 89 COLUM. L. REV. 1748, 1749-50 (1989); *cf.* R. DWORKIN, TAKING RIGHTS SERIOUSLY 150-59 (1976) (objection as applied to Rawls' hypothetical contract constructed in the original position); Cohen, *Democratic Equality*, 99 ETHICS 727, 750-51 (1989) (same).

12. *E.g.*, Ayres & Gertner, *supra* note 6, at 101-07 (illustrating circumstances in which it would be inefficient to enforce the rules that parties would have chosen, but did not choose).

vidual autonomy, promoting fair allocation of social benefits, and minimizing the costs of transacting. Parts III and IV develop a method for constructing hypothetical bargains.

The argument here amplifies the contract literature with respect to basic contract theory and its doctrinal applications. The argument extends and corrects the current understanding of contract theory in several respects. First, it clarifies the role of liberal and communitarian argument in constructing interpretive conventions for contract. As currently understood among lawyers, the predominant noninstrumental theories of contract are in large measure indeterminate as to the question of default rules.[13] Nonetheless, as I shall explain, these theories do have limited implications for the ground rules that govern interpretive conventions. The argument here, then, clarifies the role of noninstrumental theory in delimiting the conventions that the law can adopt. Second, having identified these basic limits, the argument demonstrates that analysis of interpretive conventions should proceed, within these limits, on instrumental terms. While lawyer-economists have taken for granted that their mode of analysis illuminates questions of contract law, there is no reason that lawyers — or legal decisionmakers — should defer to economists' presuppositions on the matter. My argument demonstrates that the small but growing body of instrumental analysis of contract conventions[14] bears directly, as a normative matter, on formulation of legal rules and decision of particular legal controversies.

More concretely, the analysis here makes recommendations with regard to substantive issues in contract interpretation. As Professor Avery Katz has argued, relative little formal work has addressed the questions of "what the ideal conventions of contract formation and interpretation should be."[15] As Katz observes, analytic scholarly work has focused almost entirely on the optimal set of suppletive terms, particular for contract remedies, and excuse of mistake, impossibility, and frustration of purpose.[16] In contrast, here I provide a framework for determining interpretive conventions.[17] In particular, I address such sources of perplexity as the plain meaning and parole evidence rules, the neophyte rule, the *contra proferendum* rule, the

13. For a demonstration of this point, see Craswell, *Contract Law, Default Rules, and the Philosophy of Promising,* 88 MICH. L. REV. 489, 516-28 (1989) (analyzing the work of Charles Fried and Randy Barnett).

14. *See supra* note 6.

15. Katz, *supra* note 6, at 222.

16. *Id.* at 216-19.

17. The framework is summarized schematically in the article's conclusion.

role of custom in interpreting agreements, and the proper scope of implied duties of good faith and fair dealing.

I. The Structure of Contract Interpretation

A. *The Need for a Set of Default Rules*

The law must supply a set of background conditions to interpretation and enforcement of contracts — commonly referred to as "default rules." Without default rules, *no* contract could have legal effect. This is the case for two reasons. Most fundamentally, no text can completely specify its own means of interpretation. A contractual statement that purported to be such a complete specification would itself have to be interpreted by some set of rules of interpretation. If the text purported to supply those rules, then *those* rules would have to be interpreted, and so on, ad infinitum.[18] Thus, the default rules must, at a minimum, contain a set of rules about how the language of contract is to be interpreted.

Second, aside from this basic epistemological constraint, an important set of practical constraints limits the completeness of contracts. In almost all transactions, it would be extremely costly to draft a contract that purported explicitly to address the obligations of the parties for all conceivable future contingencies.[19] As a practical matter, then, most contracts are quite incomplete.[20] The law supplies these missing terms.[21] For example, the doctrines of mistake and impracticability add terms to address low-probability contingencies;[22] so do doctrines

18. *Cf.* Davidson, *Belief and the Basis of Meaning,* 27 Synthese 309 (1974); Davidson, *Radical Interpretation,* 27 Dialectica 313 (1973).

19. In practice, of course, drafters will choose language to a degree of specificity and a style of drafting that reflects the interpretive practices of courts and the costs of reaching more precise formulation. For that reason, the epistemological observation, while establishing the need for *some* set of interpretive rules, provides scant guidance regarding what those rules should be; the particular rules and drafting style can be understood in terms of the various costs of transacting and background social conventions about the use of language.

20. Parties who act in an economically "rational" manner, for example, will not draft terms explicitly to address contingencies where they believe that the likelihood of the occurrence and its effect if it occurs are sufficiently small that it is not worthwhile to specify an applicable term.

21. Note that the law supplies a term *whenever* the contract is silent on an issue. Even if the court "refuses" to supply a term that the parties have not provided, the effect of that is to stipulate a background term: in particular, a background term that specifies that, in cases where the contract is silent, no further term will be decided, and the court will then either throw the case out or try to decide the issue adverting only to express terms, as if any implied terms that the parties are arguing for did not exist.

22. Shavell, *The Design of Contracts and Remedies for Breach,* 99 Q.J. Econ. 121 (1984), provides the basic theoretical model of suppletive terms. In the context of mistake and impracticability, use of the hypothetical bargain framework has led to analysis in terms of comparative ability to bear risk, as the parties presumably would explicitly allocate the risk, had they addressed the matter, to the one better able to bear it. *See, e.g.,* Northern Indiana Pub. Serv. Co. v. Carbon County Coal Co., 799 F.2d 265, 278 (7th Cir. 1986); *In re* Westinghouse Elec. Corp.

that impose general duties, such as the duty of good faith.[23] Correlatively, once the parties know that the law will supply the term, they take that into account when calculating the benefits of drafting an express term. Parties will not incur the costs of specifying the term if they suspect that courts will supply the appropriate term in any event.[24]

B. *The Hypothetical Bargain Standard*

The hypothetical bargains standard, then, is deployed to supply these suppletive rules of interpretation and construction. The hypothetical bargain standard must be defined on two dimensions: *generality* and *idealization.*

Generality refers to the extent to which the adjudicator particularizes her formulation to the particular transactors whose dispute is before her — adjusting the formulation for particular transactors' judgments, preferences, perceptions and so forth. For example, the adjudicator deciding whether employment is at will might conduct a detailed investigation into the understandings of the particular worker and employer involved in the dispute. Alternatively, she might simply announce a construction of the hypothetical bargain based on a generalization about all firms and workers and applicable to *all* such transactions.[25] The rule is more general, the greater the number of transactions or transactional situations that it covers (alternatively, the more general, the less one needs to know about the parties to the dispute and about their transaction in order to decide what interpretation to apply.)

A second dimension is the degree of *idealization* accomplished by the rule. By *idealization,* I mean the degree to which the interpreter

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Uranium Contracts Litigation, 517 F. Supp. 440, 453 (E.D. Va. 1981); *cf.* Fidelity & Deposit Co. of Maryland v. City of Sheboygan Falls, 713 F.2d 1261, 1269 (7th Cir. 1983) (reconstruction of possible bargain to accomplish assignment of risk to better risk bearer as matter of contract interpretation).

23. For a formulation of the hypothetical bargain framework in this context, see Katz v. Oak Indus., 508 A.2d 873, 880 (Del. Ch. 1986).

24. Conversely, parties will draft more elaborate and complete terms if they fear that courts' approaches to interpretation and construction will lead them awry. For example, John Langbein's empirical comparison of American and European contract practices suggests that American contracts, for comparable transactions, tend to be more elaborate as a "defensive" response to more freewheeling American interpretive practices, especially those in which civil juries indulge. Langbein, *Comparative Civil Procedure and the Style of Complete Contracts,* in THE COMPLEX LONG-TERM CONTRACT (F. Nicklisch ed. 1987) (Heidelberger Kolloquiuus Technologie und Recht 1986).

25. I mean to distinguish here the question of how general a rule is from whether the rule is based on what particular transactors want. A highly general rule may be what all transactors want or what none of them want; what makes it highly general is simply that it applies to a large number of cases independently of the many differences that might distinguish these cases.

constructs the bargain as it would be struck by idealized rather than real-world transactors. Most often, the idealizing adjudicator will attribute to the idealized bargainers a greater degree of rationality, or access to more extensive information, than real-world transactors possess. For example, when interpreting an employment contract, the adjudicator might ask how a worker would bargain if that worker had all the information about labor markets available to a sophisticated economist; or if the worker had information about the firm equal to the information that the firm's managers had.

Note that the two dimensions — generality and idealization — are logically independent. For example, lawyers can use a highly particularized rule that is nonetheless highly idealizing: for example, to resolve each employment dispute a court confronted, the court would conduct a distinctive hypothetical bargain inquiry, but would do so by imagining, for the situation of this worker and this employer, highly idealized bargainers — rational and well-informed. Conversely, the method can be highly generalized but not idealizing. For example, the court could adopt a single general hypothetical bargain construct for all workers and employers, but construct by reference to what the average worker and firm — with whatever their characteristic deficiencies in information, judgment, and bargaining skill — would agree on in bargaining about the matter.[26]

Thus, to take paradigmatic statements, there are four approaches to hypothetical bargains along these dimensions:

I: choose the best rule for this transaction type (general and idealizing);

II: choose the rule that *these particular parties* most likely would have negotiated to (particular and nonidealizing);

III: choose the rule that parties in this situation would have chosen if they were rational and perfectly informed (particular and idealizing);

IV: choose the rule that parties to this transaction type would most likely choose in the general run of situations (general and nonidealizing).

A set of widely cited cases from the California commercial law exemplifies the conflicts among these approaches. In *Pacific Gas and*

26. Many lawyers might think that a tendency to idealize is likely to be accompanied by a tendency to generalize: *i.e.,* that the "ideally constructed" bargain is likely to be one that holds as the ideal over a wide range of transactions. But this depends on what the relevant bargaining ideal is: in particular, it depends on how much the "ideal" bargain varies with the characteristics of *particular* transactions. *See infra* Part III.

Electric Co. v. G.W. Thomas Drayage & Rigging Co.,[27] the court had to interpret an indemnity clause.[28] Justice Traynor's influential opinion in the case offers two central propositions about how the court should resolve this problem: (a) the adjudicator's task is to discover the "intention of the parties"; and (b) the adjudicator discovers intention by considering "all credible evidence" relevant to what the parties meant. In short, the adjudicator should determine whether the defendant was liable for damage to third parties by looking at all evidence relevant to what these parties would have said had they explicitly addressed the issue. Under my framework, Traynor's approach is highly individualized — it focuses on the views of particular parties — and not idealized — it focuses on what the parties actually would have said, rather than what rational parties would have provided for.

Traynor's approach comes in for sharp attack from Judge Kozinski's recent opinion in *Trident Center v. Connecticut General Life Insurance Company.*[29] Kozinski contends that courts should stick to standardized formulations of what key contract terms mean, without inquiry into the particular views that the parties would have taken of the contingency in dispute.[30] In terms of my framework, Judge Kozinski's argument makes two points.[31] First, he argues that Traynor's approach is not generalizing enough: that it focuses too much attention on what the particular parties before the court would have said about a particular contingency.[32] Second, Traynor's approach is not idealizing enough: courts should interpret standard terms in contracts between "sophisticated" parties by determining how *rational*

27. 69 Cal. 2d 33, 442 P.2d 641, 69 Cal. Rptr. 561 (1968).

28. Under the clause, defendant promised "to perform work 'at [its] own risk and expense' and to 'indemnify' plaintiff 'against all loss, damage, expense and liability resulting from . . . injury to property, arising out of or in any way connected with the performance of this contract.' " 69 Cal. 2d at 36, 442 P.2d at 643, 69 Cal. Rptr. at 563. The issue before the court was whether the clause required defendant to indemnify plaintiff's liabilities for damage to third parties.

29. 847 F.2d 564 (9th Cir. 1988).

30. In *Trident Center,* the clause at issue prohibited prepayment of a loan; the borrower contended that other clauses in the contract permitted the borrower to prepay the loan by defaulting.

31. It should be noted that Judge Kozinski's opinion does not identify the questions of generality or idealization specifically, and, indeed, might in some respects blur the distinction between them.

32. If one side is willing to claim that the parties intended one thing but the agreement provides for another, the court must consider extrinsic evidence of possible ambiguity. If that evidence raises the specter of ambiguity where there was none before, the contract language is displaced and the intention of the parties must be divined from self-serving testimony offered by partisan witnesses . . . .

847 F.2d at 569.

parties would have wished the contract formulation to be applied.[33]

Who is right, Justice Traynor or Judge Kozinski? It is questions such as these that the hypothetical bargain framework must resolve.

II. HYPOTHETICAL BARGAINS: JUSTIFICATIONS AND METHODS OF CONSTRUCTION

Contract lawyers generally understand contracts to be enforceable on one of three possible grounds. First, courts may enforce contracts on principles of autonomy. Legal enforcement of contract promotes individual freedom by giving people the power to bind themselves with others.[34] Enforcement of promises fosters the autonomy of transacting parties by enabling them to bind themselves to cooperate with others.

Second, courts may enforce contracts on what I would call principles of benefit or social reciprocity. On this view, courts should enforce contracts to implement a conception of fair social arrangements. Michael Sandel provides an incisive statement of this general view: "With reciprocity . . . contracts bind not because they are willingly incurred but because (or in so far as) they tend to produce results that are fair. . . . On the ideal of reciprocity . . . the contract *approximates* justice rather than *confers* it . . . ."[35]

The simplest benefit-based view of contract would take the transactors' consent to an exchange as *conclusive* evidence that the contract is fair and ought to be enforced. Clearly, this fairness-based conception of contract will produce practical outcomes — as to the enforceability of express contracts — indistinguishable from those commended by autonomy-based conceptions:[36] each takes the *fact* of consent to be decisive of legal obligation.[37]

In modern contract law, however, benefit-based theories have been

33. Kozinski is less explicit about this aspect of his critique, but he seems to think that courts should assume all parties to such loan agreements to be rational and well informed. *See* 847 F.2d at 569.

34. A definitive modern exposition is C. FRIED, CONTRACT AS PROMISE 16-21 (1981). Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986), provides an alternative formulation.

35. M. SANDEL, LIBERALISM AND THE LIMITS OF JUSTICE 107 (1982). Professor Atiyah develops the contrast in legal doctrine between autonomy- and benefit-based theories of contract in P. ATIYAH, *Contracts, Promises and the Law of Obligations*, in ESSAYS ON CONTRACT 10, 10-30 (1986), and P. ATIYAH, *The Liberal Theory of Contract*, in *id.*, at 121.

36. *See* E. Posner, The Bargain Principle and the Fairness Principle in Contract Decisions: Michigan, 1900-1950 (Harvard Law School Program in Law and Economics Discussion Paper No. 81) (1991) (analyzing this phenomenon in Michigan contract cases).

37. As we shall see, however, these two conceptions may imply respectively different rules for hypothetical bargains.

distinguished by a more expansive conception of the inquiry that an adjudicator should make before upholding a transaction as fair. The adjudicator should decline to enforce, or should rewrite, contracts that would authorize one party to abuse its bargaining power or to exploit mistakes in fact or judgment by the other party. Put more affirmatively, the task of the adjudicator becomes to promote "solidarity"[38] or to enforce compliance with generally accepted social norms,[39] rather than simply to enforce bargains that the parties have made. On this view, "hard deals bind less [than from the standpoint of autonomy], but on the other hand, the need for consent fades, and I may be obligated in virtue of benefits I do not want or dependencies beyond my control."[40]

Third, many lawyers contend that contracts should be enforced strictly on instrumental grounds. Under principles of efficiency, it is welfare-enhancing for parties to be able to bind themselves in the future, and a rule for enforcing contracts accomplishes that. Contracts improve welfare because voluntary exchange presumptively enhances the welfare of both parties: the parties consent to the exchange only because each believes she will be better off after the exchange is consummated than before it.[41] This is the premise of the vast contemporary law-and-economics literature on contract enforcement; it has its roots in the vision of commercial law that developed in the eighteenth and nineteenth centuries.[42]

In this Part, I employ these three conceptions to help explain why contracts should be interpreted by the hypothetical bargain standard, and to help specify which method should be used when courts apply the standard. This inquiry is a necessary first step in answering the question whether lawyers have available a coherent doctrinal framework for interpretation.

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38. *E.g.*, Unger, *The Critical Legal Studies Movement*, 96 HARV. L. REV. 563, 644-46 (1983).

39. In modern literature, Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974), is an exemplary analysis of the various relationships between contract law and background transactional norms.

40. M. SANDEL, *supra* note 35, at 107.

41. Three reasons that it enhances welfare to make enforceable commitments: risk-shifting, differences in access to information, and need to make "reliance investments." *See* Charny, *Nonlegal Sanctions in Commercial Transactions*, 104 HARV. L. REV. 375, 398-99 (1990). For models of the gains from facilitating relationship-specific investments, see Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, in 89 YALE L.J. 1261, 1266-71 (1980); Hart & Holmstrom, *The Theory of Contract*, in ADVANCES IN ECONOMIC THEORY, 71, 129-30 (T. Bewley ed. 1987).

42. *See generally* P. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 292-358 (1979).

A. *Hypothetical Bargains as a Problem of Rights or Justice: Choice-Based (Autonomy) Theories*

1. *Justification*

In autonomy-based contract theories, obligation arises from the express consent of the parties. The basis of obligation is the act of choice. In the first instance, then, a merely hypothetical agreement regarding a particular contingency — an agreement that the transactors did not actually choose — does not display the necessary feature for obligation.[43]

Nonetheless, the adjudicator can found the authority of hypothetical bargains in actual consent. Consider the adjudicator who must decide whether the employment contract between the parties stipulates a prohibition against opportunistic or confiscatory firings. The contract contains no language that, by "ordinary language" principles of understanding, would address the matter. But this does not end the matter. For the adjudicator observes that words carry a wide range of connotations, adumbrations, "penumbrae," that can appropriately be taken as consented to by a party who utters the words, or signs the documents, that constitute the actual contract.[44] The apparently silent contract may nonetheless, in Cardozo's famous phrase, be "instinct with an obligation."[45]

The court that enforces the hypothetical bargain purports to interpret the implications of the parties' own commitments to participate in fostering their own projects. What standard should the adjudicator use for interpreting the contract to construct the hypothetical bargain? Is there a method of interpretation that follows from the premises of liberal theory?

The adjudicator's choice of a principle of interpretation depends on why she takes free choice as decisive.[46] For example, the adjudica-

43. Clearly, this question is homologous to a closely related issue in social contract theory: why in the context of fundamental social arrangements a merely hypothetical agreement would be binding, or, more fundamentally, in what way it makes sense here even to speak of an "agreement." For a recent discussion, see, *e.g.*, Freeman, *Reason and Agreement in Social Contract Views*, 19 PHIL. PUB. AFF. 122 (1989) (analyzing views of Gauthier and Rawls). In both contexts, the inquiry must explain why the implied social contract is binding or (more usually) provide a theory about why imagining the contract is a useful heuristic device.

44. *See* C. FRIED, *supra* note 34, at 85-91.

45. Wood v. Lucy, Lady Duff-Gordon, 222 N.Y. 88, 91, 118 N.E. 214, 214 (1917). Language carries with it a wide range of implicit connotative assumptions. It is taken to be situated in a complex set of conventions that constitute the expressive or referential power of even short simple phrases. Once this view of language is adopted, it would enhance autonomy, within the liberal conception, to enforce the intentions recognizable under more sophisticated theories of interpretation. It is wrong not to honor what the parties "would have agreed to" if that hypothetical agreement is part of what the parties did agree to.

