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Consideration for a Price: Using the Contract Price to Interpret Ambiguous Contract Terms

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Consideration for a Price: Using the Contract Price to Interpret Ambiguous Contract Terms

DONALD J. SMYTHE¹

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I. INTRODUCTION

Most contract cases arise from disputes about the interpretation of the contracts.² Even contracts that are carefully drafted by experienced and sophisticated parties can have ambiguous contract terms, and that creates the potential for disputes about the appropriate interpretation of the parties' contractual rights and obligations. Most of the law and economics literature on matters of contract interpretation focuses on the kind of evidence a court should consider in interpreting a contract; in particular, whether it should adopt a textualist approach and rely exclusively on the express terms of the parties' agreement, or whether it should adopt a contextualist approach and interpret the terms of the contract using evidence about the context in which they were drafted.³ Ironically, the law and economics literature does not address whether and how the contract term that is usually of most interest to economists—the contract price—might be used to interpret other ambiguous contract terms.⁴ This is no doubt because there are legal authorities that caution against evaluating the adequacy of consideration in deciding contractual disputes.⁵ But while these authorities are compelling for many contracts, the underlying logic is not particularly persuasive for others. Indeed, the authorities have not prevented some courts from evaluating the contract price in interpreting some contracts.⁶ Unfortunately, to the extent that courts have evaluated the contract price in resolving interpretive disputes, they have done so without any guidance from economic theory.

There are both theoretical and doctrinal justifications for the taboo against using the contract price to interpret other contract terms. The strongest theoretical justification draws on economic theory. Conventional economic theory assumes that the buyers in consumer contracts make their decisions in accordance with the non-quantifiable psychological values they

2. George Cohen, *Interpretation and Implied Terms in Contract Law*, in ENCYCLOPEDIA OF LAW AND ECONOMICS 125, 125-26 (Gerrit de Geest ed., 2d ed. 2011).

3. *Id.* at 130-31.

4. *See, e.g.*, RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 108-11 (5th ed. 1998) (acknowledging with approval that courts do not normally inquire into the adequacy of consideration); JEFFREY L. HARRISON, *LAW AND ECONOMICS IN A NUTSHELL* 124 (5th ed. 2011) (acknowledging that contract law reflects some ambivalence about consideration, and attributes this to tensions between its competing goals); ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 198 (5th ed. 2007) (discussing bargain theory without acknowledging any role that consideration might play in interpreting bargains); THOMAS J. MICELI, *THE ECONOMIC APPROACH TO LAW* 92 (2d ed. 2009) (implicitly addressing the peppercorn theory, but accepts the view that people are the best judges of their own interests).

5. *See infra* Part II.D-E.

6. *See infra* Part II.D-E

attach to goods and services.⁷ Since courts cannot reliably assess the strength of consumers' psychological preferences, this precludes the possibility that they might reasonably be able to evaluate whether the contract price was adequate for whatever right a consumer buyer might claim under an ambiguous contract term.⁸ The doctrinal justification derives from legal precedents established in cases in which courts rejected common law arguments rooted in principles of equity that the consideration paid was too high or too low for the consideration received.⁹ These legal precedents reflect the adequacy of consideration doctrine—or the peppercorn theory, as it is often called—which precludes courts from evaluating the adequacy of consideration in deciding whether to enforce a contract or clauses of a contract.¹⁰ The modern rationale for the peppercorn theory rests heavily on the conventional economic logic, although the doctrine actually preceded the development of modern economic theory.

The theoretical and doctrinal reasons not to evaluate the adequacy of consideration in interpreting other contract terms are particularly persuasive in consumer contracts and many common law contracts for services and real property in which the parties' valuations may be more psychological in nature than pecuniary, and the nature of their consideration may be complex. They are not particularly compelling, however, in commercial contracts between merchants, and they are largely, if not entirely, irrelevant in contracts for the sale of goods between sophisticated business parties.¹¹ In contracts for the sale of goods between sophisticated business parties, the buyers' consideration is almost always merely the contract price.¹² It can

7. The conventional economic theory of consumer behavior assumes that consumers have ordinal preferences and uses the concept of a utility function to reflect a consumer's preference ordering without in any way implying that the utility the consumer derives from the consumption of the goods can be measured. See, e.g., JAMES M. HENDERSON & RICHARD E. QUANDT, *MICROECONOMIC THEORY: A MATHEMATICAL APPROACH* 7 (3d ed. 1980) ("The consumer possesses an ordinal utility measure . . . [H]is ranking of commodities is expressed mathematically by his utility function . . . but these numbers provide only a ranking or ordering of preferences."). For a standard graduate-level treatment of consumer preference theory, see ANDREW MAS-COLELL ET AL., *MICROECONOMIC THEORY* 6-9 (1995).

8. This is the issue emphasized in the law and economics texts. See, e.g., POSNER, *supra* note 4, at 111.

9. See *infra* Part II.C.

10. For a discussion of the peppercorn theory, see Edmund Polubinski Jr., *The Peppercorn Theory and the Restatement of Contracts*, 10 WM. & MARY L. REV. 201 (1968).

11. Merchants are usually presumed to have some threshold level of business acumen. Nonetheless, there is an important difference between a sole proprietor and a large, multinational corporation. The term "sophisticated business parties" is intended to exclude from the set of all merchants those who are not sufficiently rational to comport with the fundamental postulates of rational business behavior.

12. Article 2 of the U.C.C. defines a sale as the "passing of title from the seller to the buyer for a price." U.C.C. § 2-106(1) (1977) (amended 2003).

thus be easily quantified in dollars and cents. Moreover, since business parties typically seek to maximize their profits, they do not attach any particular psychological value to the goods they buy or sell through their commercial contracts. In contrast to consumer buyers or sellers, their preferences are simple: they prefer more profits to less and their profits can be quantified in dollars and cents too. This undermines the economic rationale for the peppercorn doctrine and argues against applying it in at least some cases. Indeed, from an economic perspective, it might be socially inefficient for courts not to use the contract price to help in interpreting disputed contract terms if the use of the contract price could improve their decisions.¹³

The argument obviously flies in the face of considerable distinguished commentary to the contrary.¹⁴ But to claim that courts cannot evaluate the adequacy of the contract price in a commercial case between sophisticated business parties flies in the face of the fact that courts routinely make judgments in cases that require the application and evaluation of relatively sophisticated economic theory and econometric evidence.¹⁵ Moreover, it ignores the fact that the burden lies on the parties to adduce the arguments and evidence necessary to support their interpretations of the contract, not the courts. It may also underestimate the courts' capabilities: judges today are probably more knowledgeable in general about economics than they have ever been;¹⁶ they have exceptionally talented clerks and interns who

13. The "rational expectations" school of macroeconomics has been largely discredited, but one of its lasting contributions was to elucidate the implications of rationality assumptions for the use of information in formulating expectations. One of its basic postulates was that a rational actor should make use of all relevant and costless information in formulating expectations about the future. A corollary to this is the idea that a rational actor should use all relevant and costless information in making decisions. If the contract price is clearly specified and provides information that would be helpful in interpreting other contract terms, a judge who failed to use it would be less than fully rational and might make socially inefficient decisions. See STEVEN M. SHEFFRIN, *RATIONAL EXPECTATIONS* (2d ed. 1996), for a well-known survey of the "rational expectations" literature. Although the "rational expectations" school of macroeconomics has fallen into disfavor, the basic idea that rational actors should use all freely available information in forming their expectations and making decisions is still valid.

14. See, e.g., POSNER, *supra* note 4, at 111. As Robert Hillman has observed, many mainstream scholars subscribe to what he calls the theory of the "subjectivity of value," by which he appears to mean that only parties themselves can know their valuations of things. ROBERT A. HILLMAN, *THE RICHNESS OF CONTRACT LAW* 184 (1997). This theory is much more compelling when parties' valuations are in some part psychological in nature rather than entirely pecuniary and seems ill-suited to contracts between business parties.

15. In contracts cases, for instance, courts frequently calculate expectation damages or lost profits, and in antitrust cases, they frequently evaluate economic theories and evidence about anticompetitive conduct.

16. The Law and Economics Center at George Mason University School of Law, for instance, has been offering instruction in economics to federal and state judges for over thirty-five years. *Mason Judicial Education Program*, GEO. MASON U. SCH. L., L. & ECON.

have generally had at least some—and often significant—exposure to economic reasoning,¹⁷ and they have better access to a wide range of easily accessible academic resources through the internet and online databanks of scholarly articles, monographs, and case law than at any time in history. Finally, the claim that courts cannot evaluate the adequacy of consideration does not negate the fact that they already do and are likely to continue doing so.¹⁸ If courts are going to evaluate the adequacy of contract prices anyway, it would clearly be best if they had some guidance from economic theory.

A. EXAMPLES

Consider an example.¹⁹ Suppose that the parties to a sales contract have a dispute about a term stated in an attachment to the writing that serves as the main evidentiary basis for their contract. Suppose that the term appears to guarantee the performance of the goods and that the main writing states that the attachments are incorporated into the contract, but that the writing was drafted by the buyer and it is not clear that the seller assented to the guarantee. Suppose, in addition, that under the prevailing trade usage such a warranty term would not normally be relegated to an attachment to the main writing. Under a purely textual interpretation, the contract would normally include the guarantee. Under a contextual interpretation of the contract, however, the term purporting to make the guarantee is ambiguous. The placement of the guarantee in the attachment to the main writing, the seller's denial of assent, and the prevailing trade usage raise questions about whether it was an intended part of the parties' bargain.

Similar interpretive problems can arise even without any extrinsic evidence to suggest ambiguities in the text. Consider a contract for the sale of goods in which there is an exclusive limited remedy clause as well as a clause disclaiming consequential damages.²⁰ Suppose a court concludes that the limited remedy failed of its essential purpose. Article 2 of the U.C.C. states that if a limited remedy fails of its essential purpose the buyer should then have recourse to all the remedies that would otherwise have been available under the U.C.C. These remedies would normally include conse-

CENTER, <http://www.masonlec.org/programs/mason-judicial-education-program> (last visited July 12, 2012).

17. Many law students studied economics prior to attending law school; even if they did not, law and economics is offered as a course at many law schools, and the law and economics perspective is typically presented in most of the first year law courses, especially in contracts, property, and torts.

18. See *infra* Part IV.

19. The example is based on the case discussed *infra* Part IV.A.

20. See *infra* Part IV.C.

quential damages, but if the contract also includes a disclaimer of consequential damages, does the disclaimer trump any claims for consequential damages, or is the disclaimer void because the limited remedy has failed of its essential purpose and the U.C.C. states that the buyer is thus entitled to all the remedies otherwise available? This question has dogged courts for some time.²¹ One could argue that under a strict interpretation of the text, the disclaimer should apply, since it would serve no purpose at all if it did not apply when the limited remedy failed. Nonetheless, some courts have declined to take such a literal approach and have instead decided the matter by attempting to interpret the parties' intentions.²²

Faced with the task of deciding whether a disputed term, such as the performance guarantee or the right to consequential damages in these examples, was part of the parties' bargain, the first thing an economist might want to ask is, did the buyer pay for it? In other words, was the contract price high enough for the contract to include a performance guarantee or the right to consequential damages if a limited remedy failed its essential purpose? That seems like a perfectly reasonable, common sense question, but to answer it properly a court would have to evaluate the adequacy of the contract price, and that would contravene the peppercorn theory. This has no doubt impeded many courts from even asking the question, let alone attempting to answer it. But since the logic of the peppercorn theory is compelling primarily when the parties have non-quantifiable psychological preferences or the nature of the consideration is complex, courts might be remiss in at least some cases not to use information about the contract price to help decide whether a disputed term was an intended part of the parties' bargains.²³

To mitigate, if not completely forestall, any theoretical objections to the analysis, this Article focuses on contracts for the sale of goods between sophisticated business parties.²⁴ It accepts the bargain theory as the primary normative compass for modern commercial contracts.²⁵ The basic premise, however, is that the contract doctrines that circumscribe and define the consideration requirement, such as the peppercorn theory and the doctrines of

21. *Id.*

22. *Id.*

23. *See supra* note 13.

24. Thus, it does not purport to address common law contracts or consumer contracts. At the same time, nothing in the analysis necessarily restricts the conclusions or recommendations to contracts for the sale of goods between sophisticated business parties. Whether the conclusions or recommendations might gainfully be applied to other contracts is a question best left open for further contemplation and discourse.

25. The leading alternative to the bargain theory is a promise-based approach. *See, e.g.,* CHARLES FRIED, *CONTRACT AS PROMISE* (1981). The promise-based approach has a strong moral appeal, but it is not the central doctrinal tenet of modern contract law. *See id.* at 37.

nominal consideration and unconscionability, provide an incoherent framework for addressing many modern problems in contract interpretation and an inadequate basis for arbitrating at least some modern contractual disputes.²⁶ There is, for instance, little practical difference between a court holding, as a matter of public policy, that a particular contract clause was void at the time the contract was formed because the seller used deceptive or misleading bargaining tactics and the clause is so unfair or one-sided it shocks the conscience and a court holding, as a matter of contract interpretation, that the contract does not include that particular clause because the consideration was inadequate for it to have been part of the bargain. Yet the doctrine of unconscionability provides authority for the former holding and the peppercorn doctrine precludes the latter.

The matter is especially confounding because, as Robert Hillman has pointed out, an overreaching interpretation of a contract often works hand-in-hand with guile and deception at the negotiation stage of the contracting process.²⁷ There is thus a fine line between regulating contracts and interpreting them. If the doctrine of unconscionability does not apply, perhaps because there is insufficient evidence of guile and deception during the negotiations to find any procedural abuse, the peppercorn doctrine could preclude a court from considering relevant information in deciding whether an interpretation of the contract is overreaching. Unfortunately, therefore, a prohibition against evaluating the adequacy of consideration in contexts where it could aid in the interpretation of a contract increases the likelihood of erroneous judicial decisions and injects uncertainty into commercial transactions. If courts evaluate the contract price sensibly, and they only draw reasonable inferences where such are possible, their decisions will only be better, not worse.

B. THESIS

The central argument of this Article is that some relatively simple economic analysis may not only help to untangle some of the knots in modern contract doctrine and theory, but may also help to bring the theory of commercial contracts into closer alignment with modern sales codes, such as the U.C.C. and United Nations Convention on Contracts for the International Sale of Goods (CISG), as well as some of the modern cases.²⁸ Indeed, the

26. This approach is consistent with Robert Hillman's admonishment to eschew attempts to offer overarching theories of contract and focus instead on investigating the implications of contract doctrines. See HILLMAN, *supra* note 14, at 41.

27. *Id.* at 146-52.

28. As the discussion, *infra* Part IV, elaborates, the official comments to Article 2 of the U.C.C. actually encourage courts to look to the adequacy of the contract price, at least in some cases. Moreover, some courts have heeded the advice and considered the adequacy of

tangled knots in modern contract theory probably resulted from the way contract doctrines evolved rather than any underlying logic. Modern contract law and all of the doctrines that circumscribe and define the modern consideration requirement began to evolve in the late nineteenth century.²⁹ This was largely before the seminal developments in economic theory that gave rise to the prevailing neoclassical economic paradigm were able to congeal.³⁰ If modern economic theory had developed prior to the important doctrinal developments in contract law, and if it had influenced those developments as much as economic theory has subsequently influenced the development of legal doctrines, the bargain theory of contracts today would probably be more clearly rooted in an economic conception of bargains. This certainly would not have precluded controversy about the role of bargain theory in modern contract law, but bargain theory itself probably would have been more doctrinally coherent.

As the discussion below elaborates, courts in some sales cases have, in fact, appealed to contract prices in resolving some contractual disputes, although they may not always have done so with as much guidance as they could have used.³¹ Obviously, if courts are going to evaluate the adequacy of contract prices in resolving contractual disputes, they should do so in a manner that comports with sound principles of economics and a coherent economic theory of commercial bargains. Since the literature on law and economics offers no guidelines, this Article attempts to fill the gap. To that end, it develops a general economic analysis of contractual bargains and uses it to suggest some basic and intuitively compelling ways in which contract prices may aid in the interpretation of ambiguous contract terms. As it turns out, the economic analysis also implies some important limitations on the usefulness of contract prices in interpreting ambiguous contract terms, even in contracts for the sale of goods between sophisticated business par-

the contract price in interpreting disputed contract terms. The CISG does not expressly authorize courts to consider the adequacy of the contract price, but it does not embrace the consideration requirement either, and its focus on parties' intended bargains is compatible with the approach in this Article.

29. According to Roy Kreitner, "our current understanding of the [consideration] doctrine acquired its framework from the massive theorization and reformulation of the doctrine pursued by late nineteenth- and early twentieth-century legal scholars." ROY KREITNER, *CALCULATING PROMISES* 16 (2007).

