

UC Berkeley

Law and Economics Workshop

Title

Harnessing Litigation by Contract Design

Permalink

<https://escholarship.org/uc/item/72m8s9b7>

Authors

Scott, Robert E.
Triantis, George G.

Publication Date

2005-05-11

HARNESSING LITIGATION BY CONTRACT DESIGN

Robert E. Scott*
George G. Triantis**

Forthcoming 115 Yale Law Journal (2005-06)

May 11, 2005 draft

ABSTRACT

We advance a theory explaining the use in commercial contracting of specific and vague terms (rules and standards), as well as terms allocating litigation burdens, as key mechanisms for efficient contract design in a world of costly litigation. Economic theories of contracts and contract law postulate that parties will not contract with respect to observable facts that are nonverifiable - that is, where the cost of proving these facts to a court exceeds their benefit in the contract. Scholars apply this postulate to predict that parties will tend not to agree to vague contract terms. In fact, however, vague terms are abundant in commercial contracts and their enforcement need not entail excessively high litigation costs. The conventional nonverifiability concept has distorted contractual analysis because it treats the litigation process as simply the verification of truth to a third party. It thus fails to incorporate the interactive litigation strategies of the parties under the rules governing litigation. In the place of the nonverifiability concern, therefore, we frame the distinction between specific and vague terms – alternatively, rules and standards – as the choice between the parties choosing proxies ex ante and the court doing so ex post. The ex post proxy choice, in turn, is determined to a significant degree by the litigation process, particularly the allocation of procedural burdens and presumptions. There are default burden rules around which commercial parties often contract. Thus, contract terms that combine rules, standards and burdens permit the parties to select useful proxies ex ante, when their interests are aligned, and also ex post when uncertainty is resolved but their interests have diverged. Our analysis thus highlights the more general and valuable lesson of the nonverifiability postulate-- that the anticipated path of litigation is relevant to contract design.

* David and Mary Harrison Distinguished Professor, University of Virginia School of Law; Justin W. D'Atri Visiting Professor of Law, Business and Society, Columbia Law School.

** Perre Bowen Professor, University of Virginia School of Law. We thank Albert Choi, Michael Dooley, Victor Goldberg, Mitu Gulati, John Harrison, Kevin Kordana, Jody Kraus, Anup Malani, Caleb Nelson, Eric Posner, Chris Sanchirico and workshop participants at the 2005 AALS meetings and at Berkeley, Ohio State and Virginia law schools for helpful comments. We also thank Patrick Dempsey, Ben Doherty and Kent Olson for research assistance.

INTRODUCTION

Transaction costs in business are large. Conventional wisdom holds that contracting parties strive to minimize these costs. In fact, however, the challenge of contract design is not to minimize transaction costs but rather to maximize the net gain in contracting surplus from engaging in transactions. In short, the goal is to maximize the bang for the transaction cost buck. In particular, parties incur transaction costs to improve the efficiency of incentives in contracting behavior, and they should continue doing so until the marginal transaction cost exceeds the marginal gain in incentives.

Transaction costs are incurred at the front-end and back-end of the contracting process, where the front and back are separated by the resolution of uncertainty. For example, the front-end is the drafting of the contract and the back-end is litigating disputes that arise when the contract turns out to be a losing proposition for one party and a winning one for the other. Of course, the back-end may entail a number of alternative possible processes, such as settlement and renegotiation. In this paper, however, we limit our analysis to cases in which contracts end up either fully performed or litigated.

This paper offers a theory of contract design that anticipates the enforcement of contract by adversarial litigation. The outcome of litigation is the product of the parties' interactive strategies in presenting evidence to the court. These strategies, in turn, are affected by the rules of evidence and procedure. In designing their contract, the parties choose between vague and specific terms based on the expected path of litigation, and they have some freedom to manipulate the rules of the litigation game (particularly burdens of proof) in their ex ante agreement. As we explain below, this approach is a significant improvement over the current contract theory in which scholars tend either to assume perfect enforcement of contract terms or to overstate the informational constraints on courts through a simplistic distinction between "verifiable" and "nonverifiable" facts. This latter approach, now common in economic contract theory, postulates that some observable facts cannot be communicated to courts at reasonable cost and that the parties will simply avoid conditioning their performance obligation on such

nonverifiable information.¹

This approach essentially mischaracterizes the litigation process as consisting of a straightforward search for truth. To be sure, courts do screen and weigh available evidence relevant to a disputed fact. But fact finding in common law litigation is an adversarial process, and the court's information set is provided almost exclusively by the parties. Therefore, the litigation outcome (and the enforcement of the contract) is determined by the interactive evidentiary strategies of the parties and the governing rules of evidence and procedure, particularly the allocation of burdens and standards of proof. At the conclusion of a trial, the court makes factual determinations by comparing its confidence in the truth of a given fact against a standard of proof (such as the typical civil standard of "more likely than not"). The costs of the trial are constrained because, among other reasons, the parties bear their own costs of evidence production as they fight over a fixed amount at stake and the rules of evidence and procedure tend to exclude evidence that is unduly costly to produce.²

One of the more problematic implications of the verifiability approach is the prediction that commercial parties will avoid contracting on vague terms. Qualitative performance obligations may seem nonverifiable. For example, scholars typically assume that even though contracting parties can observe each others' effort or level of care, these variables are not verifiable—that is, the failure of a contracting partner to exert a promised level of effort costs

¹A nonverifiable factor is one for which the information cost at trial outweighs the incentive benefit of the related contractual provision. The paradigmatic example in agency contracts is a contract that requires a minimum level of effort from the agent, where a third party (such as a court) cannot observe directly how hard the agent is working. Economists postulate that parties will not contract on factors that are nonverifiable. E.g., Oliver Hart and John Moore, *Incomplete Contracts and Renegotiation*, 56 *Econometrica* 755 (1988); Ilya Segal, *Complexity and Renegotiation: A Foundation for Incomplete Contracts*, 66 *Rev. Econ. Stud.* 57, 72-3 (1999). Many legal scholars have adopted this premise as well. E.g., Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 *J. Legal Stud.* 271 (1992); Eric Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?* 112 *Yale L.J.* 829, 857 (2003) ("The literature stipulates that transaction costs mean that the [reliance] investment is not verifiable by a court, so the parties gain nothing by putting the optimal investment in the contract).

²When costs are not excessive, verifiability may reflect instead a concern with the effect of legal error in fact finding on contract incentives. As we discuss later, however, the risk of such error may not detract much from efficiency, and may even enhance it. See TAN *infra*.

more to prove than the incentive gains from tying the contract performance directly to efforts. Similarly, vague contingencies may appear nonverifiable, as where a term excuses performance when the promisor's costs rise due to factors beyond either party's control. Yet, the focus on verifiability overlooks the fact that courts do not search for direct measures of effort or cost but look instead to evidentiary proxies for the desired performance or contingency. For example, rather than assessing the promisor's efforts or costs directly, courts may rely on profits as a signal of effort and market prices or audited financial statements as a signal of cost. These proxies serve to reduce evidentiary cost, even at some sacrifice in accuracy.

A core feature of contract design is the decision of how much to invest in the drafting and enforcement of contracts, in light of the associated gains in the efficiency of contractual incentives. Because there is a tradeoff between the costs incurred at the front-end of the contracting process and those incurred at the back-end, this investment decision requires the allocation of resources between the two stages.³ As a simple example, consider that a contract can be characterized by pairs of performance obligations and contingencies: e.g., the promisor has an obligation X when contingency Y occurs. Anticipating future litigation, the parties might try to contract directly on evidence: the contract would instruct the court to compel the defendant to pay X when the parties present a set of evidence falling within a partition Y. The up-front cost of this contract is likely to be prohibitive, however, because of the number of possible future evidentiary sets.

The parties may instead express their obligations in more general terms, and rely on the court to assign outcomes to sets of evidence presented at trial. A vague term gives the court much more discretion in this regard than a specific provision. Vagueness is a continuous characteristic that might be thought of as the degree to which the parties have departed from a contract that conditions litigation outcomes directly on evidence. For ease of exposition, however, we divide contract terms into two categories: specific terms and vague terms. To

³ In a similar vein, Schwartz and Watson focus on the tradeoff between front-end investment in complex rules and back-end investment in renegotiating simple rules after uncertainty is resolved. Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 *J. Law, Econ. & Org.* 2 (2004)

follow the convention in characterizing legal regulation, we also refer to them as rules and standards, respectively. Units (or bits) of evidence prove directly whether a *rule* is satisfied. In contrast, *standards* are one step further removed from the evidentiary units: the evidence establishes whether a proxy is satisfied, and then the court must determine what weight to give to the proxy in the enforcement of the standard.⁴

The choice between rules and standards in contracts concerns *who* chooses proxies for the desirable behavior and *when* the choice is made.⁵ To illustrate, we might compare an obligation to deliver a widget weighing ten pounds and an obligation to deliver a widget of merchantable quality. There are a various evidentiary bits that can establish the weight of the delivered widget in the first case. For example, compare the testimony of the seller’s agent as to the widget’s weight immediately before delivery against the testimony of the buyer’s agent as to its weight the day after delivery. By contracting directly on the evidence, the parties delegate to the court the relatively simple task of choosing between these evidentiary bits before deciding whether to find a breach. Where the contract requires instead a merchantable widget, the weight of the widget competes with other proxies in establishing merchantability. In this case, the litigation process determines which proxies are relevant and the weight to be assigned to each.

The literature concerning the choice between rules and standards identifies the tradeoff between up-front promulgation of a legal regulation and its back-end enforcement costs. We

⁴ We use the term “proxy” in this Article to describe those evidentiary bits or (in the language of proceduralists) “operative facts” that are relevant to establishing compliance with contract terms framed either as rules or standards. A rule narrowly confines the content of the operative facts. Indeed, in the limiting case a rule directly specifies the evidentiary proxy. A standard defines a broader space within which a court can select the evidentiary proxy that best establishes compliance with the standard.

⁵This contrast is fairly well established in the literature on rules and standards in torts or other forms of regulation. See generally, Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L. J. 557 (1993). Rules purport to specify the content of an obligation ex ante, while standards leave a greater portion of the substantive provisions to be determined after the regulated behavior (e.g. breach) has occurred and, typically, by the adjudicators of disputes. The paradigmatic example in this literature contrasts the rule limiting the speed of automobiles to 55 mph with the standard that requires drivers to travel at a speed no greater than is reasonable under the circumstances. In our analysis, the distinction hinges on *who* chooses the proxies for “bad” driving, as well as *when*. In the case of the speed-limit, the legislature chooses the speed limit rule ex ante; the judge (and/or jury) fills in the content of the standard ex post by determining the relevance and weight assigned to available evidence.

develop this tradeoff here by comparing the informational advantage the parties may have at the time of contracting against the hindsight advantage of determining proxies in later litigation. A further and somewhat counterintuitive advantage of ex post proxy selection is that the chosen proxy is uncertain at the time of the regulated behavior. As a result, it is more difficult for the promisor to manipulate the evidence establishing the satisfaction of the proxy rather than simply performing.⁶

Damages for contract breach provide a familiar illustration of the choice between rules and standards. Suppose that contracting parties wish to set damages so that the breacher internalizes the expectation loss inflicted on the promisee. The parties have a choice between a rule of liquidated damages and a standard of expectation damages (which happens also to be the legal default). The parties will only choose liquidated damages that are fixed or otherwise based on fairly specific pieces of evidence, such as market prices. If the contract is enforced instead by expectation damages, the court will often reject evidence based on the promisor's costs or the promisee's valuation. Instead, the court will invite the parties to select verifiable proxies for the value of the promisee's lost expectation. In fact, the courts regularly require the parties to present market evidence of costs and values which they then use to measure damages.⁷ The choice, therefore, is not whether to condition the contract on a verifiable liquidated damages clause or nonverifiable expectation damages. Rather the choice is between more or less efficient proxies for the promisee's expected losses from breach. Efficient proxies are those that maximize the gains in contractual incentives net of expected litigation costs. For example, the parties' may choose rule-like liquidated damages because they determine that their private information at the

⁶Uncertainty in ex post proxy selection may have significant efficiencies in addressing problems of multi-tasking and evidence manipulation during the term of the contract. As a familiar example, a teacher is more likely to "teach to the test" if that proxy is selected in the employment contract, than if the test is one of a number of possible proxies correlated with teaching performance. In a similar vein, a party may be less willing to invest in fabricating evidence (e.g. fraudulently altering the test results) when the court's proxy choice is uncertain. See TAN *infra*.

⁷ See e.g., UCC §2-708(1) (seller's market damages); §2-713(1) (buyer's market damages); §2-723(2) (proof of market damages: "If evidence of a [market] price prevailing at the times or places described in this Article is not readily available the price prevailing within any reasonable time before or after the time described or at any other place which in commercial judgment or under usage of trade would serve as a reasonable substitute for the one described may be used....").

time of contracting is superior even to the court's market information ex post.

In Part I of this Article, we argue that the concern with verifiability is of limited use because it mischaracterizes the process of contract litigation and enforcement. As noted above, litigation costs are subject to significant constraints that dampen the importance of verifiability to contract design. Moreover, the concern with verifiability has led scholars to assert too quickly the inefficiency of vague terms. Where verifiability is an obstacle, economic contract theorists typically propose mechanisms that yield efficient incentives under various assumptions. But the effective operation of these mechanisms rely on the litigation process which their proponents ignore. Given that the state has a monopoly on coercion, we suggest that the more fruitful approach is to take the litigation mechanism as given, subject only to the limited ability of the parties to vary the procedure by contract.

In Part II, we tackle the persistent skepticism of vague terms in contracts scholarship by reframing the contractual choice between rules and standards (or specific and vague terms). The underlying choice governs whether the parties at the time of contracting or the court at the time of trial will select the proxies that determine outcomes at trial. We set out a general theory of proxy choice and then describe guidelines by which parties select the “chooser.” The parties use contractual rules to specify proxies whose accuracy is less likely to be affected by the future state of the world, while contractual standards delegate to the court the later choice of proxies that are more likely to be state-contingent. And, the parties create combinations of rules and standards that anticipate and rely on maxims of interpretation and thereby define the space within which a court may later choose the proxies. In this way, the evidentiary space may be made larger or smaller, along a continuum that extends from narrow rules to very broad standards.

In Part III, we turn to the significance of litigation burdens and presumptions in the choice of proxies (and the weight given to each) under a contractual standard. At trial, the parties can be expected to propose self-serving and conflicting proxies within the proxy space defined by the contract. The allocation of burdens, therefore, may determine the choice and weights of proxies within the space. To put it simply, a party enjoys an advantage in proxy

selection when the burden of proof is borne by her opponent, particularly when the standard of proof is also high. Under the governing evidentiary principles, burdens typically fall on plaintiffs, the parties that wish to alter the status quo. But contracting parties can and do depart from these default burden allocations-- either explicitly or by substantive provisions such as deposits and termination rights. We show how contracting parties can tailor burdens to their particular circumstances so as to improve the efficiency of contract performance incentives, deter opportunistic law suits, and prevent inefficient structural change such as the termination of the contract.

We conclude that much of contract design can be explained by anticipating the effect of the course of litigation on contract terms. By opening the black box of litigation to contract scholars, we can understand better the use of rules and standards in commercial contracts as well as the feedback effect of the adversarial litigation system, and particularly burdens of proof, on the parties' agreement.

I. RETHINKING THE VERIFIABILITY PROBLEM

The theory of incomplete contracts is the dominant tool in the economist's analysis of contract design and in the economic analysis of contract law. Under this theory, parties strive to achieve the dual objectives of efficient trade and efficient reliance.⁸ In a complete contingent contract, the parties anticipate and agree to the optimal exchange in each contingency, or state of the world,⁹ that might materialize during the term of the contract. An obligationally complete

⁸Efficient trade occurs when the value of the exchanged performance to the buyer exceeds the cost of performance to the seller. Efficient investment occurs when the parties each make all the reliance investments that yield a positive net return in the difference between the value and cost of the exchange, discounted by the probability that the exchange will actually take place. See, e.g., Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541, 545 (2003)

⁹States of the world reflect both exogenous and endogenous variables. For example, different oil prices produce different states, but so does the decision of a seller to tender or not. Each event changes the state of the world and may be paired in the contract with a different obligation on the buyer.

contract might lump together various states and provide for the same obligations across the states of each lumped set. Yet, an economist would view such a contract as informationally incomplete because it fails to discriminate within each set between states that optimally call for different obligations. There are various reasons why rational parties may agree to contracts that are informationally incomplete. For example, the parties may not foresee all future states of the world, or they may not calculate the efficient outcome in each state, or they may not wish to incur the contracting costs of providing specifically for low-probability states.¹⁰

One cause of incompleteness, however, has emerged as the predominant concern of contract theory: parties avoid agreeing to terms that rely for their enforcement on variables that cannot be verified to a court, even though they may be observable to both parties. The verifiability of a fact invoked by contract reflects the same concern as that over accuracy in the trial of a criminal or tort defendant: accuracy may improve deterrence but it is costly to achieve.¹¹ In other words, the verifiability approach asserts that parties do not contract for a term if either or both of the following are true: (a) the expected cost of fact-finding in litigation offsets the incentive gains, and (b) legal error and the associated uncertainty of judicial enforcement undermines the efficient alignment of incentives.

