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ARTICLE 2 AND RELATIONAL SALES CONTRACTS

*Richard E. Speidel**

I. SOME ISSUES IN THE PROPOSED REVISION OF ARTICLE 2

The official text of Uniform Commercial Code Article 2 (Sales) is thirty-five years old. Several important developments in and around the law of sales since 1957 justify revision of Article 2.¹ A revision process that will determine the future of Article 2 is now underway.²

In addition to other developments, two important theoretical approaches to contract law have blossomed in the last thirty-five years. The first is economic analysis, with its emphasis on promoting efficient bargains, actual or hypothetical, at the time of contracting and thereafter protecting the ex ante bargain from the erosion of time and tide. The second is relational contract theory, with its emphasis on deterring opportunistic behavior within and adjusting or preserving relationships in light of changing circumstances after the time of contracting.³ Because a

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1. For example: (1) Consumer protection legislation, such as the Federal Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, Pub. L. No. 93-637, 88 Stat. 2183 (1975) (codified in scattered sections of 15 U.S.C.), and state “lemon” and deceptive trade practices laws have been enacted; (2) computer technology, such as Electronic Data Interchange, has revolutionized communication between trading partners; (3) indirect marketing through vertical contracts has become widespread, with multimedia advertising promoting many commercial and most consumer products; (4) different, complex transaction types, such as the sale, lease or license of computer systems, have evolved; (5) a growing service economy has challenged the scope and importance of Article 2, and the benefits of leasing rather than buying goods have prompted the preparation of a new Article 2A; and (6) the United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, S. TREATY DOC. No. 9, 98th Cong., 1st Sess. (1983), *reprinted in* 52 Fed. Reg. 6264 (1987), became effective in the United States in 1988.

2. Debora L. Threedy, *Liquidated and Limited Damages and the Revision of Article 2: An Opportunity to Rethink the U.C.C.’s Treatment of Agreed Remedies*, 27 IDAHO L. REV. 427, 427 (1990).

3. *See infra* part III.

full contingent bargain is unlikely, the emphasis is on events and conduct *ex post*, rather than agreement *ex ante*, contract formation.

Although there are overlaps, at the extremes these theories prescribe radically different models of contract liability and remedy. The former, with its attention to the parties' *ex ante* bargain, fits comfortably into consent-based, bargain-oriented, "neo-classical" contract doctrine. The latter, with its attention to events *ex post* contract, does not.

Admittedly, it is difficult to discuss one development without confronting the other. Nevertheless, in this Essay, I propose to discuss the characteristics and normative importance of relational contracts and pose, without answering, some difficult questions for the revision of Article 2. The ultimate question is whether the "gap fillers" and principles of liability and remedy in Article 2 should be revised to better respond to the realities of relational sales contracts.⁴

II. LIMITED RELATIONAL CHARACTERISTICS OF ARTICLE 2

Article 2 deals with the agreed exchange between two or more persons of goods for a price—the contract for sale of goods. It is a legislative exception to the common law of contracts for a particular transaction. It assumes that contracts for the sale of goods require different legal treatment.

A. Context

Article 2 clearly responds to the context within which the contract for sale is to be performed. For example, Article 2 does not distinguish among different *types of goods*.⁵ Thus, contracts for the sale of a horse, a new car, a custom-designed computer system or natural gas, are subject to the same rules and standards. Differences generated by types of goods are expected to emerge in the agreement of the parties, "gap fillers" supplied by the court, and standards designed to regulate formation, performance and enforcement. To this degree, the contract for sale is rooted in, and responsive to, a relevant commercial context and the parties' course of dealing and performance. In the absence of a clear and com-

4. The argument is that contract law in general, and sales law in particular, should in most cases, be responsive to the realities of exchange transactions in context. If there is an arbitrary divergence between law and reality, the law will have less impact on the behavior of the parties as they plan, perform and resolve disputes arising under the bargain. See Melvin A. Eisenberg, *The Responsive Model of Contract Law*, 36 STAN. L. REV. 1107 (1984).

5. Nor does it distinguish among different types of sellers and buyers. Except for merchant sellers and buyers, the principles of liability and remedy are the same for all.

plete agreement, lawyers and judges are expected to search for "immanent" external norms in the commercial context.⁶

B. Types of Contracts

Article 2 does not sharply distinguish among different *types of contracts* to sell goods. It applies to bargains of short duration made in functioning markets where the parties have agreed to all material terms. It also applies to relational contracts, such as bargains of longer duration that are somewhat idiosyncratic. Because the parties have not agreed to all terms, relational contracts also rely on the exercise of discretion reserved by one or both parties and continuing efforts by the parties to cooperate and to adjust to changes in the relationship. Article 2 responds to some of the characteristics of relational contracts, but the response is both implicit and, arguably, incomplete.⁷

C. Governance Structures

Finally, Article 2 has little, if anything, to say about the agreed structure, if any, for governing performance or adjustment of the contract for sale.⁸ These structures range from organizing the parties into a single maximizing unit⁹ to maintaining separateness and relying primarily on the market to preserve the relationship and the courts to resolve disputes. These structures may take the form of model trading partner agreements, franchise and distribution contracts, and clauses devised by the parties to long-term contracts to adjust to change. They also include dispute-resolution mechanisms, such as arbitration and mediation. To

6. This approach, attributable to the jurisprudence of Karl Llewellyn, has been criticized as resting on a "triad of dubious assumptions that self-evident ideal resolutions of situational problems exist, that they can be discovered by careful scrutiny of actual situations, and that once articulated they will be widely accepted." Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 635 (1975); see also James J. White, *Promise Fulfilled and Principle Betrayed*, 1988 ANN. SURV. AM. L. 7 (discussing legal realist body of thought and effect on contract law).

