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CASE NO. 68253-9-I

COURT OF APPEALS, DIVISION I
STATE OF WASHINGTON

RYAN AND WAGES, LLC, a Washington Limited Liability Company through its Members, JULIA MCCORD and THE CONJUNCTIONAL PATRIOTIC SOVEREIGN PATHWAY,

Appellants/Cross-Respondents,

vs.

TOM WAGES, an Individual, and REDDING LAKE STEVENS, LLC, an Oregon Limited Liability Company,

Cross-Appellant/Respondent.

APPELLANTS' REPLY BRIEF ON APPEAL

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I. LEGAL ARGUMENT.

A. Redding Lake Stevens Misstates the Facts and Legal Conclusion of *Kaintz v. PLG* Because the Court did not Apply Mutuality of Remedy to a Non-Party to the Lease.

The central argument contained in Redding Lake Stevens' Response Brief is that the Mutuality Doctrine, as set forth in **Kaintz v. PLG,** dictates that Redding is entitled to rely on the attorney fees clause in the LLC Operating Agreement to justify the award it received in the Superior Court. However, Redding's analysis of **Kaintz** ignores the fact that in the **Kaintz** case PLG was an assignee of the lease and therefore *stepped into the shoes of the original lessor*. PLG became, in effect, a party to the lease and the Court's decision did not extend the Mutuality of Remedies Doctrine beyond parties to the agreement.

This is very different from the facts in the present case. Because Redding Lake Stevens was not a party to the LLC Operating Agreement, **Kaintz** is not conclusive and Redding Lake Stevens' reliance upon the Mutuality of Remedies Doctrine is misplaced.

1. The Kaintz Decision Granted Plaintiffs Attorney Fees Under the Mutuality of Remedies Doctrine Because the Assignment to PLG Voided the Lease and not Because the Court Believed the Assignment was Invalid.

In order to understand the application of the **Kaintz** decision to this case—and why the **Kaintz** decision does not stand for the holding Redding Lake Stevens argues—a clear understanding of the contractual relationship between the Kaintzes, Kelmark, LLC (referred to collectively as "the Kaintzes") and PLG, Inc. is necessary. Specifically, the Kaintzes were the owners of two commercial properties that were originally leased to Draper Enterprises, Inc. **Kaintz v. PLG, Inc.**, 147 Wn. App. 782, 784, 197 P.3d 710 (2010); *See Also* Attachment 1, p. 1.[1] Sometime in 2006, PLG, Inc. purchased the Draper Enterprises' business at the Kaintzes property and took over Draper Enterprises' lease through assignment. *Id.* However, neither PLG nor Draper Enterprises obtained the Kaintzes consent for the assignment of the leases and the Kaintzes brought an action alleging, among other things, that the assignment voided the leases. Attachment 1, pp.1-2.; *see also* Attachment 2, p.2-3. The issue with respect to the subject leases was not whether the contract between Draper Enterprises and PLG that assigned the lease to PLG was a valid contract—in fact the references to the assignment do not clearly articulate the nature

[1] Appellant has attached the briefing in **Kaintz v. PLG** to provide a more thorough analysis of the factual background of the matter.

of the transaction but it appear to have been an asset purchase agreement—but rather whether PLG's status as assignee voided the lease.

In *Kaintz* the parties agreed that PLG stepped into the shoes of Draper but disputed whether PLG voided the leases when it became the unauthorized assignee. In the its decision the Court explicitly stated that it wanted to expressly set forth *Mutuality of Remedies* as a viable doctrine because in it had been implicitly used by Washington Courts for years: "Washington's courts have regularly applied [mutuality of remedy] in deciding cases—even though the principle itself was seldom specifically identified." **Kaintz**, 147 Wn. App. at 787. In the opinion, the Court noted that that both the Supreme Court and Division I allowed for an award of attorney fees in a contract action where the party establishes that the contract is invalid or unenforceable. *Id.* at 879(*citing* **Park v. Ross Edwards, Inc.**, 41 Wn. App. 833, 706 P.2d 1097 (1985); **Mt. Hood Beverage Co. v. Constellation Brands, Inc.**, 149 Wn.2d 98, 63 P.3d 779 (2003)).

The holding in Kaintz was not the articulation of a new legal principle but rather a re-articulation of an often-used doctrine. Mutuality of Remedy has existed for decades to afford parties to a contract the legal avenue to recoup attorney fees when they successfully establish that a contract is void or unenforceable. In the subject opinion, the Court simply determined that Kaintz was entitled to attorney fees because PLG's status as assignee voided the leases. Critically, however, *PLG was deemed to be a party to the leases*—through assignment—and because of its status as a party to the lease—albeit a voided lease—served as the basis for the application of the Mutuality of Remedy Doctrine.

2. *Kaintz* and the Doctrine of Mutuality of Remedy are Inapplicable in this Matter Because It is Undisputed that Redding Lake Stevens was not a Party to the LLC Operating Agreement.

Mutuality of Remedy does not establish a legal basis for an award of attorney fees to Redding because the holding in **Kaintz** and the Court's articulation of the Doctrine limit the remedy to the parties to a contract and/or lease; nowhere does the Court's articulation of the doctrine establish that a basis for the recovery of attorney fees is extended tho third parties or non-parties. This construction also reconciles what would appear to be a deviation from other authority if the Respondents' argument were adopted.

In general, a third party cannot benefit from the terms of a contract to which it was not a party. **Touchet Valley Grain Growers, Inc. v. Opp & Seibold Gen. Constr., Inc.**, 119 Wn.2d 334, 342-43, 381 P.2d 724 (1992). Mutuality of remedy is limited to parties to a contract or lease and not to third-parties that have not assumed obligations under the contract.

Kaintz, 147 Wn. App. 789-90. Mutuality of Remedy affords a party to a contract to recover attorney fees under the terms of the agreement if the party defeats a claim on a contract by establishing the contract is void or unenforceable. *Id.* Further, courts look towards the language of the contract to determine who may recover attorney fees and under what circumstances. **Hawk v. Branjes**, 97 Wn. App. 776, 986 P.2d 841(1999). An LLC Operating Agreement is an agreement between members of an LLC on the business activities of the LLC. RCW § 25.15.005(5).

Redding Lake Stevens, LLC was not a party to the LLC Operating Agreement. No party to this appeal disputes that. Further, the language of the attorney fee provision clearly states that it is limited to "parties"—i.e. Members—that executed the Operating Agreement. (CP 164) The Members to the LLC Operating Agreement were Ryan & Wages, LLC and CMDG Investments, LLC. Because Redding Lake Stevens was not a party to the Operating Agreement, it cannot rely on the holding in **Kaintz** nor can it rely on the Mutuality of Remedy doctrine because no case to which it has cited allowed for an award of attorney fees based upon a contractual provision where the party seeking fees was not a party to the contract or lease. The purpose of the Doctrine is to afford attorney fees to a *party* who successfully establishes that a contract is void or unenforceable.

Critically, this construction is also consistent with longstanding analyses of the development of contract law and notions about conscious allocation and assumption of risk, such as risk of liability for attorney fees should a party to a contract err in seeking to enforce or bar its application. "A party's awareness of risks and the probability of their occurrence is crucial for him to evaluate accurately his expected gain [or risk of loss] from a transaction." [2] Rendering a party liable for attorney fees in an action against a non-party would mean that the party's lack of notice or knowledge that he or she bears a risk –liability to a non-party for attorney fees—is inconsistent with broad judicial themes relevant to the development and application of contract law. [3]

Because Redding Lake Stevens was not a party to the Operating Agreement and had never argued that the Operating Agreement is void or unenforceable, the lower court erred when it awarded Redding Lake Stevens, LLC its attorney fees and costs. Accordingly, reversal and remand is appropriate.

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[2] Sieta, Uncertainty and Contract Law, 46 U. Pitt. L. Rev. 75, 7 (1984).
[3] *Id*, p. 19.

II. CONCLUSION.

Respondent's assertion that the Mutuality of Remedy Doctrine allowed the lower court to award attorney fees and costs pursuant to the terms of the LLC Operating Agreement is unpersuasive. Mutuality of remedy allows a party who successfully defeats claims relating to a contract by establishing that the contract was either void or unenforceable to recoup attorney fees and costs under the provisions of the voided and/or unenforceable contract. However, the Doctrine is limited to parties to the contract or lease. Mutuality of remedy does not allow a third-party to recoup attorney fees based upon the terms of a contract to which he was never a party. Because Mutuality of Remedy is not applicable in this matter, **Kaintz** is not conclusive and Respondent's arguments to the contrary are equally unpersuasive.

Respondent was not a party to the LLC Operating Agreement and therefore cannot rely on its terms as the basis for recovery of attorney fees. Because the Mutuality of Remedy Doctrine did not authorize the Superior Court to award attorney fees and costs pursuant to the terms of the LLC Operating Agreement and because Respondent was not a party to the LLC Operating Agreement, the lower court erred when it awarded Respondent attorney fees and costs pursuant to the terms of the Redding Lake Stevens LLC Operating Agreement.

Respectfully submitted this 5th day of July 2012.

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APPENDIX

1. Brief of Appellant PLG, Inc.

2. Brief of Respondents Kaintz and Kelmark, LLC

3. Reply Brief of Appellant PLG, Inc.

1. Brief of Appellant PLG, Inc.

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COURT OF APPEALS, DIVISION I
OF THE STATE OF WASHINGTON

TIMOTHY J. KAINTZ and KERRI KAINTZ, Husband and Wife, and
Their Marital Community; and KELMARK, LLC,

Respondents,

v.

PLG, INC., a Washington corporation,

Appellant.

BRIEF OF APPELLANT PLG, INC.

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I. ASSIGNMENT OF ERROR

The Superior Court erred in ruling that Kaintz and Kelmark are the "prevailing party" and entitled to an award of attorney fees under RCW 4.84.330.

II. ISSUE PERTAINING TO ASSIGNMENT OF ERROR

Did the superior court "render" a "final judgment" in favor of Kaintz and Kelmark with respect to an "action on a contract or lease" such that they qualify as the "prevailing party" within the meaning of RCW 4.84.330?

III. STATEMENT OF THE CASE

In June 2007, Timothy and Kerri Kaintz, and Kelmark, LLC ("Kaintz and Kelmark"), owners of two separate parcels of commercial property, brought an unlawful detainer action against defendant PLG, Inc. CP 704-738. Kaintz and Kelmark alleged that PLG had taken over the "lube express" business of Draper Enterprises, Inc., which had occupied the properties under written leases ("the Draper Leases"), without Kaintz's and Kelmark's consent to assignment of the Draper Leases, such that PLG was a month-to-month tenant. CP 707 (¶¶ 5-7), CP 709-710, (¶¶ 15-17). Kaintz and Kelmark alleged that, after PLG and its principals failed to satisfy conditions for consent to assignment of the Draper Leases to PLG, they gave a month's notice to vacate pursuant to RCW 59.12.030(2) and

.040 and, after PLG failed to obey the notices and surrender the premises by May 31, 2006, filed the unlawful detainer action. CP 708 (¶¶ 8-11), CP 710-711 (¶¶ 18-21). Kaintz and Kelmark sought a writ of restitution, CP 709, 711 (¶¶ 12, 22), money damages CP 709, 711 (¶¶ 13, 23), and attorney's fees under provisions in the Draper Leases, CP 709, 711 (¶¶ 14, 24).

PLG denied Kaintz's and Kelmark's claims, CP 622-625, and asserted in counterclaims that it was entitled to remain in possession under the terms of the Draper Leases, because Kaintz and Kelmark either had consented to assignment of the leases or were estopped to deny having consented. CP 627-630 (¶¶ 3.2-3.8 and 3.9-3.16). PLG asked for a declaratory judgment and an injunction barring Kaintz and Kelmark from terminating the leases, CP 632 (¶¶ 4.5-5.3); damages for interference with PLG's right of quiet enjoyment under the leases, CP 632-634 (¶¶ 6.1-8.2); disgorgement of expenses PLG had incurred to maintain and repair the properties, CP 634 (¶¶ 9.1-9.3); and an award of attorney's fees "under the terms of the leases and any other legal or equitable basis," CP 635 (¶ 7).

Each of the Draper Leases was for ten years. One expired January 6, 2012, the other January 31, 2015. Both contained bilateral attorney's fees provisions. The earlier-expiring lease required the breaching party to pay the "non-breaching party" its attorney's fees "incurred to enforce the lease." CP 599 (¶ 32). The later-expiring lease provided for recovery, by the "prevailing party," of expenses and reasonable attorney fees incurred or paid by the other "in enforcing the provisions of the lease." CP 585 (¶ 12). (Kaintz and Kelmark never alleged any oral lease or other contract between them and PLG that included an attorney's fees provision, bilateral or unilateral.)

In August 2007, before a scheduled trial of Kaintz's and Kelmark's unlawful detainer action, PLG abandoned the premises, and the parties through counsel agreed to strike and not reset a trial date. CP 173 (¶ 17); CP 384-385; CP 499 (¶ 6); CP 607 (lines 18-20). The issue of whether PLG had succeeded to Draper's rights under the Leases was never adjudicated.[1]

In January 2008, four months after PLG abandoned the premises, Kaintz and Kelmark moved for summary judgment as to PLG's counterclaims and for an award of attorney's fees. CP 606-617. They argued that those of PLG's counterclaims that "related to" the issue of possession of the premises were moot, and that the PLG counterclaims that were unrelated to possession could not be maintained in an unlawful

[1] Kaintz and Kelmark never asked for a writ of restitution or any form of judgment on the merits with respect to their own or PLG's rights under the Draper Leases.

detainer action. CP 607 (lines 2-5); CP 616 (lines 21-24); CP 79. Kaintz and Kelmark sought attorney's fees under RCW 4.84.330 and Herzog Aluminum, Inc. v. General American Window Corp., 39 Wn. App. 188, 692 P.2d 867 (1984); they argued that they had prevailed because PLG had "surrendered" the tenancies and possession, CP 614-615, and because PLG had asserted rights under the Draper Leases and sought a fee award itself, CP 75-76.

In opposition to Kaintz's and Kelmark's motion, PLG argued, among other things, that they were not the "prevailing party" because it had abandoned the properties. CP 97-98.[2]

The Superior Court granted Kaintz and Kelmark's motion and entered an order dismissing PLG's counterclaims with prejudice, because those related to possession had become "moot," and because PLG had made no showing, in support of its other counterclaims, that it had made payments to Kaintz and Kelmark beyond what would "be expected of a tenant in possession." CP 73. The order declared Kaintz and Kelmark to

[2] PLG also argued that it was premature to hold that Kaintz and Kelmark had prevailed, because PLG still had viable counterclaims for unjust enrichment that did not depend on the Draper Leases, CP 98-99, and that Wallace v. Kuehner, 111 Wn. App. 809, 46 P.3d 823 (2002), rather than Herzog Aluminum, precludes a fee award because Kaintz and Kelmark had insisted they never consented to PLG succeeding Draper as tenant under the Draper Leases, CP 94-95.

be the "prevailing part" entitled to a fee award under RCW 4.84.330. CP 73.[3] PLG timely appealed. CP 5-15.[4]

IV. ARGUMENT

The Superior Court agreed with Kaintz and Kelmark that they were entitled to an attorney's fee award under RCW 4.84.330. The court reasoned that Kaintz and Kelmark were the prevailing party in a case in which PLG had alleged in an unsuccessful counterclaim that it had rights under the Draper Leases, which included fee-recovery provisions. CP 19. The court ruled that the case is thus subject to the rule, associated with Herzog Aluminum, 39 Wn. App. at 197, that the statutory phrase ""[i]n any action on a contract" includes "any action in which it is alleged that a person is liable on a contract."[5]

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[3] In rejecting PLG's argument based on Wallace, the Superior Court orally cited an unpublished decision of the Court of Appeals. See CP 18, 25. PLG moved for reconsideration. CP 25-28. That motion was denied, CP 16-17, the court explaining in a letter ruling that it considered the unpublished decision "apt," but that its fee-award ruling had not been based "entirely, or even primarily," upon that decision. CP 18.

[4] A typographical error was made at page 1, line 18 of PLG's Notice of Appeal (CP 73). PLG asserted that appeal is as of right pursuant to RAP 2.2(b)(3). Obviously, this is not a criminal case. PLG meant, and should have cited, RAP 2.2(*a*)(3), not (b)(3).

[5] The fact that the action was for unlawful detainer did not provide an alternative basis for awarding attorney's fees, because attorney's fees cannot be recovered in an action based on unlawful detainer of nonresidential property absent provision for recovery of fees in a lease or other written agreement. See Sunrise Group Homes, Inc. v. Ferguson, 55 Wn. App. 285, 289-290, 777 P.2d 553 (1989).

Whether RCW 4.84.330 applies to a given set of facts is a question of law. Wachovia SBA Lending v. Kraft, 138 Wn. App. 854, 858-859, 158 P.3d 1271 (2007), rev. granted, __ Wn.2d ___, 180 P.3d 1291 (April 1, 2008). Review therefore is *de novo*. RCW 4.84.330 provides:

> In any action on a contract or lease entered into after September 21, 1977, where such contract or lease specifically provides that attorney's fees and costs, which are incurred to enforce the provisions of such contract or lease, shall be awarded to one of the parties, the prevailing party, whether he is the party specified in the contract or lease or not, shall be entitled to reasonable attorney's fees in addition to costs and necessary disbursements.
>
> Attorney's fees provided for by this section shall not be subject to waiver by the parties to any contract or lease which is entered into after September 21, 1977. Any provision in any such contract or lease which provides for a waiver of attorney's fees is void.
>
> *As used in this section "prevailing party" means the party in whose favor final judgment is rendered.* [Italics supplied.]

Thus, "[f]or RCW 4.84.330 to apply: (1) the action must be 'on a contract or lease,' (2) the contract must contain a unilateral attorney's fee or cost provision, and (3) there must be a 'prevailing party.'" Wachovia SBA Lending, 138 Wn. App. at 859.

Kaintz's and Kelmark's unlawful detainer complaint, CP 711 (¶ 24), requested an award of attorney's fees for enforcing the Draper Leases, (which contained *bilateral* attorney's fees provisions), but the premise of their unlawful detainer action – and the basis upon which they invoked the court's subject matter jurisdiction – was that PLG was only a month-to-month tenant because they had never consented to assignment of Draper's leasehold rights (or obligations) to PLG. Kaintz and Kelmark invoked the court's jurisdiction by serving 30-day notices to vacate pursuant to RCW 59.12.030(2). CP 708-711 (¶¶ 10, 12, 20, 22). That statute provides that a tenant of real property for a term less than life is guilty of unlawful detainer "[w]hen he or she, having leased property for an indefinite time with monthly or other periodic rent reserved, continues in possession thereof, in person or by subtenant, after the end of any such month or period, when the landlord, more than twenty days prior to the end of such month or period, has served notice (in manner in RCW 59.12.040 provided) requiring him or her to quit the premises at the expiration of such month or period. . ."

Thus, despite their complaint's request for a fee award under the leases, Kaintz and Kelmark' action was *not* truly an "action on a contract or lease," (let alone an action on a contract or lease containing an attorney's fees provision, let alone an action on a contract or lease containing a unilateral attorney's fees provision[6]). It was an action to recover possesssion of nonresidential property from a tenant with no

[6] See Hawk v. Branjes, 97 Wn. App. 776, 843, 986 P.2d 841 (1999) ("where, as here, the agreement already contains a bilateral attorneys' fee provision, RCW 4.84.330 is generally inapplicable").

contractual rights at all. For that reason alone, Kaintz and Kelmark were not the "prevailing party" in an action, *by them*, on a contract or lease containing a unilateral attorney fee provision, and were not entitled to a fee award under RCW 4.84.330. Wachovia Lending, 138 Wn. App. at 859.

For a different reason, neither were Kaintz and Kelmark the "prevailing party" on those counterclaims *by PLG* that *were* "on a contract or lease." PLG did assert counterclaims based on the Draper Leases, CP 626-638, and other counterclaims based on common law and equity CP 638. The counterclaims based on the Draper Leases were actions "on a contract or lease," but the common law counterclaims were not. Kaintz and Kelmark did not argue that they were entitled to a fee award because they had "prevailed" against PLG's common law counterclaims. Thus, unless Kaintz and Kelmark were the "prevailing party" within the meaning of RCW 4.84.330 with respect to PLG's Draper Lease-based counterclaims, they were not the "prevailing party" in an action on a contract or lease. To be a prevailing party for purposes of RCW 4.84.330, someone must have "final judgment" entered in his or her favor. RCW 4.84.330 (third paragraph); Wachovia, 138 Wn. App. at 860-861. As the Court of Appeals, RCW 4.84.330 is the rare instance in which the legislature has specified in a statute authorizing recovery of attorney's fees that "final judgment" must be entered in order for a party to be considered the "prevailing party." Wachovia, 138 Wn. App. at 861 n.8.

"Judgment . . . means 'a formal decision or determination given in a cause by a court. . .'" Id. at 861 (quoting Webster's Third New Inter. Dictionary, at 1223). A "final judgment" is one that "'settles the rights of the parties and disposes of all issues in controversy, *except for* the award of costs (and, sometimes, attorney's fees) and enforcement of the judgment.'" Wachovia, 138 Wn. App. at 861 (quoting Black's Law Dictionary, 859 (8^{th} ed, 2004) (italics supplied)).

The Wachovia court held that, for purposes of RCW 4.84.330, there is no "final judgment" when a plaintiff takes a voluntary dismissal without prejudice under CR 41. Wachovia, 138 Wn. App. at 861-862.[7] There was no voluntary dismissal, as such, with respect to the unlawful detainer action, but PLG's abandonment of the premises, and Kaintz's and

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[7] The Wachovia court distinguished the case before it from ones in which the Court of Appeals had held that parties whose adversaries had taken CR 41 voluntary nonsuits with prejudice had "prevailed" for purposes of an attorney's fee award under RCW 4.84.330. Wachovia, 138 Wn. App. at 859 n.7 (distinguishing Escude v. King County Pub. Hosp. Dist. No. 2, 117 Wn. App. 912, 918-19, 859 P.2d 605 (1993); and Western Stud Welding, Inc. v. Omark Indus., Inc., 43 Wn. App. 293, 295-96, 716 P.2d 959 (1986)). Arguably, the reasoning and result of Wachovia conflict with that of Hawk v. Branjes, 97 Wn. App. 776, which upheld a fee award under RCW 4.84.330 after a CR 41 voluntary dismissal that may have been without prejudice. The Hawk court, however, did not address the kind of legislative-intent/statutory construction arguments that persuaded the Wachovia court to hold that a CR 41 voluntary dismissal without prejudice is not a "final judgment."

Kelmark's response – to ask the Superior Court to rule that PLG's lease-based counterclaims had become moot – left the parties and the court with no contract-based issues in controversy except for Kaintz's and Kelmark's request for fees, which was what the court would have been left to do had a Rule 41 dismissal been taken. According to Wachovia, there was no "final judgment," so Kaintz and Kelmark did not "prevail" for purposes of RCW 4.84.330, and it was error to make a fee award to them.

The Wachovia court did not note or acknowledge that the Herzog Aluminum rule (that a party's mere allegation of a contractual right to a fee award triggers RCW 4.84.330) is based on the reasoning that, because the 1977 Legislature essentially copied Cal. Civ. Code § 1717 to create RCW 4.84.330, it presumably adopted California appellate courts interpretations of the statute, too. "[P]re-1977 California judicial interpretations of § 1717," the Herzog court declared, "are persuasive evidence of our Legislature's intent." 39 Wn. App. at 871.

It so happens, though, that, as of 1977, there was a California appellate court decision interpreting the last sentence in Cal. Civ. Code § 1717, which became the last sentence of RCW 4.84.330 ("As used in this section 'prevailing party' means the party in whose favor final judgment is rendered"). The California decision held that "final judgment" has not been "rendered" for purposes of § 1717 when a plaintiff takes a voluntary dismissal without prejudice, because there is not a "final judgment" and because the result is not one that had been judicially "rendered." Associated Convalescent Enters. v. Carl Marks & Co., Inc., 108 Cal. Rptr. 782, 785 (1973) ("The word 'rendered' also has significance; it 'is appropriately used in reference to a judgment or decree, but not to a proceeding or order.'" (quoting Brownell v Superior Court, 157 Cal. 703, 707, 109 P. 91, 93 (1910)).

Under the reasoning of Herzog Aluminum, our legislature presumably was mindful of, and meant to adopt, the Associated Convalescent court's interpretation of the "final judgment has been rendered" requirement in Cal. Civ. Code § 1717 when it enacted an identically-worded statute as RCW 4.84.330. Kaintz and Kelmark asked the Superior Court to dismiss PLG's possession-related counterclaims as moot, not to adjudicate anything or render any actual decision. No "final judgment" was "rendered," so there was no "prevailing party" for purposes of RCW 4.84.330.

V. CONCLUSION

For the reasons discussed above, the Court of Appeals should reverse the Superior Court and remand with instructions to vacate the award of attorney fees to plaintiffs/respondents Kaintz and Kelmark.

RESPECTFULLY SUBMITTED this 12th day of May, 2008.

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CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury that under the laws of the State of Washington that on the 12th day of May, 2008, I caused a true and correct copy of the foregoing document, "Brief of Appellant PLG, Inc.," to be delivered by U.S. mail, postage prepaid, to the following counsel of record:

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2. Brief of Respondents Kaintz and Kelmark, LLC

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COURT OF APPEALS,
DIVISION I
OF THE STATE OF WASHINGTON

TIMOTHY J. KAINTZ and KERRI KAINTZ, Husband and Wife, and their Marital Community; and KELMARK, LLC,

Respondents,

v.

PLG, INC., a Washington corporation,

Appellant.

BRIEF OF RESPONDENTS

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I. INTRODUCTION

The Snohomish County Superior Court, Judge Richard J. Thorpe, correctly awarded the plaintiffs (the "Landlords") their attorney fees "under the terms of the leases" as the prevailing parties in this lawsuit. Defendant PLG, Inc.'s ("PLG") assignment of error – that the Landlords cannot recover attorney fees because they are not the prevailing parties under RCW 4.84.330 – would yield an unjust result and an unreasonable reading of RCW 4.84.330. PLG relies heavily upon *Wachovia SBA Lending v. Kraft*, 138 Wn. App. 854, 158 P.3d 1271 (2007), *review granted*, 163 Wn. 2d 1011, 180 P.3d 1291 (April 1, 2008).

PLG' s sole issue related to the assignment of error is whether the trial court rendered a final judgment within the meaning of RCW 4.84.330. Contrary to PLG's assignment of error: (1) The trial court rendered a final judgment in favor of the Landlords when it dismissed PLG's counterclaims with prejudice; (2) PLG's reliance on *Wachovia* conflicts with this court's decisions; and (3) the trial court properly applied *Mt. Hood Beverage Co. v. Constellation Brands, Inc.*, 149 Wn.2d 98 (2003), in which the Washington Supreme Court affirmed an award of attorney fees based upon equitable principles derived from RCW 4.84.330.

II. STATEMENT OF THE CASE

The material facts of this case are not in dispute. The Landlords brought this action under the unlawful detainer statute to recover two separate premises that had been unlawfully occupied by PLG under unapproved lease assignments from the original tenant. PLG counterclaimed for declaratory and injunctive relief, damages, and attorney fees "under the terms of the leases." PLG Br. at 2.

A week before the scheduled trial date, PLG abandoned the premises, and the Landlords took possession. The Landlords then successfully moved for summary judgment on PLG's counterclaims and for attorney fees which were granted. CP 73. (The trial court's summary judgment order and order denying reconsideration are included in the Appendix.)

PLG incorrectly asserts that the Landlords never asked for "any form of judgment on the merits with respect to their own or PLG's rights under the Draper Leases." PLG Br. at 3, n. 1. To the contrary, the Landlords argued in their summary judgment motion that PLG had abandoned the tenancies, which was the reason that PLG's counterclaims should be dismissed with prejudice. CP 612. This argument required the trial court to decide the merits of PLG's claim of tenancy under the leases.

Accordingly, the trial court's order granting summary judgment stated that PLG had abandoned the tenancies. CP 73.

PLG also incorrectly states that the summary judgment "order declared Kaintz and Kellmark to be the 'prevailing part' [sic] entitled to a fee award under RCW 4.84.330." PLG Br. at 4-5. The order makes no reference to RCW 4.84.330, or to any other statute, but relies upon the terms of the leases for the attorney fee award. The exact language of the order states: "Plaintiffs are the prevailing parties in this action, and are entitled to attorney fees under the terms of the leases." CP 73.

III. ARGUMENT

1. The Landlords are entitled to an award of fees under the terms of the leases.

> In Washington, attorney fees may be awarded only when authorized by a private agreement, a statute, or a recognized ground of equity. . . . Attorneys fees and costs are awarded to the prevailing party even when the contract containing the attorneys fee provision is invalidated. *See Mt. Hood Beverage Co. v. Constellation Brands, Inc.*, 149 Wn.2d 98, 121-22, 63 P.3d 779 (2003); *Herzog Aluminum, Inc. v. Gen. Am. Window Corp.*, 39 Wn. App. 188, 196-97, 692 P.2d 867 (1984); *Yuan v. Chow*, 96 Wn. App. 909, 915-18, 982 P.2d 647 (1999).

Labriola v. Pollard Group, Inc., 152 Wn.2d 828, 839, 100 P.3d 791 (2004). In *Labriola* an employee was awarded fees under RCW 4.84.330

when a noncompete agreement was held to be not enforceable. 152 Wn. 2d at 838-39.

Both of the leases in this case have bilateral attorney fees provisions. In the Kaintz lease the fee provision reads as follows:

> 12. ATTORNEY FEES.
>
> All costs, expenses and reasonable attorney fees that may be incurred or paid by either party in enforcing the provisions of this lease shall be recovered by the prevailing party from the other.

CP 585, ¶ 12. PLG Br. at 2-3.

In the Kelmark lease the fee provision reads as follows:

> If an attorney is retained or a lawsuit is instituted to enforce any provision contained herein the non-breaching party shall be paid by the breaching party its costs and attorney's fees incurred to enforce the lease.

CP 599, ¶ 32. PLG Br. at 3.