30. The neoclassical school of economic thought did not mature into a major intellectual force in the U.S. until John Bates Clark published his now-classic monograph, *The Distribution of Wealth: A Theory of Wages, Interest, and Profit* in 1899. Prior to then, the institutionalist school, spearheaded by economists such as Thorsten Veblen and J.R. Commons, dominated the American economics profession. See Joseph Persky, *The Neoclassical Advent: American Economics at the Dawn of the 20th Century*, 14 J. ECON. PERSP. 95, 96 (2000). Thus, the reformulation of contract doctrine that Kreitner refers to occurred prior to the ascendancy of neoclassical economics. KREITNER, *supra* note 29, at 16.

31. See *infra* Part IV.

ties. This Article, therefore, not only suggests some ways in which contract prices can be used to improve the reliability of contractual interpretations, but also offers some admonishments against using contract prices in ways that might diminish the reliability of contractual interpretations.

Part II of this Article revisits the reformulation of the consideration doctrine around the turn of the twentieth century, with a view to understanding why the taboo against evaluating the adequacy of consideration evolved. Part III offers an economic analysis of bargains and uses it to suggest how the contract price in a contract for the sale of goods might be used to interpret ambiguous terms in the contract. Part IV discusses and critiques some of the cases in which courts have, in fact, evaluated the adequacy of the contract price in resolving interpretive ambiguities and suggests other cases and circumstances in which they should have done so. Part V offers some conclusions.

II. AN EXEGESIS OF CONSIDERATION DOCTRINE

The contours of modern contract law were forged in response to social and economic changes wrought by the expansion of commercial markets and an increase in commercial activities that began in the late nineteenth century.³² In the face of the new commercial realities, courts and legal scholars reinterpreted and reformulated the doctrine of consideration, laying the groundwork for the bargain theory of contract.³³ Under the dominant conception of consideration prior to the twentieth century, consideration entailed any benefit to the promisor or detriment to the promisee, regardless of whether there was reciprocal inducement.³⁴ Late nineteenth and early twentieth century scholars, however, reinterpreted consideration to require “reciprocal . . . inducement . . . between consideration and promise,”³⁵ thus limiting the enforcement of promises to those made as part of a bargain.³⁶

32. KREITNER, *supra* note 29, at 16.

33. *Id.*

34. HILLMAN, *supra* note 14, at 20-21.

35. OLIVER WENDELL HOLMES, *THE COMMON LAW* 227-230 (Mark DeWolfe Howe ed., 1963).

36. As Fried points out, Holmes suggested that “reciprocal inducement” did not strictly require an actual bargain. FRIED, *supra* note 25, at 30. Fried interprets Holmes’ suggestion to mean that consideration might be present in “the kind of exchange that in general constitutes an actual bargain . . . [even though] . . . the usual motive might be missing.” *Id.* Fried argues for a promise-based theory of contract, but acknowledges that a theory of contract rooted in promises “is not exactly a statement of positive law.” *Id.* at 37. He does not, however, concede that the bargain theory of contracts has better predictive power than the “promise principle,” which he regards as the “moral basis of contracts.” *Id.* at 1. As he explains, “the doctrine of consideration offers no alternative basis for the force of contracts.” *Id.* at 37-38.

This framed most of the significant debates in contract theory for the remainder of the twentieth century as ones about the consideration requirement.³⁷

A. THE ROOTS OF CONTRACT IN PROPERTY

Prior to the nineteenth century, contract law was rooted in conceptions of equity.³⁸ It was only in the nineteenth century that courts began to move beyond policing the fairness of exchanges and look to the underlying bargains as the source of the parties' obligations.³⁹ In fact, prior to the emergence of modern contract law, exchanges were governed by principles of property.⁴⁰ The paradigmatic transaction was the sale of land. Contracts for the sale of land typically entailed promises to transfer title to the land in return for the payment of a price. The common law doctrine of caveat emptor obviated the need for seller disclosures, and since buyers typically did not need (or have the ability to obtain) third-party financing, there were few, if any, contingencies placed upon closing.⁴¹ Indeed, early land transactions occurred without any prior contract of sale and were simply evidenced by a deed transferring title for a price. The primary legal issues were related to defects in the title and the adequacy of the consideration. The exchange was instantaneous and involved "nothing corresponding to 'contract' in the Anglo-American sense of the term."⁴² As Lon Fuller and Melvin Eisenberg described the transaction, "[e]ach party [became] the owner of a new thing, and his rights rest[ed], not on a promise, but on property."⁴³

In the early stages of the development of contract, therefore, principles of property regulated exchange. With industrialization came not only an expansion of commercial activities, but also an increase in the complexity of market transactions.⁴⁴ Exchange no longer simply involved the passing of title for a price; it increasingly involved promises. Ultimately, courts began to hold that "a promise against a promise will maintain an action

37. See, e.g., FRIED, *supra* note 25, at 37-38; GRANT GILMORE, *THE DEATH OF CONTRACT* (1974); P.S. ATIYAH, *THE RISE AND FALL OF THE FREEDOM OF CONTRACT* (1979).

38. Morton Horowitz, *The Historical Foundations of Modern Contract Law*, 87 HARV. L. REV. 917, 917 (1974).

39. As Horowitz notes, it was only then "for the first time that the source of the obligation of contract [was] the convergence of the wills of the contracting parties." *Id.*

40. *Id.* at 919-20. See also LON FULLER & MELVIN EISENBERG, *BASIC CONTRACT LAW* 121 (3d ed. 1972).

41. *Id.*

42. Horowitz, *supra* note 38, at 919, quoted in FULLER & EISENBERG, *supra* note 40, at 121-22.

43. *Id.*, quoted in FULLER & EISENBERG, *supra* note 40, at 121.

44. Horowitz, *supra* note 38, at 936.

upon the case,”⁴⁵ and the modern conception of contracts as an exchange of promises triumphed.⁴⁶ According to Morton Horowitz, however, vestiges of property remained; indeed, “as late as the eighteenth century contract law was still dominated by a title theory of exchange”⁴⁷ One of the consequences was that damages were determined by principles of equity derived from property law, and courts would sometimes limit damages or deny specific enforcement because the consideration was inadequate and the underlying exchange was, therefore, unfair.⁴⁸

B. THE SOUND PRICE RULE

Principles of equity and fair dealing thus insinuated themselves into early commercial contract cases as well as real property cases. In the United States, this led to the emergence of the rule that “a sound price warrants a sound commodity.”⁴⁹ The sound price rule was used not only to hold the seller liable to the buyer for defects in title, but also in some cases for breaches of implied warranties of quality.⁵⁰ Thus, for example, in *Torris v. Long* in 1799, the court held that if the jury determined that a “full price” was paid for an “unsound” horse, the buyer would be entitled to damages;⁵¹ other cases from around the same time also acknowledged that where a full price was paid the goods must normally be merchantable.⁵² But not all the commercial cases were about implied warranties. In *Bourke v. Bulow* in 1787, the court upheld the jury’s decision to limit the plaintiff’s damages for breach of a contract to deliver flour and tobacco to settle a prior obligation. The plaintiff argued that the damages were too low because the flour and tobacco could have been resold for a profit, but the court characterized the agreement as “a catching bargain” and stated that the jury “exercised a very proper discretion” because “the jury have a right to give what they think just, in proportion to the loss the party sustains.”⁵³ Although the case was ostensibly about damages, the jury in effect determined that the plain-

45. THEODORE F.T. PLUCKNETT, *A CONCISE HISTORY OF THE COMMON LAW* 633-34 (1959).

46. According to Horowitz, this was not until the end of the sixteenth century. Horowitz, *supra* note 38, at 919.

47. *Id.* at 920.

48. *Id.* at 923-24.

49. *Id.* at 926.

50. *Id.*

51. *Torris v. Long*, Tayl. 17 (N.C. Super. Ct. 1799).

52. *See, e.g., Dean v. Mason*, 4 Conn. 428 (1822) (“For a long course of years, in this state, there was an implied warranty as to quality supposed to be attached to every sale.”); *Whitefield v. McLeod*, 2 Bay 380 (S.C. Const. 1802) (“The doctrine of a sound price deserving a sound commodity . . . though a very wise and salutary one, had been bandied about in our courts more than any other.”).

53. *Bourke v. Bulow*, 1 Bay 49 (1 S.C.L.1787).

tiff's consideration was inadequate for the promise to deliver the flour and tobacco.

C. THE RISE OF CAVEAT EMPTOR

The sound price rule, and other precedents authorizing inquiries into the adequacy of consideration, injected uncertainty into commercial contracts at a time when they were becoming more prevalent and increasing in complexity.⁵⁴ This encouraged many of the more sophisticated commercial actors to circumvent the legal precedents and traditional means of legal enforcement by conducting their transactions using independent bonds, with damages specified for failures to perform.⁵⁵ In fact, these practices may have impeded the refinements of contract doctrines necessary to facilitate post-industrial commercial transactions by taking disputes out of the courts and thus precluding judges from establishing new precedents.⁵⁶ Nonetheless, courts eventually did begin to address post-industrial commercial disputes and render new holdings that increasingly deferred to the will of the parties without regulating the equitableness of the commercial transactions.⁵⁷ It was only then that the sound price rule that had been so prevalent during the eighteenth century was replaced by the doctrine of caveat emptor.⁵⁸ In *Seixas v. Woods*,⁵⁹ for example, a leading American case,⁶⁰ the court held that there could be “no recovery against a merchant who could not be proved knowingly to have sold defective goods.”⁶¹ To break with the precedents that had established the sound price rule, the court in *Seixas* looked to the common law, rather than the American cases, and found no legal authority there for the sound price rule, but instead a long tradition of upholding the doctrine of caveat emptor.⁶²

The rejection of the sound price rule reflected a rejection of the idea that courts should—or could—regulate the equitableness of commercial

54. As Horowitz explains, the reliance on principles of equity mirrored a pre-industrial economy in which it was possible to identify “customary prices” for most, if not all, commodities. As markets began to expand and commercial activities increased during the Industrial Revolution, these customary prices were undermined by competition, and contract law began to assume a different role. Horowitz, *supra* note 38, at 936.

55. *Id.* at 928.

56. *Id.* at 931-32.

57. Horowitz observes that the trend “toward overthrowing the traditional role of courts in regulating the equity of agreements” began in England during Lord Mansfield’s time before spreading to the United States, and continued throughout the nineteenth century. *Id.* at 945.

58. *Id.* at 946.

59. *Seixas v. Woods*, 2 Cai. 48 (N.Y. Sup. Ct. 1804).

60. Horowitz, *supra* note 38, at 945.

61. *Id.*

62. *Seixas*, 2 Cai. at 48.

transactions by looking to the objective value of consideration.⁶³ The substitution of caveat emptor for the sound price rule was the harbinger of broader retrenchments in the application of equitable principles to contracts.⁶⁴ What emerged was a conception of contracts rooted in the will of the parties, and, increasingly, a jurisprudence that viewed contract law as instrumental to facilitating mutually gainful exchange. Principles of equity were suppressed, and contract law finally emerged from the shadows of property; in the process, a subjective theory of consideration emerged which rationalized nineteenth century laissez-faire economic doctrines that emphasized the need to enforce express bargains rather than to regulate parties' agreements.⁶⁵ The subjective theory of consideration and the ascendance of a will theory of contract created all the foundations necessary for the "entire conceptual apparatus of modern contract doctrine . . . [including] the evidentiary function of consideration."⁶⁶

It also more deeply entrenched the peppercorn theory. The principle that inadequacy of consideration should not be a bar to contractual enforcement is an old one that apparently predates the development of the modern doctrine of consideration.⁶⁷ But the rationale for the principle was clearly strengthened and more deeply entrenched by the ascendance of laissez-faire ideas in the late nineteenth century.⁶⁸ As the modern doctrine of consideration emerged, courts focused on procedural inequities, such as fraud and duress,⁶⁹ instead of regulating the substance of exchanges. They often justified their laissez-faire approach with the argument that they were unable to evaluate the size of consideration in complex transactions with subjective values.⁷⁰ The courts' frequent pronouncements in favor of the rule may have obscured the fact that it was only rarely the basis of their decisions,⁷¹ but the peppercorn theory was adopted by the Restatement (Second) of Contracts on the grounds that "in many situations there is no reliable external standard of value" and "parties are thought to be better able than others to evaluate the circumstances of particular transactions."⁷²

63. Horowitz considers this to be a turning point in American contract law. As he put it, "[T]he sudden and complete substitution of caveat emptor in place of the sound price doctrine must . . . be understood as a dramatic overthrow of an important element of the eighteenth century's . . . conception of contract." Horowitz, *supra* note 38, at 946.

64. *Id.* at 947.

65. *Id.*

66. *Id.* at 952.

67. Note, *The Peppercorn Theory of Consideration and the Doctrine of Fair Exchange in Contract Law*, 35 COLUM. L. REV. 1090, 1091 (1935).

68. *Id.*

69. *Id.*

70. *Id.* at 1092.

71. *Id.* at 1097.

72. RESTATEMENT (SECOND) OF CONTRACTS § 79 cmt. c (1981).

One of the developments in contract law that occurred in conjunction with the ascendance of the will theory of contracts and the subjective theory of consideration was an increased focus on the exchange of promises by rational individuals.⁷³ Contracts thus no longer addressed questions about whether gifts were valid, and distinctions were drawn between contracts and quasi-contracts.⁷⁴ This was part and parcel of the rise of the bargain theory of contracts, which has dominated contract law since then. It was also consonant with the laissez-faire ideology that emerged in response to the pressures of a post-industrial commercial economy: by making the rational individual the main protagonist in the creation of enforceable contractual obligations, the will theory and related contract doctrines have limited the courts and the state to a supporting role in the vast majority of commercial transactions.⁷⁵ But the modernization of the law occurred through the reinterpretation and refinement of legal doctrines, and it was neither rapid nor complete. Old legal precedents die hard, and vestiges of the pre-industrial legal order remained throughout the nineteenth century and into the twentieth.⁷⁶

D. THE VESTIGES OF EQUITY

It is far from clear that pre-industrial principles of equity were ever completely vetted from contract law. As Arthur Leff observed, when Article 2 of the U.C.C. was initially being drafted, the drafters were clearly influenced by vestiges of the equity principles that had characterized contract law prior to the nineteenth century.⁷⁷ This created particularly acute

73. KREITNER, *supra* note 29, at 17.

74. *Id.* at 28-29.

75. *Id.* at 17.

76. Indeed, according to Morton Horowitz, the “victory” of the will theory of contracts was not realized until William H. Story’s *Treatise on the Law of Contract* brought coherence to the theory of implied contractual obligations that had persisted since the eighteenth century and the theory of express contracts based on the parties’ wills. Story achieved the reconciliation by reinterpreting the role of courts in implied contracts as one of providing a contract term that was intended but not memorialized by the parties themselves. Horowitz, *supra* note 38, at 952. As Roy Kreitner writes:

Through the eighteenth century and into the early nineteenth, inadequacy of consideration was deemed a good reason to reduce damages from the otherwise accepted expectation measure. And while explicit acknowledgment of this function of consideration decreased over the course of the nineteenth century, it was still applied by the Supreme Court in a case in 1889.

KREITNER, *supra* note 29, at 28.

77. Thus, he writes, “[f]rom the beginning the procedural unconscionability question was not posed in terms of what bargaining conduct, if any, would vitiate the agreement, but whether there was bargaining conduct sufficient to *insulate* from judicial interference a

difficulties in drafting what became the unconscionability provision in U.C.C. section 2-302.⁷⁸ Indeed, the thorniest question the drafters faced was whether contracts could be voided simply because the consideration was inadequate, regardless of whether the bargaining process raised suspicions about the fairness of the parties' dealings.⁷⁹ It appears that they struggled hard to find a compromise between the equitable principles that weighed in favor of regulating the substance of contracts and the emerging conception of rationality that undergirded both the will theory of contracts and the *laissez-faire* approach to markets and that militated against interfering with the autonomy of private parties.⁸⁰

Article 2, however, clearly expanded the scope of application of the unconscionability doctrine beyond its pre-industrial territory. The sound price rule and other principles of equity had traditionally been used to void an entire contract.⁸¹ This was consistent with the conception of a contract as a transfer of title to goods or real property in return for a price or other consideration and the use of the unconscionability doctrine to regulate the fairness of the exchange.⁸² If the consideration was inadequate, the deal was not enforceable. This conception of the unconscionability doctrine no doubt owed much to the context in which it developed, and that was one in which transactions were relatively simple by modern standards. Thus, the primary purpose of exchange was to realign property rights; sellers rarely made any express covenants or warranties, and courts were not inclined to imply any as a matter of law.⁸³ Of course, this changed, not only because of the in-

contract which was, arguably, substantively 'unconscionable.'" Arthur Allen Leff, *Unconscionability and the Code – The Emperor's New Clause*, 115 U. PA. L. REV. 485, 489 (1967).

78. Vestiges of the equity principles that had been prevalent in the pre-industrial legal order militated in favor of regulating the fairness of bargains, regardless of the bargaining process. At the same time, it was difficult for the drafters to conceive of how any reasonable commercial party could make an agreement that was substantively unconscionable. According to Arthur Leff, the provisions from the 1941 draft of Article 2 "spoke throughout as if it were inconceivable that there could exist simultaneously both particularized bargaining and an unfair contract." *Id.* at 491.

79. *Id.* at 489.