Oliver Hart, one of the leading figures in the economics of incomplete contracts, describes “verifiability” as follows:

The contract, ‘I will pay you £1 million if you make the investment I’ is not enforceable, since no outsider knows whether it has been fulfilled. Similarly, the parties’ revenues and costs cannot be made part of a profit- or cost- sharing agreement. The quality of [my] book is observable, in the sense that anybody can read it... However, it would have been difficult for Oxford University Press and me to have written a contract making my royalties a function of quality, since if a

¹⁰E.g., Alan Schwartz, *Incomplete Contracts*, 2 *The New Palgrave Dictionary of Economics and the Law* 277-283 (P. Newman, ed.1998).

¹¹E.g., Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 *J. Legal Stud.* 307 (1994).

dispute arose it would be hard for either of us to prove that the book did or did not meet some pre-specified standard. (For this reason my royalties are made to depend on some (more or less) verifiable consequences of quality, e.g., sales.) In other words, quality is not verifiable.¹²

Hart's description contains three examples of nonverifiability that differ in the precision, or vagueness, of the contract term. Payment conditioned on the *quality* of his book is a much more vague term than one conditioned on a specific level of investment. Profit- or cost-based payments fall in the intermediate region because they can be interpreted in various ways by different accounting principles. Like most authors in this literature, Hart groups these three examples and suggests that parties would contract for none of these terms. We take issue with this assertion on two grounds. First, factors such as investment, cost, profit and quality, do not fall neatly into categories of verifiable and nonverifiable, so as to permit categorical assumptions about their contractibility. The relationship between the cost of enforcing terms that rely on these factors and their contribution to efficient contract incentives is far more subtle. Whereas Hart says that "no outsider knows [investment]" and "[quality is] hard to prove," the more relevant analysis would focus on the litigation strategies of the parties and the consequent distribution of litigation outcomes. Second, the relationship between verifiability and vagueness of contract terms is far more complex than Hart and other contract theorists imply. The enforcement cost for vague terms is subject to a number of institutional and incentive-based constraints discussed below. Vague provisions (*standards*) such as book quality can be included in contracts because the court ultimately selects verifiable evidence (*proxies*) to resolve disputes as to whether the standard was met. Therefore, the aggregate of front-end and back-end contracting costs may well be lower for vague terms than the alternative, specific provisions. We also explain below that the uncertainty in the enforcement of vague terms does not necessarily impair contract incentives and may indeed enhance them.

A. Verification and the Litigation Game

¹²OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 37-8 N.15 (1995).

In almost all cases, the economist's conception of verifiability is dichotomous: the courts can or cannot observe given variables.¹³ Where key elements of efficient performance are deemed nonverifiable, contract theorists then devise implementation mechanisms that elicit the truthful revelation from the parties in enforcement proceedings.¹⁴ But in order for these mechanisms to work, the courts must obey the parties instructions and specifically enforce the terms that are designed to overcome the nonverifiability problem. Typically, these mechanisms require courts either to require or prohibit trade under specified circumstances. But, in fact, courts are reluctant to compel trade by injunction and would rarely if ever seek to prohibit trade.¹⁵ We adopt instead an approach that takes the existing litigation process as given and

¹³ See e.g., Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. Legal Stud. 159 (1994).

For the most part, competence has been treated as an either/or proposition: courts either can or cannot verify a potential contracting variable...[But] verifiability is a matter of degree not dichotomy; judicial competence is more or less limited because courts make errors more or less frequently in "observing" a contract variable or translating an observation into a conclusion about efficiency...The dichotomous verifiability approach to contract enforcement is somewhat surprising in light of the extensive literature examining the implications of varying degrees of imperfection in the enforcement of tort and criminal law.
Id. at 162.

¹⁴A mechanism is a simple device that compares the announcements of the parties and rewards them on the basis of this comparison. The structure of the reward induces the parties to reveal nonverifiable facts to a court or other decision maker. The seminal contribution is by Eric Maskin, *Nash Equilibrium and Welfare Optimality*, MIT Mimeo 1977 (published much later in 66 Rev. Econ. Stud. 23 (1999)). Many revelation mechanisms have since been proposed in the setting of contracts. For a review, see John Moore, *Implementation in Environments with Complete Information*, in J.J. LAFFONT (ED.), *ADVANCES IN ECONOMIC THEORY: SIXTH WORLD CONGRESS OF THE ECONOMETRIC SOCIETY*, vol.1, 182-282; MAS-COLELL, WHINSTON AND GREEN, *MICROECONOMIC THEORY*, ch. 23 (1995). As an example of a mechanism that relies on coordinated messages, assume the contract price is x in a low demand state and $x+y$ in a high demand state, and that demand is observable but not verifiable. The mechanism feature of the contract might provide that both parties must send messages to the court indicating the state of demand. If the messages are the same, the court orders trade, if they conflict, trade is prohibited. It is a dominant strategy under such a mechanism for each party to report the ex post state truthfully. The inability of the parties to renegotiate the consequences of a mismatch is crucial to the revelation mechanism. In sum, this literature shows that when it is relatively cheap to contract, but costly to verify future actions and states, parties can write contracts that induce parties to send "messages" whose content is a function of information that is observable ex post. If courts specifically enforce the content of these messages, this contract form can provide for efficient trade. However, this enforcement assumption is not borne out in the real world and this may explain the absence of such mechanisms from real contracts. See Robert E. Scott, *Rethinking the Default Rule Paradigm*, 6 Va. J. 87 (2002).

¹⁵Moreover, these mechanisms typically assume that the parties cannot renegotiate – another premise that is unlikely to hold in the real world.

explores principles of contract design that anticipate the litigation “mechanism.”¹⁶

In the adversarial litigation system, courts make factual determinations with substantially less than complete confidence. In civil cases, the standard is typically that the fact is more likely than not to be true. The terminology and concept of verification is accordingly inapt to describe the legal enforcement of contracts. Moreover, fact finding depends almost exclusively on the evidence presented by the parties, and the court’s determination is based on a relative assessment of evidence (for example, “the preponderance of evidence”). Burdens of proof ensure that the court reaches a judgment even if the information provided by the parties is poor.

Verifiability is thus a very crude approach to a well known incentive problem. The parties’ incentive to invest in evidence production at trial is a function of the amount at stake in the litigation -- for example, the damages award being sought by the plaintiff. At the time of the trial, the parties are engaged in splitting a fixed gain or loss with little, if any, prospective efficiency value. The value of the litigation outcome is in its effect on ex ante incentives, which are of no interest to the parties at the time of trial.¹⁷ From this perspective, the nonverifiability concern might be reframed to postulate that the parties will not contract on a variable a) where the expectation that the parties will overinvest in litigation will undermine efficient contractual incentives, or b) where the parties underinvestment will undermine incentives because of excessively inaccurate outcomes.¹⁸ Even in this more refined frame, however, the concern with

¹⁶This approach is also used in Albert Choi & George G. Triantis, *Contractual Choice Between Arbitration and Litigation* (mimeo 2004); Albert Choi and George G. Triantis, *The Effect of Settlement on Contract Design* (mimeo 2005); Chris William Sanchirico & George G. Triantis, *Evidence Arbitrage: The Fabrication of Evidence and the Verifiability of Contract Performance* (mimeo 2002, 2004).

¹⁷See Steven Shavell, *The Social versus the Private Incentive to Bring Suit in A Costly Legal System*, 11 J. Legal Stud. 333 (1982)(plaintiff does not internalize the litigation cost of the defendant). Conversely, high litigation costs can undermine socially valuable incentives by discouraging the bringing of suits. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 397 (2004).

¹⁸See Richard A. Posner, *An Economic Approach to the Law of Evidence*, 51 Stan. L. Rev. 1477, 1486 (1999) (discussing the possibility that parties will either underinvest or overinvest in the search for evidence, relative to the social optimum); see also Louis Kaplow, *Accuracy*, New Palgrave Dictionary of Economics and the Law (1998). (Parties may over or under invest “because private benefits relate to the amount of damage payments ex post whereas social benefits may depend primarily on deterrent effects ex ante, which are usually of no immediate concern to the parties.” Id.at 4).

verifiability is overstated for two reasons. First, the litigation mechanism itself includes constraints on investment in evidence production. Second, the risk of error in fact finding does not necessarily compromise efficient contract incentives.

1. Constraints on Verification Costs.

Significant institutional forces and incentives constrain the costs of litigation, regardless of the substantive contract provisions. First, as indicated above, the parties bear their own cost of presenting evidence and will stop presenting when the marginal cost exceeds their marginal private benefit, which is a product of the probability of winning and the amount at stake. A significant decrease in the marginal benefit of evidence, for instance, will result in a relatively inexpensive trial. Moreover, the parties' evidentiary decisions are interactive, in the sense that the marginal benefit of one party's evidence is affected by the other's evidentiary strategy.¹⁹ One party's evidence may well discourage the other party from further investing in the litigation.

The fact-finding process in litigation is governed by burdens of proof and presumptions that tend to abbreviate trials. The burden of proof consists of two distinct burdens -- the burden of production and the burden of persuasion -- that carry distinct standards of proof. The party with the burden of production must produce sufficient evidence such that, in the eyes of the judge, a reasonable jury could infer the fact.²⁰ If that party fails to carry that burden, the court will order a directed verdict in favor of the other party, and the cost of a full-blown trial is avoided.²¹ The burden of persuasion follows if the burdens of production are met and both

¹⁹Avery Katz explains that an increase in one party's evidence production may cause the other party either to advance additional evidence or to retreat by presenting less evidence. Avery Katz, *Judicial Decision Making and Litigation Expenditure*, 8 Int'l. Rev. Law & Econ. 127 (1988). See also Chris William Sanchirico, *Harnessing Adversarial Process: Proof Burdens, Affirmative Defenses, and the Complementarity Principle* (Draft: February 2005).

²⁰The application of this standard appears to be a matter for the judgment of the court. A classic treatise suggests that certain common factual groups recur and that individual judges have incentives to be consistent, and that other courts follow to produce predictable patterns or standards. JOHN W. STRONG (ED.), MCCORMICK ON EVIDENCE § 338 (5th ed. 1999).

²¹For a justification of the all-or-nothing feature of burdens of proof, see Chris William Sanchirico & George G. Triantis, *Evidence Arbitrage: The Fabrication of Evidence and the Verifiability of Contract Performance* (mimeo 2002, 2004)

parties have presented all their evidence. The court instructs the jury that one party carries the burden of persuasion and that, unless this burden is met, the jury must return a verdict for the other party. In a civil case, such as an action for breach of contract, the burden is satisfied if it establishes the alleged fact as more likely than not to be true. This underscores the relative character of the adversarial process. One party's evidentiary production need not be any higher than that which is necessary to pass the burden threshold, given her opponent's evidence. At the same time, a party carrying the burden is more likely to retreat in the face of additional evidence presented by her opponent.²²

Legal presumptions shift burdens from one party to the other and, in so doing, further economize on litigation costs.²³ Under a presumption, the satisfaction of a burden with respect to fact A satisfies the burden of production on fact B, and it also shifts the burden to the other party to establish the non-existence of fact B or face a directed verdict against it. For example, when a shipper can show that it delivered goods to Carrier A in good condition and received them from Carrier B in defective condition, there is a presumption that the damage occurred while the goods were in the control of Carrier B.²⁴ In such cases, the presumption can be justified on the grounds that fact B is highly correlated with fact A or that the other party has superior knowledge about fact B.²⁵

²²Sanchirico, *Harnessing Adversarial Process*, supra note –.

²³McCormick defines a presumption as “a standardized practice, under which certain facts are held to call for uniform treatment with respect to their effect as proof of other facts.” MCCORMICK, supra note -- at §342. There is some division among courts as to the extent that the burden of persuasion (as well as the burden of proof) shifts to the other party. Id.at §342. Some courts hold that, in this case, not only does the defendant have the burden of production but that he has the burden of persuasion on the nonexistence of the presumed fact as well. Note that in criminal cases there are rules that are labeled presumptions even though they do not shift the burden of production. The Supreme Court has called these rules “permissive presumptions.” *County Court of Ulster County v. Allen*, 442 U.S. 140 (1979).

²⁴*Chicago & Northwestern Railway Co. v. C. C. Whitnack Produce Co.*, 258 U.S. 369 (1922).

²⁵We suggest in Part III that presumptions and shifting burdens are created by a variety of contract provisions, including conventional contract assignment restrictions, termination rights and professional certificates of performance. See TAN *infra*.

Judges also have self-interested motivations to take steps to abbreviate the duration and cost of trials. A judge's prestige and influence may well be enhanced by presiding over more rather than fewer cases, holding her personal effort constant. And, within a case, the judge may reduce the demands on her time and effort by limiting the amount of evidence. In light of the public spotlight on litigation costs, some courts have enjoyed a positive reputation for putting in place mechanisms that speed trials.²⁶ The rules of procedure and evidence provide judges with tools for doing so. For example, Judge Posner writes that judges constrain overinvestment in evidence "not only by curtailing pretrial discovery, setting an early trial date, and limiting the length of the trial...but also by excluding evidence at trial under the authority of Rule 403 of the Federal Rules of Evidence....The relevance and hearsay rules also conduce to this end."²⁷

Several commentators assert that rules of evidence and procedure are designed to drive a wedge between the lower cost of evidence supporting the truth and the higher cost of inaccurate (or fabricated) evidence.²⁸ This improves the efficiency of litigation in several ways. First, given this cost differential, Rubinfeld and Sappington suggest that the effort invested by each

²⁶ See e.g., the so-called "rocket docket" adopted by the United States District Court in the Eastern District of Virginia.

²⁷ With respect to the hearsay rule, for example, Posner observes that it is proscribed by a cost-benefit assessment that makes exception for "those forms of hearsay that have probative value equivalent to that of first-hand evidence (for example, a statement against interest...)." Posner, *supra* note— at 1530.

²⁸For example, Posner states:

In general, moreover, the party having the objectively stronger case will be able to obtain evidence favorable to it at lower cost than the opposing party can obtain evidence favorable to itself. So the competitive system of gathering evidence will tend to favor the party who would win in an error-free world....[M]ost cases, civil or criminal, are resolved correctly [because]... it is usually cheaper to obtain persuasive evidence on the side of truth."

Posner, *supra* note – at 1492-3, 1507.

See also, Hyun Song Shin, *Adversarial and Inquisitorial Procedures in Arbitration*, 29 *Rand. J. Econ.* 378, 380 (1998); Antonio Bernardo, Eric Talley & Ivo Welch, *A Theory of Legal Presumptions*, 16 *J. L. Econ. & Org.* 1 (2000). In Bernardo et al's model, the marginal cost of evidence is higher for a shirking agent than for a high-effort agent. "[T]his cost differential implies that shirking agents will rationally choose to present less evidence than their non-shirking counterparts in equilibrium. Consequently, the litigation effort expended by the agent may be an efficiency-enhancing signal of her type – a signal that is only possible when litigation occurs along the equilibrium path." *Id.* at 10-11. Chris William Sanchirico, *Evidence Tampering*, 53 *Duke L.J.* 1215 (2004); Chris William Sanchirico, *Evidence, Procedure, and the Upside of Cognitive Error*, 57 *Stan. L. Rev.* 291 (2004)(cognitive shortcomings make it more difficult to provide consistent and detailed testimony that is false than true).

party in litigation may be a signal of the truth.²⁹ If effort can be observed by the court, litigation may yield a second-best equilibrium in light of the court's inability to directly verify the truth. The nonperforming defendants invest nothing in litigation and are found liable, and the performing defendants spend until their private marginal benefit of investment (in reducing their expected liability) equals the marginal cost of additional evidence. Despite judicial pronouncements to the contrary, courts often do draw inferences in civil cases from the failure of a party to present evidence that might exonerate them. This separation ameliorates the concern with excessive litigation cost.

Second, if parties can reduce their evidentiary costs by performing their contractual obligations, this saving may have an ex ante incentive effect by inducing performance.³⁰ Therefore, contracting parties may wish to contract over factors that might entail prospectively high litigation cost, if there is a very significant discrepancy between the evidentiary cost that would be incurred by the performing party (who would tell the truth at trial) and that of the nonperforming party (who would lie). The adversary's evidentiary costs, in contrast, have no beneficial effect on performance incentives other than by raising the likelihood of a finding of liability.³¹ Nevertheless, as before, our point is simply to suggest that the focus on verification costs alone is far too simplistic to explain contract design.

Finally, the parties themselves may further reduce litigation costs by consent. They can do so narrowly, by stipulating facts or agreeing to limited discovery, or, more broadly, by settling the case altogether. Indeed, the prospect of settlement provides another illustration of

²⁹Litigation effort by an innocent defendant should be more effective than equal expenditure by the guilty, suggesting that the innocent defendant would spend more effort in her defense. "If this were not the case, litigation would serve no purpose, since it would not enable the court to distinguish more accurately the innocent from the guilty." Daniel L. Rubinfeld and David E.M. Sappington, *Efficient Awards and Standards of Proof in Judicial Proceedings*, 18 Rand J. Econ. 308 (1987).