46. The commitment to individual autonomy that traditionally goes by the name of liber-

tor might think that free choice is good and agreements should be enforced because we value the discipline that it instills for people to think through their agreements, write them down, and stand by them. With this belief, the adjudicator would be reluctant to enforce merely hypothetical obligations, for such enforcement would dilute the disciplining effect of contracts.[47] In contrast, the adjudicator who believed that the value of freedom of choice lay in the substantive good of constructing and going forward with cooperative projects would reach the opposite result: she would be willing to supply missing terms.[48] To justify a particular mode of interpretation, the interpreter specifies how that interpretive method conforms to a particular conception of autonomy.

In twentieth-century American contract theory, debate has crystallized around two paradigmatic modes of analysis for resolving the problems of interpretation posed by autonomy-based theories of contract. The one mode — the "formalist" — takes meanings as correspondence to a code; the transactor who wishes his "meaning" to be treated as part of an arrangement must make sure that the corresponding code formulation has been invoked. The adjudicator, correspondingly, treats interpretation as a problem of decoding. He consults a rule — or constructs one, if no rule is "on the books" as a matter of

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alism may serve a range of social values. (1) The commitment to autonomy may serve the function of warding off in categorical terms "rent-seeking" or oppressive conduct by powerful subgroups in society, *e.g.*, R. EPSTEIN, TAKINGS 7-18, 331-34 (1985); Shklar, *The Liberalism of Fear*, in LIBERALISM AND THE MORAL LIFE 21 (Rosenblum ed. 1989); (2) it may embody goods of self-actualization, social diversity, and independence from institutional constraint, *e.g.*, N. ROSENBLUM, ANOTHER LIBERALISM 34-56 (1987), or of a culture of trade and moderated self-interest, *see* A. HIRSCHMAN, THE PASSIONS AND THE INTERESTS (1980) ("civilizing" effect of engaging with diverse transactors in the market in cooperative projects); (3) it may follow from "a right" possessed by individuals; (4) it may be adopted to advance a utilitarian social policy, *see* P. ATIYAH, *supra* note 42, at 332-58; Grey, *Langdell's Orthodoxy*, 45 U. PITT. L. REV. 1 (1983) (suggesting an interpretation of nineteenth-century legal formalism in consequentialist terms); (5) rights may arise pragmatically, as a result of a general social consensus on the fair terms of cooperation that arises in turn from both fear of oppression and commitment to self-actualization, *see* Rawls, *Justice as Fairness: Political not Metaphysical*, 14 J. PHIL. PUB. AFFAIRS 223, 248-51 (1985); Rawls, *Kantian Constructivism in Moral Theory*, 77 J. PHIL. 515, 518 (1980).

47. More generally, the autonomy theorist who links the exercise of rights to conscious and articulated choice will be hostile to the enforcement of hypothetical bargains. One accomplishment of Fuller's work was to establish that this extreme view of formality was not necessary to the institution of contract or a necessary implication of basic premises of autonomy. *See* Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800-01, 811 (1941) (comparing grounds for formality with autonomy principle).

48. If the adjudicator mistakenly imposes a term different from what the parties would have specified, then imposition of the term — not chosen by the transactors, and not even implicitly assented to by at least one of them — no longer appears to enhance the parties' pursuit of their particular project, or properly to discover and articulate meanings immanent in their prior words and conduct. Furthermore, if parties are mistaken, the adjudicator may decide that she best fosters autonomy — in helping the parties pursue their projects — by supplying not the terms that they would have chosen given their limited information, but the terms that seems best to the adjudicator in light of all of the information and advantages of the procedures available to her.

statute, common law precedent or trade custom — that states that "indemnification means '*x*'"; he then applies that rule of decoding or translation, regardless of any evidence of what the parties thought. Interpretive conventions are conceived simply as a type of code (or menu) for translating contractual statements into obligations of parties with reference to specific future contingencies.[49]

This formalist interpreter's decisions are based on a claim of entitlement or right. The transactor's compliance with conventional, established rules of meaning entitles that transactor to recover. The formalist simply defines duty by reference to the relevant background conventions. Holmes articulates this variant of the formalist claim in his brief article on the theory of contract interpretation:[50] declining to enforce the conventionally accepted meaning "would run against a plain principle of justice. For each party to a contract has notice that the other will understand his words according to the usage of the normal speaker of English under the circumstances, and therefore cannot complain if his words are taken in that sense."[51] One might say, that is, that each party has a duty to comply with the understandings of the "normal speaker of English under the circumstances."[52] The reconciliation of these parties' claims is then accomplished at the level of interpretive convention.

The alternative "contextualist" mode of interpretation renders judgments by reference to conceptions of fault or desert. As Corbin formulates the problem, the question is whether the party was at fault for using the language as she did.[53] If not, she deserves to have her intent honored as she understood it, even if her understanding fails to comply with any generally cognizable code formulation. Language has a generative or context-specific aspect that resists reduction to code formulations.[54]

It is no accident that the problem of interpretation has been conceived in this way. The conflict between these two models of interpretation exemplifies what Lloyd Weinreb has depicted as the

49. On this approach, there is no a priori reason for contract interpretation to conform to codes or understandings that govern other "language games." The transactors will simply learn, and apply, whatever code the legal system adopts as its system of interpretation, although the legal system should be guided in its choice of conventions by convenience, cost of learning, and so forth.

50. Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417 (1899).

51. *Id.* at 419.

52. *Id.*

53. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161 (1965).

54. The jurisprudential import of this feature of language, and its tension with Holmesian positivism, is emphasized by Ross, *Tû-Tû*, 70 HARV. L. REV. 812, 812-25 (1957).

"antinomic" structure of conceptions of justice.[55] The antinomy arises from two inconsistent but equally powerful ways of interpreting the normative consequences of human action. In one view, rights are determined by entitlement: application of a predictable rule system determines the normative consequences — the rights and duties — of different modes of conduct. A "promise" creates obligations that are determined according to entirely conventional criteria. The structure of claims and benefits is fully determined by natural laws of causality and socially constructed laws that assign entitlements on the basis of actions and their consequences or outcomes.

On the other view, justice requires that a person receive what he *deserves.*

> [S]omeone may resist application of a rule, without questioning that it is the rule and that the conditions for its applications are met. He may assert that its application would be unjust and, if asked to explain further, is likely to say that the person affected by the rule does not deserve whatever are the consequences, beneficial or harmful, of its application.[56]

In contract law, the most familiar example of such a conception is the principle of promissory estoppel. In effect, the promisee who invokes the doctrine seeks an exception to the entitlements (or in her case the absence of entitlement) that the formal requirement of consideration dictates. The promisee must argue, although she has no *entitlement* under the contractual rule of consideration, that nonetheless *justice requires* that the promise be enforced.[57] Clearly, the conception of justice that the promisee invokes must be one that exempts her from the system of entitlements created by rule. Conceptions of desert are the strongest candidate.[58]

This conflict between notions of entitlement and desert appears, as

55. *See generally* L. WEINREB, NATURAL LAW AND JUSTICE 129-265 (1987).

56. *Id.* at 194.

57. *Restatement (Second) of Contracts* § 90, provides that "[a] promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee . . . and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise." RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979).

58. Alternatively, in a few carefully specified circumstances, invocation of promissory estoppel might be justified on grounds of distributive justice. *See, e.g.,* Charny, *supra* note 41, at 440-41, 448.

For a somewhat different formulation of the sources of the conflict between claims of entitlement or right and desert, see Kennedy, *Form and Substance in Private Law Adjudication,* 89 HARV. L. REV. 1685 (1976) (offering a phenomenological account, which is extended in his recent papers, on the phenomenology of judging). Weinreb's discussion deepens common understandings substantially by establishing the connection between the formal antinomies in the application of rules, and the antinomy within analytic conceptions of justice. The bearing to the present argument is direct, then, for the argument here similarly traces the conflict in the construction of hypothetical bargains to this analytic conflict. A merely phenomenological account such as Kennedy's of course suffers the deficiency that it renounces the attempt by analytic

we have seen, when the court *interprets* a clearly enforceable contract. Neither the formalist nor the contextualist view enjoys theoretical dominance.[59] For contract interpretation, particularly, the difficulties with each view are apparent. The formalist view, however appealing from the standpoint of analytic economy, founders on the inevitable incompleteness of formal "codes."[60] Language is sufficiently unclear, and legal conventions about meaning sufficiently difficult to ascertain and learn to use, so that often we do not view individuals as blameworthy when they fail to attain total clarity of meaning in the course of their engagements. If the interpreter cannot make the Holmesian move — which pretermits further inquiry into intention — then the contextualist may point, in some cases, to some further feature of her situation that relieves her of fault. Or, more affirmatively, this lets her continue to deserve to have the interpretation correspond to her intent, as compliance with intent is the core moral principle at issue.[61]

An a priori insistence on the contextualist position is, however, equally unjustified. The mistake in such insistence is well illustrated by Justice Traynor's argument in *Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co.*[62] Justice Traynor argues that the conception of intent, taken with a view of how language and mind work,

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means of those to convince those not willing to recognize that account as descriptive of their experience.

To be sure, Corbin might have wished to situate his arguments about interpretation in the context of communitarian rather than liberal contract theory. In particular, Mort Horwitz suggests in his forthcoming work on legal realism that Corbin's early writings (in the 1910s) employ the critique of contract formalism to further the larger social project of replacing the market with more solidaristic or progressive forms of social relationship. *See infra* section II.B (communitarian theory). Whatever Corbin's political conception, however, his work has powerfully influenced liberal conceptions of contract.

59. Indeed, the apparent subsistence of the two views throughout the law of contractual obligation confirms, I believe, Professor Weinreb's argument that the antinomy of these two conceptions is an inherent feature of our conceptions of justice. *See* L. WEINREB, *supra* note 55, at 221-22. As Professor Weinreb observes, in a society "that preserves large areas of life for private arrangements," entitlements created by the rules for transfer inevitably are based simply on those entitlements and not on the recipient's deserts. *Id.* at 217.

60. Codes are most likely to be incomplete for cases that come before court. Cases are likely to be settled unless parties have different ex ante predictions of how the case will come out, *see* Bebchuk, *Litigation and Settlement Under Imperfect Information,* 15 RAND J. ECON. 404 (1984), which is more likely if the code is incomplete than if it is relatively complete. Further, if courts do not have conscious a policy of developing formal code, they are likely to generate, entropically, ever increasing diversity and complexity.

61. *Cf.* Eisenberg, *The Responsive Model of Contract Law,* 36 STAN. L. REV. 1107, 1107-12, 1117-27 (1984) (describing law's move toward contextualist approach as development of general principles); Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms,* 73 CALIF. L. REV. 261, 306-09 (arguing that the law continues to be ambivalent between formalist and contextualist approaches).

62. 69 Cal. 2d 33, 442 P.2d 641, 69 Cal. Rptr. 561 (1968). Justice Traynor's rendition of the problem adopts from Corbin an analysis that appears to make an epistemic claim for contextualized interpretation based on reconstruction of meanings that the parties would recognize as their own.

implies a highly contextualized form of interpretation, one that proceeds beyond the "literal" or apparent meaning of the document itself to look at the facts and circumstances under which the agreement was concluded. " 'A word . . . has *no . . . meaning,*' " argues Justice Traynor, apart from " 'verbal context and surrounding circumstances and purposes in view of the linguistic education and experience of their users and their hearers or readers.' "[63] This argument conflates without justification two different senses in which "context" is necessary to understand language.[64] To say something about what a statement means we must make some suppositions — substantial presuppositions — about the speaker.[65] But to identify context in this sense does not require — as Traynor seems to think — that context so defined be determined in any particular way, by reference to any particular evidence.[66] Both must be "interpreted" if they are to guide decision. And there is no epistemic or semantic reason to think that the judge has more direct insight into the meaning of statements made in negotiation, of the thoughts of the parties, of internal memoranda, of trade customs, than she has into the meaning of the contractual language itself. Nothing about the necessary contexts that provide the basis for interpretation can tell one how far one should go in getting information about that context. That verbal meaning requires a "context" does not imply that any particular type of evidence is needed establish intention.[67]

2. *Methodology*

We can complete the specification of the autonomy theorist's methods of constructing hypothetical bargains by following through the consequences of the two interpretive paradigms identified above. On the one hand, theories of autonomy that embrace conventionalist

63. 69 Cal. 2d at 38, 442 P.2d at 644, 69 Cal. Rptr. at 564 (emphasis added) (quoting Pearson v. State Social Welfare Bd., 54 Cal. 2d 184, 195, 353 P.2d 33, 39, 5 Cal. Rptr. 553, 559 (1960) and Corbin, *supra* note 53, at 187).

64. *Cf.* Minow & Spelman, *In Context,* 63 S. CAL. L. REV. 1597, 1602-06, 1625-39 (1990) (tracing an analogous multiplicity in the meanings of "context" in public law and moral discourse).

65. For analytic demonstration of this point, see the sources cited *supra* note 18.

66. Traynor's particular concern is that judges should not supply assumptions about context. The exercise of interpretive judgment inheres in the resolution of the contract dispute. The parties' "circumstances" no more offer themselves up to direct, unmediated apprehension than does the language of the contract itself.

67. Traynor's approach reflects clearly the influence of Corbin's classic essay, Corbin, *supra* note 53; both Corbin and Traynor have, in turn, influenced the erosion of the rule in other jurisdictions. *See, e.g.,* Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 140 Ariz. 383, 393-94, 682 P.2d 388, 398-99 (1984); Admiral Builders Sav. & Loan Assn. v. South River Landing, Inc., 66 Md. App. 124, 126-32, 502 A.2d 1096, 1098-100 (1986); Bryan v. Vaughn, 579 S.W.2d 177, 181-82 (Mo. App. 1979).

or code-oriented views of interpretation generally lead to principles of contract justification based simply on the policies to be served by a system of contract, without regard to claims of right or justice. Most often, the goal is simply to facilitate commercial transactions; that is, act-based theory endorses the instrumentalist goal, for contract, of reducing the cost of transacting.[68] Other "principles of justice" are not in play: the adjudicator then simply would adopt the recommendations of economic analysis.[69]

On the other hand, the contextualist offers a set of principles that may diverge from norms of minimizing transaction costs. There are two reasons for this: one bears on the level of generality, the other on the degree of idealization, at which the adjudicator constructs hypothetical bargains.

Regarding generality, the contextualist may emphasize the resulting particularized fit with intuitions of the transactors whose disagreement is the subject of adjudication. The contextualist emphasizes that a hypothetical bargain is authoritative because it is grounded on the understandings and practices of the particular persons to whom the interpretation is applied. Because contractual obligation is rooted in the articulated acceptance of obligation, those upon whom obligation is imposed must recognize the obligation as one that they would have adopted willingly. The interpretation "makes sense" of the parties' understanding better than any other interpretation. On this view, the interpreter — the judge in the contract case — should exercise situated judgment: he should make the interpretive judgments by using the methods, and applying them to the material, of the participants in the practice — the transactors — themselves.[70] To construct the hypothetical bargain, then, one should ask what stipulated term makes

68. *Cf.* Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract,* 18 J. LEGAL STUD. 105, 105-06 (1989) (identifying convergence of what parties agree to and what rational parties would agree to).

69. *See infra* section III.C (application of transaction-costs framework).

70. The conception of interpretive method that this entails has been most clearly articulated by commentators who understand the common law or, indeed, political deliberation more generally, as such an interpretive practice. Dworkin, for example, writes: "[The interpreter] undertakes [interpretation when he] use[s] the methods his subjects use in forming their own opinions about what [the practice] requires. He must, that is, *join* the practice he proposes to understand . . . ." R. DWORKIN, LAW'S EMPIRE 64 (1986). What counts as interpretation is a more lucid explanation to the subjects of their own purposes and actions of what they themselves are doing.

> [H]uman behaviour seen as action of agents who desire and are moved, who have goals and aspirations, necessarily offers a purchase for descriptions in terms of meaning — what I have called "experiential meaning." The norm of explanation which it posits is one which "makes sense" of the behavior, which shows a coherence of meaning. This "making sense of" is the proffering of an interpretation . . . .

C. TAYLOR, PHILOSOPHY AND THE HUMAN SCIENCES 26 (1985) (formulation is in the context of an argument for interpretive "science," but the definition is presented as a more general defini-

sense of the parties' project, as the parties themselves understand it? To use the colloquial phrase, the legal decisionmaker should apparently try to put herself "in the shoes of the parties" at the time that they were making their transactional decisions.[71]

The premise of the paternalistic variant to autonomy-based contract adjudication is that transactors may *wrongly* understand what terms they should consent to. The adjudicator can then enhance the transactors' autonomy to correct mistakes of judgment. For hypothetical bargains, this means that the adjudicator reaches an understanding of the bargain different from that the transactor would reach or even find convincing or comprehensible. A useful description of judgment, in this regard, is provided by Hannah Arendt.

> [The process of judgment] does not blindly adopt the actual views of those who stand somewhere else, and hence look upon the world from a different perspective; [it] is a question neither of empathy, as though I tried to be or to feel like somebody else, nor of counting noses and joining a majority but of being and thinking in my own identity where actually I am not.[72]

The paternalistic element of this approach is more explicit in the following example:

> Suppose I look at a specific slum dwelling and I perceive in this particular building the general notion which it does not exhibit directly, the notion of poverty and misery. I arrive at this notion by representing to myself how I would feel if I had to live there, that is, I try to think in the place of the slum-dweller. The judgment I shall come up with will by no means necessarily be the same as that of the inhabitants, whom time and hopelessness may have dulled to the outrage of their condition . . . . [W]hile I take into account others when judging, this does not mean that I conform my *judgment* to those of others . . . .[73]

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tion of interpretive practice). For analysis of the use of this approach in construing *statutes,* see R. POSNER, THE PROBLEMS OF JURISPRUDENCE 203-06 (1990).

As a foundational matter, it should be noted that contemporary liberals apparently agree generally on the authority of this method of interpretation for discovering normative principles. To take two liberal autonomy theorists with very different programmatic commitments: both Rawls and Epstein argue that their conception of political or legal norms derive from careful reflection upon generally accepted moral presuppositions built into our language and practices. Rawls appeals to the commitment in our political culture to fostering individual autonomy and self-respect, aspects of which are captured in the primary goods; Epstein appeals to the norms of responsibility for action reflected in everyday language and moral judgments. Where Rawls and Epstein differ, then, is in the interpretive inferences that they purport to draw.

71. To the extent that the community of transactors shares a well-developed set of assumptions about what is reasonable for given transactions, the approach would seem to work quite well by consulting these accessible (in the community) assumptions. *See, e.g.,* U.C.C. § 1-205 (1986) (course of dealing and usage of trade).

72. H. ARENDT, *Truth and Politics,* in BETWEEN PAST AND FUTURE 227, 241 (1968). That the autonomy theorist might adopt this conception of judgment does not imply that Arendt herself should be taken as an example of such a theorist.