7. See, e.g., Nathan M. Crystal, *An Empirical View of Relational Contracts Under Article Two of the Uniform Commercial Code*, 1988 ANN. SURV. AM. L. 293, 303 (concluding that cases reported since UCC's inception until 1987 show "predominance of discrete over relational contracts" in litigated cases).

8. One commentator defines governance structure as the "institutional framework within which the integrity of a transaction is decided." Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 235 (1979). Transaction-cost economics involves the choices among "alternative institutional modes for organizing transactions." *Id.* at 234.

9. This structure removes the transaction from the market and, through internal organization, manages decision making under common ownership and "with the assistance of hierarchical incentive and control systems." *Id.* at 237.

the extent that these mechanisms provide content and meaning to the exchange itself, they are incorporated by the UCC's broad definition of agreement.¹⁰ To the extent that they accomplish other objectives, they are beyond the direct scope of Article 2.

In sum, Article 2 deals primarily with the agreed exchange of goods for a price. In the absence of agreed governance structures, it says very little about mechanisms for resolving disputes or for adjusting or preserving the relationship.¹¹

III. RELATIONAL CONTRACTS AND REVISED ARTICLE 2

The characteristics and importance of relational contracts have been discussed extensively by such scholars as Ian Macneil, Oliver Williamson, Stewart Macaulay, Victor Goldberg and Robert Scott.¹² Identifying characteristics is mainly a task of description. Assessing importance, however, has normative implications. The argument is that relational contracts, because of their characteristics, may, at a minimum, require different "gap fillers" and principles of liability and remedy than more discrete sales contracts.¹³

A. *The Problem of Norms*

1. Relational theory

The degree to which a contract is relational depends upon the presence of some or all of the characteristics discussed below. Most notable are whether "(1) the transaction extends over time, (2) parts of the exchange cannot be measured or specified precisely [at the time of contracting], and (3) the interdependence of the parties to the exchange extends at any given moment beyond any single discrete transaction to a range of social interrelationships."¹⁴

10. See *infra* part III.A.2.

11. For example, U.C.C. § 2-209(1) (1990) protects a modification made in good faith, but the UCC says nothing about the duty of the parties to negotiate in good faith toward the modification. U.C.C. § 2-615(a) provides limited relief for changed circumstances, but it says nothing about whether that relief should be discharge of the contract or adjustment and continued performance.

12. See generally Symposium, *Law, Governance, and Continuing Relationships*, 1985 WIS. L. REV. 461, 483-579 (discussing relational contracts). The existence and importance of relational contracts in the real world has also been verified in an interesting empirical study. See Russell J. Weintraub, *A Survey of Contract Practice and Policy*, 1992 WIS. L. REV. 1, 16-24.

13. See, e.g., Richard E. Speidel, *Warranty Theory, Economic Loss, and the Privity Requirement: Once More into the Void*, 67 B.U. L. REV. 9, 39-57 (1987) (arguing that relational theory supports abolition of privity defense in warranty disputes under Article 2).

14. Lewis A. Kornhauser, *The Resurrection of Contract*, 82 COLUM. L. REV. 184, 190 (1982) (reviewing IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MOD-*

Ian Macneil has identified norms that are necessary to hold the relationship together—such as solidarity, reciprocity and role integrity—and other norms that may be generated by party behavior over time—such as those supporting cooperation, risk sharing and preserving the relationship. These are norms internal to the relationship. The “is” of actual behavior becomes the “ought” by which the relationship is governed. These internal norms are reinforced when they can be harmonized by external norms—such as the “oughts” generated by the behavior of others similarly situated—but they are not dependent upon harmonization.¹⁵

Perhaps these internal norms function well without the intervention of courts. Nevertheless, if relational theory is to be more than a body of nonlegal principles and sanctions, the internal norms must become part of the contract.

2. Article 2: The definition of agreement

The broad definition of “agreement” in UCC section 1-201(3) is, at first blush, consistent with relational contracting. The bargain in fact of the parties is found in “language or by implication from other circumstances including course of dealing or usage of trade or course of performance.”¹⁶ The sources from which agreement can be inferred are also defined.¹⁷ The question is whether these definitions are broad enough to incorporate internal norms generated by the relationship, such as cooperation or risk sharing, into the agreement.

For example, suppose the parties are in the fourth renewal of a five-year contract for sale. The written agreement is silent on whether there

ERN CONTRACTUAL RELATIONS (1980)). See *infra* part III.C for a discussion of the characteristics of a relational contract.