PLG claimed to be the tenant on both leases through written assignments from the original tenant. The rights and liabilities of an assignee are clear.

> An assignee of a contract "steps into the shoes of the assignor, and has all of the rights of the assignor."
>
> . . . .
>
> These cases support the conclusion that an assignment carries with it the rights and liabilities as identified in the assigned contract . . . .

Puget Sound Nat'l Bank v. Dept. of Revenue, 123 Wn. 2d 284, 292, 868 P.2d 127 (1994).

PLG claimed all the rights of the tenant under the lease assignments. Having had the assignments rejected by the Landlords, PLG has to accept the liability for attorney fees under the leases to which it was claiming to be a party.

2. The Landlords have met the requirements for an award of fees under RCW 4.84.330.

a. This case is an action on a lease.

RCW 4.84.330 provides:

> In any action on a contract or lease entered into after September 21, 1977, where such contract or lease specifically provides that attorney's fees and costs, which are incurred to enforce the provisions of such contract or lease, shall be awarded to one of the parties, the prevailing party, whether he is the party specified in the contract or lease or not, shall be entitled to reasonable attorney's fees in addition to costs and necessary disbursements.
>
> . . . .
>
> As used in this section "prevailing party" means the party in whose favor final judgment is rendered.

PLG contends that this case does not fulfill the statutory requirement that the action be "on a contract or lease" because the Landlords argued that PLG was a month to month tenant only, and PLG surrendered its claim to the leases and abandoned the tenancies. PLG Br. at 7-9. PLG's position is at odds with the claims of the Landlords and PLG's own defenses and counterclaims in this case.

(1) The Landlords had lease rights to disapprove the assignments.

The Landlords' claim of possession was based on the specific provision in each lease a giving the Landlords the right to approve any assignment of the lease. The Landlords argued that they had not approved any assignment to PLG. CP 608, 610.

PLG contended that it had written assignments from the original tenant, and that the assignments gave PLG the rights of the original tenant under the leases. PLG further contended that the Landlords had orally agreed to the assignments. CP 84, 85.

(2) PLG's counterclaims asserted rights under the leases.

PLG's Answer asserted six counterclaims, five of which specifically claimed benefits under the leases. These counterclaims were as follows:

(1) For a declaratory judgment "that the leases on those properties are valid and enforceable with PLG as the lessees . . . until the expiration of the leases on January 31, 2015 and January 6, 2012 respectively." CP 631, ¶ 4.4.

(2) For injunctive relief prohibiting the Landlords "from terminating the leases." CP 632, ¶ 5.3.

(3) Breach of contract: "PLG is entitled to recover damages for the value of its remaining leasehold interest in Lake Stevens and Harbour Point properties through January 31, 2015 and January 6, 2012, respectively, associated with the Kaintzes' and Kelmark' breach of the leases." CP 633, ¶ 6.5.

(4) Breach of the implied covenant of quiet enjoyment, "PLG is entitled to quiet enjoyment of the premises until the termination of the leases." CP 633, ¶ 7.2. The Landlords "should be enjoined from interfering with PLG's enjoyment of the premises." CP 634, ¶ 7.3.

(5) Promissory estoppel: The Landlords knew "that PLG would rely upon their offers promises and representations made regarding the assignment of the leases." CP 634, ¶ 8.2.

(6) Unjust enrichment: "If PLG's tenancy is terminated, PLG has not received full benefit of its payments" and the Landlords "have been unjustly enriched thereby." CP 634, ¶ 9.2.

At the conclusion of its answer and counterclaims, PLG asked for "its attorney's fees and costs under the terms of the leases and any other legal or equitable basis." CP 635.

PLG's allegations that the Landlords were liable to PLG under the leases also makes each counterclaim "an action on a contract" under the rule stated in *Herzog Aluminum, Inc. v. General American Window Corp.*, 39 Wn. App. 188, 692 P.2d 867 (1984):

> Accordingly, we conclude that the broad language "[i]n any action on a contract" found in RCW 4.84.330 encompasses any action in which it is alleged that a person is liable on a contract.

39 Wn. App. at 197. *Accord, Yuan v. Chow*, 96 Wn. App. 909, 916, 982 P.2d 647 (1999). In *Yuan* a third party defendant was alleged to be a party to a promissory note. The defendant did not sign the note, and was not named in the note. 96 Wn. App. at 910. The court held that the third party defendant was entitled to attorney fees under RCW 4.84.330 when it was determined that he was not obligated on the note. 96 Wn. App. at 915.

The outcome of PLG's claim to be the rightful tenant under the lease assignments depended upon the determination of the Landlords' actions under the lease sections that reserved to the Landlords the right to approve or disapprove assignments.

The legal analysis of the Landlords' actions disapproving the assignments is an action on the lease. After the unsuccessful negotiations with PLG, the Landlords had to take action, or their lack of opposition to PLG's tenancies would have been considered a waiver. *See OTR v. Flakey Jake's, Inc.*, 112 Wn. 2d 243, 770 P.2d 629 (1989). ("Upon learning of the assignment, OTR [lessor] had the option to declare a forfeiture or to recognize Seilig as its tenant. However, after learning of the assignment and accepting the benefits of the assignment, OTR would not have been allowed to deny its validity.") 112 Wn. 2d at 248. *Cf. Bellevue Square Managers, Inc. v. GRS Clothing, Inc.*, 124 Wn. App. 238, 244, 98 P.3d 498 (2004) ("BSM [Bellevue Square] had the right to void the assignment, and it did so.")

b. A final dismissal with prejudice was rendered against PLG.

PLG contends that its surrender of the tenancies just before trial is equivalent to a voluntary dismissal without prejudice under CR 41. Under PLG's theory no final judgment has been rendered and the Landlords are not the prevailing party under the statutory definition. PLG's analogy that its actions are similar to a voluntary nonsuit without prejudice is incorrect.

As the Landlords argued in their motion, PLG's surrender of the tenancy was shown by its actions. CP 612-13.

> Whenever a surrender is implied from the acts of the parties, it is a surrender by operation of law. This inference may be drawn from anything which amounts to an

> agreement on the part of the tenant to abandon, and on the part of the Landlord to resume, possession of the premises.

Moore v. Northwest Fabricators, Inc., 51 Wn. 2d 26, 29-30, 314 P.2d 941 (1957). In *Moore*, the lessee sued on an option contained in a lease. The court held that because the lease had been abandoned, "[a]ppellants have no standing to sue." 51 Wn. 2d at 30.

The August 28, 2007 letter from PLG's attorney stated that PLG "doesn't want the Landlords or the tenancies" and that PLG "will vacate these tenancies." CP 506, 507. These actions and the Landlords resuming possession constituted "a surrender by operation of law." The trial court's order acknowledged that PLG had abandoned the tenancies. CP 73.

Unlike a voluntary dismissal without prejudice in which the action could be refiled, PLG's action in abandoning the premises was final. Just like the lessee in *Moore*, PLG had no future option to refile its claim under the leases. In addition, the trial court's order dismissed all of PLG's counterclaims with prejudice. CP 73. PLG did not voluntarily dismiss its counterclaims, and it continued to argue at the summary judgment motion for the counterclaims of quiet enjoyment under the lease and promissory estoppel related to the tenant's assignment under the lease. CP 98.

In short, the Landlords obtained the relief they were seeking. They obtained possession of the premises, and dismissal of PLG's counterclaims with prejudice. PLG abandoned the tenancies with no right to reassert a claim of tenancy at a later time. This is a materially different result than a voluntary dismissal without prejudice.

c. RCW 4.84.330 is not restricted to contracts with unilateral fee provisions

PLG recognizes that both leases have bilateral provisions for fees. PLG Br. at 2-3. PLG implies that RCW 4.84.330 might only apply if the attorney fee provision in a contract is unilateral. For this position PLG cites *dicta* in Hawk *v. Branjes*, 97 Wn. App. 776, 780, 986 P.2d 841 (1999). PLG Br. at 7, n. 6, and *Wachovia*. PLG Br. at 6. *Hawk*, however, dealt with the question of "whether the parties intended to adopt the statutory definition of prevailing party contained in RCW 4.84.330" when there already is a bilateral fee provision in the lease. 97 W. App. at 780. This court held that the parties did not intend to adopt the statutory definition for the purpose of interpreting the lease, 97 Wn. App. at 781, and that the landlord who had voluntarily dismissed was liable for the tenant's fees. 97 Wn. App. at 778, 782.

No case has been located that holds that RCW 4.84.330 does not apply if the contractual fee provision is bilateral. The only case that appears to have addressed the issue directly is *Park v. Ross Edwards, Inc.*, 41 Wn. App. 833, 706 P.2d 1097 (1985) where this court applied 4.84.330 and awarded fees. In *Park* the fee provision in the purchase and sale agreement was bilateral, and the contract was held invalid. 41 Wn. App. at 838. Regarding the bilateral versus unilateral issue the court reasoned:

> Certainly it makes little sense to allow a defendant who successfully defends a suit for specific performance by proving the absence of a contract to collect attorney's fees only if the purported contract included a unilateral attorney's fees provision but not if it included a bilateral provision. Such a result accomplishes what both *Herzog* and the statute seek to avoid. Accordingly, Smith and Braun [defendants] are awarded reasonable attorney's fees.

41 W. App. at 839.

3. Under this court's decisions, the Landlords qualify as the prevailing parties under RCW 4.84.330 even if PLG had voluntarily dismissed its counterclaims.

PLG relies extensively upon Division Two's recent decision in *Wachovia SBA Lending v. Kraft,* 138 Wn. App. 854, 158 P.3d 1271 (2007), *review granted,* 163 Wn. 2d 1011, 180 P.3d 1291 (April 1, 2008) to support its argument that a voluntary dismissal does not qualify as a final judgment for the purpose of attorney fees under RCW 4.84.330. This court's prior decisions, however, do not accept the reasoning of *Wachovia*. Unless the Supreme Court affirms *Wachovia*, and in so doing overrules the cases of this court discussed below, PLG's position is opposed by well reasoned cases from this court.

This court has addressed the question of attorney fees under RCW 4.84.330 in the case of a voluntary dismissal.

> In general, if a plaintiff voluntarily dismisses its entire action under CR 41, the defendant is considered to be the prevailing party for the purposes of attorney fees under RCW 4.84.330. *Walji v. Candyco, Inc.*, 57 Wn. App. 284, 288, 787 P.2d 946 (1990); *see also Andersen v. Gold Seal Vineyards, Inc.*, 81 Wn.2d. 863, 867-68, 505 P.2d 790 (1973) (holding that when the plaintiff takes a voluntary nonsuit, the defendant is the prevailing party for purposes of an attorney fee award under RCW 4.28.185(5), the long-arm statute); *Soper v. Clibborn*, 31 Wn. App. 767, 644 P.2d 738 (1982) (finding that when plaintiff's claim was dismissed, defendant was a prevailing party under RCW 59.18.290(2)).

Marassi v. Lau, 71 Wn. App. 912, 918-19, 859 P.2d 605 (1993). The Marassis had dismissed five of their claims before trial: "The trial court granted the Marassis' motion and the five claims were dismissed without prejudice." 71 Wn. App. at 914. [1]

[1] In *Wachovia*, Division Two misstates that *Marassi* and two other cases "considered CR 41 dismissals *with* prejudice." 138 Wn. App. at 860 n. 7 (emphasis by the court). PLG does not cite *Marassi* in its brief. PLG discusses *Wachovia's* footnote 7 in detail with reference to the other two cases, but omits any reference to *Marassi*. PLG Br. at 9, n. 7.

Additional analysis in *Marassi* supports the conclusion that this court would not have reached the same result as Division Two in *Wachovia*. In *Marassi* the court discussed "a recent decision by Division Three, *Hubbard v. Scroggin*, 68 Wn. App. 883, 846 P.2d 580 (1993)." This court stated that it would not follow the reasoning of *Hubbard*:

> We disagree that *Andersen* should be construed so narrowly; moreover, *Hubbard* does not address *Walji v. Candyco, Inc., supra*, wherein we stated:
>
> > The reason that an order of voluntary dismissal is not a final judgment is for the protection of plaintiffs by allowing the litigation to continue under certain circumstances. It is not for the purpose of precluding attorney fees to a defendant who has "prevailed" as things stand at that point.
>
> *Walji*, 57 Wn. App. at 289. Accordingly, we believe that *Hubbard* should be limited to its unique facts; to the extent that it conflicts with the principles set forth in *Walji* and *Andersen*, we decline to follow it.

71 Wn. App. at 919.

4. The trial court's dismissal of PLG's counterclaims with prejudice distinguishes this case from the voluntary dismissal taken by the plaintiff in *Wachovia*.

There is a significant distinction between the procedural facts of *Wachovia*, and the procedural facts in this case. In *Wachovia*, plaintiff's complaint was dismissed without prejudice under CR 41. 138 Wn. App.

at 857. PLG, however, never dismissed, nor sought to dismiss its six counterclaims, five of which claimed rights under the leases. The Landlords argued in their summary judgment motion that the counterclaims should be dismissed and the court ordered the counterclaims "dismissed with prejudice." CP 73. In this respect the court reached a final judgment as to PLG's counterclaims, unlike *Wachovia* where the court found that "Wachovia is free to file a new action against Kraft, leaving final judgment on their dispute for a future day." 138 Wn. App. at 862. PLG has no "future day" to look forward to on its claim under the lease assignments. PLG abandoned the tenancies, which was a "surrender by operation of law" and its counterclaims were dismissed with prejudice.

5. RCW 4.84.330 does not need to be applied in this case. The trial court's decision should be affirmed based upon the equitable principles recognized by the Supreme Court in *Mt. Hood Beverage Co. v. Constellation Brands, Inc.*

In *Mt. Hood Beverage Co. v. Constellation Brands, Inc.*, 149 Wn. 2d 98, 63 P.3d 779 (2003) the attorney fee provision at issue was bilateral, and it was found in a statute, RCW 19.126, that was held to be invalid. 149 Wn. 2d at 120-21. In spite of "the statute being stricken in its entirety," 149 Wn. 2d at 120, the Supreme Court awarded fees to the defendant. 149 Wn. 2d at 122. RCW 4.84.330 was not applied in *Mt. Hood*, but it was discussed as the court relied upon *Herzog* for its analysis.

A key consideration in both the *Mt. Hood* and *Herzog* cases was the concept of fairness. *Mt. Hood* discussed this fairness principle as follows:

> Significant to the case before us, *Herzog* also noted that, had the other party prevailed in its suit on the contract, it would unquestionably be entitled to attorney fees and costs. *Herzog*, 39 Wn. App. at 191.
>
> Although this case is an action on an invalid statute rather than a contract, the same principles apply. Had the Distributers prevailed, they would have been entitled to attorney fees and costs under RCW 19.126. Because the attorney fees provision was written reciprocally to apply to whichever party won, we hold that defending against an action based on a statute by successfully arguing the statute is unconstitutional allows an award of attorney fees under that statute.

149 Wn. 2d at 121-22.

In applying the "principles" of *Herzog*, in *Mt. Hood*, the Supreme Court relied on the equitable principle of reciprocity behind RCW 4.84.330, even though that statute did not apply in *Mt. Hood*. In *Yuan v. Chow*, 96 Wn. App. 909, the court described this principle as "mutuality of remedy." "[T]he purpose of the bilateral fee provision of RCW 4.84.330 is to provide mutuality of remedy." 96 Wn. App. at 918.

Mt. Hood derived equitable principles from RCW 4.84.330, *Herzog* and the other cases interpreting RCW 4.84.330. *Mt. Hood* demonstrates that the equitable principles behind RCW 4.84.330 have greater application than just the specific circumstances described by the language of the statute. In short, *Mt. Hood* provided an equitable remedy to the successful party even though no statute or contract specifically provided that remedy.

The trial court in this case was concerned about the same equality of remedy that was discussed in *Mt. Hood, Herzog* and *Yuan*. In its February 8, 2008 letter opinion explaining the denial of PLG's Motion for Reconsideration, the trial court stated, "In the case at bar, if defendant had prevailed on its claim that it was entitled to the rights afforded by the lease, it surely would have been entitled to an attorney fee award." CP 20 and Appendix.

The principles relied upon in *Mt. Hood* do not depend upon interpreting specific language of a statute. This court does not need to fit this case into the statutory structure of RCW 4.84.330 in order to affirm the trial court. This court can follow the principles recognized in *Mt. Hood* to provide the same relief for the Landlords that would have been provided to PLG if it had been successful on its claim that it was the tenant under the leases.

6. The Landlords' request attorneys fees on appeal.

The Landlords request attorneys fees on appeal. They are entitled to an award of attorney fees and costs under the terms of the leases, and under RCW 4.84.330.

IV. CONCLUSION

The trial court's decision should be affirmed. The Landlords qualify for fees on three independent grounds: (1) under the fee provisions in the leases to which PLG claimed to be a tenant through assignment, (2) as the prevailing parties under RCW 4.84.330, and (3) under the equitable principles recognized in *Mt. Hood.*

Respectfully submitted this 16th day of June, 2008.

SIMBURG, KETTER, SHEPPARD & PURDY, LLP

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V. APPENDIX

FILED

2008 JAN 31 AM 10: 46

SONYA J. KRASKI
COUNTY CLERK
SNOHOMISH CO. WASH.

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
FOR THE COUNTY OF SNOHOMISH

TIMOTHY J. KAINTZ and KERRI KAINTZ, Husband and Wife, and their Marital Community; and KELMARK, LLC, Plaintiffs, v. PLG, INC., a Washington corporation, Defendant.	No. 07-2-05043-2 ORDER GRANTING PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

THIS MATTER came before the Court on plaintiffs' Motion for Summary Judgment. The Court has reviewed the submissions of the parties, the pleadings in the case, and heard the argument of counsel. The Court makes its decision based upon the following documents.

1. Plaintiffs' Motion for Summary Judgment and plaintiffs' Reply to defendants' opposition;
2. Declaration of George A. Purdy and the exhibits attached thereto;
3. Declaration of Tim Kaintz and the exhibits attached thereto;
4. Defendants' Opposition to plaintiffs' Motion for Summary Judgment;
5. Declaration of Timothy Blue and the exhibits attached thereto;

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6. Declaration of Joe Brandmeier and the exhibits attached thereto;

7. Declaration of Lisa Brandmeier and the exhibits attached thereto;

8. Declaration of Darren Feider and the exhibits attached thereto.

NOW, THEREFORE, IT IS HEREBY ORDERED that Plaintiffs' Motion for Summary Judgment is GRANTED. Defendants' counterclaims are dismissed with prejudice. Defendants abandoned the tenancies and plaintiffs regained possession, and counterclaims related to possession are moot. Defendant has presented no evidence in support of its other counterclaims that it paid plaintiffs any more than would be expected of a tenant in possession.

Plaintiffs are the prevailing parties in this action, and are entitled to attorney fees under the terms of the leases. Plaintiffs shall submit a request for fees by February 11, 2008 2008, and defendants shall respond by February 18, 2008.

DONE IN OPEN COURT this 28th day of January, 2008.

Judge

Presented by:
SIMBURG, KETTER,
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Copy Received:

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IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
FOR THE COUNTY OF SNOHOMISH

TIMOTHY J. KAINTZ and KERRI KAINTZ, Husband and Wife, and their Marital Community; and KELMARK, LLC, Plaintiffs, v. PLG, INC., a Washington corporation, Defendant.	No. 07-2-05043-2 ORDER DENYING DEFENDANT'S MOTION FOR RECONSIDERATION [~~PROPOSED~~] 2/8/08

The court has considered Defendant's Motion for Reconsideration and Plaintiffs' Response.

The motion for reconsideration is DENIED.

The court did not rely upon the unpublished case of *Munro v. Swanson* in granting Plaintiffs' Motion, but referred counsel to the *Munro* case for illustrative purposes only.

Dated this 8 day of February, 2008.

Judge Richard J. Thorpe

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CP 16

Presented by:
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CP 17

Superior Court of the State of Washington
for Snohomish County

RICHARD J. THORPE
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Re: Kaintz et al. v. PLG, Inc. Cause No. 07 2 05043 2

Dear Counsel:

I wondered why Mr. Purdy hadn't cited the case of Munro v. Swanson & Whitehead Enterprises is support of plaintiffs' motion. Perhaps it was because he had noticed that it was not a reported case. I apologize for not doing the same.

The court's ruling was not based entirely, or even primarily, upon that unreported case – it just seemed so apt.

The motion for reconsideration will be denied because the court's ruling is wholly substantiated by the reasoning in the reported cases, the first of which is Herzog Aluminum, Inc vs. General American Window Corp., 39 Wn.App. 188 (1984).

In that case, the court concluded that RCW 4.84.330 was remarkably similar to California's Section 1717, which the Supreme Court of California analyzed in the case of Reynolds Metals Co. v. Alperson, 25 Cal. 3d 124 (1979), at page 128:

> "Section 1717 was enacted to establish mutuality of remedy where contractual provision makes recovery of attorney's fees available for only one party, and to prevent oppressive use of one-sided attorneys' fees provisions.
> "Its purposes require section 1717 be interpreted to further provide a reciprocal remedy for a nonsignatory defendant, sued on a contract as if he were a party to it, when a plaintiff would clearly be entitled to attorneys' fees should he prevail in enforcing the contractual obligation against the defendant.

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. . .

Had plaintiff prevailed on its cause of action claiming defendants were in fact the alter egos of the corporation, defendants would have been liable on the notes. Since they would have been liable for attorney's fees pursuant to the fees provision had plaintiff prevailed, they may recover attorney's fees pursuant to section 1717 now that they have prevailed."

The court in Herzog Aluminum concluded that one did have to be a signatory to the contract for the remedial provision of RCW 4.84.330 to apply and held, at pg 197:

..."Accordingly, we conclude that the broad language '[i]n any action on a contract' founding RCW 4/84.330 encompasses any action in which it is alleged that a person is liable on a contract.:

In the case at bar, it was the defendant's position in its counterclaim that it had rights under the plaintiff's leases with their original tenants.

In Park v. Ross Edward, Inc, 41 Wn.App. 833 (1985) plaintiff had brought a specific performance action on, what the court concluded was an invalid contract. Applying the reasoning of Herzog Aluminum, the court affirmed the trial court's awarding attorney fees to the defendants who had convinced the court that the Real Estate Purchase and Sale Agreement upon which the plaintiff sued, was invalid.

In Stryken v. Panell, 66 Wn.App. 566 (1992), plaintiff (purchaser) had brought action against the vendors based upon a contract for purchase of a house for damages and rescission because of defective septic sewage system. The court granted rescission, but ruled that it could not award attorney fees to plaintiff because it had declared the contract void and unenforceable. The court of appeals discussed Herzog Aluminum, and its discussion of the California cases, on pg. 572:

". . . These decisions, which Division One said were persuasive evidence of our Legislature's intent in creating RCW 4.84.330, interpreted California's state as creating a right to fees in a defendant who successfully proved, in an action on a contract, that no contract had been formed. We agree with the court in Herzog that there is an entitlement to fees in such cases."

In Labriola v. Pollard Group, Inc., 152 Wn.2d 828 (2004) the Supreme Court held that an employee who had successfully invalidated a non-compete clause in a contract, was, as the prevailing party, entitled to an award of attorney fees under 4.48.330, "regardless of whether the contract was invalidated in whole or in part." *Id.* At pg. 839.

In Mt. Hood Beverage Co. v. Constellation Brands, Inc, 149 Wn.2d 98 (2003) the trial court held that legislation which effected the contract rights between the parties was unconstitutional, and granted attorneys fees to the prevailing party. Concerning the trial court's award of attorney fees to the Suppliers, which the Distributors claimed

CP 19

was error because the statute which allowed attorney fees had been struck down as unconstitutional. After discussing the Herzog Aluminum case, the Supreme Court said at pg. 121:

> "Although this case is an action on an invalid statute rather than a contract, the same principles apply. Had the distributors prevailed, they would have been entitled to attorney fees and costs under RCW 19.126. Because the attorney fees provision was written reciprocally to apply to whichever party won, we hold that defending against an action based on a statute by successfully arguing the statute is unconstitutional allows an award of attorney fees under that statute. We thus affirm the award of attoeny7 fees to the Suppliers."

In the case at bar, if defendant had prevailed on it's claim that it was entitled to the rights afforded by the lease, it surely would have been entitled to an attorney fee award.

Defendant contends that Wallace v. Kushner, 111 Wn.App. 809 (2002) on the theory that "As plaintiffs have unambiguously stated that they did not intend to form a contract with PLG, they are not entitled to fees."

The court is not persuaded that that is the case.

In the Declaration of Plaintiff Timothy Kaintz, he states:

"5. PLG presented two proposals to me for an assignment of the lease. Both of them changed key terms of the lease, so they were unsatisfactory. In addition, PLG did not provide financial information, and the principals of PLG refused to provide their personal guarantees for the lese. Because PLG did not provide sufficient financial security, and because they would not agree to a lease assignment that I approved, I asked them to vacate the premises."

In his deposition, at pg. 70, we find:

A. What sealed the deal for me was they sent me two different ones, first the assignment and then the lease, and they still didn't give me what I was looking for...."

And at pg.72:

A. Whether they stayed there or not, I wasn't signing a lease with them. They never gave me the information. I gave them two attempts and four months to give me what I asked for, and they couldn't provide it.

There would be absolutely no reason to give them "two attempts and tour months to give me what I asked for" if there wasn't a willingness to enter a contract.

Furthermore, it is clear from the argument on page 4 of Defendants Opposition to Plaintiff's Motion for Summary Judgment the plaintiffs agreed to PLG becoming their tenant but requested that the parties enter into a new lease.

In Declaration of Lisa Brandmeier we find these statements:

> "The Kaintzes did not object and agreed to the assignment to PLG. The Kaintzes regarded PLG as their new tenant and PLG performed as the tenant under the terms of the lease for the Lake Stevens property..."
> "The Kaintzes were informed of this assignment, provided a copy of the written assignment and assumption agreement and orally consented to that assignment ....Mr. Kaintz agreed to substitute PLG as the tenant at the Lake Stevens property."
> ...
> [re Harbour Point] "Kelmark and McCalmon did not object and agreed to the assignment to PLG. Kelmark and McCalmon regarded PLG as their new tenant under the terms of the lease for the Harbour Point property."

In Wallace v. Kuehner, the court distinguished the Herzog line of cases, as follows, at pg. 822:

> ". . . The parties *intended* to form a contract, but for some reason, whether due to a lack of a meeting of the minds (*Herzog*), mutual mistake (*Styken*), or statute of limitations (*Yuan*), the contract was not enforceable. In contrast, here, there was no intention to form a contract."

In the case at bar, it appears that everyone agreed that there would be a lease or an assignment of lease, and worked on achieving it for some months, and for some reason (failing to provide financial information and an agreement in an agreeable form) an agreement which would have allowed PLG to remain in possession was not reached. This is not the Wallace v. Kuehner situation.

I have signed plaintiff's Order Denying Defendant's Motion for Reconsideration and will file it on Monday.

Yours very truly

Richard J. Thorpe

CP 21

(d) Liability for Damages to Persons or Property. LESSEE shall indemnify and hold harmless LESSORS and LESSORS' agents from all damage of every kind or nature whatsoever and all expenses arising therefrom that may be claimed to accrue by reason of any accident upon the leased premises and LESSORS shall not be liable to LESSEE or any person for claims arising from any defects in the premises, whether known or unknown, or occurring in or in front of or around the premises or for damage by storms, rain or leakage, or by reason of any act or negligence of any other tenant of the premises, or any agent or servant or employee of LESSEE.

(e) Waiver of Subrogation. LESSORS and LESSEE mutually release each other from liability and waive all right of recovery against each other for any loss from perils insured against under applicable insurance contracts, including any extended coverage endorsements.

12. ATTORNEY FEES.

All costs, expenses and reasonable attorney fees that may be incurred or paid by either party in enforcing the provisions of this lease shall be recovered by the prevailing party from the other.

13. INSPECTION.

LESSORS and its agents shall have the right to inspect the premises at all reasonable times and to enter the same whenever it is reasonably necessary for the exercise of any right or privilege of LESSORS under this lease.

14. EMINENT DOMAIN.

If the whole of the premises shall be taken by any public or governmental authority under the power of eminent domain, then the term of this lease shall cease as of the date possession is taken by such authority and the rent shall be paid up to that date. If only a part of the leased premises shall be taken and the remainder not so taken remains tenantable for the purposes for which LESSEE has been using the premises, then this lease shall continue in full force and effect as to the remainder of the premises and all of the lease terms shall continue in effect, except that the rental shall be reduced in proportion to the amount of the area, in terms of square feet, of the premises taken.

15. DEFAULT.

(a) If any rent payable by LESSEE to LESSORS shall be and remain unpaid for more than ten (10) days after it is due, or if LESSEE shall violate or breach any of the lease terms, and such violation or breach shall continue for a period of thirty (30) days after written notice of such violation or breech, in addition to any other remedies provided by law, LESSORS at its option shall have the right to declare this lease forfeited and the term ended, and to re-enter the premises, with or without process of law, using such force as may be necessary to remove all persons or chattels

31. The Leasehold and Purchase of Business Assets. This lease is being executed in conjunction with the Tenant's purchase of the Landlord's automobile lube and oil business assets. The purchase price for the business is being paid in cash. If the Tenant is in breach of the terms of this following the proper notices and execution of judicial eviction the Landlord may re-enter the premises and seize the assets, in which event this Lease is terminated without further notice from the Landlord to the Tenant. In the event of such termination the Tenant shall continue to be liable to the Landlord for the Tenant's obligations under the this lease until such time as the premises are restored and re-let for a monthly payment amount equal to or greater than the rent due herein.

32. Enforcement of the terms of this lease shall be based upon the laws of the State of Washington. Venue shall be Snohomish County. If an attorney is retained or a lawsuit is instituted to enforce any provision contained herein the non-breaching party shall be paid by the breaching party its costs and attorney's fees incurred to enforce the lease. If any provision of this Lease is determined to be unenforceable under the laws of the State of Washington, that provision shall be stricken and the balance of the lease shall remain in full force and effect. **TIME IS OF THE ESSENCE TO THIS AGREEMENT.**

In witness whereof the parties hereto have executed this lease the day and year first above written.