80. The struggle manifested itself in deliberations about whether the unconscionability clause should require some defect in the bargaining process or whether a contract that was substantively unfair because the consideration was inadequate could be voided regardless. As Arthur Leff documents, the drafters went back and forth on the matter and ultimately left the question largely unanswered. *Id.* at 491-98.

81. *Id.* at 509.

82. As Robert Hillman notes, "[t]he chancellors employed the doctrine of equitable unconscionability most often, although not exclusively, in cases involving specific performance of land sales contract. Courts denied specific performance . . . if the exchange was deemed inadequate . . ." HILLMAN, *supra* note 14, at 131.

83. Modern warranty law developed gradually in the twentieth century. For an overview of the development of the law governing the creation of express warranties, see Charles A. Heckman, "*Reliance*" or *Common Honesty of Speech: The History and Interpre-*

creasing complexity of manufactured goods, but also because of the advent of mass production and the shipment of goods from the places they had been manufactured to distant retail stores from which they were sold. In the post-industrial economy, sellers' warranties about goods became much more valuable to their buyers and, therefore, also to the sellers themselves.⁸⁴ As a consequence, questions more frequently arose as to whether particular clauses in a contract could be voided as substantively unfair. Courts began to respond in the affirmative.⁸⁵ It is no great surprise, therefore, that during the drafting of Article 2 the scope of the unconscionability clause was extended beyond providing courts with authority to void entire contracts to giving them the authority to use the unconscionability doctrine with razor-like precision to void specific contract clauses.

Arthur Leff believed that this broadening of the scope of the unconscionability clause was "the most important single transformation disclosed by [his] study of the drafting history [of Article 2]."⁸⁶ In his view, providing the courts with the power to regulate particular contract clauses delegated considerably greater discretion to the courts over questions of public policy

tation of Section 2-313 of the Uniform Commercial Code, 38 CASE W. RES. L. REV. 1 (1987); for an overview of the development of the law governing implied warranties, see John Barker Waite, *Retail Responsibility and Judicial Law Making*, 34 MICH. L. REV. 494 (1936); William L. Prosser, *The Implied Warranty of Merchantable Quality*, 27 MINN. L. REV. 117 (1943).

84. One of the most important advances in modern microeconomics is a better understanding of how informational problems can impede potentially gainful market transactions. As George Akerloff explained in a now famous article, information asymmetries are ubiquitous. George A. Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 494 (1970). Sellers typically know more about the quality of their goods than buyers. Buyers are thus inclined to make purchase decisions based on the average quality of all the goods in the market because they cannot accurately evaluate the quality of any particular good. This discourages sellers from supplying high quality goods to the market, since buyers are unwilling to pay a premium for them, and encourages them instead to supply the market with "lemons." If, however, sellers can credibly signal that their goods are high quality by warranting them to be such, the lemons problem can be surmounted. See Donald J. Smythe, *The Scope of a Bargain and the Value of a Promise*, 60 S.C. L. REV. 203, 209-10 (2008) for a more thorough discussion.

85. The official comments to Article 2 cite some of the cases. In *Kansas City Wholesale Grocery Co. v. Weber Packing Corp.*, 93 Utah 414 (1937), for instance, the court essentially voided a clause limiting the time for the buyer to complain about defects in a shipment of goods where the defects were latent and particularly difficult to discover; in *Austin Co. v. J.H. Tillman Co.*, 104 Or. 541 (1922), the court held that a clause limiting the buyer's right to return the goods was void where the seller had not delivered goods that met the contract description; and in *Hardy v. Gen. Motors Acceptance Corp.*, 38 Ga. App. 463 (1928), the court held that a disclaimer of warranties clause did not apply to an implied warranty. See *infra* Part F.

86. Leff, *supra* note 77, at 513.

than they had been able to wield when limited to voiding entire contracts.⁸⁷ In fact, in Leff's view, this broadening of the unconscionability doctrine gave courts too much discretion, since neither Article 2 nor the official comments provided sufficient guidance as to how the "one-clause" variant of unconscionability should be applied.⁸⁸ Indeed, the only real guidance provided for interpreting U.C.C. section 2-302 is in the official comments, and these refer to a number of pre-U.C.C. cases. As Leff observed, however, all of the cases addressed questions about the validity of clauses that purported to make warranty disclaimers or limit buyers' remedies.⁸⁹ Since Article 2 elsewhere sought to regulate sellers' warranty disclaimers and limitations of remedies, Leff could see little purpose to having an unconscionability clause in the U.C.C.⁹⁰ Although the drafters of Article 2 claimed their purpose in drafting U.C.C. section 2-302 was to follow the ancient tradition in equity of regulating unconscionable contracts,⁹¹ Leff concluded that they ultimately failed by broadening the scope of application of the unconscionability doctrine without in any way clarifying how it should be applied.⁹² Most importantly, the drafters failed to clarify whether inadequate consideration was itself grounds for voiding a contract or contract clause or whether some defect in the bargaining process was also necessary.⁹³

E. REGULATING V. INTERPRETING BARGAINS

Leff argued that the test for unconscionability should include two prongs: a test for whether there was a procedural abuse in the bargaining process and a test for whether the consideration was inadequate.⁹⁴ Leff's two-pronged test has become the majority approach.⁹⁵ In theory, the two-pronged test makes the doctrine of unconscionability cohere with the peppercorn doctrine, which precludes courts from considering the adequacy of

87. As Leff puts it, "if one decides to police contracts on a clause-by-clause basis, he finds that he has merely substituted the highly abstract word 'unconscionable' for the possibility of more concrete and particularized thinking about particular problems of social policy." *Id.* at 515.

88. *Id.* at 516.

89. *Id.*

90. As Leff notes, "both kinds of clauses dealt with in the official-comment cases are totally regulated by sections of the Code other than 2-302." *Id.* at 525.

91. Leff, *supra* note 77, at 529.

92. *Id.* at 538.

93. *Id.*

94. *Id.*

95. *See, e.g.,* CLAYTON P. GILLETTE & STEVEN D. WALT, SALES LAW: DOMESTIC AND INTERNATIONAL 155 (1st ed. 1999) ("Unconscionability, according to most courts, contains both procedural and substantive elements. A contract or contract term is unconscionable only if it is both procedurally and substantively unconscionable.").

consideration in interpreting and enforcing a contract. But the most compelling contract questions, the ones that still raise the ghost of the ancient equity principles that the modern doctrinal reformulations of contract law have sought to delimit, are about promises or affirmations that are not clearly made by the seller, or waivers or limitations of remedies through contract clauses that are not clearly assented to by the buyer.⁹⁶ It is primarily the cases in which there is some ambiguity about the terms of a contract that illustrate how closely the peppercorn theory and unconscionability doctrine relate to questions of contract interpretation, regardless of whether they are actually applied. Indeed, the doctrine of unconscionability has arguably always been closely related to issues of contract interpretation, in spite of its characterization as a regulatory doctrine. This can be made most clearly evident by a closer examination of the cases that the drafters cited in the official comments to U.C.C. section 2-302.

F. THE CASES CITED IN THE OFFICIAL COMMENTS TO U.C.C. SECTION 2-302

Consider each of the cases cited in the official comments:

In *Kansas City Wholesale Grocery Co. v. Weber Packing Corp.*,⁹⁷ the seller, Weber Corporation, contracted to deliver catsup to the buyer, Kansas City Wholesale Grocery Co. After the catsup was delivered, however, it was inspected by an agent from the Food and Drug Administration who found that it was blighted by mold and subjected it to condemnation.⁹⁸ Kansas City Wholesale sued Weber for breach of an implied warranty.⁹⁹ Weber Corporation defended itself against the claim in part by asserting a clause in the contract that limited the time for the buyer to make claims for defects in the goods to ten days after receipt. Kansas City's claim was clearly not made within that time.¹⁰⁰ The court observed that under established precedent there was an implied warranty for latent defects and that no clause unreasonably limiting the time for the buyer's inspection could protect the seller.¹⁰¹ What is perhaps most striking is that, although the case is the first one cited in the official comments to U.C.C. section 2-302 to illustrate the underlying basis of the unconscionability doctrine, the word "unconscionability" is nowhere mentioned. The central question in the case could just as easily be construed as whether a clause limiting the time for complaint should be interpreted to apply to complaints about latent defects as well as

96. See *infra* Part IV.

97. *Kan. City Wholesale Grocery Co. v. Weber Packing Corp.*, 73 P.2d 1272 (Utah 1937).

98. *Id.* at 1273.

99. *Id.*

100. *Id.*

101. *Id.* at 1275.

patent ones as whether a clause limiting the time for complaint about a latent defect should be unconscionable. The case clearly dances on the fine line between questions about unconscionability and contract interpretation.

In *Hardy v. General Motors Acceptance Corp.*, the court held that language in the contract stating “no warranties have been made by the seller unless indorsed hereon in writing” excluded express warranties but not implied ones.¹⁰² Once again, the case is noteworthy for the absence of any mention of unconscionability. Indeed, in *Hardy*, the court expressly addressed the question in the case as a matter of contract interpretation.¹⁰³ Since there were no issues of fact, the court construed the contract by looking to the language in the writing and employed *contra proferentem*, the principle that ambiguities should be construed against the drafter.¹⁰⁴ The doctrine of *contra proferentem* was also applied by an English court in *Andrews Bros. v. Singer & Co.*¹⁰⁵ In *Andrews*, it was used to limit the application of a warranty disclaimer to the “implied” warranty that a “new” car was in fact new.¹⁰⁶ Again, even though the court construed the question in the case as one of contract interpretation, and even though the court was English and not American, the case is cited in the official comments to U.C.C. section 2-302 to provide guidance on how the doctrine of unconscionability should be applied.

In *New Prague Flouring Mill Co. v. Sprague*, Spears contracted to buy flour from New Prague through a traveling salesman.¹⁰⁷ The terms of the agreement were specified in a writing, which the court considered to be unusually detailed for such an ostensibly routine transaction.¹⁰⁸ After the first two shipments of flour were delivered, however, Spears objected that they were not “old wheat flour” as he had expected and refused to be bound by the contract.¹⁰⁹ New Prague did not concede that anything other than old wheat flour had been delivered, but offered to replace the flour if it was “not giving entire satisfaction.”¹¹⁰ New Prague sought to assert the terms in the writing extending the delivery date for the flour against Spears, but Spears claimed not to have read them and that New Prague’s salesman orally assured him that if he was not satisfied with the flour he could cancel the contract.¹¹¹ Upon cross examination, New Prague’s salesman affirmed that

102. *Hardy v. Gen. Motors Acceptance Corp.*, 144 S.E. 327 (Ga. Ct. App. 1928).

103. *Id.* at 328.

104. *Id.*

105. *Andrews Bros. v. Singer & Co.*, 1 K.B. 17 (King’s Bench Division 1934).

106. *Id.*

107. *New Prague Flouring Mill Co. v. Sprague*, 189 N.W. 815, 816 (Iowa 1922).

108. *Id.*

109. *Id.* at 820.

110. *Id.*

111. *Id.*

Spears did not read the writing and that he had not even produced it until he and Spears had reached an agreement about the price and type of the flour and the dates of delivery of the shipments.¹¹² Although the court did not allow the parole evidence to trump the written terms, it did treat the question in the case as one of contract interpretation and invoked *contra proferentem* to void the written terms that extended New Prague's delivery date.¹¹³

A similar issue arose in *Kansas Flour Mills Co. v. Dirks*.¹¹⁴ In that case, however, the writing was much shorter and simpler. It stated that if Kansas Flour failed to deliver by December 30, 1914, Dirks could, as one of his options, extend the time for delivery.¹¹⁵ After Kansas Flour failed to deliver on December 30, on December 31, 1914, Dirks wrote Kansas Flour to extend the time for delivery to January 15, 1915.¹¹⁶ When Kansas Flour failed to make that delivery, Dirks sought damages based on the market price as of January 15, 1915, instead of December 30, 1914.¹¹⁷ The difference was significant and in Dirks's advantage. Kansas Flour argued that the contract had already terminated on December 31, 1914, and that Dirks could, at that point, no longer exercise his right to extend the time for delivery.¹¹⁸ Although Kansas Flour succeeded with this argument at trial, the Supreme Court of Kansas overruled the lower court. As the supreme court explained, Kansas Flour "should not be permitted to say that [the contract] ended on December 30, when it was expressly agreed that it might be kept alive for a longer time."¹¹⁹ What is most striking for the purposes of this Article is that the case can be construed so easily as a straightforward matter of contract interpretation. While the Supreme Court of Kansas's interpretation of the contract comports better with the equities in the case than the trial court's, it also comports better with common sense and that, by all appearances, was the basis for the Supreme Court of Kansas's holding, rather than any conception that the terms of the contract needed to be regulated in fairness to the buyer.

In *Joseph Green v. Arcos, Ltd.*, Green rejected a shipment of wood products because the quantity was short.¹²⁰ The preamble to the parties' writing and a clause in the writing stated that the seller was entitled to vary

112. *Sprague*, 189 N.W. at 821.

113. *Id.*

114. *Kan. Flour Mill Co. v. Dirks*, 164 P. 273 (Kan. 1917).

115. *Id.* at 274.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Dirks*, 164 P. at 275.

120. *Joseph Green v. Arcos, Ltd.*, 39 Lloyd's List L.R. 84, 84 (1931).

the quantity by ten percent.¹²¹ The variation in the shipment delivered was greater than that and so it was clear that the seller breached.¹²² There was, however, an additional clause in the writing that disclaimed the buyer's right to reject the goods.¹²³ The central question in the case was whether this clause barred Green from rejecting the shipment. The King's Bench interpreted the clause prohibiting rejections to pertain only to goods as specified in the contract description.¹²⁴ Since the goods Arco delivered did not conform to the contract specification, the clause did not apply to them, and Green had a right to reject the shipment.¹²⁵ The court's interpretation of the contract was tenuous, at best, and may have had much to do with its perception of the equities in the case, but it is notable that the court disposed of the question in the case as a matter of contract interpretation.

In *Meyer v. Packard Cleveland Motor Co.*, Meyer bought a rebuilt truck from Packard Cleveland Motor Co.¹²⁶ Packard had advertised that its rebuilt trucks were "ready to go to work" and "will give you the very best of service."¹²⁷ Meyer signed a purchase order, however, that purportedly waived any promises, understandings, or agreements not expressly made in the purchase order, and, of course, the purchase order made no express warranties.¹²⁸ When Meyer subsequently sued Packard for breach of warranty, Packard asserted the waiver clause in its defense. Although Packard's defense succeeded at trial, the Supreme Court of Ohio overruled the trial court, and held that the waiver did not apply to an implied warranty created by the sale of the rebuilt truck.¹²⁹ The court noted that Meyer had paid \$4,200—"a substantial sum"—for the truck and "[t]he consideration to be given Meyer for his \$4,200 was not merely a shape of 5-ton size, but a thing fitted for practical useful, substantial service as a dump truck."¹³⁰ Indeed, the court stated that the language in the purchase order that waived all promises, understandings, or agreements not expressly made in the purchase order applied solely to any express agreements between the parties and not to any contract terms implied by custom or usage of trade.¹³¹ The case is interesting because it appears that the court addressed the issue as a matter of contract interpretation but also clearly considered the contract price.

121. *Id.*

122. *Id.* at 86.

123. *Id.* at 85.

124. *Id.* at 87.

125. *Arcos*, 39 Lloyd's List L.R. at 87

126. *Meyer v. Packard Cleveland Motor Co.*, 140 N.E. 118 (Ohio 1922).

127. *Id.* at 119

128. *Id.* at 120.

129. *Id.*

130. *Id.*

131. *Packard*, 140 N.E. at 121.

In *F.C. Austin Co. v. J.H. Tillman Co.*, Austin sued Tillman for the balance owed on an asphalt mixing plant; Tillman countersued for breach of warranties.¹³² In fact, Tillman contended that the mixing plant that Austin delivered was not the one in the catalogue that he had ordered and that, although Austin had modified the machine to suit his immediate needs, his paving business nonetheless suffered as a result. Tillman therefore claimed special damages.¹³³ At trial, the jury awarded Tillman over \$10,000.¹³⁴ Upon appeal, the Supreme Court of Oregon construed the central question in the case as whether the remedy to return the machine that was expressly stated in the purchase order was an exclusive one or cumulative.¹³⁵ The majority of the court held that Austin's obligation to deliver a machine that conformed to the contract was a condition precedent to Tillman's remedy being limited to the return of the machine.¹³⁶ As the dissenting opinion noted, however, the purchase order expressly limited Tillman's remedy to the return of the machine.¹³⁷ The dissenting opinion appeared to reject the idea that principles of equity should trump express contract terms:

In construing . . . contracts, the object to be attained is the intent of the parties; but this intent must be ascertained if possible by the language which the parties themselves have adopted and used . . . and not by reading into it words that import an intent and understanding wholly unintended and unexpressed when the contract was written, but suggested by some apparent hardship in the enforcement thereof.¹³⁸

Nonetheless, this merely emphasizes that if principles of equity factored in the case, it was arguably through the majority's interpretation of the contract rather than in any direct regulation of the contract terms. There was no discussion in the case of guile or deception in the negotiations or anything else that smacked of modern unconscionability analysis.

