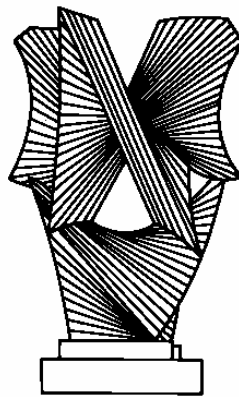


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## A Bargaining Power Theory of Gap-Filling

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# A BARGAINING POWER THEORY OF GAP-FILLING

*Omri Ben-Shahar*<sup>\*</sup>

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## Abstract

This article explores the merits of a new criterion for default rules in incomplete contracts: fill the gaps with terms that are favorable to the party with the greater bargaining power. It argues that some of the more common gaps in contracts involve purely distributive issues, such as the contract price, for which it is impossible to choose a unique, joint-maximizing, “most efficient” term. Rather, the term that mimics the hypothetical bargain in these settings must be sensitive to the bargaining power of the parties—the term they would have chosen to divide the surplus in light of their relative bargaining strength. The article explores the justifications for such a bargain-mimicking principle, the ways it can be implemented by courts, and the subtle ways it is already in place.

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## INTRODUCTION

How to fill gaps in incomplete agreements is perhaps the most important question in contract law. It is important because interpreting and supplementing contracts is what courts often do, but also because the default rules set by law determine how contracts will be written. Providing a coherent answer to this question of how to fill gaps is also where the economic approach to contracts had its greatest success.

The most broadly accepted principle of gap filling is ‘mimic the parties will.’ Only gap-fillers that mimic what the parties themselves would have chosen would be allowed by the parties to remain in place and survive opt-out; and they will reduce the unnecessary costs of drafting.<sup>1</sup> Of course, the notion of the parties’ will is hypothetical. Because the contract contains a gap, we don’t know what they would have consented to. It is here that the economic approach provides another, very powerful, insight: the parties’ will is to have the most efficient arrangement. Thus they are best served by default rules that maximize the contractual surplus.<sup>2</sup>

The idea that gap-fillers should be the surplus maximizing terms is based on the following well-known logic. If the parties are rational—so goes the argument—they would have agreed upon terms that maximize their joint surplus, irrespective of the distributive impact of such terms. Further, they would have corrected for the distributive effects of the surplus maximizing terms by an appropriate adjustment of the

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<sup>1</sup> Richard Craswell, *Contract Law: General Theories* in III ENCYCLOPEDIA OF LAW AND ECONOMICS 1, 3-4 (2000).

<sup>2</sup> RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 98 (6th ed. 2003) (“[C]ontract law cannot readily be used to achieve goals other than efficiency. A ruling that fails to interpolate the efficient term will not affect future conduct; it will be reversed by the parties in their subsequent dealings. It will only impose additional—and avoidable—transaction costs.”). See also FRANK EASTERBROOK AND DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 17-22 (1991); Alan Schwartz and Robert Scott, *Contract Theory and the Limits of Contract Law*, 113 *Yale L. J.* 541, 554-5 (2004); FARNSWORTH, *CONTRACTS* 486 (4<sup>th</sup> Ed. 2004) (courts are to provide terms “that an economist would describe as maximizing the expected value of the transaction”); Mark P. Gergen, *The Use of Open Terms in Contract*, 92 *Colum. L.Rev* 997, 1064-72 (1992) (the default rule should be a joint maximization rule.)

contractual price or of another purely distributive term. But notice that for this theory to be valid, it must assume that there is at least one term in the contract to which the theory does not apply—the term that the parties use to make the appropriate distributive adjustments—usually, the price term. The content of the purely distributive terms is not determined by the surplus maximizing criterion; it is surplus-neutral. Rather, the content of the purely distributive term is determined by the bargaining power of the parties. In other words, the surplus maximizing conception of gap-filling is, by definition, insufficient to resolve all gaps: it does not resolve gaps in the price term or in any other term in the contract that is purely distributive.

Thus, there is a troubling paradox surrounding the basic criterion of gap filling. It assumes that the parties' joint will exists—that there is a single term such that, if only the parties spent the time and attention dealing with the gap, they would have jointly desired the surplus-maximizing term. Yet the existence of a gap in a contract is often an indication that a consensus could be reached—that a single jointly preferable term does not exist. That is, the gap in the contract is often surrounding a purely distributive issue—the one over which the parties interests diverge. Ironically, many of the cases in contracts casebooks that introduce the topic of indefiniteness and gap-filling involve purely distributive gaps over issues such as price, for which the prescription “choose the terms that maximize the total surplus” does not provide a definite solution.

For example, in *Oglebay Norton v. Armco*, two large companies had a long-term relational contract for transportation of iron ore.<sup>3</sup> The term that ended up in the center of a bitter dispute was none other than the price. Their agreement originally had a price formula, but over time this formula failed and needed to be revised. When the parties turned to the court to help fill the price gap, there was no single term that reflected “market price” which the court could invoke (indeed, if there were such price, they would not need the court to supply it). Of course, there was no “surplus maximizing” price to fill the gap because the price is surplus-neutral. The court had to supply a “reasonable” gap-filler that is

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<sup>3</sup> *Oglebay Norton Co. v. Armco, Inc.*, 556 N.E.2d 515 (S.Ct. Ohio, 1990), reprinted in IAN AYRES AND RICHARD E. SPEIDEL, *STUDIES IN CONTRACT LAW* (7<sup>th</sup> Ed. 2008).

purely distributive. It ended up doing so in part by splitting the difference and in part in a creative and unorthodox manner (forcing the CEOs of the companies to meet and mediate the future price). And yet, the difficulty that the court encountered and the ad-hoc solution it found merely emphasize the absence of a systematic solution—the absence of rational criterion for filling such gaps. The purpose of this paper is to begin developing a systematic new gap-filling criterion for these distributive price gaps.

The proposed criterion, which I label the “bargain mimicking” gap filler, is consistent with the fundamental norm of mimic-the-the-parties’-will. In the case of purely distributive terms there is no joint will: each party’s will is to have a term at the more favorable end of the reasonable range of terms. What we need, then, is more information about the way the parties would have resolved the a-priori conflict of their wills. Namely, what the court needs is information to mimic the *bargain*: the division of the surplus that would have been struck between these parties, given the allocation of bargaining power. Since this division of bargaining power can be uneven, the gap filler can be different than the mid-range “market” term. It would favor the strong party—the one whose will would have more likely prevailed if an explicit bargain were to be struck. Purely distributive gaps would be filled with terms favorable to the party with the greater bargaining power.

It might seem, at first blush, that this criterion is counter-intuitive and ought to be rejected as unfair. I will defend its more subtle appeal in this paper, but the core claim is perhaps more intuitive than initially seems, and can be illuminated with an example from a non-legal setting. Take, for example, an incomplete command issued by a parent to a child (“mow the lawn”). If imperfectly specified, it needs supplementation (“only the front yard” v. “both front yard and back yard”), and more than one reasonable version can be offered. Still, if it is the parent that has the “bargaining power”—the power to dictate the command—then the precise term that ought to apply is the one that is consistent with the meaning intended by this stronger party. The parent can reasonably say to the child: “You knew or should have known what I meant,” implying that the parent’s will, by virtue of being dominant, is the controlling source of interpretation. In fact, such interpretive method would render it

unnecessary for the parent to explicitly state the meaning, and there are benefits to using minimal language. To be sure, in this example I am not talking about a legal gap filler but rather about an informal norm that governs the intra-family communications, but their function is the same—to supply a default content to an otherwise ambiguous provision, and they do so in a way that mimics the will of the party with the power to dictate.

It is not always clear that courts can figure out, *ex post*, how bargaining power was divided before the contract was concluded. The parent/child example is (in most cases) misleadingly easy, whereas the notion of bargaining strength in commercial relations is more elusive. The paper explores what it is exactly that courts would need to determine and whether they have the institutional capacity to do so. It will also argue that in a subtle way courts, when filling price gaps, are already sensitive to the division of bargaining power. For example, when courts need to determine what is a “reasonable” price under §2-305(1) of the Uniform Commercial Code, they can choose to let one party have more influence in choosing where, within a broad range, this price would lie. This is often done when courts observe that the choosing party is the one with the greater bargaining power.<sup>4</sup>

Part I of this paper introduces the idea of bargain mimicking gap fillers. It explores the conceptual basis for this idea, how it relates to other criteria of gap filling, and when it may be regarded as the natural substitute for the otherwise compelling, but indeterminate principle of maximize-the-joint-surplus. Part II explores the normative grounding for this regime. It is not an easy task. Admittedly, there is something objectionable about a legal rule that favors the strong party, the party with the greater bargaining power. Bargaining power is hardly a compelling conception of distributive fairness. Legal rules that favor the weak party, that level the playing field, are usually more appealing. But in the law of gap filling, I argue in Part II, bargaining power trumps this normative predisposition. Default rules that try to upset the potential bargaining outcome are undesirable—they are a futile effort—and I

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<sup>4</sup> See, e.g., *Curtis Co. v. Mathews*, 653 P.2d 1188, 1191 (Id. 1982), reprinted in ROBERT E. SCOTT AND JODY S. KRAUS, *CONTRACT LAW AND THEORY* (4<sup>th</sup> Ed. 2007) (a middleman was allowed to set the price of grain bought from farmer).

provide examples from actual drafting of contracts to highlight this point. The analysis shows that the traditional justifications for default rules—saving of transactions costs, facilitating entry into desirable forms of relationship, and inducing optimal reliance—carry over to the bargain-mimicking conception of gap filling.