15. For a concise summary of relational contract theory, see Ian R. Macneil, *Relational Contract Theory as Sociology: A Reply to Professors Lindenberg and de Vos*, 143 J. INSTITUTIONAL & THEORETICAL ECON. 272, 273-76 (1987) [hereinafter Macneil, *Relational Contract Theory*]. See also IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* 37 (1980) (arguing that “[o]nly when the societal norm reflects desires to stamp out or curtail contracts can the external [norms] differ fundamentally from the internal [norms]”); Ian R. Macneil, *Exchange Revisited: Individual Utility and Social Solidarity*, 96 ETHICS 567, 568 (1986) (arguing that “no pattern of exchange merely enhances individual utility respecting goods being exchanged, and all patterns of exchange accepted by all parties enhance solidarity”); Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483 (arguing that complex patterns of human interaction are necessary components in any accurate account of legal development). But see Randy E. Barnett, *Conflicting Visions: A Critique of Ian Macneil’s Relational Theory of Contract*, 78 VA. L. REV. 1175 (1992) (arguing that there are ambivalences and ambiguities in Macneil’s writings).

16. U.C.C. § 1-201(3).

17. See *id.* §§ 1-205, 2-208.

is a duty to negotiate in good faith in light of changed circumstances, and there is no applicable trade usage. In the past fifteen years, the parties willingly negotiated in good faith when an unanticipated change occurred on ten occasions. In the second year of the fourth renewal, one party refuses to negotiate despite changed circumstances and threatens to terminate the relationship. The other claims a breach of contract.

Relational theory would identify and assess the parties' pattern of behavior over time (the "is") and, in all probability, conclude that their behavior produced an internal norm of cooperation and adjustment (the "ought"). Taking the next step, one might conclude that the norm became a term of the contract and that a failure to negotiate is a breach. UCC section 1-205(1), however, might not permit this last step: "A course of dealing is a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding *for interpreting their expressions and other conduct.*"¹⁸ There is no written "expression" to interpret, and the issue is not simply how to interpret the pattern of conduct. Rather, the question is whether a refusal to engage in that conduct, properly interpreted, is improper.¹⁹ Although UCC section 1-205(3) states that a course of dealing is relevant to "give particular meaning to and supplement or qualify terms of the agreement,"²⁰ the emphasis is still on some "term." Thus, the pattern of previous conduct is, arguably, relevant to interpreting or supplementing a term in the agreement, not to supplying that term.²¹

A possible argument is that the definition of "agreement" is not necessarily limited by the definition of "prior course of dealing" found in UCC section 1-205. If an agreement under UCC section 1-201(3) to negotiate in good faith is found by "implication" from the parties' course of dealing, it is a term of the agreement to be interpreted under UCC section 1-205. Although this reaches the correct relational result, the path to that outcome could be smoothed by appropriate clarification.²²

18. *Id.* § 1-205(1) (emphasis added).

19. *See id.* § 2-208(1).

20. *Id.* § 1-205(3).

21. *See, e.g., Crescent Oil & Shipping Servs. v. Phibro Energy, Inc.*, 929 F.2d 49, 52 (2d Cir. 1991) (holding that trade usage and course of performance are relevant to interpretation of term in writing).

22. *See* Robert A. Hillman, *The Crisis in Modern Contract Theory*, 67 TEX. L. REV. 103, 123-27 (1988) (discussing broad reading of "agreement"); Amy H. Kastely, *Stock Equipment for the Bargain in Fact: Trade Usage, "Express Terms," and Consistency Under Section 1-205 of the Uniform Commercial Code*, 64 N.C. L. REV. 777, 782 (1986) (expressing view that potential of U.C.C. § 1-205 has not been realized); *see also* David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1816

B. Opportunism

1. Relational theory

Both relationalists and transaction-cost economists recognize the importance of preventing opportunism in relational contracts. Opportunism rears its ugly head when one party departs from the internally generated norms of the relationship, whether they be the primary norms of reciprocity and solidarity or the supplementary norms of cooperation and risk sharing, to engage in conduct motivated primarily by self interest. It may occur to exploit transaction-specific investments made by the other party, to recapture gains implicitly allocated at the time of contracting or to exploit internal or external changes that occur during performance. According to Macneil, opportunism is “[s]elf-interest seeking contrary to the principles of the relation in which it occurs.”²³

In short, opportunism threatens the relationship. If the contract does not have a governance structure to regulate or define opportunism, or if that structure fails and the parties cannot agree, a court may be asked to intervene. It is at this point that the responsiveness of contract law in general, and Article 2 in particular, to the relational contract may be tested. More particularly, the question is whether the allegedly opportunistic conduct is permitted or constitutes a “breach” of the relational contract.

2. Article 2: Scope of good faith duty

The UCC imposes a duty of good faith in the “performance or enforcement”²⁴ of contracts. The duty of good faith, however, is immutable: The parties cannot avoid it by agreement, although it can be

(1991) (suggesting that courts use “hypothetical bargain” framework to interpret ambiguous language, to supply implied duties in face of contingency that no language in contract addresses, and to supply terms of effective but incomplete agreement).

23. Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a “Rich Classificatory Apparatus,”* 75 NW. U. L. REV. 1018, 1024 n.20 (1981); see also Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code,* 67 IOWA L. REV. 1, 24 (1981) (noting that opportunism recaptures gains “foregone at the time of contracting”); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts,* 65 MINN. L. REV. 521, 521 (1981) (stating that opportunism is behavior by party A that is contrary to party B’s understanding, but not necessarily contrary to explicit terms of agreement, and that results in transfer of resources); Williamson, *supra* note 8, at 234 n.3 (stating that opportunism is variety of self-interest seeking that “extends simple self-interest seeking to include self-interest seeking with guile”).