Harbour Points Auto Bath

Tim Taylor
its: Managing Partner

Express Lube, Inc

Kevin McAllister
Its: President

Kevin McAllister
Individually

Casi McAllister
Individually

The tenant concurs with all of the Terms and conditions of this lease herein. KM / Cm /

initials Landlord Tenant

CP
599

CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury under the laws of the State of Washington that on the 16th day of June, 2008, I deposited a true and correct copy of the foregoing document "Brief of Respondents," in the U.S. mail, postage prepaid, to be served by U.S. mail on the following counsel of record:

<u>Counsel for Appellant</u>
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Seattle, WA 98101

Dated this 16th day of June, 2008, at Seattle, Washington.

Mary Nay

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3. Reply Brief of Appellant PLG, Inc.

61333-2

61333-2

NO. 61333-2-I

COURT OF APPEALS, DIVISION I
OF THE STATE OF WASHINGTON

TIMOTHY J. KAINTZ and KERRI KAINTZ, Husband and Wife, and Their Marital Community; and KELMARK, LLC,

Respondents,

v.

PLG, INC., a Washington corporation,

Appellant.

REPLY BRIEF OF APPELLANT PLG, INC.

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I. ARGUMENT

Whether or not a panel of judges in Division I would have reached the same conclusion as the panel in Division II did in Wachovia SBA Lending v. Kraft, 138 Wn. App. 854, 858-859, 158 P.3d 1271 (2007), rev. granted, 180 P.3d 1291 (April 1, 2008), see Resp. Br. at 14, this case likely will be argued or at least decided with the benefit of a published Supreme Court decision either affirming or reversing Division II's decision.

If the Supreme Court affirms in Wachovia, then the question for purposes of this appeal is reduced to whether this case is not only distinguishable (as Kaintz and Kelmark argue, Resp. Br. at 14) but materially different, either (a) because the contract-based claims and counterclaims were not adjudicated because they became moot rather than because of a CR 41 dismissal, and/or (b) because PLG's noncontractual counterclaims were the subject of a dismissal ruling and order and thus of an adjudication. PLG appreciates the distinctions, but submits that they make no difference. Kaintz and Kelmark asked the trial court to dismiss the contract-based counterclaims, and did not ask for judgment in their favor on their contract based claims, because PLG's abandonment of the premises rendered those claims moot. CP 607 (lines 2-5). "Moot" means "of no practical significance," and a "moot case" is one "in which a controversy no longer exists," and that "presents only an abstract question." Black's Law Dictionary, (8^{th} ed.) at 1029. Once PLG abandoned possession of the premises, a controversy over the parties' respective rights under the leases (or lack of such rights) no longer existed; Kaintz and Kelmark so recognized when they termed the lease-related claims and counterclaims moot. The court did not rule judicially upon such lease-based rights or upon claims based on them, and thus did not "adjudicate" such claims. See Black's, at 45 (defining "adjudicate" to mean "to rule upon judicially; adjudge"). The court dismissed over PLG's objection, and thus did "adjudicate," PLG's non-contractual counterclaims, but none of those sought fees under the leases.

Mt. Hood Beverage Co. v. Constellation Brands, 149 Wn.2d 98, 63 P.3d 779 (2003), upon which Kaintz and Kelmark rely for an alternative ground for affirming the superior court's decision to award fees, Resp. Br. at 15-16, is not applicable because, in Mt. Hood, there *was* an adjudication on the claim for which fees would have been recoverable had the adjudication been contrary to what it was.

Insofar as the superior court's letter explaining its fee ruling stated that "if [PLG] had prevailed on its claim that it was entitled to the rights afforded by the lease, it surely would have been entitled to an attorney fee award," Resp. Br. at 17 (citing CP 20), the point is immaterial. PLG did not prevail on its (counter)claim based on the lease(s), but neither did Kaintz and Kelmark – again, because, as they recognized below, the issue was rendered moot by abandonment, and because, if the Supreme Court affirms in Wachovia, the issue was not adjudicated and Kaintz and Kelmark for that reason are not the prevailing party for purposes of RCW 4.84.330.

Because Kaintz and Kelmark assert on appeal a contractually-based right to an award of attorney's fees if they prevail on appeal, and because an adjudication of the issue of Kaintz and Kelmark's contractual right to fees *will* occur on *appeal*, it is an irony of this case that, if Kaintz and Kelmark do *not* prevail on appeal, PLG is entitled under the Herzog Aluminum rule to an award of its attorney's fees and expenses for the appeal. Accordingly, PLG makes its RAP 18.1(a) request for such an award.

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II. CONCLUSION

For the reasons discussed above, the Court of Appeals should reverse the Superior Court and remand with instructions to vacate the award of attorney fees to plaintiffs/respondents Kaintz and Kelmark, and should award PLG its attorney's fees for the appeal.

RESPECTFULLY SUBMITTED this 18th day of July, 2008.

WILLIAMS, KASTNER & GIBBS PLLC

By ______________________
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<u>CERTIFICATE OF SERVICE</u>

I hereby certify under penalty of perjury that under the laws of the State of Washington that on the 18th day of July, 2008, I caused a true and correct copy of the foregoing document, "Reply Brief of Appellant PLG, Inc.," to be delivered by U.S. mail, postage prepaid, to the following counsel of record:

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DATED this 18th day of July, 2008, at Seattle, Washington.

Lori Wampler

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BIO:

* Assistant Professor of Law, Albany Law School of Union University. California Institute of Technology, B.S. 1973; Stanford University, J.D. 1976; Stanford University, M.B.A. 1980. Many of my friends commented on parts of earlier drafts. I am indebted to John Barton, John Brennan, Paul Cardinal, Robert Casey, Bill Chang, Tom Coates, Kristy Cook, Daniel Fessler, Douglas Hands, Carl Imparato, Arvind Khilnani, Ronald Mathias, Dale Moore, Sandy Nealon, Jon Nye, Martin Somelofske, Deborah Sze, Joyce Tsuji, Samson Tu, Brett Tucker, Beth Van Zummeran, Andrew Walkover, and Dave Wong.

LEXISNEXIS SUMMARY:
... Uncertainty is a fact of life, long evident in history. ... Next, Part III demostrates that uncertainty and risk in the litigation process prevent economic efficiency in several instances in which the damage rule for breach of contract is applied. ... In the example, which involves consumers and businesses, the existence of uncertainty together with differing risk attitudes permits efficiency gains for both contract parties when courts ignore a contrary clause and enforce a strong default rule. ... If a party is completely ignorant of the existence of a particular risk or, if aware, incorrectly assesses the probability that the risk will occur as nil, he does not take that risk into account in determining the value of his bargain. ... Even though a single consumer may understand the legal implications of the contract's terms and be aware of contrary clauses that negate default rules, he

will not be able to bargain for a more efficient outcome -- that of having the company assume certain risks for a risk premium -- because the company will refuse to bargain. ...

HIGHLIGHT: The modern scholarship on contract law, particularly that which draws on the methods of law and economics, assumes substantial certainty in the outcomes of making contract decisions. For example, contract parties presumably know when they have entered into an advantageous agreement or when an efficient breach -- harming no one and benefiting at least someone -- is possible. Yet, in many instances, significant uncertainty exists. In this Article, Professor Seita argues that, under conditions of significant uncertainty, common beliefs in contract law may be mistaken. He explains that the presence of uncertainty and risk may cause contract parties -- through no fault of their own -- to make bad bargains, encourage inefficient breaches when contract parties of differing risk attitudes confront each other, and lead the courts to misallocate contract risks when they uphold standardized agreements. In short, he believes that modern contract law should take into account more fully how contract parties behave when uncertainty is present and when they have differing risk attitudes.

TEXT:

[*77] I. INTRODUCTION

Uncertainty is a fact of life, long evident in history. To paraphrase what was stated long ago, the race is not to the swift, nor the battle to the strong, nor yet riches to men of wisdom, but time and chance happened to them all. n1 This hoary observation indicates that ancient man knew what modern man knows: uncertainty abounds in this world. There is uncertainty because man has an incomplete description of the state of the world. n2 Man lacks sure knowledge about what has occurred in the past, what is happening in the present, and what will transpire in the future.

Because the unexpected may occur, serendipity may strike, in one stroke both enriching the discoverer and improving man's condition. In this century Alexander Fleming won the Nobel Prize in Physiology and Medicine for his fortuitous discovery of penicillin, a discovery made when Fleming observed that a mold contaminating a bacterial culture had caused the disappearance of germs. n3 At other times, despite meticulous preparations and the most reliable predictions of success, unforeseen events may ruin carefully laid plans. In 1281 off the coast of southern Japan, a typhoon destroyed Kublai Khan's armada of thousands of ships and over 100,000 men, thereby stopping the Mongol conquest of Japan. n4

If in treating beliefs or expectations as absolute a person may lose a fortune or even his life, self-interest motivates him to consider the possibility that his beliefs are erroneous or that his expectations will be disappointed. Since uncertainty affects the lives of individuals as well as the actions of society, it behooves man to study the effects of uncertainty; thus, modern academic disciplines take uncertainty into account. n5 The discipline of law recognizes in a number [*78] of ways the importance of uncertainty in legal analysis. n6

A. The Traditional Role of Uncertainty in Contract Law

In the law of contracts, n7 courts have traditionally used the concept of uncertainty in two ways. First, the requirement of certainty assures that courts have enough information to make decisions. n8 [*79] For example, if the terms of an agreement are uncertain, a court will hold that the agreement fails to form a contract because there is no basis for determining whether the agreement has been kept or breached. n9 Second, courts have applied the rubric of uncertainty as a fiction n10 to promote policies having little to do with the judiciary's lack of sufficient information. n11 It is argued, for instance, that with [*80] respect to damages "the standard of 'certainty' was developed, and has been used, chiefly as a convenient means for keeping within the bounds of reasonable expectation the risk which litigation imposes upon commercial enterprise." n12

B. Uncertainty in the Outcomes of Making Contract Decisions

Uncertainty can also be viewed in a third way -- one less commonly addressed by the courts -- as a factor that affects the parties to a contract because there is uncertainty about the possible consequences or outcomes of making contract decisions. n13 These decisions may involve evaluating a contract, breaching a contract, or litigating a contract dispute. Uncertainty about the outcome of a decision exists because one or both parties do not know for sure which particular outcome will occur. A party may be totally ignorant of some possible outcomes or, even if aware of all, may be unable to predict accurately the likelihood of each outcome occurring.

1. Uncertainty and Risk

Naturally, the parties are only concerned about either adverse or favorable outcomes. If an outcome is neither adverse nor favorable to a party, the knowledge of its possible occurrence -- no [*81] matter how probable -- does not affect that party's behavior because such an outcome by definition has negligible impact should it happen. If the outcomes are adverse, they are commonly referred to as risks, such as a lender's risk that a debtor will default on a loan. Risk is therefore introduced whenever it is uncertain whether an unfavorable outcome may occur. n14

Sometimes both contract parties may view a particular outcome as adverse -- a risk. If an actor falls ill while making a film, the actor and his movie company mutually lose. With other outcomes, one party's risk may be another's good fortune. In a contract to sell manufactured goods at a fixed price, the manufacturer's risk that the price of raw materials may skyrocket -- thereby making the contract unprofitable to him -- is simultaneously the buyer's possible windfall, for the buyer may receive goods worth far more than the purchase price. Because a materialized risk may greatly diminish the value of a contract to the adversely affected party, it behooves him to be vigilant of contract risks.

2. Magnitude and Probability of Risk

Knowledge of risks alone, however, is insufficient for effective decision making. Rational planning and behavior must consider not only whether unexpected events may occur but also the likelihood that they will occur. Although a contract may have risks of large magnitude, a party takes precautions only if the chance of these risks taking place exceeds an acceptable level. A party may [*82] calculate that he stands to lose one million dollars if the other party to the contract breaches. Although cognizant of the possibility of breach, he may disregard that risk if he believes the chance of the risk occurring to be infinitesimal -- say, one chance in a million. He takes no action because the expected loss -- the product of the magnitude and the likelihood of the risk n15 -- is simply too small. But suppose the party later receives new information predicting a higher probability that the other party will breach. If the new probability is one in ten of losing a million dollars, the party may act to protect himself.

C. Summary of Article's Analysis

This Article analyzes some effects of uncertainty and risk upon the parties to a bargain contract. n16 The analysis suggests that the uncertainty involved in the consequences or outcomes of making

[*83] contract decisions can adversely affect the value of a bargain, cause an inefficient breach or nonbreach of contract, and lead inadvertently to inefficient judicial policies. Although this Article generally emphasizes risks or adverse outcomes in its discussion, the emphasis merely reflects an attempt to simplify the discussion. Obviously, a proper analysis must also consider favorable outcomes, for both favorable and adverse outcomes affect a party's contract decisions. As a practical matter, the emphasis upon risks frequently results in an indirect emphasis upon favorable outcomes since adverse outcomes to one party are often favorable outcomes to another.

The situation involving contract parties is particularly interesting because in theory the parties may mitigate the adverse consequences of risks like breach and dispute. In a contract, the parties may enumerate solutions for any problem before it arises. Even though some solutions are infeasible, perhaps because the legal enforceability of particular solutions is in doubt, if the parties know that potential problems exist they can protect themselves by paying less for a risky contract than for a risk-free contract. Although the parties may be unable to prevent problems from arising, at least they can guard against risks either in the form of contract-specified solutions or price discounts. In reality, however, many contract parties, particularly consumers, fail to account for or even anticipate important risks. These "ignorant" parties often find that if their contracts provide for the treatment of the ignored risks, the contract solutions are invariably unfavorable to these parties.

Part II observes that the bargain theory of contracts too readily assumes the parties to a contract are knowledgeable about the value of their bargain, thereby engaging in a mutually advantageous trade. Yet, when a party is ignorant of risks or the probability of their occurrence, he cannot properly place a value upon the bargain, for value implicitly takes into consideration the possibility and probability of risks.

Next, Part III demostrates that uncertainty and risk in the litigation process prevent economic efficiency in several instances in which the damage rule for breach of contract is applied. Because the outcome of litigating a contract dispute may be uncertain, an inefficient breach may occur or an efficient breach may be discouraged. Moreover, the presence of uncertainty may have an adverse effect on the efficiency of cost-minimizing efforts. If, for instance, [*84] reducing costs in the settlement process also decreases the value of a bargain, the reduction of costs causes an inefficient outcome.

Recognizing that the parties in making a contract sometimes neglect to account for risks which later occur, Part IV points out that the law handles these risks by using default rules which allocate risks between the parties. When the contract is silent about particular risks, the law fills in or completes the contract by applying default rules -- rules that govern in the absence of contrary contract provisions. Parties with knowledge of default rules may then attempt to undo the effect of these rules by drafting contrary clauses into the contract. Even though only one contract party may be aware that the contract negates a default rule, Part VI contends that in many circumstances courts should follow the contract, disregarding the default rule if the contract so provides. Judges should uphold the contract if the default rule is of the "weak" form, where the rationale for the default rule has little persuasive support. On the other hand, Part IV also argues that the judiciary should refuse to enforce the contrary clause if the default rule is of the "strong" variety, where important public policies such as the promotion of efficiency justify the rule. Otherwise, the enforcement of clauses that negate strong default rules frustrates the avowed aims of society.

Then Part V examines the behavior of consumers who sign contracts of adhesion. Although consumers often enter into such a contract knowing that they have only a minimal understanding of its terms, these consumers cannot be faulted, for they are merely behaving as rationally as possible under conditions of uncertainty. Finally, Part V provides a theoretical example of a strong default rule supported by a policy of promoting efficient outcomes. In the example, which involves consumers and businesses, the existence of uncertainty together with differing risk attitudes permits efficiency gains for both contract parties when courts ignore a contrary clause and enforce a strong default rule.

II. BARGAIN THEORY OF CONTRACT LAW

A contract has traditionally been viewed as the product of a bargaining process. n17 In a bargain contract, the parties fix terms and [*85] conditions that establish each party's benefits and duties under the contract, and the parties can create their own private law by agreeing to rules that otherwise do not apply. Since many contract transactions lack a reliable or an easily applied external standard for evaluation, the law leaves the evaluation of contract performances to the parties themselves because they, being personally involved, are presumably better able than others to gauge the value of their bargain. n18

A. Mutually Advantageous Exchange

The bargain theory of contracts assumes that in a voluntary exchange, each party to a contract will seek to maximize his own welfare, for no rational individual will ever voluntarily place himself into a position in which he is worse off. Rational individuals make exchanges when each perceives that he will gain from the transaction. Thus a successful exchange between two parties occurs when each believes that he had received more than he has given up. Given the differences in value judgments and the different performances each party has to offer, it is often possible for each party to [*86] realize a substantial advantage from the exchange. n19 By this process, individuals are better off for having entered into an exchange.

A second and broader economic justification for the bargain theory is that through the process of voluntary exchange, society as a whole is better off because resources of land, labor, commodities, or capital naturally gravitate toward those persons who value these resources the most. n20 After one exchange has taken place and resources have moved from one individual to another, these resources will again be part of another exchange. Rational individuals will continue to engage in exchanges so long as further gains are possible. Therefore, voluntary exchanges not only permit individuals to gain but also benefit society because these exchanges channel the movement of goods, services, and other resources in a socially desirable manner, leading eventually to a state of economic efficiency at which point "there are no [bargains] that could be made that would make some people better off without making others worse off." n21 In other words, the process of voluntary exchange results in the optimal allocation of resources in society.

Because contracts are usually completed, one might presume that most contracts represent mutually advantageous exhanges. Consider, for example, the countless numbers of credit purchases that are made of consumer goods each year. Although these goods are received before being fully paid for, most purchasers eventually make full payment. Although some completions might also be attributed to moral commitments or to fear of legal sanctions, such completions are probably few in number. After all, consumer goods such as cameras, stereo systems, and televisions are generally thought to be worth the price paid for them.

[*87] B. Dynamic Versus Static Environment

While most contracts may benefit all the parties concerned, the changing state of the world ensures that other contracts will not. "[I]n an absolutely unchanging world the future would be accurately foreknown, since it would be exactly like the past." n22 In such a static environment where the future is predictable and the outcomes of making contracts are certain, it might make sense to say that everyone is better off for having entered into a bargain and that resources move inexorably to their optimal use in society. A breach of contract would never arise because parties would always perform due to the unchanging benefits of the bargain. Before the parties enter into the contract, each party must necessarily view the contract as a good bargain. Because the perceived value of the exchange never changes from the time the contract arises to the time the promised performances are due, each party is better off in completing the exchange.

On the other hand, in a dynamic environment where there are uncertain outcomes, people make bad bargains. An exchange may leave one worse off than before, resulting in a suboptimal use of resources. Information arriving after an agreement has been made may lead a party to regret his contract. This information may show that because a party was unaware of or failed to appreciate fully certain risks before entering into the contract, he has miscalculated the benefit from the bargain. n23 Having omitted these risks in calculating his bargain, a party now finds his estimate of the expected gain from the bargain to be very much in error when unfavorable outcomes actually occur. A contract that once promised an attractive profit now burdens him with a loss. Yet if the other party still sees an advantage to the contract, the law often enforces the contract by awarding a remedy for breach despite unanticipated circumstances that now make the contract unprofitable to one party. n24

[*88] The law enforces an unprofitable contract even though enforcement cannot be justified on the economic theory of mutually advantageous trade. This theory cannot apply to the situation in which one party to an executory contract sees the contract as no "bargain" and thus refuses to perform. The presumption of mutual gain lacks merit, for otherwise no breach would occur. n25 True "bargains" -- agreements beneficial to both sides -- are usually self-executing; they do not need the authority of law for their completion because self-interest motivates both parties.

Furthermore, no claim can be made that society is better off by enforcing a contract if the claim is based upon the economic theory that the optimal allocation of resources in society is achieved by beneficial exchanges. That theory requires a succession of mutually beneficial exchanges, and at least one exchange -- the contract to be enforced -- fails to qualify. Therefore, the true policy behind the enforcement of a contract when one party seeks to breach is not a policy of protecting a bargain profitable for both parties nor necessarily [*89] a policy of benefiting society as a whole. n26

C. How Risk Affects the Value of a Contract

A party who faces a bad bargain may have arrived in that situation because of a limited awareness of contract risks. If a party is completely ignorant of the existence of a particular risk or, if aware, incorrectly assesses the probability that the risk will occur as nil, he does not take that risk into account in determining the value of his bargain. n27 An unperceived or disregarded outcome obviously cannot influence a person to bargain for an adjustment in the contract price. A party may face the uncertainty of whether the contract performance promised to him will be properly performed by the other party: a promise may be imperfectly performed, too difficult or expensive to perform, or impossible to perform. There is also uncertainty in whether a legal remedy will compensate the aggrieved party for a breach of contract: the remedy awarded may be inadequate, worthless, or even penalizing. If these unfavorable outcomes happen, the contract may be worthless. The higher the chance that these risks will occur, the lower the value of the contract. n28

[*90] 1. Probability of Risk Occurring

Sometimes one can see rather clearly that the value of any contract must be discounted by the riskiness of the contract, that is, what risks may occur and the probability that they will occur. For example, in certain markets the risk of default on debt instruments is reflected in their market price. n29 In the money markets, United States Treasury Bills pay the lowest rate of interest (excluding tax-exempt instruments), General Motors' commercial paper pays more, and commercial paper of a financially less secure company pays even more. n30 The probability of default is the decisive factor. Whether the transaction is buying debt instruments, placing bets on race horses, or entering into contracts, the value of what one may receive must be discounted by the probability that one will recieve it. After all, a person does not pay $ 100 for a one-in-one-hundred chance of winning $ 100; he pays substantially less.

Thus, a party's awareness of risks and the probability of their occurrence is crucial for him to evaluate accurately his expected gain from a transaction. The more relevant information he acquires before making a contract, the better able he is to protect himself against or to prevent dangerous outcomes. n31 Unsurprisingly, the information available to a party dictates his response to contract risks and thereby determines whether he enters into an advantageous exchange. Depending on his knowledge, a party's behavior may range from complete disregard to full appreciation of contract risks.

[*91] 2. Unknown Risk

Consider the situation where a risk is unknown to a party and therefore cannot influence his behavior in any manner. Suppose a person purchases an airplane ticket from an acquaintance. Upon entering the aircraft, he is informed that he may not use another's ticket and that his acquaintance may not return the ticket for a refund after the scheduled flight departs. If he purchased the ticket in complete ignorance of the possible outcome of being denied a seat and having no refund opportunity, this party has overvalued and thus overpaid for the ticket.

3. Known but Discounted Risk

Even if a person knows of a risk, he may not react to it. Suppose a ship owner agrees to transport goods from Texas to India, basing his charges on a Suez Canal route. Although he may be aware of the risk that a war could close the Suez Canal to shipping, he may not take any precautions. He may fail to act because he believes the probability of a war occurring to be too low to justify the cost of protection. He therefore refrains from any attempt to protect himself such as by getting insurance or by inserting into the shipping contract protective clauses which provide for higher fees in the event that a longer route is traveled. n32 But if he makes his bargain thinking that the probability of war is negligible and war erupts, his profitable bargain may turn out to be a loss if the law enforces the contract.

4. Revising Probability of Risk

A person may receive information that helps him refine earlier probability estimates of perceived risks. He may change his mind or gain greater confidence in his original judgment because the new information reduces uncertainty by providing a better estimate of which risks will occur. For example, consider the behavior of a consumer who purchases a new car. Prior to purchase, he may have preconceptions about maintenance expenses. His behavior may be consistent with a model forecasting three possible outcomes of [*92] purchasing the car. n33

A) the car will be trouble free for the next five years with no repair expenses,

B) the car will have minor repairs costing $ 1000, or

C) the car will require major repairs costing $ 5000.

If he estimates the probabililty of outcome A as high, and that of outcomes B and C as low, he might not pay $ 800 for a five-year warranty which covers any repairs on his car. Suppose the consumer makes these probability estimates: n34

Probability of Outcome A = .9,

Probability of Outcome B = .1, and

Probability of Outcome C = 0.

Then the expected cost of repairs will be (.9 x $ 0) + (.1 x $ 1000) + (0 x $ 5000) = $ 100 over the next five years. The consumer will probably refrain from purchasing the $ 800 warranty.

If this consumer later learns, perhaps from a consumer guide publication, that car repairs are common within the first five years of purchase for his car model, he may revise his original risk assessment. Given this new information, the consumer may revise his probability estimates: n35

[*93] Revised Probability of Outcome A = .5,

Revised Probability of Outcome B = .4, and

Revised Probability of Outcome C = .1.

Now the expected cost of repairs is (.5 x $ 0) + (.4 x $ 1000) + (.1 x$ 5000) = $ 900, $ 100 more than the price of the warranty. The revised probabilities may then lead the consumer to purchase the five-year warranty because he gains $ 100 by paying $ 800 to receive benefits worth $ 900. n36

D. Assumption of Risk

When adverse outcomes occur -- that is, from the perspective of one party, risks have materialized -- they do not necessarily vitiate the value of the affected party's bargain. Even if they reduce or completely destroy the utility of a contract, the adversely affected party still has received the entire benefit of his bargain if, at the time he made his agreement, he took the possibility and probability of loss into account (by, perhaps, paying a discounted price). Since the value of a bargain depends on the risks associated with it, n37 by having been fully cognizant of those risks and having guarded against them in some manner, this party completely assumed the risk of adverse consequences. From the viewpoint of an inveterate gambler, a bet of $ 1000 on a one-in-ten chance of winning $ 10,000 may be overwhelmingly attractive -- the chance of winning $ 10,000 more than compensating for the sure loss of $ 1000. Even if the more probable outcome occurs, the gambler already has taken it into account. Analytically, he has made a good decision although a bad outcome subsequently occurs. n38 This decision is an example of what the law calls "assumption of risk." n39

One justifiably feels little sympathy for a party who with full knowledge of the risks involved loses a fortune when an adverse outcome occurs. This is, after all, merely the case of a gambler who has taken a chance and lost. Understandably, one feels more compassionate towards an ignorant party who is bound to a losing contract [*94] in which he had no reason to suspect that any risks existed. Here is a person who has paid full value for a supposedly riskless bargain. Between these extremes of complete understanding and complete ignorance, there are cases in which a person is aware of a risk but places an erroneously low estimate on the probability of its occurrence. If reasonable individuals could also have arrived at such an estimate, it would be difficult to fault the mistaken party for his error.

Unfortunately, the lower the estimated risk, the less likely reasonable individuals are to take any precautions. In fact, the difference between being completely ignorant of risk and assigning a very low probability of occurrence to a known risk may be of minimal importance because often either case has the same effect -- that is, no effect -- on a person's behavior. Suppose the chance of incurring a million-dollar loss is one in a million. Most people will probably equate the odds of one in a million with an impossible outcome. n40 Whether or not they know about the risk, their behavior remains the same since they will not discriminate between the situation in which there is no chance of losing a million dollars and the situation in which there is one chance in a million. n41 If a person fails to perceive a difference, he rationally will not diversify away the risk or obtain any available insurance for it. Indeed, if there were one million individuals, each with a one-in-a-million chance of [*95] suffering a million dollar loss, only one person on average will be hurt.

As the probability of the risk increases, however, the difference between ignorance and awareness of a risk becomes important. Suppose a person later learns, or should be able to learn for a reasonable cost, that the probability of losing a million dollars is much higher, perhaps one chance in ten. Whereas before, the expected loss was $ 1, it is now $ 100,000, a sizable amount that is a product of the large magnitude of the risk and the higher probability of its occurrence. If an individual refuses to act when he is, or should be, conscious of the expected loss of $ 100,000, the law should hold that he assumes or runs the risk of losing one million dollars since reasonable people in his position would pay serious attention to that risk in making their decisions. The individual should be treated as though he chose not to act after carefully considering the risk. His decision to remain passive should be characterized as an assumption of the risk that the adverse outcome may occur.

III. EFFICIENCY CHARACTERIZATION OF CONTRACT LAW

In recent years, the subject of economic efficiency has stimulated much economic analysis of legal decisions. n42 Many commentators believe that appellate judges tend to decide cases in a way that promotes economic efficiency. n43 These commentators find efficient [*96] outcomes along a broad range of cases, including those involving contracts. n44 Proponents of this view argue that decisions made by judges, regardless of actual judicial motives, are consistent with a model of economic efficiency. n45

A. Model of Efficient Common Law

The model of an efficient common law, despite its popularity, has skeptics who believe that proponents of the model make exaggerated or inaccurate claims. These skeptics argue that the common law fails to pursue effecient outcomes in many instances. n46 They can [*97] even point to inefficiencies in contract law. n47 A wariness of any single overriding explanation for case decisions may account for this skepticism. One readily observes that judges reach their decision against a complicated background in which pervasive social forces interact. A reasonable person may doubt that one grand theory explains the effect of the process by which judges balance, resist, or accommodate forces like political or economic interests, and racial or religious beliefs. n48 He may question whether case decisions promote society-wide efficiency when judges respond to political pressures or show racial prejudice.

1. Efficiency as Value Maximization

Even if one assumes that the model of an efficient common law is correct, some problems remain. There are a number of ways to define efficiency. n49 One legal scholar defines economic efficiency as the exploitation of resources that maximizes value, where value is human satisfaction as measured by the aggregate willingness of consumers to pay for goods and services. n50 He then concludes that efficiency requires the maximization of value as measured in dollar amounts by the process of exchange through an existing or hypothetical market system. n51 Unfortunately, this definition attempts too [*98] much, for it requires a maximization of value for society as a whole. [*99] Obviously, one faces enormous difficulty any time one tries to determine whether anything has been maximized (that is, nothing could be better) n52 and whether everything has been looked at in a dynamic, pluralistic, and complex society like America.

At least two problems come to mind. First, in measuring value, one must consider every consumer, every good or service, and every existing or hypothetical market -- a plainly impossible task. Second, one must specify the time period in which value is measured. Should the time be a year, a century, or a millenium? Which are more important, short-term or long-term values? If the perod covers the time immediately prior to and including the Great Depression of the 1930's, the American capitalist system would be judged inefficient because the puchasing power of Americans actually declined over time. On the other hand, if the period from the nation's birth in 1776 to the present time were considered, American capitalism has increased economic output splendidly. If mankind vanishes in a nuclear war tomorrow, should its epitaph read "Man was inefficient"?