73. H. Arendt, Basic Moral Propositions (unpublished lecture at the University of Chicago)

For the autonomy theorist, the important structural feature of paternalism in constructing hypothetical bargains is that paternalism does not infringe upon the transactor's freedom to choose, as it would were the adjudicator making a decision that overrode the transactor's *actual* choice. The construction is *hypothetical* precisely because the transactor made no explicit prior choice.

To take a simple example, consider the question whether an employer may fire an employee to avoid paying him a share of merger gains. The employment contract does not address the question, for the parties articulated no explicit term to cover the question.[74] The court imposes a duty to share merger gains on principles of hypothetical bargain that are paternalistic: the adjudicator asks what the "ideally rational" employee would have bargained for.

If the contract is silent, the parties made no explicit choice on the issue. The principle of autonomy that requires courts to honor parties' choice is simply not in play: the parties made no choice. The adjudicator should therefore consult other principles of autonomy. The court might conclude, for example, that principles of autonomy require fair sharing of gains and losses not allocated by prior agreement among the parties but plausibly attributable to their joint efforts. Or it might further autonomy to construct the arrangement for the parties that corresponds to what rational parties — parties attentive to and understanding of a rational life-plan — would have agreed to.

The crucial point is that the principle of autonomy that requires adjudicators to honor parties' *express* commitments does not correspondingly require courts to hew rigorously to what the parties would have done, if there is no express agreement. Rather, the adjudicator should proceed by consulting other principles of decision that are true to her conception of autonomy.

To be sure, some principles of autonomy suggest that the adjudicator hew closely to what the parties would have done. Consider, for example, an adjudicator who enforces express agreements because she believes that she should limit as much as possible her imposition of her own views of desirable social organization. She considers that enforcing express agreements to resolve disputes usefully limits the scope of

quoted in Beiner, *Hannah Arendt on Judging*, in HANNAH ARENDT, LECTURES ON KANT'S POLITICAL PHILOSOPHY 89, 107-08 (Beiner ed. 1982) (emphasis added).

74. Of course, what one treats as the explicit term itself depends upon the interpretive principles that the judges will employ. The antipaternalist will say that she will not impose an outcome that overrides express terms. For these purposes, one should determine whether the term is "express" by deciding whether it indicates a conscious decision of the parties about their duties under the contingency now at issue, for it is to the overriding of this choice that the antipaternalist objects.

public power and thereby wards off tyrannical impositions among individuals.

This adjudicator might contend that her principle also requires, in the absence of express agreement, that she try to reconstruct what these parties would have done to resolve the dispute. Like her rules about express agreements, such a rule would serve to limit her power. As a heuristic device, it would — if she could adhere to it rigorously[75]— force her to resolve the dispute on principles that others (the transactors) would have chosen, rather on the principles that she herself prefers. In this way, her approach might appear to limit arbitrary exercises of power.

But other reasons to value autonomy do not as readily suggest this particular approach to hypothetical agreements. Consider, for example, the adjudicator who values autonomy because she considers that it serves an important disciplinary function to require persons to specify their arrangements and then live by them. This approach to autonomy would not lead the adjudicator to be sympathetic to careful reconstruction of the individual parties' choices for cases in which they were silent. Indeed, the adjudicator might be inclined to think that for her to "help the parties out in this way" might dilute the disciplinary force of her adherence to express agreements. She might then proceed by other hypothetical bargain rules — for example, she might assume that parties meant to reserve discretion on all issues on which their agreements were silent.

Most clearly, an autonomy theorist holding to a strong principle of autonomy for situations where there is no express choice would not feel that she compromised her principles: in determining that no strong principle applied where no express choice had been made she would be following her principles rigorously. This is not a case of persons "forced to be free," in Rousseau's infamous phrase. The parties are not being forced here, in the sense of having their express choice overridden; the hypothetical bargain question arises because there is no express choice.

For hypothetical bargains, then, autonomy theorists do not necessarily find it problematic to impose a bargain different from what these particular parties actually would have done, provided that doing so would enhance autonomy in this other respect.[76] The answer turns on why autonomy seems to be the relevant value.

75. As Arendt suggests, some degree of idealization may inhere in the exercise of judgment, simply because it is impossible to enter fully into the thinking of another person.

76. In other words, the autonomy theorist attaches less importance to fulfilling implicit expectations than to enforcing expressly chosen arrangements.

3. *Conclusion*

The discussion has identified two basic approaches. On the one hand, the autonomy theorist may recommend that hypothetical bargains be constructed simply to minimize transaction costs. He would do so if he considered that transactors could be expected to understand and conform to the conventional standards established on the basis of transactions-costs criteria.[77] On the other hand, the autonomy theorist may recommend that the adjudicator depart from the transaction costs analysis in two respects: this approach postulates a value of "fit" with transactors' expectations, and it may commend that adjudicators should correct transactors' mistakes.

B. *Hypothetical Bargains Within Reciprocity-Based Theories of Contract*

1. *Justification*

The role of hypothetical bargains here varies with the emphasis that the theorist places upon consent. Consider first the theorist who takes consent as conclusive, or at least strongly presumptive, evidence that the contract contemplates a fair exchange of benefits. On this view, the fact that the parties would have consented to a term seems to be strong evidence that the term is fair. The hypothetical bargain exerts the same authority as an actual bargain.[78] The imagined or hypothetical consent indicates the scope of benefits to be conferred.[79] Like the autonomy theorist, however, the benefit theorist who attaches presumptive value to consent must have a theory of interpretation that explains *what the transactors have consented to.* The questions that arise here, then, are in large measure those that we have analyzed for autonomy-based theories.

For the adjudicator who works with a more complex conception of fairness, an account of the authority of the hypothetical bargain is correspondingly more complex. An adjudicator who thought that abuse

77. That is, the conventionalist autonomy theorist is unwilling to adjust conventions to help individuals who claim that they did not appreciate the consequences of the background conventions for their transactions.

78. An actual bargain would exert greater authority only because it is more convincing evidence of fairness than a mere hypothetical bargain — presumably, because the adjudicator may not have quite the confidence in her hypothesis about the outcome of bargaining that she would have in the actual bargain.

79. In economic terms, the "expected value" of the payoff to each party over all expected contingencies — the (best possible) ex ante valuation of the benefits to be given ex post — should be equal for the two parties. Then, various contingencies should be treated so as to hold these benefits equal, under the hypothetical bargain formulation. This gives rise to great practical difficulty because one would have to value outcomes under every contingency, in theory, to decide whether one has assessed the hypothetical bargain correctly.

of informational advantages or economic power was widespread would mitigate the influence of these factors by her methods for constructing hypothetical bargains, just as she does for her rules about interpreting and enforcing actual bargains.

First, the adjudicator may construct hypothetical bargains that strongly idealize the participants — that assume the (desired) equality of knowledge and bargaining power. Most commonly, a communitarian adjudicator would attempt to determine "what the parties would have agreed to" by consulting socially extant expectations of fairness or reasonableness. For example, these adjudicators frequently limit the employer's right to fire an at will employee by referring to "reasonable expectations" of the worker.[80] The adjudicator defines these reasonable expectations by reference to "community standards" or social understandings about appropriate conduct in the workplace.[81]

Second, the communitarian adjudicator might also adopt the hypothetical bargain framework to *induce* individuals to form preferences in a way that the adjudicator conceives to be rational. The adjudicator who constructs a "rational" hypothetical bargain — who attempts to discover forms of rationality or commitments that individuals had left unarticulated — may convince individuals to adopt or endorse values in their relationships that they would not otherwise have adopted,[82] or

80. *See, e.g.,* Foley v. Interactive Data Corp., 47 Cal. 3d 654, 680, 765 P.2d 373, 387, 254 Cal. Rptr. 211, 225 (1988); Woolley v. Hoffman-LaRoche, Inc., 99 N.J. 284, 290-92, 301-04, 491 A.2d 1257, 1260-62, 1266-68, *affd. in part, revd. in part,* 101 N.J. 10, 499 A.2d 515 (1985).

81. From one perspective, it might seem that the communitarian adjudicator who arrived at her communitarian stance by a conviction of the pervasive irrationality, stupidity, and false consciousness of transactors might abandon the hypothetical bargain standard altogether. She would instead simply impose what she thought was best for transactors. But, to remain consistent to her communitarian commitments, the adjudicator should adhere to the hypothetical bargain standard rather than simply impose her own judgment. Indeed, the premises of contemporary communitarian thought would require her to do so. For the communitarian would consider that she determines what is best not from standards derived from some transcendental perspective, but rather from the standards of some relevant community. In asking what transactional structure, that is, what allocation of risk for a given contingency, is fair, the communitarian adjudicator asks, then, how the standards of the community that she takes as her guide — which may, of course, be some ideal community of other-regarding and rational social actors — would structure the transaction. In short, she conducts an inquiry into the hypothetical transactional structure or hypothetical bargain for that community.

82. A conception of preference formation through adjudication is the most coherent, perhaps the only coherent, way of making sense of attempts to describe deliberation in law as a rhetorical process. For a development of this conception, see J.B. WHITE, *Reading Law and Reading Literature: Law as Language,* in HERACLES' BOW: ESSAYS ON THE RHETORIC AND POETICS OF THE LAW 77, 91-100 (1985) [hereinafter HERACLES' BOW]. Indeed, the conception of governance by law as a process of persuasion rather than coercion can be traced to Plato, who, in the Statesman and the Laws, emphasized that the legal decisionmaker must "produce and maintain a general conviction that the laws are right and proper and just." Plato's point is that to extract the citizen's obedience to the law by mere coercion, however effective, is a wrong. *See* R. BUXTON, PERSUASION IN GREEK TRAGEDY 53-57 (1982).

The alternative, epistemic view of rhetoric sees rhetoric as systematically antithetical to realist, or more sweepingly nonrelativist, claims about truth. The best philosophical introduction is

enable them to discover their commitments to values that were somehow latent in previous conduct or social ties.[83] Adjudication under the hypothetical bargain standard is thus a process of *forming* preferences, rather than simply following them.[84]

Third, conservative communitarian adjudicators might hold that the fit with ordinary expectations or embedded community values gives persuasiveness or legitimacy to legal judgments based on hypothetical bargains. Enforcement of social norms via hypothetical bargains provides an opportunity for individuals to voice their concerns in a familiar vocabulary instead of in the technical language of efficiency

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H. BLUMENBERG, *Anthropologische Annäherungen an die Rhetorik*, in WIRKLICHKEITEN IN DENEN WIR LEBEN 104 (1981). In particular, some lawyers seek in this philosophical tradition a justification for treating all the truths upon which legal judgments are based as subject to change by community consensus. *E.g.*, Frug, *Argument as Character*, 40 STAN. L. REV. 869, 871-82 (1988). The difficulty with this position — at least for present purposes — is that it confuses the dependence of our access to truth upon some "mere" conventions with the possibility that we can change the status of those truths, in any way we please, simply by agreeing to *change* the background conventions. To the contrary, it seems clear that the character of the natural world, and of human faculties, places limits, albeit poorly understood, on the conventional systems that persons can live by and, more clearly, on their capacity to change governing conventions at will.

83. *See* C. TAYLOR, *supra* note 70, at 9-11, 91-115.

84. On one account, see Tribe, The *Curvature of Constitutional Space: What Lawyers Can Learn from Modern Physics*, 103 HARV. L. REV. 1, 17-23, 23 n.90 (1989), the interaction between adjudication self-understandings and preferences can be understood by analogy to the Heisenberg uncertainty principle. This principle is often thought to demonstrate that the intervention of the observer affects the observed values for variables that define the position and momentum of subatomic particles. There is, however, substantial reason to doubt the coherence of the disturbance theory version of uncertainty relations in quantum mechanics. *Compare, e.g.*, *id.* at 18 n.66 (describing Heisenberg's gamma-ray microscope thought experiment) *with* M. REDHEAD, INCOMPLETENESS, NONLOCALITY AND REALISM: A PROLEGOMENON TO THE PHILOSOPHY OF QUANTUM MECHANICS 67-68 (1987) (Heisenberg's analysis of the gamma-ray microscope thought experiment assumes that one of the particles is nonquantal, which leads to contradiction); Brown & Redhead, *A Critique of the Disturbance Theory of Indeterminacy in Quantum Mechanics*, 11 FOUND. PHYSICS 1 (1981) (proof); *see also, e.g.*, Bell, *On the Problem of Hidden Variables in Quantum Mechanics*, 38 REV. MOD. PHYSICS 447 (1966) (alternative interpretations of uncertainty principle); Bell, *Six Possible Worlds of Quantum Mechanics*, in SPEAKABLE AND UNSPEAKABLE IN QUANTUM MECHANICS 181 (1987) (same).

More fundamentally, one might question the extent to which useful analogy can be drawn between legal reasoning and reasoning in the physical sciences. Quantum mechanics as now understood leaves inexplicit the conditions under which some indefinite or probabilistic eventualities that *characterize* quantum systems are actualized at the level of an observer using a macroscopic ("ordinary" physics) apparatus. It is hard to see how a legal (or moral) system that must render judgment in concrete cases could live with an analogous indeterminacy. Indeed, one interpretation of the quantum-mechanical ambiguity — Hugh Everett's many worlds interpretation — "wipes out the distinction between potentiality and actuality, which is central to decision making, to ethical choice and to all practical activity. . . . 'If such a theory were taken seriously it would hardly be possible to take anything else seriously.'" Shimony, *Conceptual Foundations of Quantum Mechanics*, in THE NEW PHYSICS 373, 393 (P. Davies ed. 1989) (quoting Bell). And Niels Bohr's more generally accepted interpretation of quantum mechanics — which simply posits that the paradoxes of quantum mechanics reflect inherent limitations on the scope of human knowledge — would, if applied to ethical choice, similarly seem to posit the impossibility of making a set of ethical (or legal) judgments that cohered in any systematic way. Bohr's papers are collected in QUANTUM THEORY AND MEASUREMENT (J. Wheeler & W. Zurek eds. 1983).

On these tentative grounds, I shall not further pursue, in the present Article, the implications of Tribe's formulation for contract adjudication.

analysis.[85] It thus provides for meaningful participation, rather than decision on the basis of technical and sometimes obscure criteria. Further, it assures that these claims will not be denigrated by a mere technocratic calculation of variables. Adjudicators should, on this view, employ a heuristic — reconstructing reasonable expectations — that result in decisions readily transparent or apprehensible to particular transactors.

2. *Methodology*

The basic structure of hypothetical bargain analysis follows readily from these considerations. Again, let us begin with the question of how general the hypothetical contract inquiry should be. If the hypothetical contract inquiry is designed to discover what the parties would have considered to be a fair conception of benefit, then the degree of generality should be determined by how much a perception of fair exchange varies among individuals. If individuals' preferences differ regarding the various contingencies at issue or their conceptions of what would constitute a *fair* exchange differ, then the hypothetical bargain should be tailored to those differences. In this way, even more strongly than the autonomy conception, the benefit-based conception would endorse a mode of interpretation that emphasizes the *particularized* interpretation of transactors' expectations and understandings.

Greater degrees of generality or ideality, conversely, would be justified by appeal to *social* rather than *individual* consensus about the definition of benefit or a just arrangement: this view questions the existence, rationality, or legitimacy of variations among individual transactors in their perceptions of the value of benefits exchanged under various contingencies. Three types of considerations arise. First, an adjudicator applying considerations of benefit might conclude that there was general social consensus about how various types of transactions should be structured, so that there was little need for inquiry into variations of perceptions or preferences among individual transactors.[86] Second, the adjudicator might believe that variations in judgments were misguided — that individual transactors differed in what they imagined would be provided for under various contingencies because they *wrongly* appreciated what would constitute a fair exchange of benefits. Workers, for example, might not realize that they should not consent to be fired at will, either because they underesti-

85. *See* J.B. WHITE, *Fact, Fiction, and Value in Historical Narrative: Gibbon's Roads of Rome* in HERACLES' BOW, *supra* note 82, at 139, 151-59.

86. *See generally* Linzer, *Uncontracts: Context, Contorts and the Relational Approach*, 1988 ANNUAL SURVEY OF AMERICAN LAW 139, 151-95.

mate the costs that this would impose on them or because they misapprehend the importance of the term to employers. Or, conversely, employers might be overly generous with workers because they find it appealing or convenient to pacify workers in this way.[87] Third, a benefit theorist might note that differences in preference reflect "illegitimate" positions in social hierarchy. Constructing hypothetical bargains to ignore these would be an indirect way to correct for these differences (a version of false consciousness arguments). The adjudicator's independent determination, or general consultation of social values, would be more rational.

3. *Conclusion*

Conceptions of fairness, like those of autonomy, accommodate a range of methods for constructing hypothetical bargains. The fairness theorist could simply endorse the use of the transactions-costs framework for constructing hypothetical bargains. The theorist would do so if she assented to two premises: (1) the transactors' assent provides conclusive evidence of a transaction's fairness; and (2) the transactors assented to the entire set of conventional background terms commended by a transactions-costs analysis.[88] Contract lawyers committed to fairness theories, however, are unlikely to accept either of these premises.

Instead, theories of fair exchange suggest two modifications to instrumentalist theories. First, the adjudicator who constructs hypothetical bargains should see an affirmative value in reaching results that conform to transactors' reasonable expectations. It is a good to confirm the authority of individuals' communally shared attachments and understandings. Second, the adjudicator should idealize the construction of hypothetical bargains by conforming the terms of the contract to arrangements that ideally rational transactors would view as fair.[89]

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87. *Cf.* Williamson, *Comment*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 61, 64-66 (A. Auerbach ed. 1988) (On one formulation, employers' payment of supra-market wages is a way of sharing oligopoly gains: employers purchase employee placidity).

88. Also, a communitarian might conclude that her goals regarding fair social arrangements could not be advanced through regulation of consensual transactions, so that minimizing transaction costs is the only relevant social goal. This is unlikely without further analysis of the sort described in Part III.

89. The adjudicator might affirm these goals even though the resulting hypothetical bargains raised the cost of transacting. For example, an elaborate judicial inquiry into the individual expectations of every fired worker would impose enormous costs on the employment relationship. J. Dertouzous, E. Holland & P. Ebner, The Legal and Economic Consequences of Wrongful Termination, ix (1988) (study conducted for the Institute for Civil Justice of the RAND Corporation) (estimating annual cost of wrongful termination suits). While workers might not wish to bear the costs in the form of reduced wages — and, in that sense, it is clearly inefficient to

A clear conflict exists between these two strands of fairness-oriented theory. One might say that conservative communitarians differ from radical ones by their relative emphasis on deference to extant communal understandings rather than those reconstructed in terms of some stipulated social ideal.[90] Communitarian lawyers tend to resolve the conflict between the two principles with a case-by-case assessment of the parties' rationality, equality of bargaining power, and the like. Either principle, however, may in theory demand outcomes different from those commended by an analysis based on transaction costs or on conventionalist autonomy theories.

C. *Instrumental Grounds for Enforcing Hypothetical Bargains*

1. *Justification for Enforcing Hypothetical Bargains*

The interpreter guided strictly by instrumental considerations[91] would enforce hypothetical bargains because to do so reduces the costs of forming contracts. It is useful to begin the analysis with a simple pair of assumptions: transactors and adjudicators are ideally rational, and adjudication is costless. That is, the only costs that transactors face in forming contracts is the cost of finding a transacting partner and of specifying contract terms. Adjudicators accurately will fill contractual blanks with the terms that the parties would have bargained for. On these simple assumptions, transactors would not have to write down any terms at all.[92] Transactors would know that the law enforces whatever terms that transactors *would* specify; consequently, transactors need not actually incur these costs to get the benefits of the term. The adjudicator will enforce the same terms whether the trans-

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impose them — the communitarian theorist might nonetheless persist in reading these terms into the hypothetical contract: the theorist might claim that these suits vindicate workers' fair expectations, regardless of their actual bargaining behavior, and that the workers' unwillingness to bear these costs is irrational or manifests "false consciousness."