In *Bekkevold v. Potts*, Bekkevold sued Potts for breach of an implied warranty on a tractor and related equipment.¹³⁹ In defense, Potts asserted language in the contract of sale that stated: "no warranties have been made .

132. *F.C. Austin Co. v. J.H. Tillman Co.*, 209 P. 131, 144 (Or. 1922).

133. *Id.* at 133.

134. *Id.*

135. *Id.* at 135.

136. *Id.*

137. *Tillman*, 209 P. at 146.

138. *Id.* (quoting *Nave v. Powell*, 96 N.E. 395 (Ind. App. 1911)).

139. *Bekkevold v. Potts*, 216 N.W. 790 (Minn. 1927).

. . . unless expressly written hereon at the date of purchase.”¹⁴⁰ The Supreme Court of Minnesota observed that an implied warranty is “imposed by the law . . . to promote high standards in business and to discourage sharp dealings.”¹⁴¹ It did not, however, discuss the doctrine of unconscionability, nor did it treat the case as one arising in equity. Instead, the court construed the question as whether the waiver language included within its scope implied warranties created by law as well as express warranties created by the seller. It concluded that the parties’ intent was not to exclude the implied warranty.¹⁴² What is significant, again, is that a case cited for its illustration of the doctrine of unconscionability was, in fact, one in which the central question could so easily be construed as a matter of contract interpretation.

Finally, in *Robert A. Munro & Co. v. Meyer*, which was another English case, the English plaintiff, Munro, sued the German defendant, Meyer, for the unpaid price of two installments of meat and bone meal.¹⁴³ In his defense, Meyer asserted that Munro had breached warranties under the Sale of Goods Act of 1893, a statute under which English sales law had been codified in the late nineteenth century.¹⁴⁴ Munro, however, attributed the defects to the manufacturer of the meal and disclaimed any responsibility as the wholesaler.¹⁴⁵ Indeed, Munro cited language in the contract that stated the goods were to be taken “with all faults and defects, damaged or inferior.”¹⁴⁶ The court, however, held that the wording did not exclude the implied warranty that the goods should conform to the contract description, and that, because of the defects, the goods in this case did not conform to the contract description.¹⁴⁷ Meyer also argued that the doctrine of mutual mistake should apply, since neither they nor Munro were aware of the defects in the meal.¹⁴⁸ The court rejected Meyer’s argument in part because it was unable to find that “the making of the contract was conditioned by the mistake.”¹⁴⁹ Moreover, the court noted that the doctrine of mistake arose in equity and that the cases in which it had applied had been comparatively simple, whereas the case at hand was complex and restitution could not so easily be achieved.¹⁵⁰ This left the court with the task of measuring damages. To that task, the court, without expressly stating so, appeared to apply

140. *Id.*

141. *Id.* at 791.

142. *Id.*

143. *Robert A. Munro & Co. v. Meyer*, 2 K.B. 312, 315 (King’s Bench Division 1930).

144. *Id.*

145. *Id.* at 328.

146. *Id.* at 327.

147. *Id.*

148. *Meyer*, 2 K.B. at 329.

149. *Id.* at 335.

150. *Id.* at 335-36.

the expectations damages rule.¹⁵¹ There is nothing in the case that particularly illustrates how principles of equity might apply to void a contract or a clause of a contract; rather, the case appears to turn on the court's interpretation of the effect of waiver language in the contract.

F. CONCLUDING THOUGHTS

What is most striking about the cases cited in the official comments to U.C.C. section 2-302 is that all of them can be construed as being about matters of contract interpretation. If they figure at all, principles of equity appear to provide a subtext for the courts' opinions rather than a basis for their decisions. There is certainly nothing in the cases to suggest they are about whether the contracts or clauses of the contracts should be voided, nor is there anything remotely similar to Arthur Leff's two-prong test for unconscionability. What the cases illustrate more strongly than anything else, therefore, is the fine line between the doctrine of unconscionability and questions of contract interpretation. Unconscionability cases are rare, especially when they involve sophisticated business parties, but cases between sophisticated business parties involving disputes over the interpretation of their contracts are not. Given the fine line between the unconscionability doctrine and contract interpretation, it should not be surprising if in some cases courts have evaluated the adequacy of consideration in rendering holdings about the interpretation of contracts. In fact, not only are there recent sales cases in which courts have evaluated the adequacy of contract prices in interpreting ambiguous contract clauses, but the official comments to the U.C.C. authorized them to do so.¹⁵² Unfortunately, because there are no guidelines for courts to follow in evaluating the adequacy of consideration, when they have done so they have not always made their logic clear, nor has it always been evident whether they have done so prudently.¹⁵³ The next section of this Article attempts to provide some practical guidelines.

III. AN ECONOMIC ANALYSIS OF BARGAINS

One of the basic postulates of economic theory is that rational parties will seek to earn gains from trade through mutually advantageous bargains. Unfortunately, economic theorists have struggled to develop a general theory of bargaining that can accurately predict how the parties to bargains share in the gains from trade.¹⁵⁴ There is, therefore, no universally accepted

151. *Id.* at 336-37.

152. *See infra* Part IV.

153. *See infra* Part IV.

154. For a useful survey of various bargaining models, see ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 357-379 (1997).

economic model upon which to base an economic analysis of bargains. That does not, however, mean that the economic analysis is pointless; what it means is that it can only establish parameters within which rational parties might conclude the terms of their bargains. As it turns out, even establishing these parameters is very useful; not least of all, they help to identify circumstances in which an evaluation of the contract price will not aid in the interpretation of other contract terms; beyond that, they also help to indicate how the contract price should be used in cases where it can aid in the interpretation of other contract terms.

Consider the market for some generic good. Assume that all potential buyers and sellers are risk-neutral, profit-maximizers, and attach no psychological values to the good or anything else.¹⁵⁵ Since they attach no psychological values to the good, the buyers' expected valuations and the sellers' expected costs can be expressed entirely in monetary terms. Assume, for convenience, that transaction costs are zero.¹⁵⁶ Assume that all actual trades

155. To assume that an agent is a profit maximizer is tantamount to assuming that the only criterion in the agent's utility function is profits. This assumption is consonant with a focus on commercial contracts between sophisticated merchant-buyers and merchant-sellers.

156. This makes the analysis distinctively "neoclassical" in the narrow sense. As a general matter, transaction costs are almost impossible to specify precisely, but they would normally include all the costs of negotiating the contract terms and memorializing them in writing, as well as the expected costs associated with enforcing the agreement and the uncertainty about whether it would be completed successfully. There is a growing economics literature that relates the costs of contracting to parties' contract-specific investments, their subsequent decisions about whether to renegotiate their contracts, and courts' interpretations of the contracts. *See, e.g.*, Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 3-5 (2004); Steven Shavell, *On the Writing and Interpretation of Contract*, 22 J.L. ECON. & ORG. 289 (2006); Jesse Bull, *Costly Evidence Production and the Limits of Verifiability*, 8 B.E.J. THEORETICAL ECON. 1 (2008); Pierpaolo Battigalli & Giovanni Maggi, *Costly Contracting in a Long-Term Relationship*, 39 RAND. J. ECON. 352 (2008). Some of this literature suggests that in an efficient legal system courts might not always interpret contracts as accurately as possible, and indeed the parties themselves might like to restrict courts' use of extrinsic evidence in interpreting their contracts. The basic ideas have contributed to a recent neo-formalist argument in favor of a strict parole evidence rule. *See* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 826, 931 (2010). *See also* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006); Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023 (2009). Most of this literature, however, assumes that parties have what Richard Posner has described as a kind of "hyper-rationality"—an almost super-human capacity to process information and calculate optimal strategies commonly assumed in complex dynamic games. POSNER, *supra* note 4, at 22-26. Perhaps not surprisingly, Posner has offered a law and economics critique of the neo-formalist analysis and a more traditional law and economics view of parole evidence. *See* Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581 (2005). Some of the uses of the contract price suggested in this Article would require the admission of parole evidence, but others would not. Nonetheless, this Article presumes that parties are "intentionally rational but only limit-

are the result of bargains that are supported by contracts, and that the contracts are defined by a finite number of terms, specifying (although perhaps ambiguously) promises or disclaimers, as well as a contract price. Assume that the seller's promises increase the expected marginal value of the good to the buyer but also increase the seller's expected marginal costs and that the seller's disclaimers do the converse—that is, decrease the seller's expected marginal costs but also decrease the expected marginal value of the good to the buyer. Finally, assume that the expected marginal values and expected marginal costs of the contract terms are separable and additive—in other words, that the expected marginal value (and expected marginal costs) of any particular promise or disclaimer does not affect the expected marginal value (and expected marginal costs) of any other promise or disclaimer, and, therefore, that the expected total value of the good to the buyer (and the expected total costs of the good to the seller) is just the sum of the expected marginal values (expected marginal costs) of all the contract terms.¹⁵⁷

Each buyer's expected total valuation of the good and each seller's expected total costs of supplying the good would depend on the terms of their contract. From an economic perspective, however, a sale of the good by the seller to the buyer would be socially desirable if and only if it generated a surplus, defined here as a positive difference between the buyer's expected total valuation of the good and the seller's expected total costs in supplying it. But the transaction would not be economically efficient unless it generated the maximum amount of surplus possible and thus maximized the parties' gains from trade. The sale would maximize the parties' gains from trade if and only if the contract terms were chosen so as to add surplus value to the transaction whenever possible. In other words, the contract would have to include all surplus-increasing warranties and disclaimers and exclude all surplus-decreasing warranties and disclaimers. It is a basic postulate of economic theory that if the parties were perfectly rational and transaction costs were zero, they would realize all potential gains from trade and the transaction would be economically efficient. The contract for the transaction would, thus, include only surplus-increasing terms—that is, terms whose expected marginal value to the buyer exceeded their expected marginal costs to the seller (and thus would include no terms whose expected

edly so" and that it is generally advisable for courts to interpret their contracts as accurately as possible. HERBERT SIMON, *MODELS OF MAN*, at xxiv (1957). This is consistent with the more traditional approach to law and economics taken by scholars such as Posner, although perhaps not couched in quite the same language.

157. The assumption that the expected marginal valuations and expected marginal costs of the contract terms are separable and additive does preclude addressing complex interactions between contract clauses. Nonetheless, this does not limit the generality of any conclusions.

marginal value to the buyer was less than their expected marginal costs to the seller).

Although an economically efficient contract would, by definition, necessarily maximize the total surplus generated by the parties' trade, it could entail the parties trading at a range of prices depending on their relative bargaining power. At one extreme, if the seller had all the bargaining power, or, in terms of a market reference, had pure monopoly power and was able to engage in perfect price discrimination,¹⁵⁸ the contract price would equal the expected total value the buyer derived from the transaction; this would be equivalent to the seller's expected total costs plus the total surplus generated by the transaction. Regardless of how we think about it, the seller's surplus from the transaction would equal the maximum amount possible. At the other extreme, if the buyer had all the bargaining power, or, in terms of a market reference, had pure monopsony power and was able to engage in perfect price discrimination¹⁵⁹ (or, alternatively, if the transaction occurred in a long-run, perfectly competitive market equilibrium),¹⁶⁰ the contract price would equal the expected total costs to the seller of fulfilling its obligations under the contract, and the buyer would therefore derive the entire amount of economic surplus generated by the transaction.

If the bargaining power was shared between the seller and buyer, then the contract price would lie somewhere in between these two extremes. If the parties were perfectly rational, therefore, and drafted an economically efficient contract that realized all potential gains from trade, the contract price could lie anywhere in between a perfectly price-discriminating pure monopolist's price and a perfectly price-discriminating pure monopsonist's price (or, alternatively, the price in a perfectly competitive, long-run equilibrium). In short, a rational bargain could be consistent with a wide range of contract prices. In fact, that is the most glaring failure of the economic theory of bargaining: it can adequately characterize and predict which bargains will occur, but there is no general economic model that can predict the prices at which the parties will transact with any significant precision or degree of empirical reliability.

158. A seller is able to engage in perfect price discrimination if he or she is able to charge each individual buyer the highest price the buyer is willing to pay for the good; since different buyers will generally place different values on the good, this means the seller must be able to charge a different price to each buyer. That is the only kind of discrimination contemplated by the term. HENDERSON & QUANTDT, *supra* note 7, at 182-85.

159. A perfectly price discriminating buyer would be able to buy the good for the lowest price the seller was possibly willing to accept. In the long run, this would be a price that just covered the seller's expected costs. *Id.* at 190-92.

160. In a long run perfectly competitive equilibrium, the market price is equal to the average total cost of the good. This corresponds to the seller's expected total costs in this analysis. *Id.* at 146-49.

A. USING ECONOMIC THEORY TO INTERPRET AMBIGUOUS CONTRACT TERMS

Even sophisticated parties who have carefully negotiated and drafted their contracts occasionally have disputes about the meaning of contract terms. The rationality assumptions that characterize conventional economic theory are helpful in developing hypotheses about how people might behave, but only the most dogmatic or idealistic theorists would argue that people are always perfectly rational. Indeed, most professional economists today probably believe that people are “intentionally rational, but only limitedly so.”¹⁶¹ The persistence of perfect rationality assumptions in relatively simple economic models reflects their usefulness as an approximation to human behavior rather than any unrealistic conceptions about human capabilities. In the analysis offered here, perfect rationality assumptions are helpful in establishing some of the parameters within which parties who are intelligent and profit seeking will devise the terms for their trades. But it would obviously be a mistake to presume that real world parties are so “hyper-rational” that they always draft their contract terms unambiguously.

In fact, given the limitations on real-world parties’ rationality, it is inevitable that some ambiguities will arise in the interpretation of many contracts. The important question is whether economic analysis can provide any guidance in resolving the ambiguities. Suppose there was an ambiguity about one of the terms in a particular contract. Suppose the seller and buyer had a dispute about whether one particular promise or disclaimer had been made as a part of their bargain. Would it be reasonable for a court to use economic analysis to draw any inferences about whether the promise or disclaimer was an intended part of the parties’ bargain? In particular, could a court reasonably ever use evidence about the contract price to draw such inferences? The short answer is yes; the next parts of this section will elaborate. For simplicity, the discussion will focus on a dispute about whether a particular term is a part of the parties’ bargain, and it will suppose that whatever writing and/or parole evidence that is admissible to determine whether the term is part of the contract is ambiguous. Within these parameters, the contract price might aid in determining whether the term is an intended part of the parties’ bargain through (1) cost-benefit comparisons, (2) comparisons of the contract price to prices in other contracts made by the same buyer and seller, and (3) comparisons of the contract price to other market prices.

161. This is the conception of economic rationality proposed by the Nobel Prize-winning economist, Herbert Simon. It acknowledges that there are limits on humans’ cognitive abilities and that the costs of acquiring and processing information can be high. *See* SIMON, *supra* note 156.

B. COST-BENEFIT COMPARISONS USING THE CONTRACT PRICE

In an economically efficient bargain, the seller would never make a promise if the expected marginal costs of doing so exceeded the expected marginal value of the promise to the buyer; similarly, the seller would always make a disclaimer if the expected marginal cost savings of the disclaimer exceeded the decrease in expected marginal value to the buyer. This might provide a basis for determining whether a disputed promise was an intended part of the parties' bargain. For instance, if the parties were rational enough to achieve an economically efficient bargain, and if there was sufficient evidence to prove that the expected marginal costs of a promise clearly exceeded its expected marginal value, a court would be justified in finding that the promise was not part of the bargain. Conversely, if the presumption of rationality was sufficiently strong and the evidence was sufficient to prove that the expected marginal value of the promise clearly exceeded its expected marginal costs, a court would be justified in finding that the promise was a part of the bargain.

In practice, this kind of calculation could be within the capabilities of most courts. For instance, if the disputed contract term was a performance warranty, evidence about the expected marginal costs of making the warranty and the expected marginal value of the warranty might be available from the testimony of industry experts or insurance actuaries. Indeed, in some cases, the cost-benefit comparisons might be relatively simple, and the contract price could be very helpful in making them. From the seller's perspective, the contract price represents an upper bound on the expected total costs that any rational seller would incur to supply any particular good. If the seller's expected marginal costs of providing the contract term in dispute exceeded the contract price, that would provide evidence that the term was not an intended part of the parties' bargain. If the expected marginal costs of providing the disputed term were so high that they must surely cause the seller's expected total costs to exceed the contract price, thus leaving the seller with negative surplus from the transaction, that would also suggest the term was not a part of the bargain.¹⁶² From the buyer's perspective, the contract price represents a lower bound on the expected total value that any rational buyer would have to derive from the good without the disputed term in order to be willing to agree to the bargain. If the price was above the expected total value the buyer derived from the good, the buyer would derive negative surplus from the transaction. Since a rational buyer would never agree to a bargain that left her with negative surplus,

162. See *infra* Part IV.A; *McDonnell Douglas Corp. v. Thiokol Corp.*, 124 F.3d 1173 (9th Cir. 1997).

that would suggest that the disputed term was a part of the intended bargain.¹⁶³

The problem with simple cost-benefit evaluations such as these is that they might only rarely be helpful. In most cases, the expected marginal costs to the seller of providing the disputed term—and even the seller's expected total costs of supplying the good with the disputed term—will be less than the contract price, and the buyer's expected total valuation of the good without the disputed term will be greater than the contract price. Thus, the cost-benefit comparisons will often not be of much probative value. A cautious approach is probably best, and courts might do more harm than good by drawing inferences in cases where the cost-benefit comparisons shed too little light. The question is whether economic analysis can provide any other kind of help in all the cases that fall within the extremes. As the next two parts explain, if appropriate evidence is available, empirical inferences might still be helpful.

