GAP-FILLING AND FREEDOM OF CONTRACT

by

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CHAPTER I

INTRODUCTION

When a client asks his lawyer what his duties are under a particular contract, normally the lawyer's first response is "show me the contract." Does the contract provide all the contract duties in its expressed form? Definitely not. By now everyone acknowledges that, to some extent, all contracts have some gaps. Even the most carefully drafted document rests on volumes of assumptions that cannot be explicitly expressed.[1] The inevitability of gaps reflects both our "relative ignorance of fact" and "our relative indeterminacy of aim."[2] Generally speaking, there are three types of gaps: first, the parties to a contract have not agreed upon a term; second, the parties have agreed upon a term, but the term itself is so vague that it is impossible to ascertain its meaning; and third, the parties have agreed

[1] See Arthus Rosett, Critical Reflection on the United Nations Convention on Contracts for the International Sale of Goods, 45 Ohio St. L. J. 265, 287 (1984).

[2] See H. L. A. Hart, The Concept of Law, 125 (1961).

to agree upon a term sometime after contract formation, but then never reach an agreement on that point. A remarkable

trend in modern contract law is the relaxation of the requirement of certainty of terms. Modern legislation and courts are willing to enforce contracts even where many terms are missing, including such seemingly essential terms as time of delivery and price.[3] But once the courts relax the certainty requirement, they themselves must find a way to fill the gaps in the binding arrangements.

For centuries, “freedom of contract” has been the central, most celebrated principle of contract law. In general, “freedom of contract” means that the parties to a transaction are free, or “entitled” to agree on, or “to choose” any lawful terms. “Freedom of contract” implies that contractual obligation ultimately relies on the consent of the parties.

However, the principle of “freedom of contract” has different meanings in response to the changing social situation. Accompanying the rise of the market economy and decline of belief in value objectivity, the principle of “freedom of contract” emerged early in the nineteenth century as a powerful symbol of individual autonomy and

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[3] See UCC § 2-204(3); Restatemant (Second) Of Contracts §§ 33, 34; Jean Braucher, Contract versus Contractarianism: The Regulatory Role of Contract Law, 47 Wash. & Lee L. Rev. 697, 723, 730-31 (1990); Donald B. King, Reshaping Contract Theory and law: Death of Contracts II Part One: Generalised Consent with Lawmade obligations, 7 J. Cont. L. 245 (1994).

community well-being.[4] Early in this century, however, freedom of contract was considered as more "naive myth" than commonplace reality.[5] By 1920 Samuel Williston recognized that "unlimited freedom of contract, like unlimited freedom in other directions, does not necessarily lead to public or individual welfare."[6]

Historically and today, the courts often say that they rely on the intentions of the parties in filling gaps. To the extent that a collective intention of the parties actually guides the gap-filling, then judicial gap-filler actually facilitates freedom of contract. It preserves contract as consent-based liability. To the extent that gap-filling actually involves legislative or judicial design on the private agreement, it stands in tension with freedom of contract. This thesis seeks to review the modern development of gap-filling rules to define how significant the tension is between gap-filling and freedom of contract. Ultimately, it suggests that the gap-filling process requires adjustment

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[4] See generally P. S. Atiyah, the Rise and Fall of Freedom of Contract 660-779 (1979); Grant Gilmore, The Death of Contract 103 (1974).

[5] See generally Eugene F. Mooney, Old Kontract Principles and Karl's New Kode: An Essay on the Jurisprudence of Our New Commercial Law, 11 Vill. L. Rev. 213 (1966); Richard E. Speidel, the New Spirit of Contract, 2 J. L. & Com. 193 (1982); Mark Pettit, Jr., Freedom, Freedom of Contract, and the 'Rise and Fall', 79 B. U. L. Rev. 263 (1999).

[6] Samuel Williston, Freedom of Contract, 6 Cornell L. Q. 365, 374 (1921).

of our traditional understanding of freedom of contract. In fact, not all contractual obligations rest on the consent of the parties. Once the parties have chosen to enter a binding relationship and defined its broad outlines, the courts must creatively define the specifics of the relationship.

This thesis proceeds as follows:

Chapter II states the origin and development of the gap-filling rules. In the development of the rules, the judicial approach moved from respecting the parties' nominal freedom of contract to considering the parties' actual intention and to realizing the parties' reasonable expectations. Eventually, accumulated precedents formed a set of default rules that were later regulated by the contract law.

Chapter III examines the provisions in the Restatement, the Uniform Commercial Code and the United Nations Convention on the International Sales of Goods (hereinafter "CISG"). The Restatement (First), representing the traditional common law approach, requires a high degree of specificity in the essential terms of the contract. The Restatement (Second), UCC and CISG adopt more flexible approaches. The three laws provide "reasonable" standards for filling gaps left by the contracting parties.

Chapter IV discusses two recent scholarly theories of gap-filling rules. Both theories emphasize the position of

good faith and reasonableness in the field of gap-filling. Professor Zamir proposed that, in some extent, good faith and reasonableness should be the first source when courts fill the gaps in the contracts. The theory of penalty default rules indicates that good faith and reasonableness, in some circumstances, may prevent the parties from leaving “bad faith” gaps in their contracts.

Chapter V studies three leading cases in the field of gap-filling. Courts always prefer to fill the gaps in a reasonable and fair way so as to prevent the abuse of contractual freedom. Even before the advent of the Second Restatement and the UCC, courts already used good faith and reasonableness to supply a missing term in the contract so as to balance the freedom of contract and social values. Since the law imposed the general duty of the good faith, the courts have used it as a tool to realize the reasonable intentions of the parties and contractual justice.

Chapter VI serves as the conclusion. It argues that the relationship between gap filling and freedom of contract is complex. At times gap filling supports freedom of contract by allowing the parties to conclude a binding agreement without specifying all of the terms of the relationship. Gap-filling guarantees efficiency in that it allows for generalized agreements. In addition, gap-filling raising contemporary standards of fair dealing and reasonableness

may often reflect what the parties to generalized agreements intend at the time of contracting. The tension between judicial gap filling and freedom to specify one’s own agreement is greatest at the point when the courts actually supply the content which the parties omitted. At this point of judicial intervention we must recognize that freedom of contract is not absolute but must at times give way to the demands of fairness.