90. *Compare, e.g.,* Oakeshott, *Rationalism in Politics,* in RATIONALISM IN POLITICS AND OTHER ESSAYS 1 (1962) *with* J. HABERMAS, LIFEWORLD AND SYSTEM: A CRITIQUE OF FUNCTIONALIST REASON 153-98, 374-404 (T. McCarthy trans. 1987).

91. Again, recall the basic conception set forth in the introduction to this Part.

92. They would simply have to take some action (say, shake hands) to identify their transactional partner. In the law, the set of rules closest to this paradigm is the sale of goods under article 2 of the UCC. If two individuals identify a good that they intend to sell (for less than $500) and indicate their agreement to the sale, the UCC specifies, or authorizes the court to provide, virtually all of the remaining terms, including such matters as price, time and place of delivery, and damages for breach.

Some readers have asked why, if we are willing to go this far, we would not go even farther and permit courts not only to fill in all available terms, but also to match up transacting partners. In some circumstances, of course, the law does precisely that, *see generally* Levmore, *Explaining Restitution,* 71 VA. L. REV. 65 (1985); but in general the law is much less willing to create transactions hypothetically than it is hypothetically to specify obligations for extant contractual relationships. Levmore persuasively identifies the reasons for this greater reluctance.

actors draft a contract that includes those terms or not. The hypothetical bargain standard thus would sharply reduce the cost of transacting.

Adjudication costs complicate the analysis. The adjudicator who aims to minimize the total social costs of transacting will consider two effects of imposing a hypothetical term. Formulating the term will save the parties the costs of doing so,[93] but it also incurs costs — specifically, the adjudicator's costs of imposing the term. It may be cheaper for the parties to incur the costs of formulating the term than for the court to do so ex post. For example, determining the proper term ex post might involve costly factual inquiries that could be obviated by the parties' disclosures when they negotiated the appropriate term.[94] Thus, with imperfectly informed transactors the adjudicator must consider the effect of rules on incentives to discover or reveal information.[95]

In corporate and commercial law, lawyers have tended to assume in applying the hypothetical bargain paradigm that all rational buyers and sellers, debtors and creditors, and so on, will bargain to the same terms.[96] This is quite convenient, because one then can identify unambiguously what term the court should supply — the term that all of the parties would bargain for. The adjudicator then would save the parties the costs of negotiating the term in each contract, once the transactors understand that the law will provide the term for them.

93. These costs are (1) costs of specifying terms; (2) losses from forgoing transactions for which minimally acceptable agreements cannot be drafted or enforced; (3) costs from suboptimal conduct, by one party during the course of the contract, that is permitted because it was impossible to draft a contract provision that would prevent it; (4) costs from litigation when disputes arise over the import of contract terms. For a typology and discussion, see, *e.g.*, Ellickson, *The Case for Coase and Against "Coaseanism,"* 99 YALE L.J. 611 (1989).

The second type of cost, forgoing transactions, requires further explanation. The parties may decide not to transact at all if they cannot specify a set of contract terms that appropriately create incentives or assign risks for contingencies that might arise as the transaction proceeds. If the parties decide not to transact at all, then the resulting social loss is the lost benefit that the parties jointly could have derived from the transaction if acceptable terms could have been drafted.

94. An additional problem here is the externality that results because the public bears some costs of adjudication, whereas parties bear the costs of private negotiation.

95. For example, if courts often fill in, this may save parties transactions costs but incur large costs ex post. If courts always fill in one way, this may reduce information costs by encouraging parties to bargain or reveal information if they want a different outcome. Ayres & Gertner, *supra* note 6; Bebchuk, *supra* note 6; Coleman, Heckathorn & Maser, *supra* note 6; and Shavell, *supra* note 22, analyze examples of this phenomenon, such as disclosure of material information and disclosure of consequential or special damages.

96. *See, e.g.*, Easterbrook & Fischel, *Close Corporations, supra* note 6, at 283 n.36 ("the silence in the explicit contracts itself poses a problem of contract — the parties could solve it if they wished and were willing to bear the costs of transacting, and until they do, it is better to select the legal rule that promotes the joint wealth of the parties than to select a legal rule that defeats this (anticipated) preference"); *id.* at 298 ("[t]he right inquiry is always what the parties would have contracted for had transactions costs been zero").

Legal decisionmakers save transactors some of the costs of transacting by reducing fees to lawyers, brokers and investment bankers.[97]

Justifying the hypothetical bargain is more complex when the adjudicator will enforce a hypothetical bargain against transactors, some of whom might have bargained to a *different* term had they done so explicitly, that is, if some transactors are made better off under one formulation of the hypothetical bargain, but other transactors are better off under a different formulation. To take a relatively simple example, consider the case in which there are two possible rules and the costs of bargaining around each rule are the same. Suppose, for example, that courts must choose between "at will" and "good cause" as the standard for firing workers. Suppose further that eighty percent of worker-firm contracts would, if explicitly bargained, contain the at will rule; twenty percent would contain the good cause standard. The cost of specifying "at will" if the governing law presumes "good cause" equals the cost of specifying "good cause" if the governing rule presumes "at will." In that case, obviously, the decisionmaker should choose the rule that the parties would choose in most transactions, letting transactors in the minority of transactions who have different preferences specify their preferred alternative.

But minimizing the number of transactions in which parties bargain around the rule will not always minimize the cost of transacting. One must consider the costs that would be incurred from each possible specification of the term.[98] Suppose, for example, that it is ten times more costly for workers to specify a contractual good cause provision, with a background at will rule, than for workers to specify a contractual at will rule, when the background legal regime specifies good cause.[99] Then the adjudicator should choose the good cause rule: it minimizes the net costs of transacting for firms and workers. Generally, then, the legal decisionmaker should choose a term that would actually be desired in relatively few transactions if it is much cheaper to bargain around that term than it would be for the few parties who want that term to bargain for it (or to submit to the terms that others want or to not transact).[100]

97. Even when parties differ, they still may be situated so that all parties are at least as well off after the hypothetical bargain rule is adopted.

98. For this example, I put aside litigation costs.

99. An "at will" opt out might be a single sentence in a contract whose meaning can be easily assessed, while "good cause" might only be plausible if it carries with it a relatively complex and detailed set of contractual specifications that individual workers can assess only at great cost.

100. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1413 n.69 (1989), provides an example of redistributive consequences in choice of corporate law rules.

But the value of the resulting cost savings is quite controversial. The adjudicator saves costs for some transactors by imposing an undesired term on other transactors. Why should some transactors benefit at the expense of others?

A welfarist might compare utilities among individuals to make some general estimate of social good accomplished by alternative rules. The taboo against direct comparisons of utility among individuals by policymakers has tended to discourage explicit use of this approach.[101] Unfortunately, the most common alternative approach to justification — what one might call the "Rawlsian"[102] construction of hypothetical bargains — is incoherent; it both requires and endorses the interpersonal utility comparisons that it purportedly avoids.

The Rawlsian approach imagines the universe of potential transactors choosing rules when placed behind a "veil of ignorance": transactors do not know what they will know when actually transacting, particularly not whether they will be buyers or sellers, endowed with a certain set of resources and so on, yet possessing certain basic facts about preferences and human nature. The correct rules are the ones that transactors so situated would *unanimously* adopt.[103] For example, to construct rules for allocating benefits among shareholders, one might place all shareholders behind a veil of ignorance — not letting the shareholders know, in particular, which corporations or types of stocks they would have invested in — and ask what rules the shareholders would choose about allocation of benefits from corporate action.

For the hypothetical bargain as a standard of *legal* decisionmaking, this Rawlsian formulation amounts to no more than a way of cloaking the taboo comparison of interpersonal utilities or distributive

101. On the function of such taboos, see Clark, *supra* note 6, at 1737. The "taboo" character of the intellectual ban against direct interpersonal utility comparison is particularly striking both because such comparisons would seem to be a common and perhaps necessary feature of ordinary human life, *see, e.g.*, Davidson, *Belief and the Basis of Meaning*, *supra* note 18 (arguing that such comparisons are intrinsic in our acknowledgement that there are other "persons"), and, as I suggest below, implicit in the alternative forms of argument that are used to circumvent the making of such comparisons.

102. I hasten to add here that I do not consider "Rawlsian" an appropriate label, though it is so commonly used that I acquiesce in it. As I explain below, this approach borrows an analytic device from Rawls' work — the veil of ignorance. But, as a justificatory matter, its use is not a consequence of Rawls' analysis and indeed may be inconsistent with it. In any event, this method of aggregating preferences is presented from an instrumental perspective in Harsanyi, *Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309 (1955).

103. *See, e.g.*, Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 875-77 (1990) (imagining "that all the potential clients in the world are assembled behind a Rawlsian veil of ignorance to select the rules that would govern the initiation and conduct of litigation") (footnote omitted).

outcomes with a more acceptable appearance of apparent unanimity among transactors. To be sure, it might appear that the Rawlsian need not decide that the winner's gain from a rule outweighs the loser's loss; she instead purports to ask the transactors themselves to make this determination by asking them to choose rules from behind a veil of ignorance that prevents them from knowing, at the time of decision, whether they will be winners or losers.[104] But one cannot imagine what goes on behind a veil of ignorance without engaging in a form of interpersonal utility comparison, albeit recast by the device of the veil of ignorance in an "intrapersonal" form. A utilitarian who makes interpersonal comparisons based on "cost" and the Rawlsian constructivist always will arrive at the same rules, provided that the utilitarian is willing to use ex ante notions of cost that include risk aversion, and, more generally, to apply the same assumptions about human desires and preferences.

In some circumstances, a third approach — aside from the direct comparison of utilities and its illicit Rawlsian variant — is available. In this third approach, the Rawlsian device serves to enable the decisionmaker to make a decision that satisfies welfarist criteria of cost-minimization. This occurs when (1) the total costs imposed upon all transactors affects the *level of transactional activity,* and (2) a higher level of transactional activity increases the social good. That is, the level of activity provides a proxy for the social welfare function that otherwise would be implicit in the decisionmaker's comparison of the different transactors' welfare as she decided which rule to favor.[105]

2. *Methodology (Degrees of Generality and Idealization)*

The previous discussion has made clear how to approach the level of generality at which the hypothetical bargain is formulated. The adjudicator chooses the level of generality that minimizes costs. The degree to which the adjudicator "idealizes" in constructing the hypothetical bargain will vary with her assessment both of the bargaining behavior of transactors and of the costs and benefits of her constructing an "ideal" rule.

Consider two contrasting "pure" transaction types. In transaction type (1), contractors consciously advert to the rules. If the court

104. Also, the "Rawlsian" construction leaves unsolved the general and vexing problem of what the individuals behind the veil of ignorance are supposed to know or not know about their status in cases in which the rules that they choose are to be applied.

105. The securities markets provide a convenient example. Rules that reduce the total variance of market securities may increase the total level of investment by increasing return to shareholders. The increase in investment, it seems fair to presume, accomplishes social good.

chooses a rule different from what the contractors would have chosen, the parties will write a provision trumping the rule or simply will not transact. The type of costs the court should consider are the costs of transacting the rule.[106] In this circumstance, clearly, the proper rule is the one that the parties would *actually* have chosen had they consented to the matter.

In transaction type (2), contractors do not consciously advert to the rule, or, if they do, they accept whatever rule the law imposes. In this circumstance, the only relevant costs in choosing a default rule are the ex post costs of permitting inefficient (opportunistic or rent-seeking) conduct. The court can be "paternalistic,"[107] in the sense that the court may simply choose the rule that it considers best for the parties.[108]

The paternalistic construction of hypothetical bargains, if it is to be justified on efficient-transacting grounds, must assume that persons will not incur the costs to bargain around a rule that is best for them, or, more generally, that they will not as a result of the rule change their behavior in ways that reduce social welfare. If transactors are poorly informed, but vigorous — a feature that perhaps characterizes advanced capitalist societies — this assumption may not hold.

Suppose, for example, that elite decisionmakers determined after elaborate comparative study that a certain composition of the board of directors was best for shareholders in the long run: the board should contain only outsiders (except for the CEO), and should include substantial representation of workers, creditors, and other so-called "stakeholders."[109] The elite decisionmakers mandate their preferred

106. I shall use the term "transacting around" to refer to the sum of the costs of opting out of the judicial rule and the costs incurred by not transacting.

107. In using "paternalistic" in this sense, I adopt the usage of Clark, *supra* note 6, at 1723, and Kennedy, *Redistributive and Paternalist Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 603 (1983). Note that "paternalism" here does not connote overriding preferences *expressed* by the parties in the particular transaction at issue, though it may involve ignoring their general preferences.

108. One way to understand this approach is to say that the best rule is also the one most likely to satisfy the criteria for efficient transacting set forth above: the best rule is the one that parties are most likely to want; let the few who do not want that rule bargain around it.

It is sometimes thought that hypothetical bargains, to be *binding*, must be welfare-enhancing for the parties "by definition." *See* Kronman, *supra* note 11, at 1750-51. As the discussion in text explains, this view is imprecise, at least if it is taken to mean that the instrumentally constructed hypothetical bargain will inevitably be one that enhances the welfare of the particular parties who are held to be bound to it, compared to any other stipulations that they might have entered into.

109. To make the basic argument in simple terms, I am using a somewhat extreme example — a rule that would clearly spark widespread dissent and that lots of investors would care about. In contrast, the scope for "paternalism" — *i.e.*, hypothetical bargains under which decisionmakers simply chose the rule they like best — may be much greater with rules about which

composition, but provide for an elaborate and costly process of opt out by charter amendment. Suppose further that most shareholders do not share the elite decisionmakers' belief, but instead prefer a more conventional board. In these circumstances, most corporations will incur the costs of opting out, for those who do not will see their share values drop. The net result of the paternalistic hypothetical bargain under this scenario will be an increase in the transactions costs of drafting corporate charters.

What if the wise elite, foreseeing this outcome, makes the requirements for board composition *nonwaivable?* Shareholders who now see corporations with these newfangled boards as less desirable investments will search, at the margin, for alternative investments[110] in foreign corporations not subject to these restrictions, in partnerships and other investment vehicles, and so on.[111] Further, one can foresee various indirect transaction costs incurred to evade the rule — enterprises may reincorporate abroad or form as partnerships;[112] there may be litigation about how the corporation can comply with the new mandate but still appoint the directors that the managers want; hordes of angry investment bankers may guillotine SEC commissioners on the Washington Mall; and so forth.

The basic point is that transactors' conduct sharply limits the extent that an elite can be paternalistic in any consensual transaction involving sophisticated transactors. In terms of the efficient-contracting paradigm, it appears that hypothetical bargains that diverge from parties' understandings — whether those understandings are rational or not — should not be imposed if the parties will respond by changing their conduct in costly or undesirable ways.[113] One can ven-

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transactors are unlikely to have strong views, either because the relevant considerations for different rules seem in equipoise or simply because they do not really care which rule is adopted as long as the rule is clear. Thus, the extent of paternalism, in corporate law for example, may be linked to what some commentators have termed the "triviality" of the corresponding legal rules. *See, e.g.,* Black, *Is Corporate Law Trivial?: A Political and Economic Analysis,* 84 Nw. U. L. REV. 542, 551-61 (1990).

110. They shift assets to investments opportunities that now appear more valuable to them than the corporations with newfangled boards, up to the point where the alternative investment opportunities appear to them to yield a return no greater than the (now reduced) values of the corporations with newfangled boards.

111. *See* Jensen & Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination,* 52 J. BUS. 469, 504 (1979) (scenario for economic disaster following upon mandated composition of boards).

112. These arrangements may incorporate more or less elaborate contractual attempts to simulate the advantages of incorporation through the partnership form.

113. This may be encompassed within what Clark refers to as "weak" paternalism. *See* Clark, *supra* note 6, at 1726. It might be helpful to have a distinct label — perhaps "insipid" or "wimpy" paternalism — for the form of hypothetical bargain that tries to be rational, but gives up to a substantial degree because the decisionmaker recognizes that her efforts to impose a rational bargain will be defeated by transactors' various avoidance strategies.

ture beyond this rather insipid form of paternalism only when transactions are so poorly informed that they do not even realize what the rule is, or where they can take feasible or cost-justified avoidance measures, although they know what is at stake and would prefer a different rule.

Generally, only some — perhaps a relatively small number — of the affected transactors will bargain around the rule. Here the adjudicator must balance the benefits of mandating the "right" rule for some transactors against the costs that this imposes on other transactors who bargain around the rule. The degree to which the decisionmaker, when constructing the hypothetical bargain departs, from the rules that she considers ideal, will depend upon the benefits and costs of intervention: the "marginal costs of resistance" to the paternalistic intervention, on the one hand, and the "marginal gains from intervention," on the other. For example, when some transactors incur costs to evade the rule while others succumb to the rule (to their benefit, in the end), the gain by improving the welfare of those who succumb to the rule may outweigh the costs incurred by those who bargain around the rule. The persons whose mistaken judgment the decisionmaker is trying to correct may simply contract out of the protective duties imposed by law, or forgo the benefits of the transaction altogether, which may be a worse outcome for them.[114] The efficient-contracting view of hypothetical bargains should not, then, be equated with paternalism; only in a narrow range of circumstances will considerations of efficiency justify an attempt to correct for transactors' errors of judgment.[115]

3. *Conclusion*

A transaction-costs method for constructing hypothetical bargains distinguishes three types of cases:

(1) If the adjudicator readily can determine that all transactors would bargain to rule *X*, and would bargain around any other rule *Y* that differed from rule *X*, then she should adopt rule *X*.

(2) If transactors will not bargain around whatever rule that the adjudicator would adopt, the adjudicator should adopt the rule that

114. A paternalist should take this last phenomenon into account when setting up her rules.

115. Note that the objection does not apply to torts among strangers who cannot feasibly bargain around the rule. But even much of tort law concerns parties in contractual relationship: products liability and professional malpractice offer areas of great current controversy. And even for torts among strangers, it is possible that "paternalistic" rules would have counterproductive activity level effects, though this possibility goes beyond the scope of the present discussion.

minimizes ex post costs of opportunistic behavior to transactors taken as a group.

(3) If some transactors will bargain around rule *X*, and other will not, then the relevant total cost of rule *X* is the costs of bargaining around plus the costs of ex post opportunistic behavior under the rule for those who stick with it. The adjudicator should aggregate the costs for each alternative rule and choose the rule with the lowest total cost.