C. COMPARISONS OF THE CONTRACT PRICE TO PRICES IN PREVIOUS CONTRACTS

One way in which the contract price might still provide useful information in cases where cost-benefit comparisons are unavailing is through comparisons of the contract price to the prices in other contracts made by the same buyer and/or seller. The simplest cases would be ones in which the same buyer and seller had previously contracted, and the terms of their previous contracts were clear and known. Such cases are not as rare as one might initially imagine.¹⁶⁴ Suppose there were some previous contracts between the same buyer and seller which were otherwise identical, but some included the disputed term and some excluded it. If the contract price in the contract under dispute was within the range of the prices in previous contracts that included the term but outside the range of prices in previous contracts that excluded the term, that would provide important evidence that the disputed term was an intended part of the contract. Unless there was also evidence that the parties' relative bargaining power, or the seller's costs, or market conditions had changed significantly, it would be difficult to understand why the parties' bargain would not include the disputed term at that contract price. Conversely, if the contract price were outside the range of prices in previous contracts that included the disputed term, but within the range of prices in contracts that excluded the term, it would be

163. See *infra* Part IV.B.

164. The *Royal* cases, which raised questions about the buyer's reliance on the seller's promises in light of the buyer's experience with the goods, are of exactly this type. See *Royal Bus. Mach., Inc. v. Lorraine Corp.*, 633 F.2d 34 (7th Cir. 1980).

reasonable to infer that the disputed term was an intended part of the contract.

Of course, the circumstances might not present such a rich wealth of evidence. Suppose, for instance, all the previous contracts were ones that included the disputed term. Even in that case, a comparison of the contract price to the previous prices might still be helpful.¹⁶⁵ Suppose the disputed term was one that was clearly valued by the buyer and costly to the seller. If the contract price were above or within the range of the prices in previous contracts that included the term, this would provide some evidence that the disputed term was also included in the contract in question.¹⁶⁶ On the other hand, if the contract price were below the lowest price in the previous contracts, this would be consistent with the claim that the term in dispute had been excluded from the contract in question, but it would not, by itself, be sufficient to resolve the matter. Suppose, for instance, that the contract price was only marginally less than the lowest price in the previous contracts. That would provide much weaker evidence that the disputed term was not intended to be included in the contract than if the contract price were considerably less than the lowest price in the previous contracts. This raises the question, when could a court reasonably infer that the term was not an intended part of the parties' bargain?

If evidence could be provided about the expected marginal costs that the seller would incur as a result of the disputed term, that might help answer the question. Suppose there was plausible evidence that the expected marginal costs to the seller of including the term would fall within a particular range. This could be used to establish a plausible hypothetical range of prices for contracts between the two parties that did not include the disputed term. An upper bound on the range of prices could be established by subtracting the lowest estimate of the expected marginal costs of the disputed term from the highest price in any of the previous contracts. A lower bound could be established by subtracting the highest estimate of the expected marginal costs from the lowest price in any of the previous contracts. It would be reasonable to infer that if the contract price was above the upper bound of this plausible hypothetical range, it was probably too high for the contract not to have included the term. If the contract price was below this upper bound, then it might be reasonable to infer that the contract did not include the disputed term; the further the contract price was below the up-

165. Indeed, the *Royal* cases are of exactly this type, and, as the discussion below elaborates, the price comparisons not only seem to offer meaningful insights but might also have inclined courts to decide the cases differently. *Id.*

166. This would be in addition, of course, to any evidence provided by the previous contracts about the parties' course of dealings. See U.C.C. § 1-303 (1977) (amended 2003).

per bound, the more likely that the disputed term was not an intended part of the parties' bargain.¹⁶⁷

Suppose instead that the previous contracts did not include the disputed term and the price in the contract in question was above the range of previous prices. But suppose that it was not clear whether the contract price was so high that the contract must include the disputed term. And suppose again there was plausible evidence that the expected marginal costs to the seller of including the term would fall within a particular range. A lower bound for the plausible hypothetical range of prices in bargains between the parties that included the disputed term could be established by adding the lowest estimate of the expected marginal costs to the lowest price in any of the previous contracts that excluded the term. An upper bound could be established by adding the highest estimate of the expected marginal costs to the highest price in any of the previous contracts. If the price in the contract under dispute were significantly below the lower bound, then it would probably be too low for the contract to have included the term. If the contract price were above this lower bound, then it might include the term; of course, the higher the price, the greater the likelihood.¹⁶⁸

This kind of analysis should be within the capabilities of most courts.¹⁶⁹ Nonetheless, in a close case, comparisons of this kind might provide relevant and reliable guidance on difficult interpretive questions even if they are not, by themselves, dispositive. The point is not that any inferences can be drawn with absolute certainty; rather, it is that the contract price together with evidence about past contracts between the parties and plausible estimates of the expected marginal costs to the seller of including any disputed term in the contract might provide relevant and reasonably

167. For example, suppose the range of prices in previous contracts that included the disputed term was from \$9 to \$10 per unit of the good. Suppose the lowest estimate of the expected marginal cost of the disputed term to the seller was \$2 per unit and the highest was \$3 per unit. Then the hypothetical range of prices for contracts that did not include the term would be from \$6 to \$8 per unit. If the price in the contract under dispute were \$8.50, this would provide some evidence that the parties probably intended to include the term in their contract; if the price in the contract under dispute were only \$7, this would provide some evidence that the parties probably did not intend to include the term in their contract.

168. For example, suppose the range of prices in previous contracts that did not include the disputed term was from \$9 to \$10 per unit of the good. Suppose there was plausible evidence that the expected marginal costs to the seller of including the term could have ranged from \$2 to \$3 per unit of the good. Then the hypothetical range of prices in contracts that included the term would be from \$11 to \$13 per unit. If the price in the contract under dispute were only \$10.50, it would be reasonable for a court to infer that the contract in question did not include the disputed term. If the price were \$12 per unit, however, it would be reasonable for a court to infer that the contract probably did include the disputed term.

169. It nonetheless arguably should meet the prevailing standard for the admissibility of expert evidence under *Daubert*. See D.G. Owen, *A Decade of Daubert*, 80 DEN. U. L. REV. 345, 346 (2002) (discussing *Daubert*).

reliable evidence about the parties' intended bargain. In some cases the comparisons might be obvious and especially helpful.¹⁷⁰ Of course, in many cases there might not be any previous contracts between the buyer and seller, or the previous contracts may also have been ambiguous about whether they included the disputed term, so comparisons of this kind might not be feasible; in many other cases the comparisons might not be helpful even if they are feasible. Nonetheless, it might still be possible to help draw inferences about whether the parties intended a contract to include a disputed term by comparing the contract price to "market prices"—that is, prices in contracts between other buyers and sellers.¹⁷¹

D. COMPARISONS OF THE CONTRACT PRICE TO MARKET PRICES

If there were many buyers and sellers contracting in the market for the same good, the market outcome could be defined by all the prices and other terms in the contracts between each buyer-seller pair. A sample of these contract prices and terms would thus provide a sample of the market outcomes. The market outcomes could be consistent with any kind of market equilibrium from, at one extreme, one consistent with the economic theory of a perfectly discriminating pure monopoly to, at the other extreme, one consistent with the economic theory of a long-run, perfectly competitive market equilibrium. Indeed, some of the contracts could reflect a split of the parties' gains from trade consistent with the former and others could reflect a split of the parties' gains from trade consistent with the latter. More generally, the market outcomes might not reflect any single, coherent economic theory about market behavior. Nonetheless, as long as the parties were perfectly rational—or near enough to perfectly rational to justify the fundamental postulates about rational bargaining described above—each of the contracts in the sample would have been devised so that the parties could achieve the maximum amount of gains from trade possible and thus, maximize the amount of surplus generated by their transaction. This might still provide a basis for using the contract price to draw inferences about whether an ambiguous contract term was an intended part of any particular party's bargain.

170. In some cases there may be only one previous contract between the parties to use as a base of comparison. Such cases are particularly likely to arise when the seller attempts to use the buyer's knowledge of or experience with the good to challenge whether the buyer could have relied on the seller's promises or affirmations about it. Indeed, in such cases, the comparison might prove especially helpful. *See infra* Part IV.B.

171. To be more precise, the other contracts would have to include at least one party who was not a party to the contract in dispute. They could also, of course, include two different parties.

Suppose two parties had a dispute about whether a particular term was included in their contract for some homogenous good.¹⁷² Suppose there were market observations of some contracts that excluded the disputed term but were otherwise identical. The prices in these contracts could be used to define a market price range for contracts that excluded the disputed term. Suppose there were also market observations of other contracts that did include the disputed term but were otherwise identical. The prices in these contracts could be used to define a market price range for contracts that did include the disputed term. Suppose the price in the contract in question was within the market range for contracts that excluded the disputed term but outside the market range for contracts that included the term.¹⁷³ That would obviously provide some evidence that the disputed term was not an intended part of the parties' bargain. And, of course, the converse suppositions would imply the converse conclusion.

There are some obvious limitations to this kind of analysis. For one thing, goods are rarely homogeneous. Thus, price differences might reflect differences in the quality or other characteristics of the goods rather than simply different contract terms. For another, other contract terms might vary across buyers and sellers, and it might be difficult or even impossible to identify market price ranges for contracts that excluded and included the disputed term holding all other contract terms constant. Even setting these very important practical problems aside, however, the comparison still might not be helpful. Suppose, for instance, the price in the contract in question was higher than the market range for contracts that excluded the disputed term but lower than the market range for contracts that included the term. Alternatively, suppose the market price ranges for the contracts that excluded and included the disputed term overlapped, and the price in the contract under dispute was higher than the lowest price for contracts that excluded the term but lower than the highest price for contracts that included the term. In either of these cases, a simple comparison of the contract price to market prices would fail to provide any probative evidence.

The question then is: could a more sophisticated comparison of the contract price to market prices prove helpful? Perhaps the best answer is a

172. One of the complications in basing the analysis on a comparison of the contract price to market prices is that there are often qualitative differences between sellers' goods that are unrelated to any of the contract terms. Unfortunately, this would confound the analysis.

173. This scenario is very similar to the one addressed by the Tenth Circuit in *Universal Drilling*. See *Universal Drilling Co. v. Camay Drilling Co.*, 737 F.2d 869 (10th Cir. 1984). In fact, it is virtually equivalent to any case in which a court uses expert testimony about the market value of goods in relation to the contract price of the goods, since the market valuation should be based on empirical evidence about the prices at which other buyers and sellers would trade the goods in the market. See *infra* Part IV.A.

very cautious maybe. In theory, a more systematic statistical analysis of the data might still prove to be fruitful; in practice, it might simply end in a duel between competing experts that proved of no particular probative value. Consider the most optimistic scenario: assume that all prices in the sample of contracts without the disputed term were normally distributed around some mean and that all prices in the sample of contracts with the disputed term were normally distributed around some mean. Assume that all the contracts were otherwise identical. It would be possible then to calculate both the mean price and the standard deviation of the price in each of the samples. In principle, these statistics could provide a basis for determining whether the contract in question was more likely drawn from the universe of contracts that excluded the disputed term or the universe that included the term.

To provide some concrete intuition, suppose that the price in the contract in question was within one standard deviation of the mean of the price in all contracts that excluded the term, but more than two standard deviations from the mean in contracts that included the term. It might then be reasonable to infer that the contract in dispute was more likely drawn from the universe of contracts that excluded the term than from the universe of contracts that included it. In theory, a more precise analysis could even provide the probabilities that the disputed contract was drawn from each of the two universes. The evidence would obviously not be conclusive, but it might still be probative and in a difficult case could be of great value.

Of course, this is an exceptionally optimistic scenario. In practice, the data might very well be too complex for such simple inferences. Suppose the sellers' goods were heterogeneous or only a small number of the contracts had identical terms (except for the term under dispute). That would preclude the possibility of drawing any reliable statistical inferences from sample means and standard deviations. If the number of observations were large enough to provide sufficient degrees of freedom, it might still be possible to draw inferences from an econometric analysis with appropriately devised binary variables. In theory, an econometric model could be used to generate sample mean prices for contracts identical to the one in dispute that excluded and included the disputed term. In theory, the model could also generate the sample variances and provide a basis for evaluating whether the contract in dispute more likely included the disputed term than not. One can only suspect, however, that the more sophisticated the econometric methods, the more tenuous the inferences. At some point, the probative value of the price comparisons might not be worth the costs. Indeed, given the nuances of econometric methods, one wonders whether a more sophisticated econometric analysis of this kind would not simply end in a

confounding duel between expert witnesses that proved of no real probative value. Courts might be wise not to open that Pandora's box.¹⁷⁴

E. A SUMMARY OF THE PROPOSED GUIDELINES

The analysis suggests three ways in which the contract price might be able to help in the interpretation of contracts:

1. Through a cost-benefit inquiry: If the expected marginal costs to the seller of providing the disputed term would have been greater than the contract price or if they would have clearly pushed the seller's expected total costs over the contract price, then no rational seller would have concluded the contract with the term. Conversely, if the expected total value of the good to the buyer without the disputed term would have been so much less than the contract price that the buyer would clearly have been left with negative surplus, or, in other words, an empty bargain, then no rational buyer would have concluded the contract without the term.

2. By comparing the contract price to prices in other contracts between the same buyer and seller: if the contract price is within the actual or plausible range of prices for contracts between the buyer and seller that include the term but is not within the actual or plausible range of prices for contracts between the buyer and seller that do not include the term, then it is reasonable to infer that the parties intended to include the term in their bargain. Conversely, of course, if the contract price is outside the actual or plausible range of prices for contracts between the buyer and seller that include the term but within the actual or plausible range of prices for contracts between the buyer and seller that do not include the term, then it is reasonable to infer that the parties intended not to include the term in their bargain.

3. By comparing the contract price to market prices for the same or a very similar good: if the contract price is within the actual or plausible range of market prices for the same or a very similar good under contracts that included the term but not under contracts that did not include it, then it may be reasonable to infer that the parties intended to include the term in their bargain. Conversely, of course, if the contract price is outside the actual or plausible range of market prices for the same or a very similar good under contracts that included the term but within the actual or plausible range of market prices for contracts that did not include it, then it may be reasonable to infer that the parties intended not to include the term in their bargain.

174. On this matter the analysis here agrees with some of the recent law and economics literature on parole evidence discussed. *See supra* note 156.

IV. MODERN BARGAIN ANALYSIS UNDER THE U.C.C.

Contrary to what one might expect, Article 2 of the U.C.C. has not adopted the adequacy of consideration doctrine; in fact, at various points the official comments to Article 2 appear to encourage courts to evaluate the adequacy of the parties' consideration. Of course, it is well known that U.C.C. section 2-302, which is interpreted by most commentators and courts to require an inquiry into the bargaining process, also authorizes an inquiry into the adequacy of the consideration. Official comment 1 to U.C.C. section 2-302 states: "[t]he basic test is whether . . . the clauses involved are so one-sided as to be unconscionable."¹⁷⁵ But the purpose of U.C.C. section 2-302 is not to disturb the "allocation of risks because of superior bargaining power."¹⁷⁶ Official comment 1 then cites the cases discussed above in Part I.F of this Article.¹⁷⁷ As the preceding discussion makes clear, however, none of the cases cited in official comment 1 actually mentioned the word "unconscionability." Indeed, they can all arguably be construed as addressing the matter of interpreting whether some clause or disclaimer was a part of the parties' bargain;¹⁷⁸ it is certainly clear that none of them involved a question about whether an entire contract should be voided. Given the fine line between using the unconscionability doctrine to void a disputed contract term and simply interpreting the contract not to include it, U.C.C. section 2-302 comes very close to authorizing an evaluation of the contract price in interpreting whether disputed terms are contractually enforceable.

There are more express directives to courts to evaluate the contract price in interpreting bargains in the official comments to U.C.C. sections 2-313 and 2-314. U.C.C. Section 2-313 governs the creation of express warranties. As most courts interpret it, an express warranty is created by a promise or an affirmation of fact that relates to the goods and becomes part of the basis of the bargain.¹⁷⁹ As long as they relate to the goods, promises or affirmations of fact will normally be presumed to be part of the bargain unless the seller can adduce evidence sufficient to prove they were not part of the agreement.¹⁸⁰ Of course, sellers frequently attempt to exclude warranties with sweeping clauses that purport to disclaim all warranties, express

175. U.C.C. § 2-302 cmt. 1 (1977) (amended 2003).

176. *Id.*

177. *Id.*

178. *See supra* Part II.F-G.