CHAPTER II

HISTORICAL EVOLUTION OF GAP-FILLING RULES

The traditional common-law approach to gaps is that a court should not "make the contract for the parties." [7] The courts have adopted different practices to perform this approach. The process can be divided into three stages in the origin and development of gap-filling.[8] Warranties and impossibility are taken as examples to trace the historical evolution of gap-filling rules.

1. Strict Literalism: The Parties to the Contract Enjoyed Entire Freedom of Contract.

England courts in the seventeenth century, with the characteristic of strict literalism, regarded the agreement of the parties as an exclusive source for performance and interpretation, thereby they confined themselves to the bare

[7] "The court will not write contracts for the parties to them nor construe them other than in accordance with the plain and literal meaning of the language used." Henrietta Mills, Inc. v. Commissioner, 52 F. 2d. 931, 934 (4th Cir. 1931).

[8] See E. A. Farnsworth, Omission in Contracts, 68 Colum. L. R. 860, 862(1968). This chapter relies principally on this important article by Professor Farnsworth.

framework provided by the parties through their contract language.[9] In light of this premise, courts would not fill any gaps left by the parties. In this sense, the parties to the contract enjoyed the entire freedom of contract and took the full responsibility for providing the content of their contract. In the sales contract, if a seller made a promise to sell goods unaccompanied by an express warranty, the principle was "caveat emptor (let the buyer beware)." In the leading case of *Chandelor v. Lopes*, the buyer alleged that a stone purchased from the seller jeweler was misrepresented as a bezar-stone. The court held: "[T]he bare affirmation that it was bezar-stone, without warranting it be so, is no cause of action; and although he knew it to be no bezar-stone, it is not material; for every one in selling his wares will affirm that his wares are good …, yet if he does not warrant them to be so, it is no cause of action."[10] Similarly, a person's obligation to perform under a contract was not excused by impossibility of performance. Suppose, for instance, seller agreed to sell buyer a quantity of goods, but failed to condition his promise. Before delivery, the occurrence of some un-provided for event (like outbreak of war, a natural disaster, or a change in the law) made seller's performance impossible. A court would still

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[9] See Farnsworth, supra note 8, at 863.

[10] 79 Eng. Rep. 3, 4 (Ex. Cham. 1603).

hold seller responsible for damages despite the disastrous event, on the ground that parties should be held to the term of their contract. This doctrine was expressed in the medieval maxim *reservenda sunt pacta* - an agreement must be kept though the heavens fall.[11]

2. Actual Intention of the Parties: Subjective Standards for Filling Gaps

By the Nineteenth Century English courts played a more active role when confronted with gaps. Their approach became more flexible and more liberal. Even though the courts still proclaimed the principle that the contract of the parties remained the exclusive source for the performance, they began to go beyond the contract language provided by the parties and fill gaps with what they thought to be the actual expectations of the parties. Therefore, the judicial decisions were annouced in the name of the parties, by claiming that the result was based on the actual intention of the parties implied in the contract.[12] The content of the contract not only existed in the expressed terms, but also in the parties' intention behind the expressed terms.

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[11] See Michael G. Rapsomanikis, Frustration of Contract in International Trade Law and Comparative Law, 18 Duq. L. Rev. 551, 551 (1980).

[12] See Farnsworth, supra note 8, at 863.

The decisive case in the warranties area was *Jones v. Bright*[13]. In *Jones*, the buyer told the seller what he needed and the seller remarked, "we will supply him well." The court held that this assurance was tantamount to an express warranty that the goods would be fit for the purpose. The majority of the court went even further to establish a general rule of implied warranty. The court stated that it would "put the case on the broad principle - if a man sells an article, he thereby warrants that it is merchantable, that it is for some purpose."[14] Later, *Jones v. Just* clearly stated that this implied warranty of merchantability was believed to be the intention of the parties.[15]

The doctrine of impossibility was laid down in *Taylor v. Caldwell*.[16] In *Taylor*, the lessee contracted to hire the lessor's music hall for a series of concerts. After the signing of the contract, but six days before the first contract, the hall was destroyed by fire. The court held that the lessor was discharged from performing and that his failure to perform was therefore not a breach of contract. This conclusion was based on the theory that the parties

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[13] 130 Eng. Rep. 1167 (Ex. Cham 1829).

[14] Id. at 1172.

[15] Because "it must be assumed that the buyer and seller both contemplated a dealing in an article which was merchantable." L. R. 3 Q. B. 197, 207 (1868).

[16] 122 Eng. Rep. 309 (K.B. 1863).

regarded the continued existence of the hall as the "foundation" of the contract, and that the contract contained an "implied condition" that both parties would be excused if the hall ceased to exist. The reason given for the principle was that it carried out the intent of the parties.[17]

3. Reasonable Expectations of the Parties: Objective Standards for Filling the Gap.

The search for actual intention gradually gave way to the implication of terms through the reasonable person of the objective theory. In this stage, the court began to fill the gap with the objective intention of the parties rather than the subjective intention of the parties. Court began openly to go beyond the parties actual expectations as well as their contract language and fill in the gap with what the judges themselves thought was fair or reasonable.[18] As Learned Hand wrote, "As courts become increasingly sure of themselves, interpretation more and more involves an imaginative projection of the expressed purpose upon

[17] "There seems little doubt that this implication tends to further the great object of making the legal construction such as to fulfill the intention of those who entered into the contract. For in the course of affairs men in making such contracts in general would, if it were brought to their minds, say that there should be such a condition." Taylor, supra note 16, at 312.

[18] See Farnsworth, supra note 8, at 864.

situations arising later, for which the parties did not provide and which they did not have in mind."[19]

As courts relied less on the "intention" of the parties and took more responsibility upon themselves, the precedents came to provide ready-made terms for filling gaps. The terms supplied by the law were no longer considered to be based on the "intention" of the parties, but visualized instead as suppletive rules of law.[20] These suppletive rules were stated as the reasonable intention of the parties. As early as in 1893, the warranties of fitness and merchantability went into the English Sale of Goods Act as suppletive rules of law. The Uniform Sales Act, patterned after the English Sales of Good Act, incorporated the substance of the *Jones* decision and imposed the contractual duty upon the seller. The Act provided that: " Where the goods are brought by description from a seller who deals with in goods of that description, whether he be the grower or the manufacturer or not, there is an implied warranty that the goods should be of merchantable quality."[21] Finally, the law of implied warranty was recodified in the Uniform Commercial Code.[22]

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[19] L. N. Jackson & Co. v. Royal Norwegian Government, 177 F.2d 694, 702 (2d Cir. 1949) (dissenting opinion), *cert. denied*, 339 U.S. 914 (1950).