³⁰An agent's "evidentiary expenditures are part of her effective litigation penalty as much as any payments she must make to her opponent by virtue of verdict and remedy." Sanchirico, *Harnessing Adversarial Process*, supra note –, at 11.

³¹Id.

how the concern with verification costs is misleading. Settlement is more likely, all other things equal, the higher the anticipated litigation costs. For any given difference in the parties' expectation regarding the likely judgment, the likelihood of settlement increases with the expected aggregate cost of trial.³²

2. Judicial Error and the Underinvestment Problem.

Perhaps the verifiability concern rests more on the risk of legal error rather than cost of enforcement. Legal error may affect either the court's assessment of the actions of the defendant or the standard to which the defendant is to be held. We defer the latter context to our discussion of contractual standards. Consider Oliver Hart's first example of nonverifiability—the monetary investment of an agent. Suppose that the agent's share of profits from the venture and his reputational concerns are such that his self-interested strategy would be to invest \$30, which the parties know will be suboptimal. They agree, therefore, to a clause requiring the agent to invest \$60 and impose a penalty if the agent fails to do so. Yet, the actual investment of the agent is not verifiable: the court observes only a noisy signal of the agent's investment and therefore may assess it incorrectly. Under these conditions, the literature on legal error and uncertainty in judicial outcomes suggests that the impact on the agent's investment depends on context-specific variables. If the agent's choice is binary (she can invest either \$30 or \$60), then the risk of error will undermine incentives by raising the possibilities that an agent investing \$60 may nevertheless be found liable (Type I error) and that an agent investing \$30 may not (Type II error). If instead the agent has a range of decision points, then the effect on incentives depends

³²As Shavell observes, “a mutually beneficial settlement exists as long as the plaintiff's estimate of the expected judgment does not exceed the defendant's estimate by more than the sum of their costs of trial.” He also states that “[t]he larger are the legal expenses of either party, the greater are the chances of settlement, clearly, since the sum of legal costs will rise, and thus the greater will be the likelihood that the sum of legal costs will exceed any excess of the plaintiff's expectation over the defendant's expectation. One would expect legal expenses to rise with the size of the potential judgment.” SHAVELL, *supra* note –, at 403, 406. See Albert Choi & George G. Triantis, *Contractual Choice Between Arbitration and Litigation* (mimeo 2004). Although outside the scope of this paper, we would expect that the terms of a contract would differ depending on whether the parties anticipated that disputes would be resolved by litigation or by settlement. Settlement and litigation outcomes are likely to differ, leading to divergent incentives when the contract terms are not adjusted. Albert Choi and George Triantis, *The Effect of Settlement on Contract Design* (mimeo 2005). Shavell speculates that settlement increases deterrence by raising the likelihood of plaintiffs bringing suit. SHAVELL, FOUNDATIONS, *supra* note –, at 412.

on the distribution of error.³³ The risk of inaccurate assessment may ameliorate the degree of underinvestment in effort (a good thing) or it may overshoot and cause excessive effort (which may be either a good or a bad thing relative to the agent's contractual incentives in the absence of the contract term requiring additional effort).

The court knows that the required investment is \$60 and that the agent would invest \$30 in the absence of the investment clause in the contract. The parties do not have sufficient incentive, however, to produce evidence that leads the court to pinpoint the agent's effort in fact (e.g. because the marginal cost of evidence rises steeply beyond some point). This risk of legal error creates a wedge between the social and private return from effort above \$30: the social return in this case is the value created within the venture and the private return is the reduction in the agent's expected liability to pay the penalty (due to the lower probability of being found liable). Unless the court declines to adjudicate the dispute, it will arrive at an assessment of the agent's investment. At the time the agent makes his investment decision, however, the court's determination is a probability distribution. If the court is extremely uninformed, the distribution may be uniform across effort levels regardless of the actual effort expended. The agent would then enjoy no private return (in the way of lower expected liability) from increasing investment and it will remain at \$30. If, however, the distribution is normal and peaks at the agent's actual level, then the agent would reduce its expected liability by moving from \$30 to \$60. In fact, Craswell and Calfee demonstrate that where the variance is sufficiently low, the agent may overinvest in order to further reduce its expected liability.³⁴ For example, by expending \$70 or even \$61, the agent may achieve a safety margin that reduces its expected liability by an amount that justifies the incremental investment. Although this may be privately profitable for the agent, it would not be jointly optimal: the extra investment is not justified by the increase in the

³³Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J. L. Econ. & Org. 279 (1986); Shavell (1987).

³⁴Where the variance is especially high, underdeterrence is more likely. In the extreme case, the actor's expected liability is unaffected by his investment choice. Craswell & Calfee, *supra* note —. A standard of proof threshold is unlikely to mitigate this result because it does not help the court discriminate between complying and noncomplying agents.

contracting surplus, only by the expected reduction in the agent's liability. Thus, the clause requiring the agent to invest \$60 might correct the incentive of the seller to underinvest, but it might also overshoot its target and lead to overinvestment. Some overinvestment may nevertheless yield a reduction in efficiency losses compared to the underinvestment that would occur in the absence of the investment clause. This improvement may justify the clause, despite the uncertain enforcement.³⁵

To be sure, a complete analysis of the effect of fact finding error needs to incorporate the incentive of the principal to bring suit against the agent. In light of the fact that litigation parties bear their own costs, legal error can induce the principal to bring suit against a complying agent or to hesitate to bring suit against a noncomplying agent. Thus, accuracy can improve the selection of cases initiated against agents.³⁶ For similar reasons, it can also improve the parties' incentives to invest in the litigation once it has started. Nevertheless, this brief review of the risk of judicial inaccuracy in determining liability under a non-verifiable term suggests that the feedback effects on the parties investment incentives will be contract-specific. At least in the case where information is observable but not verifiable, there is no good reason to believe that parties will always or even often decline to contract because of the risk of inaccurate judicial assessment of liability. While much more work remains to specify fully the parameters of a

³⁵This is Gillian Hadfield's important contribution in Hadfield, *supra* note -- at --. Moreover, she demonstrates that the agent's cost of effort acts as a brake against the incentive to reduce expected liability by investing more effort: to raise effort, the expected liability reduction must exceed the cost of the incremental effort. *Id.* at --.

³⁶Polinsky and Shavell demonstrate that plaintiffs are discouraged by the prospect that guilty defendants will not be held liable (false negatives) and encouraged by the chance that even an innocent defendant may be found liable (false positives). But if the principal cannot discern the actual effort level, the effect of legal error on the incentive to sue and, correspondingly, on the effort of the agent, is ambivalent. Mitchell A. Polinsky & Steven Shavell, *Legal Error, Litigation and the Incentive to Obey the Law*, 5 *J. L. Econ. & Org.* 99 (1989). In addition, as Kaplow has emphasized, the defendant's ability to predict the court's determination (or the plaintiff's decision to sue) is highly significant. The accuracy of the court, or the distribution of outcomes, affects the incentives of the agent only to the extent that they determine the subjective distribution contemplated by the agent at the time he makes his effort decision. At the extreme, of course, his incentives are unaffected by a contract term requiring efforts if he believes that his true effort is hidden from the court in the sense of appearing as a flat distribution of liability across effort levels. Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 *J. Legal Stud.* 307 (1994)(discussing incentives to acquire information); Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 *J. Law, Econ. & Organ.* 150 (1995);

reformulated verifiability postulate, our preliminary analysis suggests that, standing alone, inaccuracy or nonverifiability do not raise general barriers to contracting.

B. Verification and Vague Terms

In the previous section, we raised doubts as to the scope of the verifiability obstacle to contracting in light of the fact that courts control litigation costs and their errors need not undermine contract incentives. Our criticism of the verifiability approach is even stronger in the case of vague terms. Recall that Oliver Hart's description of verifiability illustrates the coarseness of the verifiability concept: it encompasses a full range of specific and vague terms. One of Hart's examples of a nonverifiable term was payment conditioned on the quality of a book. As a general matter, the concern with verifiability has led to a substantial scholarly critique of vague terms, such as provisions that refer to effort or to reasonableness. Yet, the fact that parties may wish to avoid excessive litigation cost or uncertainty in enforcing nonverifiable terms does not mean that they will eschew vague terms as well. Indeed, we can be fairly sure that vague terms do not categorically lead to excessive cost and, as we describe in Part II, the uncertainty in their enforcement may in fact improve contract incentives.

Charles Goetz and Robert Scott first proposed that an informed court should interpret vague terms or gaps in contracts with decisions that provide incentives for the parties to maximize their joint wealth.³⁷ Thus, for example, a court should excuse performance in those cases in which performance is inefficient and the promisee can better bear the relevant risk.³⁸ The concern with verifiability, however, has led more recent scholarship to argue for a restrained judicial approach: the courts should refrain from such intervention when they cannot

³⁷Charles G. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089 (1981); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. Legal Stud. 597 (1990).

³⁸Richard A. Posner and Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83 (1977).

verify the existence of the state for which excuse is the efficient outcome.³⁹ A similar tension exists with respect to the provision of standards of performance. Economists postulate that parties to an agency contract do not condition payment on effort because effort is nonverifiable.⁴⁰ Although Goetz and Scott urge informed courts to interpret “best efforts” clauses to require the level of effort that maximizes the joint welfare of the parties,⁴¹ other authors have suggested that parties are unlikely to agree to a best efforts provision and that, if they do, courts would decline to give the terms substantive content. Thus, for example, Alan Schwartz has predicted that courts would decline to apply best efforts provisions when the relevant facts are nonverifiable.⁴² In a sample of cases where the best efforts obligation had been directly litigated, he found, consistent with his prediction, that the courts interpreted best efforts obligations to generally permit a distributor “to supply any quantity of efforts greater than zero.”⁴³ In short, the conventional economic wisdom is that courts prefer to treat such vague terms as mere precatory statements rather than as contract terms that violate the verifiability postulate.

Despite the claims of contract theorists, however, contracts regularly contain vague terms such as best efforts.⁴⁴ In fact, courts have a much more nuanced approach to the enforcement of best efforts clauses than suggested by Schwartz. Commercial contracts regularly invoke factors that economists label as nonverifiable, including “best efforts,” “reasonable expenses,” and

³⁹Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. Legal Stud. 271 (1992); Robert E. Scott, *The Case for Formalism in Relational Contracts*, 94 Nw. U. L. Rev. 847 (2000).

⁴⁰E.g., B. SELANIE, *THE ECONOMICS OF CONTRACTS* ch. 7 (1999)

⁴¹Goetz & Scott, *supra* note – at –.

⁴²Id. at 282.

⁴³Id. at 302. “[C]ourts passively permit the [distributor] to provide whatever quantity she deems best.” Id. at 304.

⁴⁴See George G. Triantis, *The Efficiency of Vague Contract Terms: A Response to the Schwartz-Scott Theory of UCC Article 2*, 62 La. L. Rev. 1066, 1067 (2002).

“reasonable withholding of consent.”⁴⁵ Not only are explicit best efforts obligations common, they are also the subject of extended negotiations, including negotiation over seemingly minor linguistic variations. For example, best efforts can be replaced by “commercially reasonable efforts,” “reasonable efforts” or “reasonable best efforts.”⁴⁶ While some courts interpret best efforts as the equivalent of good faith, others impose a higher standard of reasonable diligence and some even require the level of effort that would be exerted by a similarly situated integrated firm.⁴⁷

In sum, economists rely excessively on the crude concept of verifiability to explain contract design. The implications of the litigation process on contract design are far more subtle, however, than what is captured by the nonverifiability postulate. The general and valuable lesson of the contract theory approach is that the anticipated path of enforcement, through litigation or otherwise, is very important to understanding contracts. Parties are motivated to contract for the optimal amount of accuracy. Thus, they structure their contract so as to improve the efficiency of prospective litigation and to avoid excessive error in fact finding.⁴⁸ In the next two Parts, we explore the contractual choice between specific and vague terms (or, to use more familiar terms, rules and standards) and the steps that parties take to determine burdens of proof in the litigation of contract disputes.

⁴⁵ See franchise and distribution contracts cited in notes —, —, — infra; See also, University of Missouri-Columbia, Contracting and Organizations Research Institute, *CORI Contracts Library*, at <http://cori.missouri.edu> (last visited Feb. 25, 2005) (Total contracts in CORI database: 24,965. Contracts with "best efforts" terms: 4,328 (17.34%); Contracts with "reasonable expenses" terms: 2,584 (10.35%); contracts with "reasonably withheld" terms: 38 (0.0015%); contracts with "unreasonably withheld" terms: 3,525 (14.12%); contracts with "reasonable" terms: 13,281 (53.20%).

⁴⁶ Kenneth A. Adams, *Understanding “Best Efforts” and Its Variants (Including Drafting Recommendations)*, 50 *Prac. Law.* 11 (2004) (reviewing contracts of public companies filed with the SEC and finding “best efforts” used 627 times, “commercially reasonable efforts” used 425 times, “reasonable best efforts” used 345 times and “reasonable efforts” used 307 times). See also the Taco Bell contract discussed at TAN infra.

⁴⁷ See Adams, *supra* note — at —.

⁴⁸ Hadfield, *supra* note —, at 162 (parties can anticipate and adjust for legal errors in their initial contract, and the concern with legal error should also guide gap filling).

II. THE CHOICE BETWEEN RULES AND STANDARDS IN CONTRACTS

In Part I, we argued that the verifiability concern is based on a simplistic characterization of the litigation process and, as a consequence, it inaccurately explains contracting behavior. Verification costs are not predictable, nor is their effect on the efficiency of contract terms. The other verifiability concern, inaccuracy in fact finding, also requires much closer analysis than allowed by a categorical approach. We suggest a reframing of important elements of the contracting decision in terms of the choice between standards (or vague terms) and rules (or precise terms). In this Part, we explore how parties choose their mix of rules and standards to optimize the selection of efficient evidentiary proxies over two dimensions: *when* the choice of proxy is made and *who* makes the choice. We describe the way that the parties define the domain or the “space” within which the court selects proxies at litigation. A rule-like term defines a very narrow space – at the limit, a single proxy. A standard offers a broader space. Contracts that combine rules with a standard offer additional flexibility in setting boundaries for the court’s discretion.

A. Efficient Proxies and Efficient Choosers: Rules or Standards in Contracts

1. The Evidentiary Role of Proxies.

Contracts essentially provide for pairs of contingencies and performance obligations— for example, when X occurs, the promisor must pay \$Y. The parties might define X at any of three levels.⁴⁹ First, X might be the production of a specific bit of evidence, such as a signed document or testimony by a specific witness. Second, X may be a rule: a relatively specific event, such as the delivery of a widget with a specified weight. In this category, the parties delegate to the court the determination of which bits of evidence are sufficient to satisfy X and trigger the promisor’s payment obligation. Third, X may be a standard, such as the delivery of a widget in excellent or merchantable condition. In this category, the court must determine not only what evidence is sufficient to establish the weight of the widget but also the degree to

⁴⁹See Sanchirico and Triantis, *Evidence Arbitrage*, supra note –.

which the weight is relevant in the determination of whether the standard has been met. For convenience, we refer to this latter determination as the choice of proxy for the standard. The second and third category differ in the manner in which the proxy is chosen. The parties may either choose the proxy directly by a rule in their contract or delegate the choice to the court by a contractual standard. In either case, the court determines whether the relevant proxies have been satisfied by screening bits of evidence presented by the parties.⁵⁰

As an example of a court-selected proxy, consider the familiar contracts case of *Bloor v. Falstaff Brewing Corp.*⁵¹ Falstaff purchased most of the distribution network and related assets of a brewer named Ballantine. Part of the compensation consisted of royalty payments of \$.50 per barrel of beer sold during the six years following the sale. The parties designed this component of the sale price to reflect the value of the Ballantine distribution assets to Falstaff.⁵² However, the royalty threatened to induce sub-optimal effort by Falstaff by effectively taxing the marginal product from sales of beer.⁵³ To deal with this problem of underinvestment, the parties included a provision requiring Falstaff to “use its best efforts to promote and maintain a high volume of sales.”⁵⁴ When the seller sued and claimed that Falstaff had breached its best efforts obligation, the trial judge faced the dual task of verifying whether the defendant had breached and determining the appropriate measure of damages. Judge Brieant chose a market proxy as a prima facie measure of best efforts performance: the sales of two integrated firms (Rheingold and Schaefer) that both produced and distributed the same product and that were roughly

⁵⁰Admittedly, this analysis somewhat oversimplifies for the purpose of exposition the distinction between contingencies and proxies because even the narrowest proxies can be further broken down into evidentiary units. Thus, the distinction between the two approaches (standards and rules) may more appropriately be viewed as one of degree.

⁵¹454 F. Supp. 258 (S.D.N.Y.1978) aff'd 601 F.2d 609 (2d Cir. 1979) (Friendly, J.).

⁵²For discussion, see Victor P. Goldberg, *In Search of Best Efforts: Reinterpreting Bloor v. Falstaff*, 44 St. Louis U. L. J. 1465 (2000).

⁵³Goetz & Scott, *Relational Contracts*, supra note – at 1108-1119.

⁵⁴454 F. Supp. at —.

comparable in size and locale to the contract product.⁵⁵ The integrated firms provided an appropriate benchmark for efficient best efforts because they did not suffer from the skewed incentives of sharing revenues with separate organizations and because the relevant sales data was readily available.