179. U.C.C. § 2-313(1)(a) (stating "[a]ny affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise").

180. U.C.C. § 2-313 cmt. 3 (stating "no particular reliance on . . . statements need be shown in order to weave them into the fabric of the agreement").

and implied. Official comment 4 to U.C.C. section 2-313 advises that general disclaimer clauses cannot be given literal effect.¹⁸¹ But it affirms that parties are free to make their own bargains as they wish. As official comment 4 states, “[b]ut in determining what they have agreed upon good faith is a factor and consideration should be given to the fact that *the probability is small that a real price is intended to be exchanged for a pseudo-obligation.*”¹⁸² This is a clear directive from the drafters that the contract price can and should be used in deciding whether an express warranty was made.

U.C.C. section 2-314 governs the implied warranty of merchantability. Jurists and scholars have long debated whether this is implied as a matter of law or whether it is implied in fact.¹⁸³ At this point, the debate is academic and probably moot. The application of U.C.C. section 2-314 can, however, raise particular problems. One is interpreting the scope of an implied warranty of merchantability. U.C.C. section 2-314(2) defines merchantability according to whether the goods satisfy particular criteria, such as whether they “pass without objection in the trade under the contract description” and “are fit for the ordinary purposes for which such goods are used.”¹⁸⁴ Criteria such as these, however, are closer to mud than crystal and thus fail to precisely define what it means for goods to be merchantable. How should courts decide, then, how broadly to interpret the merchantability requirement? As official comment 7 to U.C.C. section 2-314 indicates, “[i]n cases of doubt as to what quality is intended, the price at which a merchant closes a contract is an excellent index of the nature and scope of his obligation under the present section.”¹⁸⁵ In other words, where there is any ambiguity, courts should use the contract price to interpret the merchantability requirement.

There is arguably also some authority to use the contract price in interpreting a sales contract in the official comments to U.C.C. section 2-719. U.C.C. section 2-719 authorizes sellers to substitute exclusive limited remedies, such as a promise to repair or replace, in place of the usual U.C.C. remedies, which include a right to reject for any nonconformity as well as the full panoply of damages for accepted goods that are nonconforming.¹⁸⁶

181. U.C.C. § 2-313(1)(a) cmt. 4 (stating “[a] clause generally disclaiming ‘all warranties express or implied’ . . . cannot be given literal effect”).

182. *Id.* (emphasis added).

183. See Smythe, *supra* note 84, at 222-23.

184. U.C.C. § 2-314(2)(a)(c).

185. U.C.C. § 2-314 cmt. 7.

186. U.C.C. § 2-719(1)(a) (stating in part, “the agreement may provide for remedies in addition to or in substitution for those provided in this Article and may limit or alter the measure of damages recoverable under this Article”); U.C.C. § 2-719(1)(b) (stating “resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy”)

It also provides that if an exclusive limited remedy fails, the buyer may resort to the remedies otherwise available under Article 2.¹⁸⁷ Sellers often include in their writings both an exclusive limited remedy clause and a clause disclaiming consequential damages. If the exclusive limited remedy fails, therefore, this can lead to a dispute about whether the clause disclaiming consequential damages is void, which would give the buyer recourse to all the U.C.C. remedies, or whether it still applies as an additional limitation on the buyer's remedies intentionally included in the agreement just in case the exclusive limited remedy fails. Official comment 1 to U.C.C. section 2-719 indicates that the parties' bargain ultimately controls whether an exclusive limited remedy fails and whether the buyer is therefore entitled to the default remedies under Article 2. According to official comment 1, "where an apparently fair and reasonable clause because of circumstances fails in its purpose or *operates to deprive either party of the substantial value of the bargain*, it must give way to the general remedy provisions of this Article."¹⁸⁸ Since the price that the buyer pays for goods may provide important information about the value the buyer expects from the bargain, this implies that the contract price might help to interpret whether a limited remedy has failed and whether the buyer is entitled to the default remedies under Article 2.¹⁸⁹

In spite of the doctrinal and theoretical taboos against evaluating the adequacy of consideration, therefore, the official comments to Article 2 clearly indicate that, at least within certain parameters, the drafters intended that courts should use the contract price to help interpret the scope of parties' bargains. It should come as no great surprise, therefore, that there are recent sales cases in which courts have evaluated the contract price in resolving interpretative disputes. Of course, there are many other cases in which courts probably should have evaluated the contract price but did not. The next section surveys some of the cases and suggests how the economic analysis might have helped to improve the courts' opinions.

A. WARRANTIES AND DISCLAIMERS

Consider *McDonnell Douglas Corp. v. Thiokol Corp.*, a case that arose from the well-publicized failure of the Space Shuttle's satellite launcher in the 1980s.¹⁹⁰ McDonnell Douglas contracted with Thiokol to design and

187. U.C.C. § 2-719(2) (stating, "[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act").

188. U.C.C. § 2-719 cmt. 1.

189. In *Milgard*, the Ninth Circuit took the idea a step beyond addressing whether the seller's limited remedy failed and looked to the contract price to help decide whether the seller's attempt to disclaim consequential damages also failed. *See infra* Part II.C.

190. *McDonnell Douglas Corp. v. Thiokol Corp.*, 124 F.3d 1173 (9th Cir. 1997).

manufacture the motor for the launcher, which was formally called “an upper-stage Payload Assist Module (PAM).”¹⁹¹ The transaction occurred in stages, with an initial design stage followed by a qualification stage where the motor was subject to testing, and then the manufacturing stage at which the motor was produced for use on the Shuttle. After Thiokol’s motor had qualified at the second stage in the process through a test-fire and review but before the parties contracted for the actual production of the motor, another test-fire of the motor failed. NASA and the Air Force conducted an investigation, which concluded that no meaningful margin of safety could be determined for the motor’s performance.¹⁹² McDonnell Douglas nonetheless contracted with Thiokol for the production of the motor. The contract terms were, of course, detailed in writing. By the terms incorporated under the writing, Thiokol warranted that the motor would be “free from defects in labor, material and manufacture” and that it would “be in compliance with any drawings or specifications incorporated or referenced herein.”¹⁹³ There was attached to the main body of the writing a “Specification Control Drawing” on which it was stated that “[a]ll rocket motor components shall be suitable for the purpose for which they are intended” and that “[t]he nozzle . . . shall be capable of withstanding the thermal mechanical loads during motor burn without any detrimental failure.”¹⁹⁴ Unfortunately, upon the attempts to deploy the satellite launcher during one of the Shuttle’s missions, the motor failed.

McDonnell Douglas sued Thiokol for breach of express warranties. McDonnell Douglas’s most interesting claim, for our purposes, was that the statements in the Specification Control Drawings attached to the main body of the contract created a performance warranty by which Thiokol, in effect, insured McDonnell Douglas against the failure of the motor.¹⁹⁵ On its face, McDonnell Douglas’s claim was plausible: by the language in the attachment, Thiokol appeared to expressly warrant that the motor would be suitable for operating the satellite launcher and the nozzle would withstand the heat generated by the motor. The district court, however, concluded that there was no performance warranty in the contract.¹⁹⁶ Upon appeal, the Ninth Circuit affirmed.¹⁹⁷ The Ninth Circuit noted that under California law an affirmation of fact or promise that relates to the goods and is part of the

191. *Id.* at 1174.

192. *Id.* at 1175.

193. *Id.* (quoting McDonnell Douglas’s Terms and Conditions Guide) (internal quotations omitted).

194. *Id.* at 1178 (quoting the parties’ production contract) (internal quotations omitted).

195. *McDonnell Douglas Corp.*, 124 F.3d at 1178.

196. *Id.* at 1179.

197. *Id.*

basis of the parties' bargain creates an express warranty.¹⁹⁸ Whether the seller's affirmations or promises become part of the basis of the bargain is a question of fact.¹⁹⁹ Judge Hug of the Ninth Circuit, who wrote the court's opinion, appeared to be persuaded in part by testimony from the McDonnell Douglas employee who drafted the Specification Control Drawings; the employee testified that such drawings did not normally include warranty provisions and that he did not intend to include any in drafting them in this case.²⁰⁰ Judge Hug also noted that McDonnell Douglas's post-failure behavior was inconsistent with its claim that it believed Thiokol had made a performance warranty.²⁰¹

Most significantly for our purposes, though, Judge Hug also looked to the contract price for evidence as to what McDonnell Douglas had bargained for. An internal memorandum written by a McDonnell Douglas employee had noted that the financial risks associated with performance warranties for the PAM program were too great to make them feasible.²⁰² Thus, McDonnell Douglas did not include the cost of a performance warranty in the price of the motor; in short, it knew what it paid Thiokol for the motor, and it knew that the price did not include a performance warranty.²⁰³ The Ninth Circuit thus used evidence provided by one of McDonnell Douglas's own employees about the inadequacy of the contract price to help interpret the contract. In part because the price was inadequate, the court interpreted the contract not to include the warranty. Although the doctrine of unconscionability did not figure in the case, it was only a short step away: the placement of the performance warranty in an attachment to the main body of the contract could easily be construed as deceptive or sharp-dealing and sufficient to meet the test for procedural abuse, and the inadequacy of the contract price could obviously be construed to meet the test for substantive abuse.

198. *Id.* at 1176.

199. *Id.*

200. *McDonnell Douglas Corp.*, 124 F.3d at 1179.

201. *Id.* After the failure, McDonnell Douglas sent Thiokol a letter stating that if an investigation concluded the failure of the motor was due to a manufacturing defect, McDonnell Douglas would expect Thiokol to comply with the warranty provisions in the contract. As Judge Hug observed, if McDonnell Douglas had truly believed Thiokol had also made a performance warranty it would not have used the limiting language about defects in the manufacture of the motor. *Id.*

202. According to Judge Hug, "[i]n an internal memorandum commenting on a NASA inquiry, a McDonnell Douglas employee stated that McDonnell Douglas 'decided early on in the PAM program that the financial risks associated with performance warranties were too high considering the price of the satellite compared to the price of the PAM' . . . [therefore] McDonnell Douglas did not include the cost of a performance warranty in the price of its product . . . [it] knew that it was not being charged for a performance warranty." *Id.* at 1179.

203. *Id.*

What is most striking about the Ninth Circuit's opinion is how closely the logic parallels the economic analysis in the preceding section of this Article. Indeed, from an economic perspective the matter is quite clear: given the enormous financial risks, the expected marginal costs to Thiokol of providing a performance guarantee would probably have exceeded the entire price that Thiokol was to receive for the motor under the contract and McDonnell Douglas knew that. There is no way that Thiokol, or any other rational seller, would have agreed to provide a performance guarantee that would have cost more than the entire price it was to receive under the contract for its motor, and there is no way that McDonnell Douglas, or any other rational buyer, could have been unaware that Thiokol did not agree to provide a performance guarantee under those circumstances. The only way in which the opinion could have been improved, at least from the perspective adopted here, would have been by the court more expressly stating its economic rationale in the appropriate terminology.

Another case in which the contract price figured in the court's opinion was *Universal Drilling Co. v. Camay Drilling Co.*²⁰⁴ In *Universal Drilling*, the buyer purchased two used oil rigs. The parties' agreement was memorialized in a writing, which included a clause that stated the rigs were being sold "in an 'as-is' condition and without any warranty of operability or fitness."²⁰⁵ There was also a merger clause that stated the writing was a complete expression of the agreement and superseded any prior agreements or understandings. When the rigs were delivered, however, the buyer discovered they were inoperable and sued, claiming that, by describing the goods as "oil rigs," the seller created an express warranty that the goods would be operable as oil rigs.²⁰⁶ The seller countered that it contracted to deliver only oil rigs and not operable oil rigs.²⁰⁷ The trial court held for the seller and the buyer appealed to the Tenth Circuit. Judge McKay, writing for the Tenth Circuit, acknowledged the authorities that argued against allowing a seller to disclaim warranties created by descriptions of the goods,²⁰⁸ but nonetheless held for the seller. Judge McKay observed that both parties were sophisticated businesspersons before holding that the contract made no guarantee that the goods would be operable and that the court "[would] not rewrite the contract *in this case*."²⁰⁹

What is most telling, perhaps, is that Judge McKay's wording did not foreclose the possibility that the Tenth Circuit might "rewrite a contract" in some other case. Judge McKay reasoned that in the instant case the court

204. *Universal Drilling Co. v. Camay Drilling Co.*, 737 F.2d 869 (10th Cir. 1984).

205. *Id.* at 871 n.*.

206. *Id.*

207. *Id.*

208. *Id.* at 874.

209. *Universal Drilling Co.*, 737 F.2d at 874 (emphasis added).

could not think of alternate language that would memorialize the intent of the parties to transact for the oil rigs in “as-is” condition.²¹⁰ Moreover, Judge McKay specifically noted that the holding did not leave the buyer with an “empty bargain,” since the buyer’s own expert had appraised the value of the oil rigs at \$3,000,000 and the purchase price was only \$2,925,000.²¹¹ The contract price was not so low, in other words, that the buyer did not earn any surplus from the transaction whatsoever. Although this part of the opinion was merely dicta, Judge McKay clearly implied that if the contract price had been so low that the buyer had received an empty bargain the court might have been persuaded by the buyer’s argument that the description of the goods created an express warranty the rigs would be operable.

Judge McKay’s opinion comports well with basic principles of economic analysis. As noted above, the contract price is an upper bound on the expected marginal costs that any rational seller would incur in supplying any individual contract term and also a lower bound on the expected total value that any buyer would be willing to receive for the good without any (valuable) individual contract term.²¹² Here, Judge McKay correctly reasoned that the buyer could have rationally purchased the oil rigs, even though he knew they were not operable, because the expected total value of the oil rigs was still greater than the price the buyer was paying for them. Although this analysis is not dispositive—and it was certainly not treated as such in the Tenth Circuit’s opinion—it supports the conclusion that the seller did not agree to deliver operable oil rigs, and the buyer did not agree to pay for the rigs only if they were operable. If the contract price had been higher—or if the expected total value of the oil rigs had been less—the court may not have reached the same conclusion.

Although the case law includes occasional opinions, such as *McDonnell Douglas* and *Universal Drilling*, in which courts have used the contract price to help interpret parties’ contracts, it probably includes even more opinions in which courts should have considered the contract price in interpreting the parties’ contract but did not. Consider, for instance, *Insurance Co. of North America v. Automatic Sprinkler Corp.*²¹³ In *Insurance Co.*, the Supreme Court of Ohio held that the words “in lieu of” did not have the same legal effect under U.C.C. section 2-316 as the words “as is,” which

210. *Id.*

211. *Id.*

212. *See supra* Part III.B. Note also that comparing the contract price to an expert’s market valuation of the goods is very similar to comparing the contract price to market prices. *See supra* Part III.D.

213. *Ins. Co. of N. Am. v. Automatic Sprinkler Corp. of Am.*, 423 N.E. 2d 151 (Ohio 1981).

effectively disclaim all implied warranties.²¹⁴ It then considered whether an attempt to disclaim consequential damages should fail because the disclaimer was not conspicuous.²¹⁵ This was controversial because the wording in the U.C.C. does not imply that a disclaimer of consequential damages must be conspicuous.²¹⁶ Nonetheless, several courts had read a conspicuity requirement into U.C.C. section 2-719(3), largely on the grounds that failing to do so would undermine the requirement in U.C.C. section 2-316(2) that any exclusion of implied warranties in writing must be conspicuous.²¹⁷ The Supreme Court of Ohio decided to follow those cases and quoted the following rationale:

The limitation must be a part of the parties' bargain in fact. If it is contained in a printed clause which was not conspicuous or brought to the buyer's attention, the seller had no reasonable expectation that the buyer understood that his remedies were being restricted to repair and replacement. As such, the clause cannot be said to be part of the bargain (or agreement) of the parties.²¹⁸

The statutory basis for this rationale is, at best, weak. U.C.C. section 2-316(4) authorizes disclaimers of consequential damages as long as they comply with U.C.C. section 2-719.²¹⁹ U.C.C. section 2-719(3) authorizes any limitations or exclusions of consequential damages as long as they are not unconscionable.²²⁰ As a general matter, contract clauses are not unconscionable simply because they are not conspicuous. Indeed, under the modern approach to unconscionability, courts typically make a substantive inquiry as well as a procedural one.²²¹ Neither *Automatic Sprinkler* nor any of the precedents it followed, however, applied the doctrine of unconscionability. Rather, they read a conspicuity requirement into U.C.C. section 2-719(3) where the language did not expressly state one. To that end, they clearly served a regulatory purpose and provided incentives to parties to

214. *Id.* at 153.

215. *Id.* at 153-54.

216. U.C.C. § 2-719(3) (1977) (amended 2003) (stating “[c]onsequential damages may be limited or excluded unless the limitation or exclusion is unconscionable.”).

217. *Ins. Co.*, 423 N.E. 2d at 153-154.

218. *Id.*

219. U.C.C. § 2-316(4) (stating “[r]emedies for breach of warranty can be limited in accordance with the provisions of this Article on liquidation or limitation of damages and on contractual modification of remedy (Sections 2-718 and 2-719)”)

220. U.C.C. § 2-719(3) (stating “[c]onsequential damages may be limited or excluded unless the limitation or exclusion is unconscionable”).