2. Practical Definition of Efficiency

Despite its literal formulation, this definition of efficiency appears to have a more workable alternative form in which a change from one situation to another is "efficient" if it is possible afterwards for those who gain from the change to be better off even after they fully compensate the losers. n53 The change increases value (measured [*100] in dollars) because a net gain in wealth results in changing from the first situation to the second, regardless of whether any actual compensation takes place. Therefore, efficiency analysis asks not whether a change maximizes value but whether it increases value. A change is efficient whether value increases by 1% or 10% -- although the latter is clearly more desirable. n54

Furthermore, although efficiency analysis in theory considers effects upon society at large, it in practice usually focuses upon separate, isolated events. n55 By demonstrating efficient changes for individual cases, scholars often assume they have shown efficient changes for all of society. Third-party effects are conveniently ignored, and no uncertainty shakes the belief that what is true in particular must also be true in general. Finally, efficiency means a better move, given the acceptance of the existing distribution of wealth, income, and power in society. n56 As a consequence, many issues of equity or fairness are disregarded.

[*101] In practice, then, efficiency analysis reduces simply to a cost-benefit analysis that compares changes in situations. A state of affairs is efficient only in comparison to another, and

either actual or hypothetical changes can be examined to determine whether an existing situation is efficient. The analysis studies individual not nationwide, specific not general cases of efficiency. It attempts to identify all costs and benefits, and to translate them into dollar terms; persumably, no important costs or benefits are overlooked and translation into dollar equivalents is possible. The analysis measures whether net value has increased when a change takes place, and the situation with the higher value is the more efficient one. Because it is easily applied, the practical approach to efficiency analysis is taken in this Article.

3. Efficiency as Cost Minimization

Some commentators also view cost minimization as identical to value maximization. n57 By showing the cost-minimizing effects of court decisions, these scholars claim to demonstrate the efficiency of the common law. They contend, for example, that cases interpreting the Uniform Commercial Code enhance efficiency because the legal principles arising from such cases reduce the long-run costs of forming contracts and resolving contract disputes. n58 They assume, of course, that minimizing costs fails to affect the intrinsic value of the exchange. n59 Suppose the joint gross value of a contract to the parties is $ 1000 and transaction costs amount to $ 100, leaving a joint net benefit to the parties of $ 900. If the gross value of the contract remains the same, reducing costs to $ 50 will increase the net value of the bargain to $ 950 and thus promote efficiency.

4. Effect of Uncertainty and Risk

Yet efficiency, defined as dollar increases in value, may not be achieved in the presence of uncertainty and risk. Although case decisions may seek to encourage efficient behavior, the uncertainties of litigation together with differing risk attitudes of the contract parties may encourage inefficient breaches if the breaching party expects to [*102] pay less than what the innocent party loses. Furthermore, the assumption that cost reduction promotes efficiency fails in situations where reducing costs decreases the potential value of the bargain.

B. Damages for Breach of Contract

There is some evidence for a theory of efficient breach in the remedy of damages for breach of contract. If one party breaches but the other party still finds the contract profitable, how should the courts treat the reluctant party? The law has traditionally answered that the goal of the law of contract remedies is not to compel the promisor to perform his promise but rather to compensate the promisee for any loss resulting from breach. "The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it -- and nothing else . . . . If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass." n60

The compensatory sum that must be paid is normally one which gives the innocent party the value of his expected gain under the contract. This places the innocent party in as good a position as he would have been in had the promise been performed, thus protecting the plaintiff's expectation interest. n61 In theory, then, only value-increasing breaches should occur because a rational party would breach a contract only if he has a net gain after fully compensating the injured party for any loss. If the injured party receives the value of his expected gain under the contract and the breaching party gains more than what he anticipates under the contract, then the breach yields an efficient outcome because the joint value to the parties is greater in breaching than in observing the contract. n62 Under this view, only efficient breaches or efficient nonbreaches will result. Unfortunately, under conditions of uncertainty, the opposite may be true.

[*103] 1. Different Risk Attitudes Resulting in Inefficient Breach and Nonbreach

Whenever contract parties choose to litigate, they necessarily expose themselves to the uncertainties inherent in the litigation process. These uncertainties often frustrate attempts to predict exactly how the courts will arrive at a decision and what that decision will be. Differences among rules, case precedents, and persuasive authorities may give courts considerable latitude in making decisions, and variations in judicial outlooks and juries may produce a diverse variety of decisions concerning which party has breached and the amount of damages to be awarded. In many instances, the risks arising from the uncertainties of litigation encourage an inefficient breach or discourage an efficient breach. This can occur because the contract parties possess different attitudes about, and thus behave differently in response to, the risks of litigation.

a. Encouraging Inefficient Breach

A common case in which inefficient breach may be encouraged involves a risk-neutral party who breaches when he realizes that the other party to the contract is risk averse. n63 A risk-averse person is one who, due to wealth constraints or other factors, dislikes taking [*105] chances. n64 To illustrate, if a party injured by breach is risk averse with respect to the risk of losing at trial, he will accept a lower amount in settlement than he expects to receive by pursuing litigation. A risk-averse party may prefer $ 10,000 in settlement to an expectation -- an expected value -- of winning $ 15,000 at trial if the expectation is derived from a .75 chance of winning $ 20,000 and a .25 chance of obtaining nothing.

In contrast, the risk-neutral person shows no preference among all outcomes with the same expected value, whether the outcome is one of definitely obtaining $ 10,000 or one of a .25 chance of winning $ 40,000 (together with .75 chance of obtaining nothing). Risk neutrality is more likely to be characteristic of large companies than small ones, of businesses than individuals, of the rich than the poor. The more wealth a person has, the more likely he is to be risk neutral in the case of financial risks because his greater wealth softens the impact of these risks should they occur. The loss of a million dollars may mean relatively little to a multibillionaire.

Further, a person may be risk neutral because he can balance out gains and losses over a great number of transactions. Businesses, for example, engage in repeated purchases and sales. A loss [*106] on any one transaction has little effect on a company's behavior because the company expects its activities to generate profits in the long run. A risk-neutral person may breach despite the risk of having to pay a large amount of damages for breach of contract or, when the other party breaches, may choose to go to trial despite the risk of losing a large claim for contract damages. Thus when juxtaposed with risk aversion, risk neutrality can be an advantage. n65

In breach of contract cases as in other types of cases, no aggrieved party can expect with total certainty to prevail in court or, if prevailing, to obtain a wholly compensatory remedy. n66 There is uncertainty in the litigation process because, for a number of reasons, litigating an innocent party's claim in court may result in little or no recovery. First, because of the wide difference in the characteristics of different juries together with the "more probable than not" benchmark used by juries to pinpoint the breaching party, a jury may mistakenly absolve the breaching party from any liability. n67 [*107] Second, even if the aggrieved party emerges victorious in a litigated lawsuit, the award of damages for breach of contract may prove to be inadequate. For example, although the rule for damages assumes that the value of an expected gain from a contract can be measured with certainty, this assumption is unjustified when the expectations of the innocent party are subjective and no substitute performance is available. n68 Third, legal principles give courts broad discretion, which can lead to an inadequate recovery or to a holding that the alleged aggrieved party is actually the breaching party. For instance, unless the contract or offer indicates otherwise, courts impose "reasonable" terms or conditions concerning the contract price, the time for performance, the quantity for a requirements contract, or the medium in which to accept an offer. n69 Since opinions frequently [*108] differ on the meaning of what is "reasonable" in a particular situation, it may be difficult to ascertain just who the innocent and breaching parties are.

The uncertainty of prevailing in court provides an incentive for a risk-averse party to compromise even though he sincerely believes that he is the aggrieved or innocent party. A risk-averse innocent party abhors litigation because there is a chance he may recover nothing. Unfortunately, a risk-averse party's reluctance to vindicate his rights in court may unintentionally encourage an inefficient breach by a risk-neutral opponent. The risk-neutral party, perhaps a company, might breach even though its gain will be less than the other party's loss if the company predicts that its expected gain from breach will be greater than its expected cost of litigation or settlement. The company will care more about what it expects to pay to the other party than about the other party's actual loss. Here the possibility of undercompensation for breach of contract may encourage inefficient breaches. n70

b. Discouraging Efficient Breach

The effect of risk aversion is not limited to the encouragement of inefficient breaches. Risk aversion may discourage efficient breaches as well. A risk-averse party hesitates to breach because there is a chance he may be liable for damages larger in amount than his gain from breaching. The prospect that a single course of action (litigation) may generate a number of possible outcomes, including one of no recovery and another of excessive damages, is in theory quite possible. Some reasons for an inadequate recovery have been mentioned above, and other reasons for an excessive recovery will be discussed below. The combination of these reasons could produce the following scenario.

Assume a party can gain $ 15,000 by breaching a contract and the other party will only incur $ 10,000 in damages. Clearly, the efficient action is to breach. Both parties, however, may foresee as a consequence of litigation three outcomes with these attendant probability estimates and expected values:

Outcome	Probability	Expected Value
1) Award of $ 200,000 in damages	.25	5,000
2) Award of $ 10,000 in damages	.50	5,000
3) No Award for damages	.25	0
		$ 10,000

[*109] Although the overall expected value is $ 10,000 -- the exact amount of damages suffered by the aggrieved party -- the scenario also has a .25 chance of an excessive award and a .25 chance of no award. Given this situation, a risk-averse party may not breach although, in fact, it would be efficient to do so.

A risk-averse party who is familiar with the vagaries of contract law may perceive substantial uncertainty about the amount of his potential liability. n71 He would know that courts, depending on the rule they select, could calculate widely varying amounts of damages. n72 Courts could "punish" breaching parties for willful or outrageous breach by awarding the innocent party damages in excess of [*110] apparent injury. n73 They could find a loss when, arguably, none exists. n74 They could protect the innocent party's restitution interest rather than his expectation interest so that he profits even in a losing contract. n75 Courts could disregard the compensation principle in favor of other public policies if the choice before a court is only whether to award a windfall gain to the wrongdoer or to the innocent party. n76 They could either void a stipulated damages clause as [*111] a penalty or enforce it as a liquidated damages clause. n77

[*112] If a risk-averse party knows with reasonable certainty the amount of damages he will have to pay upon breach, he can breach knowing what his gain will be. This encourages him to breach only under circumstances in which he profits. If he does not know with reasonable certainty, then he may be discouraged from value-increasing breaches when he takes into account the uncertainty of prevailing on the "right" damages in court. In going to trial, the breaching party not only faces the risk of losing a large judgment but also incurs unrecoverable costs such as attorneys' fees and court costs. The risk of incurring excessive liability together with his risk aversion will deter him from making an efficient breach -- especially when he confronts a risk-neutral opponent who is undaunted by uncertain outcomes. n78

2. Example of Inefficient Breach

Consider the effects of uncertainty and differing risk attitudes in the following situation. Suppose a year ago, a construction company signed a contract with a client to build a house today for $ 175,000. If it honors the contract, the company will lose $ 20,000 because its costs for materials and labor have increased unexpectedly to $ 195,000. Alternatively, it can gain $ 25,000 if it breaches by spending $ 200,000 in materials and labor to build a second client's house for $ 225,000:

	Follow Contract	Breach Contract	Gain From Breaching
Price received by company	$ 175,000	$ 225,000	$ 50,000
Cost of materials and labor	-195,000	-200,000	-5,000
Profit to the company	-$ 20,000	+$ 25,000	+$ 45,000

Regardless of the actual damages to its first client, if the company believes that its expected liability for breach will fall below its gain of $ 45,000, it can expect to profit from breaching, that is, be in a better position than if the contract were followed.

Even though the company anticipates a liability of less than [*113] $ 45,000, that is only an expected liability derived from the overall assessment of different possible outcomes and the probability of their occurrence. The uncertainties of litigation ensure that the company will never know with absolute certainty precisely what outcome will occur. Under one possible outcome, the company, if taken to trial, may be saddled with damages greater than $ 45,000 -- resulting in a net loss. A risk-neutral company, however, would breach despite the possibility of loss. Perhaps the company's wealth shelters it from the financial impact of a one-time loss or the company expects on average to gain in the long run when it breaches its contracts. And if potential clients are ignorant of its behavior, the company suffers neither loss of reputation nor business.

When the construction company breaches, assume the first client hires a second company to build his house because he still places a value on the house higher than the price the second company would charge. Suppose the price of all new houses is $ 225,000 because the basic cost of a house is $ 200,000 and a reasonable profit for a builder is $ 25,000. The second construction company must use$ 200,000 in resources in order to build the first client's house (the first construction company must likewise spend $ 200,000 to build the second client's house). The difference ($ 5000) in costs for the first and second companies to build the first house might be attributed to preliminary expenses already incurred by the first company. Obviously, the second company has yet to spend the $ 5000. These antecedent expenditures may have given the first company more information about ways to cut costs in constructing the first house. Perhaps due to prohibitive costs of transferring this information, the information cannot be sold to other construction companies.

Although the first company may have already spent $ 5000, it can ignore this sunk cost, a cost which cannot be recovered no matter what action is taken. n79 Due to its initial investment, the first company is the more efficient builder of the first house, for it can construct the house at less future cost. The effects on third parties [*114] such as the second construction company and the second client can be ignored. This is justified because all construction companies, including the first and the second companies, should charge the same price to build the second client's house. Hence, the second client neither gains nor loses from the first company's breach. As for the second company, its profits would be the same whether it built the first or second house.

If the first company breaches, the first client suffers $ 50,000 in damages by having the second construction company build his house for $ 225,000, since the client originally expected to pay only$ 175,000. But, the first company gains only $ 45,000 from breaching. Whatever transpires later, as a result of settlement or litigation, fails to change the fact that a $ 50,000 loss is matched with a $ 45,000 gain. Whether the company later pays the client $ 30,000 or $ 60,000, that sum represents only a money transfer which alters the distribution of wealth between the company and client but does not convert an inefficient breach into an efficient one.

Suppose the first company and the first client both share the [*115] same estimates of the client's chances of winning in court. n80 Assume both parties foresee three outcomes from litigation:

SCENARIO I

Outcome	Probability	Expected Value
1) Award of $ 100,000 in damages	.10	$ 10,000
2) Award of $ 50,000 in damages	.60	30,000
3) No award for damages	.30	0
		$ 40,000

Ignoring litigation costs, a risk-neutral client will settle for the expected recovery of $ 40,000, and a risk-neutral company will do the same. For this scenario, the uncertainty alone may encourage an inefficient breach, that is, the company gains less than what the client loses.

For higher probabilities of the client's success at trial, the company might not breach when faced with a risk-neutral opponent. Suppose both parties now foresee these three outcomes:

SCENARIO II

Outcome	Probability	Expected Value
1) Award of $ 100,000 in damages	.20	$ 20,000
2) Award of $ 50,000 in damages	.60	30,000
3) No award for damages	.20	0
		$ 50,000

A risk-neutral client will settle only for the expected recovery of$ 50,000 or more -- an amount greater than what the company gains [*116] from breaching. Because the company refrains from breaching in this situation, the damage rule for breach of contract appears to promote efficiency. Obviously, however, the efficiency of the damage rule -- whether it discourages inefficient breach and encourages efficient breach -- has been shown to depend on the probabilities of the outcomes of litigation, for an inefficient breach occurs under Scenario I but not under Scenario II.

Suppose the aggrieved party is not risk neutral but risk averse. Risk aversion increases the chance of inefficient breach because a risk-averse individual will take steps to reduce risks and might in Scenario II settle for $ 25,000 (a sure sum) over the expectation of recovering at trial $ 50,000 (the expected value from the uncertain outcomes of litigation). A risk-neutral company may thus be encouraged to breach despite the inefficiency that results when initially the company gains $ 45,000 and the client loses $ 50,000 as a result of the breach.

Although the company will later give up some of its initial gain when it settles with its client, the company still comes out ahead by breaching if it settles for any amount less than $ 45,000 -- a good prospect because the risk-averse client may settle for much less than $ 50,000 (the expected value of litigation). Just how much the company profits from breaching will depend on the client's degree of risk aversion: the greater his risk aversion, the lower the amount he should settle for. The upshot is that, in Scenario II, risk aversion converts an example of efficient nonbreach (when the client is risk neutral) into an example of inefficient breach because risk aversion makes the client less willing to take chances.

Not only is there an inefficient breach but, after settlement, there is undercompensation to the client as well. If the company pays a settlement of $ 25,000 to the client, the company gains $ 20,000 and the client loses $ 25,000 with respect to what each should receive under the original contract:

Price of house under original contract	$ 175,000
New price of house if second company builds	-225,000
Client's damages	-$ 50,000
Settlement from first company	25,000
Client's uncompensated damages	-$ 25,000

With the settlement, the price of the client's house will be $ 200,000 (the price of $ 225,000 less the settlement of $ 25,000), normally a good deal since a builder's cost is $ 200,000. But $ 200,000 represents [*117] additional expenses of $ 25,000 over the bargaing the client expected -- a house for $ 175,000. The efficient outcome is to have the original contract performed, but the possibility of breach exists because the parties to a contract care more about what they receive individually than whether they are jointly better off.

3. Other Inefficient Breaches

Now suppose the damage rule operates exactly as theorized, namely, a court compensates the right party for the correct amount of his financial loss. Perhaps a court finds it easy to ascertian correctly which party is the breaching one. In addition, a court may be able to measure accurately the amount of damages because an objective standard of measurement, such as an established market, exists. Under these conditions, the uncertainties of litigating a breach of contract will be minimal because a court will force the breaching party to pay for the exact amount of the innocent party's loss. Nevertheless, other types of uncertainty may also cause inefficient breaches despite the proper application of the damage rule for breach of contract.

One such uncertainty exists because a breaching party, at the time he breaches, lacks foreknowledge about the exact amount of the injured party's damages. Since some damages can only be computed at a future time, a party may breach without knowing and perhaps misjudging his future liability. Therefore, the breaching party can make an inefficient breach if, at the time he breaches, he miscalculates whether he will gain by breaching. Because he cannot predict the future, the breaching party may later find that his gain is exceeded by the injured party's loss.

Consider the common law rule that a seller who breaches a contract to deliver goods is liable to the buyer for damages as measured by the difference between the contract price and the market price at the contract-specified time for delivery. n81 If the contract goods are bought and sold in a broad and established market, the [*118] buyer's damages are easily fixed by looking at the market spot price for goods on the day of delivery. Since the buyer can obtain an acceptable substitute by acquiring a cover contract at the market price, the buyer's damages are only the market-contract differential. For example, if the seller breaches a contract to deliver goods for $ 100 and the market spot price for these goods is $ 110 on the day of delivery, the buyer receives as damages $ 110 - $ 100 = $ 10. If the contract price exceeds the market price, the buyer recovers no damages for he actually benefits from the breach by being free to buy at the lower spot price.

Assume that after contracting to sell to the buyer, the seller resells and delivers the goods to a third party, because the seller anticipates that the resale price will exceed the market price at the delivery time in the contract. The seller breaches because, for whatever reason, he believes he will come out ahead. But even if he had no reason to anticipate that the expected amount from breaching would exceed the the contract price, the seller might still breach. Despite the uncertainty of knowing what his future liability will be, a risk-neutral seller may, and a risk-seeking seller n82 will, breach when given the choice between receiving a given number of dollars for certain by following the contract and receiving an expected sum of the same amount by breaching.

Suppose the seller makes a contract today to deliver goods a month from now for $ 100 (C). He then breaches by reselling and delivering the goods to a third party for $ 120 (R). Although theoretically the seller may complete his contract by purchasing similar goods from the market for delivery to the original buyer, this might not happen if the seller has misjudged the movement of the market. If the price of these goods -- whether spot or forward -- remains above the resale price of $ 120, the seller will never be able to purchase substitute goods at a price which preserves his profit from the resale.

When the delivery date arrives, suppose the market spot price is either $ 110 or $ 130 (M):

		M = $ 110	M = $ 130
Seller's Profit	(R - C)	$ 20	$ 20
Buyer's Damages	(M - C)	-10	-30
Seller's Net Gain	(R - M)	+$ 10	-$ 10

[*119] In the first case, the buyer's damages are $ 10 but the seller gains $ 20. The seller can compensate the buyer and still be better off than if he had honored the contract. In the second case, buyer's damages are $ 30, which exceeds the seller's gain of $ 20. If the buyer is fully compensated, the seller is worse off for having breached. In either case, an efficient breach seems to depend on a breaching seller's prescience. For, depending on whether he guesses correctly or not, the seller either wins or loses by his breach. n83

C. Cost Minimization

In the previous sections, examples of inefficiency -- the absence of value-maximizing outcomes -- in the application of the damage rule were examined. n84 There is, however, an alternative way to view efficiency. This view accepts cost minimization as the mirror image of value maximization and argues, for instance, that efficiency is promoted when case decisions reduce costs by providing rules for settling future contract disputes. n85 If these settlement rules reduce [*120] costs and do not lower the value of a contract, then the net value of the bargain increases.

Suppose courts attempt to reduce the transaction costs n86 of settling contract disputes. The judges may have to allocate risks that were unanticipated by the parties. Proponents of efficiency argue that if case decisions allocating risks reflect the preferences of the parties, settlement costs should decrease in the future. n87 For example, if the parties had been apprised of a particular risk, they might have placed it upon the superior risk bearer, the party who could better prevent the risk from occurring or who could better insure against a realized risk. n88 That party would then command a premium for bearing the risk. Thus, in the absence of controlling language in the contract, the courts may allocate a realized risk to the superior risk bearer for he can better handle the risk at the least cost to both parties.

The effectiveness of judicially formulated settlement rules, which allocate risks to the superior risk bearer, is easily undermined, however, when only the superior risk bearer is knowledgeable about contract risks and these settlement rules. In such a case, the response to the settlement rules may well be a rewriting of the contract to contain terms shifting risks from the superior risk bearer to the ignorant party. Although the contract may have been drafted solely by one party, the judiciary will normally enforce it because the contract specifically covers a contract dispute and judges will be able to decide the case quickly. In a sense, the enforcement of unambiguous contract terms is itself a settlement rule, for it reduces settlement costs. Once a contract dispute arises, the parties will tend to settle without delay if they know that litigation will usually be [*121] futile. But enforcement of such contract terms may lead to inefficient results.

Enforcement in the presence of uncertainty -- one party's ignorance of contract risks -- may decrease the value of the contract as well as lower settlement costs. If the decrease in costs is less than the decrease in value, enforcement will be penny-wise and dollar-foolish. To illustrate, suppose the joint value of a contract to the parties is $ 900 because the joint gross value is $ 1000 and the transaction costs in carrying out the contract amount to $ 100. If the enforcement of the contract reduces transaction costs to $ 50 while also lowering the gross value to $ 900, the resulting net value will be $ 850 -- a smaller figure than before and, therefore, an inefficient change. n89

This may occur if a contract represents a one-time transaction for the ignorant party (perhaps a consumer) but just one of many repeated transactions for the superior risk bearer (perhaps a business). If the value of a single transaction is small (for example, the purchase of an appliance and not a house), information costs may discourage the ignorant party form acquiring information about settlement rules and possible risks in the transaction. n90 The information costs to educate all ignorant parties may also prevent the knowledgeable party from charging a higher price for assuming a [*122] risk. If the ignorant parties fail to understand the reason for a premium, they will naturally seek a less expensive contract elsewhere. The knowledgeable party may therefore find it more profitable simply to draft the contract to allocate the risk specifically to the ignorant party even though the class of ignorant parties would be better off in paying a premium to avoid bearing the risk. Thus one party's ignorance of risks may lead to a contract that lowers the value of the bargain to both parties. n91

IV. DEFAULT RULES

Inevitably, disputes will arise in the performance of some contracts. If any provision of the contract expressly covers the dispute, courts will ordinarily enforce that provision because the parties themselves have anticipated a solution to a specific problem, thereby relieving the courts from resolving the dispute. Often, however, the parties neglect to specify outcomes for every contingency not only because some problems are difficult to foresee but also because of the time and expense in negotiating and drafting a contract that covers every conceivable dispute. Yet circumstances may change: suppose the subject matter of the contract is destroyed, a party who contracts to perform personal services later dies, or the purpose of the contract is frustrated. The parties may inaccurately appraise an item to be sold because they are mistaken in their basic assumptions about the item, for example, in a contract to sell a "gold" mine, both parties may erroneously believe that the fool's gold in the mine is real gold. There may be problems of interpretation: the contract may fail to specify which party is to perform first, when time is of the essence, or what constitutes a minor breach that temporarily suspends but does not excuse a duty to perform.

If the contract is silent about the dispute and no information is available about the parties' actual preferences at the time they made the contract, courts cannot be guided by what the parties would genuinely have wanted. Instead, on the basis of their own discretion, judges will have to allocate the risk of an unfavorable outcome to one of the parties. Judges may make their decisions by hypothesizing what reasonable parties would have agreed to had such parties anticipated the outcome. n92 These court-allocated risks are default [*123] rules, which are rules that prevail unless the parties decide otherwise. n93 By filling in contract gaps left by the silence of the parties, default rules solve one of the problems of contract uncertainty.

Further, default rules exist even if a contract expressly provides for the resolution of a particular risk (the parties' intent is apparently clear) and the risk is one of first impression (no court has previously announced default rules concerning the risk). These rules, whether or not previously proclaimed by the judiciary, are simply rules that courts would apply in the absence of any guidance by the parties. If a judge writes in an opinion that he would have decided differently had it not been for a contract provision covering the dispute, he is announcing a default rule.

A. Notice and Fairness Functions

Case opinions that reveal judicially created default rules serve two major functions. First, these cases give notice to future contract parties who, if they wish, will negotiate for a different outcome. n94 Second, even if future parties affected by the default rules are unlikely to receive notice of these rules, the opinions promote fairness [*124] by informing tomorrow's courts of the rules to be applied in deciding cases, thus avoiding future arbitrariness. n95

The notice function gives fair warning to potential contract parties about judicially allocated risks that can be negated if the contract so specifies. Obviously, the effectiveness of the notice function depends on whether the contract parties are informed about judicial opinions. If the value of the transaction justifies the expense, both parties may seek legal advice. For example, when a $ 100 million revolving line of credit is negotiated between money-center banks and major corporations, the bargaining process often proceeds at a very high level of awareness of case decisions because the importance of the agreement usually ensures that both sides are represented by attorneys. n96 In this situation, informed bargaining truly takes place.

Although case opinions may provide notice of default rules in some situations, these opinions may give no warning in others. Many parties do not know of legal principles in advance of making a contract or perhaps even before breaching, and until the need to know arises, many lawyers do not either. Although a general awareness of contract obligations exists in society, a specific awareness of individual legal principles does not. Most people undoubtedly realized that the law protects contracts by providing a remedy for breach. But the details of whether a contract exists, who breaches, and what remedy follows cannot be widely known. Why else would one pay lawyers for what is essentially information? n97

[*125] In some cases, then, the practical function of case opinions containing default rules is not to provide notice but rather to give judges guidelines with which to decide cases fairly. Through these rules the judiciary allocates risks to one of the ignorant parties. Since this party will never attempt to remove any of these risks by negotiation, a risk should be placed upon him only after a court has carefully considered what the risk's impact will be.

The fairness function of default rules faces a major challenge when one contract party is knowledgeable about, but the second party is unaware of, default rules emanating from case decisions. Suppose these rules benefit the ignorant party by allocating risks to the informed party. This initial allocation will last only briefly if the informed party drafts the contract, for he will use his knowledge to replace the default allocation of risks with a contract allocation that shifts risks to the ignorant party. If the unfortunate party fails to understand what the contract accomplishes -- that it strips him of the protection of the default rules -- he will never respond to the informed party's actions.

The informed party may thus negate unfavorable court decisions by merely inserting a contrary provision into the contract -- at relatively little cost because the other party's ignorance prevents him from demanding appropriate compensation for the shift in risks. If the courts enforce a contract with such contrary provisions, the ignorant party will assume risks that the judiciary had initially decided would be better borne by the informed party. Thus, courts must determine whether to enforce contracts that negate default rules to the detriment of an ignorant party.

B. Weak Default Rules

In any given contract, the "appropriate" default rule may not always be readily apparent to a court. A number of possible rules may appear to have equal merit. Under conditions of certainty, a judge would know the exact effect of any default rule upon future contract parties and naturally would select a rule that would be the [*126] best default rule for a given dispute. It would be irrelevant that the chosen rule was marginally better than other potential default rules; the rule chosen would be the best. But in the real world the uncertain effects of applying possible default rules might make it impossible to arrive at the best rule if marginal differences exist among the potential candidates. Courts might conclude that "the slightest iota of difference" should not be the basis of selection for "minute differences . . . are likely to be either illusory or counterbalanced by [other unseen differences]." n98

1. Arbitrary Selection

The difficulty of deciding on the proper initial allocation of risks through the default rules can be solved by arbitrarily choosing an allocation which favors one party, either the plaintiff or defendant. These default rules should be characterized as "weak" default rules because their justification is debatable, and a weak default rule benefiting one party can easily be replaced by another rule that favors the other party. Nevertheless, weak default rules are important because they apply unless the agreement specifies to the contrary.

2. Necessity of Weak Default Rules

Weak default rules emerge from the necessity of making decisions. Courts will have to decide disputes when contract-specified solutions are missing, and in making those decisions, courts need and always use default rules. Any default rule helps to establish order in the legal system because it permits courts to resolve unencountered contract disputes and because the rule thereafter gives notice to future contract parties and promotes fairness in future court decisions. Ironically, rules chosen today on a totally arbitrary basis may ensure fairness in cases decided tomorrow since judges will theoretically base their decisions on rules and not upon caprice or bias.

Although unimportant in themselves because the judiciary could justifiably have selected other rules, these rules become important through their impact as default rules. A court may pick the date of breach, the date of delivery under the contract, or a date between breach and delivery as the crucial moment in computing damages for breach of contract by a seller -- with the amount of [*127] damages sometimes varying widely when calculated by using one date as opposed to another. While the date selected by the court may be arbitrary, it does establish a precedent so courts need not redecide the proper method for computing damages in future cases. If the initial allocation of risks proves to be a mistake in that the two parties can achieve a better contract for both in the absence of the rule, the parties can then negotiate to remove it.