24. U.C.C. § 1-102.

defined.²⁵ Because good faith is an imposed term of the agreement,²⁶ bad faith, however defined, is a breach of contract.

a. internal norms

The current definition of good faith does not confront a common form of opportunism in relational contracts, which is self-interest-seeking contrary to the *internal* norms of the relationship. UCC section 1-203 states that "every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."²⁷ UCC section 1-201(19) provides a subjective definition of good faith: "honesty in fact in the conduct or transaction concerned."²⁸ UCC section 2-103(1)(b), however, adds an objective element: Good faith "in the case of a merchant means honesty in fact and the *observance of reasonable commercial standards of fair dealing in the trade.*"²⁹ Under this definition, bad faith is a failure to conform to external trade standards of fair dealing, rather than to norms generated by the relationship itself. If the internal norms are part of the agreement, a deviation can be handled as a conventional breach of contract. If internal norms are apart from the agreement, they must conform to external trade norms before a deviation is considered bad faith.³⁰

In contrast, revised Article 3, in UCC section 3-103(a)(4), now defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."³¹ Note that the objective standard applies to everyone and the phrase "in the trade" has been deleted. Arguably, the source of the relevant commercial standards could be the relationship itself.

An even better definition of good faith might provide as follows: Good faith "means honesty in fact and the observance of reasonable [commercial] standards of fair dealing *in the conduct or transaction in-*

25. Although the obligation of good faith "may not be disclaimed by agreement . . . the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable." *Id.* § 1-102(3).

26. See Christine L. Kunz, *Frontispiece on Good Faith: A Functional Approach Within the UCC*, 16 WM. MITCHELL L. REV. 1105 (1990).

27. U.C.C. § 1-203.

28. *Id.* § 1-201(19).

29. *Id.* § 2-103(1)(b) (emphasis added).

30. See, e.g., *Badgett v. Security State Bank*, 807 P.2d 356, 360 (Wash. 1991) (holding that unless agreement so provided, bank had no good faith duty to consider debtor's proposal for loan restructuring, even though parties' course of dealing was consistent with such consideration, and stating that there was no "free-floating" duty of good faith unattached to terms of underlying legal document).

31. U.C.C. § 3-103(a)(4).

volved." A comment could state that "sometimes good faith is the basis for proscribing behavior that violates basic standards of decency, either generally or in the particular conduct of the transaction involved. Examples include, but are not limited to, the use of subterfuges and evasions."³² This definition supports a finding of bad faith (opportunism) when one party's conduct deviates from internal norms generated by the relationship and, if adopted, would be a better response to the problems of opportunism in relational contracts.

b. precontract negotiations

Under the current version of Article 1, the good faith duty applies to the "performance and enforcement" of the contract but not to precontract negotiations.³³ Unless there is an agreement sharing risks or defining responsibilities in bargaining, claims of opportunistic behavior before the contract is formed are beyond the scope of the UCC.³⁴

From a relational perspective, this line is softened somewhat by the ease with which parties can conclude a contract for sale without agreeing on all material terms. Parties can conclude a contract with incomplete or indefinite terms "if [they] have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."³⁵ A completely contingent contract is not required, but if there is no such manifested mutual intent, the opportunistic conduct of one party in withdrawing from negotiations that have not quite concluded a bargain is neither a breach of contract nor bad faith.

This seemingly artificial exclusion has been sharply criticized by Professor Shell, who develops a model of potential liability in precontract negotiations based upon trust rather than good faith.³⁶ Whatever the source of the restraint, in the revision process the drafters should pay

32. This proposed definition of good faith follows that proposed by Professor E. Allan Farnsworth to a committee of the American Bar Association's Business Law Section, which is considering possible revisions of UCC Article 1. Letter from William B. Davenport & Harry C. Sigman, Co-Chairs, UCC Article 1 Review Task Force, ABA Section of Business Law, to Members of Task Force 1 (Dec. 10, 1992) (on file with *Loyola of Los Angeles Law Review*).

33. U.C.C. § 1-203.

34. *Id.* Most commentators oppose the extension of contract principles to this setting. See, e.g., E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987); see also Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentation*, 15 HOFSTRA L. REV. 443 (1987) (opting for tort solution).

35. U.C.C. § 2-204(3). The "offer-acceptance" model of contract formation, however, still undergirds Article 2. See *id.* §§ 2-205 to -207.

36. See G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221 (1991).

careful attention to the importance of relational norms, regardless of the formal rules of contract formation.

In sum, internal norms may be generated by an exchange relationship in the negotiations before and in the performance after a contract is formed. If these internal norms are to be protected against opportunism, the definition of good faith should be expanded to incorporate them and its scope extended to precontractual negotiations.

C. *Characteristics of Relational Contracts*

What is a relational contract? Macneil has identified several characteristics of relational contracts, broadly conceived.³⁷ Many of these appear in long-term contracts for the sale of goods. I will note the relational characteristic and then pose the issues that might be considered in the revision of Article 2.