221. *See supra* Part II.D.

future contracts to make their disclaimers of consequential damages conspicuous. But they did not really determine whether the disclaimers were part of the parties' intended bargains. If they had wanted to interpret the parties' intentions as carefully as possible, they would have done well to consider the adequacy of the contract price. Was the contract price high enough that a rational buyer could reasonably argue that the disclaimer was not a part of the bargain? Or was it so low that no rational buyer should have expected consequential damages?

There is an interesting contrast between *Insurance Co.* and other cases in which consequential damages have been disclaimed by usage of trade. Consider, for instance, *Western Industries, Inc. v. Newcor Canada Ltd.*²²² In *Western Industries*, the central issue was whether the district court erred by excluding from evidence testimony from three expert witnesses that it was the industry custom to disclaim consequential damages.²²³ The contract in that case was for the delivery of custom welding machines; since the seller had to design the machines before manufacturing them, it was "hybrid" in nature—that is, partly for services and partly for goods. Judge Posner, who wrote the opinion for the Seventh Circuit, observed that the risks of delays and other problems with custom designed equipment were high and conjectured that it might be rational for sellers in such an industry to disclaim consequential damages and reduce the risks as a matter of custom before ultimately holding that the district court erred in excluding the evidence and remanding the case for a new trial.²²⁴ Judge Posner did not, however, consider whether the contract price was so low that a rational seller could not have intended to cover consequential damages. This would have been consistent with the rest of his analysis, and it might have buttressed the rationale for his holding.

In some respects, *Western Industries* lies at the opposite extreme from *Automatic Sprinkler*. In *Automatic Sprinkler*, the Supreme Court of Ohio held that there was no disclaimer of consequential damages in the contract even though there was an express disclaimer in the parties' writing. In *Western Industries*, the Seventh Circuit reasoned that consequential damages might have been disclaimed by usage of trade even though they were clearly not disclaimed in any writing that could have reasonably served as a final expression of the parties' intentions. In one respect, however, the cases are in accord: the courts did not attempt to make any direct inquiry into the

222. *W. Indus., Inc. v. Newcor Canada Ltd.*, 739 F.2d 1136, 1138 (7th Cir. 1984).

223. *Id.* at 1201, 1206. The seller also made an interesting "battle of the forms" argument that its writing, which excluded liability for consequential damages, should prevail over the buyer's, which did not. As Judge Posner observed, however, for the seller to prevail on this argument, it would ultimately require the seller to prove that consequential damages were excluded by usage of trade anyway. *Id.* at 1206.

224. *Id.* at 1203.

parties' intentions. While they might not have been dispositive, the contract prices might have provided additional useful evidence about whether the parties actually intended their contracts to include a disclaimer of consequential damages.

If evidence had been presented at trial to show that the expected marginal costs to Automatic Sprinkler, of remaining liable for consequential damages for the failure of its automatic sprinklers in a large, well-equipped factory, would clearly have pushed its expected total costs above the price it was receiving for the sprinklers under the contract, it might have been of great probative value. If similar evidence had been presented at trial to show that the expected marginal costs to Newcor, of remaining liable for consequential damages in a hybrid contract for the delivery of welding machines that the buyer was depending on receiving in a timely fashion, would clearly have pushed its expected total costs above the price it was receiving for the welding machines under the contract, that might also have been of great probative value. The lower courts might thus have been able to decide the cases by actually interpreting the parties' intended bargains, and that would have provided more coherent and persuasive bases for resolving the disputes than, in the one case, a court-made rule of contract interpretation that is essentially regulatory in nature, and, in the other case, extrinsic evidence from industry experts about an industry custom.²²⁵

B. RELIANCE TESTS FOR THE BASIS OF THE BARGAIN

One of the loose ends in modern sales concerns the requirements for an express warranty. U.C.C. section 2-313(1)(a) states that a seller creates an express warranty by making any promise or affirmation of fact that relates to the goods and becomes part of the basis of the bargain.²²⁶ That seems clear enough, but it raises the question: when does a promise or affirmation of fact become part of the basis of the bargain? How is the basis of the bargain determined? Article 2 does not provide clear answers to those questions. The official comments to U.C.C. section 2-313(1)(a) offer some help. They indicate that there should be a presumption that the seller's promises or affirmations are part of the basis of the bargain unless the seller can adduce evidence that disposes a jury to find otherwise.²²⁷ Courts have

225. The argument presumes, of course, that it is better to interpret contracts in accordance with the parties' intentions than to regulate them or interpret them using extrinsic evidence.

226. U.C.C. § 2-313(1)(a) (1977) (amended 2003). *See supra* note 174.

227. U.C.C. § 2-313 cmt. 3. Comment 3 states:

In actual practice affirmations of fact made by the seller about the goods during a bargain are regarded as part of the description of those goods; hence no particular reliance on such

struggled to make sense of when facts have been sufficient to take a seller's promise out of the basis of the bargain and their holdings have been far from uniform.²²⁸ Nonetheless, most courts apply a reliance test to determine whether a seller's promise or affirmation was part of the basis of the bargain.²²⁹ Thus, if the buyer did not rely on the promise, it was not part of the bargain, and the buyer cannot seek damages if it proves false.

On the strength of the reliance test, most courts would probably hold that a seller cannot be held liable for a promise or affirmation that the buyer did not see, read, or hear.²³⁰ Most would probably also hold that the seller should not be liable for promises the buyer knew were false.²³¹ The reliance test has also been applied, however, when the buyer may have had reason to doubt whether the seller's affirmations or promises were true without actually knowing that they were false. Courts have struggled with such cases. If the buyer had serious reasons to doubt whether the affirmations or promises were true, how could he or she have relied on them? One possibility is that the promises may have been a kind of "insurance policy" as to the quality of the goods.²³² Under this theory, if the promises prove to be false, the buyer has a breach of warranty claim against the seller that provides compensation for any damages. Thus, the affirmations are valuable to the buyer even if the buyer has grounds to doubt their veracity. Of course, this is fine in theory. The practical question is: how can courts determine whether the seller's promises were intended to provide such an insurance policy? Consider some cases.

In *Rogath v. Siebenmann* the seller promised that a painting was an authentic work of Francis Bacon.²³³ When the buyer attempted to resell the painting, however, the other party reneged because of concerns about whether the painting was authentic.²³⁴ The buyer sued the seller, claiming a breach of express warranty because the seller's promises about the authenticity of the painting were false. The buyer was able to prove that the seller had been aware of challenges to the authenticity of the painting before sell-

statements need be shown in order to weave them into the fabric of the agreement. Rather, any fact which is to take such affirmations, once made, out of the agreement requires clear affirmative proof.

228. See, e.g., *Royal Bus. Machs., Inc. v. Lorraine Corp.*, 633 F.2d 34 (7th Cir. 1980) (holding the seller would not be liable for promises if the buyer should have known they were false); *Rogath v. Siebenmann*, 129 F.3d 261 (2d Cir. 1997) (holding that the seller was liable for a promise even if buyer did not believe it).

229. See Smythe, *supra* note 84, at 216-30.

230. *Id.*

231. *Id.*

232. GILLETTE & WALT, *supra* note 95, at 256.

233. *Rogath*, 129 F.3d at 263.

234. *Id.*

ing it.²³⁵ The seller defended against the claim, however, by asserting that the buyer had also been fully aware of the challenges to the authenticity of the painting before contracting to buy it and thus could not have relied on the seller's promises.²³⁶ Although the court itself did not explicitly consider the contract price in deciding the case, it did quote from the buyer's affidavit: "Had either Mr. Siebenmann [the seller] or Mr. Alley hinted to me that the Painting was of questioned authenticity, it would have been a 'red flag' for me, as I had no desire to spend some \$600,000 [] to purchase a painting the authenticity of which was in dispute."²³⁷ The court noted that the important question "[was] not whether the buyer believed in the truth of the warranted information . . . but whether [he] believed [he] was purchasing the [seller's] promise [as to its truth]."²³⁸ Although the Second Circuit did not expressly say so, it is almost axiomatic that the contract price should bear on whether this is the case. The buyer in *Rogath* paid \$600,000 for the painting; if he had paid only \$600, it is difficult to imagine how he could have claimed to believe he was buying the seller's promise as to the truth of the promise that the painting was by Francis Bacon. Conversely, the expected total value of the painting could hardly have justified any rational buyer in paying \$600,000 for the painting if it had not been warranted to be an authentic work of Francis Bacon. If the buyer had not believed he was purchasing the seller's promise as to the truth of the statement that the painting was done by Francis Bacon, he would clearly have contracted for an empty bargain.

Although the case suggests how and why the contract price might apply to the basis of the bargain requirement in U.C.C. section 2-313(1)(a), *Rogath* is definitely not the approach the majority of courts have taken. Consider the *Royal* cases. In *Royal Business Machines, Inc. v. Lorraine Corp.*, for instance, the Seventh Circuit held that the defendant, Royal, would not be liable for promises or affirmations it had made to the plaintiff, Booher, if Booher should have known the promises were false through his prior experience with the product.²³⁹ Royal had sold a number of photocopiers to Booher in a series of separate transactions over a period of well over a year.²⁴⁰ Royal made several promises about its copiers in each of the transactions.²⁴¹ Some of these promises amounted to no more than sales puffery or otherwise failed to meet the requirements in U.C.C. section 2-

235. *Id.*

236. *Id.*

237. *Id.* at 266 (internal quotations omitted).

238. *Rogath*, 129 F.3d at 264 (quoting *CBS Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997, 1000-01 (1990)).

239. *Royal Bus. Machs., Inc. v. Lorraine Corp.*, 633 F.2d 34, 44-45 (7th Cir. 1980).

240. *Id.* at 40.

241. *Id.* at 41.

313(1)(a) for an express warranty, but others did meet the requirements, at least in the initial transactions.²⁴² Booher sought damages for breaches of the promises in all of the transactions. This was problematic because Booher had acquired considerable experience with the copiers over the course of his dealings with Royal.²⁴³ In the Seventh Circuit's view, Booher may have had sufficient experience with the copiers to make him doubt whether Royal's promises were true, and in that case, Booher could not have relied on them.²⁴⁴ If so, this would have taken the promises out of the basis of the bargain under U.C.C. section 2-313(1)(a). The Seventh Circuit, therefore, remanded the case for a determination by the district court as to whether Booher could have relied on Royal's promises.²⁴⁵

The same logic has been followed in other cases.²⁴⁶ In contrast to *Rogath*, what is absent from the courts' deliberations in these cases is any consideration of the contract price. The logic is that the seller's promises initially created express warranties but that as the buyer acquired experience with the goods the buyer should no longer have believed them, and thus, they could no longer have been part of the bargain. But if the bargain no longer included these express warranties, should the buyer have continued to pay the same price for the goods? It is possible, of course, that the buyer might still be able to earn some surplus from the transactions even without the express warranties, but as a general matter, if the seller offers lower quality goods and the buyer knows it, the buyer will demand a decrease in the price. What is absent from these cases is any evidence about what happened to the contract price over the course of the transactions. As the discussion in Part II suggests,²⁴⁷ if the contract price actually fell, that might substantiate the view that the promises were no longer part of the bargain.²⁴⁸ If, however, the contract price did not change, that would tend to indicate that both the buyer and seller still thought the bargain included all

242. *Id.* at 42-44.

243. *Id.* at 44.

244. *Royal Bus. Machs., Inc.*, 633 F.2d at 44.

245. *Id.*

246. *See, e.g., Royal Typewriter Co. v. Xerographic Supplies Corp.*, 719 F.2d 1092, 1101 (11th Cir. 1983) (holding the buyer's knowledge of the falsity of the seller's promises would negate the existence of express warranties); *Janssen v. Hook*, 272 N.E.2d 385, 388 (Ill. App. Ct. 1971) (stating that a buyer does not disregard any special knowledge he possesses in deciding whether to enter a bargain); *Cambridge Eng'g, Inc. v. Robert Shaw Controls Co.*, 966 F. Supp. 1509, 1524 (E.D. Mo. 1997) (holding that the seller's affirmations were not part of the bargain in sales after the buyer learned about the good's defect).

247. *See supra* Part III.

248. If the parties had previously contracted at only one price and the price fell after the buyer acquired personal knowledge that the seller's promises might not be true, that would clearly take the price outside the range of prices for contracts between the buyer and seller that included any warranties created by the promises and would suggest that the warranties were not truly part of the bargain. *See supra* Part III.C.

of the seller's promises, including any the buyer had reason to doubt by dint of personal experience with the good.²⁴⁹

In cases like *Royal*, therefore, the contract price offers readily available evidence that is both relevant to drawing inferences about parties' intended bargains and easy to evaluate. As a general matter, there is no reason why the contract price could not be considered as part of a reliance test: presumably, if a buyer's personal experience with its seller's goods undermines the buyer's reliance on the seller's promises, the buyer would, as part of any rational bargain, either want a price reduction or an assurance in the form of an insurance policy such as the court alluded to in *Rogath*, so that the buyer could hold the seller liable in the event its promises fail. If the contract price were not reduced, it would be more reasonable to infer that the buyer considered the seller's promises a kind of insurance policy than to infer that the buyer simply agreed to accept goods of lower quality. The application of this simple economic logic could have a significant effect on the outcomes of the cases.²⁵⁰

C. FAILURES OF LIMITED REMEDIES AND DISCLAIMERS OF CONSEQUENTIAL DAMAGES

Most sophisticated manufacturers attempt to limit their liabilities for breach of both express and implied warranties. The U.C.C. regulates sellers' attempts to exclude or modify express and implied warranties in U.C.C. section 2-316.²⁵¹ It also regulates their attempts to exclude or limit damages in U.C.C. sections 2-718 and 2-719.²⁵² Most sophisticated manufacturers are cautious about creating any express warranties, and they frequently exclude all implied warranties of merchantability and fitness. They also commonly avail themselves of the provisions of U.C.C. section 2-719(1) to offer a limited remedy to repair or replace the goods in substitu-

249. If the price did not fall, even after the buyer acquired personal experience with the good that might reasonably cast doubt on the veracity of the seller's promises, that would clearly leave it within the range of prices for contracts between the buyer and seller that included warranties created by the promises and would suggest that the warranties were still an intended part of the bargain. *See supra* Part III.C.

250. It seems reasonable to suspect that in most of these cases the contract price did not change, thus suggesting that the intended bargain continued to include warranties created by the seller's promises even after the buyer had reason to doubt whether they were true. If so, the application of the economic logic would reverse many of the cases.

251. U.C.C. § 2-316(2) (1977) (amended 2003) (stating in part, "to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of a writing must be conspicuous, and to exclude or modify any implied warranty of fitness the exclusion must be by a writing and conspicuous").

252. U.C.C. § 2-718 (regulating liquidated damages clauses); U.C.C. § 2-719 (regulating clauses modifying or limiting remedies).

tion for the remedies otherwise available in the U.C.C.²⁵³ In addition, to the extent that they can, they typically also limit or disclaim any consequential damages.²⁵⁴

This has created some confusion. Courts have struggled over the appropriate interpretation of Article 2 in cases where sellers' attempts to limit their buyers' remedies fail to satisfy the regulatory provisions of U.C.C. section 2-719. According to U.C.C. section 2-719(2), when a limited remedy fails of its essential purpose, the buyer has recourse to all the default remedies under Article 2.²⁵⁵ Of course, these include expectation damages under U.C.C. section 2-714 as well as incidental and consequential damages under U.C.C. section 2-715. But U.C.C. section 2-719(3) also allows sellers to limit or disclaim a buyer's right to consequential damages.²⁵⁶ The only regulations on a seller's right to disclaim consequential damages are that the disclaimer may not be unconscionable and that consequential damages may not be limited or disclaimed for personal injury in the case where the buyer is a consumer.²⁵⁷ Since courts are reluctant to apply the doctrine of unconscionability when invoked by a merchant,²⁵⁸ Article 2 in effect places very little constraint on sellers' ability to disclaim consequential damages when the buyer is a merchant. Confusion arises, however, when a seller's limited remedies fail of their essential purpose and the seller has also sought to disclaim consequential damages in a separate and distinct contract clause.

Does the provision in U.C.C. section 2-719(2), which provides the buyer with recourse to all the default remedies in Article 2, trump the additional clause purporting to disclaim consequential damages, or does the disclaimer of consequential damages clause stand independently of whether the limitation of remedy fails? The early cases tended to hold that the failure of the limitation of remedy nullified the seller's attempt to disclaim consequential damages.²⁵⁹ This has been called a "categorical approach."²⁶⁰

253. U.C.C. § 2-719(1)(a) (allowing a seller to offer a limited remedy in place of those otherwise available under Article 2); U.C.C. § 2-719(1)(b) (providing that the limited remedy will be the buyer's only one if the parties expressly agree it is exclusive).

254. U.C.C. § 2-719(3) (stating "[c]onsequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not").

255. U.C.C. § 2-719(2) (stating "[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act").

256. *See supra* note 254.