[20] See Farnsworth, supra note 8, at 865.

[21] § 15.

[22] See UCC §§, 2-313, 2-314, 2-315.

According to the draftsmen of the UCC, the implied warranties relied on a "common factual situation or set of condition" and apply "unless unmistakenly negated."[23]

Similarly, the Restatement stated the rules on impossibility as a suppletive rule. These rules would apply "unless a contrary intention has been manifested."[24] A similar suppletive provision can be found in the UCC.[25] Finally, the agreement of the parties was admitted not to be the exclusive source of their obligations, but only the source to be deferred to when their intent was clearly established.

In fact, contemporary scholarship regards most of the rules of the law of contracts as gap-filling rules or

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[23] UCC § 2-313, Comment 1.

[24] Restatement Of Contracts § 457 (1932).

[25] See UCC § 2-615.

"default rules"[26] which are implied terms of a contract unless the contracting parties explicitly agree to vary them. The development of the gap-filling rules represents a gradual accumulation of such rules.

[26] In recent years it has become popular in academic world to refer to a gap-filling rule as "default rule," a term borrowed from computer terminology. See E. Allan Farnsworth & William F. Young, Contracts: Cases and Materials (5th ed. 1992), 612, Note 2.

CHAPTER III

LAWS ON THE GAPS

1. The Restatement and the Problem of Definiteness

Based on the traditional common law doctrine, the Restatement (First) of Contracts, promulgated in 1932, purported to demand a high degree of specificity in the essential terms of the contract. According to the Reporter of the first Restatement – Professor Samuel Williston, " an agreement in order to be binding, must be sufficiently definite to enable a court to give it an exact meaning."[27] The Restatement provided that an offer "must be so definite in its terms, or require such definite terms in the acceptance, that the promises and performance to be rendered by each party are reasonably certain."[28] The commentary explained that because "the law of contracts deals only with duties by the expressions of the parties, the rule ... is one of necessity as well as of law."[29] A famous case decided

[27] 1 S. Williston, Contracts, § 37(1920).

[28] Restatement Of Contracts § 32 (1932).

[29] Id., Comment a.

nine years before the Restatement illustrates this approach to definiteness.

In *Sun Printing and Publishing Assn. v. Remington Paper & Power Co.*[30], Inc., seller and buyer entered into a contract for the sale of newsprint. The contract provided that 1,000 tons of newsprint would be delivered each month for the next sixteen months. The contract specified the price per ton for each of the first four month of the contract. After this four month period, the contract provided, "The price of the paper ... shall be agreed upon by and between the parties ... said price in no event to be higher than the contract price for newsprint charged by the Canadian Export Paper Company."[31] Near the end of the four-month period, the seller asserted that the contract was void for indefiniteness, and refused buyer's demand for 1,000 tons of paper at the Canadian Export Paper Company's price. The New York Court of Appeals held that the contract failed for indefiniteness. While it was true the buyer had an assurance under the agreement that his price would not be any greater than the Canadian Export Paper Company price, the agreement did not specify how fluctuation in the Canadian price was to affect the contract price. It was not clear under the agreement whether the buyer and seller were

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[30] 235 N.Y. 338 (1923).

[31] Id. at 342.

to agree on a new price every month, each time to be limited by the Canadian price then current, or whether they were to set one price at the beginning of the fifth month, to carry through to the rest of the contract. Because of this indefiniteness with respect to time-for-calculation, the contract was held to be fatally indefinite.[32]

The Restatement (Second) of Contracts took a different approach to gap-filling. According to its Reporter, Section 204, entitled "Supplying An Omitted Essential Term" is "new" to the Restatement Second.[33] It provides: "When the parties to a bargain sufficiently defined to be contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court."[34] Since the UCC had a substantial influence on the Restatement

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[32] See Sun Printing, supra note 30, at 350-52.

[33] Restatement (Second) Of Contracts § 204, Reporter's Note (1979). Even though the Restatement(First) adopted the strict approach dealing with the gap left by the parties, it still provided some gap-filling rules. For example, the provisions of impossibility are one of gap-filling rules. The provisions will be applied to discharge a party from performance when the parties themselves did not provide the events that would render performance impossible. Limitation on the damages is another gap-filling rules. For detailed discussion, see supra Chapter III, part 3.

[34] Restatement(Second) Of Contracts § 204 (1979).

second in the gap-filling provisions,[35] we are to consider the UCC's provisions in solving the problem of gaps.

2. The Uniform Commercial Code

Article 2 of the UCC which applies to contracts for the sale of goods has led the way for gap filling. Section 2-204 sets the stage by dispensing the rigid rules of offer and acceptance contained in the first Restatement.[36] It provides: "Even 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 remedy."[37] Under this provision, the court is authorized to fill a number of gaps if the parties have left them open in their sales contract. The underlying policy is that an agreement for the sale of goods ought to be binding when the commercial parties regard it to be binding and that in practice both parties frequently believe that they are bound even though some terms have been left open. Gap-filling provisions are based on the assumption that these are the terms that most parties would have agreed to if they had

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[35] See Richard E. Speidel, Restatement Second: Omitted Terms and Contract Method, 67 Cornell L. Rev. 785, 792 (1982).

[36] See generally Mooney, supra note 5.

[37] UCC § 2-204(3).

focused on the issues in advance. In particular, the UCC provides instructions for filling gaps in price, place for delivery, time for shipment or delivery, time for payment.

2.1. Particular Gap-Filling Rules in the UCC

2.1.1. Open Price Term

Section 2-305(1) provides for filling a missing price term. It provides, ”the parties if they so intend can conclude a contract for sale even though the price is not settled. In such a case the price is a reasonable price at the time for delivery …”[38] The price must be fixed in good faith which must be in conformity with reasonable commercial standards of fair dealing in the trade if the party is a merchant. Usually a “posted price” or a future seller’s or buyer’s “given price,” “price in effect,” “market price,” or the like will be the reasonable price.[39] If the *Sun Printing* case were decided according to the provisions of the UCC, it is most likely that the court would conclude that the parties intended to be bound. Evidence of such intent rests in details and performance.

