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RESTATEMENT SECOND: OMITTED TERMS AND CONTRACT METHOD

Richard E. Speidel†

The Restatement (Second) of Contracts is an impressive commentary on private law by an influential private group, the American Law Institute. It presents a comprehensive and integrated body of general, rather than specialized, contract law. More importantly, it provides a blueprint for judicial reasoning in the adjudication of contract disputes.¹ For this reason alone, the document deserves careful study.

One promising study technique is to select a "core" idea that, upon careful analysis, will reveal an underlying contract method. For the "core" idea I have selected section 204, entitled "Supplying an Omitted Essential Term." According to the Reporter, section 204 is "new" to the *Restatement Second*.² I focus upon method because changes in the modes of operating, or in the means of obtaining results, from the first *Restatement* to the *Restatement Second* are thought to be important. Professor Havighurst, writing in 1933, concluded that the first *Restatement*, then new, had roots in the past and was the "result of a time honored method."³ Professor Braucher, the first Reporter of the *Restatement Second*, wrote that stylistic revisions in early drafts of the *Restatement Second* were symptomatic of a fundamental shift in modes of thought from the

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¹ According to its Reporter, the *Restatement Second* was formulated with a "proper view of the judicial function in mind" to provide a "modest but essential aid in the improved analysis, clarification, unification, growth and adaptation of the common law." Farnsworth, *Ingredients in the Redaction of the Restatement (Second) of Contracts*, 81 COLUM. L. REV. 1, 5 (1981) (quoting Professor Herbert Wechsler).

² RESTATEMENT (SECOND) OF CONTRACTS § 204, Reporter's Note (1979). The problem of judicial "gap filling," however, is hardly new, see Prosser, *Open Price in Contracts for the Sale of Goods*, 16 MINN. L. REV. 733 (1932), and the *Restatement Second*'s solution is, as we shall see, hardly innovative. See U.C.C. §§ 2-301 to 2-328. See also Braucher, *Interpretation and Legal Effect in the Second Restatement of Contracts*, 81 COLUM. L. REV. 13, 14-15 (1981) (§ 204 is based on the work of the Reporter, Professor Farnsworth); Farnsworth, *Disputes Over Omission in Contracts*, 68 COLUM. L. REV. 860 (1968). For a recent and unprecedented exercise in judicial "gap filling," see *Aluminum Co. of America v. Essex Group, Inc.*, 499 F. Supp. 53 (W.D. Pa. 1980), discussed in Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 NW. U.L. REV. 369 (1981).

³ Havighurst, *The Restatement of the Law of Contracts*, 27 ILL. L. REV. 910, 922 (1933).

"doctrinal" to "explanation and rationalization."⁴ Similarly, Professor Corbin, an adviser to both Restatements, concluded just before his death in 1967 that the *Restatement Second*, although founded upon and not wholly inconsistent in substance with the first *Restatement*, would show "many differences, sometimes in substance, and throughout in forms of expression."⁵ Because "modes of thought" and "forms of expression" are important ingredients in method, examining them in conjunction with a "new" substantive idea should be instructive. Much has happened in the legal community since the *Restatement Second* project was started in the early 1960s. A study of this sort might reveal something about the nature, current utility, and future prospects of the *Restatement Second* and its place in the constantly evolving law of contracts.

I

FROM RULES TO STANDARDS

One shift in method from the *Restatement* to the *Restatement Second* is revealed by the dominance of standards over rules⁶ in the processes of contract formation and interpretation. Of course, there are still some enduring "rules," such as the requirement that a bargain contract must have both a promise and a consideration. To put the matter more elaborately, both Restatements require a "manifestation of mutual assent to a bargain" plus consideration to form a contract.⁷ The shift from rules to standards appears within this statement of general requirements. To appreciate this, some background is needed.

⁴ The crisply authoritative style of the original not unnaturally tended to reflect the doctrinal temper of the latter part of the nineteenth century. Explanation and rationalization, in contrast, are likely to force attention to social change, to produce qualification and restraint in the interest of realism, and to end in reliance on utilitarian ideals.

Braucher, *Offer and Acceptance in the Second Restatement*, 74 YALE L.J. 302, 303 (1964).

⁵ Corbin, *Samuel Williston*, 76 HARV. L. REV. 1327, 1329 (1963). According to Professor Braucher, Williston, who was the Reporter for the first *Restatement*, "provided a bridge between the contrasting dogmatisms of O.W. Holmes and C.C. Langdell, on the one hand, and the focus of mid-twentieth century thought on purpose and function, on the other." Braucher, *supra* note 4, at 303. The "modernism" of Corbin provided a bridge between Williston and the realists. Corbin was acceptable to the realists, while Williston was not. *Id.* On the influence of other persons on the drafting of the *Restatement Second*, see Farnsworth, *supra* note 1, at 3-5. For more on the roles of Langdell, Holmes, and Williston in the development of the grand theory of contract, see G. GILMORE, *THE DEATH OF CONTRACT* (1974).

⁶ In jurisprudence, the tension is between positivism, which is "a model of aid for a system of rules," and what Professor Dworkin has called "principles, policies and other sorts of standards." R. DWORKIN, *TAKING RIGHTS SERIOUSLY* 22 (1977). The difference has substantive implications. See Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1976), where it is argued that a model of clearly defined, highly administrable, general rules is used to foster the substantive idea of "individualism" while the idea of "altruism" can be realized by use of equitable standards producing ad hoc decisions with relatively little precedential value.

⁷ Compare RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (1979) with RESTATEMENT OF CONTRACTS §§ 1, 3, 4, 19, 10 & 75 (1932).

Suppose that *A* and *B* manifest assent to the exchange of a described service for a price "to be agreed upon in the future." *A* commences performance, but shortly thereafter, *B* repudiates the bargain. *A* claims that *B* has breached a contract and must pay damages measured by *A*'s expectation interest. *B* argues that no contract was formed. Who should prevail? Professor Williston, in the first edition of his treatise, stated that there could be "no legal obligation" in cases of this sort until the parties had agreed in fact on the price. Because either party could refuse to agree, it was "impossible for the law to affix any obligation to such a promise."⁸ The *Restatement*, of which Williston was Reporter, prescribed that an offer "must be so definite in its terms, or require such definite terms in the acceptance, that the promises and performances to be rendered by each party are reasonably certain."⁹ It explained that because "the law of contracts deals only with duties defined by the expressions of the parties, the rule . . . is one of necessity as well as of law."¹⁰ In dealing with the problem of an "agreement to agree," the *Restatement* made it clear that when the "only method of settling the price is dependent on future agreement of the parties, and . . . either party may refuse to agree, there is no contract."¹¹ The answer, then, was clear: *A* had no contract claim against *B* and, unless the part-performance could be severed or had benefited *B*, *A* had no claim for restitution.¹² This followed even though *A* might have been able to establish a reasonable market price for the agreed services.

There were, of course, reasons to support this result: a policy judgment that contract law should be certain, especially in the formation process; an empirical assumption that bargains were discrete transac-

⁸ 1 S. WILLISTON, CONTRACTS § 45 (1920).

⁹ RESTATEMENT OF CONTRACTS § 32 (1932).

¹⁰ *Id.*, Comment a.

¹¹ *Id.*, Illustration 10. The Comments, however, state that where the parties "intended to enter into a bargain," the "law endeavors to give a sufficiently clear meaning to offers and promises" and that definiteness might be acquired by the "subsequent words or acts" of the parties. *Id.*, Comments b-c. Thus, if the price were left open rather than "to be agreed," Professor Williston concluded, the "law invokes here . . . the standard of reasonableness" (market price). 1 S. WILLISTON, CONTRACTS § 41 (1920).