Part III of the paper identifies the existence of bargain-mimicking gap-fillers in contract law. It demonstrates how this idea was implemented in leading cases, although without courts always recognizing the fact that their decisions conform to the underlying bargain-mimicking conception. The purpose of this inquiry is to elevate the bargain-mimicking theory to a positive account. Courts actually do this, I argue, suggesting that it is not institutionally impossible to base a legal rule on a criterion as elusive as *relative bargaining power*. This section also highlights situations in which the bargain-mimicking idea was rejected, thus recognizing that the bargain mimicking idea conflicts with other, well-rooted principles.

Finally, Part IV offers one extension of the analysis by introducing the problem posed by excessive terms—terms that go beyond some mandatory threshold of permissible contracting. When such excessive terms are struck down and need to be replaced, courts may view the problem as one of gap-filling. Here, it is generally clear that one party holds greater bargaining power (which he used to dictate the excessive term). A bargain-mimicking term would maintain maximal loyalty to the bargain struck between the parties. It would fill the gap with a term that is maximally tolerable: a term that is still one-sided, still favorable to the same party who dictated the original one-sided term, but moderated sufficiently so that it would be *tolerable*. Instead of substituting the offensive term with the most balanced “majoritarian” term, the court would reduce it only so much as to fit it within the range that is considered legitimate. The court would mimic the hypothetical bargain that parties *negotiating over a truncated domain* would reach. I argue (and develop this argument further in a companion paper) that this idea of using maximally tolerable terms is surprisingly prevalent in the law.<sup>5</sup>

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<sup>5</sup> See Omri Ben-Shahar, *How to Repair Unconscionable Contracts* (Mimeo. 2008).

## I. BARGAIN-MIMICKING TERMS

### A. No Joint Will

There is a troubling paradox surrounding one of the most basic tenets of contract law, that gaps in contracts should be filled with term that mimic the will of the parties—terms that most parties would have jointly chosen. On the one hand, this conception of gap-filling makes basic sense: it minimizes the need of the parties to contract around the default rule and it spells out performance provisions that maximize the parties' joint well being. But on the other hand, the mimic-the-parties'-will principle assumes that the parties' joint will exists. It assumes that there is a single term such that, if only the parties spent the time and attention dealing with the gap, they would have jointly supported the drafting of this term. Yet the existence of a gap in a contract is often an indication that a consensus could be reached—that a single jointly preferable term does not exist. The claim from which the analysis in this paper begins is that there are situations in which more than one term satisfies the standard conception of the joint will of the parties. If so, absent a more powerful prescription, the mimicking principle would be indeterminate, too amorphous to fill the gap.

The problem with the joint will principle of gap-filling, and the reason it is indeterminate, comes from the fact that the conception of joint will that is normally articulated is one of maximization of surplus. If the parties didn't specify explicitly what they want, it is safe to assume that they would have wanted the terms that maximize their joint surplus.<sup>6</sup> Or else, it is sometimes said, they would have left "money on the table." This, irrespective of the distributive impact of such terms, because the parties are able to (and probably did) correct for the distributive effects

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<sup>6</sup> This intuitive proposition was developed in the early work of Goetz and Scott. *See, e.g.*, Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Robert E. Scott, *Rethinking the Default Rule Project*, 6 VA. J. 84, 94 n.4 (2003) ("[C]hoosing a default rule on the basis of some normative conception of fairness would be wrong, in the sense that it would not increase the amount of fair contracts in the world, but it would increase the amount of contracting costs.").

of the surplus maximizing terms by an appropriate adjustment of the contractual price or of another purely distributive term.<sup>7</sup> But notice that for this theory to be valid, it must assume that there is at least one term in the contract to which the theory does not apply, one term that is purely distributive—the price term. The existence of such term is necessary for the surplus-maximization criterion: it guarantees that gap-filling according to this criterion will not undermine the distributive consequences of the deal.

Put differently, contract design involves two tasks: creating the pie, and dividing it (many terms affect both aspects). In creating the pie, surplus maximization is normally the dominant norm. Once the pie is created, through the combination of express terms and surplus maximizing gap-fillers, it has to be divided and the term that accomplishes this aspect has no bearing on the size of the pie. If one of the distributive terms is missing from the agreement, the surplus maximizing conception of gap-filling would, by definition, be indeterminate in supplementing it. So what do we do if the gap involves one of these distributive aspects?

The basic reason to doubt whether there is one joint will that can potentially be mimicked when the gap involves a distributive issue is that the parties have opposite interests in resolving this issue. In these settings, it is impossible to articulate solely on the basis of economic efficiency what term the parties would have chosen. The process of reaching agreement over distributive elements is resolved by bargaining, and is thus determined by ad-hoc factors that affect the parties' bargaining power and how this power was applied with respect to other elements of the deal. Filling distributive gaps, then, is not an exercise in maximization of surplus or in figuring out the optimal design of the transaction, but in guessing out how the surplus would have been divided.

Consider for example, a sale contract that does not specify payment terms. There are many ways to supplement this gap but it can hardly be

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<sup>7</sup> RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 96-97 (7th ed. 2007) (“Each party wants to maximize his gain from the transaction, and that is usually best done by agreeing to terms that maximize the surplus created by the transaction – the excess of benefits over costs, the excess being divided between the parties.”)

said that they affect the “size of the pie.” In many cases, whether payment is made before, during, or after delivery, is merely a matter of the time value of money and would affect the well-being of the parties in a zero-sum fashion. There is no more or no less efficient arrangement; the only effect is distributive. There is no joint will to mimic: earlier payment is usually preferable to the seller to the same extent that it is detrimental to the buyer. The seller has one will, the buyer has another.

How could it be, you might wonder, that parties entered a binding contract without specifying the surplus division, leaving the price term out? Is this scenario realistic? Ironically, some of the most prominent cases on contractual indefiniteness are ones in which the gaps in the agreement involved price terms—the one term that by definition has purely distributive effect. For example, one leading case discusses a lease of commercial property with an option to renew that contains a gap—the renewal price is missing (needs “to be agreed upon”).<sup>8</sup> Another classic case, *Sun Printing v. Remington Paper*, involves a sale contract that contains an indefinite price formula.<sup>9</sup> Yet another well-known case deals with a contract in which the price was deliberately left out and yet the court was more than ready to supplement it.<sup>10</sup> Another casebook teaches gap-filling through a case in which the payment and credit terms—elements that are purely distributive—are not fully specified.<sup>11</sup> Further, Sales Law casebooks normally devote a substantial chapter to the case law regarding commercial contracts (usually between sophisticated parties) with a missing price—a scenario fully anticipated by Section 2-308 of the Uniform Commercial Code.<sup>12</sup>

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<sup>8</sup> Joseph Martin, Jr., *Delicatessen, Inc. v. Schumacher*, 417 N.E. 2d 541 (N.Y., 1981). In that case, the court refused to fill the gap and held that the contract was too indefinite to be enforced. But the growing trend is to enforce such contracts. See, e.g., *Validity and Enforceability of Provision for Renewal of Lease at Rental to Be Fixed By Subsequent Agreement of the Parties*, 58 A.L.R.3d 500 (1974)

<sup>9</sup> *Sun Printing & Publishing Assn. v. Remington Paper & Power Co.*, 139 N.E. 470 (NY 1923) (reprinted in BARNETT, *CONTRACTS CASES AND DOCTRINE* 404 (3d Ed. 2003).)

<sup>10</sup> *Mantell v. International Plastic Harmonica Corp.*, 55 A.2d 250 (NJ 1947) (quoted in FARNSWORTH, *CONTRACTS* 209-210 (4<sup>th</sup> Ed. 2004).)

<sup>11</sup> *Southwest Engineering Co. v. Martin Tractor Co.*, 473 P.2d 18 (Kan. 1970) (reprinted in SUMMERS AND HILLMAN, *CONTRACT AND RELATED OBLIGATION* 735 (4<sup>th</sup> Ed. 2001).)

<sup>12</sup> Cite

There might be—in fact, there is—a debate whether such distributive gaps render the contracts too indefinite to be enforced. The missing price, it can be argued, is a conclusive indication that the parties have not yet intended to be bound, having left the most essential term for further assent. And yet, modern contract law tends to conclude that a missing price does not render the contract unenforceable, if there is independent indication of intent to be bound.<sup>13</sup> In these situations, there is a binding contract with a substantial gap and the gap-filler cannot be determined by reference to the term (the price) that maximizes the total surplus. Every price, at least within a fairly broad interval, satisfies this criterion.

True, many aspects of the contract that are primarily distributive also have effect on total surplus. But it is false to conclude that gap fillers for all these aspects can be set to maximize the surplus. As I mentioned at the outset, the only reason that a sub-set of the gap fillers can indisputably be surplus-maximizing is that there are other aspects of the deal—at least one—that are purely distributive, which can be used to achieve the bargained-for distribution of value.