Commercial contracts routinely include such benchmarks in their contracts.⁵⁶ Franchisors promote sales efforts by their franchisees by requiring them to maintain sales volume comparable to other similarly situated franchisees or franchisor-owned outlets. These proxies are readily established by evidence.⁵⁷ Verifiability does not distinguish between such rules and best efforts standards. The comparison of the *Bloor* case and this common franchise contract underscores our fundamental contrast: the significant difference lies in the identity of the chooser and the timing of the choice.

2. The Determinants of Efficient Proxies.

We now examine how contracting parties would choose between contracting directly on proxies and delegating the choice of proxies to the court. It is helpful to first set out the characteristics of efficient proxies. The best proxies minimize two factors: the noise in the signal they provide for the occurrence of the contingency and the cost of verifying the proxy. The noise in the signal (yielding false positives and false negatives) is relevant because it influences the incentive effect of anticipated enforcement; the noisier the signal, the less it motivates the agent.⁵⁸ For example, where a given performance is desired from the promisor, the incentive bang of a proxy is created by the difference between the probability that the evidentiary outcome emerges following performance less the probability that it emerges following non-performance.

⁵⁵Id. at 277-81. Goetz & Scott, *Relational Contracts*, supra note – at 1122-23.

⁵⁶Adams, supra note – at —.

⁵⁷See examples TAN infra.

⁵⁸Proxies may be combined conjunctively (the promisor breaches if A and B are established) or disjunctively (if A or B are established). The addition of proxy B addresses the problems of false positives in the first case, and false negatives in the second.

All things equal, the parties would want this difference to be large. However, they also do not want to enter into an agreement that raises large expected litigation costs. Thus, the best proxy maximizes the incentive bang for the litigation buck.⁵⁹

In estimating future evidentiary costs, the parties must anticipate their joint litigation strategies. Viewed at the time of the initial contract, the prospective litigation game defines the enforcement threat that forms contract incentives. From this ex ante perspective, efficient investment in litigation takes place as long as the marginal cost of additional evidence does not exceed the marginal gain from the resulting improvement in contract incentives. This ex ante optimum may stop short of what would be necessary to achieve truth-finding objectives.⁶⁰ Moreover, viewed at the time of litigation, the parties are engaged in rent seeking: They make socially wasteful investments to secure a more favorable division of the spoils of an aborted contract. Even with the constraints identified above in Part I(C)(1), the parties may nevertheless overinvest in litigation (compared to the ex ante optimum). Therefore, they may wish to further waive or constrain their procedural rights in litigation in their ex ante contract or to design substantive provisions so as to minimize the risk of overinvestment. The concern with overinvestment, however, does not preordain whether the proxy is more efficiently chosen by the parties ex ante or the court ex post.

Specific terms (“rules”) set proxies at the time of the contract. Vague terms (“standards”) delegate the choice of proxies to the court. As noted in the introduction, the choice between liquidated damages (a rule) and expectation damages (a standard) provides a familiar

⁵⁹Sanchirico and Triantis formalize the notion of incentive bang for expected litigation buck in Sanchirico and Triantis, *supra* note –, at –.

⁶⁰This is an extension of Gary Becker’s famous insight about optimal fines and enforcement. Where the information of the parties is observable, the focus is on the resources spent at trial and the likelihood of enforcement error due to inaccuracy. The key factor remains, as in Becker, the marginal effect of liability on performance. This may explain why courts are instructed to ignore information that would be valuable to truth-finding, but that is not affected by performance. Examples are background statistics or character evidence. The litigation process leads to better ex ante incentives by only looking at evidence that varies with the parties’ decisions and/or actions. Claude Fluet, *Enforcing Contracts: Should Courts Seek the Truth*, 159 J. Inst. Theor. Econ. 49-64 (2003) (courts should start with neutral priors even if this compromises the likelihood that the court will find the truth).

illustration. To be sure, a court does not design proxies on its own initiative. Rather, it chooses from alternative proxies presented by the parties at litigation. Although there are factual bases for choosing among proxies, the selection is generally regarded as a question of law for the judge. In some cases, the proxy choice becomes fixed as a legal default rule. This is the case with expectation damages, for example, where market damages are regarded as the default mechanism for establishing the promisor's contractual expectancy in the case of goods or services traded in established markets.⁶¹ But in any event, the judge cannot simply leave the standard to be specified by the jury without identifying appropriate proxies. Thus, for example, in *Empire Gas Corp. v. American Bakeries Co.*,⁶² Judge Posner ruled that the trial judge had failed to give appropriate instructions to the jury when he did not specify what evidence would support a finding of bad faith, a widely used standard.⁶³

The best information as to proxy choice is held by the parties themselves after the resolution of uncertainty. At that time, however, unless the parties renegotiate they will have divergent private interests in the choice of proxies. In selecting a chooser, therefore, there are only two realistic contracting options: the choice of proxies will be made either at the time of the contract by the parties who enjoy private information, or after the resolution of uncertainty by the courts who enjoy the benefit of hindsight. The superior decision maker is a function of the relative incentives and information of the parties and courts; rarely are either the parties or the court ideally situated. Barring significant asymmetries in sophistication and information, the parties should have superior incentives at the time of contracting; after all, they share in the benefits of efficient contracting. A court presumably has no bias in favor of one party over another in a dispute, but it also does not have much of a stake in the efficient *ex ante* outcome. As noted earlier, the court may have incentives to contain litigation costs, but its *ex post*

⁶¹See e.g., UCC §§ 2-703(d),(e), 2-706, 2-708(1) (seller's market damages), and §§ 2-711(a),(b), 2-712, 2-713 (buyer's market damages).

⁶² 840 F.2d 1333 (1988).

⁶³ "It is not true that the law is what a jury might make out of [the obligation of good faith]. The law is the [obligation of good faith] as interpreted. The duty of interpretation is the judge's. Having interpreted the [obligation of good faith] he must then convey [its] meaning, as interpreted, in words the jury can understand." *Id.* at 1336.

perspective is likely to weigh litigation costs against accuracy in fact finding, rather than against ex ante efficiency.

The comparison of informational advantages is a closer call. At any given time, the parties have information superior to that which they can communicate to the court. Yet, as we have seen, the selection of the proxy-chooser is between the parties at the time of the contract and the court at the later time of litigation. The court, therefore, has the benefit of hindsight. Uncertainty has been resolved and the court sees realized facts rather than probability distributions.⁶⁴ Contract theory has long acknowledged the constraints on contract completeness imposed by bounded rationality. The parties cannot foresee all contingencies. They are aware, however, of the consequent incompleteness of their contract and may, therefore, delegate to the court the task of completing the contract ex post with a proxy. They indicate this intention by adopting a vague contract term. In fact, as we discuss in the next section, the vague term is often combined with specific terms that provide guidance to the court.

Bounded rationality applies as well to the description of performance obligations. The fit, or conversely the noise, of performance proxies and their verification costs may depend on the exogenous state of the world that materializes in fact. Theoretically, the parties might, therefore, provide for state-contingent performance proxies (e.g., if state A materializes, then the promisor is obligated to deliver B). However, the parties to such a contract would need to choose ex ante the efficient proxies for each possible future state. Instead, the parties might delegate to the court the choice of a single proxy particularly suited to the realized state of the world. Or, the contract may adopt a blended strategy by providing for a specific proxy and delegating to the court the choice of a replacement if the specific proxy should fail.

⁶⁴This tradeoff is not new to legal scholarship. Louis Kaplow described this tradeoff in his analysis of rules and standards in regulation: rules increase costs of promulgation but reduce costs of enforcement. The cost-effectiveness of rules is limited when the circumstances under which the regulated behavior occurs are heterogeneous. In these cases, ex post determinations are more efficient. Kaplow, *Rules versus Standards*, supra note –.

The case of *Eastern Air Lines v. Gulf Oil Corp.*⁶⁵ provides an instructive example. The parties entered into a long term contract for the sale of jet fuel at designated locations. They wished to set a price for the jet fuel in order to allocate the risk of exogenous changes in the input price of crude oil to Eastern Airlines and the risk of fluctuations in production cost to Gulf. They selected a contract proxy that adjusted the contract price according to an easily verifiable indicator of crude oil price--West Texas Sour crude “as listed...in Platts Oilgram Service.”⁶⁶ Subsequently, as a result of governmental regulation following the oil crisis in the 1970s, this proxy failed. The court declined to choose a substitute proxy. The parties might instead simply have stated explicitly in the contract that the price either would be adjusted to the price of crude oil (a standard) or that it would be tied to Platt’s or “any other appropriate index.” As we discuss in the next section, the inclusion of such a standard should be a necessary invitation to the court to choose a new proxy.

The classic contrast to the conservative approach of the court in *Eastern Air Lines* is the decision in *Aluminum Co. of America v. Essex Group, Inc.*,⁶⁷ where the court reformed the parties’ price adjustment proxy in the absence of an explicit delegation by the parties. The usual critique of this opinion is not that parties would never choose to delegate proxy choice to the courts, but rather that there was no evidence in the contract or otherwise of the parties’ intention to do so. Indeed, the fact that they had invested a great deal of resources up front to provide a specific proxy might have been evidence to the contrary. *Alcoa* is also unique because the contract reformation was the court’s initiative, in that neither party suggested a proxy even at the time of trial. One party asked for enforcement, the other argued that performance was excused.⁶⁸

⁶⁵ 415 F. Supp. 429 (1975).

⁶⁶ Id. at —. For discussion, see ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 864-69 (Rev. 3d ed. 2002).

⁶⁷ 499 F. Supp. 53 (1980).

⁶⁸ See SCOTT & KRAUS, *supra* note — at 830-33, 864-67.

In sum, the parties will choose a specific proxy when the parties' private information is more important than the effect of contingencies on the choice of proxy. When the efficient proxies are highly state-contingent and less dependent on private information of the parties, the parties will be more inclined to use standards to delegate proxy choice to the courts.

3. The Benefits and Costs of Uncertainty in the Enforcement of Standards.

Much has been made in contracts scholarship about the detrimental effect of the uncertainty of judicial interpretation of standards. In Part I, we reviewed scholarship suggesting that the risk of error in fact finding need not undermine incentives for performance. In this section, we are concerned with uncertainty in the application of a standard, particularly in the choice of proxies. The analysis and insights are similar. In fact, the classic work by Craswell and Calfee concerns the application of a (unidimensional) standard for effort. The authors demonstrate that the effect of uncertainty on deterrence is context-dependent.⁶⁹ Proxy selection is somewhat different because of its multidimensional character, and it is important to bear in mind the pertinent comparison. Suppose that the court has superior information at the time of trial but there is uncertainty as to which proxy it will choose between two alternatives: for example, the relevance of weight and of color to the merchantability of a widget. Given the court's superior information, we can presume that in some cases one or both of the proxies are less noisy under the circumstances than the one that the parties would pick *ex ante*. Therefore, even when discounted by the relevant probabilities of judicial choice, either alternative would improve performance incentives over a certain but inferior (e.g. more noisy) specific contract proxy.⁷⁰

A further virtue of delegating the proxy choice to the court via a vague standard is that the uncertainty as to which proxy will be selected might help to reduce the incentives of promisors to game specific rules once an adverse risk has materialized (a problem familiar to the

⁶⁹ See Craswell & Calfee, *supra* note — at —.

⁷⁰ See Hadfield, *supra* note —.

design of tax rules).⁷¹ Vague terms tend to be used when the performance in question is multi-dimensional, such as effort. In this type of case, compare the incentives of an agent faced with a specific proxy for effort (in the form of a contract rule) and another agent whose behavior is governed by a standard of effort. The first agent has the incentive to direct her attention to satisfying the proxy alone and ignore all other dimensions of the desired performance.⁷² When faced with a standard, the agent has many proxies that might bear probabilistically on litigation outcomes. Its optimal strategy may therefore be to focus on effort rather than any single proxy, and thereby improve its position vis-a-vis all proxies.

Consider the following example offered by Canice Pendergast:

[i]t is difficult to imagine an occupation for which there are more measures of performance [than baseball]. Despite this, it is not common for players to have contracts where pay is directly related to *specific* performance measures. Part of the reason for this is that teams are reluctant to offer a contract that rewards a player for home runs, say, because the player may have an incentive to hit home runs even when it is not in the interest of the team for him to do so. By contrast, the more common cases where players are offered explicit bonuses are for *aggregate* measures of performance, such as making the All Star Team or being the league's Most Valuable Player. Since these are more holistic measures of performance, they suffer less from the multi-tasking dilemma.⁷³

The parties to such a contract are using a standard in order to delegate to a third party the evaluation of the player's performance. Part of the motivation is the challenge of specifying all

⁷¹George G. Triantis, *The Efficiency of Vague Contract Terms: A Response to the Schwartz-Scott Theory of UCC Article 2*, 62 La. L. Rev. 1066 (2002); David Weisbach, *An Efficiency Analysis of Line Drawing in Tax Law*, 29 J. Legal Stud. 71 (2000).

⁷²This is a version of the well-known agency problem of multi-tasking. Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership and Job Design*, 7 J. L. Econ. & Org. 24 (1991); George Baker, *Incentive Contracts and Performance Measurement*, 100 J. Pol. Econ. 598 (1992).

⁷³Canice Pendergast, *The Provision of Incentives in Firms*, 37 J. Econ. Lit. 7, 22 (Mar. 1999) (italics in original).

the relevant facets of a player's contribution to his team. But as discussed in the excerpt above, a distinct difficulty is the problem of specifying the desirable state-contingent proxies as they differ among possible future states of the world. Hitting or fielding may be relatively more important depending on the course of the season. A retrospective determination of performance can economize on having to specify state-contingent performance measures and compensate for the parties' bounded rationality. Of course, the baseball contract contemplated above delegates the proxy choice to experts in the industry. If experts are not available, however, one can imagine that even a delegation to a court may be superior to the parties' attempting to list the relevant proxies *ex ante*. Moreover, the quotation also suggests that aggregate measures mitigate multi-tasking problems. Our argument is that vague standards can achieve the same effect probabilistically, as long as the individual proxies are correlated with the desired performance.

A similar, more cynical, argument may be made about the agent's incentives under a specific proxy.⁷⁴ As an alternative to performance, an agent has the option to invest in persuading the court that she has satisfied a specific proxy. For example, she may tamper with a testing mechanism or misrepresent accounting results.⁷⁵ In light of opportunities to manipulate or "manage" evidence, contractual sanctions for nonperformance might increase the incentives to perform, but they may also raise the payoffs from investing in evidence management. Where the cost of successfully fabricating evidence is lower than the cost of performance, the agent has the incentive to invest in socially wasteful evidence management rather than in performance. On the other hand, if the proxy is uncertain because it is within the discretion of a future court, the uncertainty discourages evidence management by blurring the target. The agent must discount the benefit from evidence investment with respect to any given proxy by the probability that the court will choose that proxy. As a result, the expected benefit from evidence management with respect to that proxy is lower under a standard than a rule. Thus, within some margin, the agent

⁷⁴Triantis, *Efficiency of Vague Terms*, *supra* note –, at 1076-8.

⁷⁵Other examples of evidence manipulation are the creation of records or the sponsoring of research that will support future expert testimony. It might also entail the destruction of prejudicial evidence that the other party might find on discovery. *Id.* An alternative strategy might be to not perform and invest in evidence persuading the court to give weight to a more rather than less favorable proxy.

may be better off simply performing, given that performance is correlated with all the possible proxies. Given that evidence management is socially unproductive, the parties have a joint interest at the time of contracting to deter this activity.⁷⁶

B. Rules-Standards Combinations and the Role of Maxims of Interpretation

1. The Conventional Wisdom Reframed.

The choice between party-selected proxies (rules) and court-selected proxies (standards) is not an exclusive choice based on relative informational advantages.⁷⁷ The parties can, and regularly do, include both types in their contract. The combination of vague and specific terms is widely used in commercial contracting. The conventional explanation is that the vague terms act as “catch-alls” that compensate for the under-inclusiveness of specific terms. Yet, this raises the question of why parties do not simply agree to a broad standard alone (the catch-all without the specific terms) that invites the court to choose the proxies invoked by the contract rules. We reframe this explanation in terms of the efficient delegation of proxy choice. The parties may choose to give the court a defined space within which to select proxies, but specify other proxies in contract rules. In subsequent sections, we argue that the combination of rules and standards also serves to guide the court’s future interpretation of the standard itself, as well as the accompanying rules.

Loan agreements provide a useful example. The lender is entitled to accelerate the

⁷⁶Cf., Sanchirico and Triantis, *Evidence Arbitrage*, supra note –, at --. (describing conditions under which the prospect of fabrication might improve contract incentives).