Under the UCC it is critical that the parties intend to be bound before a contract exists. Section 2-305(4) states, “where, however, the parties intend not to be bound unless

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[38] UCC § 2-305(1).

[39] UCC § 2-305(1), Comment 3.

the price be fixed or agreed and it is fixed or agreed there is no contract."[40]

2.1.2. Absence of Specified Place for Delivery

According to the UCC, if the parties do not specify where the goods are to be delivered, the place for delivery is the seller's place of business, or if he has none, his residence.[41] The only exception to this rule is that, at the time of contracting, if the goods are known by the parties to be somewhere other than at the seller's business or residence, that place is the place of delivery.[42] In other words, there the contract is silent, the court will construe the contract so as to require the buyer to take delivery at either the seller's location or where the goods are located. The buyer must bargain to place a delivery obligation on the seller.

2.1.3. Absence of Specific Time Provisions

If the contract is silent as to the time for shipment, for delivery, or for any other action under the contract, that time shall be "a reasonable time".[43] A reasonable time

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[40] UCC § 2-305(4).

[41] See id. 2-308(a).

[42] See id. 2-308(b).

[43] See id. 2-309.

for taking any action usually relies on the nature, purpose and circumstances of the action to be taken.[44]

2.1.4. Open Time for Payment or Running of Credit

If the contract does not specify whether the buyer is to have credit, payment is due at the time and place at which the buyer is to receive the goods, even if this place is the seller's place of business. Unless otherwise agreed, delivery and payment are concurrent conditions. In other words, the buyer is not entitled to credit unless the contract says so.[45]

In *Southwest Engineering Co. v. Martin Tractor Co.*,[46] the defendant agreed to sell a generator to the plaintiff for a certain price. The two parties did not come to any explicit agreement on whether or not the machine was to be paid for in full upon delivery. The defendant refused to deliver, claiming that the absence of any agreement on payment terms made the contract invalid for indefiniteness. The court held that the contract was enforceable. Even the absence of a fairly important term does not necessarily make a contract fatally indefinite. There are two reasons why absence of a payment clause was not fatal in *Southwest Engineering*: (1) UCC § 2-305(1) fills this gap (by requiring

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[44] See UCC § 2-309 Comment 1. See also UCC § 1-204(2).

[45] See id. 2-310(a).

[46] 473 P. 2d 18 (Kan. 1970).

payment on delivery); and (2) for more than four months after the defendant repudiated the contract, it did not even list lack of a payment clause as the reason why the contract was unenforceable, indicating that it did not attach too much importance to this absence.

The gap-filling rules in the UCC are far more than the above provisions. In fact, most of the provisions in Article 2 are gap-filling rules because these rules imply the contract terms when the parties to the contract have not reached on agreement on such terms.[47]

2.2. Requirements Contracts

A requirements contract gives the buyer discretion in determining the quantity of goods to be purchased. In this instance, the parties foresaw that, at the time of delivery, a specific quantity would have to be named. The parties, however, did not find it practicable or desirable to make those decisions when the contract was formed. Earlier cases, especially ones decided before the advent of the UCC, frequently held that such requirements contracts were invalid for lack of consideration (as well as for indefiniteness). In this circumstance, the court's theory was that although the seller had undergone detriment by

[47] Besides the above provisions, some provisions in Article 2 of the UCC contains the language "unless otherwise agreed" or comparable language, therefore fall into the category of gap-filling rules, e.g., see UCC §§ 2-210, 2-319 to 327, 2-503 to 504, 2-507, 2-511, 2-513 to 514, 2-601, 2-706.

promising to sell at a particular price whatever the buyer required, the buyer had not in fact bound himself to do anything at all because he could refrain from having any requirements.[48]

The UCC explicitly validates requirements contracts. UCC § 2-306 provides that "a term which measures the quantity by ... the requirements of the buyer means such actual ... requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior ... requirements may be ... demanded." Comment 2 to this section states that such contracts do not "lack mutuality of obligation since under this section, the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his ... requirements will approximate a reasonably foreseeable figure."

UCC § 2-306 apparently contemplates that the buyer in a requirements contract will deal exclusively with the seller with whom has contracted. In other word, the buyer must promise that he will buy all of his requirements from that

[48] See e.g. Oscar Schlegel Mfg. Co. v. Peter Cooper's Glue Factory, 231 N. Y. 459 (1921) (the defendant who had agreed to supply all the plaintiff's glue offers at 9 cents per pound, was released when the market price hit 24 cents and the plaintiff's orders quintupled).

particular seller. This promise, coupled with the buyer's good faith obligation to order quantities constitutes consideration for the seller's counter-promise to meet the buyer's needs. When a change in market condition makes it highly advantageous for a requirements buyer to increase his requirements sharply, the UCC does not permit such abuse of the contract. This is especially true where the buyer uses the extra purchases to speculate, rather than using them in the ordinary course of his business, such sharply increased requirements could be invalid either under the buyer's duty to purchase in "good faith" or as being "unreasonably disproportionate" to any normal or otherwise comparable prior requirements.[49] Obviously, the UCC fills the open quantity term with the reasonableness principle.

2.3 What Kind of Gap Can Not Be Filled by the UCC?

According to the Report of the Study Group of the Permanent Editorial Board for the UCC, Article 2 of the UCC may impose obligations on the parties whose agreement has gaps. The provisions of Article 2 are flexible and the standards "depend on (a) what the parties intended or (b) what they would have intended if they had considered it." But, how much of an agreement must be reached before a contract exists? That is, what kind of gap can not be filled by the UCC? According to the Study Committee, the UCC has no

[49] See UCC § 2-306(1).

direct answer to the question.[50] Under its provisions, the only term must appear in the contract is the quantity term that need not be accurately stated but must provide the basis for the recovery.[51]

3. The United Nations Convention on the International Sales of Goods

The approach of the CISG in gap-filling rules is similar to that of the UCC. The most distinctive provision is that the CISG clearly provides what constitutes a definite offer. “A proposal for concluding a contract ... constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. A proposal is sufficiently definite if it indicates the goods and expressly or implicitly the quantity and the price.” [52] In other words, if an agreement provides the subject matter and the basis for determining the quantity and the price, there is a contract provided the

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[50] Preliminary Report of the Study Group of Permanent Editorial Board for the UCC released on March 1, 1990, 11-12.