III. INTEGRATING THE COMPETING CLAIMS OF ALTERNATIVE INTERPRETIVE STRATEGIES

A. *Integration of Interpretive Strategies*

There is considerable diversity among the types of arguments made in the course of constructing a legal system for enforcing agreements. This diversity is not always troubling, however. For example, the different conceptions that I have described roughly coincide in the basic conclusions that they draw as to enforcement of expressly made agreements. For when two rational and well-informed parties make an agreement, all three modes of justification argue for enforcement. On autonomy grounds, the parties have chosen to be bound. On benefit grounds, that the parties have freely chosen could be taken to indicate that the proposed exchange is fair. On efficiency grounds, free choice ex ante indicates that the exchange will enhance joint welfare. Conversely, when parties are mistaken or poorly informed, all three modes provide grounds for setting aside the transaction. To protect persons from fraud, force, or error enhances autonomy; the mistake vitiates the inference that a fair exchange of benefit was contemplated; and, correspondingly, if the parties are mistaken, it might enhance joint welfare to prevent the transactions from going forward.[116]

The three justificatory principles often converge on a standard for constructing hypothetical bargains with the goal of minimizing costs of transacting. Both the autonomy and the benefit theorist may endorse this standard: both may view the scope of bargains hypothetically consented to as a question to be resolved by interpretive conventions established by the adjudicator, and may conclude that these conventions should be established simply to advance the social goal of facilitating transactions.

The three paradigms nonetheless often conflict. Consider, for ex-

116. Again, these principles might point in different directions on subsidiary questions such as the scope of excuses or of responsibility for mistaken assumptions. Differences regarding what *counts* as mistake or poor judgment under different normative theories generate different outcomes. As to the question of what constitutes an exercise of judgment sufficient to bind a party to a contract, the principles that we have considered may come to very substantial disagreement.

ample, the case in which ninety percent of transaction pairs contemplate rule *X;* ten percent contemplate rule *Y.* A theorist who, on autonomy and fairness grounds, thought that courts should adopt the rule that each pair contemplated would conduct a careful inquiry into whether the pair at issue contemplated rule *X* or rule *Y.* If this were costly or impossible, she might adopt rule *X,* with the understanding that she likely matched the parties' intention.

In contrast, an efficiency analyst would want to know what the costs of adopting each approach would be. Recall the example in which it is quite easy for the ninety percent transaction pairs to bargain around the rule and quite difficult for the ten percent transaction pairs. On these facts, the efficiency analyst would urge the court to adopt rule *Y,* if it must choose between the two.[117]

When the liberal learned of the efficiency theorist's approach, she might respond: "Oh, I see . . . I didn't think of that. Well, what I should do is define my goal to get maximum possible fit with expectations at minimum cost. By that standard, I should choose rule *Y,* because then everyone will get the rule that they want, at relatively less total cost." She would then have to reconsider whether this outcome — maximum fit at minimum cost — is a more sensible definition of her goals of autonomy than her first definition — maximum case-by-case fit with expectations when parties do not advert to any preannounced rule. She will face several analytic difficulties, however. She will have to decide how much extra fit is worth how much extra cost. Further, she at first might be able to explain why those who want rule *X* should bear the transaction costs that result from setting *Y* as the default — why this reduction in costs can count as a good sufficient to justify departure from the goal of obtaining fit ex post. She might invoke some notion of probabilistic compensation to solve this problem. Or she might have a supplemental set of communitarian values that would permit her to tax one group to help another group get closer to a truly autonomous (self-governing) structure for their relationship. Finally, the liberal adjudicator who regularly employs a hypothetical bargain construction may have to consult some notion of prospectivity or retroactivity that the efficiency analyst, relying on accepted transitions analysis, would feel free to ignore, at least for moderately sophisticated transactors.[118] Perhaps she could announce rule *Y* for future

117. The adjudicator would choose one of the two rules for all cases, rather than tailoring the rule to the specific transaction, if the costs of a case-by-case inquiry outweighed the benefits (in terms of costs saved by a case-by-case inquiry as contrasted to the costs of either rule *X* or rule *Y*).

118. *Compare, e.g.,* L. FULLER, ANATOMY OF LAW 6-8 (1968), *with* Kaplow, *Economic Analysis of Legal Transitions,* 99 HARV. L. REV. 509, 536-50, 576-80 (1986).

cases, trying to figure out in the present case what the parties had expected, but commit to forgo that inquiry in the future.[119]

This problem often arises. In many instances, adjudicators construct background rules that are easy to opt out of, even though many will opt out of them, because they wish to make those rules available to the few who really require them. Indeed, this is the general structure of implied legal duties, such as fiduciary duty and the duty of good faith. These duties encompass an elaborate set of specific norms that have been developed by courts and that apply automatically to various relationships — such as the fiduciary duty of the agent to his principal, or the good faith duty of a seller of goods to the buyer. But, as the example here illustrates, courts should not construct these implied duties simply by asking "what the parties would have agreed to." Rather, courts should consider as well the effect of the particular method that they adopt on the conduct of other transactors. In particular, a focus on the *actual* expectations of particular parties may impose enormous costs on other transactors by forcing them to specify terms that they could otherwise leave out, or by imposing on them terms that are undesirable for them.

Through a process by which the abstract norms of the three frameworks are appropriately defined, one might laboriously specify how courts should resolve these conflicts. In what follows, however, I shall propose a framework that indicates the appropriate method of interpretation without a complex analysis for each possible transactional setting. The framework categorizes transaction types by social facts about the transactors.

First, the framework describes cases in which a clear choice between formalist and contextualist strategies is dictated equally by each of the three justificatory models. Here there are three types of cases: (1) all pairs of transactors would bargain to the same set of contract terms; (2) sophisticated transactors have fully "internalized" efficiency norms; or (3) transactors follow "localized" conventions or customs to which courts should defer.[120] In the next section I consider each of these types of cases.

119. Prima facie, then, conflicts among principles are most likely to arise in instances in which different pairs of transactors would bargain to different terms because of differences in preferences, knowledge, or bargaining skill.

120. In particular, some cases arise in which the attempt to implement autonomy or reciprocity norms via the construction of hypothetical bargains — as conceived by some contract lawyers — will be frustrated or "trumped" by contracting around by transactional participants. The priority of efficiency considerations follows from the social conditions in which the conflicts might arise, rather than from inherent normative features of the justificatory conceptions, abstractly considered.

Second, the framework identifies cases in which the choice of interpretive strategy is determined by a conception of "cost" that includes some conception of social interest identified in terms of autonomy or reciprocity. In my view, it is best to think of this second type of case as one in which the different principles serve supplementary justificatory roles. Most often, as I shall explain, considerations of autonomy or just distribution might be useful in supplementing or filling out the notion of transaction costs by presenting reasons that certain types of costs should be valued in certain ways by adjudicators. These interests are simply guidelines to an adjudicator who must either estimate the cost of a given rule to some transactor or who must find a formula for aggregating costs that the rule imposes on different transactors.[121]

B. *Concurrence of Justificatory Paradigms*

1. *Unanimity Among Transactors*

When every pair of transactors would agree to the same term if they negotiated it, the three principles generally will call for enforcement of that term.[122] If the adjudicator implies a different term from what the transactors would specify, the transactors simply will incur the added costs of bargaining around or of adjusting other transactional conduct. For example, if all employers and workers would bargain for at will employment, all three paradigms commend this as the appropriate hypothetical bargain term when the employment contract is silent on duration of employment and conditions of termination.

2. *Incorporation of Efficient Rules into Socially Embedded Understandings*

In many types of transactions, the understandings of the parties in fact coincide with those that are or would be prescribed by instrumental construction of conventions. The meaning attributed to words by most transactors and by a legal decisionmaker establishing a set of

121. Another way to conceive of this relationship is to see the three principles as fitting into an overall framework which is broadly consequentialist or pragmatic in focus. This "meta"-framework sorts out the relative weight to be given to concerns with autonomy, fair distribution, and the cost of transacting in different types of situations. While I find this less intuitively appealing, persons who like to think of "cost" in a restrictive sense will find that various other interests must be considered under the rubric of autonomy or fair distribution. I think it is clearly preferable to use the broad instrumental formulation in the previous paragraph.

122. To be sure, courts should not enforce a reconstructed hypothetical bargain if they wish to provide an incentive for the parties to specify the terms. As we have seen, principles of contract might commend this approach if, for example, it is more costly for the courts to determine what term the parties want than for the parties to specify the term, or if forcing parties to specify the term would have a desirable disciplinary effect on their conduct of transactions. Clearly, the considerations do not apply where the court at reasonable cost makes the judgment that virtually all transactors would bargain to the same term.

conventional (code) formulations will often coincide. And transactors understand that unspecified or ambiguous terms will be interpreted in accordance with instrumental criteria.

This occurs when three prerequisites are satisfied. First, the transactors advert to legal enforceability of their bargain. Second, transactors follow well-defined and efficient conventions for drafting contracts. Third, transactors can inform themselves of the set of background interpretive conventions.[123]

These conditions obtain when sophisticated, well-advised commercial parties (usually, repeat players) contract on the basis of carefully drafted contracts. In these cases, the law should choose norms on the basis of contracting costs: the countervailing interpretivist claims for further contextualization are weak. If interpretive conventions are well defined, there is no point in incurring the costs of further contextualization. The adjudicator plausibly confines its attention to the plain language of a written document — ignoring other evidence of the parties' intent or understandings — on the view that focus on the plain language is efficient. The costs of erroneously determining the parties' "real" intent would, on this view, be outweighed by the benefits of a plain language rule, such as cheaper adjudication and incentives to the parties to express themselves clearly.[124]

For example, in *Trident Center v. Connecticut General Life Insurance Co.*,[125] the court had to decide whether the contract unambiguously set the terms of the parties' right to declare default on a loan.[126]

123. The transactors can form a reasonably accurate probability estimate of the value of the entire contract as a package of contingent outcomes.

124. To be sure, under some suppositions about ordinary language, it might appear desirable to use a code that incorporates many ordinary usages. A rule that always applied ordinary rules of meaning might appear easy to comply with, stable (as it would always exactly correspond to these ordinary rules), and easy for courts to apply (on the assumption that this information is readily available). But no generalization is powerful enough here to confirm a priori the validity of Traynor's formulation of the appropriate interpretive test. The difficulty is that ordinary conversational usage is likely to be much sloppier than what would be desirable for determining legal rights and obligations. Note in particular that ordinary language develops to achieve the degree of precision required for what is at stake in casual exchanges, which is much less than for many formal contracts. Further, ordinary language is less precise to the extent that we interpret, in ordinary conversation, statements in light of other contextual cues — eye and body language, knowledge of a person's character and linguistic habits, and so on — all of which would have to be adduced to the court to make ordinary conversational language fully comprehensible even with the degree of precision it obtains in ordinary speech. And, as legal language will evolve in the context of related meanings that gradually diverge from ordinary meaning, the choice among possible meanings grows larger. The attempt always to approximate ordinary understandings then leads to the vices that Kozinski identifies — complex litigation, use of unreliable evidence, arbitrary judgment, and consequent transactional uncertainty.

125. 847 F.2d 564 (9th Cir. 1988), discussed *supra* Part I.

126. In particular, the borrower claimed the right to prepay the loan under a contract term setting a prepayment fee "[i]n the event of a prepayment resulting from a default." 847 F.2d at 566. The lender pointed — quite reasonably, it would seem, though to no avail — to a term that

The borrowers were two large law firms; the lender a life insurance company. From an efficient-contracting perspective, the document requires no clarification or supplementation by other contextual evidence: the standard "code"[127] for commercial arrangements determines the relevant meanings.

The interpretive problem in *Trident Center* exemplifies the convergence of instrumental and embedded norms: *Trident Center* is an easy case because the plausibly invoked norms of the community coincide readily both with those that are most plausibly efficient and with the familiar moral and political claims for formalist adjudication.[128] Indeed Judge Kozinski's opinion does not proceed directly to considerations of efficiency. Rather, Judge Kozinski considers the commercial context with sufficient depth to conclude that highly formalized norms are appropriately applied in this context. The type of transaction and the sophistication of the parties, Judge Kozinski emphasizes, lead readily to the invocation of formalized norms of interpretation.

A key empirical indication that transactors have entirely incorporated within their own understandings the conventional structure of interpretation is that, when an interpretation is unclear, they gamble on interpretive outcomes in the course of transacting. In *Harcourt Brace Jovanovich, Inc. v. Sun Bank, National Association*[129] it was unclear ex ante what conversion rights would remain to holders of convertible debentures after the dividend was paid. But holders could make a large profit by converting before the dividend was paid. Nonetheless, two arbitrageurs and a previous bidder for the company bought up about a quarter of the outstanding debentures and did not convert them. Under the interpretation of the antidilution provision for which these purchasers subsequently argued, the provision would have entitled them to acquire 42.5 million shares and thereby wrest

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provided that the borrower "shall not have the right to prepay the principal amount hereof in whole or in part before January 1996." 847 F.2d at 566.

127. Aside from establishing a "code" in the sense of a set of applicable rules, the Uniform Commercial Code and accompanying background law creates a code in the sense of a set of terms and their stipulative definitions.

128. The extension of this formalist interpretive paradigm to other cases involving rights and duties of lenders has been subject to considerable controversy. *See infra* section III.B.3.

129. No. 87-3985 (Fla. Cir. Ct. June 25, 1987) *available in* Harcourt Brace Jovanovich schedule 13D (filed July 9, 1987). In this case, literal construction of the antidilution provision of Harcourt's convertible indentures, as applied following HBJ's recapitalization through a special dividend of cash and preferred stock, would have resulted in a negative conversion price — a perverse outcome that reflects discrepancies between asset and share values analyzed in Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Move*, 88 COLUM. L. REV. 891 (1988).

control of the company from current management.[130] Clearly, the purchasers were not acting on the assumption of any generally shared, or even subjectively held, standard about how the indenture should be interpreted; rather, they were simply betting on the (relatively low) probability that the interpretation most profitable to them subsequently would be adopted.[131]

More difficult cases arise where one party misunderstands the contract because he does not understand the "code" to which it refers. It is tempting for courts to protect the ill-informed party. In particular, principles of autonomy or fairness might commend such protection. The misinformed party might be thought not to have actually consented to the bargain. Or to permit the more sophisticated party to derive profit from its sophistication might be thought to victimize the misinformed party undeservedly, to confiscate wealth from him in contradiction to conceptions of just distribution, or to deprive him of needed resources.

Nonetheless, neither autonomy nor fairness principles can justify departures from the code for misinformed parties. Where one party to a transaction type is a sophisticated repeat player, attempts to protect other values through construction of hypothetical bargains are self-defeating. The transactors will trump the adjudicator's intervention by bargaining around the rule.

A recurrent example of this sort of intervention is the tendency of courts — under the guise of "interpretation," particularly the *contra proferentem* rule of construction[132] to try to tilt litigation outcomes toward the party whom they perceive to be the adherent to a "contract of adhesion."[133] The *contra proferentem* rule is highly wasteful be-

130. The purchasers, supported by the indenture trustee, argued that under New York law the conversion price could not drop below the par value of the stock.

131. The purchasers' probability estimate can be calculated from the amount spent acquiring the debentures, their transaction and litigation costs, and, most problematically, the value that the purchasers attached to control of the company. From publicly available data, one might calculate this probability if one assumes that the value was some specified fraction more than the bidder's highest previous bid.

132. Under the *contra proferentem* rule, courts resolve contractual gaps and ambiguities against the drafter of the contract in situations where the other party has no opportunity to negotiate particular terms. Thus, the rule is routinely applied when courts interpret form contracts used and drafted by banks, insurance companies, consumer finance companies, and so forth, for use in mass transactions.

133. A classic discussion is Kessler, *Contracts of Adhesion*, 43 COLUM. L. REV. 629, 638-40 (1943). The *contra proferentem* rule has greater bite, the more willing courts are to find ambiguities in contract terms. Modern courts show little restraint in finding ambiguity. In particular, courts seem to have discovered that in contracts with multiple provisions it is frequently possible to create an ambiguity by taking two clauses — the one designed to modify the other — and pretending that in fact the purported modification creates an ambiguity or contradiction. *See, e.g.*, Nathaniel Shipping, Inc. v. General Elec. Co., 920 F.2d 1256, 1266 (5th Cir. 1991) (finding conflict between express warranty clause and limitation on liability for consequential or inciden-

cause it forces parties constantly to revise terms to override judicial rulings that are overly protective of the nonproferring parties. In addition, the rule makes it harder for parties to adopt innovative contract terms, for an innovative term will leave the parties uncertain about what "ambiguities" courts will find to resolve against the drafter.

Nor can the *contra proferentem* rule redistribute between the proffering and nonproffering parties.[134] The proffering party that recognizes that the *contra proferentem* rule will be applied in various contingencies not clearly covered by express contract language[135] will simply "price" the probability of such contingencies;[136] or, the drafter will fashion other terms more onerously to compensate for the possible loss of advantage under the potentially ambiguous term.[137]

This is not to say that the *contra proferentem* rule should never be applied. The rule should be understood as a particular form of the duty to disclose and applied accordingly. The rule requires one party to explain to the other what the clause means in circumstances where its application is ambiguous. In effect, the drafting party is required to explain to the other what the clause means. She should be required to do so when it would be substantially cheaper for her to explain the ambiguity to the other party than it would be for the other party to detect and clarify the ambiguity itself. At best, then, application to all form contracts might be justified on the rough generalization that drafter is better situated than its transactional partners to appreciate the meaning of the term, and to explain to each of them the terms that are most likely otherwise to be misunderstood. But the rule should

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tal damages); Crescent Corp. v. Procter & Gamble Co., 898 F.2d 581, 582-83 (7th Cir. 1990) (refusing to read paragraph 4's requirement of arbitration in connection with paragraph 6's requirement that arbitration be sought in Cincinnati). Such cases seem particularly anomalous because they deal with sophisticated business "repeat players." Increasingly, courts simply ignore the distinction, applying the rule equally to all types of transactors, *see, e.g., In re* Delta Am. Reins. Co., 900 F.2d 890, 892 n.4 (6th Cir.) (noting courts' failure to make distinction), *cert. denied sub nom.* Wright v. Anon Ins. Co., 111 S. Ct. 233 (1990), a trend clearly incorrect, for reasons explained in text.

134. *Cf.* Kennedy, *supra* note 107, at 609 (describing purported redistributive effect of *contra proferentem* rules).

135. If the *contra proferentem* rule is coherently applied, this will be true because the rule is designed to select out highly sophisticated contract drafters to bear the risks of mistakes or ambiguities in draftsmanship.

136. *Cf.* Kaplow, *supra* note 118 (transactors' anticipatory pricing of prospective changes in legal rules).

137. The rule may have some effect regarding distribution among two classes of nonproffering parties — those who are and those who are not affected by a contingency as to a contract term about which the *contra proferentem* rule is applied. But it is not clear why one would wish to redistribute from those who are not affected by a given contingency to those transactors that are (and are willing to litigate the dispute about how the contingency should be treated).

not be applied where no real duty to clarify is contemplated: it is pointless to force parties to draft contracts slightly more carefully for the benefit of parties who will not read the form in any event.[138] Courts should invoke the rule, then, only in exceptional cases, where it can serve to supplement a strong duty to explain the force of terms.[139]

3. *Interpretation Based on Embedded Social Understandings*

A third type of transaction displays these features: transactors have a range of preferences and knowledge, and they would bargain to a range of terms to which transactors would bargain, depending on preferences, knowledge, and bargaining skills. Understandings regarding any contingency not written into the formal contract arise locally as a matter of custom, tradition, received wisdom, widely shared but unarticulated assumptions, and so forth.