The observation that the surplus-maximization conception is potentially indeterminate is reinforced by an account why contracts are indefinite. Negotiations—the bargaining and haggling over the terms—require time, effort, strategy, and often fail, not because parties are under-trained in solving maximization exercises. The failure to reach agreement and to conclude the negotiations is not a result of some difficulty in cracking a mathematical equation, or of the limits of the parties' ability to foresee and imagine contingencies. Rather, negotiations are hard precisely where the issue is distributive, when there is no single maximizing term over which an agreement would naturally arise. Workers go on strikes because of disagreements on zero-sum wage terms; Nations go to wars because of disputes over zero-sum boundary lines; and merger agreements fail when the price offered by the buyer is regarded by the shareholders as not high enough. The irony is that negotiations are harder and more likely to fail when the issues are purely distributive. For these

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<sup>13</sup> UCC 2-305; FARNSWORTH, CONTRACTS 207-211 (4<sup>th</sup> Ed. 2004).

issue, the “engine” of increased surplus does not provide a focal point for agreement.

Still, even when parties fail to resolve a distributive term, they might nevertheless choose to enter a binding contract, and leave the term open or subject to an agreement to agree. I have explored elsewhere why they choose this strategy.<sup>14</sup> In a nutshell, they may do so because they expect an agreement to be more likely be attained at a future point in time, when walking away from the deal would become costlier. Or, they may leave price gaps to be resolved later because they expect that some contingency would materialize, making the distributive issue moot or easier to resolve in reference to market indices. Or, they may expect that upon failure to resolve the issue they will have a mechanism to arbitrate or split the difference. In all these cases, courts may face a reality in which the disputing parties entered a binding contract but left a crucial distributive term out.

### **B. Mimic One Party’s Will**

As a mechanism for gap filling, the surplus-maximization principle is easy to justify. It improves the well being of both parties; it gives them what they would rationally have chosen, ex-ante. If a distributive gap cannot be filled with a surplus maximizing term, it may nevertheless be possible to provide a similarly justified gap-filler, one that solves the problem of what the parties would have chosen ex-ante.

In the case of distributive terms, the parties do not have a joint interest, ex ante. To be sure, consensus over distributive issues can emerge, but it would be a result of bargaining and maneuvering, in the shadow of market conditions. The argument, therefore, is that the central conception of what the joint will is—the term that maximizes the surplus from the transaction—must be supplemented by a criterion that would apply to settings that are purely distributive. Luckily, courts often have information that can help them tease out what the parties would have agreed upon: information about the relative bargaining power.

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<sup>14</sup> Omri Ben-Shahar, *Agreeing to Disagree: Filling Gaps in Deliberately Incomplete Contracts*, 2004 Wisc. L. Rev. \_\_\_.

When the interests of the parties concerning a particular term are conflicting, the term that the parties would have agreed upon depends on *the allocation of bargaining power*. If one party had a significant bargaining power advantage, he would have been able to dictate a one-sided term, and thus the gap-filler should favor that party. If, instead, the parties have equal bargaining power, the gap-filler should resemble the split-the-difference, mid-range term. Generally, a gap-filler that depends on any information the court has regarding the relative bargaining power at the time of the contract is a superior proxy for the missing term. Call this gap-filler a ‘bargain-mimicking’ default rule. Unlike standard mimicking terms—the familiar surplus maximizers—the key feature of bargain-mimicking terms is their sensitivity to bargaining power factors, namely, factors that affect the division of the contractual surplus.

Thus, for example, in the context of a missing payment term, the bargain-mimicking gap-filler would potentially favor the party that was in a bargaining position to force the other to acquiesce and surrender to her dictates. Unlike mid-range, split-the-difference default terms that reflect, say, the average interest rate or the most common credit arrangement, the bargain mimicking term could fall anywhere within a broad interval and could be significantly different than the mid-range solution. The greater the seller’s bargaining power, the higher the interest rate and that would be supplied by the gap-filler. And conversely, the greater the buyer’s bargaining power, the more lenient the credit terms.

Another example for a gap-filler that would tilt in favor of one party comes auto manufacturing contracts. Sellers, known as “tier-1” suppliers, compete through a bidding process to produce auto parts to be assembled into a car model manufactured by an automaker. Because there are only a few automakers but many suppliers, the buyer in this setting has much of the bargaining power, and indeed once the supplier is selected and the price is set, the buyer dictates all the remaining terms of the contract, including price adjustments over time.<sup>15</sup> The standard form contracts, however, are short and contain many gaps. For example,

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<sup>15</sup> See Omri Ben-Shahar and James J. White, *Boilerplate and Economic Power in Auto Manufacturing Contracts*, 104 Mich. L. Rev. 953 (2006).

they often leave unspecified the price under which “service parts” will be sold. Service parts (which are repair parts sold to dealers and car owners in the retail market for a substantial premium) are a significant source of profits, but how should this surplus be divided between the automaker and the parts supplier in the absence of specific agreement?<sup>16</sup> Here, there is no “market” term to refer to. A mid-range, split-the-profit price, is one way to fill the gap. Of course, it does not reflect the true bargaining power of the parties and does not come close to mimicking the express deal they would have reached (the deal the buyer would have dictated, and that some automakers do in fact dictate.) The bargain-mimicking gap filler would supply a price that accords the greater share of the premium to the buyer.

Notice that the content of the bargain-mimicking gap-filler is “tailored”—it depends on factors that are specific to the parties. The same contract, with the same gap, can be filled with a pro-seller term in one case and a pro-buyer term in another, depending on the relative bargaining power in each case. For example, a lease with an option to renew under a price to be agreed upon would be supplemented with a high, pro-landlord price if the landlord happens to enjoy greater bargaining power (say, because of migration of many tenants into the region). The same lease would be supplement with a low, pro-tenant price if the tenant is the party with the greater bargaining power (say, because of the presence of many vacant sites in the area.) Or, a regional supplier who sells to WalMart would have its contract filled with a pro-buyer term, whereas the same supplier selling to a local business that has no other sources of supply would enjoy a pro-seller gap filler.

In an interesting way, bargain-mimicking gap fillers share the same empirical premise, and also can be contrasted with, the *contra proferentum* principle. Both principles envision situations in which one of the two parties has the bargaining power to dictate the language of the terms and yet this party left some element ambiguous or unspecified. That is, both principles require a determination of relative bargaining power.<sup>17</sup> But at the same time, the bargain-mimicking principle provides

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<sup>16</sup> See, e.g., Toyota Motors Manufacturing N.A., Inc. Term and Conditions § 4.2 (Oct. 1988) (leaving the price for service parts to be determined later).

<sup>17</sup> Cite from insurance cases – insurer has all the bargaining power.

the opposite prescription relative to *contra proferentum*. When a contract is ambiguous or indefinite, the *contra proferentum* principle prescribes the term that is *least favorable* (within reason) to the party who drafted the contract. The bargain-mimicking principle does the opposite: it supplies the term that is *most favorable* to the drafter, the term that resembles the deal that the drafter was able to dictate. While the *contra proferentum* doctrine relies on the notion that the strong party should be “punished” for leaving ambiguity or indefiniteness in the contract,<sup>18</sup> the bargain-mimicking principle gives the strong party what she could have gotten explicitly through bargaining. The normative case for the *contra proferentum* rule is well known. Part II of the paper examines the normative case for the bargaining mimicking approach.

### C. Majoritarian versus Bargain-Mimicking Terms

The bargain-mimicking conception of gap-filling breaks a discontinuity that is otherwise created by mid-range, majoritarian gap-fillers. If all gaps are filled with mid-range terms, a decision by the strong party to leave a gap in the contract as opposed to filling it with a bargained-over express term would result in an expected forfeiture of a discrete chunk of the private payoff. For this party, the choice to leave the contract with a gap might well save some transactions costs, but would at the same time cost her the opportunity to exploit her bargaining advantage and to appropriate a clause that is more favorable to her than the mid-range default rule. The agreement that results from mid-range gap-filling is distinctly different from that which she would have expressly negotiated; the more gaps she leaves, the greater the wedge between the hypothetical agreement and the legally supplemented contract. It is this discontinuity—the divergence between the hypothetically negotiated deal and the legally-implied deal—that the proposed conception of gap-filling resolves. The closer the gap-fillers are to the hypothetical bargain, the smaller the divergence.

It is clear that in many distributive contexts the bargain mimicking criterion would prescribe terms that are generically different from the

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<sup>18</sup> See, e.g., Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 Mich. L.Rev. 531, 545 (1996); Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 91 (1989).

majoritarian, mid-range reasonable terms. The majoritarian criterion recognizes that different parties could have perhaps reached different reasonable terms; namely, that there is a distribution of bargained-for terms. It chooses a term that measures a “center” of this distribution. Unlike the majoritarian criterion, the bargain-mimicking criterion relies on specific information indicating the deal that *these* parties would have struck, reflecting the division of bargaining power.