1. Extended duration

a. *characteristics*

Relational contracts continue over an extended period of time. The exchange relationship may consist of a series of contracts between the same parties over an indefinite period, or it may be expressed as, say, a twenty-year contract for the supply of goods. Alternatively, the extended relationship may involve others, such as suppliers, sureties, customers and banks. In short, patterns of interaction and expectation develop that transcend the boundaries of the traditional discrete bargain.

b. *issue*

Extended duration reduces the likelihood that the parties will be able or willing to agree on all material terms at the time of contracting. It increases the need for one or both parties to have discretion in performance as the contract unfolds.³⁸ Extended duration also raises the question of when the relationship terminates. In cases in which there is no agreed time limit or method of termination, UCC section 2-309 states that the contract is "valid for a reasonable time"³⁹ but that either party can terminate "at any time [upon] reasonable notification" to the other party.⁴⁰

37. See Macneil, *Relational Contract Theory*, *supra* note 15, at 273-76.

38. The consequences of extended duration are well discussed in Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

39. U.C.C. § 2-309(2).

40. *Id.* § 2-309(3).

The revision issue is whether termination at will with a "reasonable notification" requirement adequately protects the reliance interests of the parties and those persons who interact with them. For example, if an internal norm favors preserving the relationship and one party has made transaction-specific investments, does a statutory limitation that a termination notice must be "reasonable" adequately control opportunism or measure when the norms of reciprocity and solidarity have deteriorated? Arguably, an unadorned standard of reasonableness is too slender a reed for the relational contract.

2. Open terms and reserved discretion

a. characteristics

One consequence of extended relationships is that the participants neither intend nor expect to see the whole future relationship presentiated at any single time. They view the exchange as an ongoing integration of behavior that will grow and vary with events in a largely unforeseeable future. Thus, the parties may intentionally leave important terms open, or explicitly "agree to agree" in the future. Or, they may reserve to one or both parties discretion to be exercised during performance. Thus, the agreement may say nothing about price, or the seller may be given discretion to fix the price. Similarly, the seller may agree to supply "output," the buyer may agree to purchase "requirements," or, in an exclusive dealing contract, one or both may agree to use "best efforts."

A consequence of open or flexible terms or reserved discretion, is that the contract "tracks the market" over time. It shares rather than divides market risk.⁴¹ The standard of performance or allocation of risk is judged by behavior and conditions at the time of performance, rather than by fixed terms agreed ex ante contract.

b. issue

The current Article 2 seemingly responds well to open terms and reserved discretion in long-term contracts. Section 2-204(3) provides that "[e]ven though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate

41. See Victor P. Goldberg, *Price Adjustment in Long-Term Contracts*, 1985 WIS. L. REV. 527 (noting that incentive to engage in opportunistic behavior increases as divergence between contract price and market alternatives increases).

remedy.”⁴² In addition, Part 3 of Article 2 supplies a variety of terms to fill gaps in the agreement, and the duty of good faith in the performance of the contract regulates the exercise of reserved discretion by one or both parties.⁴³

Nevertheless, there are several lurking issues. For example, are the “gap fillers” in Part 3 of Article 2 appropriate for relational contracts? Suppose the parties have agreed to agree on a price, but fail to do so because of one party’s opportunistic behavior. What happens next? Under UCC section 2-305(1)(a), if the parties intended to be bound, even though they do not agree to a price, the price is a “reasonable price at the time for delivery.”⁴⁴ But UCC section 2-305(1) seems to assume that the relationship will terminate and the dispute will go to litigation. Nothing is said about the probability that a long-term contract will continue despite the failure to agree or the manner in which one party’s opportunistic behavior is to be treated. Moreover, it is doubtful whether the phrase “reasonable price at the time for delivery” is sufficient to ensure that the market risk is shared as the parties intended. In short, UCC section 2-305 is both incomplete and too sparse to deal with all of the relational complexity.

Suppose further that one party’s opportunistic behavior in failing to negotiate is treated as a breach. What is the appropriate remedy if the nonbreaching party wants the exchange to continue and this is supported by relational norms? An ideal remedy is a decree of specific performance, with the court either supplying a price term to fill the “gap” or attempting to facilitate agreement by the parties.⁴⁵ Although Article 2 does not foreclose this relief, it does nothing to facilitate or encourage it.⁴⁶ Without an inspired leap of equitable faith, there is a real risk that

42. U.C.C. § 2-204(3).

43. *See, e.g., id.* §§ 2-305(2), -306(1), 1-203.

44. *Id.* § 2-305(1)(a).

45. *See Oglebay Norton Co. v. Armco, Inc.*, 556 N.E.2d 515 (Ohio 1990). The parties, under a very long-term contract, agreed that they “shall mutually agree” upon a rate for the transportation of iron ore if an external price standard failed. *Id.* at 516. The external standard failed and the parties, apparently due to the reluctance of the shipper, failed to agree. *Id.* at 517. The court, without stating that the shipper had breached the contract, granted specific performance and ordered the appointment of a mediator if the parties were unable to agree on a rate. *Id.* at 521. If the mediator failed to obtain agreement, the court reserved the power to fill the gap. *Id.*

46. U.C.C. § 2-716(1) states that specific performance “may be decreed where the goods are unique or in other proper circumstances,” and U.C.C. § 2-716(2) provides that the “decree for specific performance may include such terms and conditions as to payment of the price, damages, or other relief as the court may deem just.” Thus, the legislative framework is barely adequate for a court with a relational perspective.

the relationship will terminate or fail for "indefiniteness" under UCC section 2-204(3).

