

# ESSAY

## A BARGAINING POWER THEORY OF DEFAULT RULES

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*This Essay explores the merits of a new criterion for default rules in incomplete contracts: filling 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. Instead, 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 strengths. This Essay explores the justifications for such a bargain-mimicking principle, the ways in which it could be implemented by courts, and the subtle ways it is already in place.*

### INTRODUCTION

How to fill gaps in incomplete agreements is perhaps the most important question in contract law. It is important both because courts often interpret and supplement contracts and because the default rules set by law determine how contracts will be written. One of the greater successes of the economic approach to contracts is the development of systematic ways to think about gap filling.<sup>1</sup> The most broadly accepted principle of gap filling is that courts should “mimic the parties’ will.”<sup>2</sup> Under this principle, only gap fillers that mimic what the parties themselves would have chosen are allowed to remain in place and survive opt-out, thereby eliminating unnecessary drafting costs. Of course, the notion of the parties’ will is hypothetical. Because the contract contains a gap, we do not know what they would have consented to. Here, the economic approach provides another powerful insight: The parties’ will is to have the most efficient arrangement. That is, they are best served by de-

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1. See Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881, 890–92 (2003) (summarizing contribution of economic analysis to theory of default rules).

2. Richard Craswell, Contract Law: General Theories, in 3 Encyclopedia of Law and Economics 1, 3–4 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000); see Ian Ayres, Default Rules for Incomplete Contracts, in 1 The New Palgrave Dictionary of Economics and the Law 585, 586 (Peter Newman ed., 1998).

fault rules that maximize the contractual surplus.<sup>3</sup> The idea that gap fillers should maximize the contractual surplus is based on the following well-known logic. Assuming parties are rational, they would have agreed upon terms that maximize their joint surplus, irrespective of the distributive impact of such terms. True, such terms might be more favorable to one side, but the parties would have corrected for any distributive effects by appropriately adjusting the contractual price or another purely distributive term.<sup>4</sup> But for this theory to be valid, it must assume that there is at least one contract term that the parties use to make the appropriate distributive adjustments—usually the price term—to which the theory does not apply. 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 because it does not resolve gaps in the price term or in any other contract term 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 not be reached because a single jointly preferable term does not exist.<sup>5</sup> If the parties' interests had coincided, they would have been able to agree on a term. But when the issue is distributive, the parties' interests are in conflict, and it is this divergence of interests that leads to the gap. Ironically, as I will show later, many of the cases used in contracts casebooks to introduce the topic of indefiniteness and gap filling involve purely distributive gaps over issues such as

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3. See E. Allen Farnsworth, *Contracts* 486 (4th ed. 2004) (noting courts may provide terms “that an economist would describe as maximizing the expected value of the transaction”); Richard A. Posner, *Economic Analysis of Law* 99 (7th ed. 2007) (“[C]ontract law cannot readily be used to achieve goals other than efficiency, as a ruling that fails to interpolate the efficient term will be reversed by the parties in their subsequent dealings.”); see also Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 21–22 (1991) (stating that gap fillers must duplicate terms that optimally promote parties' interests); Mark P. Gergen, *The Use of Open Terms in Contract*, 92 *Colum. L. Rev.* 997, 1064–72 (1992) (asserting that default rule should be a joint maximization rule); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *Yale L.J.* 541, 554 (2003) [hereinafter Schwartz & Scott, *Contract Theory*] (“Parties jointly choose the contract terms so as to maximize the surplus, which the price may then divide unequally.”).

4. See, e.g., George L. Priest, *A Theory of the Consumer Product Warranty*, 90 *Yale L.J.* 1297, 1313 (1981) (pointing out that disclaimers of warranty result in price adjustments); Schwartz & Scott, *Contract Theory*, supra note 3, at 554 (“Bargaining power instead is exercised in the division of the surplus, which is determined by the price term.”).

5. See, e.g., Omri Ben-Shahar, “Agreeing to Disagree”: Filling Gaps in Deliberately Incomplete Contracts, 2004 *Wis. L. Rev.* 389, 399–405 [hereinafter Ben-Shahar, *Agreeing to Disagree*] (arguing that gaps in contracts are often created deliberately when parties fail to agree on a negotiated provision).

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, but ended up in a bitter legal dispute about the price.<sup>6</sup> 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 the “market price” which the court could invoke.<sup>7</sup> Indeed, if there were such a price, the parties would not have needed the court to supply it. Of course, there was no “surplus-maximizing” price to fill the gap because price is surplus-neutral. Instead, the court had to supply a “reasonable” gap filler that was purely distributive. It ended up doing so by splitting the difference in a creative and unorthodox manner, forcing the companies’ CEOs to meet and mediate the future price.<sup>8</sup> And yet, the difficulty the court encountered and the ad hoc solution it found merely emphasize the absence of a systematic and rational criterion for filling such gaps. The purpose of this Essay 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 norms of mimicking the parties’ will. In cases of purely distributive terms there is no joint will. Instead, each party’s will is to have a term at the more favorable end of a range of reasonable terms. What courts need, then, is more information about how parties would have resolved their a priori conflict of wills. Specifically, a court needs information that would help it mimic the *bargain*: the division of surplus that the parties would have struck given their relative bargaining powers. Since the division of bargaining power between two parties may be uneven, the gap filler in these situations would be different than the midrange “market” term. When one party has greater bargaining power, the gap filler should tilt to favor this party, because this is the party whose will would have more likely prevailed if an explicit bargain were struck. Purely distributive gaps, therefore, would be filled with terms more favorable to the party with greater bargaining power.

At first blush this criterion might seem unfair. As a normative criterion, it is counterintuitive. Uneven bargaining power is hardly a desirable phenomenon; why then should it be mimicked? I will defend its more subtle appeal later in this Essay, but the core claim is perhaps less objectionable than it initially seems and can be illuminated with a nonlegal example. Take, for example, an incomplete command issued by a parent to a child to “mow the lawn.” If imperfectly specified, it needs supplementation—“only the front yard” or “both the front yard and the back

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6. 556 N.E.2d 515, 518–20 (Ohio 1990).

7. The court found that any price between \$5.00 and \$7.44 per gross ton was a reasonable rate. *Id.* at 520.

8. *Id.* at 518.

yard”—and more than one reasonable version could be offered. Still, if the parent has the “bargaining power”—the power to dictate the exact scope of the command—then the precise term that ought to be followed 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 her greater bargaining power, is the controlling source of interpretation. In fact, such interpretive method would render it unnecessary for the parent to be more explicit in her command, and there are benefits to using minimal language, such as saved transaction costs and the ability to utilize simple, generic templates of transactions. To be sure, this example is not about a legal gap filler but rather about an informal norm that governs intrafamily communications. Nonetheless, their functions are the same. These norms supply a default content to an otherwise ambiguous provision, and they do so in ways that mimic 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 a contract was concluded. While the parent/child example I provided is misleadingly easy, determining relative bargaining strength in commercial relations is more elusive. This Essay explores and identifies what courts would need to know in order to fill contract gaps and discusses whether they have the institutional capacity to do so. It also argues 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 constitutes a “reasonable” price under section 2-305 of the Uniform Commercial Code, they can let one party have more influence in choosing where, within a broad range, this price would lie.<sup>9</sup> In doing so, courts often acknowledge that the choosing party is the one with the greater bargaining power.<sup>10</sup>

Part I of this Essay 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. Admittedly, there is something objectionable about a legal rule that favors the party with the greater bargaining power. Bargaining power is hardly a compelling conception of distributive fairness. Legal rules that favor the weaker party and level the playing field are more commonly defended.<sup>11</sup> But, as I demonstrate in Part II using actual contracts

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9. U.C.C. § 2-305(1)–(2) & cmt. 3 (2004) (establishing that one party may be accorded power to set price, but must do so in good faith).

10. See, e.g., *D.R. Curtis, Co. v. Mathews*, 653 P.2d 1188, 1189, 1191 (Idaho Ct. App. 1982) (using original price set by middleman in damages calculation, even though final price was not set by contract).

11. For example, the doctrine of duress is often justified as redressing the disparity of bargaining power. See, e.g., John P. Dawson, *Economic Duress—An Essay in Perspective*,

as examples, default rules that try to upset the potential bargaining outcome are undesirable because they are a futile effort—the parties can always opt out of them, and strong parties likely will. Moreover, the analysis in Part II illustrates that the traditional justifications for default rules—saved transactions costs, facilitating entry into desirable forms of relationship, and inducing optimal reliance—also apply to the bargain-mimicking conception of gap filling.

Part III of this Essay identifies the existence of bargain-mimicking gap fillers in current contract law. It demonstrates how this idea was implemented in leading cases, although without courts always recognizing that their decisions relied on—or at least conformed to—a bargain-mimicking principle. In illustrating that courts already do this, I suggest that it is not institutionally impossible to base a legal rule on a criterion as elusive as relative bargaining power. This Part also highlights situations in which the bargain-mimicking idea was rejected, thereby recognizing that in certain situations the bargain-mimicking idea conflicts with other, deep-rooted principles of contract law. Finally, Part IV extends the analysis by introducing a problem posed by excessive terms, which go beyond the threshold of permissible contracting. When such excessive terms are struck down and need to be replaced, courts are faced with a problem of gap filling. The original, excessive, term is no longer valid; what should be put in its place? Here, it is generally clear that one party holds greater bargaining power, which it employed to dictate the excessive term.<sup>12</sup> A bargain-mimicking term would maintain maximal loyalty to the bargain struck between the parties by filling the gap with the maximally tolerable term that remains one-sided and favorable to the party who dictated the original one-sided term, but which is moderated sufficiently so that it is tolerable. Instead of substituting the offensive term with the most balanced “majoritarian” term, the court would reduce it only enough to fit within the range that is considered legitimate. In so doing, the court would mimic the hypothetical bargain that parties negotiating over a truncated domain would reach.