Still, it would be a mistake to conclude from this discussion that the bargain-mimicking gap-fillers would always diverge from the majoritarian, mid range, gap-fillers. The two gap-filling criteria may be reconciled—they may prescribe the same content of gap filler—in situations in which the bargaining positions of the parties are the common positions that similar parties in similar situations have. These are situations in which information about the specific parties’ bargaining does not change the inference about the hypothetical bargain. For example, if the parties are “price-takers”—if they are dealing in matters for which there is a thick market and neither of them is in a unique position within this market—it is likely that the term they would agreed upon is the same term most parties in the market adopt. If, say, bargaining power is determined by outside options, and if there is a thick market of alternative partners for each party, the terms of that bargain are influenced by the terms in that market. Here, the bargain-mimicking principle would prescribe a term that reflects the market term—the same term prescribed by the majoritarian criterion. But it would do so, not because this term best reflects some statistical regularity regarding the market, but rather because it is the best guess as to each parties’ share of purchasing power. Put differently, majoritarian gap fillers that refer to “reasonable market prices” can be viewed as consistent with the bargain-mimicking criterion, applied to specific situations in which the bargaining power of the parties is determined by the market.<sup>19</sup>

To illustrate, consider one of the well-known cases in which parties left the price term open.<sup>20</sup> This was a long-term distribution agreement between a wholesaler and a distributor. The agreement did not fix the

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<sup>19</sup> James Gordley, *Foundations of Private Law* 363 (2006) (“the market price preserves (so far as possible) each party’s share of purchasing power.”)

<sup>20</sup> *Mantell v. International Plastic harmonica Corp.*, 55 A.2d 250 (NJ 1947).

price. It made reference to the prices charged to other distributors, but as it turned out there were no other distributors. The court decided to fill the gap with a reasonable price term, but explained that what constitutes a reasonable price depends on the price that the seller can get from other dealers, competition between wholesalers as well as between dealers, the uniqueness of the product, the quantity produced, and more.<sup>21</sup> These are precisely the factors that determine the bargaining power of the parties. If the seller had market power in setting a price, this market power should be mimicked by the gap-filler.

#### **D. Can Courts Identify the Bargain-Mimicking Terms?**

There is something admittedly deceptive about the idea of bargain-mimicking gap fillers. It is assumed that the division of bargaining power between the parties is a measurable parameter that can be verified by the court. Bargaining power is, of course, a real factor in negotiations, and economic theory demonstrates that it depends on relative risk preferences, outside options, discount factors, negotiation protocol, and the like.<sup>22</sup> It reflects, in short, the relative facility of each party to say “no” to the deal. But it is one thing to recognize the theoretical existence and role of this parameter; it is another thing to measure it and base legal policy on its measurement.

It is probably naïve to expect that courts would be able to measure bargaining power with precision. Still, implementing a regime with error, or only in those cases where the parameter *is* verifiable, is better than nothing. There are situations in which some crude approximations of relative bargaining power are likely to be correct, even if not perfect. A seller of a good for which demand is inelastic is known to have bargaining power. Or, when many bidders compete for a single job, the party inviting the bids has bargaining power. While it is hard, even in these situations to quantify a party’s bargaining strength on a scale of 0 to 1, is it harder than adjudicating other parameters that courts ordinarily scale, such as comparative fault in torts?

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<sup>21</sup> *Id.*, at 256.

<sup>22</sup> See, e.g., Martin Osborne and Ariel Rubinstein, *Bargaining and Markets* (1990).

In fact, courts already (and quite regularly) refer to bargaining power as a factor that justifies case outcomes. Under unconscionability doctrine, the presence of one-sided bargaining power is often identified and invoked for the purpose of reforming some explicit term.<sup>23</sup> Under the duress doctrine, weak bargaining power is often identified and invoked for the purpose of relieving the weak party from a coerced deal.<sup>24</sup> Under the *contra proferentum* doctrine courts have to figure out which party had the power to dictate a term, and rule *against* this party. The Restatement recognizes that *contra proferentum* is “often invoked in cases of standardized contracts and in cases where the drafting party *has the stronger bargaining position*.”<sup>25</sup> While courts at times misjudge the relative bargaining positions (there is a misguided tendency to view a take-it-or-leave-it offer as a sign of bargaining power<sup>26</sup>), a substantial doctrinal tradition is nevertheless founded on the belief that courts can identify bargaining power and fine tune the legal consequence based on this identification.

And yet, existing doctrines that refer to bargaining power usually favor the weaker bargainer, whereas the approach discussed here favors the strong bargainer. This difference might be more crucial than initially seems. For a weak party, there is no danger in arguing in court that the other side had all the bargaining power. For a strong party, on the other hand, arguing that she herself had all the bargaining power may be risky. For example, if she were to argue that her bargaining power is due to a monopoly position, she might face antitrust consequences. If she were to argue that her bargaining power is due to information advantage, she might face heightened disclosure requirements, or simply lose the sympathy of the court and the jury. In other words, one’s superior bargaining power might be a trait that one prefers to keep secret, rather

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<sup>23</sup> See, e.g., *Carboni v. Arrospide*, 2 Cal.Rptr.2d 845 (1991) (“there was inequality of bargaining power which effectively robbed [promisor] of any meaningful choice.”) See also UNIDROIT principles of International Commercial Contracts art. 3.10(1) (“lack of bargaining skill” is a factor relevant to determination of unconscionability.)

<sup>24</sup> *Rubenstein v. Rubenstein* [cite]

<sup>25</sup> Restatement (Second) of Contracts §206 cmt a (*emphasis added*).

<sup>26</sup> See, e.g., *Circuit City Stores v. Adams*, 279 F.3d 889, 892 (9<sup>th</sup> Cir. 2002)

than prove in court.<sup>27</sup> A legal regime that relies on litigants demonstrating their own superior bargaining strength faces this obstacle.

Moreover, and adding to the difficulty, even in the clear presence of verifiable uneven bargaining power, identifying the bargain-mimicking term may be tricky. Gaps in the contract may result from the parties' inability to agree. Or, they may result from the strong party's strategic calculation to leave an issue open, recognizing that on this specific issue the weak party would not acquiesce to a one-sided term, or would be alerted to some hidden unfavorable aspect of the deal. If the strong party suppressed a specific issue and left a gap deliberately, it may in fact be an indication of the limits of her bargaining power—that in an explicit agreement she cannot, in fact, extract the one-sided term she covets. Here, the bargain-mimicking term is not necessarily favorable to her. Granting her a favorable gap-filler would only encourage her to leave gaps in areas in which she cannot bargain for an advantage. Instead of mimicking the bargain, this regime could distort it.

Thus, the craft of filling gaps with bargain mimicking terms is more nuanced than merely identifying the party with the greater overall bargaining power. It requires attention the specific issue left open and the parties' special concerns regarding this issue. Recognizing that a bargain usually involves some concessions even by the overall stronger party, the court has to figure out how the parties would have used their bargaining power over *this* specific term, given that some leverage—some bargaining chips—were already spent on other, expressly drafted, terms.

Daunting as this task might appear upon first reflection, it is probably not more complicated than other gap-filling principles. For example, under the surplus-maximizing principle, figuring out which term is most efficient requires a sophisticated account of costs and benefits, an understanding how different terms and issues interact, what each party values more, all with an eye to idiosyncratic preferences. Here, too, some terms cannot be supplemented without careful attention to other aspects of the deal. Still, the surplus-maximization criterion has broad appeal

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<sup>27</sup> See Omri Ben-Shahar and Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 Yale Law Journal 1885 (2000).

because it makes normative sense, despite the fact that it is harder to implement than other, simpler default rules. It is the right thing to ask courts to make the effort to figure out—it is worth the cost. In Section II below, I will propose a normative defense of the bargain-mimicking criterion, suggesting that here too it is a worthy effort to trace the bargain that parties would have struck. And, at the very least, if it so happens that courts have good information about the bargain-mimicking term, it ought not be ignored.

## II. ARE BARGAIN-MIMICKING TERMS DESIRABLE?

The purpose of this article is not to advocate for the general use of bargain mimicking gap-fillers, but to identify it as a conceptual and practical possibility and explore arguments in support of such a regime. Before turning, in section III, to examine incidents of actual implementation of this regime, let us explore some normative aspects.

### A. Transactions Costs

When the gap in the contract involves an issue that affects the size of the surplus, a well-rehearsed argument explains why the gap-filler ought to be the surplus-maximizing provision. It is an argument of exceptional appeal, because it side-steps any distributive implications. Surplus-maximizing gap-fillers increase the well-being of both parties to the contract, indiscriminately. If the law were to provide off-the-shelf terms that are anything but the surplus-maximizing arrangements, it would have the effect of inducing the parties to write explicit provisions instead, and other than occasional indirect benefits (say, in the form of exposing private information), this would merely increase transactions costs.<sup>28</sup> And once the price or another distributive term is adjusted appropriately to divide the saving in transactions costs—each party ends up with a greater net payoff.

It might be perceived, though, that in the context of bargain-mimicking terms this same distributive-neutral defense is inapplicable. If the law

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<sup>28</sup> Richard Craswell, *Contract Law: General Theories*, in 3 *ENCYCLOPEDIA OF LAW AND ECONOMICS* 1, 2-4 (Bouckaert & De Geest, Eds., 2000).

provides a gap-filler that is more favorable to one of the parties, without affecting the size of the surplus, how can it be said that this term accords both parties a greater surplus to divide? If it is a term that mimics one party's will, against the will of the other party, how could the other party benefit from it?