3. Contrary Clauses

Suppose only the party disadvantaged by the default rule is knowledgeable about its effect and, in addition, is solely responsible for drafting the contract. If the party benefited by the rule is ignorant of the contract terms, the disadvantaged party might insert into the contract a contrary clause which defeats the default rule. A common example occurs when consumers (the ignorant parties) sign standardized contracts drafted by businesses (the knowledgeable parties). Because many consumer purchases are one-time transactions or transactions of low monetary value, rational consumers will rarely take the time and expense to appreciate the risks that standardized contracts may impose. n99 This allows businesses to shift risks onto consumers by the use of contrary clauses, thereby negating unfavorable court decisions.

a. Unfair to Ignorant Parties?

Suppose courts initially allocate risks to businesses by construing contracts to contain implied warranties. n100 A business will respond by revising its standardized agreement to include a contrary clause that eliminates the implied warranty. n101 And since consumers would be oblivious to any contract changes, the business need not bargain with consumers prior to changing its standard form.

But if a consumer fails to understand the significance of the contrary clause, he will not adjust downward the price he is willing to pay -- an adjustment normally made to reflect the lower value of the contract due to its increased risk. The consumer may sign the contract whether there is one, two, or a multitude of changes that [*128] disadvantage him and, in ignorance, still place the same value on the bargain. Thus without any concession on its part, the knowledgeable business obtains a better agreement to the detriment of the ignorant consumer. All rational businesses would behave in this manner. No single business would offer better contract terms to consumers because few consumers would understand the improvements offered.

b. Rationale for Enforcement

If the courts enforce a contrary clause, the law gives all the advantage to an informed party for he can unilaterally allocate unfavorable outcomes to the ignorant party. Yet, enforcement would have its attractions if weak default rules were involved. By assumption, these rules have little to justify them. Perhaps the judicial allocation of risks fixed by the rules burdens the informed party without benefiting the ignorant one, or a different allocation is better for both parties. n102 Either situation might not be uncommon in view of the difficulty in selecting weak default rules. n103 Errors can be made; the "wrong" rule chosen. n104 In negating the weak default rules, the informed party may only be correcting the judiciary's error and, at worse, be appropriating a minor benefit.

Therefore, if the affected default rule is of the weak variety, a contrary contract clause should be routinely upheld even though only one party is knowledgeable about the nullifying effect of the contrary clause. n105 Although the knowledgeable party uses the contrary [*129] clause to obtain an advantage (thus exposing the ignorant party to a potential risk), if there are no convincing reasons to place a risk upon one party rather than another, following the contract not only aids the judicial decision-making process but also avoids substantial unfairness. After all, enforcing a contrary clause benefits the courts if it helps them to decide cases quickly, thereby freeing court time for other more pressing matters. Enforcement of the clause also avoids substantial unfairness since enforcement violates no strong public policy and since a disadvantage had to be placed on someone, whether it was the knowledgeable or ignorant party.

C. Strong Default Rules

Enforcing contrary clauses in all cases where one party is informed and the other is ignorant would be a mistake. Ignorant parties may sometimes lose much of their bargain if the law forces them to assume risks not considered when the contract was made. Since the value of a bargain depends on the risks involved, a party who never realizes that certain important risks have been allocated to him under the terms of the contract may pay too much for his bargain.

1. Justification

If contrary clauses shift risks which substantially diminish the value of a contract to an ignorant party, public policy may dictate that the judiciary deny enforcement on the ground that the contract is too one-sided. n106 The contrary clauses may produce a bargain that is patently unfair to the ignorant party. n107 In some cases, then, courts should refuse to follow a contract laden with these contrary [*130] clauses. Because courts presumably have reasons of public policy for upholding certain default rules, these irremovable and indefensible rules might aptly be characterized as "strong" default rules. n108

Of the many reasons that could justify strong default rules, one reason is that the rules promote economic efficiency. If a default rule has allocated risks on the basis that efficiency is clearly increased, it may be inefficient to enforce a contract clause that replaces the default rule. For example, if the informed party is the superior risk bearer who can better prevent risks and protect against them should they occur, then he might be allocated these risks regardless of any contrary language in the contract. This might be the case if the materialized risk can significantly affect the uninformed party and if the informed party can act in effect as an insurer by passing on the cost of absorbing the risk to many other parties. n109 Certain risks might therefore be allocated to the company rather than the individual, to the merchant rather than the consumer. The knowledgeable party should be allowed to undo a strong default rule only with the intelligent and meaningful approval of the other party, for in that situation the parties will have truly bargained for the removal of the default rule and the party favored by the rule will have taken its negation into account.

2. When Courts Fail to Uphold Strong Default Rules

If strong default rules are allowed to be undone without an authentic approval by the party favored by the rule, then an invitation is open to legislative bodies to transform these rules into statutes. Although legislative bodies may not have the flexibility of the judiciary in changing laws in response to changing needs, legislative action would at least preserve strong default rules when the judiciary had failed to act.

Many standardized agreements that were formerly controlled [*131] by judge-made contract law -- e.g., agreements in the areas of communications, transportation, banking and insurance, minimum wages, and maximum interest rates -- became governed in part by statute or administrative regulations as legislative bodies responded to the perceived deficiencies of the common law. n110 Part of this change stemmed from obvious failures in the bargaining process, because one side had little information or had little bargaining power. n111 Consumer protection was frequently a motivating concern, for when standardized agreements were involved, consumers often lacked any understanding of and any bargaining power over the terms of the contract. n112 Thus laws were enacted, for example, to prevent manufacturers from limiting their liability for personal injury arising from product defects. n113

One area of standardized agreements requiring legislative intervention was the insurance field, for insurance companies were notorious for exploiting the ignorance of insured parties. n114 As a result, insurance became increasingly regulated, with state laws typically dictating what provisions were required and what provisions were prohibited in insurance policies. n115 The legislative response was inevitable given the fact that hardly any insured party read or even understood the contractual provisions in an insurance policy, relying instead on the representations of an insurance agent. n116 The need for legislation is emphasized by looking at those cases in which legislation neglected to treat certain important risks in insurance contracts. There, the courts in a baffling display of inconsistency sometimes enforced and sometimes voided provisions that worked [*132] harsh results in unexpected circumstances. n117

V. UNCERTAINTY AND JUDICIALLY ALLOCATED RISKS

Whenever the issue of enforcing a contrary clause arises, the judiciary's response should depend on whether a strong default rule is involved and, if it is, on whether the party disadvantaged by the contrary clause has given his intelligent and meaningful approval to it. Naturally, a contrary clause that negates or reverses the risk allocation of a weak default rule should be routinely upheld without regard to any real approval because enforcement probably results in little harm. But if a court faces a strong default rule justified, for example, on efficiency grounds, the court should determine whether an authentic approval has been given by the disfavored party. Otherwise, judicial enforcement of the contrary clause may have undesirable consequences. If the strong default rule promotes efficiency, enforcing a contrary clause will lead unintentionally to an inefficient allocation of risks. Thus in some instances, to promote efficiency, it may be necessary for judges to ignore the terms of a contract and enforce default rules.

A strong default rule should be negated only if the court finds an approval of the contrary clause. Special care, however, is required when the contract parties are consumers and businesses, for the appearance of approval by consumers may be an illusion. Although a consumer signs a contract it may be unreasonable to assume that he has approved each term of the agreement -- specifically, the contrary clause which deletes a strong default rule. The mere signing of a contract without reading or obtaining legal advice about it should not be viewed as an approval by assumption of risk. The consumer may be unaware of the risk presented by the contrary clause and may be reasonably justified in his ignorance. In considering whether an approval has been made, the judiciary [*133] should appreciate the way in which uncertainty about contract risks affects the actions and expectations of reasonable consumers.

When entering into consumer transactions, an individual usually encounters contracts of adhesion -- standardized contracts offered on a take-it-or-leave-it basis. n118 He must then decide how much time and expense should be devoted to scrutinizing the contract. His behavior is that of an individual under conditions of uncertainty in which he must make decisions when there is very little information about risks and where the cost to obtain such information normally exceeds its benefit. n119 Because the vast majority of contracts are successfully completed, a reasonable consumer should pay little attention to the terms of a contract unless he values the contract highly or is alerted to potential problems. Therefore, for the typical consumer transaction in which the consumer merely signs without understanding the contract, no approval should be found, and any strong default rule should be upheld.

A. Standardized Contracts and Reasonable Consumer Behavior

In many cases in which a consumer signs a standardized agreement, he may unknowingly bind himself to a contract that deletes default rules. Because of the immense volume of transactions that a consumer may enter into, he may find it impossible to read, much less understand, all standardized forms that accompany consumer transactions. n120 Whether purchasing goods or employing services, a consumer -- before signing any particular agreement -- rarely reads the contract and is not reasonably expected to. Otherwise, besides having to understand legal terminology, he would spend endless hours studying the ubiquitous standardized agreements that today account for most written contracts. n121

No reasonable consumer would waste his life perusing all the legal documents that accompanied consumer purchases, nor would he hire an attorney to do so. The time spent in reading a contract [*134] could be better spent in earning a living or in leisure, and because the vast majority of contracts are completed to the satisfaction of both consumers and businesses, the cost of legal advice would exceed any benefits received. n122 But while the average consumer may not look at the form he signs, he still gives his assent to a contract. The contract he assents to, however, has been described as consisting of an agreement to the price of the product (which consumers consciously understand) and another agreement to reasonable contract terms (which consumers probably assume). n123 While a consumer may have a general awareness that he will be held to the terms of a contract even though he has not read them, he must surely expect those terms to be reasonable. In a practical sense, consumers are trusting the businesses they deal with to act fairly. n124

1. Consumer Behavior under Conditions of Uncertainty

Given the fact that a person realistically can afford to scrutinize only a few of the agreements he signs -- either by his own effort or by obtaining legal advice -- a rational consumer should be expected to examine a contract only if he faces a relatively large expected loss. The magnitude (potential loss) of the contract risk may be great, coupled with a modest probability of the risk occurring, or a significant combination of both magnitude and probability may exist. For example, although many consumers who are buying a house (a purchase often requiring most of their wealth) will seek legal advice, few consumers who are buying a watch, radio, or car (purchases requiring a much smaller percentage of consumers' wealth) will do the same. n125 Here, the decision to seek legal advice is influenced by the amount of money at risk, for the cost of legal advice is such that consumers will seek out lawyers only when relatively important [*135] tansactions are involved. And if the expected loss is sufficiently high to catch his interest but too low to justify hiring an attorney, a consumer may himself closely analyze the terms of the contract -- a distinct possibility when he purchases a car.

This description of consumer behavior is consistent with reasonable behavior under conditions of uncertainty. An individual probably recognizes that there is always a chance he may fail to receive the benefit of any contract he makes. In the absence of information that would alert him to a special problem with a particular contract, a person subjectively might assess the chance of failure to be the same for every contract. Assuming an identical probability of failure, a consumer clearly will be more concerned about those contracts in which he has more to lose if a failure occurs.

Suppose the consumer enters into the following contracts with these possible losses:

Loss	Magnitude (potential loss)	Probability	Expected Loss
1) house	$ 100,000	.01	$ 1000
2) car	10,000	.01	100
3) radio	100	.01	1
4) watch	10	.01	.1

Under these assumptions, reading a standardized agreement for the purchase of a watch makes no sense, and hiring a lawyer to scrutinize a contract for the purchase of either a car or radio is financially irrational. Since the magnitude of most financial risks arising out of typical consumer transactions is far lower than that from purchasing a house and since the probability of consumer satisfaction from these consumer transactions is generally high, a heavy reliance on either legal advice or consumer scrutiny of contract terms in most consumer transactions would be an unnecessary cost or effort. n126

A rational consumer who seeks to minimize costs would obtain legal advice or read the contract only if he expects the benefit of any reduction in the expected loss to be greater than his legal costs or the value of his time. The two likely candidates to evoke consumer action -- in which the consumer hires an attorney or reads the contract himself -- are obviously the contracts to buy a house or car. An additional factor working in favor of consumer action when the contract [*142] concerns a house or car is a consumer's greater apprehension over a large (as opposed to a small) potential loss even though the expected loss may be low. When the potential loss or stakes are high a consumer may show risk-averse behavior, whereas when the stakes are low he may behave in a risk-neutral manner. n127

This behavior may cause a consumer to take precautions that cost more than they benefit (in terms of reducing expected loss) in the situation involving a large potential loss. Consider again the examples of the house and car. Assuming that consumer precautions can reduce the expected loss to zero, a consumer may take precautions that entail these costs:

Loss	Magnitude	Expected Loss	Cost of Precautions
1) house	$ 100,000	$ 1000	$ 1500
2) car	10,000	100	125

On the other hand, when potential losses are low, a consumer may take precautions only if justified by the decrease in expected loss.

2. Advantages of Doing Business

Assume that a consumer actually tried to take precautions in a typical consumer transaction by attempting to read a standardized agreement. Unfortunately, the merchant selling the goods might object. After all, businesses use standardized contracts not only to eliminate the time spent in bargaining, n128 but also to limit the risks of enterprise. n129 Consider the case in which businesses seek to limit [*137] their liability for acts of negligence. A bus company, for example, may issue a ticket containing a contract that has a clause limiting the company's liability to $ 25 per passenger for losing a passenger's luggage. Few passengers will object because passengers generally do not read their bus tickets, and the few passengers who do read their tickets might conclude that a ticket's limitation applies only to unavoidable accidents and not to acts of negligence by the company.

Suppose the judiciary voids the limitation on the ground that no real consent is given by the passengers. The bus company might choose to absorb the cost of paying for lost luggage rather than obtain each passenger's assent if the cost to explain to each passenger about the contract's particular limitation is too high. Assume that a company employee who is paid five dollars an hour requires three minutes on average to explain adequately the contract limitation to a passenger -- a cost of twenty-five cents per passenger. If 400,000 passengers ride the bus each year, or only a little more than 1000 passengers per day, the annual cost of educating passengers would amount to $ 100,000. n130 If the expected cost of paying for lost luggage is less than $ 100,000 the company is better off by absorbing the cost. And $ 100,000 would be the cost for educating passengers about just one contract provision. If there were other risk-shifting provisions, the cost of informing passengers would be greater.

On the other hand, if the law upholds the limitation, the company has protected itself against the risk of damages for lost luggage without having to bargain with a single passenger. The validation of the limitation clause may be an inevitable outcome, for no matter what flaws courts find in the standardized form, the bus company will eventually remove every defect that the judiciary condemns. If courts object to the notion that a ticket could be a contract, the company in response may require each passenger to sign a one-page standardized form containing the limitation of liability. The company can react to every judicial obstacle simply because it is a business [*138] that engages in repeated transactions of the same kind, that is, selling transportation to passengers.

a. Justifies the Cost of Legal Advice

By making repeated sales and doing a large volume of business, any company gains a number of advantages in "bargaining" with consumers who make relatively few purchases. n131 The aggregate value of a company's sales may justify the cost of obtaining legal advice about contract risks. A business will consult an attorney who can anticipate the risks his client faces and who will draft a standardized agreement that, as much as possible, shields the company from contract risks. Such an agreement will naturally contain contrary clauses undoing default rules that disadvantage the company. Any enterprise will seek to shift risks to the consumer because, among other things, this will limit the amount of its liability for breach of contract. n132 The cost of hiring an attorney to incorporate the necessary protective language into the standardized form may only result in a one-time expense and merely constitutes part of the cost of doing business. Furthermore, legal costs will be negligible for each individual transaction since they are spread over a large number of transactions.

b. Fosters Risk Neutrality

The higher a company's sales the greater a company's assets and equity are likely to be. A large equity position allows a company to take a risk-neutral attitude towards losses on individual transaction is small. If a loss arises, the company will absorb it and proceed to carry on business as usual. Risk neutrality gives a business a superior negotiating position in lawsuits involving a solitary consumer, for a risk-neutral company is indifferent between courses of action with the same expected value -- whether one course of action, settlement, provides a certain recovery (of perhaps $ 1000) and the other, litigation, guarantees no recovery (because the expected [*139] value of $ 1000 is derived from a .25 chance of winning $ 4000 and a .75 chance of obtaining nothing). n133 In contrast, a risk-averse consumer may settle for an amount much less than the expected value of going to trial.

c. Makes Risks More Certain

If the volume of sales reaches a sufficiently high level, the business can act like an insurer, assuming risks for all its customers in return for a risk premium. Because large numbers of transactions are involved, the total expected loss of all risks a firm assumes may become reasonably certain. n134 Dealing in many transactions [*140] reduces uncertainty in that the variance in the number of unfavorable outcomes that may occur will be reduced. n135 For instance, suppose a merchant sells microwave ovens of which 5% on average are defective. If he sells 1000 ovens, the risk that a defective model will be found by the consumer and returned may be 50 plus or minus 15 ovens (35 to 65, or up to 6.5% of the number sold), whereas if he sells 100 ovens, the risk may be 5 plus or minus 10 ovens (0 to 15, or up to 15% of the number sold). By selling many ovens, a merchant may be able to predict more accurately the number of defects that will eventually occur and accordingly take more or less a risk-neutral attitude towards the risk of defective models from all of his transactions. n136

[*141] In contrast, consider an individual who makes a one-time purchase. He may exhibit risk-averse behavior if he values his bargain highly and cannot diversify away or insure against risks that can significantly impair the value of his bargain, for example, the risk that his new $ 500 microwave oven will fail to work one week after its purchase. If this person is aware of such a risk and assigns a nontrivial probability to its occurrence, he may attempt to protect himself at an expense exceeding the expected loss. By dealing in only one transaction, the individual faces only two outcomes: the risk occurs or it does not. In this situation, a risk-averse individual will gladly pay a risk premium to the risk-neutral company who should be quite willing to assume contract risks for the right price. Thus, if the monetary value of a particular group of risks is reasonably ascertainable, a business may accommodate informed risk-averse consumers by increasing the price of its performance.

d. Gives Greater Bargaining Power

Because he may represent but a small portion of a large company's business, the individual consumer often has little bargaining power vis-a-vis the company. n137 Unequal bargaining power may cause the consumer to accept unfavorable contract provisions without the choice of deleting these through a price adjustment since consumer contracts -- almost always contracts of adhesion -- are offered on a take-it-or-leave-it basis, that is, a consumer who desires the company's product can only purchase it on the company's terms. Even though a single consumer may understand the legal implications of the contract's terms and be aware of contrary clauses that negate default rules, he will not be able to bargain for a more efficient outcome -- that of having the company assume certain risks for a risk premium -- because the company will refuse to bargain. A rational company will not change the contract for only one individual [*142] because it thereby loses the advantage of the standardized form in reducing bargaining costs.

Nevertheless, a consumer who is knowledgeable about contract risks may enter into the contract if the individual's need for the transaction (e.g., buying a car) outweighs his fear of a potentially harmful outcome. He may sign the contract despite the risks he perceives because he believes that on balance the contract as written is still an advantageous exchange even though a better -- that is, more efficient -- deal is possible. n138 If other consumers were similarly informed, they would support the knowledgeable consumer when he bargained with the company for a modification of its standardized form. But the cost of informing other consumers would be tremendous and invariably discourage the knowledgeable consumer from making any attempt to inform others, leaving them ignorant of the benefits of modifying the contract. Thus an individual may be unable to use his knowledge to any effect. Although consumers as a group could bargain effectively against a large corporation, individual consumers no matter how well informed would be powerless to change the company's position. n139

B. Example of Preserving a Strong Default Rule

Sometimes uncertainty about other, better contract allocations of risks may result in an inefficient contract, for example, where a different allocation would clearly provide a higher value for each party. The parties to a contract may agree to a bargain that allocates risks inefficiently because one party is unaware of possible value-increasing allocations due to information costs. To arrive at the efficient outcome in such a case, judges will have to ignore the [*143] actual contract terms and replace them with judge-made, value-increasing terms. In certain instances, this may preserve strong default rules by preventing a party knowledgeable about those rules from undoing their effect. n140

By making a number of assumptions, a hypothetical situation can be constructed in which a default rule unmistakably serves to promote efficiency. If this is the case, then the judiciary should apply the default allocation of risks regardless of what the contract states and regardless of whether the default rule has been specifically negated by a knowledgeable party. An example from the recent past might have involved a bank that had purchased sales contracts (and accompanying promissory notes) from businesses which had sold goods to consumers. If a contract contained a clause that waived contract defenses, n141 the bank could demand payment from the consumer even when the business had induced the sale by fraud or had sold defective goods. n142 The consumer's only remedy was a lawsuit against the business responsible for his complaint; meanwhile, the consumer had a legal obligation to pay the bank despite having a worthless product. n143 A contract containing a waiver clause was an example of a contract undoing a default rule, for in the absence of such a waiver clause, the default rule preserved the right of the consumer to withhold payments. n144

Assume that there are 1000 individuals who expect to purchase a $ 1000 videotape recorder from various merchants, all of whom will sell the resulting consumer contracts to a single bank. [*144] Suppose that there is a .005 chance that any one recorder will be totally defective. As a risk-neutral party, the bank should place a value of $ 5000 on the protection provided by the waiver of defense clause since this amount is the expected dollar loss to the bank if it became liable for the failure of the businesses to sell merchantable videotape recorders: n145

Expected Cost of Liability to Bank / $ 1000 X 1000 machines X .005 defective rate = $ 5000.

Since the bank would lose $ 5000 by being liable for the defective product, it would voluntarily assume liability only if it were compensated in excess of $ 5000. In theory, the possibility of such compensation could occur because of the differing risk attitudes of the two contract parties: the risk neutrality of the bank and the risk aversion of the consumers.

If consumers had known about the legal effect of the waiver clause and had been able to assess properly the value of deleting the clause, they might have bargained for its removal because individuals are usually risk averse to the outcome of paying $ 1000 for a videotape recorder that subsequently fails to work. If the expected cost of replacing defective recorders for all 1000 individuals totalled $ 5000, the individuals would altogether be willing to pay more than that due to their risk of aversion. n146 Suppose they were each willing to pay an extra $ 10 to have the clause deleted and thus forego the .005 chance that they would spend $ 1000 on a totally defective machine. Then consumers as a class would be willing to pay $ 10,000 to have the bank eliminate the waiver clause:

Value of Consumers' Risk Aversion / 1000 individuals X $ 10 = $ 10,000

The risk neutrality of the bank paired with the risk aversion of the consumers creates the possibility of mutual gain if the bank accepts liability for defective recorders in exchange for a payment in excess of $ 5000 -- that is, a risk premium -- from the consumers. That payment could take the form of a higher price that consumers would pay for a videotape recorder. Since the consumers by assumption would pay up to $ 10,000 to avoid the risk of a defective recorder, [*145] both sides could gain from the deletion of the clause. Placing the risk of defective recorders upon the bank would therefore be the efficient outcome. n147

But the information costs of educating consumers about the legal effect of a waiver clause prevents the bank and individuals from arriving at the efficient outcome. n148 Without such education, no single bank would voluntarily delete the waiver clause because its expected costs would increase, requiring it to either pass the increased costs on to consumers or to absorb the costs itself. The first choice of passing on costs will decrease sales since consumers will probably fail to realize that the removal of the detrimental contract term is worth an increased purchase price. By deleting the term, the bank places itself and the businesses it deals with at a competitive disadvantage because these businesses operate in a price-competitive but not a term-competitive market. n149 Although a lower price generates greater demand for a consumer product, better contract terms -- never being understood by individual consumers -- do not. And the second choice of absorbing costs lowers profits. Thus, a rational bank would retain the waiver clause.

Even if one individual was willing to pay $ 10 to have the clause eliminated from his contract, the bank (and hence, the businesses selling the recorders) would object to it, requiring the individual either to take the standardized contract or to leave it. Although one reason for having the standardized form -- that of reducing the bank's risk by placing the unfavorable outcome of a defective recorder upon the consumer -- would be obviated by offering to the bank a greater sum ($ 10) than the bank's expected cost of liability ($ 5) for any single sale, another reason would remain. The bank would argue that the standardized contract served to reduce transaction costs by eliminating individualized contracts. While modifying the contract for one individual might be unprofitable because of transaction costs, if all consumers were willing to change, the modification [*146] of the contract might become attractive to the bank. But with prohibitive information costs in educating consumers about the risk presented by the waiver clause, how would consumers know of the efficient outcome?

The judiciary might easily be able to determine the efficient outcome. Although courts will incur costs in determining whether the contested contract terms are inefficient, if information costs for the courts are less than those for the contract parties, the judiciary may be able to achieve a result that the parties themselves could not. Judicial costs are probably minimal because courts do not have to educate consumers about the advantages of eliminating waiver clauses. Furthermore, courts are not handicapped by the bank's problem of lower profits. Courts need only recognize that individuals, if informed, would exhibit risk aversion by preferring to pay an extra amount ($ 10) rather than to take a gamble (a .005 chance) that a significant unfavorable outcome (a $ 1000 loss) might occur. n150 Because information costs prevent consumers from bargaining for the deletion of the term, judicial intervention by deleting the contrary term is necessary to promote efficiency. n151 The judiciary should therefore void waiver clauses and have banks pass increased costs on to consumers. n152

In effect, the banks may be looked upon as insurers who will protect consumers against rare but significant risks. Of course, there is the possibility of adverse selection and moral hazard, but courts could make a judgment about what risks were likely to be affected by adverse selection or moral hazard. n153 The risk of defective consumer [*147] goods might be free from either problem. Although people who are prone to carelessness may damage goods, they can hardly make the goods defective, and the issue of whether the goods are defective (seller's fault) or damaged (buyer's fault) can be dealt with by the judicial fact-finding process.

In determining whether default rules should be characterized as strong ones in given situations, the judiciary necessarily makes judgments, decisions which ultimately may be shown to be erroneous. The nature of the judicial process contains the possibility of error for it requires educated guesses about the importance and future effect of default rules. And if a decision made in the past proves in hindsight to have been in error, it can be corrected. Principles of the law are not formed totally by logic, for no court can contemplate every future variant or effect of the case it decides today. Any principles arising out of today's decision necessarily find limitations tomorrow. n154 And if prior case decisions engender injustice, judges not surprisingly change their reasoning to arrive at different outcomes. n155 The law responds to new information, for "rules and doctrines are not, and are not meant to be, universals." n156 This applies [*148] to the law of contracts as well as to any other.

VI. CONCLUSION

When uncertainty and risk exist, common beliefs in contract law can go awry. Normally one believes that there is substantial justification for the benefits of bargain contracts, the efficiency of the damage rule for breach of contract, and the wisdom of upholding contracts that parties have voluntarily entered into. This belief assumes, however, that all the parties to a contract have full knowledge of the consequences of making contract decisions. If this assumption were true, a party would accurately evaluate his contract because he would know whether the contract would be performed and how it would be performed; the damage rule would more probably encourage efficient breaches and discourage inefficient breaches because the parties would know the outcome of litigating a contract dispute; and a contract knowingly entered into by the parties should be enforced by providing a remedy for breach because each party would understand the legal impact of the contract terms.

In reality, however, contract parties often have limited information about the value of particular contract terms or about the outcome of litigation. Moreover, the parties may have different risk attitudes and thus behave differently towards certain risks. Finally, under conditions of uncertainty, a consumer may quite reasonably conclude that it is unnecessary to read or understand contracts that he signs. Uncertainty presents some problems for the law of contracts because the presence of uncertainty and risk in some aspects of making contract decisions may impair bargains, prevent efficiency in the application of the damage remedy for breach of contract, and cause the judiciary to misallocate risks.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawBreachEfficient BreachContracts LawBreachNonperformanceContracts LawTypes of ContractsExecutory Contracts

FOOTNOTES:

n1 See Ecclesiastes 9:11.

n2 See, e.g., K. ARROW, THE LIMITS OF ORGANIZATION 33-34 (1974); Arrow, General Economic Equilibrium: Purpose, Analytic Techniques, Collective Choice, *64 AM. ECON. REV. 253, 268 (1974).*

n3 See L. LUDOVICI, FLEMING: DISCOVERER OF PENICILLIN 131-34 (1952).

n4 See G. SANSOM, A HISTORY OF JAPAN TO 1334 448-50 & n.8 (1958).

n5 In making business decisions, a rational entrepreneur recognizes that a particular decision may have various possible financial outcomes, none of which is certain to occur. He therefore takes uncertainty into account in the decision-making process. See generally C. HOLLOWAY, DECISION MAKING UNDER UNCERTAINTY: MODELS AND CHOICES (1979) (discussing methods for making rational choices under conditions of uncertainty); H. RAIFFA, DECISION ANALYSIS (1968) (same).

Psychological studies of individuals' preferences indicate that human beings are highly sensitive to the difference between certainty and high probability but relatively insensitive to differences between intermediate gradations of probability. Kahneman & Tversky, The Psychology of Preferences, SCI. AM., Jan. 1982, at 160. See generally Tversky & Kahneman, Judgment Under Uncertainty: Heuristics and Biases, 185 SCI. 1124 (1974) (showing that individuals rely on a few heuristic principles which reduce to simpler tasks the complex decisions of assessing probabilities and values).

Political scientists observe that uncertainty affects voters, political parties, and government decision making. See A. DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 77-95 (1957). For example, "voters are not always aware of what the government is or could be doing, and often they do not know the relationship between government actions and their own [welfare]." Id. at 80.