¹² The *Restatement* did not cover restitution as a remedy if an intended contract failed for indefiniteness. See RESTATEMENT OF CONTRACTS § 347, Introductory Note (1932). The *Restatement Second* deals with restitution claims if a contract has been voided for fraud, duress, mistake, or impracticability. See Perillo, *Restitution in the Second Restatement of Contracts*, 81 COLUM. L. REV. 37 (1981). It states that action in reliance on an agreement that fails for indefiniteness "makes appropriate a contractual remedy" in that the agreement may be treated as divisible with payment at the contract rate, or an implied promise may be found in order to reimburse *A* for the reasonable value of his part-performance. RESTATEMENT (SECOND) OF CONTRACTS § 34(3) (1979); *id.*, Comment d; see *Coleman Eng'r Co. v. North Am. Aviation, Inc.*, 65 Cal. 2d 396, 417-20, 420 P.2d 713, 727-29, 55 Cal. Rptr. 1, 15-17 (1966) (Traynor, C.J., dissenting). For a discussion of restitution in contracts unenforceable for indefiniteness, see E. MURPHY & R. SPEIDEL, *STUDIES IN THE CONTRACT LAW* 291-309 (2d ed. 1977); II G. PALMER, *LAW OF RESTITUTION* § 6.1 (1978).

tions in which the parties would reach agreement on all material terms at the time of contracting; and an aversion to the practical difficulties involved in supplying a term when the parties had failed to agree. These reasons translated into rules of law that required the initial agreement to be clear and complete and were typified by the bromide that courts do not "make contracts" for the parties.¹³ Frequently, however, these reasons were hidden as the courts searched "out there" for the rules to be applied with ineluctable logic to the issues posed in the particular dispute at hand. These rules were, of course, the product of prior judicial decisions that had been abstracted, synthesized, and classified by scholars for future use. One can overstate the dominance of this "time-honored method" in contract law. Yet Pound called it mechanical jurisprudence¹⁴ and, for some, it typified the classical model of contract—a model that featured the reasonable man as the arbiter of disputes, rules that demanded complete agreement before a bargain contract was formed, and impossibility before performance was discharged, while enforcing bargains primarily through damage awards rather than specific performance.¹⁵

Both the classical model of contract and the time-honored method have been under continuous attack. The realists¹⁶ mounted the attacks most relevant to the tension between rules and standards in the early part of this century. From the realist perspective, any view that there was a universe of rules discoverable by deduction and applicable to a limited set of operative facts was suspect. The realists rejected the argu-

¹³ See, e.g., *Transamerica Equip. Leasing Corp. v. Union Bank*, 426 F.2d 273 (9th Cir. 1970); *Walker v. Keith*, 382 S.W.2d 198 (Ky. 1964); *Willhelm Lubrication Co. v. Bratrud*, 197 Minn. 626, 268 N.W. 634 (1936); *Varney v. Ditmars*, 217 N.Y. 223, 111 N.E. 822 (1916). See also *Goebel v. National Exchangers, Inc.*, 88 Wis. 2d 596, 277 N.W.2d 755 (1979) (agreement fatally vague as to a material term). On the nature of discrete transactions and the demands of classical contract law, see Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854, 856-65 (1978) (law requires for certainty a complete projection of the transaction into the future through promises). For the dilemmas posed by contract doctrine that requires complete agreement for contract formation and stipulates the effect of failure as either contract or no-contract, see Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U.L. REV. 673 (1969).

¹⁴ Pound, *Mechanical Jurisprudence*, 8 COLUM. L. REV. 605 (1908). See also White, *From Sociological Jurisprudence To Realism: Jurisprudence and Social Change in Early Twentieth-Century America*, 58 VA. L. REV. 999, 1000-12 (1972). But see R. DWORKIN, *supra* note 6, at 15-16 (suggesting that real mechanical jurists are difficult if not impossible to find).

¹⁵ The essence of this grand theory of contract is caught in G. GILMORE, *supra* note 5, at 5-53. See Strasser, *Contract's "Many Futures" After Death: Unanswered Questions of Scope and Purpose*, 32 S.C.L. REV. 501, 530-37 (1981) (primary goal of conventional contract law is to resolve private disputes, not to regulate society). For another view, see M. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1780-1860*, at 161-210 (1977) (primary goal of contract law is to protect private markets).

¹⁶ According to Pound, realism was not a school but, rather, a "point of view." Pound, *Fifty Years of Jurisprudence*, 51 HARV. L. REV. 777, 790-98 (1938). The perspective was that law in society was part of life and must be viewed in relation to a changing social context. See Yntema, *American Legal Realism in Retrospect*, 14 VAND. L. REV. 317, 323 (1960).

ment that there was a theory of contract that required results even though harsh and, at times, inconsistent with the precedents or relationships surrounding the bargain. Much of this attack was launched against Williston's early editions. Corbin, for example, claimed that Williston had failed to distinguish between "operative facts" and resulting legal relations and that he placed an excessive reliance on theory not supported by the precedents or responsive to the actual facts in dispute.¹⁷ Twenty years later, W. W. Cook, reviewing Williston's second edition, made similar criticisms and questioned whether important questions arising in actual cases could be answered by "a priori theorizing or by tacit assumptions. . . ."¹⁸ Cook argued that the "relevant phenomena" for observation were the reported judicial decisions and that a better method would be to classify the cases by factual patterns rather than by doctrine. He claimed several advantages for this method:

(1) it would first of all recognize the complex character of the human relationships dealt with in the law of contracts; (2) it would thereby help to bring into the forefront of the discussion the social and economic problems involved; (3) it would not relegate to the category of "exceptional" or "anomalous" rules of law which deal sensibly with those problems; and (4) it would enable courts to deal more intelligently with new situations as these arise in a developing social and economic order.¹⁹

Cook proposed a general method capable of better comprehending reality in contract litigation. Corbin, a contracts scholar, spent most of his life elaborating and perfecting this method. Corbin viewed contract law as an evolutionary process consisting of tentative generalizations derived from a vast number of individual instances to be continually tested and reexamined in the light of the sources from which they are drawn: the customs, business practices, feelings, and opinions of man—the prevailing mores of the time and place.²⁰ In this process, the certainty of law was an illusion and the creativity of judges a necessity. Consequently, standards rather than rules were essential, for standards both permitted and required the particular dispute to be set in context. The answers were not "out there" in some system of rules, but "in" the social and economic context surrounding the particular transaction.²¹

¹⁷ Corbin, Book Review, 30 *YALE L.J.* 773 (1921); Corbin, Book Review, 29 *YALE L.J.* 942 (1920).

¹⁸ Cook, *Williston on Contracts*, 33 *ILL. L. REV.* 497, 502 (1939).

¹⁹ *Id.* at 511.

²⁰ For a succinct summary of Corbin's method, see Kessler, *Arthur Linton Corbin*, 78 *YALE L.J.* 517, 521 (1969).

²¹ Corbin's view of law was expressed early in his career:

[L]aw does not consist of a series of unchangeable rules or principles. . . . Every system of justice and of right is of human development, and the necessary corollary is that no known system is eternal. In the long history of the

Corbin's approach is illustrated in part by his solution to the "agreement to agree" problem. He rejected the classical rule that there could be no contract until there was agreement. The initial question was whether the parties intended to conclude a bargain even if an essential term were left to future agreement.²² If so, the court should be "slow to conclude" that no contract was formed and should make every effort to fill the gap by recourse to reasonable market terms: "Many a gap in terms can be filled, and should be, with a result that is consistent with what the parties said and that is more just to both than would be a refusal of enforcement."²³ The search for intention and reasonable market terms might be unsuccessful, in which case the contract would fail for indefiniteness. But contract law, packaged as standards rather than rules, directed the court to consider a wide range of circumstances in the transactional context. Cook's general method of perceiving reality, therefore, was sharpened and focused by Corbin's commitment to contextualize the particular dispute.

Another example of this commitment and the triumph of standards over rules is found in Article Two of the Uniform Commercial Code, whose principal architect, Karl N. Llewellyn, has been described as a "leader of the American realists."²⁴ How would our "agreement to agree" hypothetical come out under the UCC?

Section 2-204 sets the stage by dispensing with the rigid rules of offer and acceptance contained in the first *Restatement*.²⁵ A contract for the sale of goods can be made "in any manner sufficient to show agreement, including conduct by both parties that recognizes the existence of such a contract," and "[a]n agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined."²⁶ Section 2-204(3) then provides:

law can be observed the birth and death of legal principles The law is merely a part of our changing civilization. The history of law is the history of man and of society. Legal principles represent the prevailing *mores* of the time, and with the *mores* they must necessarily be born, survive for the appointed season, and perish.

Corbin, *Preface* to W. ANSON, *LAW OF CONTRACTS* v (A. Corbin ed. 1919).

²² "A transaction is complete when the parties mean it to be complete." 1 A. CORBIN, *CONTRACTS* § 29 (1963).

²³ *Id.* § 97. See also *id.* § 95.

²⁴ Clark, *Karl N. Llewellyn*, 29 U. CHI. L. REV. 614, 614 (1962). See generally W. TWINING, *KARL LLEWELLYN AND THE REALIST MOVEMENT* (1973); Verdun-Jones, *The Jurisprudence of Karl Llewellyn*, 1 DALHOUSIE L.J. 441 (1974). According to Grant Gilmore, Llewellyn was an "enthusiastic demolisher" of the classical jurisprudence but was not a system builder—he preferred the particular over the general and method over theory. Gilmore, *In Memoriam: Karl Llewellyn*, 71 YALE L.J. 813, 813-14 (1962).

²⁵ See generally Mooney, *Old Contract Principles and Karl's New Kode: An Essay on the Jurisprudence of Our New Commercial Law*, 11 VILL. L. REV. 213 (1966) (obligation based on agreement-in-fact rather than rules).

²⁶ U.C.C. § 2-204(1) & (2).

Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.²⁷

Section 2-305, which deals with "agreements to agree" on price, builds upon section 2-204(3). If the parties "so intend," they can conclude a contract for sale even though the price is "open"; that is, they have left it to "be agreed."²⁸ They may intend "not to be bound unless the price be . . . agreed"; if so, "there is no contract" until agreement is reached.²⁹ But if they intend to conclude a contract and the price is not agreed upon, then the price is "a reasonable price at the time for delivery,"³⁰ subject to the overall limitation that the agreement with the supplied price term must afford a "reasonably certain basis for giving an appropriate remedy."³¹ This "Corbinesque" approach to the problem of open price is carried over to other omitted terms by Article Two, Part Three of the UCC. If the parties "intend" to create a contract, if there is no agreement to the contrary, and if there is a reasonably certain basis for enforcement, the Code provides judicial "gap filling" standards for all terms thought essential to the bargain.³²

A more complete triumph of standards over rules is hard to imagine. Furthermore, such standards as "intention to conclude a contract," "reasonable price," and "reasonably certain basis" for enforcement require particularization within the commercial circumstances made relevant by the definition of agreement. According to Richard Danzig, this method reflects Llewellyn's view that the law of the transaction is imbedded in the total situation and that the task of the "law authority" is to discover it. Law is "immanent" in existing patterns of conduct or relationships and, when discovered, provides a more reliable source of certainty than does the rigid, external system of classical contract law.³³ The problem with standards is that they may lead the court to water without explaining how to drink. As Danzig describes it, the drafters of

²⁷ *Id.* § 2-204(3).

²⁸ *Id.* § 2-305(1).

²⁹ *Id.* § 2-305(4).

³⁰ *Id.* § 2-305(1)(b).

³¹ *Id.* § 2-204(3).

³² *See, e.g.,* Caisson Corp. v. Ingersoll-Rand Co., 622 F.2d 672, 677-79 (3d Cir. 1980); Riegel Fiber Corp. v. Anderson Gin Co., 512 F.2d 784 (5th Cir. 1975); U.C.C. §§ 2-304 to 2-315; J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 96-147 (2d ed. 1980).

³³ Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 626 (1975); *see* Corbin, *A Tribute to Karl Llewellyn*, 71 YALE L.J. 805, 812 (1962), concluding that Llewellyn sought a "situation sense" from similar cases grouped as "human histories about situations which have arisen . . ." *See also* Kennedy, *supra* note 6, at 1704-05, suggesting that the UCC adopted standards on the ground that concepts like "reasonableness" and "good faith" provide greater predictability in practice than the intricate rule system they have replaced."

the Code left off at critical points, leaving the judge to fill in from what the parties could extract from the commercial context.³⁴ Put another way, the method pointed to the commercial context without clarifying how the diverse data were to be assembled and used.

The difficulties posed by this apparent delegation of discretion to the court are reflected in the continuing debate over "unconscionability,"³⁵ the current interest in the scope and content of the "good faith" duty,³⁶ and the concern over how one ascertains the "intention" of the parties.³⁷ In short, it seems clear that the triumph of standards in Article Two is not without problems, for the very method of perceiving and ordering reality is incomplete. The conscious decision to contextualize, itself of jurisprudential significance,³⁸ may be undercut by the lack of guidance to, and control over, both the parties and the court.

II

OMITTED TERMS: THE *Restatement Second* APPROACH

In the remainder of this Article, we will consider the *Restatement Second's* approach to solving the problem of omitted terms. It is not surprising that Article Two of the UCC has had a substantial influence on the Restatement process and that standards rather than rules dominate the discussion and analysis. We will next consider whether the *Restatement*

³⁴ Danzig, *supra* note 33, at 627-31. According to Danzig, Article Two operates more as a means of dictating a method than as a means of dictating a result. "That method was designed to prompt decision not according to the letter or the logic of a statute or juristic concept but rather according to the 'situation-reason.'" *Id.* at 632. Yet Article Two masks the reasons needed to support results and, by delegating the task of finding the law "immanent" in the situation to the judge, reinforces the morals of the market place. For additional discussion of code methodology, see Hillman, *A Study of Uniform Commercial Code Methodology: Contract Modification Under Article Two*, 59 N.C.L. REV. 335 (1981); McDonnell, *Purposive Interpretation of the Uniform Commercial Code: Some Implications for Jurisprudence*, 126 U. PA. L. REV. 795 (1978); Note, *How Appellate Opinions Should Justify Decisions Made Under the U.C.C.*, 29 STAN. L. REV. 1245 (1977).

³⁵ See, e.g., Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293 (1975); Hillman, *Debunking Some Myths About Unconscionability: A New Framework for U.C.C. Section 2-302*, 67 CORNELL L. REV. 1 (1981); Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967); Murray, *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1 (1969).

³⁶ See generally Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981); Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619.

³⁷ See generally Murray, *The Realism of Behaviorism Under the Uniform Commercial Code*, 51 OR. L. REV. 269, 272-76 (1972).

³⁸ See Kennedy, *supra* note 6, at 1701-10 (suggesting that while contextualization may enhance understanding of the function and workability of law in particular situations, it is likely to ignore "other ideas about the proper ordering of society, and particularly . . . ideas about the proper substantive content of legal rules." *Id.* at 1702; cf. B. ACKERMAN, *PRIVATE PROPERTY AND THE CONSTITUTION* 1-22, 88-112 (1977) (perspective of "ordinary observer"). In short, contextualization, no matter how clearly defined as a method, tends to reinforce the "is"—the dominant pattern of social expectations.

Second improves upon Code method in ascertaining, where relevant, the intention of the parties and, where agreement fails, in supplying a term under section 204. My conclusion is that the method for ascertaining intention has been improved by use of the "reason to know" test, but that no method has been developed to assist or control the parties and the court in supplying terms when section 204 is applicable. The analysis defining when section 204 can be used, however, is helpful. Finally, I offer some tentative conclusions about the strengths and weaknesses of the *Restatement Second* as American contract law heads for the twenty-first century.

A. *Bargains, Assent, and the "Reason to Know" Test*

Section 204, which is at the heart of the matter, is entitled "Supplying an Omitted Essential Term." It is placed in Chapter 9, dealing with the "Scope of Contractual Obligations," and in Topic 1, entitled "The Meaning of Agreements." Section 204 provides:

When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court.³⁹

Section 204 does not apply unless there is a bargain, defined as an "agreement to exchange" promises, performances, or a mix thereof.⁴⁰ Agreement is defined as a "manifestation of mutual assent on the part of two or more persons."⁴¹ The theoretical structure of the bargain contract is built upon these definitions. Working with the essential operative facts of "promise" and "consideration,"⁴² the formation of a contract requires a "bargain in which there is a manifestation of mutual assent to the exchange and a consideration."⁴³ To this extent, the *Restatement Second* is consistent with the first *Restatement*,⁴⁴ although the pervasiveness of the consideration requirement has clearly been reduced.⁴⁵

In the bargain contract, words or conduct may manifest assent to an exchange.⁴⁶ Here, the *Restatement Second* makes a distinction and

³⁹ RESTATEMENT (SECOND) OF CONTRACTS § 204 (1979).

⁴⁰ *Id.* § 3 (1979).

⁴¹ *Id.*; cf. U.C.C. § 1-201(3) ("'Agreement' means the bargain of the parties in fact . . .").

⁴² Under the *Restatement Second*, a legally enforceable contract cannot exist without a promise, but there can be such a contract without consideration. See RESTATEMENT (SECOND) OF CONTRACTS §§ 1, 17(2), 82-94 (1979). To constitute consideration, the agreed exchange must be "bargained for." RESTATEMENT (SECOND) OF CONTRACTS § 71(1) (1979); see Knapp, *Reliance in the Revised Restatement: The Proliferation of Promissory Estoppel*, 81 COLUM. L. REV. 52 (1981).

⁴³ RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (1979).

⁴⁴ See RESTATEMENT OF CONTRACTS §§ 1, 3, 4, 19, 20, 75 (1932).

⁴⁵ This retreat is tracked and applauded in G. GILMORE, *supra* note 5, at 76-77.

⁴⁶ RESTATEMENT (SECOND) OF CONTRACTS § 4 (1979).

states a test that is vital to understanding section 204. It differentiates between "term of the promise" and "term of the contract." The former, like a promise and consideration, is an operative fact: it is "that portion of the intention or assent manifested which relates to a particular matter."⁴⁷ An agreed price term is a "term of the promise." The latter is that part of the resulting legal relationship that relates to a particular matter "whether or not the parties manifest an intention to create those relations."⁴⁸ "Term of the contract," then, would include the duty to perform in good faith⁴⁹ as well as a term supplied under section 204. Neither are agreed upon; both are imposed as part of the bargain contract.