Moreover, upon first reflection, bargain mimicking terms might seem to encounter an objection that surplus-maximizing terms avoid, namely, that they conflict with social concerns and intuitions regarding the fairness of distribution. While surplus-maximizing terms need not have any distributive effect—they merely secure more value to divide—bargain-mimicking terms do not create a greater surplus and do have a clear distributive effect in favor of the strong party. Why, it might be asked, should it be the objective of the law to resolve ambiguities and gaps in distributive aspects in favor of the strong party? Surely, this party can take good care of herself and secure advantages by bargaining; If at all, it is the weak transactor that should be protected by the law and enjoy a distributive bias. A prescription of distributive fairness, so goes the objection, can hardly be based on bargaining power as the conception of merit. It should aim to undo the unfairness that unfettered bargaining might generate, not mimic it.

Compelling as this argument might be, it is unfortunately beside the point. The benchmark argument in favor of bargain mimicking terms is not that these terms are fair or that they otherwise conform to an attractive conception of distributive desert. They probably do not. Bargain mimicking is a principle of gap-filling, not of redistribution. The reason why bargain mimicking terms may be desirable as gap-fillers is that, *very much like surplus-maximizing terms, they save transactions costs*. If the law accords her the same terms that she can secure by explicit (and harsh) bargaining, the party with the bargaining power need not spend the cost of specifying the same terms in an explicit fashion. If gap fillers tried to do anything other than mimic the term that this party were able to dictate, they would have the ex ante effect of inducing this party to dictate the term, to preempt any adverse allocation that would otherwise be brought upon by the gap filler. Perhaps even more than in other contexts, it is very likely that when the distribution is at stake the strong party will insist on contracting around a non-mimicking gap filler.

In the context of surplus maximizing gap-fillers, it is commonly noted that both parties enjoy the saving of transactions costs afforded by such terms.<sup>29</sup> Thus, by similar logic, it must also be true that when one party has the bargaining advantage, both parties enjoy the saving of transactions costs achieved by bargain mimicking terms, and prefer them over majoritarian gap-fillers. The only difference in the current context is that the saving achieved by the mimicking terms is, like other sources of value in the contract, enjoyed disproportionately by the party with the greater bargaining power. Her leverage enables her to dictate a division of the salvaged transactions cost that is favorable to her.

What, exactly, are these transactions costs that are saved by a bargain-mimicking term? Beyond the obvious category of drafting costs, in the context of unequal bargaining power there might be additional “psychic” burdens that may be saved. There are settings in which weak parties endure humiliation when the strong party openly dictates a one-sided term. While this cost of punctuating one’s powerlessness owes to emotional and behavioral (that is to say, irrational) grounds, it is recognized as important in the negotiation literature.<sup>30</sup> Strong parties are advised to accord their counterparts the sense that the pie is equally divided, even when it is not, to make it easier for them to acquiesce. A default rule that eases the need of strong parties to openly “stick it” to the weaker parties, has this cost-mitigating effect.

### **B. Drafting of One-Sided Contracts**

In long term contracts, gaps result not only from transactions costs (i.e., the difficulty to foresee and stipulate for all future contingencies), but also from a deliberate drafting choice to leave room for more flexibility. Parties recognize that conditions might change and special needs or priorities might arise, such that would render it mutually beneficial to make future adjustments in their respective obligations. It is, of course, possible to dictate rigid terms that apply to future contingencies and later, if flexibility is needed, to accord waivers and accommodations

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<sup>29</sup> POSNER, *ECONOMICS ANALYSIS OF LAW* 96 (6<sup>th</sup> Ed. 2003).

<sup>30</sup> CITE Lax and Sibenius, *The Manager as Negotiator*; Mnookin et al. ....

through course of performance. But this means that the strong party would “waste” bargaining power to secure terms and privileges that he would be willing to waive and that might not matter all that much, ex post. Alternatively, recognizing the need for flexibility, the strong party may choose to leave some issues less than fully resolved in the contract, expecting to nail them down if and when they become relevant. A bargain-mimicking gap-filling regime would render the open term strategy safer for the strong party, promoting its use whenever it is the cheaper method to draft the contract.

This technique of flexible drafting is used in various ways. At the extreme, the contract might stipulate that a particular provision would be agreed upon by the parties at a later stage.<sup>31</sup> This is not an agreement to agree; there is enough definiteness in the remainder of the contract, and there is a clear statement of intent to be bound, to make the entire agreement enforceable. Rather, it is an agreement with a specific methodology for subsequent, contingent, gap filling. The gap is expressly recognized by the parties and the methodology to resolve it is set in the contract. When this methodology fails—when the parties do not manage to agree at a later stage on the to-be-agreed-upon open issue, the court has to resort to a different methodology. The bargain-mimicking principle instructs the court, in choosing a gap filler, to lean towards the will of the party who would had more bargaining power at the contracting stage. To be sure, at the ex-post stage in which the term was to be settled, bargaining power may shift and the party who originally had more power may now be committed to the relationship and have less leverage. Still, the parties chose the flexible drafting technique recognizing this possible shift in bargaining power, and thus it is the relative power at the time of that the terms was to be agreed upon that should matter.

A common technique of flexible drafting is to allocate to one party the power to determine, ex-post, the content of the term and to change it as needs and circumstances change. The party with this power is not always the strong party. For example, in output contracts the seller is entitled to set the quantity, but it is hardly the seller who has any bargaining power.

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<sup>31</sup> Cite (GM contracts; franchising contracts)

Thus, when a farmer sells his small crop to a large distributor/buyer, the farmer sets the quantity ex post, but has very little bargaining strength ex ante. In some contexts, however, the parties use this technique of one-sided ex-post control over a term to create what is effectively a bargain mimicking gap-filling regime. When a seller has the power to set the price and vary it throughout the term of the contract, the seller is translating his bargaining strength ex ante into a scheme that supplies terms ex-post that are favorable to the seller. This is how oil companies deal with their local distributors. The role of courts here is to police any overreaching—to determine the boundaries of tolerable reach of bargaining power (through the requirement of good faith).<sup>32</sup> But if courts were unwilling to allow strong parties to use this self-favorable technique, flexible drafting of long-term contracts would be undermined.

Another technique of flexible drafting is to attach the meaning of a particular term to some objectively observable index. For example, a supplier in a long-term sales contract may demand that the price will equal someone else's posted price at the time of delivery.<sup>33</sup> Disputes may arise once the contractually selected index ceases to exist in the midst of the contractual period and can no longer be referenced. Which price should be used in its place? The strong party has, again, a sensible claim that the supplemented price ought to mimic the bargain that would have been struck by the parties had they expressly negotiated over a substitute index. Or, more directly, the price ought to mimic the division of bargaining power between the parties. If the failed index was a pro-supplier price, located in the upper range of the market prices, so ought to be the supplemented price. Any other choice would merely force parties to choose a different pricing methodology, perhaps sacrificing some of the flexibility.

Termination terms also illustrate the benefit of bargain-mimicking defaults. A party enjoys strong bargaining power when there are many potential partners whom he can choose, who bid to be chosen. Once a bidder is chosen and awarded the contract, however, the one-on-one relationship would no longer preserve the asymmetric bargaining power.

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<sup>32</sup> UCC 2-305

<sup>33</sup> Cite

Termination, however, allows the strong party to maintain the bargaining advantage throughout the relationship, by credibly threatening to choose another bidder. Thus, the duration gap-filler—the rule that allows parties to terminate an open-ended contract at will<sup>34</sup>—is effectively a bargain mimicking default rule. True, under this rule both parties have the symmetric right to terminate. But often it is only one party—the initially strong party who faced many bidders—who might potentially want to terminate. The other party has too little choice to go elsewhere, or too much sunk in the relationship, and thus if terminated will not likely find another business. The right to terminate effectively mimics the will of the strong party. With this safeguard in place, the strong party is freed to use a variety of terms that he would otherwise not use. First, he is free to use an open-ended duration. Second, he can give the other party leeway and control over aspects of performance, not having to specify them in the contract, knowing that if these privileges are abused there is always the option to terminate. Finally, he can choose a bidder who is relatively less known.

A final example where a bargain-mimicking criterion might affect the way parties design their bargain is a prenuptial agreement. A millionaire who is about to marry a fortuneless person often has a greater bargaining power regarding the financial consequences of divorce. If divorce occurs, a gap-filler that tracks this bargaining advantage would significantly differ from a gap-filler that provides a more generous distribution to the less affluent spouse. True, in this setting the notion of bargaining power could be more elusive than in commercial settings. Bargaining power is not equivalent to financial prowess; there are less tangible factors that affect the power of a party to say “no” to the relationship. And yet, bargaining power surely exists, it is often played out in express prenuptial bargains, and identifying it ex-post might relieve the parties from the costly and often damaging need to punctuate it, ex-ante.