3. Future cooperative behavior is expected and, perhaps, facilitated by agreed governance mechanisms

- a. *characteristics*

In contracts with an extended duration, in which terms are open or flexible or discretion is reserved, it is expected that change generated by internal events or circumstances external to the relationship may require both parties to cooperate in sharing risks or making needed adjustments. Thus, if an external price-fixing mechanism fails to operate or a term in the contract fails of its essential purpose, the parties may agree to negotiate in good faith or to submit the problem to arbitration or mediation while continuing performance. Or, the agreement may contemplate shared decision making to maximize joint profits, as if the parties were a single entity.

- b. *issue*

Under Article 2, an expectation of future cooperative behavior is enforceable when that expectation is expressed in an agreement. In the absence of agreement or an applicable statute, there is no duty to negotiate in good faith, much less agree, and, of course, there is no duty to arbitrate or mediate unless agreed. Fortunately, the broad definition of agreement may incorporate such a duty in some cases.⁴⁷ But, as discussed previously,⁴⁸ that definition may not pick up relevant norms generated by the relationship itself.

The issue, for relational contracts at least, is whether this position should be reversed. For example, should revised Article 2 provide that, unless otherwise agreed, the parties to a relational contract have a duty to negotiate in good faith to preserve or adjust the relationship in the face of changed circumstances? This duty would be justified by the nature of the contract rather than by agreement and would require some explication of when the duty arises, what is bad faith bargaining, and what are the consequences of failing to negotiate in good faith. Although these issues are difficult, they are responsive to recurring characteristics in relational contracting. The question is whether these default rules for rela-

47. See Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis Under Modern Contract Law*, 1987 DUKE L.J. 1 (making most of broad definition of agreement in U.C.C. § 1-201(3)).

48. See *supra* notes 16-22 and accompanying text.

tional contracts reflect terms to which the parties probably would have agreed if they had bargained over them.⁴⁹

4. Many benefits and burdens of the relationship are to be shared rather than divided and allocated

a. characteristics

In relational contracts, the parties may at the time of contracting agree to a price that tracks a changing market or provide for "output" or "requirements" to follow changing quantity, or may make short-term adjustments to alleviate the burden of changed circumstances. Under these agreements, the relationship is preserved by the agreed handshake of cooperation, rather than fragmented by the invisible hand of self interest. Put differently, provisions or incentives for flexibility and adjustment reduce the opportunity for strategic or opportunistic behavior by one party and tend to preserve the relationship.

b. issues

Article 2 both encourages and enforces market-tracking and risk-sharing agreements. The problem arises when the contract extends over time and the parties have agreed to, say, a fixed price or a fixed quantity and have failed to provide a mechanism for excuse or adjustment. As litigation over long-term energy contracts reveals, the tension between seemingly fixed contract terms and changing markets has disrupted if not proved fatal to many relationships. Moreover, the courts have rarely granted relief. The entire financial risk, instead of being shared, is left on the party against whom the market moved.⁵⁰ This result is consistent with consent-based theories of contract and, perhaps, practical limitations upon the judicial process.⁵¹

49. For a lukewarm endorsement of a "cooperative model" for relational contracts, see Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535 (1990).

50. See, e.g., Harold A. Lewis, Comment, *Allocating Risk in Take-or-Pay Contracts: Are Force Majeure and Commercial Impracticability the Same Defense?*, 42 SW. L.J. 1047 (1989).

51. See Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992) (concluding that courts, lacking sufficient information about party intent and market alternatives, are reluctant to intrude if parties have failed to agree). For an example of how relational contract theory might operate, however, see Danton B. Rice & Michael A. Schlueter, Note, *Deregulation and Natural Gas Purchase Contracts—Neoclassical and Relational Contract Theories*, 25 WASHBURN L.J. 43 (1985).

Perhaps Article 2 should leave this problem alone, relying on the parties to work it out.⁵² On the other hand, Article 2 could stimulate the process of bargaining without dictating the content of an adjustment. As suggested, the conduct of the parties may generate internal norms that support an effort to adjust despite the lack of agreement. If so, they should be recognized. Furthermore, if the agreed term has, in light of changed circumstances, apparently failed of its essential purpose, the parties have been unable to agree and the aggrieved party is entitled to some relief,⁵³ the court could be permitted to supply an appropriate gap-filler term around which the parties could continue to bargain. Both of these moves are consistent with the characteristics of relational contracts and respond to the dilemma posed when the parties, for whatever reason, select a term suitable for short-term contracting for a relationship that extends over time.

5. There may be "transaction-specific" investments

a. characteristics

The binding nature of the relationship and the cost of termination are often enhanced when one party makes a transaction-specific investment, such as if an electrical utility, requiring a unique type of coal, requires the coal mine to invest in special equipment to produce the coal. Or, as revealed in a recent case, if the shipper of iron ore under a long-term contract requires the carrier to invest in special equipment to load, unload and preserve the ore.⁵⁴ These investments tend to distance the exchange from the market, increase costs and enhance incentives to preserve the contract.

b. issue

Under Article 2, the presence of "transaction-specific" reliance supports a conclusion that the parties "intended to contract" even though terms were left open or agreed price-fixing methods failed.⁵⁵ Even so, Article 2 does not single out this type of reliance for special treatment. For example, there is no indication how reliance might (1) influence the content of the other's good faith duties, (2) limit the power to terminate

52. Professor Scott, an experienced relationalist, would prefer to rely on patterns of cooperative behavior that are predicted to function rather than rely on judicial intervention. See Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987).