In physics, the Heisenberg "uncertainty principle describes an inherent fuzziness that must exist in any attempt to describe nature. Our most precise description of nature must be in terms of probabilities." 1 R. FEYNMAN, R. LEIGHTON & M. SANDS, THE FEYNMAN LECTURES ON PHYSICS § 6-5 (1963) (emphasis in original).

n6 Under federal constitutional law, for example, the vagueness doctrine governs the allowable uncertainty in penal statutes and renders any such statute void for vagueness if "men of common intelligence must necessarily guess at its meaning." *Connally v. General Construction Co., 269 U.S. 385, 391 (1926).* See generally Note, The Void-For-Vagueness Doctrine in the Supreme Court, *109 U. PA. L. REV. 67 (1960)* (stating that the doctrine accommodates conflicting principles of "order" and "liberty").

n7 Although it is difficult to capture in a succinct definition the meaning of "contract," a useful though limited definition describes a contract as "a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." *RESTATEMENT (SECOND) OF CONTRACTS § 1* (1981) [hereinafter cited as RESTATEMENT]; see Uniform Commercial Code § 1-201(11) (1978) (defining contract to mean "the total legal obligation which results from the parties' agreement") [hereinafter cited without cross reference as U.C.C.]. See generally E.A. FARNSWORTH, CONTRACTS §§ 1.1-3 (1982) (explaining the meaning and role of contract); Symposium: The *Restatement (Second) of Contracts, 67* CORNELL L. REV. 631 (1982) (analyzing the provisions of the newly adopted RESTATEMENT).

n8 This requirement ensures that the judiciary has sufficient information to determine that the parties to an agreement intended to make a contract, that the terms of a contract provide a basis for determining a breach, or that a feasible remedy can be awarded for breach. See RESTATEMENT, supra note 7, § 33 comments a-f. See generally Leubsdorf, Remedies for Uncertainty, *61 B.U.L. REV. 132 (1981)* (discussing several approaches courts can follow to reduce uncertainty in awarding proper remedies).

The allowable uncertainty in the terms of a bargain contract may depend upon the dispute involved and the remedy sought. If what is uncertain is not important to the dispute or remedy, the uncertainty can be disregarded. RESTATEMENT, supra note 7, § 33 comment b. See, e.g., *Blanton v. Williams, 209 Ga. 16, 70 S.E.2d 461 (1952)* (the contract terms were too uncertain for specific performance against buyer but not too uncertain against seller because the buyer could always pay cash; seller agreed to furnish a mortgage to buyer for the purchase of land but the terms of the mortgage were unstated); *Southwest Eng'g Co. v. Martin Tractor Co., 205 Kan. 684, 473 P.2d 18 (1970)* (if a contract was intended, a court can use reasonable commercial standards to cure indefiniteness; facts showed that uncertainty in the terms of payment was insignificant to the breaching party when the agreement was made, and that the defense of uncertainty was raised as an afterthought).

The allowable uncertainty can also depend on the "contract" involved. A nonbargain contract based on promissory estoppel, see infra note 16, does not require a promise with such certainty as a bargain contract might -- the promise need only be certain enough to provide a remedy. *Hoffman v. Red Owl Stores, Inc., 26 Wis. 2d 683, 133 N.W.2d 267 (1965);* RESTATEMENT, supra note 7, § 90 illustration 12. Finally, initial uncertainty does not foreclose the possibility of future clarification, for the subsequent conduct of the parties may show that the parties intended to make a binding agreement. See, e.g., *Yoder v. Rock Island Bank, 47 Ill. App. 3d 486, 362 N.E.2d 68 (1977).*

n9 E.g., *Walker v. Keith, 382 S.W.2d 198 (Ky. 1964)* (finding no contract where the parties to a lease renewal agreed to fix the rent at whatever level that national business conditions warranted).

n10 See generally Fuller, Legal Fictions (pts. 1-3), *25 ILL. L. REV. 363, 513, 877* (1930-1931) (discussing the utility of legal fictions) (the journal is now NW. U.L. REV.).

n11 To recover damages for breach of contract, the plaintiff must establish his loss with reasonable certainty. RESTATEMENT, supra note 7, § 352. See generally Farnsworth, Legal Remedies for Breach of Contract, *70 COLUM. L. REV. 1145, 1210-15 (1970)* (discussing the certainty requirement). This requirement aids administrative convenience in assessing damages. Fuller & Perdue, The Reliance Interest in Contract Damages (pts. 1-2), *46 YALE L.J. 52, 373, 374-76* (1936-1937). For example, the requirement excludes damages if the loss suffered has an uncertain value, perhaps because no market value exists, or if the plaintiff seeks business profits that are difficult to calculate. Compare *Freund v. Washington Square Press Inc., 34 N.Y.2d 379, 314 N.E.2d 419, 357 N.Y.S.2d 857 (1974)* (giving no recovery for loss of royalities from breach of contract to publish a novel because this loss was not reasonably certain) with *Rombola v. Cosindas, 351 Mass. 353, 220 N.E.2d 919 (1966)* (holding that a jockey who was denied her contract right to ride a race horse could recover for lost profits if her prior successes with the same horse could establish her loss with reasonable certainty).

But other undeclared policies also play an important role in the application of the uncertainty standard:

(1) a desire not to broaden unduly the liability of the defaulter by making "remote" injuries compensable; (2) a desire not to impose on the defendant a liability felt to be disproportionate to the gains which he stood to make from the contract; (3) a desire to restrict the lia-

bility imposed on the "innocent" defaulter in comparison with that imposed on the "wilful" defaulter . . . .

Fuller & Perdue, supra, at 376.

In cases involving liquidated damages, the standard of uncertainty appears to voice an empty requirement. A contract clause that stipulates damages in advance for breach of contract must meet two criteria in order to be enforceable as a liquidated damages clause. First, it must contain a reasonable forecast of the anticipated harm from a breach. Secondly, the anticipated harm must be uncertain and difficult to estimate. Otherwise, the stipulated damages clause fails as a penalty. See generally 5 A. CORBIN, CONTRACTS §§ 1054, 1057 (1964) (discussing the rationale for designating a stipulated damages clause as a valid liquidated damages clause as opposed to a void penalty). The reasonableness of the prebreach forecast is a function of the uncertainty surrounding the anticipated harm. As the uncertainty increases, so does the range of reasonable stipulated damages. If the uncertainty decreases, what is reasonable has more narrow boundaries. See Goetz & Scott, Liquidated Damages, Penalites and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, *77 COLUM. L. REV. 554, 559-60 (1977).*

It is argued, however, that the uncertainty requirement carries little weight in making decisions. First, any damage resulting from breach in the future will naturally be unknown or uncertain today. There may be uncertainty in predicting what loss will occur, proving that a loss has occurred, measuring the extent of loss even if some injury were shown, determining which losses result from the breach, or equating a loss in dollar terms. Further, courts often enforce stipulated damages clauses even in those cases in which actual damages can be easily calculated by referring to established market prices. Second, the more certain the expected damages, the less incentive for the parties to negotiate a stipulated damages clause. Thus, reasonableness is the key criterion for distinguishing liquidated damages from penalties. See Clarkson, Miller & Muris, Liquidated Damages v. Penalties: Sense or Nonsense?, *1978 WIS. L. REV. 351, 354-57.*

n12 C. McCORMICK, DAMAGES § 28, at 105 (1935). The requirements of causation, foreseeability, and unavoidability of damages from breach provide other constraints on the amount recoverable as contract damages. See D. DOBBS, REMEDIES §§ 12.3, 12.6 (1973).

n13 See generally K. ARROW, Exposition of the Theory of Choice Under Uncertainty, in ESSAYS IN THE THEORY OF RISK-BEARING 45 (1971) (explaining which action among a number of available actions will be taken when uncertainty is present). This Article focuses on uncertainty about the future consequences of making decisions rather than uncertainty about future preferences that decision makers may have. See generally March, Bounded Rationality, Ambiguity, and the Engineering of Choice, 9 BELL J. ECON. 587 (1978) (observing that rational choice involves two guesses, a guess about uncertain future consequences and a guess about uncertain future preferences).

n14 "Risk" and "uncertainity" have more technical definitions in certain academic disciplines. In finance, risk refers to the "possibility that the actual return from holding a security will deviate from the expected return." J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 33 (5th ed. 1980). The deviation may be adverse or favorable. Similarly, in game theory there is risk if an "action leads to one of a set of possible specific outcomes, each outcome occuring with a known probability." R. LUCE & H. RAIFFA, GAMES AND DECISIONS § 2.1, at 13 (1957). On the other hand, if an action "has as its consequences a set of possible specific outcomes, but where the probabilities of these outcomes are completely unknown or are not even meaningful," then the situation is one involving uncertainty rather than risk. Id.; cf. F. KNIGHT, RISK, UNCERTAINTY & PROFIT 19-20, 197-232 (1971) (explaining that, in economics, risk is measurable and insurable while uncertainty is unmeasurable and uninsurable).

The distinction in game theory between making decisions under risk and under uncertainty disappears if the decision maker transforms objective uncertainty (in which the probabilities are objectively unknown) into subjective risk. By assigning probabilities to specific outcomes on the basis of hunch or guess, the decision maker can act as though the probabilities are known. See R. LUCE & H. RAIFFA, supra, § 13.1, at 277-78 ("In general, if an a priori probability distribution over the states of nature exists, or is assumed as meaningful by the decision maker, then the problem can be transformed into the domain of decision making under risk." Id. at 277.); C. HOLLOWAY, supra note 5, at 82-84.

n15 See generally C. HOLLOWAY, supra note 5, at 74-76 (expected value); H. RAIFFA, supra note 5, at 8-9 (same).

n16 In a bargain contract, two parties typically exchange promises to render future performances. Each party seeks to purchase the promise of the other party by giving his own promise in return. See RESTATEMENT, supra note 7, § 71. Strictly speaking, a bargain contract is not just a bargain. A bargain contract requires that promises be supported by an elusive element called consideration. See generally id. §§ 71-81 (defining consideration and discussing the necessity of consideration for a bargain contract). But for purposes of this Article, the terms contract (in the sense of a promise supported by consideration) and bargain can be used interchangeably.

Nonbargain contracts also exist. The law of contracts routinely enforces promises given in situations where no bargain was made. See, e.g., *Davis v. Wells, Fargo & Co., 104 U.S. 159 (1881)* (promise to guaranty payment of an existing debt of another); *Webb v. McGowin, 232 Ala. 347, 168 So. 199 (1936)* (promise to pay for past benefit received); *Linz v. Schuck, 106 Md. 220, 67 A. 286 (1907)* (promise to pay additional compensation for construction work that had become burdensome due to unforeseen ground conditions); *Solomon Mier Co. v. Hadden, 148 Mich. 488, 111 N.W. 1040 (1907)* (one dollar given for promise to keep an option irrevocable); *Allegheny College v. National Chautauqua County Bank, 246 N.Y. 369, 159 N.E. 173 (1927)* (promissory estoppel protects a promisee who has detrimentally relied on another's promise) (dicta); *Marshall v. Holmes, 68 Wis. 555, 32 N.W. 685 (1887)* (express promise to pay a debt barred by the statute of limitations). See also *Thomason v. Bescher, 176 N.C. 622, 97 S.E. 654 (1918)* (promise enforceable if under seal); RESTATEMENT, supra note 7, §§ 95-109 (contracts under seal). See generally id. §§ 82-94 (covering contracts without consideration, where the bases for enforcement are unjust enrichment and reliance).

An example of a common nonbargain contract is one based on promissory estoppel. The doctrine of promissory estoppel seeks to protect detrimental reliance. See RESTATEMENT, supra note 7, § 90 comment d; Braucher, Freedom of Contract and the Second Restatement, *78 YALE L.J. 598, 604-07 (1969);* Henderson, Promissory Estoppel and Traditional Contract Doctrine, *78 YALE L.J. 343, 378 (1969).* It developed in response to a rising number of cases in which the bargain principle precluded a remedy because no bargain had been involved. In these cases, parties who had been harmed by having reasonably relied upon another's unbargained for promise had no remedy for breach of contract. See, e.g., *Kirksey v. Kirksey, 8 Ala. 131 (1845)* (refusing to enforce a gratuitous promise despite heavy reliance expenses incurred by the promisee).

n17 See, e.g., G. GILMORE, THE DEATH OF CONTRACT 19-21 (1974). The usual justification for enforcing a contract is that enforcement promotes socially beneficial conduct. See, e.g., RESTATEMENT, supra note 7, ch. 16 introductory note (remedies) and reporter's note; Fuller & Perdue, supra note 11, at 55-61. But see C. FRIED, CONTRACT AS PROMISE (1981) (arguing that contracts should be enforced, not because enforcement encourages socially useful behavior, but because parties are morally obligated to keep their agreements).

n18 See RESTATEMENT, supra note 7, § 79 comment c (adequacy of consideration). Proceeding on this premise, courts typically refrain from ascertaining the values of promised performances -- performances that frequently are difficult to evaluate. E.g., *Batsakis v. Demotsis, 226 S.W.2d 673 (Tex. Civ. App. 1949)* (enforcing promise to pay $ 2000 in post World War II America; promise was given in 1942 German-occupied Greece for 500,000 drachmas worth $ 50 at that time); see also Horwitz, The Historical Foundations of Modern Contract Law, *87 HARV. L. REV. 917, 918-19, 953-55 (1974)* (describing the theory of subjective value in contract law which justified the judiciary's refusal to inquire into the adequacy of bargained-for performances). But see Gordley, Equality in Exchange, *69 CALIF. L. REV. 1587 (1981).* See generally Dawson, Economic Duress -- An Essay in Perspective *45 MICH. L. REV. 253, 276-82 (1947)* (comparing the legal and equitable treatment of adequacy of consideration).

Instead, courts concentrate on the fairness and voluntariness of the bargaining process (an easier task than determining value). They more readily investigate whether duress, fraud, mental incapacity, mistake, misunderstanding, unconscionability, or undue influence may have vitiated one party's consent to a bargain. See, e.g., *Austin Instrument Inc. v. Loral Corp., 29 N.Y.2d 124, 272 N.E.2d 533, 324 N.Y.S.2d 22 (1971)* (duress); *Elizaga v. Kaiser Foundation Hosps., Inc., 259 Or. 542, 487 P.2d 870 (1971)* (fraud; *Jackson v. Seymour, 193 Va. 735, 71 S.E.2d 181 (1952)* (constructive fraud); *Ruffini v. Avara, 121 Colo. 567, 220 P.2d 355 (1950)* (mental incapacity); *Elsinore Union Elementary School Dist. v. Kastorff, 54 Cal. 2d 380, 353 P.2d 713, 6 Cal. Rptr. 1 (1960)* (unilateral clerical mistake); *Sherwood v. Walker, 66 Mich. 568, 33 N.W. 919 (1887)* (mutual mistake of basic assumption); see cases cited infra note 24 (misunderstanding); *Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965)* (unconscionability); *Odorizzi v. Bloomfield School Dist., 246 Cal. App. 2d 123, 54 Cal. Rptr. 533 (1966)* (undue influence).

n19 Farnsworth, The Past of Promise: An Historical Introduction to Contract, *69 COLUM. L. REV. 576, 577 (1969);* see A. SMITH, THE WEALTH OF NATIONS 14-15 (E. Cannan ed. 1937).

n20 THE ECONOMICS OF CONTRACT LAW 1-2 (A. Kronman & R. Posner eds. 1979); cf. R. POSNER, ECONOMIC ANALYSIS OF LAW § 1.2 (2d ed. 1977) (explaining why voluntary exchanges are efficient).

n21 Thurow, Toward a Definition of Economic Justice, 31 PUB. INTEREST 56, 70 (1973). This definition of economic efficiency is the familiar one of pareto optimality. Id. at 59. A pareto-optimal state of affairs exists if no other state is pareto superior to it. If at least one person is better off and no one else worse off in one situation as compared to a second, then the first situation is pareto superior to the second (and the second situation is pareto inferior to the first). Coleman, Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law, *68 CALIF. L. REV. 221, 226 (1980);* Sager, Pareto Superiority, Consent, and Justice, *8 HOFSTRA L. REV. 913, 914 (1980);* see J. GRAAFF, THEORETICAL WELFARE ECONOMICS 8-11 (1971); R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 62-75 (3d ed. 1980); P. SAMUELSON, FOUNDATIONS OF ECONOMIC ANALYSIS 212-14 (1947).

n22 F. KNIGHT, supra note 14, at 313.

n23 See, e.g., *Crenshaw County Hosp. Bd. v. St. Paul Fire & Marine Ins. Co., 411 F.2d 213 (5th Cir. 1969)* (a contractor who submits a bid subsequently finds that it contains an arithmetical error which eliminates his profit); *Costello v. Sykes, 143 Minn. 109, 172 N.W. 907 (1919)* (after purchasing stock, a buyer learns that previous misappropriations have depleted the assets of the corporation and that the corporate stock is worth far less than what he paid for it); *Wood v. Boynton, 64 Wis. 265, 25 N.W. 42 (1885)* (after selling a pretty stone to a jeweler for one dollar, a party learns that the stone is an uncut diamond worth a small fortune).

n24 See, e.g., *Lloyd v. Murphy, 25 Cal. 2d 48, 153 P.2d 47 (1944)* (a lessee must honor a lease obtained for the purpose of selling new cars although the government subsequently restricts the sale of new cars); *Tompkins v. Dudley, 25 N.Y. 272 (1862)* (a contractor must rebuild a home that was destroyed by fire just as he was about to finish constructing it); RESTATEMENT, supra note 7, § 261 illustration 3 (an employer must continue to pay his employee under a two-year contract although the employer has liquidated his business due to new, burdensome government regulations). In these examples, the unfavorable outcomes (having to complete the contract despite sale restrictions, fire, or government regulations) are held to be risks assumed by the losing party.

The burdened party may be relieved of liability, however, if one of the various doctrines of excuse apply. See, e.g. *Smith v. Zimbalist, 2 Cal. App. 2d 324, 38 P.2d 170 (1934)* (mutual mistake as to the identity of the subject matter; imitation mistaken for authentic "Stradivarius"); *Wasserman Theatrical Enter. Inc. v. Harris, 137 Conn. 371, 77 A.2d 329 (1950)* (incapacity of person necessary for performance; star of show refused to perform due to a throat irritation); *Krell v. Henry, [1903] 2 K.B. 740* (C.A.) (frustration of purpose; defendant rented a room to view a parade that was later cancelled); Taylor v. Caldwell, *3 B. & S. 826, 122 Eng. Rep. 309 (K.B. 1863)* (destruction of thing necessary for performance; defendant contracted to rent a music hall but, before he could use it, a fire destroyed the hall).

Alternatively, the court may decide on the basis of the parties' relative fault in preventing or protecting against the occurrence of risks. See, e.g., RESTATEMENT, supra note 7, § 20 (the effect of misunderstanding). Section 20 handles the effect of a material misunderstanding of the contract in two ways, depending on whether the parties are equally at fault or whether one party is more at fault than the other. Id. comment d. If both parties are equally at fault, no contract exists. See, e.g., *Raffles v. Wichelhaus, 2 H. & C. 906, 159 Eng. Rep. 375 (Ex. 1864)* (neither party had reason to know of the other's interpretation; both seller and buyer of cotton were mistaken about which ship named "Peerless" was to transport cotton). If one party is more at fault than the other, a contract exists and has the understanding attached by the party less at fault. See, e.g. *Frigaliment Importing Co. v. B.N.S. Int'l Sales Corp., 190 F. Supp. 116 (S.D.N.Y. 1960)* (buyer had reason but seller had no reason to know of the other's interpretation; buyer thought "chicken" only meant broilers or fryers but seller understood it to include stewing chickens) (dicta).

n25 See Kennedy & Michelman, Are Property and Contract Efficient?, *8 HOFSTRA L. REV. 711, 739-41 (1980).* Of course, a party may also refuse to perform an agreement that is beneficial to him if he can obtain a better bargain elsewhere.

n26 An alternative explanation postulates that the policy is one of protecting an innocent party's reliance upon a contract and that through this different route society benefits. See Fuller & Perdue, supra note 11, at 60-63. But see Kennedy & Michelman, supra note 25, at 745-47.

n27 Suppose a party can choose between contract 1 and contract 2, and understands that there are only two possible outcomes, 1 and 2, each equally likely to occur as far as he can determine. Depending on which outcome occurs, the value (in arbitrary units) of each contract to the party may differ. Assume that the different possible combinations of contracts and outcomes provide the following set of values (for example, if contract 1 is selected and outcome 1 occurs, the value to the party is 6):

	Outcome 1	Outcome 2
Contract 1	6	2
Contract 2	3	4

Given this set of values or payoff matrix, the party should choose contract 1 with its expected value of 4 (8 divided by 2) rather than contract 2 with its expected value of 3.5 (7 divided by 2).

But suppose there are three other possible outcomes of which he is completely ignorant. Assume that, instead, there are actually five possible outcomes and all of the outcomes are equally likely. Suppose the payoff matrix is this:

	Outcome 1	Outcome 2	Outcome 3	Outcome 4	Outcome 5
Contract 1	6	2	2	2	3
Contract 2	3	4	4	4	5

Then the expected value of contract 1 is 3.0 compared to that of 4.0 for contract 2. A party who is ignorant of the other possible outcomes (3, 4, and 5) may make the wrong decision.

n28 On occasion, the law expressly recognizes that value and risk are intimately related. Under contract law, a breaching party is liable for any damages caused by his breach if, at the time he made the contract, he could foresee those damages as the probable result of his breach. *Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854);* RESTATEMENT, supra note 7 § 351 & comment a. Sometimes, despite the foreseeability of the harm, the breaching party's damages are limited to avoid charging him with a liability wholly disproportionate to his compensation under the contract. "The fact that the price is relatively small suggests that it was not intended to cover the risk of such liability." RESTATEMENT, supra note 7, § 351 comment f; see, e.g., *Lamkins v. International Harvester Co., 207 Ark. 637, 182 S.W.2d 203 (1944)* (holding that the seller was not liable for large lost profits despite the foreseeability of such harm from a breach of contract; seller contracted to deliver an inexpensive lighting attachment that would have enabled the buyer to farm at night).

n29 See generally Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383 (1970) (discussing the efficient capital market hypothesis); W. SHARPE, INVESTMENTS 95-124 (1978) (same).

n30 See J. VAN HORNE, supra note 14, at 408-14. See generally M. STIGUM, THE MONEY MARKET (rev. ed. 1983) (detailing the various instruments and participants in the American money market).

n31 It is assumed that a party understands the information in the sense that he becomes better aware of contract risks, or can more accurately assess the magnitude of such risks or the probability of their occurrence. That understanding, of course, may depend heavily on one's alertness, education, experience, or mental capacity. And it is possible that no relevant information is available with respect to adverse outcomes because a contract party may be unable either to obtain the information or to understand the information he has.

n32 If the ship owner acquires more information, this may reinforce his original decision or, conversely, change his outlook. But information costs can discourage him from acquiring more data. Although large companies may engage profitably in risk forecasting with many different scenarios and probability estimates, individuals or small companies may find such activities economically infeasible.

n33 This Article does not contend that consumers in fact make such forecasts consciously. It merely proposes that consumers can behave as though these forcasts had been made. Naturally when human judgment operates, an assessment of risks and their associated probabilities is unlikely to be accurate or even exact. In reality, a consumer may only "feel" that he has a good chance of having no problems with his car over the next five years.

n34 These estimates might be discrete values, a range of values, or just ordinal values. For example, if there are three possible outcomes X, Y, and Z, then the discrete probabilities of each may be P(X) = .2, P(Y) = .3, P(Z) = .5. One range of probabilities may be P(X) = .2 + or - .1, P(Y) = .3 + or - .2, P(Z) = .5 + or - .3. Finally, an ordinal arrangement may have P(Z) greater than P(Y) which in turn is greater than P(X). Although outcomes X, Y, and Z, need not be mutually exclusive, mutually exclusive outcomes with probabilities summing to 1.0 simplify calculations under a model of decision making.

n35 The notation for these revised probability estimates are commonly given as P(A/I) = .5, P(B/I) = .4, and P(C/I) = .1. P(A/I), for example, represents the probability of outcome A given the information I, or

P(A/I) = P(A,I) / P(I) where P(I) represents the probability that the information will be available and where P(A,I) represents the probability of A and I both occurring (essentially, the measure of the information's credibility). See C. HOLLOWAY, supra note 5, at 311-67 (discussing Bayesian revision of probabilities and the value of information). Cf. Kaplan, Decision Theory and the Factfinding Process, *20 STAN. L. REV. 1065, 1083-86 (1968)* (applying Bayesian revision of probabilities in a criminal trial); Tribe, Trial by Mathematics: Precision and Ritual in the Legal Process, *84 HARV. L. REV. 1329, 1350-58 (1971)* (same).

n36 Even if the revised expected cost of repairs was lower than the price of the warranty, a risk-averse individual might purchase the warranty if the expected cost is uncomfortably close to the warranty price. See infra note 63 (risk aversion).

n37 See supra notes 27-36 and accompanying text.

n38 See generally C. HOLLOWAY, supra note 5, at 7-11 (distinguishing between good decisions and good outcomes).

n39 See generally J. MURRAY, MURRAY ON CONTRACTS §§ 197-205 (2d rev. ed. 1974) (reviewing contract cases that involve risk allocation).

n40 This statement may seem easily disproved by the fact that many people commonly purchase lottery tickets which have a very small chance of winning. These individuals would never pay one dollar for no chance of winning a million dollars but readily pay the dollar for a one-in-five-million chance of winning a million dollars. This indicates some comprehension of the difference between no chance and the one-in-five-million chance. On the other hand, this may only show that these gamblers subjectively believe the odds to be much higher (the individuals feel "lucky") or that there are other inducements to gamble aside from the pitiful odds of winning, such as the excitement of gambling or the support for the purpose of the lottery. The cheap price for a possible million dollars is surely a factor in making the actual odds to be viewed as being much higher -- after all, a person will at most be a dollar out of pocket.

n41 See generally A. MACKAY, ARROW'S THEOREM: THE PARADOX OF SOCIAL CHOICE 49-60 (1980) (explaining that discrimination failure occurs when a person fails to discriminate between two things because the difference between the two is less than the person's threshold of perception).

As a practical matter, it is difficult to distinguish between an unknown risk and a known risk that has an infinitesimal probability of occurrence. For instance, which situation was it when oil-importing nations were caught unprepared by the birth of OPEC and the accompanying increases in oil prices? Or when savings and loan associations were surprised by the jump in interest rates of the short-term deposits the associations were using to fund their long-term, low interest rate assets?

n42 Decisions in contract law are among the many analyzed. See e.g., Goetz & Scott, supra note 11; Goetz & Scott, Measuring Sellers' Damages: The Lost-Profits Puzzle, *31 STAN. L. REV. 323 (1979);* Jackson, "Anticipatory Repudiation" and the Temporal Element of Contract Law: An Economic Inquiry into Contract Damages in Cases of Prospective Nonperformance, *31 STAN. L. REV. 69 (1978).*

There has also been economic analysis of contract law on theories other than efficiency. See, e.g., Birmingham, Legal and Moral Duty in Game Theory: Common Law Contract and Chinese Analogies, *18 BUFFALO L. REV. 99 (1969)* (applying game theory to contract law); Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, *94 HARV. L. REV. 369 (1980)* (using the concept of opportunity costs to establish a theory of bad faith breach); Farber, Contract Law and Modern Economic Theory *78 NW. U.L. REV. 303 (1983)* (examining links between contract law and some important models of the economy as a whole);cf. Easterbrook, Ways of Criticizing the Court, *95 HARV. L. REV. 802 (1982)* (applying Arrow's Impossibility Theorem to decisions of the Supreme Court). See generally *THE ECONOMICS OF CONTRACT LAW, supra* note 20 (containing articles that apply economic principles to contract law); The Place of Economics in Legal Education, *33 J. LEGAL EDUC. 183 (1983)* (a symposium on the "law and economics" movement of the past decade).

n43 See, e.g., Easterbrook, Criminal Procedure as a Market System, *12 J. LEGAL STUD. 289 (1983);* Posner, Some Uses and Abuses of Economics in Law, *46 U. CHI. L. REV. 281, 287-97* and authorities cited therein (1979); Priest, The Common Law Process and the Selection of Efficient Rules, *6 J. LEGAL STUD. 65 (1977).* See generally 4 RESEARCH IN LAW AND ECONOMICS (EVOLUTIONARY MODELS IN ECONOMICS AND LAW) (P. Rubin ed. 1982) (collection of essays that considers, among other things, whether economic and legal systems evolve towards efficiency).

It would be misleading, however, to characterize the development of the common law as an evolutionary movement towards greater efficiency for society as a whole, at least if "evolution" is used in its Darwinian sense. From a Darwinian perspective, evolution or

[n]atural selection is a theory of local adaptation to changing environments. It proposes no perfecting principle, no guarantee of general improvement; in short, no reason for general approbation in a political climate favoring innate progress in nature.

Darwin's independent criterion of fitness is, indeed, "improved design," but not "improved" in the cosmic sense that contemporary Britain favored. To Darwin, improved meant only "better design for an immediate, local environment." Local environments change constantly: they get colder or hotter, wetter or drier, more grassy or more forested. Evolution by natural selection is no more than a tracking of these changing environments by differential preservation of organisms better designed to live in them: hair on a mammoth is not progressive in any cosmic sense . . . . And Darwin delighted in showing that local adaptation often produced "degeneration" in design-anatomical simplification in parasites, for example.