### **C. Ex Ante Investment**

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<sup>34</sup> UCC 2-309

The analysis so far assumed that the relative bargaining power of the parties is an exogenous factor, determined before the parties enter the negotiations. Many features may affect bargaining power—outside options, impatience to reach a deal, reputation, financial distress, negotiation savvy, and more—but until now it was implicitly assumed that none of these factors depend on the gap-filling methodology. Thus, the premise was that gap fillers can be a function of the relative bargaining power of the parties, but not vice versa.

Theoretically, though, a bargain mimicking regime can create incentives for the parties to make investments that affect their bargaining power. Of course, parties already have the motive to invest in strengthening, or to refrain from actions that weaken, their bargaining power. Such actions help them secure better express terms in the deal. But in the shadow of bargain-mimicking gap-fillers, the incentive to manipulate the bargaining positions would be bolstered. Investing in stronger bargaining power would now affect not only the explicit provisions, but also the gap fillers.

It is not clear what to make of these potential effects. *Prima facie*, much of the investment in bargaining leverage is a social waste—it is a social cost that only redistributes value without creating a corresponding social benefit. This may suggest that the bargain-mimicking regime has the undesirable effect of further distorting already excessive investments.

But the picture is more complex. There are other types of precontractual investments—investments that have an effect on the total surplus of the potential bargain, not on the relative bargaining power—that are often set at a level that is *too low*, due to the hold-up problem (the anticipation that some of the fruit of this investment will be appropriated by the other party).<sup>35</sup> If the party who makes the surplus-enhancing investment is also the one who is in a position to make the bargaining-leverage investment, it is no longer clear that the latter investment is a social waste. Investing in greater bargaining leverage would have an indirect positive effect: it would diminish the ability of the other party to engage in hold-up and would thus lead to a more efficient level of surplus-creating investments.

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<sup>35</sup> See, e.g., Lucian Bebchuk and Omri Ben-Shahar, *Precontractual Reliance*, 30 *Journal of Legal Studies* 423 (2001).

For example, a builder who successfully acquired an exclusive position in a specific market can now afford, in the course of negotiating a project with a client, to make precontractual investments in plans and materials, knowing that his bargaining leverage would shield him from hold up.

Moreover, sometimes the same investment has both a surplus-enhancing effect and a bargaining leverage effect. For example, learning a special skill would make a potential employee more valuable (that is, increase the surplus) but also accords the employee more leverage in negotiating her wages. The incentive to make *too much* of this investment to enhance the bargaining leverage is now a counterforce to the incentive to make *too little* of this investment in light of the hold up problem. The bargain-mimicking legal regime, which amplifies the “too much” side of this trade off, is not necessarily bad.

In the end, though, whatever effect the bargain-mimicking gap-filling regime has on ex-ante investment, one should doubt whether this effect is significant. Parties have strong incentives to make investments that increase their bargaining power even in the absence of this gap-filling regime. Such investments secure greater payoffs through the more favorable express terms that the investing party can draft. Ex ante, the incremental effect of the gap-filling regime is probably negligible.

### III. BARGAIN MIMICKING TERMS IN ACTION

#### A. General

To be sure, a general principle of bargain-mimicking gap-fillers was never explicitly endorsed by the law. Notably, Section 204 of the Restatement instructs courts to supply gap fillers that are “reasonable in the circumstances,” expressly rejecting the bargain mimicking approach:

“Where there is in fact no agreement, the court should supply a term which comports with community standards of fairness and policy *rather than analyze a hypothetical model of the bargaining process.*” (*Emphasis added*)<sup>36</sup>

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<sup>36</sup> Restatement (Second) of Contracts §204 cmt d.

Despite this abstract mandate, I hope to show that in many subtle ways contract law applies gap fillers that reflect relative bargaining power.

Before turning to judicially supplied gap-fillers, it is important to note that principles of gap-filling can be enacted in the contracts themselves. Bargain-mimicking gap-fillers can emerge in practice as a result of contractual drafting that instructs courts to apply such a criterion. Contracts often include terms that, while ambiguous and in need of interpretation or supplementation, nevertheless point in the direction of one-sided, bargain-mimicking arrangements. Typical boilerplate contracts include severability or “savings” clauses that instruct courts to enforce the contract *to the maximal extent permitted by law*. If a provision that is otherwise drafted vaguely is appended by this *maximal extent* boilerplate, the ambiguity is resolved in a one-sided manner. Such drafting technique may apply to a single provision, as in warranty disclaimer clauses,<sup>37</sup> or it may apply to the entire contract.<sup>38</sup> Effectively, by including such provisions, the drafting party opts out of the “fair community standards” gap-filling approach of Section 204 and opts into a bargain-mimicking, one-sided gap-filling regime. The incentive to draft such terms is particularly strong when applied to distributive issues, where the one-sidedness does not come at the expense of the overall surplus.

## **B. Examples**

This section demonstrates instances in which courts explicitly recognize the bargain-mimicking criterion of gap-filling and reach decisions in line with it.

*Termination Terms.* A striking example of the application of the bargain-mimicking principle came up in a case that called for interpretation of a

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<sup>37</sup> See, e.g., RealNetworks EULA (“To the maximum extent permitted by applicable law, RealNetworks further disclaims all warranties.”)

<sup>38</sup> See, e.g., Charles Sennewald, *Security Consulting* (“If the scope of any of the provisions of the agreement is too broad in any respect whatsoever to permit enforcement to its full extent, then such provisions shall be enforced to the maximum extent permitted by law...”)

termination clause in a franchise contract. When the parties have an open ended contract duration, Section 2-309 of the Code allows each party to terminate it at will. Even when the contract guarantees a minimum duration, termination can occur prior to the expiration of this period if one of the parties misbehaves. In this context, courts are often asked to determine whether a particular event or misconduct by the franchisee provides legitimate grounds for termination by the franchisor. In one of the casebook favorites, *The Original Great American Chocolate Chip Cookie Co. v. River Valley*,<sup>39</sup> Judge Posner provides a striking answer. He rejects the claim that “in a dispute between franchisee and franchisor the judicial thumb should be on the franchisee’s pan of the balance.” This, despite the fact that the franchisee was clearly the party with the weaker bargaining power and should be the natural target of any redistributive sentiment. Such a tilt, he explains, will not help franchisees as a group: “The more difficult it is to cancel a franchise, the higher the price that franchisors will charge for franchises. So in the end the franchisees will pay for judicial liberality...”<sup>40</sup> Posner continues and invokes the logic underlying bargain-mimicking terms:

“The idea that favoring one side or the other in a class of contract disputes can redistribute wealth is one of the most persistent illusion of judicial power. It comes from failing to consider the full consequences of legal decisions. Courts deciding contract cases cannot durably shift the balance of advantages to the weaker side of the market; they can only make contracts more costly to that side in the future, because franchisors will demand compensation for bearing onerous terms.”<sup>41</sup>

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<sup>39</sup> 970 F.2d 273 (7<sup>th</sup> Cir. 1992).

<sup>40</sup> *Id.*, at \_\_\_\_.

<sup>41</sup> *Id.*, at \_\_\_\_\_. In a somewhat mocking dissent, Judge Cudahy agrees that franchisees have less bargaining power than franchisors but responds to Judge Posner’s bargain-mimicking default rule by saying:

Apparently, the legislators had not read enough scholarly musings to realize that any efforts to protect the weak against the strong would, through the exhilarating alchemy of economic theory, increase rather diminish the burden upon the powerless. I agree that the thumb of judges ought not be placed on the scales of justice. But judges have no obligation to ignore the numerous thumbs already put down on the side of economic power...”

Posner's decision in the *Original Great American Chocolate Chip Cookie Co.* case is an illustration of a bargain-mimicking term because the contract at issue had a vague termination clause that needed interpretation (was breach by the franchisee "material"? Did it constitute "good cause" for termination?) The answer the court gave had nothing to do with maximization of surplus. The court did not focus on reliance by the franchisee and its interest to recoup its investment (as courts sometimes do in other cases). It also did not focus on the need of a franchisor to efficiently protect its brand and provide adequate incentives for management of its franchised stores. Moreover, the court did not invoke notions of hypothetical consent—terms or meanings that both parties would have willingly chosen, if only they drafted terms with increased resolution. Instead, the court viewed the problem as distributive in nature, but rejected a solution that would be redistributive in favor of the weak party. It examined the relative bargaining power and held that the franchisor's superior economic position would make it futile for courts to interpret the contract in any way that does not mimic the franchisor's bargaining strength. Any judicial attempt to favor weak parties for redistributive reasons would fail because of its *ex ante* unintended effect on the terms drafted into the contract.

*Force Majeure Terms.* Another interesting illustration of the bargain-mimicking principle in action came up in the context of *force majeure* clauses—clauses that expand the scope of excuse otherwise available under the doctrine of impracticability. Courts recognize that any party can use its bargaining power to secure a favorable list of excuses by drafting a self-interested *force majeure* clause. But even when the express *force majeure* clause is clear, questions arise that require gap filling and interpretation. For example, if a seller is excused against the buyer when the seller's source of supply defaults, must the seller assign its remedial rights against its own defaulting supplier to the disappointed buyer? Usually, when the grounds for excuse are in the default rule of Section 2-615 of the Code, the answer is yes: the disappointed buyer cannot get redress from the seller, but can step into the seller's shoes and recover from the interfering party. But if the grounds for excuse are not

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*Id.*, at \_\_.

in Section 2-615 but instead in the expressly drafted *force majeure* clause, the answer appears to be no: the disappointed buyer is *not* assigned any recovery rights against the defaulting supplier. Despite being excused against the buyer, the seller can still recover from his own defaulting supplier.