The analysis initially requires distinguishing among three roles of "custom" in constructing the hypothetical bargain. First, to determine what transactors intend by using a term, courts may advert to how transactors ordinarily use that term. For example, firm commitment underwriters attach, in their ordinary way of speaking and writing, a particular connotation to the term "adverse market conditions";[140] film stars and their agents, and book writers and their agents, attach precise, albeit very different, meanings to the term "edit";[141] courts naturally consult the standard usages of persons in

138. While the slight tilt towards clarity created by the *contra proferentem* rule might save judges' time in sorting out ambiguous provisions, the rule correspondingly foments controversy by encouraging transactors to root out contract "ambiguities" that then would be construed against the drafter. On balance, then, the rule is as likely to increase the amount of energy that judges devote to construing contract provisions.

139. A few courts have claimed that there is never a duty "to explain to each other the terms of a written contract." *See* Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d 282, 287 (9th Cir. 1988) (Kozinski, J.). *But see* Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1263-84 (1983) (identifying cases that articulate this duty, and arguing for its expansion); *cf.* Shavell, *supra* note 22, and Bebchuk, *supra* note 6. Substantial research remains to be done on these issues. It seems likely that such requirements will often be useful, given large discrepancies in access to information about transactional terms and conditions. For a preliminary assessment, see Charny, *supra* note 41, at 444-45.

Kozinski's approach has virtue of consistency: he has combined his hostility to duties of explanation with a narrowing of the *contra proferentem* rule, accomplished by a resolute refusal to find contract ambiguity. His position goes too far, however, in focusing only on the literal language of the contract to assess clarity, without regard to the transactor's reasonable assumptions about the background or customary term. For example, in *Travelers Ins. Corp. v. Budget Rent-a-Car Sys.*, 901 F.2d 765 (9th Cir. 1990), only the most scrupulous and astute reader of form contracts would notice that the clause used by Budget Rent-a-Car, as a grammatical matter, changes the meaning of the commonly used insurance clause, which would have included the accident in question.

140. *E.g.*, Walk-In Medical Centers, Inc. v. Breuer Capital Corp., 818 F.2d 260, 264 (2d Cir. 1987).

141. *Compare* Edison v. Viva Intl., Ltd., 70 A.D.2d 379, 382 N.Y.S.2d 203, 205 (1979) (construing publisher's "right to edit . . . the Work") *with* Preminger v. Columbia Pictures Corp., 49

the trade to find out what they would have meant by employing a particular term.

Second, courts consult trade custom to infer meaning from *how parties conduct themselves.* In these cases, the relevant interpretive datum is not how transactors in the trade ordinarily *use a word,* but how they act. For example, to determine whether the words "distributorship" or "best efforts" imply that the distributor will deal *exclusively* with a particular source of supply, courts often take as decisive the general business arrangement in the trade, without considering whether that arrangement arises from the use of any particular contractual language.[142]

Third, courts may infer meaning from parties' conduct in reference to particular language. To extend the example in the previous paragraphs, a court might note that, when transactors used a "best efforts" clause, the distributor always represented one manufacturer exclusively; when transactors omitted a "best efforts" clause, the distributor represented many manufacturers. The case differs from the previous inference, for here the court finds a link between *particular contract language* and particular conduct, not just between a *particular transaction* (such as the manufacturer-dealer relationship) and particular conduct. This third type of inference is surprisingly uncommon in the case law. Most frequently, courts draw such an inference from conduct of the *particular transactors* at issue: that is, an inference from course of dealing.[143] For example, the parties' acceptance of a letter of credit for "dry coking coal" — under a contract for "coal" — may indicate that they understood the contract term "coal" to mean "dry coking coal."[144]

Misc. 2d 363, 367, 267 N.Y.S.2d 594, 599, *affd.,* 25 A.D.2d 830, 269 N.Y.S.2d 913, *affd.,* 18 N.Y.2d 659, 273 N.Y.S.2d 80, 219 N.E.2d 431) (1966) (construing movie producer's "right to 'finally' cut and edit . . . the original production of [a] motion picture") *and* Stevens v. National Broadcasting Co., 270 Cal. App. 2d 886, 891-93, 76 Cal. Rptr. 106, 110 (1969) (considering whether insertion of television commercials in television exhibition of movie constitutes "cutting and editing"). Law review editors, in turn, apparently attach still a third, and some might say deeply idiosyncratic meaning, to "edit."

142. *See, e.g.,* Steven Star Shoe Co. v. Strictly Goodies, Inc., 657 F. Supp. 917, 921 (S.D.N.Y. 1987) (contract term "representative" connotes to represent exclusively); Joyce Beverages of N.Y., Inc. v. Royal Crown Cola Co., 555 F. Supp. 271, 275-77 (S.D.N.Y. 1983) (construing "best efforts" clause to require exclusivity); *cf.* Polyglycoat Corp. v. C.P.C. Distribs., Inc., 534 F. Supp. 200 (S.D.N.Y. 1982) (holding on basis of industry practice that "best efforts" clause not breached by taking on a competitive product line).

143. This is no doubt the most common because it is difficult for litigants and courts to get information both about the preponderant practice in an industry *and* to link the practice to specific contract language; courts do not insist on the latter link, but are satisfied by evidence of standard practice industry — the inference described in the preceding paragraph. As I shall explain below, judges are incorrect to draw this inference as readily as they apparently do.

144. East Europe Domestic Intl. Sales Corp. v. Island Creek Coal Sales Co., 572 F. Supp.

In these cases, each of the justificatory paradigms commends construction of the hypothetical bargain by a fairly strenuous inquiry into the assumptions of particular transactors: it is efficient — as well as "right" or "fair" from the perspective of theories of autonomy or benefit — to interpret by reconstructing the parties' actual understandings.

The fairness of the inquiry follows readily from basic considerations of autonomy and benefit. These conceptions favor attempting to achieve maximum fit with individual transactor's reasonable expectations.

The claim for the efficiency of reconstructing understandings is more complex and depends on two empirical generalizations. First, any single highly general norm diverges from many parties' understandings because understandings vary with trade contexts.[145] If individual transactors become aware of this divergence, the divergence raises transaction costs: individuals will decline to transact, or draft more elaborate contracts, to prevent adjudicators from later reaching decisions that depart from the treatment of contingencies that they would contemplate.[146]

Second, the more likely the custom itself is efficient, the more likely it will be efficient to reconstruct embedded understandings in adjudication.[147] For several reasons, such understandings are likely to be efficient. The understandings have been tested over time, and likely would have changed if they did not work well.[148] Self-interested transactors have a clear incentive to change (by negotiating around or by adopting new practices) customs that are dysfunctional for them, or customs that, because they are dysfunctional for other transactors, raise the cost to them of transacting. Further, repeat transactors will have substantial experience with the trade custom, so they will be rela-

702, 708-09 (S.D.N.Y. 1983). Such use of past conduct is quite common in the reported cases, and presumably even more so when transactors informally resolve disagreements.

145. For example, it would be absurd to attempt to define a single meaning of the term "edit" in contracts throughout the communications industry.

146. John Langbein's comparison of American and European drafting practices provides interesting comparative evidence for such defensive contracting. Langbein, *supra* note 24.

147. A linguistic usage is efficient if it minimizes drafting and error costs. For example, it would be very inefficient for American transactors to draft contracts in Latin, because most transactors do not know Latin and so would have to bear the cost of hiring a translator in order to interpret the contract. Further, those who think they know some Latin, and so forgo a translator, may often make mistakes because of their imperfect knowledge.

148. This analysis of the efficiency of transactional customs draws on more general work on efficiency of customary formulations in Clark, *supra* note 6, at 1730-37; Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623, 657-85 (1986); *cf.* Ellickson, *A Critique of Economic and Sociological Theories of Social Control*, 16 J. LEGAL STUD. 67, 93-98 (1987) (reviewing theories about origins of social norms).

tively well informed about how the custom works out in practice. Relatedly, trade customs are likely efficient because they represent the consensus judgment of numerous transactors, thus smoothing out errors that individual transactors might make.[149] For these reasons, the court should take the trouble to determine the local trade practice, rather than simply construct a general rule.

This analysis supports four propositions about the adjudicators' use of customary formulations in constructing hypothetical contracts:[150]

(a) *When a contract is silent on a contingency, courts should generally incorporate trade custom as a source of obligation.* When a contract explicitly addresses an issue, courts should interpret or modify the contract term by reference to trade custom when the contract term itself is facially ambiguous.[151] Trade custom may provide rational or efficient gap-fillers for defining specific terms — the first and third uses of custom noted above. But transactors may not wish to attach legal sanctions to customary norms. In particular, it may be desirable to leave enforcement of custom to nonlegal sanctions, such as informal complaint, loss of future business, and the like. Before employing the second use of custom — the inference that custom provides a legally enforceable contract term — courts should carefully consider whether the term is one that parties would rationally leave to nonlegal sanctions.[152]

(b) *Courts should take a skeptical view of the wisdom of transactors' express decisions to override custom.* Courts that have analyzed the

149. Finally, trade customs, unlike other types of customary rules, will generally be hard to fabricate; evidence of the custom will be reliable. *Cf.* J. HERRIN, THE FORMATION OF CHRISTENDOM (1987) (fabricated traditions in the canon law); E. HOBSBAWM & T. RANGER, THE INVENTION OF TRADITION (1983) (discussing fabrication of custom).

To be sure, there is a flipside to the considerations discussed in text. Once a custom is established, it may be hard for any individual transactor to change it, even if changing it is a good idea. And the consensus judgment of numerous transactors is of warrant to the value of the custom only if the transactors are making an independent judgment rather than simply "following the crowd"; in fact, there are strong pressures to imitate, and much evidence shows that transactors in these circumstances simply will unquestioningly follow the established rule, whatever it is. Most problematically, the adjudicator must try to distinguish between customs that are efficient to use as *nonlegal customs, i.e., standard social practices,* as contrasted to customs *that should be enforced as well as a legal or contractual matter.* I build these caveats into the proposed rules for interpretation of customary formulations that follows.

150. The most complete analysis of the role of custom in contract interpretation is to be found in Goetz & Scott, *supra* note 61, at 305-20. The propositions for which I argue here, however, substantially expand the role of custom beyond that acknowledged by Goetz and Scott.

151. *See, e.g.,* U.C.C. § 1-205 (1986). Aficionados of contract doctrine may think of these — as Goetz and Scott propose — as formulations of the plain meaning and the parol evidence rules, respectively. I am not confident, however, that Goetz and Scott's normative principles fit completely into these doctrinal pigeonholes.

152. For guidelines regarding this assessment, see Charny, *supra* note 41, at 456-63.

trumping of customary formulation have done precisely that. For example, in *Provident Tradesmen's Bank & Trust v. Pemberton,*[153] the contract between the bank and an automobile dealer provided for a waiver of notice of insurance cancellation on vehicles that the dealer had leased or had sold on credit. But trade custom and course of dealing had been to give such notices. The court held that trade custom and course of dealing overrode the express provision because the provision had not been "conspicuous."[154] Apparently, parties may contract to overrule custom only if they have deliberated carefully about the matter.

Provident Tradesmen's Bank ignores the UCC's mandate that express contract terms override implications from custom and usage. Nonetheless, the decision makes sense from an efficient-contracting perspective if transactors' customary practices are generally efficient and if the term is one for which legal sanction is appropriate. If so, then adjudicators, in reconstructing the bargain as a matter of interpretation, should place extra constraints on the ability of the parties to modify customary terms.[155]

(c) *Adjudicators should consider the likely efficiency of customary formulations when resolving the crucial question of the interpretive standard by which one determines whether the contract is "silent" or "facially ambiguous" as to the issue that might be resolved by custom.*[156] How ready the legal decisionmaker is to conclude that a provision is silent depends on how convinced the legal decisionmaker is that custom, or other forms of embedded interpretation that appeal to community norms, are more likely to be efficient than the explicit clauses of a particular document.

To resolve these issues within the efficient-contracting perspective, one must specify the institutional costs of inquiry in custom and balance those costs against the efficiency gains from incorporation of the customary rule into the court's interpretation. The institutional costs for inquiry into custom include, for example, the costs to the legal decisionmaker of discerning that the custom is extant and that it is efficient, and the importance of fixed interpretive code for parties' planning (degree of risk aversion about possible *variations* in judicial interpretations). The benefits from incorporation of custom will in-

153. 196 Pa. Super. 180, 173 A.2d 780 (1961).

154. *See also, e.g.,* Brunswick Box Co. v. Coutinho, Caro & Co., 617 F.2d 355 (4th Cir. 1980) (custom trumps FAS term).

155. *Cf.* Clark, *supra* note 6, at 1744 (calling for deference to "traditional rules" in the context of corporate law).

156. Goetz and Scott seem to beg this question in distinguishing between the role of custom in interpreting "clear" and "ambiguous" agreements.

crease with several factors, including, most importantly, the likelihood that there will evolve a custom that is efficient, but deviant from the perspective of a simplified interpretive code; and the cost to the parties of formalizing customs in express contract provisions (rather than relying on customs not so formalized).[157]

Contrast, in this respect, interpretive approaches under articles 2, 5, and 9 of the UCC.[158] In ordinary contracts for purchase and sale of goods (at least for small businesspersons dealing with moderately idiosyncratic transactions), transactors likely will have developed customs that deviate from the formalized interpretive code and that would be costly to articulate in express contractual language.[159] And it is likely

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157. This last criterion has been developed, first by some legal realists and then by the empirical work of the law and society movement, into a general critique of formalist norms of contract interpretation. The argument is that legal norms that diverge from what transactors actually do simply will not matter very much; all that the law can do is mirror what transactors do in fact. The conception seems to be that, when legal norms diverge from actual practice, parties simply do not bother to incur the costs of drafting contracts that comply with interpretive norms stipulated by law. Thus, transactors frequently entered into, and purportedly conceived as binding, agreements that did not satisfy the requirements of commercial law or that were interpreted in commercial law very differently from ordinary business understandings: divergences between legal and business norms were observed for matters such as claims settlements, renegotiations of loans between creditors and debtors, output and requirements contracts, the perfect tender rule, formalization under the parol evidence rule, and so forth. *See generally* Gordon, *Macaulay, MacNeil, and the Discovery of Solidarity and Power in Contract Law,* 1985 WIS. L. REV. 565, 571-79 (sympathetic account of Law-and-Society view of the "marginality" of contract law); Macaulay, *An Empirical View of Contract,* 1985 WIS. L. REV. 465; MacNeil, *supra* note 39.

To be sure, a large body of evidence indicates that transactors' conduct — both in forming contracts and in postformation conduct — deviates from what would be required as a matter of contract law. Classic works include Kessler, *Automobile Dealer Franchises: Vertical Integration by Contract,* 66 YALE L.J. 1135 (1957), and Macaulay, *Non-contractual Relations in Business: A Preliminary Study,* 28 AM SOC. REV. 55 (1963). More recent studies have confirmed, in particular, that businesses often depart from the norms stipulated in the express contract: they tolerate other parties' breaches or perform when the contract entitles them to renege. *See, e.g.,* Palay, *Comparative Institutional Economics: The Governance of Rail Freight Contracting,* 13 J. LEGAL STUD. 265 (1984); Ross & Littlefield, *Complaint as a Problem-Solving Mechanism,* 12 LAW & SOC'Y. REV. 199 (1978); White, *Contract Law in Modern Commercial Transactions, An Artifact of Twentieth Century Business Life?,* 22 WASHBURN L.J. 1 (1982) (chemical companies' supply allocations during shortages).

Nonetheless, this evidence does not imply that law is irrelevant or should serve merely to reflect extant social norms. Transactors' dependence upon express contract will depend on drafting and enforcement costs and on the availability of nonlegal sanctions; the parties' decision to embody imperfectly the governing norms in an express contract does not indicate that they do not advert to these norms or to the background suppletive contract terms that would govern them. To the contrary, parties are likely to make decisions about what commitments to make legally enforceable, and about when to enforce them, by consulting and comparing the various relevant legal *and* nonlegal sanctions. For a fuller demonstration, see Charny, *supra* note 41, at 391-425.

158. Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code,* 27 STAN. L. REV. 621 (1975), and Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules,* 100 HARV. L. REV. 465 (1987), describe article 2's strong deference to commercial custom. Attributing this deference to the distinctive (and in some regards idiosyncratic) features of Llewellyn's jurisprudence, however, these articles fail to consider the instrumental basis for the various attitudes towards custom in the different branches of commercial law.

159. The circumstances under which efficient customs will evolve are complex, and a full

that the custom would be enforced as a legal matter, rather than left to nonlegal sanctions, because the transactor is likely to have an unduly optimistic view of the probability that his partner will comply with the custom. Conversely, the importance of a clear, highly predictable set of encoded formulations arguably is low, because parties do not often advert ex ante to the probabilities of legal outcomes for particular contingencies. Letters of credit and secured loans appear very different by these criteria. Here formality is important; drafters are sophisticated parties who can incorporate customary practices; and nonlegal incentives may work well.

From this perspective, it is not surprising that lender liability cases have provided a context where there is substantial disagreement about how willing courts should be to modify the meaning of express UCC formulations by reference to custom or course of dealing. The troublesome feature of these cases is the apparent difficulty that some borrowers have had in appreciating the divergence between fixed contract formulations and their own understanding of commercial custom.[160]

(d) *The law should hold all transactors to established customs, even when some transactors' understandings differ from those customs. Most prominently, the question arises when the courts apply the "neophyte rule."* Under that rule, only a transactor experienced in the trade has a duty to know trade practice. The transactor new to the trade — the "neophyte" — is not legally bound to trade customs that the contract does not spell out.

Courts are sharply split on the appropriate scope of the rule. Clearly, two complementary issues are key to analysis: (a) the newcomer's duty to learn the customs and usages of the trade; and (b) the experienced transactor's duty to ascertain that it is dealing with a new-

consideration is beyond the scope of this Article. For example, it appears that efficient commercial customs are most likely to evolve among a group of traders who are roughly homogeneous in variables such as the number of transactions each engages in and the large number of other traders with whom each interacts. *See supra* note 48. This fits one paradigmatic market type for sales of goods. Note that the criteria would not be satisfied by consumers markets or in long term "lock-in" contracts between a buyer and seller. For these contracts, different rules should apply, as the UCC suggests.

160. For examples of the divergence of interpretive approaches applied to letters of credit from those applied to sales contracts, see Exxon Co. U.S.A. v. Banque de Paris et des Pays-Bas, 828 F.2d 1121 (5th Cir. 1987), *vacated,* 488 U.S. 920 (1988); Amoco Oil Co. v. First Bank & Trust Co., 759 S.W.2d 877 (Mo. App. 1988). Similar principles apply to interpretation of trust indentures. *See* Sharon Steel Corp. v. Chase Manhattan Bank, 691 F.2d 1039, 1042 (2d Cir. 1982), *cert. denied,* 460 U.S. 1012 (1983). For these instruments, the ease of incorporating divergent custom and the importance of clarity would seem to be decisive factors. (Judge Winter's opinion in *Sharon Steel* emphasizes the latter).