53. See U.C.C. § 2-615(a) (providing standards for excuse in Article 2).

54. See *Oglebay Norton Co. v. Armco, Inc.*, 556 N.E.2d 515 (Ohio 1990).

55. See U.C.C. § 2-204(3).

under UCC section 2-309(3), or (3) shape remedies for breach. By exalting expectation in UCC section 1-106(1), the UCC does not begin to tap the potential of the reliance interest as a tool to solve hard cases or a device to facilitate the compromise settlement of business disputes.⁵⁶

6. Close, whole-person relations may form an integral aspect of the relationship⁵⁷

a. characteristics

In relational contracts, many persons with individual and collective poles of interest may be involved, along with entangling strands of friendship, reputation, interdependence, morality and altruism. These strands may include both parties to, and third persons who become involved with and dependent upon, the relationship.⁵⁸

b. issue

If relational exchange encompasses more than just the parties to the contract, the framework for analysis is expanded. For example, should the interests of third persons be considered when the power to terminate is exercised? If third persons are integrally involved in and, perhaps, have relied upon the relationship, the termination power arguably should take those interests into account. Similarly, if there is a "bargain of sorts" between multiple players in the sale and distribution of goods, with information and expectations created over a broad base of purchasers, the current adherence to the privity requirement in warranty disputes seems misplaced.⁵⁹ In any event, revised Article 2 might take these factors into account in considering the treatment of various nonparties.

7. Conclusion: The content of relational default rules

a. assumptions

Assuming a relational contract for sale, two proposals and several suggestions for the revision of Article 2 have been made. First, the UCC's definition of agreement should be revised to clearly incorporate

56. See Stewart Macaulay, *The Reliance Interest and the World Outside the Law School's Doors*, 1991 WIS. L. REV. 247, 274-87.

57. Macneil identifies two other characteristics of relational contracts that will not be discussed here: (1) Trouble is expected as a matter of course; and (2) the relationship apart from the exchange has independent value. The former encourages the parties to plan for dispute resolution, and the latter helps to explain why parties in an extended relationship are willing to share risks and engage in cooperative behavior. MACNEIL, *supra* note 15, at 75-76.

58. See generally Melvin A. Eisenberg, *Third Party Beneficiaries*, 92 COLUM. L. REV. 1358 (1992) (discussing when third-party beneficiaries should be allowed to enforce contracts).

59. See Speidel, *supra* note 13, at 13.

into the contract internal norms generated by the relationship. Second, the scope and content of the good faith duty should be expanded to better deter opportunism in both pre- and post-contract relationships. Third, depending on the relational characteristic involved, possible responsive revisions of the Article 2 "default" rules were discussed and suggestions were made.

Throughout, it was assumed that the parties had power to plan for relational contracting. Except for limitations imposed on the power to vary the duty of good faith,⁶⁰ the parties' agreement on the questions discussed would control. The probability is that many of these terms have been left open or are to be agreed upon rather than negotiated at the time of contracting.

Finally, I have assumed that in the absence of an agreement, most parties to relational contracts would probably prefer gap fillers and principles of liability and remedy that respond to relational realities. Under this assumption, relational default rules for Article 2 will be complex rather than simple. This latter assumption is debatable and leads us to the current law-and-economics literature on contract default rules.

b. default rules

i. nonrelational default rules

In essence, default rules are the gap fillers and principles of formation, interpretation, performance and remedy provided by law in the absence of contrary agreement. In general, these principles should respond, wherever possible, to transactional realities. Put differently, divergence and contradiction between the transaction in context and contract law should be avoided, unless law is performing an overtly regulatory function.

One version of economic analysis deals with the efficiency of contract behavior and law in discrete exchanges in "thick" markets, where all material terms are agreed and transaction costs are assumed to be zero. This model of analysis, like classic contract-law doctrine, works best for more discrete transactions. Default rules built upon this model will not work for relational contracts.⁶¹

Other economists have worked with the reality that not all agreements are fully contingent, that many markets do not supply fungible

60. See U.C.C. § 1-102(3).

61. See Macneil, *supra* note 23, at 1062; see also Victor P. Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 AM. BEHAV. SCI. 337 (1980) (discussing new directions of research in economic activity).

substitutes and that all exchange involves transaction costs. The result is a body of scholarship devoted to the nature and effect of transaction costs in contracts in which, because of high bargaining costs or bounded rationality, the parties are unable to reach a complete ex ante agreement. In the absence of agreement, the question is what default rules should be supplied by law to fill "gaps" in the agreement or to provide the basic principles of liability, performance and remedy?⁶² The objective is to provide a hypothetical ex ante bargain that, in theory at least, minimizes various transaction costs. To the extent that an ex ante focus is relevant, this model for default rules works better for relational contracts.

Under this model, one first determines exactly what terms and which principles of liability and remedy the parties have power to supply, vary or define by agreement. This is a very long list under Article 2. Except for the duty of good faith imposed in Article 1, virtually everything in Article 2 is a default rule.