## 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 terms that mimic the will of the parties—terms that most parties would have jointly

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45 Mich. L. Rev. 253, 282–88 (1947) (discussing work of duress doctrine in context of economic bargaining power). Likewise, weak bargaining power can support a claim of unconscionability. See, e.g., *Shell Oil Co. v. Marinello*, 307 A.2d 598, 601 (N.J. 1973) (declaring that courts may find void a “grossly unfair contractual provision [ ]” when “there is grossly disproportionate bargaining power”).

12. Many cases of intervention in unconscionable contracts explicitly recognize the presence of superior bargaining power. See Farnsworth, *supra* note 3, at 301–02.

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 not 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 to a contract. Absent a more powerful prescription, then, the will-mimicking principle would be indeterminate and too amorphous to fill the gap.

Put differently, contract design involves two tasks: creating the pie and dividing it, with many terms affecting both aspects. Principles of surplus maximization are synonymous with the creation of the pie. Once the maximal pie is created, through a combination of express terms and surplus-enhancing gap fillers, it has to be divided. But 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 fundamental reason to doubt whether there is a single joint will that could 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.<sup>13</sup> Filling distributive gaps, then, is not an exercise in surplus maximization or in figuring out the optimal transaction design, but in guessing how the surplus would have been divided.

Consider, for example, a sales contract that does not specify payment terms. There are many ways to supplement this gap, but it can hardly be said that the different modalities for payment 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 it 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. As a result, there is no joint will to mimic. Earlier payment is usually preferable to the seller

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13. See, e.g., Martin J. Osborne & Ariel Rubinstein, *Bargaining and Markets* 50–55 (1990) (showing that strategic bargaining power depends on bargaining procedure; parties' relative costs of delay and relative patience; outside options; and more).

to the same extent that it is detrimental to the buyer. The seller, therefore, has one will, while the buyer has another.

How, you might wonder, could parties enter a binding contract without specifying the surplus division and leaving the price term out? Is this scenario realistic? Not only is this scenario possible, but some of the most prominent cases on contractual indefiniteness involve gaps in the price term, the one term that by definition has a purely distributive effect. For example, one of the leading cases, *Joseph Martin, Jr., Delicatessen, Inc. v. Schumacher*, involved a lease of commercial property with an option to renew under an indefinite price, the contract stating that the renewal price needed “to be agreed upon.”<sup>14</sup> Another classic case, *Sun Printing & Publishing Ass’n v. Remington Paper & Power Co.*, involved a sales contract that contained an indefinite price formula.<sup>15</sup> Furthermore, sales law casebooks typically devote a chapter to the case law of commercial contracts with missing price terms—a scenario that is fully anticipated by section 2-305 of the Uniform Commercial Code and other international sales law provisions.<sup>16</sup>

Courts and commentators may disagree whether such distributive gaps render contracts too indefinite to be enforced.<sup>17</sup> The missing price, it is sometimes argued, is a conclusive indication that the parties have not yet intended to be bound, since they left the most essential term for further assent.<sup>18</sup> And yet, modern contract law tends to conclude that a

14. 417 N.E.2d 541, 542 (N.Y. 1981). In that case, the court refused to fill the gap and held that the contract was too indefinite to be enforced. *Id.* at 543–44. But the growing trend is to enforce such contracts. See, e.g., Daniel E. Feld, Annotation, 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, 503–06 (1974) (surveying case law on lease renewals subject to price agreement).

15. 139 N.E. 470, 470 (N.Y. 1923) (examining role of mutual assent in interpreting open terms and agreements to agree). See generally *Sw. Eng’g Co. v. Martin Tractor Co.*, 473 P.2d 18 (Kan. 1970) (addressing gap filling where payment and credit terms—elements that are purely distributive—are not fully specified); *Mantell v. Int’l Plastic Harmonica Corp.*, 55 A.2d 250 (N.J. 1947) (addressing gap filling in contract in which price was deliberately left out and yet court was more than ready to supply it).

16. U.C.C. § 2-305 (2004) (“The parties if they so intend may conclude a contract for sale even if the price is not settled.”); see also United Nations Convention on Contracts for the International Sale of Goods (CISG) art. 55, Apr. 11, 1980, S. Treaty Doc. No. 98-9 (1986), 1489 U.N.T.S. 59, 69 (implying price where contract was validly concluded but without a price); Int’l Inst. for the Unification of Private Law, UNIDROIT Principles of International Commercial Contracts art. 5.1.7 (2004) [hereinafter UNIDROIT Principles] (same); Bruce W. Frier & James J. White, *The Modern Law of Contracts* 256–89 (2005) (discussing interpretation of contract terms); Richard E. Speidel & Linda J. Rusch, *Commercial Transactions: Sales, Leases and Licenses* 174–203 (2d ed. 2001) (discussing effect of open contract terms).

17. See Feld, *supra* note 14, at 503–06 (surveying different approaches taken by courts); see also sources cited in Ben-Shahar, *Agreeing to Disagree*, *supra* note 5, at 395–96 nn.15–19 (citing sources that describe some reasons why case outcomes differ).

18. See, e.g., *Walker v. Keith*, 382 S.W.2d 198, 203–04 (Ky. 1964) (finding that missing price indicates lack of mutual assent); U.C.C. § 2-305 cmt. 2 (“Under some circumstances the postponement of agreement on price will mean that no deal has really been

missing price does not render a contract unenforceable, so long as there are independent indications of intent to be bound.<sup>19</sup> These situations present a binding contract with a substantial gap, and the gap filler cannot be determined by reference to the term that maximizes the total surplus—the price—because every price, at least within a fairly broad interval, satisfies this criterion.

It is true that many aspects of a contract that are primarily distributive may also affect the total surplus. For example, payment terms can be more or less efficient because the seller may or may not be the efficient supplier. But it is false to conclude that gap fillers for all these aspects can be set to maximize the surplus. As I noted at the outset, the only reason a subset of the gap fillers can be indisputably surplus maximizing is that there is at least one other aspect of the deal that is purely distributive and that 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 of why contracts are indefinite. Negotiations—the bargaining and haggling over terms—require time, effort, and strategy, and they often fail, not because parties are undertrained in maximization exercises, or because of limits on the parties’ ability to foresee and imagine contingencies. Rather, negotiations are hard precisely where the issue is distributive and there is no single maximizing term over which agreement would naturally arise. Workers go on strikes because of disagreements over zero-sum wage terms; nations go to wars because of disputes over zero-sum boundary lines; merger agreements fail when the price offered by the buyer is regarded by the shareholders as too low. Negotiations are hardest and most likely to fail specifically when the issues are purely distributive, because these are the areas for which the “engine” of increased surplus cannot provide a focal point for agreement.

Still, even when parties fail to resolve a distributive term, they may nevertheless choose to enter a binding contract, leaving the distributive term open or subject to an agreement to agree. They may do this because they believe agreement to this distributive term will be more likely at a future date, and it would therefore be inefficient for them to walk away from the remainder of the deal.<sup>20</sup> Or, they may leave price gaps because they expect some contingency to materialize that will make the distributive issue moot or easier to resolve in reference to market indi-

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concluded . . . .”); Farnsworth, *supra* note 3, at 202–03, 210–11 (distinguishing indefiniteness that is due to lack of assent).

19. See, e.g., U.C.C. § 2-305 (rejecting principle that indefinite agreements, or agreements to agree, are unenforceable); Farnsworth, *supra* note 3, at 207–11 (noting that U.C.C. § 2-305 rejects traditional common law nonenforceability rule).

20. See Ben-Shahar, *Agreeing to Disagree*, *supra* note 5, at 403 (discussing negotiation practice of avoiding contentious issues that may make agreement impossible).

ces.<sup>21</sup> Or, they may expect that, if needed, a third party can arbitrate or split their difference.<sup>22</sup> In all these cases, if the price resolution mechanism subsequently fails, courts are presented with the reality that disputing parties entered a binding contract but left out a crucial distributive term.

### B. *Mimic One Party's Will*

As a mechanism for gap filling, the surplus-maximization principle is easy to justify. It improves both parties' well-being and gives them what, *ex ante*, they would rationally have chosen.<sup>23</sup> If a distributive gap cannot be filled with a surplus-maximizing term, it may nevertheless be possible to provide a similarly justified gap filler 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 must be supplemented by a criterion that would apply to settings that are purely distributive. Fortunately, courts often have information that can help them tease out what the parties would have agreed upon: information about the parties' relative bargaining power.

When the parties' interests concerning a particular term conflict, the term the parties would have agreed upon depends on the allocation of bargaining power. Having the greater bargaining power means that a party can exert more influence in the design of the terms. A gap filler that mimics the division of bargaining power would then favor that party. If, instead, the parties have equal bargaining power, the gap filler should resemble the split-the-difference, midrange term. Generally, a gap filler that depends on information the court has regarding the parties' relative bargaining power at the time of the contract is a superior proxy for the missing term. I refer to this gap filler as a "bargain-mimicking" default rule.

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 midrange, split-the-difference default terms that reflect 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 midrange solution. The

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21. This is the typical situation in lease agreements with a tenant option to renew upon its expiration.

22. See U.C.C. § 2-305(1)(c) & cmt. 4 (recognizing situation in which third party's judgment as to price is used to fill gap).