⁷⁷While the discussion below concentrates principally on the efficiency of a mixed strategy, using combinations of rules and standards, it is conceivable that parties may elect either polar alternative of 100% standards or 100% rules. In the first case, a contract with only a vague standard risks being found unenforceable on the grounds of indefiniteness. See, e.g., *Kraftco Corp. V. Kolbus*, 274 N.E. 2d 153, 156, (Ill. App. Ct. 1971). In such a case, the parties are likely motivating self-enforcement by using deliberately indefinite terms to harness norms of reciprocity. See Robert E. Scott, *A Theory of Self-Enforcing Indefinite Contracts*, 103 Colum. L. Rev. 1641 (2003). On the other hand, assume that parties want to craft a contract consisting of 100% rules and wish those rules to be applied strictly with no attention to any contractual purpose. In theory, parties should be permitted to instruct the courts to interpret these specific requirements literally and not in terms of a more general contractual purpose. The absence of any vague standards thus may signal a preference for literal interpretation of specific contractual terms. See TAN–infra.

maturity of the loan and enforce collection of the principal and accrued interest upon an event of default. Failure to make a scheduled payment is an event of default, but so are the violations of covenants such as the debtor's promise to maintain insurance on important assets or to refrain from issuing future secured debt. In addition, many agreements provide that the lender may accelerate if it deems itself insecure or believes in good faith that the prospect of repayment is impaired.⁷⁸ The parties thus find it desirable to list specific proxies for inefficient debtor behavior but, being boundedly rational, they cannot list all. So, they agree to a vague good faith standard that would catch the residual behavior not covered by the specific covenants. Why then do the parties not cover all suspect behavior with the insecurity standard alone? After all, the specific concerns of the failure to insure or the issuance of more debt fall within the scope of events that would impair the prospect of repayment. The reason is that the parties wish to contain the proxy-choosing discretion of the court.

In this insecurity standard (as well as elsewhere in commercial law), "good faith" is interpreted by the law as meaning honesty in fact and the observance of reasonable commercial standards of fair dealing.⁷⁹ An economist concerned with verifiability might observe, therefore, that a lender's good faith belief that the prospect of repayment is impaired is not verifiable. We have shown, however, that this misconceives the parties' intentions. In enforcing this vague term, the court will choose proxies that invoke verifiable factors. The conventional explanation for the combination of specific and vague terms in loan agreements might, therefore, be restated as follows. The parties choose specific proxies whose appropriateness is (a) not significantly context dependent and (b) not a determination that benefits from the ex post information advantage of a court. Conversely, the parties agree to a standard when they wish to harness the benefit of a court's hindsight and to address the risk that the debtor will game specific events of default. The parties combine their description of the standard with specific rules so as to define the constraints or space within which the court can choose proxies ex post. Their motivation in

⁷⁸Uniform Commercial Code §1-309 imposes the requirement that the lender must believe in good faith that the prospect of payment is impaired, and this is often explicitly incorporated in loan agreements.

⁷⁹ See UCC §1-201(20); §2-103(1)(b) (2004).

doing so is to police opportunism by the lender in triggering default for ulterior purposes.

Parties thus delegate proxy choice to the courts through the language of the standard and its combination with the specific rules in the contract. Where parties do not include a standard in combination with specific rules, a contract may contain a genuine gap between the specific rules. It is tempting to argue that the existence of such a contractual gap is an implied delegation justifying contract law in supplying default standards such as best efforts or commercial reasonableness. Apart from the question of whether such a gap exists, however, the case for filling gaps with vague defaults is weak.⁸⁰ Parties adopt standards with superior knowledge of the context of their contractual relationship, and, as we have seen, generally in combination with specific contractual rules. Moreover, when standards are appropriate, the parties can always include them in their contract at relatively low cost. The courts, therefore, are wise to interpret the absence of vague standards in particular cases as instructions from the parties to abstain from proxy choice and to limit their construction to the specific terms of the contract.

2. The Function of Rules-Standards Combinations.

The preceding section argued that the combination of vague and specific terms allows the parties to tailor the delegation of proxy choice in order to exploit the information advantages of both the court and the parties. In this section, we explore in more detail the precise function of different rules-standards combinations.

Casual empiricism suggests that rules-standards combinations are ubiquitous in commercial contracts and, in each case, they define the discretion delegated to the court. Force majeure clauses, for example, typically provide that performance is excused in the event of

⁸⁰This conforms with the interpretative maxim of *expressio unis* discussed in the next section. TAN *infra* note –. For a sampling of the arguments for judicial restraint in filling gaps with vague defaults, see Schwartz & Scott, *Contract Theory*, *supra* note – at 598-609; Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 *Nw. U. L. Rev.* 847, 859-862 (2000); Robert E. Scott, *The Death of Contract Law*, 54 *U. Tor. L. J.* 369, 374-377 (2004). Cf. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 *U. Chi. L. Rev.* 1391 (1992).

specific contingencies (such as war, labor strikes, supply shortages, and government regulation that hinders performance). But these clauses also identify excusing contingencies that fall within a vaguely stated category of factors beyond the control of the parties.⁸¹ Another common example concerns liquidated damages clauses that provide for a calculation of damages based on a laundry list of specific market factors together with a general reference to “any similar valuation.” For instance, a recent gas and power supply agreement provided that liquidated damages should be determined by comparing the contract price to the relevant market prices either quoted by a bona fide third-party offer or which were reasonably expected to be available in the market under a replacement contract. To ascertain the market prices of a replacement contract, the contract permitted the promisee to consider, “*among other valuations*, any or all of the settlement prices of NYMEX energy futures contracts, quotations from leading dealers in energy and gas swap contracts and other bona fide third party offers, all adjusted for the length of the remaining contract term and differences in locational basis.”⁸²

Similar combinations of rules and standards are commonly found in franchise and distributorship contracts. These contracts typically provide both that an agent satisfy specific requirements and generally exercise best efforts. The Taco Bell franchise contract is a good illustration.⁸³ It provides that “[t]he Franchisee shall devote his or her full time, best efforts and constant personal attention to the day to day operation of the Restaurant” and “[i]n addition, and without limiting the generality of the foregoing... [the Franchisee shall] [d]iligently promote and make every reasonable effort to increase the business of the Restaurant.”⁸⁴ The same section

⁸¹E.g., Citgo Petroleum Corporation Distributor Franchise Agreement, http://library.consusgroup.com/library_sbn/144/144936.asp; Automobile Dealer Sales and Service Agreement, American Honda Motor Co, Inc., http://library.consusgroup.com/library_sbn/137/137834.asp.

⁸²See Tolling Agreement by and among Liberty Electric Power, LLC and PG&E Energy Trading - Power, L.P., § 14.2(a) (April 14, 2000) (on file with the authors)[emphasis added].

⁸³Many of the contracts in these industries provide for disputes to be resolved by arbitration, other than when one party seeks temporary injunctive relief. The Taco Bell Sample Agreement in our files does not, but it is dated 2000. http://library.consusgroup.com/library_sbn/146/146107.asp.

⁸⁴Taco Bell Corp. Franchise Agreement Sample Copy, section 3.1, http://library.consusgroup.com/library_sbn/146/146107.asp. The agreement is discussed in greater detail in TAN--
infra.

also states that the franchisee may not have any financial stake or contractual relationship with any similar business (a non-competition covenant) (§3.8). The agreement also requires that the manager of the franchisee attend a training course and refresher courses offered by the franchisor, comply with the methods, techniques and material taught at these courses, and instruct employees in the same material. The franchisee must keep the restaurant open for the business hours specified in the company manual (§3.1). And, as a final illustration, the agreement requires the franchisee to maintain and repair the restaurant, including signage and landscaping.⁸⁵

The performance obligations in these franchise and distributorship agreements address two distinct incentive problems. The first stems from the distortion in incentives caused by the sharing of the profits of the franchise outlet. We noted this effect in our earlier discussion of the court’s opinion in *Bloor v. Falstaff Brewing*. In the Taco Bell Agreement, the monthly franchise fee is a percentage (5.5%) of gross restaurant sales (§7.0(b)). The franchisee must deliver annual reports to the franchisor that are prepared in accordance with specified accounting standards and accompanied by the signed opinion of a certified public accountant (§8.2).⁸⁶ The combination of a “best efforts” standard and associated specific terms are intended to address the incentive distortion caused by this marginal tax on receipts.

The second incentive concern addressed by best efforts is that, despite the tax on sales, the franchisee has an incentive to take actions that would raise its own profits but impair the value of the Taco Bell trademark and reputation (a cost that the franchisee externalizes to the franchisor and other franchisees). The agreement appears to address this concern within the best efforts provision because the best efforts standard is followed by: “without limiting the generality of the foregoing [best efforts],” the franchisee shall operate the restaurant in a clean,

⁸⁵Id.

⁸⁶The report must comply with the Statement on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants (AICPA). The franchisor has broad rights of inspection of books and the restaurant. If there are discrepancies in the reported and actual sales figures, the franchisee agrees to pay interest, administrative charges and inspection expenses.(§8.5)

safe and orderly manner, providing courteous, first-class service to the public (§3.1(a)). Later, the agreement provides that the franchisee must also sell only products authorized in the company manual (§3.5) and it must prevent the use of the restaurant for any immoral or illegal purpose or for any other use not expressly authorized in the agreement or in the company manual (§3.1(d)).

The preceding examples show how parties to commercial contracts deploy specific terms alongside a standard. These combinations have several effects on proxy choice. The existence of specific terms constrains the court's choice of proxies under the standard. In addition, the existence of the vague term affects the application of the specific contractual proxies. First, consider the court's choice of proxy under a mixed rules/standards contract. In the adversarial system, the choice of proxy is likely to be a choice between the proxies offered by the litigating parties. The court's task is (a) to ensure that the proxy falls within the space contemplated by the parties in their agreement and (b) within this space, to choose the appropriate proxy or proxies. The former is a matter of contract interpretation and, in this task, the courts are guided by interpretation maxims. These principles are followed with sufficient regularity that the parties can anticipate them at the time of contracting. In the following section, we outline the most relevant principles and then demonstrate how they are reflected in the patterns of rules and standards in commercial contracts.

3. Maxims of Interpretation and The Effect of Rules-Standards Combinations on the Interpretive Space.

As a general matter, the canons and maxims of contract interpretation do not depend on a finding that a contract term is ambiguous. Rather, they are used both in determining what meanings are reasonably possible as well as in choosing among divergent interpretations.⁸⁷ These maxims first instruct the court to view the agreement *ex ante*: that is, to put itself in the position the parties occupied at the time of contracting,⁸⁸ and to interpret provisions in light of

⁸⁷Restatement (Second) of Contracts §202 comment a.

⁸⁸ *Id.* at comment b

the purpose of the contract.⁸⁹ Consistent with the notion of purposive interpretation, a contract must be read as a whole and each part must be interpreted in light of all provisions.⁹⁰

For this paper, it is useful to examine the interpretive effect of the choice of combined rules and standards, as compared to stand-alone rules or standards. Three well-known maxims are particularly relevant: *ejusdem generis*, *noscitur a sociis* and *expressio unis est exclusio alterius*. If a contract through its exclusive use of precise terms provides only for specific proxies, the maxims of interpretation guide the court to refrain from adding proxies at the time of trial. Under the *expressio unis* maxim, the expression in the contract of one or more things of a class implies exclusion of all that is not expressed.⁹¹ The inference is that all omissions should be understood as exclusions, and the specification of particular items impliedly excludes other items relating to the same general matter.⁹² Moreover, when a contract provides that a thing should be done in a certain way, it is presumed to be exclusive.⁹³

A standard on its own gives the court a relatively large space within which to choose proxies. Where the parties combine standards and rules that relate to the same subject matter, the *ejusdem generis* canon applies, whether the general language is preceded or followed by the enumerated specific terms. The meaning of the general language is then limited to matters

⁸⁹Bourke v. Dun & Bradstreet Corp., 159 F.3d 1032, 1039 (7th Cir. 1998) (“purpose” is given great weight). Restatement (Second) of Contract §202(1).

⁹⁰Restatement (Second) of Contracts §202(2). “[A] word changes meaning when it becomes part of a sentence, the sentence when it becomes part of a paragraph.” Id. comment d. Because of the force of the principle of purposive interpretation, parties sometimes signal their purpose in a preamble or in recitals (such as a “whereas clause”).

⁹¹ See Smart v. Gillette Co. Long-Term Disability Plan, 70 F.3d 173, 179 (1st Cir. 1995) (where contract listed specific benefits, any other benefit not so listed is excluded); Eden Music Corp. v. Times Square Music Publications Co., 514 N.Y.S. 2d 3 (1987); United States v. First Nat’l Bank of Crestview, 513 So. 2d 179 (Fla. App. 1987).

⁹²See, e.g., Tate v. Ogg, 170 Va. 95 (1938) (enumeration which included “any horse, mule, cattle, hog, sheep or goat” excluded turkeys).

⁹³NORMAN J. SINGER, SUTHERLAND ON STATUTES AND STATUTORY CONSTRUCTION §47.26 (6th ed. 2000).

similar in kind or classification to the enumerated specific terms.⁹⁴ But the parties must be careful when using combinations of standards and rules to use words that signal to the court a desire to have new proxies created at trial. In a recent case, a lease contract provided that the lessor could terminate “for good cause” and this general language was then followed by enumerated items such as nonpayment of rent, serious or repeated damage to the premises, or the creation of physical hazards. The appeals court held that the general phrase “for good cause” did not include other violations of the lease, such as keeping a dog on the property.⁹⁵ Contracting parties can avoid a restrictive interpretation under the *ejusdem* rule by providing that the general language includes *but is not limited to* the specific enumerated items that either precede or follow it.⁹⁶

Under *noscitur a sociis*,⁹⁷ the meaning of vague phrases may be determined by reference to their relationship with other associated words and phrases. Under this maxim, the coupling of words or phrases indicates that they should be understood in the same general sense.⁹⁸ As noted above, where the parties provide for specific proxies but no standard, *expressio unis* might prevent the court from reading a general purpose. Moreover, even under *noscitur a sociis*, a

⁹⁴ See *Liberty Mutual Ins. Co. v. East Cent. Okla. Elec. Coop.*, 97 F. 3d 383, 390 (10th Cir. 1996) (when interpreting a general word that follows a series of specific words, the specific words restrict the meaning of the general-encompassing only action of the same general type). As an example of the limiting effect of the *ejusdem* maxim, in the gas and power supply agreement discussed TAN note --above, one of the parties in litigation sought to introduce, as evidence of a replacement contract, expert testimony based on an economic model of projected prices for electrical power over the remaining term of the contract. The other party objected to the evidence on the grounds that an economic model was not properly included within the general provision “among other valuations” because it was not in the same family as “the settlement prices of NYMEX energy futures contracts, quotations from leading dealers in energy and gas swap contracts and other bona fide third party offers....” See pre-trial brief of Liberty Electric Power LLC in *Liberty Electric Power, LLC, Claimants v. NEGTEnergy Trading - Power, L.P., Respondents*, AAA Case No. 70 198Y 0028 04 (on file with the authors).

⁹⁵ *Housing Auth. of Mansfield v. Rovig*, 676 S.W. 2d 314 (Mo. 1984).

⁹⁶ *Cooper Distrib. Co. v. Amana Refrigeration, Inc.* 63 F. 2d 262, 280 (3d Cir. 1995); *Eastern Airlines v. McDonnell Douglas Corp.*, 532 F. 2d 957 (5th Cir. 1976) (delays in performance due to causes beyond seller’s control, including but not limited to enumerated events). This has been called a common drafting technique designed to save the drafters from spelling out in advance every contingency in which the specific factors could apply. *Moore v. California State Bd. of Accountancy*, 831 P. 2d 798 (1992).

⁹⁷ *noscitur a sociis* means “it is known by its associates”.

⁹⁸ *Utility Elec. Supply v. ABB Power T & D Co. Inc.*, 36 F.3d 737 (8th Cir. 1994).

series of specific proxies may not have enough in common to indicate to the court the general objective that associates them. But when a broad standard is added to a listing of specific terms, it communicates the underlying objective and helps the court interpret the specific terms in light of the general purpose. The *noscitur* maxim requires that the general and the specific words must be considered together in determining the contract's meaning, so as to "give effect to *both* the particular and the general words."⁹⁹ Thus, the general term informs the interpretation of the specific proxies as well, and might allow the court to fine-tune a specific proxy in light of its information advantage in hindsight.

A contract standard thus presents the court with two tasks. The first is to define the space for proxies allowed by the standard, in light also of the specific proxies specified in rules of the contract. This application of the interpretative maxims is a question of law.¹⁰⁰ The second is to choose the most appropriate proxy, or set of proxies, within that space. The court will weigh the fit, or conversely the noise, of the proxy, and the verification costs. The goal, as we have previously noted, is to find the proxy with the biggest incentive bang for verification buck. Both the bang and the buck are likely to depend somewhat on extrinsic facts. However, at least with respect to evidentiary costs, the judge would seem to have an advantage over the jury in comparing alternative proxies as to verification costs.

III. HARNESSING BURDENS OF PROOF AND PRESUMPTIONS

A. Burdens and the Enforcement of Contract Standards.

1. Competing Proxies in Litigation

In the preceding Part, we analyzed the use of combinations of rules and standards in

⁹⁹Peterson v. Hawaii Elec. Light Co., Inc., 85 Haw. 322, 944 P.2d 1265 (Hawaii 1997) (statutory interpretation); Nat'l Bank of Commerce v. Estate of Ripley, 61 S.W. 587 (Mo. 1901).