[51] “A writing is not insufficient because it omits or incorrectly states a term agreed upon but the contract is not enforceable under this paragraph beyond the quantity of goods shown in such writing.” UCC § 2-201(1). See also UCC § 2-201, Comment 1.

[52] CISG, Art. 14(1).

parties intend to be bound. Because Article 55 provides that open price term can be filled by “the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned”,[53] the provisions of the CISG imply that only the subject matter and quantity cannot be filled by the gap-filling rules. A purported offer which omits the two terms is not an effective offer.

Like the UCC, the CISG provides many gap-filling rules. Those rules seem familiar and, in some extent, more abstract as the CISG applies to countries of different legal, social and economic system. In case of open price, the CISG fills the gap with the price generally charged at the time of the conclusion of the contract for similar transaction,[54] in other word, market price. For absence of specified place for delivery, the CISG’s provisions are different from that of the UCC. The CISG imposes the obligation on the seller to hand the goods over to the first carrier for transmission to the buyer or place the goods “at the buyer’s disposal at the place where the seller had his place of business at the time of the conclusion of the contract.”[55] This difference between the two laws is mainly because the CISG applies to

[53] CISG, Art. 55.

[54] Id.

[55] Id. Art. 31.

contracts of sales of goods between parties whose places of business are in different countries.[56] The gap-filling rule in such a circumstance involves a more complicated handing-over procedure. For absence of specified time for shipment, the CISG's provisions are almost the same as that of the UCC. That is, the delivery must be "within a reasonable time after the conclusion of the contract."[57] For the question of open time for payment, we find another quite similar provisions in the CISG. That is, delivery and payment are concurrent conditions.[58]

Besides providing the particular gap-filling rules, the CISG regulates the hierarchy for gap-filling rules. The first one used to fill the gap is the parties' intent, the second one is the "understanding of a reasonable person, the last is "all relevant circumstances of the case including the negotiations, any practices which parties have established between themselves, usages and any subsequent conduct of the parties."[59]

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[56] CISG, Art. 1(1).

[57] Id. Art. 33(c).

[58] See id. Art. 58(1), "The seller may make such payment a condition for handing over the goods or documents."

[59] Id. Art. 8. This article is provided in the name of interpretation. It also applies to gap-filling.

4. Summary of Evolution

The historical evolution of gap-filling rules indicates that emphasis has been gradually moving from protecting the parties' private will to realizing the fair and reasonable meaning of the contract. At the beginning, the strict literalism approach strictly protected nominal freedom of contract. Nevertheless, sometimes the expectations of the parties were denied merely because they failed to make one term of the contract explicit. Realizing this, the courts relaxed their strict approach. When the parties intend to conclude a bargain, even though the contract is incomplete, the court will not deny the existence of the contract only if there is the basis for enforcement. "A transaction is complete when the parties mean it be complete."[60] The court will make great effort to find out what is the intention of the parties thereby realize the intention (freedom) of the parties. "Many a gap in terms … can be filled, and shall be, with the result that is consistent with what the parties said and that is more just to both than would be refusal of enforcement."[61] On the one hand, the term supplied by the court or imposed by the law can be said to violate the principle of freedom of contract because it imposes a specific term which one or more of the parties did not agree

[60] 1 A Corbin, Contracts § 29 (1963).

[61] Id. § 97. See also id. § 95.

to and would not have agreed to if they had focused on the specific issue. What the law recognizes as a reasonable or good faith specification may in fact be unacceptable to one or more of the parties. On the other hand, the evolution of gap-filling can be said to respect the freedom of contract to the maximum degree is that the courts try their best not to deny the parties' intention to conclude a contract.

Modern development of laws on gap-filling rules indicates that the legal system is ready to undertake the role of filling the gaps, that is, determining much of the contract's content. The standard of filling the gaps is "good faith and reasonableness," which is usually understood as the reasonable expectation of the parties.[62] This development raises such a question: with the development of gap-filling rules, will freedom of contract survive as the central principle of contract?

5. The Definition of Good Faith and Reasonableness

Without doubt, good faith and reasonableness is established as a general principle of contract law by both the UCC and the Restatement. Even though good faith and reasonableness has potential for widespread application to gap-filling cases, because the principle is amorphous, some commentators argued that this principle is too vague to be

[62] Restatement of Contract § 204, Comment d. (1979).

helpful to either party or even to the court.[63] We have to admit that, even though the law clearly provides the principle, the law itself does not provide a clear formula to inform the court's discretion.

The Restatement (Second) of Contract § 205 provides that, "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Its comment further indicates that good faith "emphasized faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."[64]

The UCC expressly "imposes an obligation of good faith in its performance or enforcement" on every contract and duty within its scope.[65] The Code gives two definitions of good faith. In the introductory Article 1, good faith "means honesty in fact in the conduct or transaction concerned."[66] However, this definition is displaced in Articles 2, 3, 4, 8 and Revised Article 9, where the Code provides a special

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[63] See Clayton P. Gillette, Limitations on the Obligation of Good Faith, 1981 Duke L. J. 619. William E. Deitrick & Jeffrey C. B. Levine, Contractual Good Faith: Let the Contract, Not the Courts, Define the Bargain, 85 Ill B. J. 120, 120 (1997).

[64] Restatement (Second) of Contracts § 205, Comment a. (1981).

[65] See UCC § 1-203 (1987).

[66] See UCC § 1-201 (1987).

good faith standard in these articles. “Good faith” “means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”[67]

At the broadest level, it is agreed that the principle imports an obligation “to preserve the spirit of the bargain rather than the letter, the adherence to substance rather than form,”[68] or that the principle exists to “protect the reasonable expectations” of the contracting parties,[69] but it is still not clear from its provisions the extent to which “honest” encompasses fairness, decency, reasonableness and similar values.

Professor Farnsworth suggested an answer to this unclear condition based on the UCC’s comment:” part of the strength of such general concepts as ‘good faith’ and ‘commercial reasonableness’ lies in an elasticity and lack of precision that permits them to be, in the language of the Code’s own comments, ‘developed by the courts in the light

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[67] UCC § 2-103 (1)(b); § 3-103(a)(4); § 4-104(b); § 4A-105(a)(6); § 8-102(a)(10); § 9-102(a)(43).