23. Craswell, *supra* note 2, at 3-4.

greater the seller's bargaining power, the higher the interest rate that the gap filler would supply. And conversely, the greater the buyer's bargaining power, the more lenient the credit terms.

Another example of a gap filler that would tilt in favor of one party arises in 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.<sup>24</sup> 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>25</sup> The standard form contracts utilized in the auto industry, however, are short and contain many gaps.<sup>26</sup> For example, they often leave the price under which "service parts" will be sold unspecified.<sup>27</sup> Service parts, which are 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 a specific agreement? There is no "market" term to refer to because there is no competitive market. There is only a single seller who sets different prices for different buyers. A midrange, split-the-profit price is one way to fill the gap. Of course, it would not reflect the parties' relative bargaining powers. Nor would it come close to mimicking the express deal they would have reached—that is, the deal the buyer would have dictated, and that some automakers do in fact dictate.<sup>28</sup> The bargain-mimicking gap filler, by contrast, would supply a price that accords the greater share of the premium to the buyer.

The content of a bargain-mimicking gap filler is fact dependent and specifically tailored to the contracting 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 parties' relative bargaining power in each case. For example, a lease with an option to renew under a

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24. See Omri Ben-Shahar & James J. White, Boilerplate and Economic Power in Auto Manufacturing Contracts, 104 Mich. L. Rev. 953, 961–63 (2006) (describing contracting process in auto manufacturing).

25. *Id.* at 963–64.

26. For example, General Motors, who in 2004 entered into close to one million procurement transactions for a total volume of \$80 billion, used for all these contracts a short, thirty-one paragraph, standard form. *Id.* at 957.

27. *Id.* at 961; see, e.g., Toyota Motors Mfg. N. Am., Inc., Terms and Conditions § 4.2 (Oct. 1, 1998) (leaving price for service parts to be determined later). Due to the confidential nature of this contract, the *Columbia Law Review* does not have a copy of it on file.

28. For example, Nissan's contract forces suppliers to commit to selling the service parts for fifteen years at the price negotiated during the production phase, which is typically the lowest possible price and the one that accords the entire surplus from the service parts market to the buyer. Nissan N. Am., Inc., Master Purchase Agreement art. 19 (2003), available at [http://www.butzel.com/AutoIndustry/080907tcNissan\\_AI.pdf](http://www.butzel.com/AutoIndustry/080907tcNissan_AI.pdf) (on file with the *Columbia Law Review*).

price to be agreed upon would be supplemented with a high, pro-landlord price if the landlord happens to enjoy greater bargaining power because of a migration of many tenants into the region. The same lease would be supplemented with a low, pro-tenant price if the tenant has the greater bargaining power because there are many vacant sites in the area.

In an interesting way, bargain-mimicking gap fillers share the same empirical premise, but can also be contrasted with, the *contra proferentum* principle. This is the principle under which ambiguous language in the contract is interpreted against the drafter.<sup>29</sup> Both principles—bargain-mimicking and *contra proferentum*—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, such that a court needs to fill the language gap. Both principles can only be applied after a court makes a determination of relative negotiation power.<sup>30</sup> But, relative to the *contra proferentum* principle, the bargain-mimicking principle provides the opposite prescription. When a contract is ambiguous or indefinite, the *contra proferentum* principle prescribes gap filling with the term that is least favorable, within reason, to the party who drafted the contract. By contrast, the bargain-mimicking principle supplies a term that is most favorable to the drafter and that most closely resembles the deal the drafter would have been 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>31</sup> the bargain-mimicking principle gives the strong party what she could have gotten explicitly through bargaining.

### C. Majoritarian Versus Bargain-Mimicking Terms

The bargain-mimicking conception of gap filling breaks a discontinuity that is otherwise created by midrange, majoritarian gap fillers. If all gaps are filled with midrange terms, a decision by the stronger party to leave a gap in the contract would result in an expected forfeiture of a discrete chunk of the private payoff. For this party, the choice to leave the contract gap might save some transaction costs, but it would simultaneously cost her the opportunity to exploit her bargaining advantage and

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29. See 5 Margaret N. Kniffin, *Corbin on Contracts: Interpretation of Contracts* § 24.27 (Joseph M. Perillo ed., rev. ed. 1998) (explaining that *contra proferentum* is “technique” in which courts “adopt the meaning that is less favorable in its legal effect to the party who chose the words”).

30. See, e.g., *Gaunt v. John Hancock Mut. Life Ins. Co.*, 160 F.2d 599, 601–02 (2d Cir. 1947) (“[C]ontra proferentum is more rigorously applied in insurance than in other contracts, in recognition of the difference between the parties in their acquaintance with the subject matter.”).

31. See, e.g., Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 *Mich. L. Rev.* 531, 534 (1996) (noting that typical justification for *contra proferentum* is liability for negligent drafting); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *Yale L.J.* 87, 91 (1989) (arguing that penalty default rules provide incentives for drafting explicit terms).

appropriate a term more favorable than the midrange default rule. The agreement that results from midrange 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.

In many distributive contexts, the bargain-mimicking criterion would prescribe terms that are significantly different from the midrange, reasonable terms that would be prescribed by the majoritarian criterion. Specifically, the majoritarian criterion recognizes that different parties could have reached different reasonable terms and that there is a distribution of bargained-for terms. Accordingly, it fills contract gaps with a term that measures a “center” of this distribution.<sup>32</sup> Unlike the majoritarian criterion, the bargain-mimicking criterion relies on specific information that reflects the division of bargaining power, and consequently the deal, that these particular parties would have come to.

Still, it would be a mistake to conclude from this discussion that the bargain-mimicking gap fillers would always diverge from the majoritarian, midrange gap fillers. The two gap-filling criteria may prescribe the same content of gap filler in situations where the bargaining positions of the parties are relatively equal. In these situations, information about the specific parties’ bargaining does not change the inference about the hypothetical bargain. For example, if the parties are price-takers, dealing in matters for which there is a thick market and neither is uniquely positioned within this market, it is likely that the term they would have agreed upon is the same term that most parties in the market adopt.<sup>33</sup> Similarly, if 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 will necessarily be influenced by the terms in that market.<sup>34</sup> In these situations, the bargain-mimicking principle would prescribe a term that reflects the market term. But unlike the majoritarian principle, 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 party’s relative purchasing power. Put differently, majoritarian gap fillers that refer to “reasonable market prices” will be consistent with the bargain-

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32. Craswell, *supra* note 2, at 4–5.

33. See 1 James J. White & Robert S. Summers, *Uniform Commercial Code* § 3–8 (5th ed. 2006) (describing use of market prices as gap fillers).

34. See, e.g., *Oglebay Norton Co. v. Armco, Inc.*, 556 N.E.2d 515, 519–20 (Ohio 1990) (affirming use of market shipping rates in thick market for shipping, when contract pricing mechanism failed).

mimicking criterion when applied to specific situations where the parties' bargaining power is determined by the market.<sup>35</sup>

To illustrate, consider the well-known case *Mantell v. International Plastic Harmonica Corp.*, in which a wholesaler and distributor arranged a long-term distribution agreement that did not fix the price term.<sup>36</sup> The agreement instead referred to the prices charged to other distributors, but, as it turned out, there were no other distributors.<sup>37</sup> The court decided to fill the gap with a reasonable price term, but explained that what constituted a reasonable price depended, inter alia, on the price the seller could get from other dealers, competition between wholesalers as well as between dealers, the uniqueness of the product, and the quantity produced.<sup>38</sup> These factors are precisely those that determine parties' relative bargaining powers.

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

There is something admittedly deceptive about the idea of a bargain-mimicking gap filler. It assumes that the division of bargaining power between parties is measurable and verifiable by a 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>39</sup> It reflects, in short, the relative facility of each party to refuse the deal. But it is one thing to recognize the theoretical existence and role of this parameter; it is quite another to actually measure relative bargaining power and to base legal decisions on these measurements.

It would be naïve to expect that courts will be able to measure bargaining power with complete precision. Still, implementing a regime with error, or only in those cases where the parameter is verifiable, is better than nothing. Moreover, in some situations crude approximations of relative bargaining power are likely to be correct, even if imperfect. For example, someone who sells a good for which demand is inelastic undeniably possesses greater bargaining power than those with whom she is negotiating.<sup>40</sup> Similarly, when many bidders compete for a single job, the party inviting the bids has greater bargaining power. While it is difficult even in these situations to quantify a party's bargaining strength on a scale of one to ten, is it any more difficult than weighing the other parameters that courts ordinarily assess, such as comparative fault in a tort action?

35. See James Gordley, *Foundations of Private Law* 363 (2006) (“[T]he market price preserves (so far as possible) each party’s share of purchasing power.”).

36. 55 A.2d 250, 254 (N.J. 1947).

37. *Id.* at 254–55.

38. *Id.* at 256.

39. See, e.g., Osborne & Rubinstein, *supra* note 13, at 29–65 (analyzing factors that affect bargaining outcome).

40. Robert Pindyck & Daniel Rubinfeld, *Microeconomics* 357–58 (6th ed. 2005).

In fact, courts already quite regularly refer to bargaining power as a factor that justifies case outcomes. Under the unconscionability doctrine, the presence of one-sided bargaining power is often identified and invoked for the purpose of reforming some explicit term.<sup>41</sup> Under the duress doctrine, weak bargaining power is often identified and invoked for the purpose of relieving the weaker party from a coerced deal.<sup>42</sup> Under the *contra proferentum* doctrine courts have to figure out which party had the power to dictate a term, and they then rule against this party. As the Restatement recognizes, *contra proferentum* is “often invoked in cases of standardized contracts and in cases where the drafting party has the stronger bargaining position.”<sup>43</sup> While courts may at times misjudge relative bargaining positions, particularly because there is a misguided tendency to view a take-it-or-leave-it offer as a sign of bargaining power,<sup>44</sup> a substantial doctrinal tradition is nevertheless founded on the belief that courts can identify bargaining power and determine legal consequences based on this identification.