The test is designed to determine the scope, effectiveness, and meaning of agreement. Suppose that *A* asserts that conduct by *B* constituted a promise, defined as a "manifestation of intention to act or refrain from acting in a specified way, so made as to justify a promisee in understanding that a commitment has been made."⁵⁰ Because the promise may be "inferred wholly or partly from conduct,"⁵¹ how is the court to determine whether *A*'s inference of a commitment was justified? The answer is found in section 19(2): *B*'s conduct is "not effective" as a manifestation of assent (here a promise) unless *B* "knows or has reason to know" that *A* "may infer from *B*'s conduct that *B* assents." If the "reason to know" test is satisfied, *A* is presumably justified in believing that a commitment has been made.

When does a person have "reason to know" that another has concluded from his words or conduct that a promise has been made? The "reason to know" test⁵² can be broken into five related questions:

⁴⁷ *Id.* § 5.

⁴⁸ *Id.*

⁴⁹ *Id.* § 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."); *cf.* U.C.C. §§ 1-203, 1-201(19), 2-103(1)(b) (requiring good faith). For recent literature on good faith, see note 36 *supra*.

⁵⁰ RESTATEMENT (SECOND) OF CONTRACTS § 2(1) (1979).

⁵¹ *Id.* § 4. The Comments and Reporter's Note concede that both "inference" and "implied in fact" refer to the ascertainment of agreement in fact. To avoid confusion with the term "implied in law," however, the use of "inference" is preferred. *Id.* § 4, Comment b, Reporter's Note.

⁵² A person has reason to know a fact, present or future, if he has information from which a person of ordinary intelligence would infer that the fact in question does or will exist. A person of superior intelligence has reason to know a fact if he has information from which a person of his intelligence would draw the inference. There is also reason to know if the inference would be that there is such a substantial chance of the existence of the fact that, if exercising reasonable care with reference to the matter in question, the person would predicate his action upon the assumption of its possible existence [T]he words "reason to know" are used both where the actor has a duty to another and where he would not be acting adequately in the protection of his own interests were he not acting with reference to facts which he has reason to know.

Id. § 19, Comment b. "Reason to know" depends not only on the words or other conduct,

(1) Did *A* understand in fact that *B* had made a promise? If not, there is no manifestation of assent.

(2) If so, did *B* know (that is, have actual knowledge) at the time of his conduct of *A*'s understanding? If so, a promise is made.

(3) If *B* did not know, of what facts in the "total situation" did *B* have actual knowledge?

(4) Given this knowledge, and taking *B*'s level of intelligence into account, would *B* infer that if he acted or spoke in a certain way, *A* would understand that a commitment was made? If so, *B* has "reason to know" of that understanding.

(5) If not, would *B* infer that there was a substantial chance that *A* would understand that a commitment was made? If so, *B* does have a duty to act with reasonable care to avoid misunderstanding; a failure to proceed with reasonable care is, apparently, tantamount to "reason to know."

Thus, the "reason to know" test is the *Restatement Second*'s connecting link between the alleged promise in a particular bargain and the surrounding context. Whether a promise was made is a question of fact inferred from what the promisee understood and what the promisor "had reason to know" would be understood. The test is a technique for inference that is employed for different purposes throughout the *Restatement Second*.⁵³ As with all such techniques, there is room for policy to

but also on the circumstances, including previous communications of the parties and the usages of their community or line of business." *Id.* § 26, Comment a. "A wide variety of elements of the total situation may be relevant to the interpretation of such conduct." *Id.* § 19, Comment a.

⁵³ Exactly what *A* knew or had reason to know *B* understood is a question for the trier of fact. *See* *Harvey v. Fearless Farris Wholesale, Inc.*, 589 F.2d 451 (9th Cir. 1979). The relevance of this fact question will vary with the legal questions poscd. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 15(1)(b) (mental capacity), 19(2) (conduct as assent), 20 (material misunderstanding), 26 (preliminary negotiations), 69 (conduct as acceptance), 153 (mistake by one party), 201 (ascertainment of meaning), 220-221 (effect of usage) (1979). Resolution of disputes over the meaning of words and conduct in an otherwise enforceable bargain contract will be a principal use of the test. *See* Farnsworth, "Meaning" in the *Law of Contracts*, 76 YALE L.J. 939, 942-52 (1967). Section 201 was strongly influenced by Professor Corbin and drafted to "deemphasize meaning supplied by rules of construction existing in the law and to direct attention to the context in which the parties make their agreement." Braucher, *supra* note 2, at 14. According to Professor Corbin, in determining whether *A* had reason to know the meaning attached by *B* to a term in the agreement, the trier of fact should be advised of:

[A]ll the surrounding circumstances; of the meaning that is given to the language of the agreement by common usage, by usage in the trade or business or profession of the parties; of communications between the parties during the preliminary negotiations and during execution of the writing; and of subsequent interpretations and practical application by either party that is assented to or acted upon by the other.

3 A. CORBIN, *supra* note 22, § 538, at 69. *But see* Palmer, *The Effect of Misunderstanding on Contract Formation and Reformation Under the Restatement, Second*, 65 MICH. L. REV. 33, 39-44 (1965) (arguing, in part, that the "reason to know" test puts an excessive emphasis upon "fault" and improperly permits the use of context evidence even though the language being interpreted is not ambiguous).

color the edges of inference.⁵⁴ Nevertheless, the "reason to know" test is an attempt to connect a number of standards determining the effect, scope, and meaning of assent to the relevant commercial context and to guide the court in determining which party's understanding should be preferred. As such, it offers greater guidance than does Article Two of the UCC.⁵⁵

B. *Failure of Agreement—Nature and Effect*

A vital condition to the court's power to supply a term under section 204 is that the "parties . . . have not agreed with respect to a term which is essential to a determination of their rights and duties . . ." There are two main problems with this condition. First, what is a failure of agreement, and second, what is the effect of such failure of agreement? Does a failure to agree mean that no contract was formed and hence that performance should be discharged, or that the court should supply a reasonable term? These questions go to the heart of the problem. To illustrate, let us focus on the price term.

Some failures of agreement are apparent from the time the parties conclude the bargain. For example, the bargain may say nothing about price or may explicitly leave the price "to be agreed" upon by the parties. Other failures become apparent as performance unfolds, new information is discovered, or circumstances change. Suppose, for example, that the bargain provides for a "base price subject to escalation" every four months. After performance has begun, the parties disagree over the meaning of "escalation," the supplier claiming that escalation according to the wholesale price index was intended and the purchaser insisting that the intended index used consumer prices. If the parties cannot resolve the dispute by agreement, their failure to agree jeopardizes the bargain. Finally, suppose that the bargain provides for a "base price subject to quarterly escalation based upon the wholesale price index." At the time the bargain was concluded, the parties assumed that the historical pattern of wholesale price fluctuation would, within a pro-

⁵⁴ See, e.g., *Steinberg v. Chicago Medical School*, 69 Ill. 2d 320, 371 N.E.2d 634 (1977) (equal treatment in medical school admissions); *Barker v. Allied Supermarket*, 596 P.2d 870 (Okla. 1979) (personal injuries in self-service store).

⁵⁵ In the UCC, "reason to know" refers to a party having notice of a fact, U.C.C. § 1-205(25)(c), and is used sparingly in Article Two. See U.C.C. §§ 2-312(2), 2-315, 2-712(2)(a). Disputes over the effectiveness and meaning of manifestations must be resolved by first consulting the definition of agreement, U.C.C. § 1-201(3), and then the particular sections of Article Two that govern the issue at hand. On contract interpretation, see U.C.C. §§ 1-205, 2-202 to 2-208. See also *Brunswick Box Co. v. Coutinho, Caro & Co.*, 617 F.2d 355 (4th Cir. 1980); *Kleinschmidt Div. of SCM Corp. v. Futuronic Corp.*, 41 N.Y.2d 972, 363 N.E.2d 701, 395 N.Y.S.2d 151 (1977) (failure to agree means that parties did not intend to contract); U.C.C. § 2-204. Despite its commitment to contextualization, the UCC tends to mask the critical choices that must be made in contract formation and interpretation. See *Danzig, supra* note 33.

jected scale, continue for the duration of the contract. In fact, the pattern escalates sharply beyond the original projections and a dispute arises. The supplier argues that the price term has failed its essential purpose and should be modified. The purchaser argues that the agreement was clear when the bargain was concluded and that the supplier assumed the risk of such a change. In each of the above cases, the initial agreement was deficient in some manner, and the parties failed to cure the defect by subsequent agreement. Are these cases instances in which the court should supply a reasonable term under section 204?