For controversy under article 9, compare, *e.g.,* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (limiting discretion to demand payment on note payable on demand), with Flagship Natl. Bank v. Gray Distrib. Sys., 485 So. 2d 1336, 1340-41 (Fla. App. 1986) (declining to follow *K.M.C.*).

comer and to inform him of relevant customs.[161]

Principles of autonomy and reciprocity clearly accommodate a wide range of approaches to these issues. Whether the neophyte rule is efficient depends upon whether it is cheaper for sophisticated transactors to adapt their conduct to the occasional neophyte than for the neophyte to learn *all* of the rules of the trade before entering it or to bear the risk of his mistakes.[162] In this regard, the common run of cases applying the "neophyte" rule goes too far, for it seems quite unlikely that the uniform duty of disclosure — in effect, a duty to inquire into the background and skills of one's transacting partner — would be cheaper than holding the neophyte to at least a minimal standard of care.

C. *Assessing Costs by Reference to Principles of Autonomy and Reciprocity*

The analysis of the previous section applies to transactions characterized by one of three features: (1) all transactors would bargain to the same rule; (2) transactors rationally advert to the probabilities that rules will be adopted; (3) transactors have divergent understandings, but these understandings are determined by efficient customary understandings.

The analysis leaves unresolved cases with two characteristics. First, transactors are not fully rational or do not advert to legal enforceability of their statements in deciding what to say. Second, there is (or at least there likely will be) a set of interpretive and contracting conventions that diverge from ordinary usages of the group of transactors whose transactions are at issue. Under these conditions, one cannot without further analysis apply the conclusion of the previous section that efficiency and other norms commend the same principles for constructing hypothetical bargains. The key feature of these cases is that, depending on what rule one adopts, one will have different

161. Courts and legislatures are sharply split on both issues. *See, e.g.*, Flower City Painting Contractors, Inc. v. Gumina Constr. Co., 591 F.2d 162, 165 (2d Cir. 1979) (neophyte not held to trade meaning of term "units" because not aware of the meaning and had no duty to know the meaning); Marion Coal Co. v. Marc Rich & Co. Intl., Ltd., 539 F. Supp. 903, 905-06 (S.D.N.Y. 1982) (distinguishing *Flower City;* under U.C.C. § 1-205(3) persons bound by " 'any usage of trade in the vocation or trade in which they are engaged' " even if they are new to the trade (quoting U.C.C. § 1-205(3)); Doyle Dane Bernbach v. Avis, 526 F. Supp. 117, 119-20 (S.D.N.Y. 1981) (business florist not bound to know customs of advertising industry, having had no regular dealings with advertisers); Shubtex, Inc. v. Allen Snyder Inc., 49 N.Y.2d 1081, 399 N.E.2d 1154, 424 N.Y.S.2d 133 (1979) (usage binding); Shaw v. Dreyfus & Co., 64 Misc. 2d 122, 314 N.Y.S.2d 372 (1969) (usage binding only if "universal" so that "everyone" would know custom).

162. In some instances, the rule has an effect on the distribution of transaction costs among neophytes and more sophisticated transactors. The next section takes up the analysis of such effects.

effects on different transactors, or generate different types of costs. Principles of free choice or fair sharing of benefits may help supplement efficiency analysis when the adjudicator must decide what allocation of costs is preferable in order to determine what legal rule to adopt, or what type of cost should be incurred.

In particular, three features of these cases call for further analysis. First, the adjudicator's choice about how to construct the hypothetical bargain may affect the distribution of wealth among transactors. Second, the adjudicator's choice may affect other social values, particularly whether there is a good "fit" between the expectations of transactors and the outcomes of adjudicated cases.[163] Third, the adjudicator's choice may influence transactors' assessment of their own preferences.

1. *Aggregation of Gains and Losses*

In these cases, the question is distributional. The adjudicator must decide *who* should bear transactions costs. Consider a simple example where some workers would bargain for good faith protection in an at will regime; others would bargain for at will in a good faith regime. The background rule one adopts determines which group of workers bears these bargaining costs.

What considerations would lead an adjudicator to favor one distributional impact over another? One possibility is differences in wealth: if workers who would bargain for good faith protections are relatively wealthy, that might support adoption of an at will regime.[164] Another reason is that the adjudicator might consider, on autonomy or benefit grounds, that the transactor should have an entitlement to a "good": for example, rules about unions may impose costs on workers who disprefer unions, but that may be consistent with social judgment about importance of worker self-determination.

This analysis readily extends to distribution of ex post costs. Consider, for example, this situation: if adjudicators imply a good faith

163. One could consider the questions here as different aspects of the (here informally treated) problem of constructing the social welfare function that aggregates the various costs and benefits of various hypothetical bargains. The first section deals with how the costs are weighted depending on who bears them; the second section deals with the problems of estimating how much the costs are.

164. This may be the case for several characteristic reasons. Wealthier workers may win larger recoveries in suits for unjust dismissal; they may be more likely to hold jobs where such dismissals are a problem (because the firm can profit more by opportunistic behavior vis-à-vis highly paid workers); legal protections may be luxury goods that wealthy individuals are more willing to purchase (by forgoing additional wages) than poorer workers; and wealthier workers may be more sophisticated bargainers. The first three factors suggest that, even if bargaining costs were zero, wealthy workers would be more likely than poorer workers to prefer good faith protections.

term, most workers would bargain around it; only a few would not. If adjudicators imply an at-will term, a few workers who want it won't bargain for it, but most are spared the costs of bargaining. The costs of bargaining around are high. Workers who do not bargain for the term bear high costs from unjust terminations.

If poor workers bear costs of firing, this argues for adopting the rule that protects them, placing bargaining costs on wealthier workers. Thus, distributive effects are relevant both to distribution of ex ante costs and to distribution of ex post losses.

2. *Estimating the Magnitude of Transactions Costs*

The adjudicator who constructs the hypothetical bargain on efficiency terms must first determine the ex ante and ex post costs generated by the various alternative rules. A natural approach would be to assign the costs that the parties themselves would assign. But such shadow pricing is notoriously difficult, and adjudicators may lack the relevant data. Moreover, when transactors have limited information or are irrational, they may assign incorrect values. Instead, the adjudicator may have to consider autonomy or benefit values in determining the magnitude of the relevant costs.

Consider the values that she might consider in the previous example. The court deciding whether to imply a good faith or nongood faith term would have to compare the bargaining costs under the good faith rule to the ex post losses under the at will rule. Bargaining costs are straightforward, although one might want to include indirect costs such as the effects of such bargaining on employee relations and so forth. But the costs from unfair job terminations might include not only direct losses — search costs of new job, unemployment costs, costs of moving — but a large component of "psychic loss" such as loss of self-esteem or a feeling of being wronged by social arrangements that courts would have trouble attaching value to.[165]

In theory, the adjudicator might evaluate these losses by constructing a shadow price: figuring out the compensating wage differential that can be accounted for by the greater risk of opportunistic discharge. Such a calculation would be extremely difficult, however, because it would require the calculator to discern the rate of opportunistic discharge in various industries. Further, the wage adjustment is a poor index of the workers' actual valuation of job security when workers are poorly informed or overly optimistic about their

165. *See, e.g.*, B. BLUESTONE & B. HARRISON, THE DEINDUSTRIALIZATION OF AMERICA 61-66 (1982) (psychic and social losses from unemployment); P. WEILER, GOVERNING THE WORKPLACE 70 (1990).

job prospects, arguably a common occurrence.[166] Finally, the adjudicator might believe that the valuation attached to job security by workers, as reflected by wage adjustments, is an inadequate measure of the value of job security because it reflects *individual* valuations, rather than the collective benefits of a workplace where the worker-firm relationship is more scrupulously protected, and because it is limited by workers' current income and opportunity set.

These objections to shadow-pricing — in effect, objections to the definition of cost that method implies — point to the types of considerations to which a liberal or communitarian adjudicator might refer in valuing the ex post losses that result from alternative contract terms. Theories of moral personality attach particular substantive importance to some fundamental interests and to the opportunity to give a "lucid" or "true" account of these, which workers individually contracting may not be able to do ex ante.[167]

Further, the adjudicator should consider an inherent value to fit of social expectations and legally enforced norms. Suppose, for example, that workers and employers mistakenly think that no good faith term is the rule. They find out ex post that they are subject to the term. Autonomy might also focus on desirability of comporting obligation to intention, as well as to the direct ex post costs of these losses. Note that those who *can* bargain for an applicable norm will know what it is, so fit suggests imposing costs on them in order to make sure that those not informed also enjoy fit ex post if they find out only then what the rule is.[168]

In appealing to these values, the adjudicator effectively can consult norms purportedly independent of transactors' actual preferences and

166. *See* Charny, *supra* note 41, at 417-18.

167. *See, e.g.*, Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 786-97 (1983).

168. If she focused solely on the impact of the rules on the cost of transacting, the adjudicator would determine the appropriate degree of generality by two inquiries: (1) if transactors will bargain around, what is the costs incurred in doing so? (2) If transactors will not bargain around, what are the ex post (conduct and enforcement) costs of the different rules? In contrast, an adjudicator influenced by conceptions of autonomy could conclude that there is an inherent good to individualizing outcomes with prior assumptions, other things being equal. If transactors bargain around, one obtains fit either way, and so the conflict disappears; the only issue is whether it is cheaper to get at the parties' preferences for a term by forcing them to write it down or by reconstructing it ex post. If there is no bargaining around, however, fit might lead to the choice of a rule without adverting to, or considering decisive, the ex post costs incurred. This type of conflict may occur frequently. Imaginative reconstruction may mean greater level of specificity than instrumental calculation if one concludes that analysis should be conducted at a fairly high level of generality (rules with broad scope of application). An instrumentally defined convention may accomplish cheaper adjudication because it avoids the need for lots of the specific proof one needs for more contextualized demonstrations of intent or practice. And the instrumentally defined convention may be more predictable as formalized rules of interpretation develop and as values of formality are generally inculcated as a social matter.

valuations because, by hypothesis, transactors will not trump the adjudicator's construction of the (now idealized) hypothetical bargain by bargaining around. In other words, the analysis here only applies where there are at least *some cases* where the adjudicator's choice of the rule determines what the rule turns out to be for the transactors.

3. *Preferences Influenced by the Default Rules*

A final case where direct evaluation of costs is difficult is the case where transactors' preferences — their evaluation of costs and benefits — are influenced by the rule that the court adopts. Consider, again, the example of employment at will: If adjudicators adopt an at will rule, workers and employers will not bargain around it. If adjudicators adopt a good faith rule, workers and employers will not bargain around that rule, and experience with the rule will change perceptions of appropriate workplace relationships (resolve differences rather than firing, loyalty to the firm and so forth).

There is suggestive evidence for such effects. For example, empirical laboratory studies of bargaining behavior indicate that persons will demand a larger payment to give up a good than they would make to obtain that good.[169] This suggests that *where* the background (default) rule places an entitlement may, correspondingly, affect how much transactors would have to pay to change the background rule:[170] em-

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169. Harless, *More Laboratory Evidence on the Disparity Between Willingness to Pay and Compensation Demanded,* 11 J. ECON. BEHAV. & ORG. 359 (1989) (measuring "endowment effect"); Knetsch & Sinden, *Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value,* 99 Q.J. ECON. 507 (1984) (same). The celebrated work of Kahneman and Tversky documents the closely related phenomenon of "loss aversion": persons see a loss from the status quo as more harmful than a corresponding gain is seen as beneficial. *See* Kahneman & Tversky, *Prospect Theory: An Analysis of Decision Under Risk,* 47 ECONOMETRICA 263, 286 (1979). Finally, the phenomenon posited in text may be created by the familiar phenomenon of "sour grapes" or "adaptive preferences" reasoning: persons convince themselves that whatever they have is best for them. *See* J. ELSTER, SOUR GRAPES: STUDIES IN THE SUBVERSION OF RATIONALITY 109-40 (1983).

170. Analysts dispute the extent to which such cognitive distortion impairs transactional outcomes in markets. *See, e.g.,* Scott, *Error and Rationality in Individual Decisionmaking: An Essay in the Relationship Between Cognitive Illusions and the Management of Choices,* 59 S. CAL. L. REV. 329 (1986); Schwartz, *supra* note 6. There are at least three problems with drawing direct inferences about transactors' conduct from experimental studies of cognitive processes. First, it may be that transactors understand that such distortions affect their judgment and so deliberately attempt to correct for them in deliberating about what contracts to enter into. Second, countervailing distortions often make it difficult to extrapolate from laboratory data to real world conduct. For example, there is evidence that persons both overestimate and underestimate the probabilities of low probability events. (Similarly, if more colloquially: while the fox may think that the grapes she cannot reach are always sour, the cow may conclude that the grass is always greener on the other side of the fence.) Third, "shopping" by a subgroup of rational transactors may suffice to generate efficient results in the market as a whole. *See* Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal Economic Analysis,* 127 U. PA. L. REV. 630, 650 (1979); *cf.* Charny, *supra* note 41, at 437 n.190 (limitations to this mechanism for correcting informational distortions). Nonetheless, there is at least suggestive

ployees may not be willing to pay employers enough to obtain good will protections; but, once given, employers may not be able to pay employees enough to induce them to give up these protections.[171]

For the adjudicator, the difficulty is that each rule, once adopted, would seem to be efficient. Each rule incurs the same bargaining costs, at least to the extent that transactors accept the rule rather than bargaining to change it. Further, each rule corresponds ex post to the preferences of the parties.[172] Thus, there is no direct efficiency ground for choosing one rule over the other. A decisionmaker might be perplexed by the circularity of the choices presented.

Instead, the adjudicator must make a judgment based on some other set of values about social relationships. If there is some substantive reason to prefer one's projected (and different) values, then that reason, duly acknowledged, simply becomes part of the set of the decisionmakers' considerations. One thus would reach a judgment ex ante about the preferability of the various outcomes, lucidly considering the desirability of each state of affairs from the point of view of one's current values.[173]

D. *Critiques of Instrumental Analysis*

As I indicated at the beginning of the article, there is a standard set of criticisms of the use of efficiency as a normative conception in contract adjudication, and similarly, within contract theory, a standard, if not always carefully formulated, set of nonefficiency justifications for enforcement of contracts. I have argued, notwithstanding these other approaches, that a transaction costs framework provides a fair basis

evidence of the effects of entitlements and accompanying cognitive distortions on workers' decisionmaking, *see* Anderson, *Values, Risks, and Market Norms,* 17 PHIL. & PUB. AFF. 54, 58-62 (1988) (surveying research in the field).

171. The legal rule also may affect the outcomes of bargains by creating a background reference point against which workers test the fairness of contracts that are offered to them. *Cf.* Kahneman, Knetsch & Thaler, *Fairness and the Assumptions of Economics,* 59 J. BUS. S285, S287-88 (1986). The perception that the contract is fair is an important determinant in bargaining outcomes; often workers appear to prefer a fair arrangement over a more lucrative arrangement that appears to be unfair, because, for example, it benefits other workers more than them on arbitrary grounds. *See, e.g.,* J. DEUTSCH, DISTRIBUTION JUSTICE 133-95 (1985) (empirical studies in laboratory conditions); P. WEILER, *supra* note 165; Akerlof, *Labor Contracts as Partial Gift Exchange,* 97 Q.J. ECON. 543, 549-57 (1982) (economic analysis).

172. That is, whatever costs are incurred by the rule — such as the litigation costs incurred ex post to enforce a good faith rule — are perceived by the parties to be worth the cost.

173. If one can arrive at no ex ante preference and each outcome is ex post preferred to the other, then the preference criterion is indeterminate. This is not a conceptual problem, however, but simply reflects the psychological fact that the decisionmaker is genuinely indifferent between the two outcomes, a situation unlikely to exist. Similarly, if one can arrive at no ex ante preference and each outcome is ex post dispreferred to the other, one faces the prospect of inevitable dissatisfaction; again, this identifies a fact about the decisionmaker's psychology, or perhaps, psychopathology.

for constructing a set of guidelines for enforcing hypothetical bargains. Before turning to specific examples of the analysis, it might be useful to summarize the ways in which the framework incorporates the concerns expressed by these alternative approaches. The principles of autonomy and fairness, as we have seen, provide a framework for understanding how these concerns bear on contract adjudication.

The critiques of efficiency analysis in contract law focus on three aspects. (1) Economic analysis, by emphasizing welfare maximization based on the sum of individuals' current preferences, takes an overly simple view of human motivations and decisionmaking capabilities and thereby neglects other social values that should be served by adjudication.[174] (2) Economic analysis takes preferences as fixed, as rational, or as uninfluenced by legal rules, and ignores the effect that allocation of goods by market transactions and adjudication that enforces rights based on those transactions have on preferences and social relationships.[175] (3) Economic analysis is blind to or biased in analyzing distributional consequences of legal rules.[176] For critics, these features of economic analysis point to the need for another justificatory paradigm for judicial decisionmaking. These critiques are undoubtedly serious concerns for some domains of legal rules.[177]

The unified framework presented here appropriately accommodates these concerns. First, regarding other "social values," autonomy and fairness theorists may claim that hypothetical contract adjudication should recognize an independent value to obtaining a close fit between adjudicated outcomes and socially embedded expectations; moreover, that hypothetical contract adjudication should correct for false or mistaken preferences held by individual transactors. In appropriate cases, efficiency analysis accommodates and, indeed, may endorse these values. In cases where transactors will defer to the hypothetical bargain formulated by an adjudicator, the adjudicator should construct the bargain to minimize ex post contract losses, and,

174. *E.g.*, M. KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 126-41 (1987); A. SEN, ON ETHICS AND ECONOMICS (1987); Harrison, *Egoism, Altruism and Market Illusions: The Limits of Law and Economics*, 33 UCLA L. REV. 1309, 1332-34 (1986); Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849, 1866-71 (1987).

175. J. ELSTER, *supra* note 169; A. SEN, *supra* note 174; Radin, *supra* note 174, at 1871-87, 1909-14.

176. *E.g.*, Kennedy, *supra* note 107; Harrison, *Trends and Traces: A Preliminary Evaluation of Economic Analysis*, 1988 ANN. SURV. AM. L. 73, 102-03 (reviewing literature).

177. For example, legal rules regarding taxation undoubtedly influence the distribution of wealth. More recently, it has been argued that some rules of corporate law — for example, those fostering takeovers or tolerating insider trading — may have had a similar effect over the past decade. Another example is the law of racial discrimination, which takes as one of its primary goals the changing of preferences with regard to racial contacts in society.

in doing so, may consider costs caused by deviation from extant expectations or mistaken judgments by individuals.[178]

The second and third criticisms of efficiency analysis — the need to consider effects of adjudication on transactors' preferences and on distribution of wealth among transactors — also are readily reflected in the construction of hypothetical bargains by transaction costs criteria. Indeed, the efficiency analyst would have to consider effects on preferences and distribution when they occur, for these effects alter the assessment of alternative contract terms on efficiency grounds. When the choice of contract term by the adjudicator influences preferences or distributions, efficiency analysis is indeterminate without some further set of criteria to acertain which preferences or distributive outcomes are desirable, and the adjudicator may turn to theories of autonomy and fairness to help her make this determination.[179]

IV. THE FRAMEWORK APPLIED

The challenge for the adjudicator is to apply these paradigms to concrete cases. This requires an empirical assessment of the features of the transaction and the market in which the transaction occurs. Here I consider three exemplary cases that present problems for adjudicators' construction of hypothetical bargains.

A. *Contracts Among Shareholders in Close Corporations*

Recent developments in the law of close corporations pose particularly difficult problems for the theory of hypothetical bargains. These

178. In contrast, if transactors will bargain around the hypothetical contract imposed by adjudicators, the autonomy and fairness theorists should recognize by reference to their own goals that it is self-defeating to attempt to impose a different contract term by hypothetical bargain.