Yet, unlike the approach presented in this Essay, existing doctrines that refer to bargaining power typically favor the weaker bargainer. This distinction is crucial. For a weak party, there is no danger in arguing in court that the other side had all the bargaining power. In contrast, for a strong party, arguing that she had all the bargaining power may be risky, lest existing contract doctrines and laws equalize her bargained-for gains. For example, if she were to argue that her bargaining power stems from a monopoly position, she could face antitrust consequences. If she were to argue that her bargaining power is due to information advantage, she could 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 than prove in court.<sup>45</sup> Accordingly, any 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 verifiably uneven bargaining power, identifying a bargain-mimicking term may be tricky. Gaps in the contract may result from the parties’

41. See, e.g., *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 850 (Ct. App. 1991) (“[T]here was an inequality of bargaining power which effectively robbed [promisor] of any meaningful choice.”); see also UNIDROIT Principles, *supra* note 16, art. 3.10(1) (listing “lack of bargaining skill” as factor relevant to determination of unconscionability).

42. See, e.g., Restatement (Second) of Contracts § 176 cmt. f (1979) (discussing improper threats in bargaining process).

43. *Id.* § 206 cmt. a.

44. See, e.g., *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 893 (9th Cir. 2002) (reasoning that employer “possesse[d] considerably more bargaining power than . . . its employees” such that employees had to “take the contract or leave it”).

45. See generally Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 *Yale L.J.* 1885 (2000) (discussing interest of contracting parties in concealing information for strategic purposes).

inability to agree.<sup>46</sup> Or, they may result from the stronger party's strategic calculation to leave an issue open, recognizing that on this specific issue the weaker party would not acquiesce to a one-sided term or would be alerted to some hidden unfavorable aspect of the deal. If the stronger party suppressed a specific issue and deliberately left a gap, it could actually be an indication of the limits of her bargaining power. In other words, it could be a reflection of the fact that in an explicit agreement she could not extract the one-sided term she coveted. Here, the bargain-mimicking term would not necessarily favor the stronger party, and granting her a favorable gap filler would encourage her to leave gaps in all areas in which she cannot bargain for an advantage. Instead of mimicking the bargain, then, 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 to 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, and recognizing that some leverage has already been spent on other, expressly drafted terms, the court must figure out how the parties would have used their remaining bargaining power over this specific term.

Daunting as this task might first appear, 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 of how different terms and issues interact, and a perception of what each party values more—all with an eye to idiosyncratic preferences.<sup>47</sup> Here, too, some terms cannot be supplemented without careful attention to other aspects of the deal. Still, the surplus-maximization criterion has broad appeal because it makes normative sense, despite the fact that it is harder to implement than other, simpler default rules. It is socially desirable to instruct courts to make the effort to apply the surplus-maximization criterion, even crudely, because the benefit arising from more efficient obligations is worth the adjudicative cost. In the next section, I 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, when courts do have accurate information about the bargain-mimicking term, it ought not be ignored.

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46. See Ben-Shahar, *Agreeing to Disagree*, *supra* note 5, at 402–05 (arguing that gaps in contracts often result from failed attempts to agree on negotiated provision).

47. See, e.g., *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 593–95 (7th Cir. 1991) (demonstrating various factors that need to be evaluated in figuring out how to interpret gap in contract).

## II. ARE BARGAIN-MIMICKING TERMS DESIRABLE?

The purpose of this Essay is not to advocate for the general use of bargain-mimicking gap fillers, but to identify their use as a conceptual and practical possibility and to explore arguments in support of such a regime. Before turning, in Part III, to examine instances where courts have actually implemented this regime, let us explore some reasons why a bargain-mimicking regime is normatively desirable.

### A. *Transaction Costs*

When a contract gap involves an issue affecting the size of the surplus, a well-rehearsed argument explains why the gap filler ought to be a surplus-maximizing provision.<sup>48</sup> It is an argument of exceptional appeal because it sidesteps any distributive implications. Surplus-maximizing gap fillers indiscriminately increase the well-being of both parties to the contract. If the law were to provide off-the-shelf terms that were anything but surplus-maximizing, it would have the effect of inducing parties to write explicit provisions which, other than occasional indirect benefits, as, for example the exposure of private information, would merely increase transaction costs.<sup>49</sup> But once the price or other distributive term is adjusted appropriately to divide the savings in transaction costs, each party ends up with a greater net payoff.

One might assume that in the context of bargain-mimicking terms this same distributive-neutral defense is inapplicable. In other words, if the law 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 stronger party. Why, one might ask, should it be the law's objective to resolve distributive ambiguities and gaps in favor of the stronger party when the overall welfare of the parties is not enhanced? Surely, this party can take good care of herself and

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48. See, e.g., 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 . . .”); see also sources cited *supra* note 3.

49. Posner, *supra* note 3, at 96–99 (“[C]ontract law cannot readily be used to achieve goals other than efficiency, as a ruling that fails to interpolate the efficient term will be reversed by the parties in their subsequent dealings.”).

secure her own advantages through bargaining. If anything, 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 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 transaction costs. If the law accords a party the same terms that she could secure by explicit (and harsh) bargaining, the party with the bargaining power need not expend the costs of explicitly specifying these same terms. If gap fillers do anything other than mimic the term this party could have dictated herself, they will have the *ex ante* effect of inducing this party to dictate the term in order to preempt any adverse allocation that would otherwise result from the gap filler. Perhaps even more than in other contexts, when the distribution is at stake it is likely that the stronger party will insist on contracting around a nonmimicking gap filler.

In the context of surplus-maximizing gap fillers, it is commonly noted that both parties enjoy the saved transaction costs afforded by such terms.<sup>50</sup> By similar logic, it must also be true that when one party has the bargaining advantage, both parties enjoy the saved transaction costs achieved by bargain-mimicking terms and would therefore prefer them to majoritarian gap fillers. The only difference in the current context is that the savings achieved by the mimicking terms are, 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 transaction costs that is favorable to her.

What, exactly, are these transaction 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 the parties are spared. In certain settings, for example, we can imagine that weaker parties endure humiliation when the stronger party openly dictates a one-sided term. While the cost of punctuating one's powerlessness is emotional and cannot be measured in monetary terms, it is nonetheless recognized as an important cost in negotiation literature.<sup>51</sup> In this vein, stronger parties are often advised to impart to

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50. See, e.g., *id.* at 95–96 (explaining mutual benefit to parties of leaving gaps in contract for contingencies that are unlikely to occur).

51. See, e.g., David A. Lax & James K. Sebenius, *The Manager as Negotiator* 112–13 (1986) (highlighting cooperative bargainer's concern for preservation of "self-esteem" and "helping counterparts to save face when necessary"); Robert H. Mnookin, Scott R. Peppet

their counterparts a sense that the pie is equally divided, even when it is not, to make it easier for their opponents to acquiesce.<sup>52</sup> A default rule that eases the need for stronger parties to openly “stick it” to weaker parties has this cost-mitigating effect.

### B. *Flexibility in Contract Performance*

Another reason why a bargain-mimicking regime is normatively desirable has to do with the parties’ need to leave issues unresolved in order to allow flexible adjustments down the road. In long-term contracts, gaps result not only from transaction costs (i.e., the difficulty of foreseeing and stipulating for all future contingencies), but also from deliberate drafting decisions to leave room for more flexibility when new contingencies arise.<sup>53</sup> Parties recognize that conditions may change and special needs or priorities may arise, such that it would be mutually beneficial to allow for future adjustments in their respective obligations. It is, of course, possible to dictate rigid terms that apply to future contingencies and then later, if flexibility is needed, to accord waivers and accommodations through the course of performance. But doing so means the stronger party would “waste” bargaining power to secure terms and privileges that he would be willing to waive and that, *ex post*, might not matter all that much. Alternatively, recognizing the advantages of flexibility, the stronger party may choose to leave some issues in the contract unresolved, with the expectation that she will nail them down if and when they become relevant. A bargain-mimicking, gap-filling regime would render the open term strategy safer for the stronger party whenever it is the cheaper method for drafting the contract.

This technique of flexible drafting is used in various ways. At the extreme, a contract might stipulate that the parties will agree upon a particular provision at a later stage.<sup>54</sup> This is not an agreement to agree; there is enough definiteness in the remainder of the contract, and there

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& Andrew S. Tulumello, *Beyond Winning: Negotiating to Create Value in Deals and Disputes* 44–68 (2000) (asserting that expressing “concern and respect” during negotiations “tend[s] to defuse anger and mistrust, especially where these emotions stem from feeling unappreciated or exploited”).

52. See Richard H. Thaler, *The Winner’s Curse: Paradoxes and Anomalies of Economic Life* 21–35 (1992) (surveying experimental research that shows that parties with less bargaining power will nevertheless refuse to accept deals in which they are treated unequally).

53. See, e.g., Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 *J. Legal Stud.* 271, 284–90 (1992) (analyzing reasons for incompleteness of long-term contracts).