S. GOULD, EVER SINCE DARWIN: REFLECTIONS IN NATURAL HISTORY 45 (1977) (emphasis in original). See generally C. DARWIN, ON THE ORIGIN OF SPECIES (1964) (a facsimile of the first edition) (proposing the theory of natural selection).

n44 Kronman, Mistake, Disclosure, Information, and the Law of Contracts, *7 J. LEGAL STUD. 1 (1978)* [hereinafter cited as Kronman, Mistake]; Kronman, Specific Performance, *45 U. CHI. L. REV. 351 (1978)* [hereinafter cited as Kronman, Specific Performance]; Priest, Breach and Remedy for the Tender of Nonconforming Goods under the Uniform Commercial Code: An Economic Approach *91 HARV. L. REV. 960 (1978).*

n45 See Posner, supra note 43, at 287-91; Note, The Inefficient Common law, *92 YALE L.J. 862 & nn.1-3 (1983).*

n46 See, e.g., Epstein, The Social Consequences of Common Law Rules, *95 HARV. L. REV. 1717 (1982)* (contending that the common law has had minimal effect on the allocation of resources in society); Kennedy & Michelman, supra note 25 (finding that many of the arguments in support of the economic efficiency of legal institutions, such as private property and free contracts, have weak theoretical as well as factual justifications). Cf G. CALABRESI, THE COSTS OF ACCIDENTS 26-31 (1970) (stating that the law should aim to minimize the total costs of accidents, accident avoidance, and administration of the treatment of accidents); H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (arguing that the prohibition under the 1934 Securities Exchange Act against insider trading prevents the efficient operation of the securities markets); Stigler, Public Regulation of the Securities Markets, 37 J. BUS. 117 (1964) (concluding that the Securities and Exchange Commission's review of stock prospectuses conducted under the authority of the 1933 Securities Act has failed to improve the welfare of purchasers of new stock issues).

n47 See, e.g., Barton, The Economic Basis of Damages for Breach of Contract, *1 J. LEGAL STUD. 277 (1972)* (showing that the remedy of damages for breach of contract does not necessarily promote allocative efficiency); Macneil, Efficient Breach of Contract: Circles in the Sky *68 VA. L. REV. 947 (1982)* (arguing against the theory of efficient breach); infra note 77 (liquidated damages, although thought to be an efficient way to allocate risk, are nevertheless often unenforced by the courts).

n48 Cf. G. GILMORE, THE AGES OF AMERICAN LAW 99-100 (1977) ("The quest for the laws which will explain the riddle of human behavior leads us not toward truth but toward the illusion of certainty, which is our curse." Id. at 100.).

n49 Coleman, supra note 21 (reviewing some definitions of efficiency used in welfare economics); see E. MANSFIELD, MICROECONOMICS 458-60 (4th ed. 1982) (discussing different ways to measure an improvement in social welfare).

n50 R. POSNER, supra note 20, § 1.2, at 10.

n51 See id. § 1.2 at 10-11 R. POSNER, THE ECONOMICS OF JUSTICE 60-62 (1981). Thus, value is synonymous with wealth, and value maximization refers to wealth maximization. See id. at 60-65. Wealth, however, is said not to be exactly the same as price times quantity:

The market price of a good is its value to the marginal purchaser, and intramarginal purchasers will value it more in the sense that they would pay more for it if the price were higher. The wealth of society includes not only the market value in the sense of price times quantity of all goods and services produced in it, but also the total consumer and producer surplus generated by those goods and services.

Id. at 60. Nevertheless, the market price can serve as a useful measure of wealth in that under conditions of perfect competition, the market price produces an output of goods or services that maximizes the sum of consumer and producer surplus. Compare J. HIRSHLEIFER, PRICE THEORY AND APPLICATIONS 212-24 (2d ed. 1980) (discussing consumer and producer surplus) with E. MANSFIELD, supra note 49, at 291-92 (showing that such surplus is less with a monopoly) and P. SAMUELSON, ECONOMICS 486 n.10 (11th ed. 1980) (same).

Obviously, there are limitations in using a competitive market paradigm for maximizing wealth. Market imperfections including changes over time, third-party effects, transaction costs, and wealth effects may hinder existing markets from producing wealth-maximizing outcomes. See J. HIRSCHLEIFER, supra, at 535-39, 549; E. MACKAAY, ECONOMICS OF INFORMATION AND LAW 19-24 (1982); A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 123-26 (1983) Coleman, Efficieny, Utility, and Wealth Maximization, *8 HOFSTRA L. REV. 509, 540-42 (1980);* Kelman, Choice and Utility, *1979 WIS. L. REV. 769, 778-88;* Polinsky,Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law, *87 HARV. L. REV. 1655, 1671-80 (1974).*

When actual markets are unavailable, it is suggested that legal rules mimic the likely terms of a hypothetical market transaction. See Posner, Utilitarianism, Economics, and Legal Theory, *8 J. LEGAL STUD. 103, 127 (1979)* ("the wealth-maximization principle implies . . . legal rules that simulate the operations of the market when the costs of market transactions are prohibitive").

Some commentators go beyond a purely descriptive view that common law decisions tend to maximize wealth and make a normative judgment that society is better off because wealth is maximized. See, e.g., R. POSNER, supra, at 88-115. Even assuming that wealth is somehow maximized, one can hardly generalize that the welfare of society is improved. In maintaining that society gains by the maximization of wealth, one in essence argues that the total value of the social welfare function has increased. There are at least two objections to this view.

First, this normative view says nothing about the existing distribution of wealth and income. Each different distribution has a different effect on the prices of goods and services because different individuals have different wants and needs. A rich man like Midas would spend his fortune on gold thereby increasing the demand and price for gold. But another rich man like Faust would spend his fortune on elixirs of longevity thereby increasing the demand and price for life-increasing potions. If wealth were increased but only one person owned all of the wealth and everyone else owned nothing, would society be better off? If the distribution of wealth and income is a very unequal one, "demand price does not reflect the relative urgency of the needs of different persons, and the allocation of resources determined by the demand price offered for consumers' goods is far from attaining the maximum of social welfare [for w]hile some are starving others are allowed to indulge in luxury." Lange, On the Economic Theory of Socialism, in ON THE ECONOMIC THEORY OF SOCIALISM 100 (B. Lippincott ed. 1938); see Thurow, supra note 21, at 57.

Second, this presupposes that interpersonal comparisons of welfare are possible, with individuals' welfare functions being assigned numerical weight and aggregated. Here wealth is being substituted for the traditional notion of utility. See K. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES 3-5, 9-11 (2d ed. 1963). It is difficult, however, to compare the values and desires of different human beings. Even the Golden Rule may not be universally revered: "Do not do unto others as you would they should do unto you. Their tastes may not be the same." G. SHAW, Maxims for Revolutionists, in MAN AND SUPERMAN 251 (1908). Individual welfare or utility is inherently unmeasurable, and thus, interpersonal comparisons of utility are impossible unless one makes an essentially ethical judgment in selecting wealth as the measure of utility. See J. GRAAFF, supra note 21, at 8-9; E. MANSFIELD, supra note 49, at 439-40.

Assuming that an ethical judgment has been made that wealth is an appropriate surrogate for welfare in a particular contract, the advantage to using wealth is the ease in which it can be measured since dollars are quantifiable and each dollar is the same as any other. If parties enter into contracts primarily for pecuniary gain, as in a purely commercial context, expressing their welfare in terms of dollars may not be unreasonable. In this situation, if contract performances have readily available market substitutes, courts can award damages for breach that reflect actual loss.

But the disadvantage arises in those situations in which wealth maximization cannot be established with reasonable certainty or in which the utility of a contract cannot be measured solely in dollar terms; some items elude any meaningful representation through a price system. First, even though the value of a particular contract to its parties is purely in wealth or dollar terms, court decisions may fail to maximize wealth if contract performances have no market price. Courts may err in awarding an incorrect amount of damages for breach of contract. Second, it would be difficult to quantify the utility of a contract in dollar terms if the utility arises from a sense of victory or vindication or if the contract serves to promote qualities like trust or honesty.

n52 The exception, of course, occurs when conditions of perfect competition exist. See supra note 51. Perfect competition by definition is nonexistent. See E. MANSFIELD, supra note 49, at 248-49.

n53 Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, *8 HOFSTRA L. REV. 487, 491-97 (1980).* This definition of efficiency is based on the Kaldor-Hicks compensation principle which does not require that the losers, in fact, be compensated. See Kaldor, Welfare Propositions of Economics and Interpersonal Comparisons of Utility, 49 ECON. J. 549, 550 (1939); Hicks, The Foundations of Welfare Economics, 49 ECON. J. 696, 711 (1939). Inconsistent results can arise, however, when only potential rather than actual compensation is considered. Scitovszky, A Note on Welfare Propositions in Economics, 9 REV. ECON. STUD. 77 (1941); see Coleman, supra note 51, at 519 n.14.

n54 When one defines efficiency in this way, any change which results in a small increase in value is efficient even though large increases via other changes are also possible. Suppose state A is the original situation and states B, C, D, and E are feasible alternative situations. Assume A, B, C, D, and E have these values (in arbitrary units): value(A) = 100, value(B) = 101, value(C) = 110, value(D) = 200, and value(E) = 1100. Since A is the original situation, a move to any of the other states will be an efficient change. Hence, a move from A to B would be efficient. But B is only 1% greater in value than A while C, D, and E are, respectively, 10%, 100%, and 1000% greater; moves to C, D, and E clearly would be more efficient changes.

Since most human beings can be expected to try to improve their situations whether that involves earning more money, developing more skills, or doing a better job, it should surprise no one that efficient actions -- in the sense of small improvements -- are commonplace for individual situations. Even judges in formulating the common law should conform to this very human behavior. It would be surprising, however, if one could show, with respect to a particular period of time, that the most efficient change had occurred for all of society.

Ironically, in the long run, efficiency may not be particularly important. In evaluating an economic system, one should look at its capacity for growth rather than its efficiency in allocating existing resources. Also, what is efficient must be determined in light of an existing distribution of income and wealth. A stagnant society may operate very efficiently even though all of the wealth and income belong to 1% of the society's members and the other 99% languish in idleness and apathy.

n55 See, e.g., A. POLINSKY, supra note 51, at 8, 15-24; R. POSNER, supra note 20, §§ 3.1, 3.4, 4.1, 4.9, 5.2, 6.1, 6.3, 6.9, 6.12, 6.15. This reliance on individual cases may be misplaced when extrapolations are made to cover all of society, for what is efficient from the perspective of one person or a small number of persons may be inefficient from the perspective of society. The monopolist, for example, only seeks to maximize his profits -- an efficient state for him but an inefficient state for society (consumers of the monopolist's product). See, e.g., J. HIRSHLEIFER,supra note 51, at 332-48.

n56 See, e.g., R. POSNER, supra note 20, §, 1.2, at 10; Thurow, supra note 21, at 57. See generally A. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF (1975) (discussing the conflicts that arise when society pursues the goals of equality and efficiency).

n57 The proper description should be cost reduction since cost minimization would be difficult to achieve. Cf. supra notes 49-52 and accompanying text (value maximization).

n58 Priest, supra note 44, at 960, 981-1000.

n59 Id. at 962 n.5.

n60 O. W. HOLMES, The Path of the Law, in COLLECTED LEGAL PAPERS 167, 175 (1920). Our legal system operates to encourage promisees to rely on the promises of others rather than to coerce promisors to complete their promises. "[C]ourts in this country, as in most of the rest of the world, expressly reject the notion that remedies for breach of contract have punishment as a goal, and with rare exceptions, refuse to grant 'punitive damages' for breach of contract." Farnsworth, supra note 11, at 1146.

n61 See Fuller & Perdue, supra note 11, at 53-57; RESTATEMENT, supra note 7, § 344(a) & comments a-b. See generally Fuller & Perdue, supra note 11, at 57-66 (discussing the factors which justify the protection of the expectation interest).

n62 See A. POLINSKY, supra note 51, at 29-32.

n63 A person's risk attitude is an important factor to consider in predicting his behavior. This footnote contains a simplified discussion of risk-averse, risk-seeking, and risk-neutral attitudes.

Risk aversion exists when an individual prefers a monetary outcome certain to occur over a gamble with an equal or greater expected monetary outcome. For example, suppose you can chooe between two choices: one with a sure gain of $ 90 and the other being somewhat risky -- with a 95% chance of winning $ 100 and a 5% chance of winning nothing.

(SEE ILLUSTRATION IN ORIGINAL)

If you choose the first, you are risk averse because the expected value of the first choice, $ 90, is lower than that of the second, $ 95. Another example might be between losing $ 100 for certain or taking a chance -- with a .5% chance of losing $ 10,000 and a 99.5% chance of losing nothing.

(SEE ILLUSTRATION IN ORIGINAL)

Choosing the first makes you risk averse for the expected value of the first, -$ 100, is lower than that of the second, -$ 50. The second example describes a person's preference for insurance.

Risk seeking, conversely, exists when an individual rejects a monetary outcome certain to occur in favor of a gamble with an equal or lower expected monetary outcome. For example, suppose you must decide between two choices, one with a sure loss of $ 90 and the other being a gamble -- with a 95% chance of losing $ 100 and a 5% chance of losing nothing.

(SEE ILLUSTRATION IN ORIGINAL)

If you select the second, you are risk seeking because the expected value of the first choice, -- $ 90, is higher than that of the second, -- $ 95. A second example would be to choose between gaining $ 100 for certain or taking a chance -- with a .5% chance of winning $ 10,000 and a 99.5% chance of winning nothing.

(SEE ILLUSTRATION IN ORIGINAL)

Choosing the second choice shows a risk-seeking attitude because the expected value of the first choice, $ 100, is higher than that of the second, $ 50. The second example is similar to betting on lotteries.

Finally, risk neutrality exists when a person is indifferent between a certain monetary outcome and a gamble with the same expected monetary outcome. A risk-neutral individual will always choose the outcome with the higher monetary value, even if that outcome involves a gamble. See C. HOLLOWAY, supra note 5, at 390-414; Kahneman & Tversky supra note 5. See generally K. ARROW, Theory of Risk Aversion, supra note 13, at 90-120 (analyzing risk aversion).

n64 A standard assumption in the economic analysis of risk is "that the higher a person's wealth, the less averse he is to a given size risk." A. POLINSKY, supra note 51, at 52 n.31; see M. DAVIS, GAME THEORY 59 (rev. ed. 1983).

n65 Risk neutrality when paired with risk-seeking behavior, however, could present a disadvantage. Given a small chance of winning a large amount of money, perhaps a .01 chance of prevailing in a $ 50,000 tort suit, a risk-seeking individual may spend more than $ 500 (the expected value of tort suit) to litigate a frivolous lawsuit against a risk-neutral company. The company would settle for any amount less than the sum of the expected cost of expenses in defending against the lawsuit and the expected loss of $ 500 from an adverse judgment.

Curiously, under different circumstances, the same individuals may exhibit behavior ranging from risk seeking to risk aversion. See C. HOLLOWAY, supra note 5, at 411-14;

Friedman & Savage, The Utility Analysis of Choices Involving Risk, 56 J. POL. ECON. 279, 279, 286 (1948) (giving the example of an individual who shows risk aversion by buying insurance while also showing risk-seeking behavior by purchasing a lottery ticket). The risk-averse individual in a breach of contract case involving a large amount of damages may become a risk-seeking litigant quite willing to spend a small amount of money in a gamble on a tort suit.

n66 "Perhaps nine-tenths of legal uncertainty is caused by uncertainty as to what courts will find, on conflicting evidence, to be the facts to cases." *Zell v. American Seating Co., 138 F.2d 641, 648 (2d Cir. 1943),* rev'd on other grounds, *322 U.S. 709 (1944).* See generally Shavell, Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs, *11 J. LEGAL STUD. 55 (1982)* (presenting a model that analyzes how a party, when faced with the uncertainty of litigation, might decide whether to file suit, to settle, or to go to trial). Even the validity of a compromise agreement is uncertain to some degree. See, e.g., *Headley v. Hackley, 50 Mich. 43, 14 N.W. 693 (1883)* (voiding a settlement that lacked a good faith dispute).

On a more etiological note, several commentators have addressed the causes of uncertainty in the law. See, e.g., D'Amato, Legal Uncertainty, *71 CALIF. L. REV. 1 (1983);* Easterbrook, supra note 42; Farago, Intractable Cases: The Role of Uncertainty in the Concept of Law, *55 N.Y.U. L. REV. 195 (1980);* Hirsch, Reducing Law's Uncertainty and Complexity, *21 UCLA L. REV. 1233 (1974).*

n67 Theoretically, the "more probable than not" standard that is used in civil cases requires only that there is a probability greater than 50% that it is this party who has breached rather than the other party. In close cases, it may be difficult to distinguish between the breaching and innocent parties, and the innocent party at the trial level may become the breaching party on appeal. Compare, e.g., *Walton Water Co. v. Village of Walton, 122 Misc. 294, 203 N.Y.S. 338 (1923)* (plaintiff wins at trial by arguing successfully that an agreement is invalid) and *Walton Water Co. v. Village of Walton, 207 A.D. 708, 203 N.Y.S. 343 (1924)* (plaintiff again prevails, this time in the intermediate appellate court) with *Walton Water Co. v. Village of Walton, 238 N.Y. 46, 143 N.E. 786 (1924)* (defendant triumphs in the highest appellate court).

n68 A party's expectations under a contract, whether it is to purchase certain property or receive personal services, has a "fair market value" only if there exists a market in which substitute property or services can be obtained. The term fair market value is somewhat misleading because it actually refers to price not value. Even when an established market exists, this only determines a fair market price as fixed by supply and demand. See J. HIRSCHLEIFER, supra note 51, at 212-14. This price may not necessarily reflect an item's value to a particular purchaser. That is, he may be willing to pay much more. A promisee's special needs may make a bargained-for promise particularly valuable, despite a low market price. But because a substitute is readily available from the market, the law makes the common sense conclusion that the price of the substitute is all that has been lost.

In the absence of such a market, determining the value of expectations may be impossible. In a breach of contract to sell land, for example, a potential buyer may have had plans to utilize it in a more productive manner than other persons. On the other hand, his reasons for the purchase may have been entirely esthetic ones. The only truly compensatory remedy may be to compel performance, but specific performance may be unavailable. Perhaps the breaching party can no longer perform or one of the many defenses to specific performance is present. See RESTATEMENT, supra note 7, §§ 359-69 (listing circumstances in which specific performance will be denied). See generally Kronman, Specific Performance, supra note 44 (arguing that specific performance is justified if it becomes prohibitively expensive to determine whether a suitable substitute can be purchased with money damages); Schwartz, The Case for Specific Performance, *89 YALE L.J. 271 (1979)* (arguing that the remedy of specific performance should be routinely available).

n69 See, e.g., RESTATEMENT, supra note 7, §§ 41 (if no time is specified, an offer must be accepted within a reasonable time), 204 (when the parties to a contract omit an essential term, the court may supply a reasonable term under the circumstances); U.C.C. §§ 2-206(1)(a) (unless otherwise indicated, an offer invites acceptance in any reasonable manner), 2-305(1) ("a reasonable price"), 2-306(1) ("no quantity unreasonably disproportionate to any stated estimate" of seller's output or buyer's requirements), 2-309(1) ("a reasonable time" for shipment or delivery). See generally Speidel, Restatement Second: Omitted Terms and Contract Method, *67 CORNELL L. REV. 785 (1982)* (analyzing the Restatement's method of handling contracts with omitted essential terms).

n70 See, e.g., Farber, Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract, *66 VA. L. REV. 1443 (1980)* (arguing that compensatory damages do not necessarily produce economically optimum conduct and that supercompensatory damages can improve economic efficiency); *Jackson, supra* note 42, at 86 n.59 (stating that the damage rule appears to be undercompensatory).

n71 Moreover, the law of contracts developed in great part from the adjudication of exceptional, not typical, cases. Extraordinary contracts cases that were decided in court made law for ordinary contracts cases that were normally settled by nonlegal considerations such as a continuing business relationship. See Farnsworth, supra note 19, at 605-06 (noting that contract law develops out of "disputes that arise outside of established markets, such as those that stem from family transactions, and . . . those that arise when an established market suffers an abnormal dislocation, such as those that are occasioned by the outbreak of war," id., footnote omitted); cf. L. FRIEDMAN, A HISTORY OF AMERICAN LAW 466 (1973) (observing that, in the latter part of nineteenth century America, the contract cases which "came into court tended to be marginal: special situations, unusual cases"). Thus, one involved in a business transaction may find it risky to predict what might happen in court on the basis of an analogy to a prior, noncommercial contracts case.

n72 Compare *Groves v. John Wunder Co., 205 Minn. 163, 286 N.W. 235 (1939)* (applying the cost of completion test to compute damages for breach of contract) and *Peevyhouse v.*

Garland Coal & Mining Co., 382 P.2d 109, 114 (Okla. 1963) (on essentially the same facts as Groves, the dissenting opinion arguing that the cost of completion should be awarded) with *Peevyhouse, 382 P.2d 109* (applying the diminution of value test, which awards as damages the difference between the market value of the property had the contract been performed and the market value of the property as left by the breach) and *Groves, 205 Minn. 171, 286 N.W. at 239* (dissenting opinion arguing for the diminution of value test). See generally D. Dobbs, supra note 12, § 12.21, at 899-903 (discussing the difficulty of choosing only between the two tests applied in Groves and Peevyhouse); Birmingham, Damage Measures and Economic Rationality: The Geometry of Contract Law, *1969 DUKE L.J. 49, 69-70* (suggesting a decree of specific performance as a solution in Groves and Peevyhouse, thereby forcing the parties to bargain over the appropriate compensation if both parties wish to avoid specific performance); Farnsworth, supra note 11, at 1175 (arguing that it would have been better in Groves and Peevyhouse "to give the trier of fact discretion to fix any figure, not unreasonable under the circumstances, as long as it lies within those two limits" of the cost to complete and the diminution in market price); Simon & Novack, Limiting the Buyer's Market Damages to Lost Profits: A Challenge to the Enforceability of Market Contracts, *92 HARV. L. REV. 1395, 1425-27 (1979)* (predicting future court decisions may show award flexibility, making "partial awards of contract damages, based on degrees of fault and degrees of probability").

n73 See, e.g., *Bright v. Ganas, 171 Md. 493, 189 A. 427 (1937)* (breaching employee's immoral conduct bars any recovery by him whether on the contract or in quantuim meruit); *Glazer v. Schwartz, 276 Mass. 54, 176 N.E. 613 (1931)* (contractor who intentionally breaches may recover nothing); cf. Ellis, Fairness and Efficiency in the Law of Punitive Damages, *56 S. CAL. L. REV. 1, 46-48, 57 (1982)* (arguing that uncertainty as to the amount of punitive damages which may be awarded in a lawsuit can deter socially useful behavior and thus reduce aggregate social welfare). But the general rule allows the breaching party to recover if the innocent party has been fully compensated. See, e.g., *Reynolds v. Armstead, 166 Colo. 372, 443 P.2d 990 (1968); Ficara v. Belleau, 331 Mass. 80, 117 N.E.2d 287 (1954);* cf. U.C.C. § 2-718(2) (entitling a breaching buyer to restitution).

n74 "Traditionally, the common law ha[s] declared a clear preference for a contract-market formula when measuring a seller's damages for breach of contract." Goetz & Scott, supra note 42, at 372. But courts may apply the "lost profits" rule rather than the market-contract differential if a breach of contract causes "lost volume." See *Neri v. Retail Marine Corp., 30 N.Y.2d 393, 285 N.E.2d 311, 334 N.Y.S.2d 165 (1972);* U.C.C. § 2-708(2). But see Goetz & Scott, supra note 42, at 373 (arguing that the market-contract formula should generally apply even to cases involving lost volume).

The problem of "lost volume" arises when a first buyer breaches a contract to purchase goods, and the seller eventually resells the goods to a second buyer. Had there been no breach, the seller might have made two sales and gained two profits. The breach and resale have reduced the seller's total volume of sales by the sale rejected by the first buyer. Thus in cases of lost volume, the lost profits rule yields a recovery greater than the market-contract formula. This assumes, however, that the second buyer would have bought the goods in the hypothetical case in which the first buyer had not breached. See Harris, A Radical Restatement of the Law of Seller's Damages: Sales Act and Commercial Code Results Compared, *18 STAN. L. REV. 66, 80-83 (1965).*

n75 See, e.g., *United States ex rel. Susi Contracting Co. v. Zara Contracting Co., 146 F.2d 606 (2d Cir. 1944).* An injured party will ordinarily prefer expectation damages because they will cover his restitution damages and provide a net profit. "In the case of a contract on which he would have sustained a loss instead of having made a profit, however, his restitution interest may give him a larger recovery than would damages on either [the expectation or reliance] basis . . . . The [rules under the Restatement nevertheless] give him the right." RESTATEMENT, supra note 7, § 373 comment d.

n76 When a seller breaches a contract for the delivery of a commodity that is freely traded in a fluctuating market, some courts have awarded the buyer damages as measured by the market-contract price differential, but others have limited damages to profits actually lost when the market-contract differential exceeds lost profits. See Simon & Novack, supra note 72. Compare *Coombs & Co. v. Reed, 5 Utah 2d 419, 303 P.2d 1097 (1956)* (applying the market-contract differential or the market theory of damages) with *William B. Tanner Co. v. WIOO, Inc., 528 F.2d 262 (3d Cir. 1975)* (applying the lost profits theory). See generally supra note 74 (discussing the case of lost volume in which lost profits exceed the market-contract differential).

The two measures of damages may diverge if the contract price is less than the market (spot) price and the buyer resells the commodity to a second buyer for a price higher than the contract price but lower than the market price. If the contract, market, and resale prices were

Contract Price (C)	= $ 100
Market Price (M)	= $ 120
Resale Price (R)	= $ 110

then the buyer's measure of damages under the market and lost profits theories would be

Market Theory	Lost Profits Theory
M - C = $ 20	R - C = $ 10

Under the market theory, the seller could be liable for $ 20, but under the lost profits theory, his liability would be $ 10 plus any liability the first buyer incurs for failing to deliver to the second buyer. Theoretically, the first buyer's liability to the second buyer would be M - R = $ 10 so that the seller's total liability to the first buyer would be $ 20. This makes the outcome the same for either theory. But in many circumstances, the first buyer's liability to the second buyer could fall short of M - R:

There could, for example, be special defenses available against the second buyer; the amount of such liability . . . may not yet have been established; the first buyer may have succeeded in settling with the second buyer at a lesser figure; the second buyer may have dropped his claim against the first buyer entirely; or the second buyer's market damages may be measured in a different forum or on different evidence. In these circumstances, is the first buyer still entitled to recover full market damages, thereby keeping for himself the portion of those damages which, in effect, belong to the second buyer?

Simon & Novack, supra note 72, at 1404; cf. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 6-4, at 224 (2d ed. 1980) (observing that the market-contract price differential under U.C.C. § 2-713(1) bears no necessary relationship to the lost profits that the breach causes).

Hence, the market theory might award $ 20 when the lost profits theory only gives $ 10. Following the market theory would give a windfall to the buyer since market damages exceed his economic loss, but applying the lost profits theory would provide a windfall to the breaching seller because his liability would normally be the market-contract differential. See Simon & Novack, supra note 72, at 1395-97. Yet, in particular markets, awarding the windfall to the injured party may be essential for the market to function as expected. See id. See generally id. at 1403 & nn.38-43 (listing arguments for overcompensating the injured party).

n77 See supra note 11. In fact, the common law treatment of penalties and liquidated damages appears to lead to inefficient results. See, e.g., Goetz & Scott, supra note 11; Posner, supra note 43, at 290 ("the refusal of the common law to enforce penalty clauses in contracts . . . apparently promotes inefficiency").

In bargained-for contracts, the law has typically focused not on the disparity in the value of the exchange to the contracting parties but rather on reliable, relatively objective evidence of a voluntary exchange. Goetz & Scott, supra note 11, at 555 n.12 and authorities cited therein, 589 n.90. The same approach, it has been argued, should apply to penalties and liquidated damages, so that the law's concern should center on the fairness of the bargain creating the stipulated damages clause rather than on the overcompensation of the nonbreaching party. Id. passim, accord Barton, supra note 47, at 286-87.

This approach has consistently been applied to the area of underliquidated damages, where a stipulated damages clause limits damages to an amount clearly much lower than what would be expected from many possible breaches. Goetz & Scott, supra note 11, at 588-90, 590 nn.93 & 94; see, e.g., *Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal. 2d 179, 253 P.2d 10 (1953)* (upholding a clause limiting damages for failure of a burglar alarm system).

n78 This Article leaves undiscussed the situation in which both contract parties are risk averse. Game theory would undoubtedly have some application to the problem of two risk-averse parties, each trying to take advantage of the other's risk aversion. See generally M. DAVIS, supra note 64 (a nontechnical introduction to game theory); R. LUCE & H. RAIFFA, supra note 14 (a readable though technical introduction to game theory); J. VON NEUMANN & O. MORGENSTERN, THEORY OF GAMES AND ECONOMIC BEHAVIOR (3d ed. 1953) (a mathematical discussion of game theory).

n79 Because a sunk cost is a past -- hence, unsalvable -- cost, it is irrelevant for future decision making. See, e.g., C. HORNGREN, COST ACCOUNTING 388 (5th ed. 1982); E. MANSFIELD, supra note 49, at 181-82.

Consider the first company's situation. It has already spent $ 5000 and now faces the choice of either following the contract or breaching it. Neither choice would recover the $ 5000 spent on the first house for whether the contract were followed or breached the company has incurred a $ 5000 expense. In deciding whether to breach, the company should look only at the future gains and losses from the available choices:

(See Illustration in Original)

Since the difference between -$ 20,000 and +$ 45,000 gain, the first company should breach if it believes that S, the anticipated settlement with the first client, will be less than $ 45,000.

Although the first company would take the spent $ 5000 into account as a cost of doing business in preparing its income statement, the company would do this whether or not it breached. Following the contract would result in a construction cost of $ 200,000 for the first house ($ 5000 plus $ 195,000) while breaching would result in a cost of $ 205,000 for the second house ($ 5000 spent on the first house plus $ 200,000 for the second). The construction expense -- as characterized on an income statement -- is greater for breaching because the company will spend $ 5000 in preliminary expenses for each of the two houses. Of course, the decision to breach would be unaffected even if income statements were considered:

(See Illustration in Original)

The difference between -$ 25,000 and +$ 20,000 is a +$ 45,000 gain, the same amount as before, and again, the first company should breach if it believes that the amount of settlement will be less than $ 45,000.

n80 Realistically, identical assessments of risk probabilities are the exception rather than the norm. The parties to an alleged breach of contract usually have different information concerning the chances of winning at trial and may even assess the same information differently. A party's probability forecasts of victory or defeat may depend on his evaluation of his opponent's character and strategy. The effectiveness of bluff, exercises in game theory, and other litigation tactics may determine the probabilities he arrives at. Naturally, a party's level of confidence in his case affects his desire to litigate or to settle. If the injured party feels more pessimistic about the chances of prevailing than does the breaching party, the injured party may find it more attractive to settle for an amount less than his true loss rather than go to trial. Polinsky & Shavell, Contribution and Claim Reduction Among Antitrust Defendants: An Economic Analysis, *33 STAN. L. REV. 447, 471 (1981);* see Posner, supra note 20, § 21.4, at 434-37. Nevertheless, even if the two parties have different probability estimates of their prevailing in court, the analysis can still proceed. See D'Amato, supra note 66, at 12-18; Shavell, supra note 66, at 63-69.

n81 *Acme Mills & Elevator Co. v. Johnson, 141 Ky. 718, 133 S.W. 784 (1911);* see J. WHITE & R. SUMMERS, supra note 76, § 6.3, at 217; cf. U.C.C. § 2-713(1) (giving an aggrieved buyer damages measured by the difference between the contract price and the market price at the time the buyer learns of the breach).