179. As Richard Posner has argued, instrumental economic analysis (particularly what he calls "wealth maximization") does not provide a definitive normative standard for the legal system in regulating transactions where diverse social values or ends are at stake. *See* R. POSNER, *supra* note 70, at 374-87; Posner, *What Has Pragmatism to Offer Law?*, 63 S. CAL. L. REV. 1653, 1668 (1990). Nonetheless, as Terry Fisher pointed out to me in discussing an earlier draft of this Article, even lawyers with a deep skepticism of a strictly economic or instrumental approach to legal problems find that, as a practical matter, the recommendation of an instrumental approach largely coincides with those of frameworks that begin with a conception of the right or a noninstrumental conception of the good. *E.g.*, Fisher, *Reconstructing the Fair Use Doctrine*, 101 HARV. L. REV. 1659 (1988); Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

In the context of hypothetical bargains, this convergence reflects at least two sociological aspects of instrumental theory as applied to contract law. First, in consensual transactions, persons react to legal norms in various ways that create costs. Second, market transactions inevitably contemplate a minimal common sense of instrumental purpose, without which bargains make no sense at all. Conversely, there remain large areas — involving preference formation and distribution of entitlements or goods where individuals lack information to bargain — where economic reasoning must be supplemented by the fuller set of considerations outlined here.

difficulties reflect several features of transactions among close corporation participants, including the complexity of the relationship among participants over time (the large number of contingencies that arise, most of which cannot be dealt with explicitly in ex ante agreements), the diversity among participants in foresight and ability to bargain, and the high costs to enterprise of ex post judicial intervention.

A recurrent problem in this context arises when the venturers make a decision that deprives one of the shareholders of what she perceives to be her fair share of the gains from the enterprise. This may occur because the participant loses or leaves a job with the company that had provided as compensation a share in the company's profits.[180] Or active shareholders may deprive others of income by refusing to pay dividends[181] or by diverting business opportunities to themselves. Or the shareholder may suffer by having his shares bought out at less than full value, either through fraud[182] or exercise of majority power to put the shareholder in a position where he is desperate to sell.[183]

Because it is generally feasible for the small number of shareholders in a close corporation to bargain among themselves, one view of the appropriate hypothetical bargain — forcibly expounded by Easterbrook and Fischel — would leave these questions to express contract. Hypothetical bargain will impose no obligation bargain, because the parties feasibly can expressly provide for whatever distribution of profits and business advantages they believe to be appropriate.[184]

This approach distinguishes distributional rules from the basic fiduciary prohibitions against incompetence and theft. Although presumably shareholders might contract out of these in specific instances, it seems correct to assume that shareholders in close corporations would generally want basic fiduciary prohibitions in place, rather than having to build them into express contracts. On distributional questions, in contrast, managers and shareholders should be free to make whatever decisions they wish, as long as they comply with basic fiduciary norms.

In contrast, some jurisdictions have gone considerably farther,[185]

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180. *E.g.*, Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976).

181. Sugarman v. Sugarman, 797 F.2d 3 (1st Cir. 1986); Smith v. Atlantic Properties, Inc., 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981).

182. *E.g.*, Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

183. Sugarman v. Sugarman, 797 F.2d 3 (1st Cir. 1986).

184. Easterbrook & Fischel, *Close Corporations*, *supra* note 6. The methodological assumptions made by Easterbrook and Fischel are discussed in *supra* section II.A.1.

185. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983).

protecting shareholders' legitimate or reasonable expectations in such matters as employment, dividends and distributions, and buy-outs. Express contract terms are not the only source of such judicially protected expectations; courts also look to more informal discussion or arrangements, past practices, and a general sense that participants have reason to expect a stable and equitably allocated flow of profits to themselves as income.

The framework that I have developed suggests that this emergent judicial approach is preferable to the more austere set of background norms that Fischel and Easterbrook proposed. Occasions for opportunistic distribution of gains from the enterprise arise in an enormous array of situations that may be difficult to anticipate via contract terms. Given the complexity of the requisite provisions, it would seem to be substantially cheaper to imply a strong set of background duties and permit individual transactors to draft opt out provisions. Further, many close corporation participants are ill-advised or unsophisticated and so may not anticipate such matters. Finally, a freeze-out may have very onerous financial consequences for the excluded shareholder, whose livelihood or human capital is likely to be tied up with his opportunities to profit from participation in the enterprise.

To be sure, it is not clear that the more protective judicial approach can be justified as efficient in a strict sense. The choice of a more protective hypothetical contract regime involves imposing costs of drafting opt out agreements on some transactors to protect other transactors who would not have the sophistication or good judgment to insist by contract on the protections that they automatically receive under a more protective regime.[186]

186. One might justify a "Rawlsian" bargain among idealized close corporation participants in advance. As a practical matter, this idealization simply represents a judgment that courts should try to assure a fair distribution of benefits in close corporation cases, even if that increases drafting costs for other transactors.

As noted in *supra* section II.A, the Rawlsian bargaining rigorously embodies efficiency concerns when transactors advert to the risks of opportunism ex post. For example, if all close corporation shareholders rationally advert to the possibility of ex post redistributive behavior, but realize that they cannot contract against it because the contract provisions are too costly, then it reduces transactions costs for the courts to provide these terms. In particular, it facilitates close corporation arrangements that parties would otherwise not enter into because they feared that they would lose out from opportunism that they could not protect themselves against by contract.

The argument seems not entirely plausible, however, because many shareholders may not have the sophistication to appreciate the risks that they would face. For that reason, their ex ante transactional behavior would not be affected by the background legal regime, and one cannot say that, by providing a more protective regime, one facilitates transactions that otherwise would not go forward.

B. *Contracts Between Doctors and Patients*

In regulating medical care, courts face the problem of determining the meaning or scope of therapeutic assurances that doctors give to patients.[187] In *Garcia v. von Micsky,*[188] for example, plaintiff sought to enforce what she claimed was a promise, made to her by a physician after a tubal ligation and a subsequent examination of the patient, that she could no longer become pregnant. The court held that it was a mere "therapeutic reassurance":[189] it was not to be interpreted as a *promise* that the woman would not get pregnant, and so did not give rise to legal liability.

As Judge Oakes argues in dissent, a simple reconstruction of the doctor-patient interaction makes the court's decision seem questionable under standard rules of contract. The court's opinion reports: "Dr. Von Micsky entered the waiting room with Mrs. Garcia and, in the sister-in-law's hearing, told Mrs. Garcia 'that she had nothing to worry about, that it was impossible for her, you know, to have any more children and to try to relax and take it easy.' "[190] As Judge Oakes argues, the statement, accompanied by suitable evidence of substantial reliance, would seem to provide a classic case for invocation of promissory estoppel.[191]

But the question of interpretation — whether promissory estoppel is to be invoked to impose liability upon the doctor — is not quite as clear as Judge Oakes' formulation would suggest. First, consider how the doctor and patient themselves might have understood their interaction. Promissory estoppel applies only to *promises:* it articulates the community conception that it is morally culpable to lead an individual into foreseeable reliance on the basis of one's commitment, and then to breach that commitment. So the interpretive question is whether the doctor's statement was a promise.

The difficulty is that not all statements about the future are promises.[192] "It's not going to rain today" does not give rise to promissory estoppel liability if you are soaked through because you left

187. Courts often face the question whether doctors' predictions or reassurances rise to the level of enforceable promises. For general discussion of courts' approaches, see Stephens v. Spiwak, 61 Mich. App. 647, 233 N.W.2d 124 (1975); Mason v. Western Pa. Hosp., 286 Pa. Super. 354, 428 A.2d 1366, 1368 (1981), *vacated,* 499 Pa. 484, 453 A.2d 974 (1982).

188. 602 F.2d 51 (2d Cir. 1979).

189. 602 F.2d at 53.

190. 602 F.2d at 52.

191. 602 F.2d at 53-54 (Oakes, J., dissenting).

192. The promise has a performative function that the simple prediction lacks. *Cf.* J. AUSTIN, *Performative Utterances,* in PHILOSOPHICAL PAPERS 233 (2d ed. 1970).

home without your umbrella.[193] But often the distinction is only inchoate in the statement at the time it was made. As we try to determine whether Mrs. Garcia, or her physician, conceived of the reassurance as a promise, it becomes apparent that we often do not consider the nature of the statement until an event arises that may count as breach. From a moral point of view, the issue is whether the patient should have understood that there was some chance that this was mere reassurance that could be erroneous, rather than one that invoked the very powerful moral conventions that attach opprobrium to breach of a promise. The doctor could plausibly conceive of the statement as a mere reassurance — an apparently somewhat desperate attempt to get Mrs. Garcia through a very difficult emotional situation — while the patient, particularly given her apparent emotional difficulties, might have understood a higher level of trust being invoked. It is such a breach of trust, which causes damage through invoked reliance, that the law chooses to make actionable under the doctrine of promissory estoppel.

An instrumental approach to the interpretive problem would proceed by analyzing a very different set of considerations. From an instrumental point of view, there is no reason to make the semantic or hermeneutic distinction between promises and other statements at all; the problem of interpretation does not appear in that guise. Instead, the instrumental question — which generates an answer to our interpretive problem — is which rule lays out optimal ground rules for transfer of information between doctors and patients: which maximizes net benefits from the doctor-patient relationship? Under this approach, all statements are analyzed simply for their value as information.

In particular, the question in the case would focus on who should bear the risk that the doctor's communication to the patient would be misunderstood. The background rule for the doctor-patient relationship is the tort rule of negligence: the doctor is liable for unreasonably caused harms to the patient. We take the negligence rule as efficient — as do courts that have analyzed the problem[194] and assume, as well, that there is no allegation (as there was not) that the doctor's statement to the patient was negligent in the sense of constituting malpractice. In that case, the effect of the patient's theory of recovery is

193. The distinction is one that we learn quite young. Children seem to perceive fairly early that the claim — "but Daddy, you *promised*" — is one that at least puts Daddy on the defensive by suggesting a culpable breach of trust; and so the wise parent inculcates the distinction between promise and prediction, if only to maintain his or her own freedom of action and sanity.

194. A useful statement of the characteristic approach to physicians' promises is Gault v. Sideman, 42 Ill. App. 2d 96, 100-02, 191 N.E.2d 436, 441-43 (1963).

to transmute the rule of negligence into a rule of strict liability for any case in which the doctor's statement misinforms the patient of the probability of some future conduct on the patient's part. But there is no reason to think that the strict liability rule would be efficient for this type of physician conduct, if the negligence rule is efficient everywhere else. One would conclude, then, that the patient's theory should fail. We should not treat physicians' assurances as promises, in other words, because the instrumental effect of such an interpretation would be an undesirable shift in the standard of liability from negligence to strict liability in tort.

In the *Garcia* situation, doctors advert to legal standard quite explicitly in their decisions about medical treatment, including the types of commitments to be made to patients. To the extent permitted by law, a rational doctor would obtain a disclaimer against liability under a rule that held therapeutic assurances to be an enforceable contract. In any event, by hypothesis, a holding of liability will not change physicians' conduct, as reassurance is not negligent. At best, then, imposition of liability would function as a type of compulsory insurance policy, distributing among patients as a group the costs of accidents such as that suffered by the plaintiff in Garcia.

C. *Contracts in Intimate Nonmarital Relationships*

Carroll v. Lee[195] posed the question whether the parties, two unmarried persons living together, had reached "an implied partnership or joint enterprise agreement" to acquire jointly certain property. Under the court's reading of the partnership agreement, "Judy,"[196] who was trained as a darkroom technician, agreed to stay home and keep house while "Paul" worked as a mechanic in an auto repair shop. In construing the agreement, the court gave decisive weight to this testimony by Judy:

> Q: What type of an arrangement, if any, did you and Paul discuss about what he expected from your relationship in terms of your contribution?
> A: We didn't really discuss it. *It just was there.* He went to work. I stayed home and kept the house and, mostly because that's what he wanted me to do.
> Q: He told you that's what he wanted you to do; didn't he?
> A: Oh, yeah.

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195. 148 Ariz. 10, 14, 712 P.2d 923, 927 (1986). For a survey and comparative analysis of developments in this area of law, see M. GLENDON, THE TRANSFORMATION OF FAMILY LAW 277-84 (1989).

196. The court refers to the plaintiff and defendant as "Judy" and "Paul" throughout its opinion.

Q: And that, that included all the things that I went through with him, such as taking care of the laundry —
A: Uh-huh, of course.
Q: — doing the dishes —
A: Yes.
Q: — cleaning the house —
A: Yes.[197]

From this (and confirming evidence from Paul about the facts of the domestic relationship), the court concluded that "the trial court could find the existence of an agreement for property to be acquired and owned jointly . . . . [W]e find a valid implied contract to combine efforts and jointly accumulate certain property . . . ."[198]

The method of interpretation here diverges sharply from that in cases like *Garcia.* Here there is no question but that legal consequence attaches to the reconstruction of the parties' actual understandings, as imagined or inferred from the court based on the circumstances of their relationship. The expectation that Judy would share jointly in accumulated property is transmuted directly into a legal claim.

An alternative approach to the case would have adverted, as courts do in a cases like *Garcia,* to an instrumental construction of interpretive convention. The empirical considerations are parallel to those of the doctor-patient relationship. Again, the intimacy of the relationship may lead to numerous statements or assurances that could be construed as enforceable promises or warranties. The opportunity for perjured or innocently distorted recollection may tempt litigants. Public policy has provided an alternative set of regulatory structures for regulating similar claims: here, the institution of marriage (and, in some jurisdictions, common law marriage), as well as the formalities concerning acquisition, gift, and disposition of property. On these grounds, some jurisdictions have insisted on a more formalized demonstration of agreement.[199]

In *Lee* the interpretive strategy of imaginative reconstruction can be justified on several grounds. Most important, decisions like *Lee* may help to change social attitudes about duties of men and women living in intimate relationships. The process of imagined reconstruction enables courts to face, explicitly or implicitly, the question of empowerment: how much to idealize the imagined bargain to an approximation of ideal speech situation of full lucidity, access to relevant information, and equal freedom to assert claims (equal bargaining

197. 148 Ariz. at 15, 712 P.2d at 928.

198. 148 Ariz. at 15-16, 712 P.2d at 928-29.

199. *See, e.g.,* Morone v. Morone, 50 N.Y.2d 481, 413 N.E.2d 1154, 429 N.Y.S.2d 592 (1980).

power). Often, the woman or, more generally, the domestic partner would have grave self-doubts and only the most tenuous hope of escaping with some shred of financial and personal integrity. And the reluctance to ask for any sort of commitment in writing, or to consummate a marriage, may be a symptom of doubts about the strength or durability of the relationship or the reliability of the purported promises. The agreement that Judy successfully argues for in *Lee* may not be "just there." In these circumstances, to approximate a bargain that included these psychological contingencies would be to perpetuate or reenact what many would condemn as the unjust distribution of power among men and women, or the roles traditionally associated with them, in our society.

It is equally important to note, however, that the implicit paternalism of this approach will not be self-defeating to the extent that such decisions can change persons' attitudes or at least obtain their acquiescence. The judicial standard of fair conduct may be one that persons will defer to, at least if it is within a socially acceptable range. Men may be reluctant to insist on bargains that circumvent legal rules regarding distribution of property, or they may fail to do so simply because of the costs of fully adverting to the legal rule.[200]

CONCLUSION

Courts generally interpret contracts — resolve ambiguities and fill in missing terms — by asking what the parties would have agreed to had they explicitly addressed the issue before the court. But this hypothetical bargain formulation conceals a complex set of issues.

I have developed here an alternative approach to the problem of interpretation:

(1) The interpreter must first determine whether subsequent transactors will be in a position to bargain around the interpretation that it will proffer. This is a crucial yet generally ignored first step to choosing the method of interpretation.

(2) If transactors will be in a position to bargain around the court's interpretation, then the court should interpret by a strictly instrumental calculation. It should choose the interpretation that will minimize prospective bargaining costs. As section III.C has explained, this does not mean choosing what most bargainers would want, or choosing

200. To the extent that men incompletely bargain to nullify the rule, the effect would be to redistribute from men to women. (It would provide the mirror image of the California rules for distribution on no-fault divorce, which have enriched men and impoverished women. *See* L. WEITZMAN, THE DIVORCE REVOLUTION: THE UNEXPECTED SOCIAL AND ECONOMIC CONSEQUENCES FOR WOMEN AND CHILDREN IN AMERICA 20-32, 357-66 (1985)).

what the parties before the court would have wanted; nor should the court make any attempt to correct what they believe to be mistakes made by transactors. Rather, the court should choose the interpretation that will induce parties to expend the least effort in bargaining around the court's interpretation.

(3) If some future transactors would *not* bargain around the court's interpretation, then the court faces a more complex inquiry. The court should consider the costs that future parties will incur in bargaining around the rule. But the court must also consider three other factors.

First, it should consider which interpretation would be desirable for the parties who will simply accept whatever interpretation the court now adopts. In this inquiry, the court should consider all of the consequences of alternative rules, and may decide to advance values or goals different from those that the transactors would choose for themselves. Second, the court should keep in mind that different interpretations may impose costs on different classes of transactors. The court then should consider which distribution of costs is most desirable. Third, the court may find that enforcing a proposed interpretation may modify transactors' understandings or preferences in a way that the court believes to be socially desirable. That finding would provide a reason to adopt the interpretation, even though it does not correspond to what the parties would now explicitly bargain for.

In short, careful analysis requires that courts adopt the simple hypothetical bargain conception in a number of important respects. Courts that pursue a more naive conception — most often, simply focusing on the intent of the parties before the court — will often adopt interpretations that are neither fair nor efficient. The conception of the hypothetical bargain is no more than a misleading metaphor unless it is understood in terms of the type of analysis advocated here.

Aside from the important task of achieving conceptual clarity, the analysis proposed here has, as we have seen, practical implications for courts' approach to particular types of contracts. Cases will often involve situations in which a simplistic notion of hypothetical bargain leads to incorrect results.[201] For example, in many corporate contexts, courts should adopt a rule different from the one that parties would opt for. With complex contracts it is much more expensive to draft a detailed, complicated set of terms than to opt out of them, once the

201. Indeed, this is the prediction of litigation models that propose that parties will litigate cases where the rule is inefficient. To the extent that the analysis here has identified modes of interpretation that are inefficient, these theories would predict that litigation frequently involves the types of transactions where inefficient modes of analysis are used.

law has put them in place. The opt out can foreclose an area of law from application, or it can identify particular exceptions that leave in place a large number of other rules for other situations. In both instances, it is easier to draft the opt out than the entire body of rules. Much of corporate law and the law of complex or relational contracts is characterized by this asymmetry.

Also, in a large number of transactions, parties will not bargain around whatever rule the courts put in place: either they will simply defer to the rule, having no preference against it; or, in some instances, application of the rule will persuade parties that it is correct; or parties will defer to the legal decisionmaker who they believe to be better informed than the parties themselves; or bargaining costs for alternative rules may simply be too high. Thus, in these cases, "what the parties would have done" — the hypothetical bargain — should exert no authority on courts whatever. In large areas of the law, where parties are naive or where social norms are in flux, the usual notion is conceptually not in play.