54. This technique is common in auto manufacturing contracts. The big auto manufacturers stipulate in long-term contracts with their suppliers that replacement parts will be sold at a price that will be agreed upon later. See, e.g., Gen. Motors, *General Terms and Conditions* § 20 (rev. Sept. 2004) (“[T]he price(s) during the first 3 years of this period shall be those in effect at the conclusion of current model purchases. For the remainder of this period, the price(s) for goods shall be agreed to by the parties.”); Toyota Motors Mfg. N. Am., Inc., *supra* note 27, § 4.2(d) (“[Toyota] will establish, after good faith

is a clear statement of the parties' intent to be bound, thereby making 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 issue—the court must utilize a different methodology to fill the gap. In choosing a gap filler, the bargain-mimicking principle instructs a court to lean toward the will of the party who would have had more bargaining power at the subsequent negotiation stage. Indeed, at the *ex post* stage in which the term would have been settled, bargaining power may have shifted and the party that originally had more power may now have less leverage. The parties chose the flexible drafting technique recognizing this possible shift in bargaining power. The parties anticipated and agreed to follow the terms that would emerge from subsequent bargaining—terms that would reflect bargaining power at the subsequent round. Thus, the bargain-mimicking term should trace the relative bargaining power at this subsequent stage.

A common technique in flexible drafting is to allocate to one party the power to determine, *ex post*, the content of the term and to change it as circumstances change.<sup>55</sup> The party with this power is not always the stronger party. For example, in output contracts the seller is entitled to set the quantity, but it is hardly the seller who has the bargaining power.<sup>56</sup> 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 duration of the contract, the seller is translating her bargaining strength *ex ante* into a scheme that supplies terms that are favorable to her *ex post*. This is how oil companies deal with their local distributors.<sup>57</sup> The role of courts here is to police overreaching—to determine if a party acted in bad faith and used its power to set terms that are unreasonable or intolerable.<sup>58</sup> If courts were unwilling

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negotiations with Supplier, a price for Service Parts.”). Due to the confidential nature of these contracts, the *Columbia Law Review* does not have copies of them on file.

55. White & Summers, *supra* note 33, at 231.

56. For example, in the case law favorite *Feld v. Henry S. Levy & Sons, Inc.*, 335 N.E.2d 320, 321 (N.Y. 1975), the parties had an output contract for breadcrumbs. The seller was entitled to set the quantity but did not have much bargaining power and indeed failed to induce the buyer to agree to pay for a cost increase of one cent per pound. *Id.*

57. See, e.g., *Mathis v. Exxon Corp.*, 302 F.3d 448, 452–54 (5th Cir. 2002) (illustrating that oil companies follow one-sided pricing practices); *Shell Oil Co. v. HRN Inc.*, 144 S.W.3d 429, 432–33 (Tex. 2004) (same).

58. U.C.C. § 2-305(2) & cmt. 3 (2004); White & Summers, *supra* note 33, at 226–34 (surveying cases in which courts applied good faith limitation to scrutinize price adjustment).

to allow stronger parties to utilize this self-promoting technique, flexible drafting of long-term contracts would be undermined.

Another technique of flexible drafting attaches the meaning of a particular term to some objectively observable index. For example, a supplier in a long-term sales contract may demand that price will equal someone else's posted price at the time of delivery.<sup>59</sup> Disputes may arise if 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? Here again, the stronger party has a sensible claim that the supplemented price ought to mimic the bargain the parties would have struck 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, the gap ought to be supplemented with a comparable price. Any other choice would force parties to choose an alternate pricing methodology, perhaps sacrificing some of the flexibility.

Termination terms also illustrate the benefit of bargain-mimicking defaults. A party enjoys stronger bargaining power when there are many potential partners who bid to be chosen by her. Once a bidder is chosen and awarded the contract, however, the one-on-one relationship no longer preserves the asymmetric bargaining power. Nonetheless the possibility of termination allows the stronger party to maintain a bargaining advantage throughout the relationship because she can credibly threaten to choose another bidder. Thus, the duration gap filler—the rule that allows parties to terminate an open-ended contract at will<sup>60</sup>—is effectively a bargain-mimicking default rule. True, under this rule both parties have a symmetric right to terminate.<sup>61</sup> But often it is only one party—the initially stronger party with many bidders—who might potentially want to terminate.<sup>62</sup> The other party has too little choice to go elsewhere, or has already sunk too much into the relationship.<sup>63</sup> If the weaker party chooses to terminate the agreement, she is unlikely (or at least less likely) to find other business. The right to terminate effectively mimics the will

59. U.C.C. § 2-305(1)(c) & cmt. 4 (applying to cases in which a particular person is chosen to set price); White & Summers, *supra* note 33, at 232 (providing examples for such formulae).

60. U.C.C. § 2-309(2).

61. *Id.* (“[U]nless otherwise agreed [the contract] may be [T]erminated at any time *by either party.*” (emphasis added)).

62. See, e.g., *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 131 (5th Cir. 1979) (describing manufacturer's termination of distribution contract and holding “arbitrary termination . . . permissible under both the contract and the law of Iowa”).

63. *Id.* at 132 (detailing distributor's claim that it made investment in relationship that would be squandered if contract was terminated). Indeed, this nowhere-to-go problem is often the case in termination of franchise contracts. See, e.g., Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 *Stan. L. Rev.* 927, 951–53 (1990) (discussing problem of relationship-specific investment).

of the stronger party. With this safeguard in place, the stronger party is free to use a variety of terms she could not otherwise use. First, she is free to use an open-ended duration. Second, she can give the other party leeway and control over aspects of performance without specifying them in the contract, since she knows that if these privileges are abused she can simply terminate the contract. Finally, she can choose a lesser-known bidder.

A final example where a bargain-mimicking criterion might affect the way parties design their bargain is a prenuptial agreement. Imagine a situation in which a billionaire is about to marry a person with no assets. It is plausible to suggest that the billionaire has greater bargaining power regarding the financial consequences of divorce. In the event of divorce, a gap filler that tracks this bargaining advantage would differ significantly from one that provides a more generous distribution to the less affluent spouse. It is true that in noncommercial settings bargaining power may be particularly elusive because bargaining power is not simply equivalent to financial prowess. There are obvious factors other than wealth that affect each party's relative eagerness to enter the relationship and thus his or her relative power to say "no" to versions of the prenuptial agreement proposed by the other party. And yet, bargaining power surely exists—it is often played out in express prenuptial bargains. Allowing the parties to leave some aspects vague, by assuring them that their relative bargaining power will be reflected *ex post*, might relieve them of the costly and often damaging need to punctuate who has the upper hand *ex ante*.

### C. *Ex Ante Investment*

The analysis so far has assumed that the relative bargaining power of the parties is an exogenous factor, determined before the parties enter the negotiations. In reality, many features may affect bargaining power: outside options, impatience to reach a deal, reputation, financial distress, negotiation savvy, and more.<sup>64</sup> The implicit assumption so far was that none of these factors depend on the gap-filling methodology. Thus, the premise was that gap fillers could be a function of the relative bargaining power of the parties, but not vice versa. But can the cause-and-effect be reversed? Is it possible that the gap-filling rule would induce parties to make investments in increasing their bargaining power?

Theoretically, a bargain-mimicking regime could create incentives for parties to make investments that affect their bargaining power. Of course, parties already have a motive to invest in strengthening their bargaining power because such actions will help them secure better express terms in the deal. But in the shadow of bargain-mimicking gap fillers, the incentive to manipulate bargaining positions would be bolstered. Invest-

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64. See *supra* note 13 and accompanying text (exploring factors that affect bargaining outcomes).

ing 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 redistributes value without creating a corresponding social benefit.<sup>65</sup> This could suggest that a bargain-mimicking regime would have the undesirable effect of further distorting already excessive investments.

But the picture is more complex. There are other types of precontractual investments—such as those having an effect on the total surplus of the potential bargain, and not on relative bargaining power—that are often set too low. Specifically, where parties are exposed to the holdup problem, the anticipation that some of the fruit of this investment will be appropriated by the other party may induce them to set investment too low.<sup>66</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 other party's ability to engage in hold up and would thus lead to a more efficient level of surplus-creating investments. For example, a builder who successfully acquires an exclusive position in a specific market would be able, in the course of negotiating a project with a client, to make precontractual investments in plans and materials since he knows his bargaining leverage will shield him from hold up.

Moreover, sometimes the same investment has both a surplus-enhancing effect and a bargaining-leverage effect. For example, a potential employee who invests in learning a specialized skill increases the overall surplus from the employment arrangement, but at the same time gains more leverage in negotiating her wages and securing a bigger slice of the surplus for herself. The incentive to invest too much to enhance bargaining leverage is at least partially offset by the incentive to invest too little because of the holdup 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

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65. See, e.g., David M. Frankel, *Creative Bargaining*, 23 *Games & Econ. Beh.* 43, 49–50 (1998) (proving parties overinvest in creative strategies that improve their bargaining position).

66. See, e.g., Lucian Arye Bebchuk & Omri Ben-Shahar, *Precontractual Reliance*, 30 *J. Legal Stud.* 423, 431 (2001) (showing parties will make insufficient investments in relationship in absence of precontractual liability).

favorable express terms that the investing party can draft. Ex ante, the incremental effect of a gap-filling regime would probably be negligible.

### III. BARGAIN-MIMICKING TERMS IN ACTION

#### A. *Interpretive Practices*

To be sure, a general principle of bargain-mimicking gap fillers has not been 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: “[W]here 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.*”<sup>67</sup> Despite this sweeping mandate, I hope to illustrate that in many subtle ways courts’ current interpretation of existing contract law applies gap fillers that reflect relative bargaining power.