[68] Corbin on Contracts § 654A (C. Kaufman, 1989 West Supp.)

[69] See id. § 654D (B); E. A. Farnsworth, Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666, 669 (1963)(Good faith results in an “implied term of the contract requiring cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations.”)

of unforeseen and new circumstances and practices.’”[70] This idea is joined by Professor Summers. He suggested that good faith does not and in fact ought not contain a clear formula to guide a court’s discretion in applying the covenant. Rather, the principle is best thought of as an ‘excluder”, giving courts a license to judicially developed rules that prohibit actions that are taken in bad faith.[71]

The position advanced by Professors Farnsworth and Summers are supported by the evolution of gap-filling rules. The historical evolution of the gap-filling rules shows the role of this elastic principle in the gap-filling rules. The nature of the good faith requirement explains the vagueness of the principle. With it, the courts have a tool to fill the gap so as to ensure the parties’ freedom in making contracts. Moreover, the principle of good faith and reasonableness can be used to reshape the existing default rules in response to the changing societal conditions based on the reasonable standard. For example, as a default rule, the rule that a sales agreement without a quantity term

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[70] See Farnsworth, id. at 676.

[71] See Robert S. Summers, “Good Faith” in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 215 (1968).

would not be enforced has long been recognized. This rule was adjusted by adding “requirements contract rule” based on the reasonable standard.

CHAPTER IV

SCHOLARLY ANALYSES OF GAP-FILLING

As recently as 1970, two commentators indicated that the question whether there was a general duty of good faith imposed upon the parties to a contract under our system of law has been almost entirely neglected in the legal literature.[72] That statement no longer holds true. The idea of contractual good faith has been the subject of extensive scholarly examination.[73] Moreover, the duty of good faith in performance and enforcement, recognized by both the UCC and the Restatement, has become a general principle of American contract law[74] and influences many aspects of contract

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[72] See F. Kessler & G. Gilmore, Contract – Cases and Materials 912 (2d ed. 1970).

[73] See e.g. Steven J. Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 Harv. L. Rev. 369 (1980); Steven J. Burton, Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code, 67 Iowa L. Rev. 1 (1981); Summers, supra note 71; Eyal Zamir, The Inverted Hierarchy of Contract Interpretation and Supplementation, 97 Colum L. Rev. 1710 (1997).

[74] See Steven J. Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 Harv. L. Rev. 369, 369 (1980). See also UCC § 1-203 (1977); Restatement (Second) of Contracts § 205 (1979). For judicial opinion, see e.g. Baker v. Ratzlaff, 1 Kan. App. 2d 285, 288-89, 564 P. 2d 153, 156-57 (1977).

law,[75] including the gap-filling rules. In this chapter, we are to study two theories proposed in recent years with respect to the function of the principle of good faith and reasonableness in the field of gap-filling.

1. Zamir's Hierarchy of Gap-Filling Rules

1.1 Conventional Hierarchy of Gap-Filling Rules

According to Professor Zamir, gap-filling is conceived of a multistage process, in which a variety of sources and means are turned to sequentially. These sources and means are considered to form the hierarchy of gap-filling rules. According to the traditional hierarchy, the intentions of the parties are to be deduced from the totality of the contract documents; secondly from the circumstances surrounding the making of the contract; and thirdly from course of performance, course of dealing and trade usage. If all these above sources and means are not useful, the default rules will be applied. If there is no definite answer in the ready-made default rules, general principles of contract law, such as good faith or reasonableness may be

[75] See UCC §§ 1-201, 1-203, 2-103(1)(b); Restatement (Second) of Contract § 205 (1979); Summers, supra note 71; Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, supra note 74; 3A Arthur L. Corbin, Corbin on Contracts 654A, 654I (Supp. 1997).

consulted.[76] As one proceeds down the hierarchy, the level of generality and abstraction of the sources increases: first comes the specific transaction, followed by the totality of transactions made between the same parties, trade usage, legal rules applicable to similar contracts, general rules of contract law, and finally, the general standard of reasonableness. In a word, the gap-filling rule is that the parties' specific intentions prevail if there is inconsistency between the parties' own intention and general or reasonable intention.

Even in the same layer of the hierarchy, such as course of performance, course of dealing and trade usage, there is still a movement from the specific transaction to general transaction. A course of performance exists where a contract involves repeated occasions for performance and a certain manner of performance is accepted without objection by the other party (thus indicating the parties' specific understanding of the contract's meaning.)[77] A course of dealing is a sequence of previous conduct between the same parties, which is established a common basis of understanding for interpreting their current expressions and

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[76] See Zamir, supra note 73, at 1711. See also Restatement (Second) Of Contracts, § 203; UCC § 1-205(4); 2-208.

[77] See Zamir, supra note 73, at 1717. See also UCC § 2-208(1); Stephen Charles, Interpretation of Ambiguous Contracts by Reference to Subsequent Conduct, 4 J. Cont. L. 16 (1991).

other conduct.[78] A usage of trade is a practice or method of dealing having such regularity of observance in a place, vocation, or trade, as to give rise to an expectation that it will also be observed in a particular transaction.[79] A course of performance is given greater weight than an inconsistent course of dealing, which in turn is given greater weight than an inconsistent usage of trade.[80]

This hierarchy reveals an order for resorting to the different sources, when filling the gaps in the contract, a court should not turn to any "inferior" source before exhausting all the "superior" one. This hierarchy also implies that the preference among sources prevails in case there is inconsistency between the different sources.[81]

According to Professor Zamir, this conventional hierarchy is based on the principle of freedom of contract and its underlying political-legal ideologies.[82] The ideologies have two origins: the liberal-individualistic moral ideology and the utilitarian-economic ideology. According to liberalism, every person is the best judge of his own goals, and of the means by which they are to be

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[78] See UCC § 1-205(1).

[79] See UCC § 1-205(2).

[80] See Restatement of Contract § 203 (b).

[81] See Zamir, supra note 73, at 1718.