The next question is what is the most efficient term or principle to be supplied in the event that the parties reach no agreement defining a term or varying the applicable principles. This is a matter of dispute. Should it be a "rule" to which most parties would probably have agreed if able to engage in costless bargaining, or should it be the "rule" that is the easiest for the parties to bargain around? The former is a reasonable rule that lowers transaction costs when the parties accept it without bargaining, but increases them if the parties bargain in fact. The latter minimizes transaction costs if the parties in fact bargain around it, but increases them if the parties are forced to live with a rule that neither probably would have wanted.⁶³ Another possibility is a "rule" that deviates from what most parties would have wanted by requiring one party with a strategic advantage in bargaining to reveal critical information. These so-called "penalty" default rules decrease transaction costs if important information is disclosed ex ante contracting and penalize the nondisclosing party if it is not.⁶⁴

62. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKET AND RELATIONAL CONTRACTING* (1985); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985).

63. See Charny, *supra* note 22, at 1877-78. Professor Charny argues that the lawmaker should first supply a rule that is easy to bargain around. *Id.* at 1877. If this is not possible, the rule should be one with which most parties probably would have agreed and has desirable social consequences. *Id.* at 1878. Although Professor Charny's discussion is limited to "gap fillers" and rules of interpretation, the analysis has a broader scope.

64. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). For a critique, see Jason S. Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990).

ii. relational default rules

Other scholars have turned their attention to default rules for relational contracts. Because of the relational characteristics, the question shifts to what hypothetical terms or principles are most likely to reduce transaction costs, deter opportunism and facilitate adjustment over the duration of the relationship. Should it be a complex rule derived from the structural relationship between the parties (an internal norm) or a clear, categorical rule that facilitates agreement but relies, primarily, on social rather than legal norms to promote risk sharing and adjustment?⁶⁵

The latter approach, advanced by Professor Robert Scott, is questionable for at least three reasons. First, the strict, arbitrary default rule diverges from relational reality and, presumably, from what the parties or those similarly situated would want. It seeks certainty through strict rules in a transaction in which uncertainty is the rule. Second, the strict, arbitrary default rule is selected without regard to whether the parties can or will efficiently bargain around it. Suppose they do not. In a relationship characterized by the absence of complete ex ante agreement, the parties are left with gap fillers and principles of liability and remedy that do not respond to transactional reality. Third, the theory eschews legal intervention under realistic principles to rely on assumed nonlegal incentives and sanctions to influence the conduct of the parties.

Perhaps these patterns of cooperation and adjustment are more likely to exist in relational contracts. But if they do not, the parties, again, are left to the vicissitudes of neoclassical contract law with its ex ante preoccupation. Put differently, in a relational contract with its concern about ex post opportunistic behavior, the parties are left to the ex ante bias of neoclassical contract law. If litigation follows, a sound relational result may be impossible, or, at best, may be achieved only by forcing relational contract issues into the neoclassical mold.⁶⁶

The two commentators respond to Johnston in Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992).

65. Compare Gillette, *supra* note 49 (arguing for more complex rules) with Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597 (1990) (arguing for simple default rules).

66. The "clear rule" approach, however, might be justified by practical considerations. For example, internal norms may rarely emerge from conduct within the relational contract for sale. The task of devising relational default rules may, itself, be too complex. Finally, courts appear to be reluctant to intervene in relational contracts where neither the parties nor external norms can provide plausible solutions. See Schwartz, *supra* note 51.

IV. RECOMMENDATION

Conceding the complexity of the project, at a minimum the following steps should be taken. First, relational theory should be developed apart from, not dependent on, the *ex ante* preoccupation of modern contract law and most economic analysis. Second, a fresh assessment of which principles should not be variable by private agreement should be made. It is important to know which principles are inalienable and why, if relational contracts are involved. The remainder, of course, will be relational default rules. Third, default rules should be selected that respond to relational reality. But as David Charny has suggested in another setting, this is more complicated than simply deciding what the parties would have agreed if they had explicitly addressed the issue.⁶⁷ The final result may be a mix of simple and complex default rules.⁶⁸ For example, Charny argues that a simple default rule should be selected if it is known that subsequent parties will be in a position to bargain around it.⁶⁹ In this case, the rule will minimize transaction costs because it is designed to induce the parties to expend their best effort in bargaining around it. If parties are not in a position to bargain around the rule, a more complex inquiry must be made.

In addition to considering the costs of bargaining, the more complex default rule must be appropriate for most bargainers who will simply accept it and modify the actual preferences or understandings of one or both parties in a way that is socially desirable. Finally, efforts to develop information about the nature and content of relational sales contracts and the behavior of persons involved in those relationships should be intensified.

V. CONCLUSION

In all probability, development of the principles and policies of relational theory will be the most important challenge and accomplishment of twenty-first century contract law.⁷⁰ Despite disagreement and complexity, revised Article 2 should make an effort to respond to these important exchange relationships. Otherwise, the divergence between

67. See Charny, *supra* note 22, at 1878.

68. *Id.* at 1877-78.

69. *Id.* at 1877.

70. See generally Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 739 (1990) (discussing communitarian dimensions of contract law and concluding that in "legal activities of interpreting and supplying contract terms, we should be wary of approaches that sacrifice norms of trust, cooperation and participation for supposed short-term gains").

transactional reality and the law of sales will continue to grow, with predictable damage to the utility and integrity of Article 2.