It is important to note that principles of gap filling could be enacted in contracts themselves. Bargain-mimicking gap fillers could emerge in practice as a result of contractual drafting instructing courts to apply such a criterion, effectively telling courts to fill any particular gap with terms more favorable to one of the parties. How is this done? For example, typical boilerplate contracts include severability or “savings” clauses that instruct courts to enforce the contract to the maximum extent permitted by law.<sup>68</sup> If a provision that is otherwise drafted vaguely is appended to this maximum extent boilerplate, the ambiguity will be resolved in a one-sided manner. Such a drafting technique may apply to a single provision, as in warranty disclaimer clauses,<sup>69</sup> or it may apply to the entire contract any time a term is unenforceable.<sup>70</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 parties are effectively telling a future court that if a specific term will be deemed unenforceable as too one-sided, it ought to be filled with a substitute term that achieves the desired effect to the maximum permissible extent. The incentive to draft such terms is

67. Restatement (Second) of Contracts § 204 cmt. d (1979) (emphasis added).

68. See, e.g., Charles A. Sennewald, Security Consulting 151 (3d ed. 2006) (“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 . . .”).

69. See, e.g., RealNetworks, Inc., Realplayer Distribution Agreement for Educational Institutions § 11, at <http://forms.real.com/rnforms/products/tools/rpedist/index.html> (last visited Nov. 16, 2008) (on file with the *Columbia Law Review*) (“To the maximum extent permitted by applicable law, RealNetworks further disclaims all warranties . . .”).

70. C. James Levin & Avery R. Brown, Severability, in *Negotiating and Drafting Contract Boilerplate* 539, 547–48 (Tina L. Stark ed., 2003) (noting that severability clauses can apply to provisions such as indemnity and exculpation, noncompete, acceleration, damages and penalties, interest rates, and more).

particularly strong when applied to distributive issues, where the one-sidedness does not come at the expense of the overall surplus.

Before exploring instances where courts have already indicated openness to a bargain-mimicking principle, it is important to highlight one major area of contracting in which the principle is, or appears to be, regularly rejected. In insurance contracts, courts consistently fill gaps with provisions that favor the weaker party—the insured. Through doctrines like reasonable expectations, *contra proferentum*, and implied warranty of fitness for intended purpose,<sup>71</sup> courts supply meaning to ambiguous terms that increase rather than reduce coverage, thereby favoring the party with the lesser bargaining power. There are good reasons to use these techniques and to give primacy to the insured’s expectations. But is this practice truly in conflict with the bargain-mimicking principle? It may be argued that despite the fact that the insureds have no bargaining power to change the policy terms, they do have the power to walk away from policies that provide insufficient coverage, or that cost more than they are worth. Through these interpretive practices, courts merely give insureds the coverage they originally sought (and paid for): the terms without which they would not have signed onto the contract. It is this *ex ante* power to say no to the policy that is effectively mimicked. Moreover, the pro-insured gap filling is consistent with the bargain-mimicking criterion in another way. It is often the case that, despite having the power to prospectively revise the interpreted language and redraft it in a self-serving way, insurance companies do not pursue this strategy. When a court interprets the meaning of an insurance policy in a pro-coverage manner, insurance companies often adjust the premium, rather than the language.<sup>72</sup> They are happy to maintain the broader coverage as long as they can charge for it in a profitable way. Put differently, insurers who have bargaining power are not interested in selling *less* coverage. On the contrary, their interest is in selling *more* coverage and raising prices. Viewed in this light, the pro-coverage gap fillers are essentially subtle bargain-mimicking terms. Insureds get the coverage they would have insisted on, and the insurer adjusts the premium to fit the actual coverage. The insureds have the bargaining power to choose the scope of coverage; the insurer has the bargaining power to price it; and the gap fillers reflect this allocation of powers.

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71. See, e.g., *C & J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169, 176–81 (Iowa 1975) (analyzing interpretation doctrines for insurance contracts); Kenneth S. Abraham, *The Expectations Principle as a Regulative Ideal*, 5 Conn. Ins. L.J. 59, 63–64 (1998) (exploring foundations of reasonable expectation doctrine).

72. See, e.g., Kenneth S. Abraham, *Insurance Law and Regulation* 33–37 (3d ed. 2000) (discussing value of interpreted terms); Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, in *Boilerplate: The Foundation of Market Contracts* 176, 180 (Omri Ben-Shahar ed., 2007) (discussing reasons why insurance companies do not redraft).

## B. *Examples*

This section demonstrates instances in which courts explicitly recognize a bargain-mimicking criterion for gap filling and reach decisions in line with it. It does not argue that the bargain-mimicking criterion is universally applied. Instead, the argument—by way of examples—is more modest, asserting that the bargain-mimicking criterion is not as alien to the task of judicial gap filling as might otherwise seem.

1. *Termination Terms.* — When parties have an open-ended contract duration, section 2-309 of the U.C.C. allows each party to terminate at will.<sup>73</sup> Even when the contract guarantees a minimum duration, termination can occur prior to the expiration of this period if there is misconduct by one of the parties, even if this misconduct does not rise to the level of total breach.<sup>74</sup> 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. A powerful example of the application of the bargain-mimicking principle comes up in a case that called for interpretation of a termination clause in a franchise contract. In the casebook favorite, *The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*,<sup>75</sup> Judge Posner discusses the power of the franchisor to terminate the franchise. 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.”<sup>76</sup> He made this determination despite the fact that the franchisee was clearly the party with the weaker bargaining power and should therefore have been the natural recipient 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>77</sup> Posner continues, invoking 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 illusions 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>78</sup>

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73. U.C.C. § 2-309(2) (2004) (noting that contract with indefinite duration “may be terminated at any time by either party”).

74. Antony W. Dnes, A Case-Study Analysis of Franchise Contracts, 22 J. Legal Stud. 367, 370–74 (1993) (analyzing termination of franchise agreements).

75. 970 F.2d 273 (7th Cir. 1992).

76. *Id.* at 282.

77. *Id.*

78. *Id.* 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:

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 presented a vague termination clause that needed interpretation: Was breach by the franchisee "material"? Did it constitute "good cause" for termination?<sup>79</sup> The court's answer had nothing to do with surplus maximization. The court did not focus on the franchisee's reliance or its interest in recouping its investment, as courts sometimes do. Nor did the court focus on the franchisor's need 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, or terms that are standard in the industry. 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 parties' relative bargaining powers and held that the franchisor's superior economic position would make it futile for courts to interpret the contract in any way that did not mimic the franchisor's bargaining strength. In essence, Judge Posner asserted that any judicial favoring of the weaker party for redistributive reasons would fail because it would be undone through overriding provisions dictated by the stronger party in the contract.

2. *Force Majeure Terms.* — Another interesting illustration of the bargain-mimicking principle arises in the context of force majeure clauses, which expand the scope of excuse otherwise available under the doctrine of impracticability.<sup>80</sup> 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 ex-

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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 than 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 . . . .

Id. at 283 (Cudahy, J., dissenting).

79. "Material breach" was defined in the contract to include, among other things: "failing to maintain and operate the Cookie System Facility in a good, clean, wholesome manner and in strict compliance with the standards then and from time to time prescribed by" the Cookie Company; selling any product not authorized by the Cookie Company; failing to pay any service fee within 10 days after it is due; failing to pay any of the company's invoices within that period; underreporting gross sales (on which the Cookie Company's royalty from its franchisees royalty is based) by 1 percent or more; or failing to maintain certain insurance coverage. . . . Any three breaches, whether or not material, entitle the company to terminate the franchise within a 12-month period without giving the franchisee notice or an opportunity to cure.

Id. at 278 (majority opinion).

80. White & Summers, *supra* note 33, § 3-10 (analyzing U.C.C.'s force majeure jurisprudence).

cused 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 gap-filling list of section 2-615 of the U.C.C., the answer is yes: The disappointed buyer, while unable to get redress from the excused seller, can instead step into the seller's shoes and recover from the interfering party (the defaulting upstream supplier).<sup>81</sup> Put differently, the U.C.C. attaches to its excuse gap fillers an assignment gap filler: Unless stated otherwise, the rights against the interfering party are automatically assigned from the excused seller to the buyer.

But what if the grounds for excuse are not in section 2-615 and instead appear in the expressly drafted force majeure clause? Are the rights of the excused party against the interfering party assigned here too? Is the disappointed buyer entitled to any recovery rights against the defaulting upstream supplier? Or does the seller get to keep the right to recover against his own defaulting supplier, despite being excused against the buyer? The U.C.C.'s assignment gap filler does not speak to this situation and so the answer is less clear and must be provided by courts.

In a leading case, *Interpetrol Bermuda Ltd. v. Kaiser Aluminum International Corp.*, the Ninth Circuit decided that the seller does *not* have to assign the recovery rights against the supplier to the disappointed buyer.<sup>82</sup> The court based its decision on a bargain-mimicking principle. 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 against the seller.<sup>83</sup> Accordingly, the seller was excused even though his supplier was not. The court held that it saw

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 adjustments not to transfer [the seller's] rights.<sup>84</sup>

The court's decision in *Interpetrol* hinged on mimicking the parties' likely bargaining outcome. While the parties did not stipulate who, in the event of excuse, would be entitled to recover from the defaulting supplier, only one party could recover this right, and the court chose to award it to the party with the greater bargaining power. This decision did

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81. U.C.C. § 2-615 cmt. 5 (2004) ("[E]xcuse should not result in relieving the defaulting supplier from liability nor in dropping into the seller's lap an unearned bonus of damages over.")

82. 719 F.2d 992, 999–1001 (9th Cir. 1983).

83. *Id.* at 1000.

84. *Id.* at 1000–01.

not hinge on an efficiency analysis, or on the assumption of a hypothetical joint will. In fact, the court even speculated that its holding, which obviously favored the stronger party, might affect the incentive of future parties to enter contracts with such unfavorable terms.<sup>85</sup> It nevertheless found that the gap filler in this case, with its distributive effect, needed to mimic the division of bargaining power.