257. *Id.*

258. This may be in part a legacy of Arthur Leff's two-prong test for unconscionability, since merchants are generally unlikely to be able to prove the test for procedural abuse. *See supra* Part III.

259. GILLETTE & WALT, *supra* note 95, at 350.

The categorical approach does not offer a particularly convincing interpretation of the parties' contract. If the seller's limitation of remedy does not fail of its essential purpose, then that alone is sufficient to deny the buyer any consequential damages, and thus, whether the contract includes an additional clause purporting to disclaim consequential damages is irrelevant. If the failure of the seller's limitation of remedy clause nullifies the seller's attempt to disclaim consequential damages, then the additional clause purporting to disclaim consequential damages is again irrelevant. In other words, under this early reading of the Code, an additional contract clause purporting to disclaim consequential damages under U.C.C. section 2-719(3) was irrelevant if the seller had also sought to limit the buyer's remedy under U.C.C. section 2-719(1). Since rational parties would not normally draft irrelevant contract terms, this is not a particularly compelling interpretation of the Code.

A more convincing interpretation, and the one that is dominant in the recent case law,²⁶¹ gives an independent effect to any contract clause that seeks to disclaim consequential damages. Under this approach, whether the disclaimer of consequential damages is effective is completely independent of whether the limitation of remedy failed of its essential purpose. Thus, the limitation of remedy is effective as long as it does not fail of its essential purpose, and as long as it is effective, of course, the disclaimer of consequential damages clause is irrelevant. But if the limitation of remedy does fail of its essential purpose, the disclaimer of consequential damages clause remains effective unless a court determines that it fails for independent reasons. The clause disclaiming consequential damages thus provides an additional layer of protection for the seller and therefore at least serves an intelligible purpose. Since a contract interpretation that imputes an intelligible purpose to contract terms seems preferable to one that does not, this seems the more compelling approach.

U.C.C. section 2-719(3) states that consequential damages may be limited or disclaimed unless the limitation or disclaimer is unconscionable.²⁶² If the effectiveness of a disclaimer of consequential damages is to be treated as an independent matter, this suggests that the disclaimer should stand unless it fails the test for unconscionability. As a general matter, however, courts have not always simply applied the modern test for unconscionability.²⁶³ Instead, courts that have rejected the categorical approach have sought to interpret whether a disclaimer of consequential damages clause is

260. The Seventh Circuit termed this approach "categorical" in *Smith v. Navistar Intern. Transp. Corp.*, 957 F.2d 1439, 1443 (7th Cir. 1992).

261. GILLETTE & WALT, *supra* note 95, at 350-51.

262. U.C.C. § 2-719(3) (1977) (amended 2003).

263. GILLETTE & WALT, *supra* note 95, at 350-51.

still effective even though a limited remedy has failed of its essential purpose on a case-by-case basis.²⁶⁴ In theory, the case-by-case approach requires courts to interpret the parties' intentions.²⁶⁵ In practice, however, courts' application of the approach appears to run the gamut from something resembling a modern unconscionability analysis to something that more closely resembles an inquiry into the parties' intended bargain.²⁶⁶ To the extent that courts do wish to inquire into parties' bargains, the question they need to ask is clear: did the parties intend that the disclaimer of consequential damages provide an additional layer of protection to the seller in the event that the limited remedy failed of its essential purpose, or was the disclaimer merely excess verbiage associated with the exclusive limited remedy? It is equally clear that the contract price could prove helpful in answering such a question.

In *Milgard Tempering, Inc. v. Selas Corp. of America*, the Ninth Circuit did evaluate the contract price in applying the case-by-case approach.²⁶⁷ The buyer, Milgard, contracted for the design and delivery of a tempering furnace in what the court described as a "carefully negotiated" agreement.²⁶⁸ The seller, Selas, regarded the design of the furnace as "experimental" but agreed to deliver it for a price of \$1.45 million.²⁶⁹ The contract also included some timeliness provisions. When Selas was unable to comply, the parties had a dispute that they initially settled out of court, but when Selas failed to perform within the additional period provided under the settlement agreement, Milgard sued.²⁷⁰ At trial, Selas was initially granted a summary judgment, but this was overturned on appeal.²⁷¹ On remand, the trial court held not only that the limited remedy clause failed of its essential purpose, but also that Selas's default was fundamental enough

264. See *Smith*, 957 F.2d at 1443.

265. The Seventh Circuit, for instance, provided the following description of the case-by-case approach:

An analysis to determine whether consequential damages are warranted must carefully examine the individual factual situation including the type of goods involved, the parties and the precise nature and purpose of the contract. The purpose of the courts in contractual disputes is not to re-write contracts by ignoring parties' intent; rather it is to interpret the existing contract as fairly as possible when all events did not occur as planned.

AES Tech. Sys., Inc. v. Coherent Radiation, 583 F.2d 933, 941 (7th Cir. 1988) (cited in *Smith*, 957 F.2d at 1443).

266. See *infra* this Part.

267. *Milgard Tempering, Inc. v. Selas Corp. of Am.*, 902 F.2d 703 (9th Cir. 1990).

268. *Id.* at 705.

269. *Id.*

270. *Id.* at 706.

271. *Id.*

to void the disclaimer of consequential damages. The court awarded Milgard over \$1 million in net damages.²⁷²

Selas appealed on the grounds that the trial court erred in holding that the limited remedy clause failed of its essential purpose and that the trial court erred in holding that the failure of the limited remedy voided the disclaimer of consequential damages.²⁷³ Writing for the Ninth Circuit, Judge Hall upheld the trial court on the failure of the limited remedy clause and then addressed the question of consequential damages. According to Judge Hall, the appropriate test under the case-by-case approach was “whether Selas’ [sic] default caused a loss which was not part of the bargained-for allocation of risk.”²⁷⁴ In fact, this was the test that the trial court had actually applied, and the Ninth Circuit therefore not surprisingly also upheld the trial court’s decision to void Selas’s exclusion of consequential damages.²⁷⁵ As Judge Hall explained, “Milgard did not agree to pay \$1.45 million in order to participate in a science experiment.”²⁷⁶ The clear implication is that Milgard would have received an empty bargain unless the clause in the contract disclaiming consequential damages was interpreted as excess verbiage associated with the limited remedy clause.²⁷⁷

Milgard certainly uses the contract price to help interpret the parties’ contract, but the opinion is not particularly persuasive since simply stating that the buyer did not agree to pay \$1.45 million for a “science experiment” seems conclusory. A more convincing analysis, for instance, might have inquired into whether the expected marginal costs to Selas of covering Milgard’s consequential damages in the event that the limited remedy failed would have been exorbitant relative to a price of \$1.45 million. Would the expected marginal costs have pushed Selas’s expected total costs over the contract price? Milgard was awarded over one million dollars in net damages.²⁷⁸ The award for Milgard’s consequential damages was even larger—over \$1.1 million.²⁷⁹ That seems like a large amount relative to a contract

272. *Milgard*, 902 F.2d at 709-10.

273. *Id.* at 709.

274. *Id.*

275. *Id.*

276. *Id.*

277. In the terms used in the economic analysis in Part III of this Article, the expected total value of the furnace to Milgard, if the contract foreclosed a right to consequential damages when the limited remedy failed of its essential purpose, would have been so small that Milgard would have basically received nothing in return for the price it paid of \$1.45 million.

278. *Milgard*, 902 F.2d at 706.

279. The district court calculated lost profits separately for two periods, one during which the furnace was unable to meet any of its performance targets and the other during which it was able to meet only some of them. The Ninth Circuit affirmed the district court’s

price of \$1.45 million, especially when the seller had characterized the design and construction of the furnace as “experimental.”²⁸⁰ The expected marginal costs to Selas of remaining liable for consequential damages would have been quite high and might have pushed Selas’s expected total costs over the contract price. One wonders, therefore, whether the contract price was high enough for any rational seller to have agreed to cover consequential damages, even if only in the event that the seller’s limited remedy failed. One also wonders whether Selas had ever agreed to cover consequential damages under a similar contract with another buyer, and, if so, how the price in that contract compared to the \$1.45 million price in its contract with Milgard. A more systematic economic analysis of Selas’s expected marginal and total costs in comparison to the contract price might have inclined the Ninth Circuit to reverse the trial court.

Other courts that have applied the case-by-case approach have generally not evaluated the contract price in interpreting parties’ bargains. In *Smith v. Navistar International Transportation Corp.*,²⁸¹ the buyer, Smith, purchased a truck for use in his long-haul trucking business.²⁸² There was an exclusive limited remedy clause in the contract as well as a disclaimer of consequential damages clause.²⁸³ Smith had problems with the truck’s brakes almost immediately after the purchase.²⁸⁴ Although the seller, Navistar, attempted to repair the brakes, the truck was out of service for forty-five days and so, after revoking acceptance, Smith sought significant consequential damages.²⁸⁵ The district court held, as a matter of summary judgment, that Navistar had effectively disclaimed consequential damages even though the limited remedy failed of its essential purpose. Smith appealed.²⁸⁶

On appeal, the Seventh Circuit applied a case-by-case analysis.²⁸⁷ In writing for the Seventh Circuit, Judge Coffee affirmed the district court’s summary judgment, noting that the buyer read the terms and conditions of the warranty and failed to ask any questions before signing the writing.²⁸⁸ He also observed that there was no evidence in the record that “bargaining power was so unequal that the disclaimer was unconscionable.”²⁸⁹ The Seventh Circuit did not, however, evaluate whether the contract price could

calculation of \$860,497 in lost profits for Milgard over the first period and an additional \$252,608 over the second period. *Id.* at 710.

280. *Id.* at 705.

281. *Smith v. Navistar Intern. Transp. Corp.*, 957 F.2d 1439, 1439 (7th Cir. 1992).

282. *Id.* at 1440.

283. *Id.* at 1440-41.

284. *Id.* at 1441.

285. *Id.*

286. *Smith*, 957 F.2d at 1442.

287. *Id.* at 1444.

288. *Id.* at 1445.

289. *Id.*

have been adequate to interpret the parties' bargain to allocate the risk of consequential damages to the seller. If it had done so, that might have provided an additional basis for its decision. The buyer paid only \$19,527.70 for the truck; that seems far too little for the seller to have borne the risks of consequential damages on a commercial truck. A systematic evaluation of the contract price in relation to the expected marginal costs to the seller of providing consequential damages or to market prices for the same or similar trucks under contracts with and without the seller assuming liabilities for consequential damages might have buttressed the rationale for the court's holding. What the Seventh Circuit essentially did in following the case-by-case approach was little more than to apply an unconscionability test; since Smith was unable to prove any procedural abuse, the disclaimer of consequential damages passed the test. In spite of the Seventh Circuit's characterization of the case-by-case approach, *Smith* did not provide a particularly penetrating interpretation of the parties' intent.

The contrast between *Milgard* and *Smith* emphasizes some of the fault lines in modern contract law. There is little practical difference between a court voiding a contract clause on the grounds that it is unconscionable and a court interpreting a contract not to include the clause on the grounds that it was not part of the parties' intended bargain. Indeed, the only real theoretical difference between a court voiding a contract clause on the grounds that it is unconscionable and interpreting the contract not to include the same clause on the grounds that the contract price is inadequate for it to have been part of the parties' intended bargain arises from the procedural abuse prong of the modern test for unconscionability. It is far from clear whether the drafters intended the doctrine of unconscionability in U.C.C. section 2-302 to require a test for procedural abuse.²⁹⁰ It is therefore, perhaps, not surprising that the case law often appears to fall on either side of the fine line between regulating contracts and interpreting them. In *Milgard*, the Ninth Circuit decided that a disclaimer of consequential damages clause was not effective as a matter of contract interpretation, largely, it seems, on the grounds that the contract price was so high that the buyer would have been left with an empty bargain otherwise. In *Smith*, the Seventh Circuit upheld a disclaimer of consequential damages clause largely on the grounds that there was no procedural abuse and it was therefore not unconscionable.

It obviously matters which side of the fault line a court decides to take. If, in *Milgard*, the Ninth Circuit had applied the modern test for unconscionability instead of inquiring more broadly into the parties' intent, the case probably would have come out the other way. And if, in *Smith*, the Seventh Circuit had made a more strenuous effort to interpret the parties' intent instead of basically just applying the unconscionability test, that case

290. See *supra* Part II.D-E.

might have come out the other way too.²⁹¹ As a general matter, courts that apply the unconscionability test will probably tend to show more deference to parties' writings than those that address the issue as a matter of contract interpretation, especially in contracts between merchants. They will also, therefore, tend to favor the parties with the preponderance of bargaining power, since it is usually the party with the preponderance of bargaining power that drafts any writing. This may incline some courts to treat cases as matters of contract interpretation rather than contract regulation. The use of the contract price to help interpret parties' intended bargains may help to prevent courts from basing their interpretations on nebulous or even ill-founded conceptions of the equities. But if courts are going to use contract prices to help interpret parties' intended bargains, they would be wise to apply some basic principles of economic analysis in doing so.

V. CONCLUSION

Most contract cases involve disputes about the interpretation of contracts. There is voluminous law and economics literature on contract interpretation, but much of it overlooks what to most economists should be one of the key issues: how to use the contract price to help interpret whether disputed terms were intended to be part of the parties' bargains. This is no doubt, in part, because there are legal authorities that ostensibly prohibit courts from considering the adequacy of the contract price in deciding whether other clauses are contractually enforceable. These authorities are much more persuasive for some contracts, however, than for others. They are particularly compelling in contracts for services or real estate and those involving at least one party that can be characterized as a consumer or household. They are not particularly persuasive, however, in contracts for the sale of goods, especially those between two (or more) sophisticated business parties. Indeed, in contracts for the sale of goods between sophisticated business parties, the contract price may provide costless information that is highly relevant to interpreting the parties' intended bargains. From an economic perspective, therefore, courts would be remiss if they ignored it.

It is far from clear that the U.C.C. was ever intended to preclude courts from considering the adequacy of the contract price in interpreting sales contracts; in fact, the official comments to the U.C.C. appear to prescribe

291. *Smith* probably would have come out the same way. *Milgard*, however, might very well have come out the other way. The irony therefore is that the court that considered the contract price in interpreting the parties' bargain may have reached the wrong outcome. The moral is that it is not enough for courts to evaluate the adequacy of the contract price; they must do so wisely and in accordance with basic principles of economic reasoning.

that, in at least some contexts, courts should evaluate the adequacy of the price in interpreting parties' intended bargains. It should not be surprising, therefore, that many courts have considered the adequacy of the contract price in interpreting parties' intended bargains under U.C.C. contracts. But to the extent that they have, they have done so without any guidance from economic theory. In some cases, their opinions have been less persuasive than they might have been if they had applied some basic economic reasoning. This Article presents an economic analysis of bargains and uses it to offer some guidance as to how the contract price can be used to interpret whether disputed terms were an intended part of the parties' bargain in sales contracts between sophisticated business parties.

The analysis suggests three ways in which the contract price might be able to help in the interpretation of contracts:

1. Through a cost-benefit inquiry: If the expected marginal costs to the seller of providing the disputed term would have been greater than the contract price or if they would have clearly pushed the seller's expected total costs over the contract price, then no rational seller would have concluded the contract with the term. Conversely, if the expected total value of the good to the buyer without the disputed term would have been so much less than the contract price that the buyer would clearly have been left with negative surplus, or, in other words, an empty bargain, then no rational buyer would have concluded the contract without the term.

2. By comparing the contract price to prices in other contracts between the same buyer and seller: If the contract price is within the actual or plausible range of prices for contracts between the buyer and seller that include the term but is not within the actual or plausible range of prices for contracts between the buyer and seller that do not include the term, then it is reasonable to infer that the parties intended to include the term in their bargain. Conversely, of course, if the contract price is outside the actual or plausible range of prices for contracts between the buyer and seller that include the term but within the actual or plausible range of prices for contracts between the buyer and seller that do not include the term, then it is reasonable to infer that the parties intended not to include the term in their bargain.

3. By comparing the contract price to market prices for the same or a very similar good: If the contract price is within the actual or plausible range of market prices for the same or a very similar good under contracts that included the term but not under contracts that did not include it, then it may be reasonable to infer that the parties intended to include the term in their bargain. Conversely, of course, if the contract price is outside the actual or plausible range of market prices for the same or a very similar good under contracts that included the term but within the actual or plausible range of market prices for contracts that did not include it, then it may be

reasonable to infer that the parties intended not to include the term in their bargain.

Some courts have considered the contract price in interpreting parties' bargains, and in some cases their opinions comport well with the economic analysis offered in this Article. The case law is replete, however, with examples in which courts probably should have used the contract price to help interpret parties' bargains but did not or in which they used the contract price but perhaps to ill effect. This Article has provided several examples of how courts have used contract prices to help resolve interpretive disputes in sales cases and suggested how the opinions could have been made more persuasive through the application of the economic analysis. It has also provided examples of cases in which courts could easily have used the contract price to good effect in helping to resolve interpretive disputes but did not, perhaps because they labored under the misimpression that doing so would contravene established legal authorities and sound principles of economics. The purpose has been to show how some relatively simple economic reasoning might help to improve the resolution of at least some contractual disputes.