1. *Open Price*

The easiest case is one in which the parties have left the price term open or "to be agreed." If, at the time of litigation, the parties still have not agreed on this essential term, can the court supply a "reasonable" price under section 204? They may do so if, at the time of contracting, the parties intended to conclude a bargain without a further manifestation of assent and the bargain is "reasonably certain"—that is, the "terms of the contract" provide a basis for determining the existence of a breach and for giving an appropriate remedy.⁵⁶ How is a dispute over the parties' intention to be resolved? Under the *Restatement Second*, the fact that a term is left open "may show that a manifestation of intention is not intended to be understood as an offer or as an acceptance,"⁵⁷ and the "may show" question is answered by determining if the person to whom the purported offer is made "knows or has reason to know that the person making it does not intend to conclude a bargain until he has made a further manifestation of assent."⁵⁸ Uncertainties over intention may be resolved by subsequent "part performance."⁵⁹ In the absence of this, however, the *Restatement Second* suggests that the presence of an explicit provision for future price agreement strongly indicates that the parties do not intend to be bound.⁶⁰ Even so, the conclusion that no contract exists is not automatic. The parties may intend to conclude the bargain and this intention, in disputed cases, is ascertained through the

⁵⁶ RESTATEMENT (SECOND) OF CONTRACTS § 34(1) & (2) (1979); *id.*, Comment a.

⁵⁷ *Id.* § 33(3).

⁵⁸ *Id.* § 26; *see id.* § 33(3), Comment c. The question is what the purported offeree, rather than the purported offeror, "has reason to know" in the total situation. *See id.* § 26, Comment a.

⁵⁹ *Id.* § 34(2). Part performance may also "remove uncertainty," and action "in reliance on an agreement may make a contractual remedy appropriate even though uncertainty is not removed." *Id.* § 34(3); *see* Blackhawk Heating & Plumbing Co. v. Data Lease Fin. Corp., 302 So. 2d 404, 408 (Fla. 1974) ("The courts should be extremely hesitant in holding a contract void for indefiniteness, particularly where one party has performed under the contract and allowed the other party to obtain the benefit of his performance.").

⁶⁰ RESTATEMENT (SECOND) OF CONTRACTS § 33, Illustration 8 (1979); *see* U.C.C. § 2-204(3), Comment ("The more terms the parties leave open, the less likely it is that they have intended to conclude a binding agreement . . .").

"reason to know" test. If the requisite intention is present, section 204, much like UCC 2-305,⁶¹ is waiting in the wings to assist in filling the gap.

2. *Disputes Over Meaning*

A more complex case arises when the parties have intended to conclude a bargain, the price term assented to is "base price plus escalation," and both parties assert different understandings of what "escalation" means, the supplier claiming that it means "wholesale price index" and the purchaser claiming that the "consumer price index" provides the better definition. Even though the parties have apparently failed to agree on an essential term, section 204 is inapplicable until (1) the process of contract interpretation is completed,⁶² and (2) if that process does not produce a basis for preferring one party's understanding over the other's, courts find that the manifestation of assent does not fail because the parties attached "materially different meanings to their manifestations"⁶³ In both of these inquiries, "the reason to know" test plays an important role.

The problems here are familiar and have received extensive treatment in the literature.⁶⁴ The *Restatement Second's* approach to contract interpretation rejects the view that words have plain meanings, that the court should, as a matter of law, determine meaning from the four corners of a writing, and that there are rules of interpretation or reasonable meanings waiting "out there" for discovery and application.⁶⁵ Rather, whether or not the language used is ambiguous on its face, the *Restatement Second* encourages the parties to plumb the context surrounding the particular bargain to aid the trier of fact in interpreting the "term"—that is, ascertaining its "meaning."⁶⁶ To illustrate, consider briefly what the supplier must do to establish that his understanding of the term "escalation" should prevail.

Under section 201, the supplier's meaning prevails if both parties

⁶¹ The *Restatement Second* follows the Code's approach regarding the effect of an "open" price term with the following exceptions: (1) the question under the Code is whether the parties intended "to make a contract" rather than to conclude a bargain; (2) the "reason to know" test is adopted to resolve disputes over intention; and (3) the standards apply to all bargains, not just contracts for the sale of goods. See RESTATEMENT (SECOND) OF CONTRACTS § 21 (1979) (intention to create legal obligations not required).

⁶² *Id.* §§ 201-204.

⁶³ *Id.* § 20(1).

⁶⁴ See, e.g., Farnsworth, "Meaning" in the Law of Contracts, 76 YALE L.J. 939 (1967). See also Braucher, *supra* note 2.

⁶⁵ See Braucher, *supra* note 2, at 13-15.

⁶⁶ "Interpretation of a promise or agreement or a term thereof is the ascertainment of its meaning." RESTATEMENT (SECOND) OF CONTRACTS § 200 (1979). When the meaning attached by one party to a term is to be preferred, the term is "interpreted in accordance" with that meaning. *Id.* § 201(2).

have attached the same meaning to the term. This result follows even though the language has a more reasonable meaning in prevailing trade usage.⁶⁷ But if each party attaches a different meaning, the supplier's meaning prevails if "at the time the agreement was made" either (1) the supplier did not know that the purchaser attached a different meaning and the purchaser "knew the meaning attached" by the supplier, or (2) the supplier "had no reason to know of any different meaning attached" by the purchaser and the purchaser "had reason to know the meaning attached" by the supplier.⁶⁸ Assuming this actual knowledge test is not satisfied and both parties are of ordinary intelligence, where do we go from here?⁶⁹

What either party "had reason to know" must be determined in "light of all the circumstances" at the time of the contract formation.⁷⁰ There are certain "rules" or guides that aid interpretation; for example, the "principal purpose" of the parties will be given "great weight," and a "writing is interpreted as a whole"⁷¹ But if the "principal purpose" is simply that both parties wanted to achieve price flexibility based upon changes in costs, and the other written terms shed no light on the intended meaning of the term in dispute, these rules do not advance the inquiry. A potential source of guiding principles is the actual conduct of the parties, either in a previous course of dealing⁷² or in a course of performance under the particular bargain.⁷³ If either pattern shows mutual acquiescence to the wholesale-price index as the measure of escalation, the supplier would have no "reason to know" that the purchaser originally meant the consumer-price index, and the purchaser would have "reason to know" that the supplier meant the wholesale-price index. If conduct of the parties does not resolve the dispute, the supplier might be able to show that the term "escalation" had a "generally prevailing meaning"⁷⁴ or a usage consistent with "wholesale-price index."⁷⁵

If these requirements are satisfied, then the supplier's consistent meaning should prevail over the purchaser's inconsistent meaning under the "reason to know" test.⁷⁶ Even if a contextual analysis shows that

⁶⁷ *Id.* § 201(1); see Farnsworth, *supra* note 64, at 942-52.

⁶⁸ RESTATEMENT (SECOND) OF CONTRACTS § 201(2) (1979); see *id.* § 20(2).

⁶⁹ Assume also that the parties did not intend to adopt either a completely or partially integrated writing. See *id.* §§ 209-218. For a critical review of the *Restatement Second's* treatment of the parol evidence rule, see Murray, *The Parol Evidence Process and Standardized Agreements Under the Restatement (Second) of Contracts*, 123 U. PA. L. REV. 1342 (1975).

⁷⁰ RESTATEMENT (SECOND) OF CONTRACTS § 201, Comment b (1979).

⁷¹ *Id.* § 202(1) & (2).

⁷² *Id.* § 223; cf. U.C.C. § 1-205(1).

⁷³ *Id.* § 202(4); cf. U.C.C. § 2-208 (course of performance).

⁷⁴ *Id.* § 202(3)(a).

⁷⁵ *Id.* § 220.

⁷⁶ See *id.* where the "reason to know" test links usage relevant to interpretation to the

neither party knew nor had reason to know anything that would justify preferring one understanding over the other, the *Restatement Second* provides some tie breakers. The court might be persuaded to interpret the language against the draftsman,⁷⁷ or to find that the supplier's meaning "serves the public interest" and the purchaser's does not.⁷⁸ In any event, the range of relevant evidence, tie breakers, "rules in aid," and "standards of preference" in interpretation, coupled with a predisposition to find a meaning when the parties have intended to conclude a bargain,⁷⁹ suggest that one party's meaning probably will be found to prevail in most cases. This reduces somewhat the probability that the court will be unable to interpret the term, and therefore narrows the potential scope of section 204 in disputes over meaning.

What is the legal effect when the interpretation process fails to produce a sensible basis for preferring one party's attached meaning over the other's? Put another way, what happens when the "reason to know" test fails to produce a winner, or where, in the words of the *Restatement Second* commentary, "neither party is at fault or . . . both parties are equally at fault?"⁸⁰ According to section 20(1), there is "no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations." In short, there is no contract. According to section 204, the court may supply a term, and presumably enforce the contract, where the parties "have not agreed with respect to a term which is essential to a determination of their rights and duties" But the assumption underlying section 204 is that the agreement is sufficiently defined to be a contract. Its application, therefore, depends upon whether the different meanings attached to the terms "escalation," "wholesale price index," and "consumer price index" are material. Except for Illustrations of the continuing voyage of the good ship *Peerless*,⁸¹ the Comments and Reporter's Notes to Section 20 offer little assistance, only suggesting that a "contract should be held nonexistent under this Section only when the misunderstanding goes to conflicting and irreconcilable meanings of a material term that could

search for meaning under § 201. In the ranking of priorities, however, usage of trade is given less weight in interpretation than course of dealing and course of performance. *See id.* § 203(b); Warren, *Trade Usage and Parties in the Trade: An Economic Rationale for An Inflexible Rule*, 42 U. PITT. L. REV. 515 (1981). *Cf.* U.C.C. § 1-205(4) (course of dealing controls trade usage).