3. *Dividing a Windfall*. — Current case law dealing with missing distributive terms may suggest that courts are up to the task of ascertaining bargain-mimicking terms. A recent Sixth Circuit decision dealing with the division of a pot of money that the parties had not expected illustrates this nicely.<sup>86</sup> In this case, a pension plan that was originally set up to provide employees with fixed benefits had to be redesigned under ERISA and ended up being managed in a way that created unanticipated financial benefits. The employer and the employees disputed how to divide this surplus.<sup>87</sup> The court turned to the “community standards of fairness” principle of section 204 of the Restatement and held that the party who bore the risk was the one entitled to the unforeseen proceeds.<sup>88</sup> Interestingly, though, the court recognized that the same result would be achieved by applying a “hypothetical model of bargaining” approach, which the court noted was the Restatement’s less favored mode of analysis.<sup>89</sup> The court reasoned that the party responsible for any downside in the case the funding source defaulted or became insolvent would have demanded that any unanticipated proceeds from this source inure to it. Put differently, the court did not need to ask who had more bargaining power in the abstract. Its reasoning was founded on the bargain-mimicking observation 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 also help explain case outcomes in another important area: the selective application of the cost-of-completion damages in cases of defective performance. In the classic case *Peevyhouse v. Garland Coal & Mining Co.*, the court had to determine what

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85. *Id.* at 1000 (stating that future parties might hesitate to move into the “more contractually secure part of the market”).

86. See *Bank of N.Y. v. Janowick*, 470 F.3d 264 (6th Cir. 2006).

87. *Id.* at 267–68.

88. *Id.* at 272.

89. The court stated that:

Were we to attempt to discern the term to which the parties to the annuity contracts would have agreed (the less-favored mode of analysis under § 204’s comment d), we would reach the same conclusion. . . . [U]nder the “hypothetical model of bargaining” approach, [the employees’ trustee] would have demanded that any unanticipated proceeds . . . inure to the Employees to compensate them for this additional risk. Prudential would not have been in a position to favor either the Employees or Southwire, and would not have objected to this term.

*Id.* at 272 n.7.

damages applied when a stripmining company breached its promise to restore mined farm land to its original condition.<sup>90</sup> 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. The Supreme Court of Oklahoma ruled five to four in favor of the diminution-in-value measure.<sup>91</sup> Other state courts have held differently, and authorities remain split on the appropriate resolution of this issue.<sup>92</sup>

For the purpose of our discussion here, it is interesting to analyze what the trial court did in *Peevyhouse*. Rather than grant one of the two competing pure measures of recovery, the trial court awarded the plaintiffs \$5000.<sup>93</sup> This solution, it turns out, was not merely a split-the-difference compromise, as it might be perceived; it was a remedy that closely resembled the bargain-mimicking outcome. It is well documented that when the contract between the plaintiffs and Garland Coal was signed, the plaintiffs wielded strong bargaining leverage.<sup>94</sup> They were not particularly eager to enter the contract, and when they eventually agreed, they leveraged their bargaining strength and insisted on including a restoration clause.<sup>95</sup> In fact, they waived their right to receive the customary upfront restoration allowance of \$3,000—close to the entire value of the farm—in order to secure that restoration clause.<sup>96</sup> Thus, if instead of a restoration clause the plaintiffs had bargained for an explicit liquidated allowance to fund self-managed restoration, it would have been roughly \$3,000—the sum they traded away for the restoration clause, not \$29,000, or \$300. The jury award of \$5,000, therefore, came close to mimicking the bargained-for remedy of \$3,000, augmented by lost royalties and 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.<sup>97</sup> It is an ongoing struggle for contracts scholars to provide a descriptive theory of the result reached by courts. Why do

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90. 382 P.2d 109, 111 (Okla. 1962).

91. *Id.* at 111–12, 120.

92. See, e.g., Timothy J. Muris, *Cost of Completion or Diminution in Market Value: The Relevance of Subjective Value*, 12 *J. Legal Stud.* 379, 384–92 (1983) (exploring a systematic understanding of case outcomes); Alan Schwartz & Robert E. Scott, *Market Damages, Efficient Contracting, and the Economic Waste Fallacy*, 108 *Colum. L. Rev.* 1610, 1620–33 (2008) (surveying prevalence of economic waste notion in case law).

93. *Peevyhouse*, 382 P.2d at 111.

94. See Judith L. Maute, *Peevyhouse v. Garland Coal & Mining Co.* Revisited: The Ballad of Willie and Lucille, 89 *Nw. U. L. Rev.* 1341, 1358–64 (1995) (describing negotiations by Peevyhouses to protect their interests by insisting on terms that went beyond standard industry provisions).

95. *Id.* at 1365–66.

96. *Id.* at 1358, 1363.

97. See Patricia H. Marschall, *Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract*, 24 *Ariz. L. Rev.* 733, 734–36 (1982) (arguing willfulness is a factor explaining choice of remedy); see also sources cited *supra* note 92.

some plaintiffs get the former, usually higher, measure, while 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 who had the superior bargaining power to insist on a completed performance, like the *Peevyhouses*, should be entitled to the more generous measure. Providing higher damages to parties with superior bargaining powers mimics the high-end liquidated damages clauses 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" and "a mansion or a skyscraper."<sup>98</sup> Why did Cardozo think courts should allow the margin of noncompletion to be greater (and the remedy smaller) in the case of common chattels or, as understood by a later court, when the client purchased a stock floor plan house,<sup>99</sup> but require stricter compliance and award the higher cost-of-completion measure for mansions? Plausibly, clients who purchase common chattel and stock floor plan homes have less bargaining power against sellers and little ex ante leverage to demand strict adherence to detailed specifications or the cost-of-completion remedy when tender is less than perfect. But when mansions and skyscrapers are designed, the client is often in a stronger bargaining position. Hence, when the aggrieved party had the ex ante bargaining power to insist on precise tender of performance, courts award the more generous measure.<sup>100</sup>

Remedies for breach of contract are not the sort 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 significantly influence the overall surplus.<sup>101</sup> Thus, there is a strong argument that contract gaps concerning remedies ought to be filled with surplus-maximizing—rather than bargain-mimicking—terms. Indeed, in the context of *Peevyhouse*, commentators have expressed concerns about how the cost-of-completion measure would influence incen-

98. *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889, 890 (N.Y. 1921).

99. *Plante v. Jacobs*, 103 N.W.2d 296, 298–99 (Wis. 1960) (holding that in stock floor plan house, a small shift of a wall does not entitle buyer to cost of repair measure).

100. See, e.g., *Groves v. John Wunder Co.*, 286 N.W. 235, 238 (Minn. 1939) (finding cost of performance to be appropriate measure of damages even though this cost was much higher than decrease in value caused by breach); *O.W. Grun Roofing & Constr. Co. v. Cope*, 529 S.W.2d 258, 262–63 (Tex. Civ. App. 1975) (noting that homeowners contracting for amenities can insist on perfect tender to their specifications); see also Marvin A. Chirelstein, *Concepts and Case Analysis in the Law of Contracts* 174 (4th ed. 2001) (arguing that recovery should equal amount promisee could have bargained for at agreement stage); Robert A. Hillman, *Principles of Contract Law* 140 (2004) (explaining that court should have considered "nature of the parties' bargaining over the restoration clause at the time of contracting" since this "would have shed light on Groves' motives").

101. See, e.g., Steven Shavell, *Foundations of Economic Analysis of Law* 304–12 (2004) (analyzing effect of remedies on overall surplus).

tives to breach or perform.<sup>102</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 the damage measure were too high it would induce inefficient performance and the parties would likely renegotiate. And if the damage measure is too low it would induce inefficient breach, and again the parties would have an incentive to renegotiate.<sup>103</sup> Thus, to the extent that the damages merely affect the parties' bargaining positions in the renegotiation phase, but not the performance outcome, the argument that such damages should reflect the ex ante bargaining power of the parties—thereby saving them the trouble of explicitly stipulating these damages in the contract—is all the more compelling.

#### IV. MAXIMALLY TOLERABLE TERMS<sup>104</sup>

When bargaining power is unevenly distributed, a stronger party would naturally use its bargaining leverage to draft one-sided, self-serving terms. But the doctrines of unconscionability and duress (as well as other rules) grant courts the power to invalidate excessively one-sided terms, thereby preventing stronger parties from overreaching. Once an excessively one-sided term is vacated, the court needs to fill the gap that is created with an alternative provision.

There are several possible heuristics that can shape the way in which this sort of gap is filled. First, a court could replace the excessive term with a midrange, majoritarian term that it deems reasonable. Alternatively, a court could 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 court could fill the gap with a bargain-mimicking term that is still one-sided and 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 would be to prescribe a “maximally tolerable” term—a term that is still one-

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102. See, e.g., Posner, *supra* note 3, at 121 (suggesting that overcompensatory remedies would make efficient breach more costly).

103. Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. Pa. L. Rev. 45, 95–98 (1999) (discussing effect of damage measure on subsequent rounds of bargaining over release from inefficient performance and inefficient breach).

104. For background on the concept of maximally tolerable terms, see generally Omri Ben-Shahar, *How to Repair Unconscionable Contracts* (Univ. of Chi. Law Sch., John M. Olin Law & Economics, Working Paper No. 417, 2008), available at <http://ssrn.com/abstract=1082926> (on file with the *Columbia Law Review*).

sided, still favorable to the drafting party, but which falls just within the range that is considered tolerable. Once the offensive term is replaced by a term that is within the tolerable range, even if only barely so, there is no remaining justification for intervention.