[82] See Zamir, supra note 73, at 1768-69.

achieved. Society should respect the freedom of every individual and refrain from interfering with the outcome of free negotiations between the parties. Private will is the source of and the standard for the rights and obligations in a contract. Respecting freedom of individuals requires recognition of their power to conclude contracts and undertake obligations. The role of the law is to give effect to the contracts and obligations. As long as the contracting process is neither affected by defects such as coercion or misrepresentation nor subject to a few exceptions of illegality and public policy, the law should not interfere with the content of the rights and obligations that the parties have voluntarily undertaken.[83] Freedom of contract also ensures social justice. In a free-market jurisdiction, each person is provided with equal opportunity to improve his position by making any contract according to his private will. Voluntary exchange is the basis of reciprocity and fairness since no one would enter a contract unless he regarded that what he receives is more valuable than what he gives away.[84]

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[83] See Zamir, supra note 73, at 1769. See also John N. Adams & Roger Brownsword, Understanding Contract law, 186-89 (2d ed. 1994).

[84] See Zamir, supra note 73, at 1769. See also Hugh Collins, the Law of Contract, 1720 (2d ed. 1993).

The principle of freedom of contract also derives from utilitarian and economic conceptions aimed at ensuring the total happiness or wealth in society to the maximum extent.[85] The rule of supply and demand brings about an optimal allocation of resources precisely when individuals seek their own utility and wealth. A voluntary exchange implies that, for each contracting party, the worth of what he receives is greater than the worth he parts with. In this way, resources are transferred to the people who value them the most, and utility derived from them is thereby increased. Contract Law enables the parties to rely on promises for future performance when immediate and simultaneous exchange would be impracticable or less profitable. Thus, consequential considerations of efficiency also support the respect for individual will, as manifested in voluntary contracts.[86]

According to these views, the starting point regarding the content of a contract is the parties' intentions and wills. [87] Absent a clearly expressed intention, one should

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[85] See Zamir, supra note 73, at 1770. See also Alan Schwartz, Justice and the Law of Contracts: A Case for the Traditional Approach, 9 Harv. J. L. & Pub. Pol'y 107 (1986); John N. Adams & Roger Brownsword, supra note 83, 184-89. 1994).

[86] See Zamir, supra note 73, at 1770. See also Michael J. Trebicock, the Limits of Freedom of Contract, 1517 (1993).

[87] See Zamir, supra note 73, at 1770. See also 4 Samuel Williston, A Treatise on the Law of Contracts § 610, at 284-

examine whether the parties' intentions may be deduced from the contract language, the circumstances of its making, or previous dealing between the parties. Reference to trade usages or to statutory or judicial default rules as gap-filling rules is made when attempts to reveal the actual intention of the parties has failed.[88] Furthermore, even default rules are considered as "implied terms", deriving their force from the parties' presumed or hypothetical intention.[89] Therefore, it is natural to place the general principles of contract law -- the principle of good faith and reasonableness at the bottom of the hierarchy which begins with the realization of the parties' actual intention.

1.2 Zamir's Inverted Hierarchy of Gap-Filling Rules

Professor Zamir proposed that the conventional hierarchy of gap-filling rules should be inverted. In the reality, there is no clear borderline between the various sources in conventional hierarchy even though it seems well-

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85(3d ed. 1961): "The guiding principle, polestar or lodestar of interpretation, whatever the form or nature of the instrument, is always the same: to ascertain the will, or intent, of the market."

[88] See, e.g. Continental Bank, N.A. v. Everett, 964 F. 2d 701, 705 (7th Cir. 1992).

[89] This conception prevailed in the eighteenth and nineteenth centuries, against the background of the will theory which was then dominant. See Tome II, 1 Henry Mazeaud et al., Lecons de Droit Civil, 319-21(8th ed. 1991).

ordered and supported by the existing laws.[90] For example, the standard the law usually provides in default rules to fill the gap is “reasonableness”,[91] and most usages of trade have been formed in the long-run practices based on the understanding of reasonableness. When courts fill gaps in the contract, they frequently resort to several sources simultaneously.[92]

Professor Zamir’s argument is made on three levels. First, legal principles and judicial practice reveal that the courts actually prefer the inverted hierarchy. When filling gaps, courts always prefer values of fairness and justice to the actual intentions of the parties. Courts fill gaps so as to give contracts a reasonable, lawful, and fair meaning, a meaning in favor of the public, a meaning that promotes equality between the parties, serves efficiency in the society, and enhances the fairness in the society. In some circumstances, courts creatively resolve the problem of gap-filling in order to achieve the above goal.[93] Moreover, gap-filling rules do not focus only on revealing the actual

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[90] See Zamir, supra note 73, at 1719.

[91] See supra Chapter III, Part 2 & 3.

[92] See Zamir, supra note 73, at 1719.

[93] See Zamir, supra note 73, at 1732.

and private intentions of the parties. Rather, they reflect distinctively public policies.[94]

Second, the parties' behavior reflects that they try to stick to the default rules and usages applicable to their transactions. There are many reasons for the contracting parties refrain from contracting out of default rules: legal rules usually reflect the prevailing preferences of contracting parties; contracting parties can reduce transaction cost if they do not deviate from the general usages and default rules applicable to their transaction; many parties feel secure when they know their agreements is in keeping with the default rules or the general usages; contracting parties fear mistakes resulting from incomplete drafting of terms or their misinterpretation by the courts. Even when the formal contract does deviate from the legal rules and general usages, parties usually perform their contractual duties in good faith and in accordance with the rules of fair dealing, default rules, and general usages. [95]

Finally, the inverted hierarchy is ethically superior to the conventional one. Based on the empirical research, the actual intentions of the parties at the time of contracting and performance are more in conformity with general standards of fair dealing and general usages than

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[94] See id. at 1721.

[95] See Zamir, supra note 73, at 1753-68.

with the conventional hierarchy.[96] The inverted hierarchy is supported by the modern idea that contract law should enhance fairness and equivalence in exchange, realize redistributive goals, and implement paternalistic policies.[97] Consideration of economic efficiency also supports the inverted hierarchy, considering that market failures and considerable transaction costs are prevalent phenomena in most markets, the limitations of cognitive faculties on one hand and people's moral and social capabilities exist in contracting processes on the other hand.[98]

2. The Theory of Penalty Default Rules

Professor Ian Ayers and Robert Gertner have proposed the theory of penalty default rules.[99] This theory reveals, in some circumstances, a party may choose to leave a gap in bad faith. The scholars indicate that the lawmaker or courts, in order to encourage the parties not to leave "bad

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[96] See id. at 1771-1777.

[97] See id. at 1777-1788.

[98] See id, at 1788-1800.