⁷⁷ RESTATEMENT (SECOND) OF CONTRACTS § 206 (1979).

⁷⁸ *Id.* § 207.

⁷⁹ *See id.* § 33, Comment a (In cases in which the parties "have intended to conclude a binding agreement, even though one or more terms are missing or are left to be agreed upon . . . courts endeavor, if possible, to attach a sufficiently definite meaning to the bargain.").

⁸⁰ *Id.* § 20, Comment d.

⁸¹ *Raffles v. Wichelhaus*, 2 H. & C. 906, 159 Eng. Rep. 275 (Ex. 1864); RESTATEMENT (SECOND) OF CONTRACTS § 20, Comment d, Illustrations 1-4 (1979).

have either but not both meanings.”⁸² This being the test, perhaps the rarity of true cases of equivocation, coupled with a bias toward enforcement in cases in which the parties intend to conclude a bargain, will tip the balance in favor of section 204. Even so, if there is no reasonable meaning of the term “escalation” in the commercial context, the bargain is arguably fatally indefinite and should not be enforced.⁸³

3. *Failure of Basic Assumption*

In this final example of failure of agreement, the price term is initially clear and complete: the purchaser agrees to pay a base price subject to quarterly escalation by a formula based on the “wholesale price index.” Later, changed circumstances cause wholesale prices to escalate to unanticipated heights. Although the price term is still clear, the supplier claims that the agreement has failed because the term is no longer suitable for its intended purpose. This claim raises a defense called “impossibility” of performance in the first *Restatement*⁸⁴ and “impracticability” of performance in the *Restatement Second*.⁸⁵ Whether the defense succeeds turns upon whether the supplier, either by agreement or for other reasons, assumed the risk of the changed circumstances and their effect upon performance. Section 261 of the *Restatement Second* concludes that the answer is no if the supplier’s “performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made . . . unless the language or the circumstances indicate the contrary.”⁸⁶ Although the “reason to know” test does not apply here, the “basic assumption” test—with its emphasis on “language” and

⁸² RESTATEMENT (SECOND) OF CONTRACTS § 20, Comment d (1979); *id.*, Reporter’s Note. See also *Oswald v. Allen*, 417 F.2d 43 (2d Cir. 1969); Young, *Equivocation in the Making of Agreements*, 64 COLUM. L. REV. 619, 621 (1964).

⁸³ Put differently, § 20(1) permits *A* to escape from a bargain intended to be final because of a mutual, material misunderstanding of a term assented to. *B* is able to enforce the bargain, however, if either the process of interpretation reveals that *A* had reason to know of *B*’s meaning or, if there was no agreement, the court can supply a reasonable term under § 204. If the “total situation” cannot produce either an agreement or a reasonable term, the rare situation of equivocation apparently has been reached. But should the court conclude that no contract was formed or that a contract failed for indefiniteness? Part performance or reliance on the bargain dictates the indefiniteness route because the *Restatement Second* provides more coherent protection for the reliance interests involved. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 344(b); *id.*, Comment c. See also *Frigalment Importing Co. v. B.N.S. Int’l Sales Corp.*, 190 F. Supp. 116 (S.D.N.Y. 1960); Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 169-70 (1965).

⁸⁴ RESTATEMENT OF CONTRACTS §§ 454-469 (1932).

⁸⁵ RESTATEMENT (SECOND) OF CONTRACTS §§ 302-315 (1979).

⁸⁶ Sections 261-272 of the *Restatement Second* are derived from the “basic assumption” test of U.C.C. § 2-615. To date, the courts have rejected the Code’s apparent invitation to expand the basis for relief from the current changed circumstances doctrine. See Speidel, *Excusable Non-Performance in Sales Contracts: Some Thoughts About Risk Management*, 32 S.C.L. REV. 241, 254-71 (1980).

"circumstances"—indicates that the total context must be considered in determining whether the occurrence of the event was contemplated in the establishment of the agreed price term and whether, if so, the supplier should still assume this risk.⁸⁷ If the supplier succeeds in this uphill battle, the legal effect is that "his duty to render that performance is discharged."⁸⁸ Although one could easily conclude that the parties had "not agreed" within the language of section 204, the "constructive condition" of impracticability that is imposed upon the parties leads to discharge of performance rather than preservation of the contract with a reasonable term supplied by the court.⁸⁹ Thus, there is no readily discernible middle ground on questions of enforceability in this area of failed agreement: the bargain is either enforceable under the term as originally agreed, or performance is discharged. If discharged, however, section 204 still provides the basis for supplying a reasonable term to achieve justice in the fashioning of appropriate remedies, including severing and enforcing the unexecuted parts of the bargain.⁹⁰

⁸⁷ The crucial interpretation question is this: At what point can courts conclude that the parties did not intend the promisor to assume a particular risk, even though the language used is clear and unconditional? The limits of agreement, tacit or otherwise, are reached when, at the time of contracting, the risk was not foreseeable, and its occurrence makes performance "vitally different." See RESTATEMENT (SECOND) OF CONTRACTS, Introductory Note to ch. 11 (1979); *id.* §§ 261-272. But this interpretation process overlaps with a policy question: When should the promisor be held to assume the risk even though he did not agree? One answer is when the promisor is the "least-cost" or "superior" risk bearer, because he is in the best position to anticipate the risk and provide against it in the contract or through market insurance, even if he has not in fact done so. Excusing the promisor would constitute an inefficient reallocation of resources. See Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977). See generally Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980). This "gap filling" model for risk allocation may be inappropriate in some situations. See Speidel, *supra* note 2, at 383-86, 396-400.

⁸⁸ RESTATEMENT (SECOND) OF CONTRACTS § 261 (1979).

⁸⁹ See Patterson, *Constructive Conditions in Contracts*, 42 COLUM. L. REV. 903, 943-54 (1942).

⁹⁰ See RESTATEMENT (SECOND) OF CONTRACTS § 272(2) (1979), which provides that when the normal rules for post-discharge relief "will not avoid injustice," the court may grant relief on such terms as justice requires, including protection of the "reliance interest." According to Comment c, in appropriate cases a court may "sever" the agreement, "require that some unexecuted part of it be performed on both sides," and in the process, supply a term "which is reasonable in the circumstances." Cf. U.C.C. § 2-165, Comments 5 & 6 (court has power to adjust the contended terms). A similar remedy is available when a contract is voided for mutual mistake. See RESTATEMENT (SECOND) OF CONTRACTS § 158(2) (1979); *id.* Comment c. In the Reporter's view, these "innovative" sections are designed to "take account of a party's reliance losses even if expenditures have not benefited the other party." Farnsworth, *supra* note 1, at 7-8; see Young, *Half-Measures*, 81 COLUM. L. REV. 19, 30-34 (1981) (predicting frequent invocation of § 272(2) by parties to bargains dislocated by changed economic circumstances). Despite this innovation, the *Restatement Second* does not directly support the unprecedented result in *Aluminum Co. of Am. v. Essex Group*, 499 F. Supp. 53 (W.D. Pa. 1980), in which the court held that: (1) the promisor did not assume the risk of economic dislocations not anticipated at the time of contract formation as likely to occur; (2) although the promisor was entitled to some relief, the completed performance would not be disturbed and the unexecuted part of the bargain's performance would not be

C. *Supplying the Reasonable Term*

The *Restatement Second's* commitment to contextualization in disputes over intention is structured by a series of analytical steps that must be taken before section 204 can be applied. First, have the parties failed to agree with respect to a term that is essential to a determination of their rights and duties under the bargain? In answering this question, the "reason to know" test provides a link between disputes over the particular bargain and the surrounding context, and reduces somewhat the dangers of overbreadth in the use of standards.⁹¹ Second, what are the legal consequences if the parties have failed to agree? If they did not "intend" to conclude a bargain or if there was a "material misunderstanding," no contract is formed. If performance was rendered impracticable under section 261, performance under the contract is discharged. In these situations, section 204 is not available, except to achieve remedial justice in post-discharge cases. Finally, in the seemingly limited case in which section 204 should apply, what is a term that is "reasonable in the circumstances" which the court is invited to supply? It is here that the court must focus upon how to fill gaps in a bargain that, subject to the general requirement of definiteness, should be enforced.