Thus, for example, if the excessive term were an intolerably high price, the legal intervention would be to lower the price. If we analogize the process of judicial intervention in the contract to a force that pulls the price from its currently intolerable level toward the permissible region, the force gradually weakens as the price gets closer to the tolerable level, and vanishes entirely once this level is hit. The point at which this adjustment process is no longer justified is not the midrange, majoritarian, most balanced term. Instead, the justification disappears at the maximally tolerable price, which, though it remains one-sided, is not as intolerable as the original term. Once this term is set, the weaker party no longer has a reasonable basis for demanding additional redress.<sup>105</sup>

There are numerous instances in which courts apply maximally tolerable terms. The doctrine of partial enforcement is one such example.<sup>106</sup> Under this doctrine, a court is authorized to reform an unreasonable term in a contract and enforce it to the extent necessary to avoid the unreasonableness.<sup>107</sup> The most common application of this technique involves noncompete clauses that are excessive in either duration or geographic scope. In most states, courts repair excessive noncompete terms by reducing them to the maximally tolerable level.<sup>108</sup>

At times, the maximally tolerable level is defined explicitly by statute. Some states have enacted bright line rules stating the maximal duration of noncompete clauses in employment contracts.<sup>109</sup> There, only the increment of the restraint that is socially intolerable is eliminated; the rest stands.<sup>110</sup> In other states there is no bright line statute. There too, courts reduce the noncompete term, bringing it down to a level that is maximally tolerable. The restraint “is not enforceable beyond the time or area considered reasonable by the [c]ourt.”<sup>111</sup>

105. This rationale is recognized by Corbin: “[T]he 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.” Arthur L. Corbin, *A Comment on Beit v. Beit*, 23 Conn. B.J. 43, 46 (1949).

106. 15 Grace McLane Geisel, Corbin on Contracts § 89.4-.5, at 626-31 (Joseph M. Perillo ed., rev. ed. 2003) (discussing practice of severing offensive portion of contract and enforcing remainder).

107. *Id.* at 629 (surveying cases in which courts partially enforced an overreaching term).

108. See, e.g., Harlan M. Blake, *Employee Agreements Not to Compete*, 73 Harv. L. Rev. 625, 646-51 (1960) (exploring common law treatment of noncompete clauses).

109. See, e.g., Fla. Stat. Ann. § 542.335(1)(d)1 (West 2007) (“[A] court . . . shall presume unreasonable in time any restraint more than 2 years in duration.”).

110. See, e.g., *Flickenger v. R.J. Fitzgerald & Co.*, 732 So. 2d 33, 34-35 (Fla. Dist. Ct. App. 1999) (holding that three year duration is excessive and reducing it to maximally tolerable term of two years).

111. *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 685 (Tex. 1974).

Another example of the use of maximally tolerable terms relates to the doctrine of unconscionability. Corbin noted in the context of a money loan that “a contract that requires the payment of a very high rate of interest will be enforced, up to the point at which ‘unconscionability’ becomes an operative factor.”<sup>112</sup> In the context of unconscionable arbitration clauses, courts can replace an arbitration mandate that includes unreasonable terms with one that is tolerable. For example, in *Brower v. Gateway 2000, Inc.*—a leading New York unconscionability decision—the court held that a term mandating arbitration in the International Chamber of Commerce forum was unconscionable because of an excessive \$4,000 filing fee.<sup>113</sup> It also held, though, that Gateway could cure this defect by agreeing to arbitrate in another forum, if it entailed filing fees that were not unconscionable.<sup>114</sup> The consumer still viewed this as a one-sided provision, but once the provision was tolerable, the court found no grounds for further intervention.<sup>115</sup>

Maximally tolerable terms can also be used in the context of the legal control over liquidated damages clauses. Courts do not enforce liquidated damage terms that are clearly excessive and punitive,<sup>116</sup> but what is the damage term that courts supply instead? Does the court replace the liquidated damages term with its own ex post estimate of the loss, equal to the average or most reasonable compensatory measure? Or does it use a bargain-mimicking term, somewhere at the high-end estimate of expectation damages—the level that most closely reflects the division of bargaining power?

While there are statements throughout American case law that reject the use of a bargain-mimicking approach in this context,<sup>117</sup> there are many other legal traditions that appear to directly endorse this approach. Under Israeli contract law, for example, courts are instructed to reduce excessive damages to a level that reflects the magnitude of loss reasonably expected at the time of contracting. In one case where an Israeli court reduced liquidated damages, it explicitly set the damages above actual harm, at a level equaling “the maximal amount the parties could have anticipated as possible harm from delay.”<sup>118</sup> Furthermore, a leading Israeli commentary has stated that excessive liquidated damages should be reduced

to the highest level the court regards as reasonably related to the harm anticipated at the time of contracting . . . that is, reduced to the measure closest to the agreed sum, such that if that

112. 1 Arthur L. Corbin, *Contracts* § 129, at 402 (1964).

113. 676 N.Y.S.2d 569, 573–74 (App. Div. 1998).

114. *Id.* at 575.

115. *Id.*

116. Farnsworth, *supra* note 3, at 811–12.

117. For an explicit rejection of the reduce-and-enforce methodology in penalty clauses, see *Cad Cam, Inc. v. Underwood*, 521 N.E.2d 498, 503 (Ohio Ct. App. 1987).

118. CA 539/92 *Zaken v. Ziva* [1994] 1, 4 (Isr.) (on file with the *Columbia Law Review*).

measure were the one agreed upon in the first place, the court would not have been justified in reducing it.<sup>119</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 it as a distributive task. Unless there is clear evidence about actual but imperfectly specified intent, courts are instructed to identify the "reasonable" term, the most efficient term, the majoritarian term, or some other uniquely distinguished content. Yet none of these criteria are defined with respect to their distributive effect. This Essay suggests that in fact the gap-filling task of courts is often purely distributive. In many contexts—as in the case of a missing price—there are several potential provisions courts can choose from, all of which satisfy the reasonable or efficient criteria, but differ in their distributive allocation. Thus, contract law needs to provide an appropriate criterion for choosing the default rule in these instances of distributive gaps.

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 do not apply. It is quite another to propose a bargain-mimicking solution that favors the stronger party. Some readers may object to this proposed criterion as morally unjust. If there is a distributive aspect to gap filling, they would argue, why not turn it into an opportunity to favor the weaker party? Should not the law reverse the outcomes of unfettered, unequal bargaining power?<sup>120</sup> The answer I provide in this Essay is that distributive gaps cannot effectively become an occasion for redistribution. I argue that gap fillers cannot effectively favor the weak party. Gap fillers that go against the background allocation of bargaining power will only induce stronger parties to exert express, self-favoring terms. The more redistributive gap fillers are, the less likely it is they will come into play.

Identifying the division of bargaining power between parties can be difficult and error prone. In this Essay I suggest that the problem might not be as challenging as it initially appears, but nonetheless concede that

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119. Uri Yadin, *Hok Hahozim: Terufot Beshel Hafarat Hozeh 1970* [Contract Law: Remedies for Breach of Contract 1970] 132 (2d ed. 1979) (Hebrew text); see also Eyal Zamir et al., *Haperush Hakatsar Lehukim Bamishpat Haprati* [Brief Commentary on Law Relating to Private Law] 302 (2d ed. 1996) (Hebrew text) (stating, as translated, that "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").

120. See, e.g., Symposium, *Power, Inequality and the Bargain: The Role of Bargaining Power in the Law of Contract*, 2006 Mich. St. L. Rev. 841 (describing various approaches to dealing with bargaining power asymmetries).

it poses a significant obstacle to the implementation of a bargain-mimicking regime. Still, no matter how daunting this judicial task may be, the difficulty alone cannot justify utilizing a different gap-filling criterion. There may well be easier-to-apply criteria that are straightforward and require very little case-specific information. The problem, however, is that if parties expect courts to supply gap fillers other than the bargain-mimicking ones, they will be forced to draft contracts with fewer gaps and less flexibility.

The concept of bargain-mimicking default rules is quite general and can apply beyond the standard contractual context explored in this Essay, anytime a contest occurs over distribution. It is applicable, for example, as a gap-filling principle for unclear legislation, by justifying statutory interpretation that mimics the preferences, or the division, of power within the enacting polity.<sup>121</sup>

The idea of the law mimicking the unequal division of bargaining power may seem to conflict with notions of fairness.<sup>122</sup> In the end, though, it is merely a sober *descriptive* principle, which can be harnessed to advance any normative agenda, including redistributive ones. It is a reminder that gap-filling regimes cannot effectively level the playing field or advance any significant redistribution. Even if default rules are sticky, parties that have greater bargaining power are likely to opt out of redistributive gap fillers. Still, this is not a manifesto against redistribution. Laws can surely accomplish redistribution in effective ways. If we are serious about helping weaker parties secure better deals through contract law, we probably need to get our hands dirty and engage in more aggressive forms of market regulation including mandatory quality rules and regulation of the bargaining process. Using redistributive gap fillers might create the ad hoc impression that contract law is sensitive to the plight of weaker parties, but it would have very little, if any, systematic effect.

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121. See Einer Elhauge, *Statutory Default Rules: How to Interpret Unclear Legislation* 5–12 (2008).

122. *Ocean Accident & Guarantee Corp. v. Indus. Comm'n of Ariz.*, 257 P. 644, 645 (Ariz. 1927) (“Our enlightened modern thought realizes that an equality of bargaining power between two such unequal parties is impossible, and has attempted to equalize the balance . . .”).