¹⁰⁰Restatement (Second) Contracts §212(2) (the judge should not defer to the jury unless the interpretation "depends on the credibility of extrinsic evidence or on a choice among reasonable inferences to be drawn from extrinsic evidence").

commercial contracts as mechanisms for determining both the timing and the identity of the chooser of the evidentiary proxy on which contract enforcement is conditioned. The parties delegate to the court the choice of proxies within a space that they define contractually, using the techniques described earlier. This reference to the “court” as the delegated decision-maker was highly stylized, however. More accurately, the proxies are selected at trial, after the parties propose self-serving and typically conflicting proxies that they support with evidence. In this Part, we begin to open the litigation black box to examine selected aspects of the dynamic of proxy selection, and trace its effect on contract design.

Ultimately, the court typically chooses among competing proxies presented by the parties, in a process governed by rules of procedure and evidence, particularly the allocation of burdens of proof and presumptions. Burdens are not significant when fact finding is straightforward and this is more commonly the case when parties have contracted for rules because they tend to implement specific proxies based on relatively cheaply available evidence. In enforcing rules, therefore, fact finding is straightforward. Burdens are more likely to be determinative, however, in the choice among competing proxies within the space defined by contractual standards. When the burden is assigned to one party, the other effectively enjoys an advantage in proxy selection.

Suppose, for example, that an agent such as a fast-food franchisee is bound by a contractual promise not to injure the reputation of the franchise. The agent coaches little league baseball but is also known to have a drinking problem. Each is a candidate proxy that might be selected under the standard. In many (if not most) cases, the factual issues are not whether the proxy is or is not satisfied (e.g., did the agent coach little league and drink), but rather the choice of (and weight assigned) to the proxy. Under the default rules of litigation, a principal (or franchisor) who seeks to prove a breach of promise by its agent typically will be allocated both the burden of production and the burden of persuasion. Unless the principal satisfies its burden, the result will be as if the agent's proxy were chosen. As a formal matter, the court determines the proxy, but the burden effectively assigns the advantage to the agent by favoring his proxy (coaching) over the employer's proxy (drinking).

The contrast between two classic contracts cases illustrates the significance of burden allocation.¹⁰¹ Consider *Raffles v. Wickelhaus*¹⁰² and *Frigalment Importing v. B.N.S. International Sales*.¹⁰³ In *Raffles*, the parties entered into a contract to buy and sell cotton. Their contract called for the delivery of cotton by way of a ship named “Peerless” sailing from Bombay to Liverpool, when in fact there turned out to be two ships named “Peerless” sailing from Bombay to Liverpool within three months of each other. The buyer believed “Peerless” referred to a ship departing Bombay in October, while the seller believed “Peerless” referred to a ship departing Bombay in December. The defendant buyer refused to accept and pay for that cotton and the court agreed, holding that “there was no consensus and therefore no binding contract.”¹⁰⁴ In *Frigalment*, the buyer sued the seller for selling it “fowl” (lower grade chicken) instead of “broiler” (higher grade chicken). The seller argued that the term “chicken” in the contract included all types of chickens, while the plaintiff contended it meant only broiler chicken. The court found that the meaning of “chicken” was vague and found for the seller on the grounds that the buyer, as plaintiff, had not carried its burden of proving which of the two plausible meanings the parties intended.¹⁰⁵

Alan Farnsworth explains the importance of the burden allocation in both *Raffles* and *Frigalment*:

For the seller to prevail in a suit against the buyer [in *Peerless*], it would seem that the seller would have to sustain ‘the burden’ – as the court in *Frigalment* put it – of showing that the word *Peerless* was used to refer to the ship that sailed in December. This the seller did not do. But if the buyer had sued the seller, it would seem that the buyer would have had to sustain the burden of showing that

¹⁰¹FARNSWORTH, *supra* note – at 451.

¹⁰²2 H & C 906, 159 Eng. Rep. 375 (1864).

¹⁰³190 F. Supp. 116 (S.D.N.Y.1960).

¹⁰⁴ 159 Eng. Rep. at —. For discussion, see SCOTT & KRAUS, *supra* note – at 789-807.

¹⁰⁵190 F. Supp. at —.

the word Peerless was used to refer to the ship that sailed in October. This presumably, the buyer could not do. The explanation, then, for the judgment for the seller is not that there is no contract, but that neither party can sustain the burden of showing that its meaning should prevail.... If the buyer in *Frigaliment* had rejected the chickens and the seller had sued for the price, the same court might have found for the buyer on the ground that the seller had not sustained the burden of showing that chicken was used in the broader sense.”

In sum, because the buyer in *Raffles* had rejected the goods, the seller had the burden of establishing that the parties had agreed to the delivery of cotton via the December “Peerless” and was unable to do so. In *Frigaliment*, the buyer had the burden (of establishing a narrower interpretation of “chicken”) because it had accepted the goods, but failed to satisfy that burden.¹⁰⁶ The contrasting effects of burden allocation raise two questions that have yet to be addressed in contracts scholarship. First, which is the more efficient allocation? Second, if the common law does not provide for such efficient allocation, how might the parties themselves do so by contract? The first question is complex and context-dependent. We set out below some of the factors that may affect the optimal allocation in any given case, without attempting to resolve the conditions. Our contribution instead is to draw attention to the contractual mechanisms by which parties might assign burdens in their ex ante agreement.

2. Efficiency Considerations for Allocation of Burdens of Proof.

The nascent scholarship on the efficiency of burdens of proof falls into two groups: one is concerned with the efficiency of truth-finding and the other with the deterrence effect on the primary behavior being regulated.¹⁰⁷ The first approach examines the effect of burden allocation on the cost of communicating information to the court. The advantage of the adversarial system is that the process can choose between two sources of information with different cost schedules.

¹⁰⁶ Id.

¹⁰⁷ See notes – and – infra.

Bruce Hay and Kathy Spier suggest that the burden of proof ought to be assigned to the party with superior knowledge of the facts in dispute or the party asserting the more unusual version of the facts.¹⁰⁸ This allocation reduces the expected evidentiary costs of trial. In a similar vein, several authors suggest that burden allocation enhances the informativeness of negative evidence -- the failure of a party to present evidence favorable to its case.¹⁰⁹ Such negative evidence is costless. However, negative evidence is also noisy when a party might be uninformed, because the court cannot infer whether the failure to present favorable positive evidence is due to the fact that it does not exist or simply that the party is unaware of it. Thus, the burden should be placed on the more informed party, or the party more likely to have access to the evidence if it is available.¹¹⁰

As explained in the next section, the allocation of burdens in practice are far more crude than envisaged by these theories. For example, plaintiffs tend to bear the burden of establishing the facts necessary to plead their case. This seems invariant and even inconsistent with plaintiffs' relative access to information. As Chris Sanchirico points out in this respect, tort plaintiffs carry the burden of proving their defendant's negligence, while the defendant has the burden of proving that the plaintiff was contributorily negligent.¹¹¹ Modern discovery practices may be one explanation for the insensitivity of burdens to presumed informational advantages.

¹⁰⁸ Bruce L. Hay & Kathryn E. Spier, *Burdens of Proof in Civil Litigation: An Economic Perspective*, 26 J. Legal Stud. 413 (1997). Hay and Spier state that the burden should fall on the plaintiff when the probability that the plaintiff's version is true multiplied by the plaintiff's cost of producing the evidence is less than the probability that the defendant's version is true multiplied by the defendant's cost. Hay and Spier assume that the parties have access, perhaps at different cost, to the same pool of evidence. And, neither can lie or otherwise fabricate evidence.

¹⁰⁹ Hyun Song Shin, *Adversarial and Inquisitorial Procedures in Arbitration*, 29 Rand. J. Econ. 378, 389 (1998) ("the absence of a report from the well-informed party makes it likely that the well-informed party knows the true circumstances but that the news is unfavorable to him. The greater the disparity of information, the more informative is the absence of any announcement.") See also, Jesse Bull & Joel Watson, *Evidence Disclosure and Verifiability*, 118 J. Econ. Theory 1 (2004).

¹¹⁰ Bull and Watson provide an example in which one party has access to a documentary bit of evidence of a state A, if such state has materialized. If this party benefits from the court finding that state A has occurred, the burden is appropriately placed on that party (to exploit the informational benefit of negative evidence). Otherwise, the negative evidence stemming from the failure of the document to be presented in court is not informative. *Id.* at --.

¹¹¹ Sanchirico, *Harnessing Adversarial Process*, *supra* note -- at 14-15.

Discovery attenuates the informational advantages that one party might have over the other. In this light, Hay and Spier suggest that the reason for placing burdens on plaintiffs is that they typically assert the more unusual facts because people tend to comply with the law.¹¹² But this claim does not account for an important selection effect: the fact that the plaintiff has decided to bear the cost of initiating a law suit, suggesting that the defendant is more likely than average to have done wrong.

The second line of scholarly analysis of burdens examines the effect of burden allocation on deterrence--in our analysis, on contract performance. Burdens affect the evidentiary strategies and costs of plaintiffs and defendants. Each effect bears on ex ante incentives in two respects. First, where the expected evidentiary cost of the *plaintiff* rises, plaintiffs are less likely to sue, all other things equal. However, the lower incidence of litigation may lead to a string of consequences that complicates the analysis. The reduction in law suits may undermine the performance incentives of the defendant, causing a rise in nonperformance and a consequent increase in the expected recovery of plaintiffs.¹¹³ It might thereby result in an offsetting increase in the number of cases filed, which would in turn deter nonperformance. The ultimate effect on incentives is unclear and context-dependent.¹¹⁴

Second, assuming that plaintiffs bring actions, the evidentiary costs of *defendants* have a direct impact on incentives because, like the ultimate determination of liability, they impose a sanction. This sanction improves deterrence (or contract performance) if the evidentiary-cost sanction on complying defendants is lower than that on noncomplying defendants. At first blush, it may appear that the allocation of burdens does not affect this process because burdens assigned to defendants fall indiscriminately on complying and noncomplying actors alike. However, the following simple example suggests otherwise by taking into account the plaintiff's

¹¹²Hay & Spier, *supra* note – at –.

¹¹³This assumes that judicial determinations are somewhat accurate.

¹¹⁴Bernardo, et al., *supra* note – at –. The authors explain that the only equilibrium in this example is in mixed strategies.

incentive to sue.¹¹⁵ Suppose that a principal-agent contract requires an action that will cost the agent \$100 and provides that the agent must pay liquidated damages of \$105 if she fails to perform. In order for the principal to enforce the provision, the court must determine whether the agent performed or not. Suppose that the evidentiary cost to the agent of proving performance is \$10. The net gain to the agent from performance is $\$105 - \$100 = \$5$, less whatever evidence cost the agent would have to pay to exonerate itself. If the burden is on the principal, the principal simply will not sue if the agent performs, and the agent would enjoy the full gain of \$5 from performing. If the burden is on the agent, however, the agent would suffer a net loss of \$5 compared to nonperformance because of the \$10 it would have to pay to satisfy the evidentiary burden. Thus, the litigation burden imposes a prospective tax on the defendant agent that discourages performance. In this example, therefore, the burden is more appropriately placed on the principal, the potential plaintiff.¹¹⁶

For the purposes of this paper, it is particularly important to note that whether the objective is to reduce evidentiary costs or to improve contractual incentives, the effects of burden allocation are highly context-dependent. These advantages are not very susceptible to general rules of allocation; at best, the law can provide default allocations from which the parties may contract away if they wish. Thus, parties may tailor burdens to accommodate their particular circumstances. For example, the contract might shift the burden to the defendant if the defendant has access to a key exculpatory document and if discovery is costly or imperfect in enabling the other party to obtain the document. In a similar vein, parties who seek to use burdens to sanction non-performance and reward performance must also be sensitive to such context-specific factors. Harnessing burdens by contract, however, requires first an appreciation of how the law allocates burdens by default. As we emphasized earlier, the rules of burden allocation will have greatest salience in connection with proxy selection under contractual standards.

¹¹⁵Again, we are assuming in this discussion that fact finding is accurate, but at a cost. We also assume that the plaintiff bears a positive cost in bringing suit.

¹¹⁶The parties would share the cost ex ante in the price of the contract.

3. The Default Rules for Allocating Burdens of Proof.

The importance of burdens in influencing the standard of performance raises the question of whether the law is sensitive to efficiency considerations in allocating burdens of proof between the parties. The default rule in practice is that the burden of production and the burden of proof rest on the party who must plead the particular fact (the element of the case). According to pleading rules, that party is typically the one who wishes the intervention of the court to change the status quo.¹¹⁷ There are exceptions, however, for “affirmative defenses,” most of which are grouped in one of three categories.¹¹⁸ First, the defendant may have the comparative advantage in information production.¹¹⁹ Second, the defendant may be assigned the burden with respect to a fact that is particularly unusual.¹²⁰ Third, commentators sometimes mention a category comprising defenses that are normatively disfavored, such as contributory negligence or statutes of limitations.¹²¹ Unhappily, however, given their generality and the inconsistency of their application, none of these supposed policies are reliable as a working rule.¹²² In particular, the comparative advantage in information production fails to predict the

¹¹⁷MCCORMICK, *supra* note -- at §336.

¹¹⁸ E.g., Edward W. Cleary, *Presuming and Pleading: An Essay on Juristic Immaturity*, 12 *Stan. L. Rev.* 5, 12-13 (1959).

¹¹⁹ See, e.g. *Fitzgerald v. Wright*, 382 A.2d 1162 (N.J. App. 1978) (allocating burden of proving extent of injury based on superior knowledge); *Wiles v. Mullinax*, 168 S. E. 2d 366 (NC 1969) (same). MCCORMICK, *supra* note -- at §337.

¹²⁰ MCCORMICK, *supra* note -- at §337; Cleary, *supra* note -- at 11. Allocating burdens based on the finding of “unusual” facts begs the question about the factual basis for finding a fact “unusual.” There must be some background fact, either established before the court or of which the court takes judicial notice, before the court can say that fact Z is “unusual.” One way to frame this policy choice is as equivalent to a presumption that if X, then the court presumes not-Z, thus placing on the party pleading Z the burden of showing that it occurred despite X.

¹²¹*Id.*

¹²² See e.g., FLEMING JAMES, JR., ET AL, *CIVIL PROCEDURE* §7.16 (5th ed. 2001)(“There is no a priori test for allocating the burden of persuasion or the burden of producing evidence”). Cf., Hay & Spier, *Burdens of Proof*, *supra* note --. Hay and Spier’s analysis concerns the desirable burden of proof given the objective to reduce litigation costs and does not address efficient incentives in primary activity. See Hyun Song Shin, *Adversarial and Inquisitorial Procedures in Arbitration*, 29 *Rand. J. Econ.* 378, 380 (1998).

allocation of burdens in practice.¹²³ For example, in breach of contract claims the plaintiff has the burden of proving that the defendant's conduct constituted a breach notwithstanding the fact that the defendant has better access to the facts in question.¹²⁴

A reason for the failure of burdens systematically to promote efficiency may be that they hinge on pleading responsibilities – particularly in the determination of whether a fact is part of the plaintiff's prima facie case or the defendant's affirmative defense. This determination, in turn, depends on categories drawn from substantive law rather than any policies supporting the litigation process. In contract breach actions, the claim of nonperformance must be plead and proved by the plaintiff. The plaintiff must allege and prove the making of the contract, its consideration, and the satisfaction of all conditions precedent (whether express or implied) to the defendant's reciprocal obligation to perform.¹²⁵ The defendant may respond that the obligation to perform has been discharged on any of a number of substantive grounds, including novation, accord and satisfaction, cancellation and termination, impossibility, mutual mistake, release, alteration, merger, and the failure of a condition subsequent to performance. As affirmative defenses, all of these must be plead and the burden of production carried by the defendant.¹²⁶ Once all the burdens of production are met, the overall burden of persuasion, however, remains on the plaintiff. Thus, the burdens with respect to most facts in contract breach cases – particularly performance standards with which we are mostly concerned – fall on the plaintiff, the party who is seeking to change the status quo.¹²⁷

¹²³JAMES, JR., ET AL at §7.16. (“The burden of proof traditionally is placed on the party having the readier access to knowledge about the fact in question. This consideration, however, has never been controlling”); Sanchirico, *supra* note –.

¹²⁴*Id.* at §7.16.

¹²⁵SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 674 (3d ed. 1961 by Walter H. E. Jaeger).

¹²⁶Note that it is commonly said that once a party offers evidence sufficient to avoid a directed verdict, that the burden of production shifts to the adversary. But that is not strictly true if the burden is defined as the quantum of evidence needed to avoid an adverse verdict. McCormick suggests, therefore, that in this instance the better view is that neither party has the burden of production. MCCORMICK, *supra* note — at §338.

¹²⁷*Id.*

In some cases, substantive contract law determines which party will be the plaintiff in disputes: for example, the identity of the plaintiff may depend on the course of the parties actions. Consider § 2-607(4) of the Uniform Commercial Code, which assigns the burden of proving that a delivered good does not comply with the contract to the buyer, if the buyer has accepted the good. If instead the buyer simply rejects the good, the burden falls on the seller who sues for breach of contract. This burden includes the burden of establishing facts as to the condition of the goods upon delivery.¹²⁸ The identity of the plaintiff in any dispute—and the consequent allocation of the burden of proof—thus may rest on factors having little to do either with informational advantages or self-interested behavior.¹²⁹ In the case of an allegedly defective good, the burden hinges on whether the plaintiff has accepted or rejected delivery. In short, the parties' ex post behavior can affect the burdens in litigation. Consequently, the default allocation of burdens is neither predictable at the time of contracting nor based on factors that seem to have clear efficiency consequences. More pertinent to our project, therefore, is the ability of the parties to determine burden allocation (and the proof standards) by their ex ante contract.