Unfortunately, a conscientious focus reveals an imperfect methodological blueprint. The Comments remind us that although the processes of interpretation and gap filling overlap in that both use the surrounding context, the application of section 204 first requires a conclusion that there was in fact no agreement. Clarity of analysis therefore dictates that the court should not supply a term that the parties probably would have agreed to had they considered it.⁹² Instead, the court, in searching for a term that is "reasonable in the circumstances," should supply a term that "comports with community standards of fairness and policy."⁹³ This is the direct and fair way to proceed when a court is imposing terms without agreement—to identify the relevant "community," to ascertain the standards that control similar problems in that community, and if they are fair or comport with reasonable policy, supply them to fill the gap. If this effort is not successful, presumably the contract fails for indefiniteness.⁹⁴

discharged; and (3) the appropriate remedy was reformation in the form of a court-imposed price adjustment to replace a price term that had failed of its essential purpose, with the expectation that the parties would continue performance under the adjusted term.

⁹¹ *But see* Palmer, *supra* note 53 (arguing that in interpretation cases, the "reason to know" test provides an inadequate control upon judicial access to the surrounding circumstances).

⁹² RESTATEMENT (SECOND) OF CONTRACTS § 204, Comments a, c (1979).

⁹³ *Id.*, Comment d. In an earlier article, Professor Farnsworth suggested that "gap filling" should be by "inference" whether based on "actual expectations or on general principles of fairness and justice." Farnsworth, *supra* note 2, at 860, 891.

⁹⁴ A sensible reading of § 204 is that the bargain must be "sufficiently defined to be a contract" *after* the court has supplied a term. A fatal indefiniteness, therefore, may lie either

It is, of course, at this point that the *Restatement Second*, much like Article Two of the UCC, launches the court into the commercial context without a paddle. There are some helpful hints, such as the suggestion that evidence unearthed in the interpretation process may be relevant to gap filling and that the term to be supplied when the parties fail to agree on price is a "reasonable price at the time for delivery."⁹⁵ Beyond this, the going is a bit murky. The *Restatement Second* provides no guidance on (1) who has what burden of proof,⁹⁶ (2) whether the term to be supplied is a question of law or fact, (3) how contextual evidence should be developed, particularly the ascertainment of "community" standards,⁹⁷ or (4) the judicial "style" to be pursued by a court in supplying terms.⁹⁸ The search is further complicated by the explicit extension of the power to supply terms in contracts that call for more than just the sale of goods. In transactions in goods, at least, there is some basis for belief that functioning markets and the practices of merchants will pro-

in the term supplied or in other terms in the bargain. See RESTATEMENT (SECOND) OF CONTRACTS §§ 33, 34 (1979).

⁹⁵ *Id.* § 204, Comment d; see U.C.C. § 2-305(1).

⁹⁶ Normally, the burden of establishing the "reasonable" term would be on the party seeking to enforce the contract as completed by the court. Standards rather than rules in these cases arguably provide the plaintiff an opportunity to produce contextual evidence relevant to the dispute over meaning or indefiniteness. See *Varney v. Ditmars*, 217 N.Y. 223, 234, 111 N.E. 822, 826 (1916) (Cardozo, J., dissenting). See also Farnsworth, *supra* note 2, at 884-87 (relevance of which party has the "burden of expression").

⁹⁷ The complexity and importance of identifying norms in the social matrix surrounding the particular contract is developed in I. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* (1980). In addition to "common" contract norms, Macneil suggests that more particular norms are derived from the nature of the exchange relationship, *i.e.*, whether its characteristics are "discrete" or "relational." Thus, a "common" contract norm is "contractual solidarity," the norm of holding exchanges together. This norm is intensified in a highly relational exchange, such as a long-term supply contract, and is supplemented by the relational norms of preserving the relationship and harmonizing conflict. *Id.* at 66-69. Among other effects, these norms should influence how the court approaches "gap filling," if not actually providing the "reasonable" term. See Speidel, *supra* note 2, at 400-04. Professor Macneil views the *Restatement Second* as an example of neo-classical contract law. See Macneil, *supra* note 13. One major limitation of this approach is that the parties are expected, at the time of contracting, to reach a high level of agreement on future performance and risk and are penalized for failures of agreement that are explicable when relational features are taken into account. See Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974). For an application of economic analysis to relational contracts, see Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

⁹⁸ For an argument that Llewellyn's grand style of judicial decisionmaking is best suited for finding the law "immanent" in the total situation, see Note, *How Appellate Opinions Should Justify Decisions Made Under the U.C.C.*, 29 STAN. L. REV. 1245, 1247-54 (1977). For recent examples of judicial method in gap filling, see *North Central Airlines, Inc. v. Continental Oil Co.*, 574 F.2d 582, 592-93 (D.C. Cir. 1978) (search for reasonable price when external price escalation standard fails); *Aluminum Co. of America v. Essex Group, Inc.*, 499 F. Supp. 53, 58-59, 80 (W.D. Pa. 1980) (court replaces escalation formula that had failed its essential purpose). See also *Borg-Warner Corp. v. Anchor Coupling Co.*, 16 Ill. 2d 234, 244-46, 156 N.E.2d 513, 518-19 (1958) (standards for court or jury to fix reasonable terms of employment).

vide the ingredients for gap filling.⁹⁹ In short, under section 204, the court and the litigating parties could be lost in a sea of overbroad standards and conflicting evidence in the search for norms which, if they exist, rise no higher than the morals of the marketplace.¹⁰⁰

Even if these difficulties can be overcome, section 204 seems to be strangely isolated from the bargaining dynamics of the parties and the remedy available to enforce the bargain as completed by the court. The *Restatement Second* recognizes the relationship between the degree of certainty in the bargain and the appropriateness of the specific performance as a remedy;¹⁰¹ beyond this, however, it appears to be indifferent to whether enforcement of the section 204 bargain is by damages or specific performance. Suppose that equitable remedies, including specific performance, become the rule in contract litigation¹⁰² and preservation and completion of the exchange becomes a dominant objective. In this case, the absence of a clearer method for gap filling raises serious questions about the legitimacy of judicial power in transactions in which consent, rather than imposition, provides the theoretical underpinning for contract liability and remedy. To the extent that the method provides a control on the exercise of this power, it also structures the exercise of equitable remedial powers.¹⁰³

These concerns are softened somewhat by the power of the parties at any time to resolve the dispute or supply the essential term by agreement. Even if the court supplies a term thought to be unreasonable in the circumstances and orders specific performance, the parties could still by agreement either discharge performance under the contract or adjust and continue performance under the decree. Thus, section 204, like the duty of good faith,¹⁰⁴ can be viewed as a court's control mechanism for

⁹⁹ See generally W. TWINING, *supra* note 24, at 340.

¹⁰⁰ See Danzig, *supra* note 33, at 629-30. To Danzig, the delegation of a legislative function to courts through standards is premised on the "triad of dubious assumptions that self-evident ideal resolutions of situational problems exist, that they can be discovered by careful scrutiny of actual situations, and that once articulated they will be widely accepted." More important, the delegation of power to make "ethical judgments about the good society and technical observations . . . about how to reach that society" to judges is objectionable on grounds of democratic theory: these judgments and techniques should be openly debated in the legislatures. *Id.* at 635.

¹⁰¹ RESTATEMENT (SECOND) OF CONTRACTS § 33(2) (1979); *id.*, Comment b.

¹⁰² See Linzer, *On the Amoralism of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111 (1981) (arguing for the general use of specific performance; traditional concerns for efficiency are often unfounded). See also Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979) (specific performance should be available on request). On the whole, the *Restatement Second* continues the preference of the common law for damages over specific performance. See RESTATEMENT (SECOND) OF CONTRACTS §§ 345, 357-369 (1979); Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1149-60 (1970).

¹⁰³ See Speidel, *supra* note 2, at 395-419.

¹⁰⁴ Section 205 provides that "every contract imposes on each party a duty of good faith and fair dealing in its performance and its enforcement." The presence of this duty preserves

holding the deal together and providing pressure for agreed adjustments by the parties. Despite the costs involved in this effort, the long-range efficiencies of mechanisms that encourage completion of the exchange under agreed adjustments may justify the effort.¹⁰⁵

III

LIMITATIONS OF THE *Restatement Second* APPROACH

The Restatement (Second) of Contracts, commenced in the ebb of the realist attack on classical contract law, was completed after the triumph of standards over rules in Article Two of the UCC. The results are reflected in the *Restatement Second's* treatment of the bargain contract and in section 204. Contract formation is not precluded simply because the parties have failed to agree on an essential term. If they intended to conclude a bargain, if there is no material misunderstanding, and if the terms are reasonably certain, the court may supply a term "reasonable in the circumstances" and enforce the contract as completed. At each stage of the analysis, the key questions within the general requirements for contract formation are determined by standards that require contextualization rather than strict application of rule. When the effectiveness of the assent or the meaning of the agreement is disputed, the "reason to know" test provides a method to link the particular transaction to the surrounding context. Through this linking technique and the more elaborate analysis contained in the Comments and Reporter's Note, the *Restatement Second* has improved upon the neo-classical model of contract represented by Article Two of the UCC. To this extent, it is an impressive document in the post-realist analytic tradition.¹⁰⁶

Nevertheless, certain limitations within the *Restatement Second* formulation undercut any conclusion that section 204 represents a new spirit of contract law.¹⁰⁷ First, the scope of section 204 is limited by the

the contract against most assertions that one party has reserved excessive power, e.g., to specify price or to order requirements (see RESTATEMENT (SECOND) OF CONTRACTS § 34(1) (1979); *id.*, Comment b) without the need to give the standard content. Although placed side by side, §§ 204 and 205 make no explicit reference to each other. One definition of bad faith, however, is conduct that violates "community standards of decency, fairness or reasonableness." *Id.* § 205, Comment a. Since this definition is consistent with the standards set to measure a term "reasonable in the circumstances," *id.* § 204, Comment d, it is probable that the sections reinforce and establish a floor below which a court cannot go to supply a term. See Note, *supra* note 98, at 1256-59.