In a leading case, the 9<sup>th</sup> Circuit based this result on the bargain-mimicking principle.<sup>42</sup> It noted that the seller used its bargaining power to extract a *force majeure* clause from the buyer, and that the seller's supplier was unable "because of market forces" to require a similar excuse provision. Accordingly, the seller was excused even though his supplier was not. The court held that

"We see no reason to award the windfall of recovery against the supplier to the buyer, who agreed to excuse the seller, instead of the seller, who was able to insist on better protections. [...] We find no reason to transfer the benefit of [the seller's] superior negotiating position to [the buyer] by giving [the buyer] rights against [the defaulting supplier]. We do find that it serves the forces of natural market adjustment not to transfer [the seller's] rights."<sup>43</sup>

The decision hinged on mimicking the bargaining outcome between the parties. True, the parties did not say anything as to whom, in the event of excuse, would be entitled to recover from the defaulting supplier. Only one party can get this right, and the court chose to award it to the party with the greater bargaining power. Here, too, the decision did not hinge on efficiency analysis, or on hypothetical joint will. The court even speculated how the holding, with its obvious tilt in favor of the stronger party, might affect the incentive of future parties to enter contracts with such unfavorable terms (e.g., to move into "the more contractually secure part of the market."<sup>44</sup>) It nevertheless found that the gap filler in this case, with its distributive effect, must mimic the division of bargaining power.

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<sup>42</sup> *Interpetrol Bermuda Ltd. V. Kaiser Aluminum International Corp.*, 719 F.2d 992 (9<sup>th</sup> Cir. 1983).

<sup>43</sup> *Id.*, at 1001.

<sup>44</sup> *Id.*

*Dividing a Windfall.* Reading through case law on missing distributive terms suggests that courts are clearly up to the task of ascertaining the bargain-mimicking terms. A nice example is provided in a recent 6<sup>th</sup> Circuit decision on how to divide a pot of money that the parties did not expect.<sup>45</sup> The court turned to the “community standards of fairness” principle of Section 204 of the Restatement in holding that the party who bears the risk is the one entitled to the unforeseen proceeds. Interestingly, though, the court recognized that the same result would be achieved by applying the “hypothetical model of bargaining” approach, which the court noted to be the Restatement’s less favored mode of analysis. It reasoned that the party who was responsible for any downside in case the funding source defaulted or became insolvent would have demanded that any unanticipated proceeds from this source inure to it.<sup>46</sup> Put differently, the court did not need to ask who has more bargaining power in the abstract. Rather, it reasoned that with respect to *this specific term*, one party would have naturally prevailed had it been the subject of an explicit agreement.

### C. Peevyhouse

The bargain-mimicking idea can help explain case outcomes in another important area: the selective application of the cost-of-completion measure of damages in cases of defective performance. In classic case of *Peevyhouse v. Garland Coal*<sup>47</sup> the court had to decide what damages apply when the stripmining company breached its promise to restore the mined farm land to its original condition. The case provides a dramatic illustration of the choice between two measures of expectation damages: cost-of-completion, which would have been \$29,000, and diminution-in-market-value, which was only \$300. It was a hard choice, and the Supreme Court of Oklahoma ruled 5-to-4 in favor of the diminution in value measure. Other courts in other states held differently. Authorities are still split.

For the purpose of our discussion here, it is interesting to note what the trial court did in that case. Rather than granting one of the two competing

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<sup>45</sup> *Bank of New York v. Janowick*, 470 F.3d 264 (6<sup>th</sup> Cir. 2006).

<sup>46</sup> *Id.*, at 272.

<sup>47</sup> *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109 (Ok. 1962).

measures of recovery, the trial court awarded the plaintiffs \$5000. This, it turns out, is not merely a split-the-difference compromise; it is the remedy that closely resembles the bargain-mimicking outcome. It is well-documented that when the contract between the plaintiffs and Garland Coal was signed, the plaintiffs had strong bargaining leverage.<sup>48</sup> They were not particularly eager to enter the contract, but when they eventually agreed, they leveraged their bargaining strength and insisted on including a restoration clause. In fact, they waived their right to receive an upfront restoration allowance of \$3000—close to the entire value of the farm—in order to secure that restoration clause. Thus, if instead of a restoration clause the plaintiffs would have bargained for an explicit liquidated allowance to be used to fund self-managed restoration, it would have been roughly \$3000—the sum they traded away for the restoration clause. Not \$29,000, nor \$300. The jury award of \$5000, it turns out, comes close to mimicking that bargained-for remedy of \$3000 (augmented by incidental costs arising from breach, delay, and trial).

The choice of cost-of-completion versus diminution-in-value is a fundamental and controversial one, leading to seemingly conflicting outcomes across cases. It is an ongoing struggle for contracts scholars to provide a descriptive theory of the result reached by courts. Why do some plaintiffs get the former, usually higher measure, whereas others receive the latter, stingier recovery? Criteria such as the willfulness of the breach and the disproportionality of the cost-of-completion are only partial and ad-hoc organizing factors. The bargain-mimicking principle, I argue, can bolster our understanding of case outcomes. Promisees, like the Peevyhouses, who had the superior bargaining power to insist on a completed performance, are entitled to the more generous measure. It mimics the high-end liquidated damages clause they would have bargained for. This idea, focusing on the ex-ante bargaining power of the transactors, underlies Cardozo's famous but cryptic distinction between "common chattel" versus "a mansion or a skyscraper."<sup>49</sup> Why does Cardozo think that courts should allow the margin of non-completion to be greater (and the remedy to be smaller) in the case of common chattels

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<sup>48</sup> See Judith L. Maute, *Peevyhouse v. Garland Coal and Mining Co. Revisited: the Ballad of Willie and Lucille*, 89 Nw.U.L.Rev 1341 (1995).

<sup>49</sup> *Jacob & Youngs v. Kent*, 129 N.E. 889 (N.Y. 1921)

or when the client purchased a stock floor plan house,<sup>50</sup> but require stricter compliance and award the higher cost-of-completion measure for mansions? Plausibly, clients who purchase common chattel and stock floor homes have less bargaining power against sellers and little ex ante leverage to demand the cost-of-completion remedy. But when mansions and skyscrapers are designed, the client is often in a strong bargaining position. Hence, when the aggrieved party had the ex ante bargaining power to insist of precise completion of performance that courts award the more generous measure.<sup>51</sup>

To be sure, remedies for breach of contracts are not the kind of gap-fillers that have solely distributive effects. A long and distinguished literature has shown that, through their effect on performance and reliance decisions, remedies have significant influence on the overall surplus.<sup>52</sup> Thus, there is a strong argument suggesting that gaps in the contract concerning remedies ought to be filled with surplus maximizing terms rather than bargain-mimicking terms. Indeed, in the context of *Peevyhouse*, commentators have expressed concerns how the cost-of-completion measure would affect the incentive to breach-or-perform.<sup>53</sup> And yet, despite this fundamental concern, it is quite plausible that the damage measure chosen in cases like *Peevyhouse* would have only a distributive effect. If damages are too high, inducing inefficient performance, the parties would likely renegotiate them. And if damages are too low, inducing inefficient breach, again the parties would have an incentive to renegotiate.<sup>54</sup> Thus, to the extent that the damages merely

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<sup>50</sup> *Plante v. Jacobs*, 103 N.W.2d 296 (Wis. 1960)

<sup>51</sup> See also *Groves v. John Wunder Co.*, 286 N.W. 235 (Min, 1939) (awarding \$60,000 cost-of-restoration when the diminution in value was no more than \$12,000), and case commentary by Robert Hillman, *Principals of Contract Law* 140 (2004) (arguing that the factor that should determine the outcome is the bargaining power when restoration clause was drafted), and Marvin A. Chirelstein, *Concepts and Case Analysis in the Law of Contracts* 174 (4<sup>th</sup> Ed. 2001) (arguing that the recovery should equal the amount the promisee could have bargained for at the agreement stage.)

<sup>52</sup> Shavell, *Foundations of Economic Analysis of Law* 304-312 (2004).

<sup>53</sup> Posner, *Economic Analysis of Law* 121 (6<sup>th</sup> Ed. 2003).

<sup>54</sup> Ian Ayres & Krisin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U.of Pa. L.Rev. 45 (1999) discuss the effect of the damage measure on the subsequent rounds of bargaining over release from inefficient performance and inefficient breach.

affect the bargaining position of the parties in the renegotiation phase, but not the performance outcome, the argument is all the more compelling that such damages should reflect the ex ante bargaining power of the parties, to save them the trouble of explicitly stipulating these damages in the contract.

#### IV. MAXIMALLY TOLERABLE TERMS<sup>55</sup>

When bargaining power is unevenly distributed, the strong party would naturally use its bargaining leverage to draft one-sided, self-serving terms. But the strong party cannot overreach. The doctrines of unconscionability and duress (as well as other rules) grant courts the power to invalidate excessively one-sided term. Once such unreasonable term is vacated, the court needs to fill the gap that is created and to choose an alternative provision.