B. Allocating Burdens and Standards of Proof by Contract

We argued in the previous section that the default allocation of burdens may not improve contractual incentives. Consequently, the parties themselves may wish to contract over the allocation and standards of burdens of proof. We now consider the direct and indirect contractual mechanisms by which the parties may allocate burdens and standards of proof. We note a common pattern of providing for presumptions and shifting burdens, instead of all-or-nothing assignments. Termination rights, constraints on contract assignment and professional certification of performance are three instances. These shifting burdens are similar to those used in Title VII Civil Rights Act discrimination actions brought by employees against their

¹²⁸For an analysis, see ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 263-72 (2d ed. 1991).

¹²⁹We concede that there is some information explanation for this contrast: it induces the buyer to examine the goods earlier rather than later. *Id.*

employers.¹³⁰ The employee-plaintiff bears the initial burden of showing the basic facts that make out a prima facie case. Once the employee does so, the burden of production shifts to the employer-defendant who must present evidence sufficient to support a finding that its actions were not discriminatory. Then, the burden of persuasion falls on the plaintiff to establish that the employer's actions were discriminatory. As we discuss below, the shifting scheme is not the default for contract disputes, but it may be invoked by explicit contract terms.

1. Explicit Contractual Allocation of Burdens and Standards.

The most straightforward way for parties to reallocate burdens and/or alter the standard of proof is for them to do so directly through an explicit term in the contract. To be sure, a threshold question is whether burdens and standards of proof are regarded as mandatory background rules or as defaults subject to alteration by individual parties. While there is little in the way of scholarly commentary, the considered judgment of experts in the field is that express terms allocating burdens and standards of proof would be enforceable by most courts.¹³¹ And, indeed, many contracts contain such provisions.¹³² Indemnity agreements, for example,

¹³⁰McDonnell Douglas Corp. v. Green, 411 U.S. 792 (1973).

¹³¹E-mail from Professor Caleb Nelson 2/23/05; e-mail from Professor John Harrison 2/27/05 [copies on file].

¹³²For as sampling of contracts that contain express provisions respecting burdens and standards of proof, see University of Missouri-Columbia, Contracting and Organizations Research Institute, CORI Contracts Library, at <http://cori.missouri.edu> (last visited Feb. 25, 2005). Sample provisions include (a) employment agreements: "(iii) in all cases both the burden of production of evidence and the ultimate burden of persuasion with respect to any allegations or claims that this Section 10.2 has been breached or violated by the Executive shall be borne by AAI and the Corporation." (contract dated January 10, 2003, between Ascent Assurance, Inc., and ("AAI"), Ascent Management, Inc.); (b) securities purchase agreements: "Any Person asserting that such Guarantor's obligations are so avoidable shall have the burden (including the burden of production and of persuasion) of proving (I) that, without giving effect to this Section 10.8, such Guarantor's obligations hereunder would be avoidable and (ii) the extent to which such obligations are reduced by operation of this Section 10.8." (Securities purchase agreement by and among Overhill Farms, Inc., and Levine Leichtman Capital Partners II, L.P., Dated as of April 16, 2003); (c) Technology License Agreements: "Company and Licensee shall bear the burden of proof with respect to establishing that any of its claimed confidential information falls within any of the foregoing exceptions." (License Agreement entered into as of October 23, 1998, by and between SurgiJet, Inc., a ("Company") and VisiJet, Inc. ("Licensee")); and (d) most, commonly, indemnity agreements (see note —*infra*).

commonly reallocate burdens and elevate standards of proof.¹³³ Consider the standard indemnification agreement between DAOU Systems, Inc., and its directors and officers. The contract provides in relevant part:

Presumptions and Effect of Certain Proceedings.

(a) *Upon making a request for indemnification, Indemnitee shall be presumed to be entitled to indemnification under this Agreement and the Company shall have the burden of proof to overcome that presumption in reaching any contrary determination.*

....

(b) Indemnitee shall be deemed to have acted in good faith if Indemnitee's action is based on the records or books of account of the Company, including financial statements, or on information supplied to Indemnitee by the officers of the Company in the course of their duties, or on the advice of legal counsel for the Company or on information or records given or reports made to the Company by an independent certified public accountant or by an appraiser or other expert selected with reasonable care by the Company. In addition, the knowledge and/or actions, or failure to act, of any director, officer, agent or employee of the Company shall not be imputed to Indemnitee for purposes of determining the right to indemnification under this Agreement. Whether or not the foregoing provisions of this Section 7(b) are satisfied, it shall in any event be presumed that Indemnitee has at all times acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Company. *Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence [emphasis added].*¹³⁴

Indemnification agreements such as the DAOU Systems standard form allocate the burden to the indemnitor, who is typically the defendant, and also elevate the standard of proof from the default “balance of probabilities” to “clear and convincing evidence.” In the absence of an express contract term, the corporate officer seeking indemnification would be the plaintiff and thus would have the burden to prove that her actions on behalf of the corporation did not constitute self-dealing and were undertaken in a good faith belief that they represented the best interests of the firm and its shareholders. Self-dealing and negligence are standards that require

¹³³ ¹³⁴ 134 contracts in the CORI data base contain indemnity contracts that elevate the burden of proof from preponderance of the evidence to a clear and convincing standard; 25 contracts create a presumption that the indemnitee is entitled to indemnification; 51 contracts create a presumption that the indemnitee acted in good faith; and 38 contracts allocate to the indemnitor the burden of proof on the issue. See CORI Contract Library, supra note 15.

¹³⁴ CORI Contracts Library, note — supra.

the selection of an evidentiary proxy *ex post*.¹³⁵ The default burden therefore favors the proxy of the indemnitor, over that of the indemnitee, who is the typical plaintiff. Instead, the contract provides for a presumption in favor of the agent (or shifts the burden to the corporation) when the agent presents the minimal evidence that her actions were based on the company's records or books, or on the advice of legal counsel or on information supplied by an independent certified public accountant.

As we noted above in Part III(A)(2), a burden allocation will affect the incentives of the agent to perform or shirk her contractual responsibilities. But the link between the burden and the agent's incentives is complex, and the optimal allocation is accordingly context-specific. The agent would seek indemnification only if the corporation's projects fail (otherwise, it is unlikely that she would have any liability to pass on). Placing the burden on the agent, as plaintiff, increases her cost of litigating over the indemnification and decreases her likelihood of success. By thereby raising the cost on the agent of failed projects, the burden affects her incentives in two ways; the first is efficient while the second is not. First, she will invest more effort into avoiding failure. Second, however, the fact that she bears some of the cost of failure regardless of her performance, exacerbates her incentive to underinvest in risky positive value projects on behalf of the firm.¹³⁶ The indemnity contract reproduced above shifts the burden of persuasion to the corporation and elevates the firm's standard of proof to clear and convincing evidence. The contract therefore reverses the two foregoing effects: the agent's effort incentives are diluted but so is its conservatism in investment choice. Like the business judgment rule in derivative suits against directors, the contractual provision reproduced above shifts the burden away from the agent by creating a pro-agent presumption of good faith. This protects the agent from liability resulting simply from the materialization of adverse risks and thereby moderates the incentive for excessive conservatism. If the incentives for effort are otherwise fairly strong,

¹³⁵ *[insert examples here]*

¹³⁶ Moreover, absent the indemnity provision and its burden shifting terms, corporate officers are vulnerable to a change of control in which a new board fails to protect them against shareholder derivative suits. Anticipating this risk, an agent would be motivated to pursue low value /low risk projects rather than risky projects with high expected value to the firm.

placing the burden on the corporation is efficient.¹³⁷

2. Contract Provisions that Harness Burdens Indirectly.

Parties can harness burdens indirectly even without an explicit contract term. As an example, consider once again a simple sales contract between buyer and seller. Recall that the default burden of proving whether a good is defective or not depends on whether the buyer has accepted or rejected the good. The rejecting buyer sues the seller for damages and carries the burden; the seller sues the accepting buyer for the price and carries the burden. As in the indemnification contract in the previous section, parties to a sales contract could contract directly over which party, the seller or the buyer, would bear the burden of proof as to the condition of the goods in all cases. As an alternative to an explicit contract term, however, the parties can harness the efficiency benefits of burdens indirectly. Deposits are a simple example of how the parties to commercial contracts may structure substantive provisions to influence the likely identity of the plaintiff. When the buyer has prepaid or made a deposit, the seller has less to gain by suing for the price. Thus, the buyer is more likely to be the plaintiff whether she has accepted or rejected the goods. As we will explore in more detail below, termination provisions have similar, though more subtle, effects. A dispute as to the legality of termination may be initiated either by the party terminating (often the principal) or her contracting partner (the agent). For example, the agent may sue for wrongful termination or the principal may sue following termination to enjoin further use of its trademark by the agent or to enforce a provision authorizing it to take possession of the agent's premises. In the following section, we explore in greater depth the function that contractually allocated burdens serve in enhancing the efficiency of contractual incentives.

C. Burdens as a Means of Disciplining Self-Interested Proxy Proposals.

The primary function of burdens in the enforcement of contract standards is to discipline self-interested proxy proposals. Under the default allocation, plaintiffs proxies are disfavored

¹³⁷Bernardo, Talley and Welch make a similar point in observing that the business judgment rule protects corporate officers from claims of negligence (but not from allegations of self-dealing) and thereby distorts managers' decisions less. See Bernardo, et. al., supra note – at 2.

and, as an initial effect, this tends to discourage litigation and undermine performance incentives. This may or may not be a tradeoff that the parties desire. Moreover, the ultimate effect may be more complicated, because the promisee's incentive to shirk raises the likelihood of plaintiff success at trial and restores some of the incentive to bring suit. The result is context dependent and the parties may wish to tailor their own burden allocation. In the previous section, we showed that parties may set burdens by determining ex ante who will be plaintiff and defendant. In this section, we elaborate the parties' motivation to reallocate burdens by contract (whether directly or indirectly). We do so by distinguishing between two categories of litigated disputes, that we label "division of the spoils" and "structural change" cases, respectively.

In both categories, the core factual issue is whether the "agent" (seller, franchisee, etc.,) performed as required. The first category is the "division of the spoils" case: both parties agree that the relationship has ended, but one party argues that the contract was fully performed and the other claims damages by alleging a failure of performance. Accordingly, the parties have divergent incentives as to the selection of a proxy that properly lies within the space defined by the operative contractual standard. The analysis here tracks closely that of optimal burden allocation in tort cases - say, liability for negligence in an auto accident - except for the fact that the parties have the opportunity to contract over burdens ex ante. The second category is the "structural change" case: one party (but not the other) alleges the failure of the other's performance in order to induce a change in the structure of their relationship, particularly by termination. The significance of the second category is that it has prospective as well as retrospective efficiency consequences. We consider first the relatively simpler case of the division of the spoils of a concluded relationship.

1. Division of the Spoils Cases.

If the contract is performed and the parties are merely debating whether the performance meets the contractual standard, they are simply fighting over the distribution of the amount at stake in the litigation. The resolution of their dispute is of no *prospective* efficiency consequence, but the parties' expectation of this resolution does affect the ex ante incentives.

Consider a construction contract.¹³⁸ In defining the builder's obligations, the parties contract for ex ante rules that specify proxies and/or for standards that delegate proxy selection to the court. In the case of construction contracts, the default standard is "substantial performance."¹³⁹ Under this standard, the parties at trial advance self-serving proxies in order to improve their payoffs from litigation, irrespective of the ex ante efficiency of the ultimate disposition. The owner may introduce evidence that apparent defects in construction (such as noncomplying piping material) reduce her value substantially, whether or not this is true. The owner would argue that this defect violates the corresponding proxy within the space of the substantial performance standard. As we have emphasized previously, the factual dispute is unlikely to concern the existence of the defect (which is easily "verified," to use the conventional language), but rather concerns the proxy choice-- whether the defect breaches the standard. Conversely, the builder's opportunistic strategy is to shirk on performance but claim that it nevertheless complied with the standard, by offering an alternative proxy.

A construction contract typically requires the property owner to make progress payments to a builder during construction. An important contract design choice is whether each payment is made before or after the builder has completed the construction to which the payment relates. One might think of this as choosing which party will give value first -- essentially, a deposit. Assume initially that payments are made in advance, and particularly that the final payment is made prior to the completion of construction. This provision places the default burden on the owner (as plaintiff suing to recover its payments) in litigation concerning whether the builder has substantially performed its obligation. The burden deters opportunistic suits by the owner. Yet, a reduction in the likelihood of litigation might also affect the builder's incentives to perform: the plaintiff's burden of proof privileges the builder's proxy and this may undermine the builder's incentives. If this is the net effect of the burden allocation, then the parties must trade off the litigation cost savings against the adverse effect on performance incentives. This is a

¹³⁸ We draw the example from the famous case of *Jacob & Youngs v. Kent* 230 N.Y. 239, 129 N.E. 889 (1921).

¹³⁹ For discussion, see Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 Va. L. Rev. 967, 995-97, 1009-11 (1983).

similar tradeoff to that described above in the context of suits by corporate officers for indemnification. These incentive effects are determined not only by the allocation, but also the standard of proof. The standard for the burden of persuasion in civil trials is relatively modest: the owner only needs to establish a proxy on the preponderance of the evidence. Thus, the effect on the incidence of litigation and on contract incentives is likely to be correspondingly small.

Suppose, instead, the owner's payments are due only after the builder has completed designated phases of construction. The last payment, which may be sizeable, is due after construction is completed.¹⁴⁰ This provision has the effect of allocating the burden of proof to the builder who must assume the role of plaintiff in order to obtain the balance of the contract price. The builder's burden of proof privileges the owner's proxy. This reduces the owner's expected litigation costs, raises its likelihood of success and deters suits by the builder. As a result, it raises the prospect of the owner opportunistically withholding funds. At the same time, the effect on the builder's incentives is unclear. It may in fact undermine the builder's incentives because it runs the risk of not receiving the final payment, whether or not it performs.

In sum, the contracted order of performance – whether the construction occurs before or after the corresponding payment from the owner – determines who is more likely to be the plaintiff and, accordingly, who will carry the burdens of proof. Given the standard of proof, the burdens may be significant because of the relative costs they impose on the litigants and their relative likelihood of victory. Thus, the alternative burden allocations have contrasting effects on incentives. As discussed above, the simple choice of placing the burden on one party or the other does not achieve efficient incentives for builder performance. In the construction contract in the famous case of *Jacob & Youngs v. Kent*, the parties adopted a more intricate solution of presumption (or burden-shifting) that is common in construction contracts. Their contract provided that final payment was due upon the issuance of the architect's certificate.¹⁴¹ In our terminology, the certificate is a readily verified proxy for substantial performance that is chosen

¹⁴⁰ Id. at —.

¹⁴¹ 230 N.Y. 239, 240 129 N.E. 889, 890 (1921).

ex ante by the parties. It functions in combination with the substantial performance standard that delegates some discretion to the court even in the face of the certificate. The architect's expertise makes her judgment a good proxy for the builder's efforts because evidence of its existence is cheap and the architect is disciplined by her reputational stake in not appearing to be biased in favor of builders or owners. Given the substantial performance standard, the architect's certificate operates as a presumption: Once issued, it shifts the burden of proof to the owner to propose proxies demonstrating that the decision to issue the certificate was influenced by fraud, bias or mistake.¹⁴²

The division of the spoils case illustrates the effect of burdens on the efficiency of incentives to litigate proxy selection. The effects are important, but they are also complex. More analysis is required to trace fully the efficiency implications of burden allocation, but it is clear that the parties' contract design bears significantly on them. In the next section, we introduce a further complication in which the litigation concerns also the prospective structure of the parties' relationship.

2. Structural Change Cases: Contract Assignments and Terminations.

In this category, the parties' suit occurs in the midst of a potentially on-going relationship, such as a distributorship or franchise. As in the case of the construction contract, the parties are concerned with optimizing contractual incentives and litigation cost. But the parties must also weigh the prospective efficiency consequences of changes in their relationship. The additional threat comes in the form of opportunistic change, or resistance to change. For example, one party may seek to assign the contract and the other may resist. Or, one party may seek to terminate the contract, and the other resist. We consider these examples in turn.