By setting a price today for future delivery of goods (a forward price), the parties essentially make a bet about the future market (whether the future spot price or other future forward prices will be favorable). A party may hope to guess more accurately than the other or, being risk averse, may prefer a certain price today to an uncertain price tomorrow. See Barton, supra note 47, at 277-78. See generally R. TEWELES, C. HARLOW & H. STONE, THE COMMODITY FUTURES GAME (abridged ed. 1977) (discussing the economic importance of commodity futures contracts).

n82 See supra note 63 (discussing risk-seeking behavior).

n83 Third-party effects, that is, gains obtained or losses suffered by other parties besides the buyer and seller, are ignored on the assumption that such gains and losses constitute purely wealth transfers. Furthermore, it is assumed that because of transaction costs or some special advantage, the seller can deliver the goods to the buyer at a lower joint cost than anyone else, thereby making the seller the most efficient party to sell to the buyer. This might will be true since the buyer and seller, at a minimum, incur additional costs by having to negotiate two other contracts -- the buyer's cover contract and the seller's resale contract.

n84 Thus far, this Article has examined cases in which the application of the damage rule leads to inefficient breaches because uncertainties exist in litigating a contract dispute and in predicting the future amount of damages for breach. The damage rule is, of course, a contract remedy which protects the innocent party's expectation interest. Other articles have focused on different uncertainties in determining the effect of various contract remedies in promoting an efficient breach, efficient reliance expenditures, and the efficient allocation of risks. These different uncertainties, for example, can be about alternative contracts, the level of the parties's profits, and a seller's production cost. See, e.g., Polinsky, Risk Sharing Through Breach of Contract Remedies, *12 J. LEGAL STUD. 427 (1983);* Shavell, Damage Measures for Breach of Contract, 11 BELL J. ECON. 466 (1980). Some economists have concluded that "there does not exist a breach of contract remedy that is efficient with respect to every consideration [such as] . . . the breach decision[,] . . . reliance [expenditures,] . . . [and] risk allocation." A. POLINSKY, supra note 51, at 63; Shavell, supra, at 472 (concluding that no single contract remedy leads both to an efficient breach and to efficient reliance expenditures).

n85 See, e.g., Kronman, Mistake, supra note 44, at 2-9; Posner & Rosenfield, Impossibility and Related Doctrines in Contract Law: An Economic Analysis, *6 J. LEGAL STUD. 83, 89-92 (1977);* Priest, supra note 44, at 961-62; cf. E. MANSFIELD, supra note 49, at 179-80 (stating that the efficient level of law enforcement is obtained when the joint costs of crime and of law enforcement are at a minimum).

n86 Transaction costs are costs associated with a contract, such as the cost to find a party to contract with, to negotiate a contract, to investigate alternative agreements, to carry out the contract, or to pursue remedies for breach of contract. See, e.g., Coase, The Problem of Social Cost, *3 J.L. & ECON. 1, 15 (1960).*

n87 Those who believe in the theory of an efficient common law argue, for instance, that the parties to a contract

presumably will want to resolve a contract dispute in a way that minimizes joint costs . . . [Thus,] if courts resolve a dispute in the way that the parties would have resolved it had they provided for it explicitly in the contract, the costs of negotiating a resolution to the dispute will be minimized.

Priest, supra note 44, at 962.

n88 See Posner & Rosenfield, supra note 85, at 90-91.

n89 Cf. supra text accompanying note 59 (giving an example of efficient cost reduction).

From one perspective, however, reducing costs would always increase the value of a contract. Suppose costs are defined to be the difference in value between two situations. Assume the net value of future contracts will be $ 1000 with settlement rule A and $ 1500 with settlement rule B. The costs of using rule A would be $ 500, the difference in value from the alternative situation with rule B, and reducing costs be decreasing the difference in value between the two situations would -- by definition -- always increase value.

Such a definition of costs might be roughly analogous to the economic concept of opportunity costs or alternative costs where "costs attributable to doing one thing rather than another stem from the forgone opportunities that have to be sacrificed in doing this one thing." P. SAMUELSON, supra note 51, at 448 (emphasis in original); see E. MANSFIELD, supra note 49, at 178-79; G. STINGLER, THE THEORY OF PRICE 104-10 (3d ed. 1966); Grant & Ireson, The Comparison of Alternatives, in MANAGERIAL ECONOMIES AND OPERATIONS RESEARCH 11-19 (E. Mansfield 4th ed. 1980). See generally Burton, supra note 42 (discussing the role of opportunity costs in defining a good faith performance of a contract).

The advocates of cost minimization, however, apparently define costs differently, for these advocates generally view costs as out-of-pocket expenses. See, e.g., Priest, supra note 44, at 962 n.5, 975-81. Perhaps costs as expenses are easier to identify and to quantify than costs as the dollar difference from a higher-valued, alternative situation.

n90 Transaction costs also include information costs, such as the cost to obtain information about certain products (price, quality, availability, retailer), the cost to understand a contract (hire an attorney), or the cost to inform or educate other parties (advertisement, personal explanations). See E. MACKAAY, supra note 51, at 109; A. POLINSKY, supra note 51, at 11-12, 20.

n91 This point is elaborated upon later in this Article. See infra notes 140-53 and accompanying text.

n92 See A. POLINSKY, supra note 51, at 25.

n93 See, e.g., Rakoff, Contracts of Adhesion: An Essay in Reconstruction, *96 HARV. L. REV. 1174, 1258-61 (1983)* (background rules are those a court applies to a contract dispute in the absence of contract provisions dealing with the dispute).

Although the courts initiated the use of default rules in the law of contracts, legislatures today have replaced the judiciary as a source of these rules in many kinds of contracts. Legislative default rules are a common sight in agreements that involve the sale of goods or the creation of partnerships. See, e.g., U.C.C. §§ 2-305 (if not contract price is given, fixing the price as a reasonable price), 2-308 (if nothing is stated in the contract, fixing the place of delivery of goods at particular locations), 2-309 (fixing the time of delivery), 2-310 (fixing the time and place of payment), 2-509 (fixing the passage of the risk of loss in the absence of breach); Uniform Partnership Act §§ 18 (1914) (if the partnership agreement is silent, this section governs the rights and duties of the partners in relation to the partnership), 40 (if the partnership agreement fails to provide for the distribution of partnership assets among partners after dissolution, this section gives rules for settling accounts among partners).

Whatever their source, default rules often cannot be mechanically applied by the courts. Many legislative default rules are open-ended, thereby giving courts broad discretion in applying these rules to the facts of a particular case. See Danzig, A Comment on the Jurisprudence of the Uniform Commercial Code, *27 STAN. L. REV. 621, 631-35 (1975);* Note, How Appellate Opinions Should Justify Decisions Made Under the U.C.C., *29 STAN. L. REV. 1245, 1256-59 (1977).* And judicially created rules may be equitable in nature, requiring a judge in analyzing a case to consider societal values like good faith, fairness, unconscionability, unjust enrichment, and reasonableness.See Kennedy, Form and Substance in Private Law Adjudication, *89 HARV. L. REV. 1685* passim (1976).

n94 Cf. *Lanzetta v. New Jersey, 306 U.S. 451, 453 (1939)* (a law must provide fair warning of what is forbidden for "[n]o one may be required at the peril of life, liberty or property to speculate as to the meaning of penal statutes").

n95 Cf. *Grayned v. City of Rockford, 408 U.S. 104, 108 (1972)* (to prevent arbitrary and discriminatory enforcement, criminal "laws must provide explicit standards for those who apply them").

n96 Sometimes, however, to the chagrin of many bank and corporate counsel, even major deals are done on a "gentlemen's agreement" with complicated contract documents written only to "confirm" the simple agreement. In cases of a strong and continuing business relationship, these gentlemen's agreements normally present no special problem. The parties find it in their own long-term interest to resolve any differences between them in a reasonable manner. A problem arises, however, if changed circumstances or misunderstanding poses a potentially large loss or windfall. See generally Goetz & Scott, Principles of Relational Contracts, *67 VA. L. REV. 1089 (1981)* (analyzing relational contracts which typically involve long-term contracts marked by personal relationships between the contract parties); Macneil, Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus," *75 NW. U.L. REV. 1018 (1981)* (same); Speidel, Court-Imposed Price Adjustments Under Long-Term Supply Contracts, *76 NW. U.L. REV. 369 (1981)* (arguing that courts should modify long-term supply contracts, a type of relational contract, when unanticipated change causes unbargained for gains and losses which imperil the relationship between the contract parties).

n97 How many individuals know that an offer can be revoked at any time before a formal acceptance, so that a revocation make take place even after an offeree has announced that he is ready and able to tender an acceptance? See *Petterson v. Pattberg, 248 N.Y. 86, 161 N.E. 428 (1928).* How many know of the technical rules of tender and excuse of tender that may make the aggrieved party at trial the breaching party on appeal? See *Cohen v. Kranz, 12 N.Y.2d 242, 189 N.E.2d 473, 238 N.Y.S. 928 (1963).* How many know whether the measure of damages for breach of an contruction contract will be the "cost of completion" or the "diminution in market value"? See RESTATEMENT, supra note 7, § 348. Only lawyers who have studied the matter in advance would know.

n98 A. DOWNS, supra note 5, at 86-87.

n99 The disadvantages consumers face are further explored later in this Article. See infra notes 120-39 and accompanying text.

n100 See, e.g., U.C.C. § 2-314 (creating an implied warranty that goods sold by a merchant will be merchantable).

n101 See, e.g., U.C.C. §§ 2-316(2), (3) (permitting the exclusion of implied warranties).

n102 For example, a business may conclude that negating certain default rules will streamline its operations and, on an annual basis, save it $ 10,000 while only costing its customers $ 5,000. If the business passes on some of its savings to its customers -- in an amount greater than $ 5,000 -- both sides will be better off.

n103 Cf. Schwartz & Wilde, Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis, *127 U. PA. L. REV. 630, 679-80 (1979)* (concluding that courts are poor institutions to resolve problems in which the absence of information is alleged to vitiate a party's consent to certain contract terms).

n104 In close cases, a court might cut short its investigation rather than obtain more information about the proper allocation of risks, for the cost to the judiciary in terms of its time and effort may exceed the expected value of any information obtained. The decision to refrain from further investigation might be based on the expected value of information as predicted by past experience with similar cases. But because of the peculiar nature of information, its value to the judiciary may not be known in any meaningful sense until judges actually have the information. See K. ARROW, Economic Welfare and the Allocation of Resources for Invention, supra note 13, at 151-52.

n105 "[C]ourts should presume buyer consent to any contract clauses at issue; and then ask whether those clauses are consistent with the courts' notions of public policy . . . ." Schwartz, Seller Unequal Bargaining Power and the Judicial Process, *49 IND. L.J. 367, 396 (1974).*

n106 Courts have the inherent power to void an unconscionable contract or contract clause. See, e.g., *Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965);* RESTATEMENT, supra note 7, § 208 & comments a-g and reporter's note; cf. U.C.C. § 2-302 (unconscionable contract or clause). See generally Ellinghaus, In Defense of Unconscionability, *78 YALE L.J. 757 (1969)* (defending unconscionability as a workable test); Leff, Unconscionability and the Code -- The Emperor's New Clause, *115 U. PA. L. REV. 485 (1967)* (criticizing unconscionability as a hopelessly abstract test).

n107 Professor W. David Slawson has argued that the parties inserting contrary clauses ought to be viewed as being entrusted with powers similar to those exercised by administrative agencies, so that the parties' actions would be upheld barring unreasonable conduct. See Slawson, Standard Form Contracts and Democratic Control of Lawmaking Power, *84 HARV. L. REV. 529 (1971)* [hereinafter cited as Slawson, Standard Form Contracts]. But see Slawson, The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms, *46 U. PITT. L. REV. 21, 41 (1984).*

n108 Cf. Schwartz & Wilde, Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests, *69 VA. L. REV. 1387, 1388-95 (1983)* (analyzing the argument that consumers' imperfect information justifies judicial or legislative regulation of contract terms by banning or requiring disclosure of disfavored contract terms); Note, Enforcing Waivers in Products Liability, *69 VA. L. REV. 1111 (1983)* (evaluating the four arguments usually given for prohibiting waivers in products liability cases: the consumer lacks information about product risks; he cannot correctly assess risks; he should not assume all of the risks of personal injury; and external social costs exist).

n109 See infra notes 140-153 and accompanying text; cf. G. CALABRESI, supra note 46, at 27-28, 39-67 (discussing the argument that large losses resulting from accidents would be most efficiently handled by spreading these losses broadly among people and over time).

n110 See generally E. A. FARNSWORTH, supra note 7, § 1.7 (observing that statutes, rather than the terms of a contract itself, dictate the legal effect of many contracts).

n111 See Farnsworth, supra note 19, at 600-04.

n112 E. MACKAAY, supra note 51, at 193-221 (justifying consumer protection legislation on the grounds that inadequately informed consumers are frequently exploited). But see

Schwartz & Wilde, supra note 103 (criticizing judicial intervention in consumer contracts if the basis for intervention is that consumers are imperfectly informed).

n113 U.C.C. § 2-719(3) (making prima facie unconscionable any limitation of consequential damages for personal injuries in the case of consumer goods); see also id. § 2-302 (giving broad discretion to courts to police unconscionable bargains).

n114 See Keeton, Insurance Law Rights at Variance with Policy Provisions (pts. 1-2), *83 HARV. L. REV. 961, 1281 (1970).* See generally 2 G. COUCH, INSURANCE § 21:1 (2d ed. 1959) (insurance contracts are regulated to protect the public).

n115 See, e.g., Insurance Code of 1937 § 224, ILL. REV. STAT. ch. 73, § 836 (amended 1982) (requiring certain provisions in life insurance policies); id. § 225, ILL. REV. STAT. ch. 73, § 837 (amended 1981) (prohibiting certain provisions in life insurance policies).

n116 See, e.g., *Slawson, Standard Form Contracts, supra* note 107, at 540.

n117 Compare *Hanna v. Commercial Travelers' Mut. Accident Ass'n, 204 A.D. 258, 197 N.Y.S. 395 (1922),* aff'd *236 N.Y. 571, 142 N.E. 288 (1923)* (barring recovery for the death of her husband, the insured, because the beneficiary failed to commence an action against the insurance company within the contractual time limit; she brought an action only when evidence emerged establishing that her husband, who had disappeared years before, had died) with *Semmes v. Hartford Ins. Co., 80 U.S. (13 Wall) 158 (1871)* (excusing the insured's failure to bring a lawsuit within the policy's time limit on the ground that the civil war had made compliance impossible). See generally Rakoff, supra note 93, at 1195-97 (finding contradictory outcomes when courts confront contracts of adhesion -- these contracts are at times overridden, but at other times, upheld).

n118 When standardized contracts are offered to consumers on a take-it-or-leave-it basis, they are commonly referred to as contracts of adhesion. See, e.g., Kessler, Contractions of Adhesion -- Some Thoughts about Freedom of Contract, *43 COLUM. L. REV. 629 (1943);* Rakoff, supra note 93, at 1176-77.

n119 See E. MACKAAY, supra note 51, at 107-18.

n120 See, e.g., Rakoff, supra note 93, at 1179 & nn.21-23; cf. Farber, supra note 42, at 331 (observing that consumers find it difficult not only to understand legal language used in warranties but also to place a value on such warranties).

n121 See *Slawson, Standard Form Contracts, supra* note 107, at 529-30; Rakoff, supra note 93, at 1189 n.57.

n122 The process of getting enough information to understand standardized forms is time-consuming and costly. See E. MACKAAY, supra note 51, at 107-18; cf. Stigler, The Economics of Information, 69 J. POL. ECON. 213, 223 (1961) (finding that buyers do not read all advertisements about the prices of various goods and sellers do not advertise all price changes for these goods because it is too expensive for buyers to keep currently informed and for sellers to provide current information).

n123 See K. LLEWELLYN, THE COMMON LAW TRADITION 362-71 (1960).

n124 Cf. Anderson, Conflicts of Interest: Efficiency, Fairness, and Corporate Structure, *25 UCLA L. REV. 738, 739-40* (arguing that specialized exchange forces members of society to rely on others to produce needed goods and services and also to make such goods and services available on fair terms).

n125 Cf. Note, supra note 108, at 1128-30 (concluding that when the information costs of assessing the risks of using a product are relatively high compared to the price of the product, a consumer "will rarely undertake even a cursory analysis of the safety hazards of" the product).

n126 See Murray, The Standardized Agreement Phenomena in the *Restatement (Second) of Contracts, 67* CORNELL L. REV. 735, 739-40 (1982).

n127 The general results of empirical evidence on risk-taking behavior indicates that

[f]or 'small' gambles that are repetitive, individuals are often risk-neutral . . . . There is no precise definition of 'small,' but it is clearly dependent on the resources available to the individual taking the risk.

Risk-seeking behavior is observed in settings where there is a threshold, or level of aspiration, which is important . . . .

Risk aversion is the most generally observed attitude toward risk for uncertain events whose consequences are significant. The existence of insurance markets attests to this behavior.

C. HOLLOWAY, supra note 5, at 412, cf. Friedman & Savage, supra note 65, at 279, 284-87 (discussing instances in which risk-averse and risk-seeking behavior arise).

n128 Llewellyn, What Price Contract? -- An Essay in Perspective, *40 YALE L.J. 704, 731 (1931);* see K. LLEWELLYN, supra note 123, at 362; E. MACKAAY, supra note 51, at 208-09.

n129 See K. LLEWELLYN, supra note 123, at 362. Adhesion contracts typically contain numerous protective clauses:

Encyclopedic force majeure clauses, for example, held to avoid the risks of aberrant events. Limits on liability for consequent damage allow the firm to reduce the risks that remain. Short time limits for making claims and filing suit facilitate the closing of accounts and reduce the need for contingency funds. Finally, if legal liabilities are set lower than the obligations that the firm recongizes in its actual practice, the gap can provide room to maneuver in the face of inevitable adversity.

Rakoff, supra note 93, at 1221.

n130 $ 5/hour X one hour/60 minutes X three minutes/passenger X 400,000 passengers =$ 100,000. Three minutes may be a low estimate and $ 5, a conservative sum. The company employee must not only be able to explain the legal effect of a limitation of liability but also be able to answer passengers' questions.

n131 In essence the consumer's problem is his comparatively small stake in the choices he makes in the market. They limit the amount of information processing he can rationally afford to undertake for his choices, they make him a comparatively poor risk bearer, and they restrict his desire to enforce his rights in the courts.

E. MACKAAY, supra note 51, at 217.

n132 See Kessler, supra note 118, at 631-32; Mueller, Contracts of Frustration, *78 YALE L.J. 576, 579-80 (1969).*

n133 A company with owner's equity of one million dollars would probably exhibit risk-neutral behavior with regard to the two courses of action, but a company with $ 25,000 in equity might show risk-averse behavior by choosing the certain recovery of $ 1000. The greater its equity position the more likely a company will be risk-neutral for a given-size risk. See A. POLINSKY, supra note 51, at 52 n.31.

n134 See 1 W. FELLER, AN INTRODUCTION TO PROBABILITY THEORY AND ITS APPLICATION 243-63 (3d ed. 1968) (discussing the laws of large numbers).

Consider a gamble in which there are two outcomes, one providing a reward of one million dollars, and the other resulting in death for the gambler. Suppose the toss of a fair coin, giving either heads or tails, is used to determine which outcome occurs. Assuming that the tosses are independent of each other, the probability of either heads or tails appearing is .5 for any single toss. Suppose the gamble states that the unfavorable outcome of death occurs if the number of heads appearing equals or exceeds 75% of the total number of tosses (or the number of tails appearing is equal to or less than 25%), and that the favorable outcome of a million dollars occurs if the number of heads appearing is less than 75%.

(SEE ILLUSTRATION IN ORIGINAL)

Whether a rational person will accept the gamble should depend on the probability that the unfavorable outcome of death will occur. If the probability is sufficiently small, many persons will choose to gamble.

For this hypothetical gamble, the probability of death decreases as the number of tosses increases. With four coin tosses, the probability of heads appearing in 75% or more of the tosses equals .3125, a significant possibility. See C. HOLLOWAY, supra note 5, at 227-34, 500-06 (discussing the binomial distribution). With 20 tosses, the probability reduces to nearly .021, a small but still noticeable possibility. See id. And with 100 tosses, the probability diminishes to approximately one-in-three million, an impossibility by everyday standards. See id. at 239-44, 513-14 (discussing the normal distribution and the normal approximation to the binomial distribution). Obviously, the higher the number of tosses the greater the tendency for a rational person to gamble. Although most individuals would avoid the gamble with four tosses, they should accept it with 100 tosses; after all, the chance of one-in-three-million is less than that of many other lethal risks in daily life.

n135 See C. HOLLOWAY, supra note 5, at 402-05.

n136 Furthermore, if the variation in the expected loss is sufficiently small, a merchant may even find it profitable to increase the expected number of unfavorable outcomes. A retailer of stereo systems may decide to increase his sales by relaxing the credit standards for his customers. He may calculate that his total profits will increase even though proportionally more bad (nonpaying) accounts will also result. Suppose the merchant arrives at his optimum sale quantity by the following calculations:

1) Total Profit	=	total revenue -- total cost
	=	(price) (quantity) -- (cost) (quantity)
	=	PQ -- CQ.

One simplistic assumption here is the linear cost curve.

2) But 1), supra, must be adjusted to account for losses from bad debts. The merchant believes the loss factor to be L = .001Q, so that the total losses from bad debts would vary with the number of sales:

Total Number Of Losses From Bad Debts = QL = .001QX[2].

This assumes that the rate of increase of losses exceeds the rate of increase for sales, a plausible assumption if a business becomes less selective about its customers. This also assumes among other thngs that all bad accounts are totally written off, a deadbeat fails to pay for any amount of the purchase price, and no recovery by way of lawsuit for damages or replevin is possible.

3) Thus, the adjusted total profit function is

Total Profit	=	total revenue -- total cost
	=	PQ(1-L) -- CQ.

4) Assuming the sale price to be $ 1000 and the product cost, $ 900:

Total Profit	=	1,000Q -- 900Q
	=	100Q (.001Q[2]
	"	100Q -- Q[2].

5) It can be shown graphically that the merchant should sell Q = 50 stereo systems to obtain the maximum profits (of $ 2500). Alternatively, if the Total Profit function, TP, meets certain conditions, differential calculus may be applied:

$f'(TP) = 100\text{-}2Q = 0$ results in $Q = 50$, and

$f''(TP) = -2$ results in $Q = 50$ being optimum.

See 1 T. APOSTOL, CALCULUS §§ 4.16-17 (2d ed. 1967); G. THOMAS & R. FINNEY, CALCULUS AND ANALYTIC GEOMETRY §§ 3-5, -11 (5th ed. 1979).

Although his decision to increase sales will also increase the absolute number of defaults, the large number of sales enable him to treat the expected losses and profits as relatively certain and cause him to behave as if he were risk-neutral to the inevitable occurrence of consumer defaults.

n137 See generally Kennedy, Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power, *41 MD. L. REV. 563, 614-24 (1982)* (examining whether unequal bargaining power in contract or tort cases justifies society's protection of the party with weaker bargaining power); *Schwartz, supra* note 105 (arguing that the concept of unequal bargaining power has no useful definition and should be disregarded by the courts).

n138 On the other hand, despite his awareness of the contract risks, a consumer may be unable, whether intellectually or emotionally, to evaluate properly the probability that the risks will occur and therefore may discount the risks excessively. See G. CALABRESI, supra note 46, at 56; Farber, supra note 42, at 331-32 (concluding that consumers have limited ability to process information about risks); cf. Eisenberg, The Bargaining Principle and its Limits, *96 HARV. L. REV. 741, 763-73 (1982)* (observing that a party's lack of experience, education, or insight affects his ability to make a deliberate and well-informed judgment concerning the desirability of entering into a complex transaction). But see Note, supra note 108, at 1130-32.

n139 "Firms . . . commonly respond to consumers in the aggregate and not as individuals." Schwartz & Wilds, supra note 108, at 1462. Perhaps this is why the Restatement, in the case of standardized agreements, treats "alike all those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing." RESTATEMENT, supra note 7, § 211(2); see also id. comment e (equality of treatment for all who sign standardized agreements). See generally Murray, supra note 126 (comparing the treatment given by the RESTATEMENT, supra note 7, and the U.C.C. to the problem of standardized agreements).

n140 See generally E. MACKAAY, supra note 51, at 193-221 (using economic analysis to show that a consumer's risk aversion and informational disadvantages lead to his exploitation).

n141 This kind of clause typically provides that the consumer agrees to assert any claim or defense only against the merchant or contractor and not against any assignee of the contract such as the bank. See, e.g., *Block v. Ford Motor Credit Co., 286 A.2d 228, 230 (D.C.*

1972); RESTATEMENT, supra note 7, § 336 comment f and illustrations 10-11; U.C.C. § 9-206(1). The holder-in-due-course doctrine accomplished the same effect by allowing the bank to take a promissory note free of all claims and most defenses. See U.C.C. § 3-305.

n142 See, e.g., *Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E. 2d 847 (1964).*

n143 Today court decisions, state laws, and federal administrative rules have substantially eroded the bank's position. See, e.g., *Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967);* Uniform Consumer Credit Code § 3.404 (1974) (assignees take consumer paper subject to consumer claims and defenses) (different versions of the Code have been adopted in over ten states); FTC Holder-In-Due-Course Regulations, *16 C.F.R. § 433.2 (1983)* (preventing the holder-in-due-course doctrine from applying when consumer contracts are involved); see also Rohner, Holder In Due Course in Consumer Transactions; Requiem, Revival, or Reformation?, *60 CORNELL L. REV. 503 (1975)* (reviewing the Holder-In-Due-Course doctrine's impact upon consumers).

n144 See, e.g., RESTATEMENT, supra note 7, § 336(1); U.C.C. § 9-318(1).

n145 The consumers would then be able to avoid making payments on the contracts and to obtain refunds on any payments made to the bank.

n146 See supra note 63.

n147 See A. POLINSKY, supra note 51, at 51-53. See generally Coase, supra note 86 (under certain ideal conditions such as zero transactions costs, a party who values a particular legal right the most will ultimately obtain it regardless of whether another party is initially given that right; this outcome results in the efficient allocation of resources).

n148 The bank not only must overcome the difficulty consumers face in understanding the legal effect of deleting the waiver clause but also must cure a frequent consumer inability to comprehend the probability of a risk's occurrence and thus to assess the value of the risk's removal. Cf. Farber, supra note 42, at 329-33 (discussing problems consumers have in acquiring and processing information about product warranties).

n149 See, e.g., Schwartz & Wilde, supra note 103, at 659-61.

n150 See, e.g., Arrow, Limited Knowledge and Economic Analysis, *64 AM. ECON. REV. 1, 6 (1974)* ("[w]hen there is uncertainty, risk aversion implies that steps will be taken to reduce risks").

n151 See Calabresi, Transaction Costs, Resource Allocation and Liability Rules -- A Comment, *11 J. LAW & ECON. 67, 69-70 (1968).* Although the preceding text provides an example in which efficiency is achieved by the enforcement of a default rule (despite the presence of a contrary clause), this Article makes no claim that, in general, default rules should prevail over contrary clauses on efficiency grounds. Rather, in analyzing a case before it, a court must determine that the enforcement of a default rule clearly promotes efficiency before rendering a contrary clause unenforceable. For a critique of two divergent views on the efficiency of enforcing contract terms, see Note, Efficiency and a Rule of "Free Contract": A Critique of Two Models of Law and Economics, *97 HARV. L. REV. 978 (1984)* (criticizing the "Chicago" and "Liberal" models of the economic analysis of contract law).

n152 See Schwartz, Optimality and the Cutoff of Defenses against Financers of Consumer Sales, *15 B.C. INDUS. & COM. L. REV. 499 (1974);* cf. Posner & Rosenfield, supra note 85, at 89-93 (arguing that efficiency requires allocating risk to the superior risk bearer).

n153 Requiring the bank to act as an insurer against some contract risks exposes it to common problems of insurance such as adverse selection and moral hazard. Adverse selection occurs when the availabilty of "insurance" attracts parties who face a greater likelihood than other insured parties that the risk insured against will materialize. For example, the more careless a person, the more likely he is to buy products which carry a lifetime guarantee. And the greater the incidence of adverse selection by the higher risk parties, the more the lower risk parties will pay for insurance. Moral hazard occurs when the purchase of "insurance" increases the probability that the risk insured against will materialize. For instance, if a consumer purchases a product whose manufacturer guarantees satisfaction or a complete refund, the consumer might become more careless in using the product, and consequentially may damage it. He may then demand his money back if he is no longer satisfied with the product. And if the likelihood of the risk increases, the insurance premiums will also increase. See E. MACKAAY, supra note 51, at 176-80 (observing that adverse selection and moral hazard limit the effectiveness of insurance); W. SHARPE, supra note 29, at 55-56 (same). See generally Pauly, The Economics of Moral Hazard: Comment, *58 AM. ECON. REV. 531 (1968)* (discussing the problem of moral hazard in medical insurance programs); Arrow, The Economics of Moral Hazard; Further Comment, *58 AM. ECON. REV. 537 (1968)* (emphasizing the importance of nonfinancial incentives in combating moral hazard).

n154 Cf. *Hudson County Water Co. v. McCarter, 209 U.S. 349, 355 (1908)* (Holmes, J.) ("All rights tend to declare themselves absolute to their logical extreme. Yet all in fact are limited by the neighborhood of principles of policy which are other than those on which the particular right is founded, and which becomes strong enough to hold their own when a certain point is reached.")

n155 See, e.g., D. DOBBS, supra note 12, § 2.4, at 49-52 (explaining the demise of the mutuality of remedy doctrine); E.A. FARNSWORTH, supra note 7, § 7.3 (analyzing the erosion of the parol evidence rule).

n156 Gilmore, Law, Logic and Experience, *3 HOW. L.J. 26, 26 (1957);* cf. O. W. HOLMES, THE COMMON LAW 1 (1881) ("[t]he life of the law has not been logic: it has been experience").