¹⁰⁵ In short, the efficiencies involved in encouraging adjustments in exchange relationships may be greater than those involved in discharging the contract or enforcing it as originally agreed. See Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 238-42 (1979); note 97 *supra*.

¹⁰⁶ See White, *The Evolution of Reasoned Elaboration: Jurisprudential Criticism and Social Change*, 59 VA. L. REV. 279 (1973). See also Feinman, *The Role of Ideas in Legal History*, 78 MICH. L. REV. 722 (1980).

¹⁰⁷ See *Aluminum Co. of America v. Essex Group, Inc.*, 499 F. Supp. 53, 89, 91 (W.D. Pa. 1980), in which the court suggested that the "new spirit" of contract reflected the "need for a

bias of the *Restatement Second* toward either-or solutions. Courts will tend to find either that the parties agreed on the essential term, or if they did not, that no contract was formed or that performance should be discharged. The middle ground allowing for the application of section 204 is thereby reduced, although half-measures may be appropriate in the fashioning of post-discharge remedies.¹⁰⁸

Second, when section 204 is applicable, there is no discernible method to guide or control a court as it searches for a term "reasonable in the circumstances." The "reason to know" test is limited to ascertaining the effectiveness and meaning of agreement. Unless the process of interpretation uncovers market standards or establishes usage or practice to which the parties have not agreed, section 204 seemingly invites the court to meddle in the total situation in the search for "community standards of fairness or policy."¹⁰⁹ Without guidance, this invitation could be costly and contribute to a conclusion that the bargain fails for indefiniteness. This is the price to be paid for the use of overbroad standards in a general theory of contract that, unlike Article Two of the UCC, is far removed from the particular types of exchange transactions that generate the disputes.¹¹⁰ In fact, section 204 stops at the very point where it might have begun to develop a method to employ the context more fully.¹¹¹

Third, the *Restatement Second* is insensitive to other issues likely to arise in disputes involving section 204. The focus is upon failures of agreement at the time of contracting. Does either party have a duty to negotiate in good faith thereafter in an effort to resolve the dispute by agreement? What are their responsibilities to "keep the deal together," and what effect should this have upon the application of section 204? Similarly, to what extent should the application of section 204 depend on the remedy sought by the aggrieved party? Beyond the level of certainty needed for specific performance, the *Restatement Second* makes no connection between the power of the court to supply a term under sec-

body of law compatible with responsible commercial practices and understandings" and required the courts to give "close attention to the legitimate business aims of the parties, to their purpose of avoiding the risks of great losses, and to the need to frame a remedy to preserve the essence of the agreement." On the facts in *Essex*, this spirit, waiving in from such post-realist triumphs as the Uniform Commercial Code and the *Restatement Second*, directed the court to reform the contract by imposing a new escalation term on an unwilling buyer. Whether the court unwittingly released a more powerful spirit from an untapped keg remains to be seen.

¹⁰⁸ See Young, *supra* note 90.

¹⁰⁹ RESTATEMENT (SECOND) OF CONTRACTS § 204, Comment d (1979).

¹¹⁰ "The Restatement of this Subject . . . does not deal with special rules governing particular types of contracts . . ." *Id.*, Introduction.

¹¹¹ See Gordley, *European Codes and American Restatements: Some Difficulties*, 81 COLUM. L. REV. 140, 149 (1981). The author suggests that the reason for "cloudy" rules in a code or Restatement may be the inability "to distinguish the cases that call for one result from those that call for another." Greater clarity does not result; rather, the effect is "merely to draw a circle around a problem and leave it for someone else to resolve."

tion 204 and the power of the court to enjoin breach and order specific performance. In future transactions, the presence of "reasonable certainty," plus an increased availability of equitable remedies, will give a court wider latitude to preserve the relationship and adjust it with a supplied term. The either-or approach of the *Restatement Second* and its preference for damages slights this potential development and, by so doing, could impede its utility as a transitional device.¹¹²

A final limitation lies in the failure to articulate a complete theory of contract. This is to be expected in a document that intentionally isolates itself from much of the world around it¹¹³ and was drafted by a private group. The perspective was necessarily retrospective. Compromises were made. In fact, the Reporters should be congratulated for improving on the first *Restatement's* undergirding theory, providing useful analysis and method, and resisting the temptation to embrace the positive or normative implications of economic analysis.¹¹⁴ Nevertheless, the *Restatement Second* was completed at a time when a rich, new literature on contract was emerging. Whether the focus of this literature is on economic efficiency, relational theory, moral obligation, altruism, or distributive justice,¹¹⁵ the underlying and competing values are relevant to both a more complete theory of contract and the clutch of questions that swirl around section 204. Whether these values—these concerns over substance—simply help to fill out or supplement a theory based upon contextualization, or are the lynchpins for an overarching

¹¹² Some of these questions and the voluminous literature have been analyzed in Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 Nw. U.L. REV. 369 (1981). See also the excellent work of Professor Robert Hillman, much of which is cited and discussed in Hillman, *A Study of Uniform Commercial Code Methodology: Contract Modification Under Article Two*, 59 N.C.L. REV. 335 (1981).

¹¹³ The focus of the *Restatement Second* is upon the "legal relations arising from promises and the remedies available when a promise is broken." The *Restatement Second* does not "attempt to state the rules governing executed transactions or obligations not based upon promises" or attempt a "comprehensive statement of the rules governing particular types of contracts, or of the impact of modern legislation on the law of contracts." RESTATEMENT (SECOND) OF CONTRACTS, Introduction (1979). Although Chapter 8, Topic 1, deals with the unenforceability of promises on grounds of public policy, the *Restatement Second* makes "no effort . . . to state comprehensively the rules governing statutory obligations imposed on contracting parties regardless of their assent." *Id.*

¹¹⁴ See, e.g., A. KRONMAN & R. POSNER, *THE ECONOMICS OF CONTRACT LAW* (1979). For critical comments on the role of economic efficiency in contract law, see Kennedy & Michelman, *Are Property and Contract Efficient?*, 8 HOFSTRA L. REV. 711 (1980); Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"*, 75 Nw. U.L. REV. 1018 (1981).

¹¹⁵ See, e.g., C. FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATIONS* (1981); I. MACNEIL, *supra* note 97; Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980); Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1713-37, 1767-76 (1976); Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472 (1980); Symposium, *Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980); *A Response to the Efficiency Symposium*, 8 HOFSTRA L. REV. 811 (1980).

structure for the future, remains to be seen. In any event, the *Restatement Second* largely downplays these substantive questions.

CONCLUSION

This, perhaps, is the way of contracts Restatements. The first *Restatement*, completed in 1933, perfected the time honored methods of the past for then current consumption. The *Restatement Second* has elaborated, if not perfected, the methodology of contextualization implicit in 1933 in the work of Arthur Corbin. The *Restatement Third*, scheduled for completion in 2030 under the direction of an as yet unnamed Reporter, will undoubtedly incorporate those substantive ideas that emerge in an ever-changing world, and perhaps perfect a new system of rules imposed more from "out there" than derived from the commercial context. As Corbin so aptly put it:

Life marches on, with new conditions and interests, causing constant judicial development. Other times, other mores; other mores, other law.¹¹⁶

¹¹⁶ Corbin, *supra* note 5, at 1329. To paraphrase Grant Gilmore, contract law is the process by which courts accommodate change without abandoning society's fundamental structure. G. GILMORE, *THE AGES OF AMERICAN LAW* 14 (1977). The *Restatement Second* can best be understood as a limited summary of marginal changes that are underway within a structure assumed to be stable. As such, it also can be described as a rationalization for results that are determined by the allocation of economic power within that structure. *See* Tushnet, *Post-Realist Legal Scholarship*, 1980 *Wis. L. Rev.* 1383.