¹⁴²As any student of contracts knows, the contractual solution to the standard moral hazard problem in construction cases did not work perfectly in *Jacob & Youngs*. The architect refused to certify that the builder had fully complied, though the defect appeared trivial. The seeming disjunct between the size of the withheld final payment and the nature of the noncompliance suggested possible fraud or mistake by the architect. The builder, however, did not attempt to impeach the architect's decision. Rather, the builder asked the court to hold that perfect compliance was not a condition to receiving the entire last payment. The court agreed. It believed that forfeiture of the entire last payment would have been unfair, and that the parties could not have intended this result. 230 N.Y. 239, 129 N.E. 889 (1921). For a critique of the court's opinion, see Schwartz & Scott, *Contract Theory*, supra note – at –.

a. Assignment clauses. Assignments of contract rights have mixed efficiency consequences. On the one hand, they can move contract rights from lower to higher valued uses. On the other hand, leaving the assignment decision to the promisor may lead to inefficient transfers because she does not internalize the cost of the assignment to the promisee. So, for example, franchise agreements restrict the ability of the franchisee to assign its rights under the contract because the franchisee is interested only in maximizing the proceeds from a purchaser, without regard to the effect of the new franchisee on the franchise's reputation and value. Thus, agreements do not permit assignment but, recognizing that transfers may be efficient, the contracts also do not prohibit all transfers. Banning assignments completely would prevent the exploitation of the franchisee's private knowledge of higher-value franchisees. It is difficult, however, to distinguish between the benign and malign scenarios by specific rules. So, the parties rarely attempt to list requirements that must be met. Instead, they invoke a "reasonableness" standard under which the franchisor's consent to any assignment is required but will not be "unreasonably withheld." The reasonableness requirement is intended to have bite. The parties to a franchise agreement with Ace Hardware, for example, explicitly state that the franchisor's discretion is qualified.¹⁴³ The parties guide the courts by explicitly stating the joint value-maximizing purpose of the contractual standard. The Taco Bell franchise agreement, for example, states that "[t]he Franchisee acknowledges that the purpose of the aforesaid restriction is to protect the Company's trademarks, service makers, trade secrets and operating procedures as well as the Company's general, high reputation and image, and is for the mutual benefit of the Company, the Franchisee and other franchisees of the Company" (§13.3). The contract further provides that "[i]n considering a request for a transfer, the Company will consider, among other things, the qualifications, apparent ability and credit standing of the proposed transferee as if the same were a prospective, direct franchisee of the Company" (§13.0).

Consider two alternative ways of framing the reasonableness condition that illustrate the

¹⁴³“Except where this Agreement expressly obligates the Company reasonably to approve or not unreasonably to withhold its approval of any action or request by Distributor, the Company has the absolute right to refuse any request by Distributor or to withhold its approval...” Ace Hardware Corporation National Supply Network, Distributor Franchise Agreement §§13(b)(ii), 16(h), http://library.consusgroup.com/library_sbn/144/144968.asp.

parties' anticipation of burdens of proof. Under either alternative, litigation addresses the issue of whether the assignment is "reasonable" and the parties present alternative proxies. The first approach permits the franchisee to assign its rights only if reasonable. The second permits the franchisee to assign its rights only with consent of the franchisor and provides that such consent will not be unreasonably withheld. Agreements uniformly adopt the latter approach. The choice of the latter version anticipates the assignment of burdens of proof in litigation. In the former case, the franchisor, suing for damages and to prevent the continued use of its trademark, would be required to prove that the transfer was not reasonable. Under the latter version, the franchisor would initially establish that it withheld consent. Then, the burden would shift to the franchisee to show that the franchisor's consent was unreasonably withheld. One might speculate that this allocation may be efficient on grounds of comparative information advantages: the person in contact with the intended transferee is likely to have better information about the qualifications of the new franchisee.

b. Contract Termination. Explicit termination clauses are common in many different categories of commercial contracts, including employment agreements, service contracts, merger and acquisition agreements, and franchise and distributorship arrangements.¹⁴⁴ Their role is puzzling because even in their absence, either party to an on-going relationship can terminate by declaring that the other party materially breached its obligations. Under the common law of contracts, material breach entitles the nonbreaching party to withhold performance and seek damages for breach.¹⁴⁵ One reason for explicit termination clauses is to provide for the conditions that trigger termination, rather than relying on the common law requirements for material breach. We suggest in this section that termination clauses also tailor burden allocation.

¹⁴⁴ See e.g., the following sample contracts in the CORI Contract Library: Cruikshank & Associates Consulting Agreement; National Penn Bankshares Share Purchase and Merger Plan; Northwest Bancorp Merger Agreement; Pak Mail Centers Franchise Agreement; Rexnord Corp. Employment Agreement; Sears License Agreement; Smart Serv Online Product License and Services Agreement. CORI Contract Library, *supra* note —. The phrase "termination" appears in 15,343 contracts (or 60.95% of the total) in the CORI Contracts Library. Of the 25,172 total documents in the data base, the phrase "right to terminate" appears 2,263 times; "termination with cause" appears 1,747 times; "terminated with cause" appears 1,139 times; "termination without cause" appears 673 times; and "terminated without cause" appears 365 times. *Id.*

¹⁴⁵ See e.g., Restatement (Second) of Contracts §§ 235, 237, 243.

Indeed, the burden design tends to be more refined than a deposit because it entails burden shifting rather than a binary allocation to either party. Before describing this pattern, we compare the factors bearing on the optimal allocation of burdens against the default allocation.

(i) Optimal allocations and default termination burdens compared. Consider the example of a manufacturer and a dealer who negotiate a ten-year dealer franchise contract for the sale of heavy duty trucks within a designated region.¹⁴⁶ The contract contains a combination of rules and standards governing the distributor's performance under the contract. These provisions commit the distributor, *inter alia*, to exercise its best efforts to promote the sales of the manufacturer's product, to "provide and maintain physical facilities commensurate with the sales possibilities and service needs in the distributor's sales area," and to "achieve a reasonable share of the market for the goods covered by the agreement in the normal trade area served by the dealer's location."¹⁴⁷ The manufacturer has the right to terminate upon breach of these requirements, either under the common law or an express termination clause. Although the manufacturer may also have the right to damages, we set these aside in order to focus on the termination decision and its effect on litigation burdens.

The manufacturer may seek to cancel the contract for any of the following three reasons. First, the dealer may have failed to exert the level of effort required in the contract and thereby jeopardized the value of the relationship. Second, the materialization of an exogenous risk, such as changed market conditions, may have rendered the contract unprofitable to the manufacturer (but not to the dealer). The manufacturer therefore seeks to invoke the contract's performance standards to escape the contract. For example, the manufacturer might claim that the dealer's sales are unreasonably low, thus violating its promise to maintain a "reasonable market share." Cancellation for this reason alone would lead to the loss of the relationship's future value, and it would also undermine the contract's allocation of risks. The manufacturer's incentive to guard against exogenous risks that make its own performance more costly or that make the return

¹⁴⁶ The example is drawn from *International Harvester Company v. Calvin*, 353 So. 2d 144 (Fla. 1978).

¹⁴⁷ The facts are drawn from *Id.* at —.

performance less valuable is undermined by its ability to use the standard to escape adverse changes in circumstances.¹⁴⁸ Third, the manufacturer may seek to threaten termination in order to force a renegotiation of its terms that would give it a larger share of the contract surplus. This opportunism is an attempt to appropriate the dealer's contract-specific investments in the ongoing relationship. As with the second reason, the manufacturer's invocation of the standard is opportunistic and contrary to the ex ante interests of the parties. The threat of opportunistic cancellation would lead the dealer to underinvest in the franchise (by hesitating to expand inventory, enhance physical facilities, advertising, etc.,).

The first motivation (dealer shirking) is an efficient justification for termination: it both arrests a relationship that is no longer valuable because of the dealer's shirking and yields an ex ante discipline that might deter shirking.¹⁴⁹ The second and third motivations (regret avoidance and hold-up) impose the efficiency costs described above. The allocation of burdens, however, is insensitive to the manufacturer's motivation. Assigning the burden of proof to the manufacturer deters inefficient cancellation but also efficient cancellation in response to dealer shirking. Therefore, if burden allocation is a binary choice, the best available arrangement depends on the relative magnitude of efficient and opportunistic cancellation. For example, to the extent that the dealer's incentive to shirk is disciplined by reputational constraints, the burden of proof should fall on the manufacturer.

If the parties provide neither for express burden allocation nor an explicit termination clause, the default allocation of burdens governs. The plaintiff has the burden of establishing the prima facie case and the defendants bear the burden of proving affirmative defenses. Of course, either the manufacturer or the dealer might be the plaintiff in litigation. The manufacturer who

¹⁴⁸ See e.g., *Paradine v. Jane*, Ayleyn 26, 82 Eng. Rep. 897 (K.B. 1647) ("When a party by his own contract creates a duty or charge upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract.") For discussion of the principle of "promisor's risk" see SCOTT & KRAUS, *supra* note – at 77-88.

¹⁴⁹The same may be said of events of default in debt instruments, such as loan contracts. See George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy*, 16 Int'l Rev. Law & Econ. 101, 104-7 (1996).

has terminated may seek to enjoin further use of the trademark by the dealer and exercise its option to buy the dealer's premises on termination. Or, the dealer may be the one who sues in order to recover damages for unjust termination. Yet, the optimal allocation of burdens depends on their impact on incentives and litigation costs, and these are unlikely to be affected by whether the plaintiff is the manufacturer or the dealer. We made the same observation earlier in connection with the effect of a buyer's acceptance or rejection on the burden of proving the defect or conformity in goods delivered under a sales contract. The failure of the default burden allocation to respond to incentive effects thus leads parties to tailor burdens through an express termination provision.

(ii) Express termination clauses. Termination clauses typically have graduated termination rights. At the first level, there is a right, most often granted to both parties, to terminate the agreement without cause upon appropriate notification. In the license agreement used by Sears Roebuck, for example, §20.1 provides for "No Fault Termination" under which either party "without cost, penalty or damages for any reason whatsoever" has the right to terminate the agreement upon providing the other party with at least 180 days written notice.¹⁵⁰ Second, the termination clause grants both parties a right to terminate for cause as specified. Most significant for our purposes are termination provisions granting a right of immediate termination to the licensor or manufacturer.¹⁵¹ For example, §20.7 of the Sears License Agreement provides for "Termination With Cause Immediately." This clause lists a number of specific grounds for termination followed by a general standard. Collectively, these terms

¹⁵⁰See Sears License Agreement made on January 1, 2003 between Sears Canada, Inc. and Sears Roebuck & Co. and CPI Corp., at CORI Contracts Library, *supra* note —.

¹⁵¹In addition to the example in the text consider the Taco Bell Franchise Agreement: The Taco Bell agreement provides that "[a]ny failure to adhere to the standards, specifications, requirements or instructions contained in this Agreement or in the Manual shall constitute a material breach of this Agreement." (§3.4) The franchisee's material breach triggers the franchisor's contractual right to terminate and to collect liquidated damages. The franchisor must allow the franchisee 30 days within which to cure the failure, before exercising its contractual right to terminate the agreement. If the failure is repeated within one-year after an earlier default, the franchisor may terminate without allowing any period for cure. In the event of default or repudiation by the franchisee, the franchisor is entitled to liquidated damages equal to the greater of the amount of 11% times the previous twelve months' gross sales or \$100,000 (§15.4). See note – *supra*.

specify the conditions under which Sears as the licensor may terminate the contract immediately. Specific grounds for termination include insolvency or bankruptcy of the licensee, sales of assets not in the ordinary course of business, a failure to operate and conduct business for more than three consecutive days, misappropriation of funds of the licensor, disclosure of confidential information, a change of control, and implementation of a change of practice without prior approval.¹⁵² The list of precise terms authorizing termination is followed by a single broad standard that grants Sears the right to terminate for the “licensee’s refusal to co-operate... in the performance of the Agreement, or for the “licensee’s failure or refusal, within 3 business days after receipt of written notice from Sears, to comply with *any material provision or condition*” of the contract.¹⁵³ This is consistent with the usual pattern of requiring notice and opportunity to cure before permitting termination on the basis of the violation of a standard rather than rule. The notice informs the licensee of the proxy that the licensor intends to rely on in declaring the termination of the contract.

The case of *International Harvester v. Calvin*¹⁵⁴ demonstrates how termination clauses yield more complex and shifting burdens of proof. *International Harvester* concerned a heavy truck franchise agreement and, as noted earlier, contained a termination clause giving the manufacturer the right to terminate the contract for cause if the dealer failed to “achieve a reasonable share of the market for the goods covered by the agreement, in the normal trade area served by the dealer’s location.”¹⁵⁵ Two years after the contract was concluded, the manufacturer notified the dealer it was in violation of the termination clause and would be terminated unless corrective action were taken. Subsequently, the manufacturer notified the dealer that the agreement was terminated, effective in 90 days.¹⁵⁶ A state regulatory body issued

¹⁵² Id at §20.7 (a) through (x).

¹⁵³ Id. at §20.7(y) (emphasis added)..

¹⁵⁴353 So. 2d 144 (Fla. 1978).

¹⁵⁵Id. at —.

¹⁵⁶Id. at —.

an order setting aside the termination, and the manufacturer sued to reverse the administrative order. Unlike the default allocation of burdens to plaintiffs generally, the court held that the termination provision assigned to the dealer the initial burden to show by a preponderance of the evidence the unfairness of the manufacturer's decision to terminate the franchise agreement.¹⁵⁷ Thus, the termination provision effectively operated as a presumption that the termination was justified, if the manufacturer established that it had delivered the required termination notice and if it presented to the court a simple affidavit that the dealer had failed to comply with the reasonable market share requirement.¹⁵⁸ The termination clause then shifted to the dealer the burden of proof of its own performance under the contract.

The burden on the dealer might be costly to satisfy, but the court gave the dealer another option. The dealer could respond by introducing evidence of opportunistic termination: for example, that the manufacturer had attempted to install another dealership in the adjoining county. Indeed, in *International Harvester*, the dealer had filed a formal protest with the agency charged with jurisdiction over claims of unfair treatment of dealers. Only then, the dealer contended, did the manufacturer's evaluations of its sales performance begin to deteriorate. The dealer also testified that the manufacturer attempted to coerce it to expand its facilities and greatly increase its investment in inventory and fixed costs. The notice of termination, the dealer argued, was the result of its reasonable refusal to comply with these demands. The court held that this prima facie showing of bad faith shifted the burden to the manufacturer to show by a preponderance of the evidence that the termination was not motivated by strategic considerations – that it would have terminated even in the absence of the alleged bad faith purpose.¹⁵⁹

In fact, the manufacturer presented evidence that the dealer's sales were only 70% of its estimated sales potential. Moreover, the dealer's market penetration was only 6% when the other franchise dealers in the area averaged 15.3%. Finally, the national advertising budget for

¹⁵⁷Id at 148.

¹⁵⁸Recall the Jacob & Youngs presumption based on the architect's certificate. TAN supra note –.

¹⁵⁹Id. at 148.

all dealers averaged .5% of total operating budget, while this dealer only spent .1% on advertising. The court in *International Harvester* held on these facts that the objective data introduced by the manufacturer and substantially uncontradicted by the dealer was “so overwhelming” as to carry its burden of proving an independent reason for termination of the contract.¹⁶⁰ Thus, once the “dueling proxies” were introduced into evidence, the ultimate burden of persuasion fell on the principal rather than the agent: the principal was required to bear the burden (and internalize the consequent cost) of bad faith terminations.

This example of shifting burdens (or presumptions) suggests that the parties have more flexibility in burden design than all-or-nothing allocations to each party. More generally, our discussion underscores the importance, but also the complexity, of the contracting task of efficient burden assignment, whether by explicit or implicit provisions. On the one hand, the parties must identify and evaluate the relative severity of the agent’s incentives to shirk and the principal’s incentives to make opportunistic claims of breach, both in terms of their likelihood and their efficiency consequences. On the other hand, the parties must anticipate the future litigation, particularly, who is more likely to be suing and for what. Although the parties can undoubtedly improve on the default burden allocations, the tailoring task is likely to involve substantial up-front transaction costs.

CONCLUSION

The relationship between the front-end and back-end stages of contracting can be analyzed usefully with the tools of contract theory. Much of contract design can be explained in this light, by anticipating not only the effect of litigation, but the effect of renegotiation and settlement as well. In this paper, we offer a preliminary exploration of the impact of the anticipated course of litigation on contract terms. By opening the black box of litigation to

¹⁶⁰Id. at 148. In implementing its scheme of presumptions and shifting burdens, the court held that it was adopting the test for using burdens to decouple claims of bad faith from claims of non-performance that was first proposed by the Supreme Court in *Mt. Healthy City School District Board of Education v. Doyle*, 429 U.S. 274 (1977).

contract scholars, we offer some fresh insights into the use of rules and standards in commercial contracts.

In particular, we have offered a preliminary theory explaining the feedback effect of the adversarial litigation system, and particularly burdens of proof, on the parties' agreement. In doing so, we seek to rebut a persistent skepticism in contract scholarship of the use of vague terms and broad standards in contract design. Where the parties include these terms, the courts should do their best to interpret them by inviting the parties to select the most efficient proxies that fall within the proxy space as defined by the combination of rules and standards specified in the contract. We also introduce burden allocation as a valuable objective in the choice of substantive contract provisions, and we explain deposits, assignment restrictions and termination clauses on this basis.

The claim that party-created standards can enhance efficiency in harnessing the ex post informational advantage available at litigation does not imply, however, that courts and legislators should create default standards to fill gaps in incomplete contracts. After all, the cost to the parties of writing such vague terms is low. Moreover, the combinations of rules and standards that we have examined reveal a complex contractual design that public law makers are often unable fully to comprehend. Therefore, the courts would be wise to interpret the absence of vague terms or standards in commercial contracts as instructions from the parties to limit their construction to the specific terms of the contract.