There are several systematic ways in which the gap can be filled. First, the court can replace the excessive term with the most reasonable term. This would likely be a mid-range, majoritarian term. Another way is to plug in a term that is *least* favorable to the overreaching party, as a penalty for overreaching and as an incentive not to overreach. Finally, a third possible way to fill the gap is to use a bargain-mimicking term: a term that is still one-sided, favorable to the strong party. Admittedly, there is something paradoxical about a bargain-mimicking principle in this context. The term that best reflects the division of bargaining power was in fact written in the contract, and yet it was found unenforceable under a policy aimed at limiting the reach of bargaining power. A pure bargain-mimicking term would be equivalent to that offensive term; surely, the court would not reinstate the same term it has just struck down. The practical effect of the bargain-mimicking principle in this setting is to prescribe a “maximally tolerable” term—a term that is still one sided, still favorable to the drafting party, but just within the range that is considered tolerable. Once the offensive term has been replaced by a term that is within the tolerable range, even if only barely so, there is no remaining justification for intervention.

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<sup>55</sup> This section is based on Omri Ben-Shahar, *How to Repair Unconscionable Contracts*, Mimeo (2008).

Thus, if for example the excessive term is high price, the legal intervention would be to push this price down. If we analogize the process of judicial intervention in the contract to a force that pulls the price from its current intolerable level towards the permissible region, the force gradually weakens as the price gets closer to the tolerable level, and vanishes completely as soon as this level is hit. The point where this adjustment process runs out of justification is not the mid-range, majoritarian, most-balanced term. Rather, it is the maximally tolerable price: it is still a one-sided term, albeit not as bad as the original term. Once this term is set, the weak party has no reasonable grounds to demand more additional redress.<sup>56</sup>

There are numerous instances in which courts apply maximally tolerable terms. The doctrine of partial performance is one such example. Under this doctrine, a court is authorized to reform an unreasonable term in a contract and enforce it to extent necessary to avoid the unreasonableness. The most common application of this technique involves non-compete clauses that are excessive either in duration or in geographic scope. In most states, courts repair the excessive non-compete terms by reducing them to the maximally tolerable level.<sup>57</sup>

At times, the maximal tolerable level is defined explicitly by statutes. Some states have enacted bright line rules stating the maximal duration of non-compete clauses in employment contracts.<sup>58</sup> There, only the increment of the restraint that is socially intolerable is eliminated; the rest stands. In other states there is no bright line statute. There, too, courts reduce the non-compete term, bringing it down to a level that is

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<sup>56</sup> This rationale is recognized by Corbin: “The line [representing the enforceable term] must be drawn somewhere, and it is drawn at the point where the protection to which the buyer is justly entitled ends.” See Arthur L. Corbin, *On the Doctrine of Beit v. Beit: A Comment*, 23 Conn.B.J. 40, 46 (1949).

<sup>57</sup> See, e.g., Harlan M. Blake, *Employee Agreements Not to Compete*, 73 Harv. L.Rev. 625, 646-651 (1960)

<sup>58</sup> See, e.g., Section 542.335(1)(d)1, Florida Statutes (1997) (“a court... shall presume unreasonable in time any restraint more than 2 years in duration”), enforced in *Flickenger v. Fitzgerald & Co.*, 732 So.2d 33 (Fl. 1999)

maximally tolerable. The restraint “is not enforceable beyond the time or area considered reasonable by the court.”<sup>59</sup>

Another example for the use of maximally tolerable terms relates to the doctrine of unconscionability. Corbin noted, in the context of a loan of money, that “a contract that requires a payment of a very high interest will be enforced, *up to the point at which ‘unconscionability’ becomes and operative factor.*”<sup>60</sup> In the context of unconscionable arbitration clauses, courts can replace a an arbitration mandate that includes unreasonable terms with one that is tolerable. For example, in *Brower v. Gateway*—a leading New York unconscionability decision—the court held that a term mandating arbitration under the ICC forum is unconscionable because of the excessive filing fee of \$4000.<sup>61</sup> It held, though, that Gateway can cure this defect by agreeing to arbitrate in another forum, if it entails filing fees that are not unconscionable. The consumer still viewed this as a one sided provision, but once it was cured to be tolerable, the court saw no grounds for further intervention.

Finally, the doctrine of liquidated damages can provide an opportunity to use maximally tolerable terms. Courts do not enforce liquidated damage terms that are clearly excessive and punitive, but what is the damage term that courts supply instead? Under a bargain-mimicking approach, the court would replace the unenforceable liquidated measure, not with the average or most reasonable compensatory measure, but rather with the high-end estimate of expectation damages.

There are some statements in American case law that reject this notion.<sup>62</sup> But other legal traditions seem to directly endorse the maximally tolerable approach. Under Israeli contract law, for example, courts are instructed to reduce excessive damages to the level reflecting the magnitude of loss reasonably expected at the time of contracting. In one case in which the court reduced the liquidated damages it explicitly set the damages above actual harm, at a level equaling “the maximal amount

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<sup>59</sup> See, e.g., *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 685 (Tex. 1974).

<sup>60</sup> 1 Corbin, *Contracts* § 129, p. 556 (1963) (*emphasis added*).

<sup>61</sup> *Brower v. Gateway* 2000, 246 A.D.2d 246 (N.Y.A.D 1998).

<sup>62</sup> For an explicit rejection of the reduce-and-enforce methodology in penalty clauses, see *Cad Cam, Inc. v. Underwood*, 521 N.E.2d 498 (Oh. 1987)

that the parties could have anticipated as possible harm from delay.”<sup>63</sup> A leading commentary states that excessive liquidated damages should be reduced “to the *highest level* that the court regards as reasonably related the harm anticipated at the time of contracting...; that is, reduced to the measure *closest to the agreed sum, such that if that measure were the one agreed upon in the first place, the court would not have been justified in reducing it.*”<sup>64</sup> This, in other words, is the maximally tolerable level, the term within the reasonable range that comes closest to mimicking the parties’ bargaining power.

### CONCLUSION

When we think about courts interpreting contracts and supplying missing terms, we do not usually regard this as a distributive task. Unless there is clear evidence about actual but imperfectly specified intent, courts are supposed to identify the “reasonable” term, the most efficient term, the majoritarian term, or some other uniquely distinguished content, but none of these criteria is defined with respect to its distributive effect. This Article suggests that in fact the gap-filling task of the court is often purely distributive. In many contests (as in the case of a missing price) there are many potential provisions courts can choose from, all satisfying the reasonable or efficient criteria, but differ in their distributive allocation. Thus, contract law needs to provide a criterion for choosing the gap-filler in these distributive contests.

It is one thing to argue that we are faced with a recurring contractual gap that needs a systematic solution, for which existing gap-filling principles surprisingly do not apply. It is another thing to propose a bargain-mimicking solution—one that favors the strong party. Some readers might object to this proposed criterion as morally unjust. If there is a distributive aspect to gap filling, why not turn it into a redistributive

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<sup>63</sup> Zaken v. Ziva, Civil Appeal No. 539/92 (Unpublished), p. 4.

<sup>64</sup> U. Yadin, CONTRACT LAW (REMEDIES FOR BREACH OF CONTRACT ) 1970, p. 132 (2d Ed. 1979) (in Hebrew). See also Eyal Zamir et. al, BRIEF COMMENTARY ON LAW RELATING TO PRIVATE LAW 302 (1996) (in Hebrew) (“the measure of reduction of liquidated damages ought to be to the level for which the element of excessiveness no longer applies...[such that] if that level was set in the first place, it would not have been reduced by the court.”)

occasion in favor of the weak party? The answer I provide in this Article is that we don't really have a redistributive occasion and that gap fillers cannot effectively favor the weak party. Those who have greater bargaining power can always use this power to dictate explicit terms, rather than leave room for "more balanced" gap-fillers. The more redistributive gap filler are, the less likely it is that they will come into play. Gap fillers that go against this allocation of power and try to upset it will only induce the strong parties to exert express, self-favorable, terms. Perhaps there is something the law can do to level the playing field, but it is surely not a gap-filling regime. If we are serious about helping weak parties secure better deals, we probably need to get our hands dirty and engage in more aggressive forms of market regulation, mandatory quality rules, and redistribution. Using redistributive gap-fillers might give the ad-hoc impression that contract law is sensitive to the plight of weak parties, but would effectively do very little to have any systematic effect. Thus, along the well established view that the most that gap-filling rules can accomplish is simpler contract formation rituals, I concluded that purely distributive gap-fillers must adhere to a bargain-mimicking criterion and tilt in favor of the stronger party.

It is true that identifying the division of bargaining power can be difficult and error-prone. In the Article I suggested that this problem might not be as severe as it initially appears, but conceded that it does poses a significant challenge. Still, no matter how daunting this judicial task might be, it cannot justify a different gap-filling criterion. To be sure, there might be easier-to-apply criteria that are straightforward and require very little case-specific information. The problem is that if parties expect courts to supply gap-fillers other than the bargain-mimicking ones, they will be forced to draft terms with less gaps and with less flexibility. In this sense, the bargain-mimicking criterion is inevitable.

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