[99] The term "penalty default rules" was first proposed by Ian Ayers & Robert Gertner, in Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L. J. 87 (1989).

faith" gap in their contract, should sometimes impose penalty default rules.[100]

2.1. Two Reasons for Contractual Gaps

The theory of penalty default rules bases its theory on studying the reasons for the gaps. One reason the contract has gaps is the cost of contracting. In some cases, the transaction costs of explicitly contracting for given contingencies may be greater than the benefits.[101] Many of those contingencies are better left open in the hopes that they will not happen or can be settled through negotiation when they do happen. These considerations may lead one or both parties keep silent as to a particular issue.[102] By keeping silent, the parties can reduce their transaction costs including legal fees, negotiations costs, drafting and printing costs, the costs of researching the effects and probability of a contingency, and the costs to the parties and the courts of verifying whether a contingency occurred. Sometimes even though the transaction costs are quite low, but the probability of a contingency is much lower, the

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[100] See id. 95.

[101] See O. Williamson, The Economic Institutions Of Capitalism 70 (1985); Ian R. Macneil, Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract law, 72 NW. U. L. Rev. 854, 871-73 (1978).

[102] See Randy E. Barnett, The Sound of Silence: Default Rules and Contractual Consent, 78 Va. L. Rev. 821, 822 (1992).

rational party may choose to remain silent to such a contingency.[103] For example, no one would be willing to discuss the problems such as “what if the Third World War happens?” when they negotiated their contract. In this case, the default rules will come to fill the term left by the parties when the contingency materializes or the parties cannot reach an agreement on the materialized contingency. The default rules can efficiently minimize the transaction costs by providing binding terms in the absence of consent.

Another reason for contractual gap is called “strategic” gap[104] or “bad faith” gap. Only one party might be more informed as to the background of the contract conditions or the default rules. He might choose to conceal that information in order to increase his private share of the gains from the contracting. In the employment-at-will contract, for instance, the employee might be ignorant of that, under the traditional employment-at-will rule, their contract can be terminated by either party at any time for any reason or for no reason. The informed employer might choose to conceal this information to the at-will employee, so that he could hire the employee with an ordinary salary for a higher risk employment relationship. This “strategic gap” is the focus of the analysis of the penalty default

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[103] See Ayers & Gerner, supra note 88, at 93.

[104] See id. at 94.

rules. The scholars propose that lawmakers can reduce this strategic behavior by discouraging the concealment of information, therefore reduce the opportunities for this rent-seeking, “bad faith” behavior.

Although the term “penalty default rules” is new, rules of this type can be found in earlier England common law.[105] Those default rules were formed based on the understanding of reasonableness.

2.2 Examples of Penalty Default Rules

2.2.1 Limit on the Lost Expectancy Damages

Hadley v. Baxendale[106] established the principle of limitation on the recovery of expectancy damages. It also is a good example of penalty default rule. In *Hadley*, the plaintiff operated a mill which was forced to suspend operations because of a broken shaft. An employee of the plaintiff took the shaft to the defendant carrier for shipment to another city for repairs. The carrier knew that the item to be carried was a shaft for the plaintiff’s mill, but was not told that the mill was closed because the shaft

[105] For example, the “zero quantity rule” is a penalty default rule. The court would not supply the missing “quantity term” from the beginning of the contract law. Obviously, it is difficult or even impossible for the court to decide the quantity terms with “reasonable” standard. The “zero-quantity rule” gives both contracting parties incentive to reveal their contractual intentions during negotiation.

[106] 9 Ex. 341, 156 Eng. Rep. 145 (1854).

was broken. The carrier negligently delayed delivery of the shaft, with the result that the mill was closed for several more days than it would if the carrier had adequately performed the contract. The plaintiff sued for the profits they lost during those extra days. The court held that the plaintiff could not recover for the lost profit because the loss of profits was not disclosed as a damage which would follow from breach of the transportation contract.

The holding in *Hadley* is a penalty default rule. The miller plaintiff could have informed the carrier defendant of the potential consequential damages and contracted for full damage insurance. Then the informed carrier defendant might have been in a better position to prevent the potential loss. If the miller plaintiff had informed the carrier, the carrier would have been able to prevent the loss more efficiently because he could foresee the loss. At the same time, however, informing the carrier of the potential consequent damages would undoubtedly increase the price of shipping. In a competitive industry, the uninformed carrier, in effect, assumes he was facing an average-damage miller and charges a price accordingly. Therefore, the miller with above-average risk could reduce his high transportation cost by withholding strategically the

potential consequent damages in the hope that they would not happen.[107]

Hadley stands for the principle that "if a risk of loss is known to only one party to the contract, the other party is not liable for the loss of it occurs."[108] This principle encourages the party with knowledge of the risk either to take effective precaution or reveal the risk to the less informed party.

Hadley also indicates that good faith and reasonableness should apply to the "bad faith" gap. When the informed party withholds information in bad faith and thereby cause "bad faith" gap, courts, to promote the production of the information, should choose a default rule that reflect the reasonable expectation of the less informed party. For example, in *Hadley,* the less informed carrier's reasonable expectation was that he was facing an average-damage miller.

2.2.2 Employment-At-Will Rule

A gap in an employment-at-will contract is the termination term of employment. The traditional common law rule of employment-at-will contract is that the employer or employee may terminate an employment-at-will contract at any

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[107] See Ayers & Robert, supra note 99, at 101.

[108] R. Posner, Economic Analysis Of Law, 114-15, (3d ed. 1986).

time for any reason or for no reason. However, in recent years, most courts recognize some limitations on the employer's ability to terminate the employment of the at-will employee. One of the reasons the scholars advocate this department from the traditional rule is that the employees go into the job search and negotiation with inaccurate information while the employers start with much greater power and much more information regarding at-will rules.[109]

According to one survey,[110] there is striking level of misunderstanding of the most basic legal rules governing employment relationship.[111] The employees consistently overestimate the degree of job protection afforded by law, believing that employees have far greater rights not to be fired without good cause than they in fact have.[112] For example, "overwhelming majorities of the respondents erroneously believed that an employer cannot legally fire an employee in order to hire someone else at a lower wage, for

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[109] See e.g. Joseph Grodin, Toward a Wrongful Termination Statute for California, 42 Hastings L. J. 135, 137 (1990); Arthur S. Leonard, A New Common Law of Employment Termination, 66 N. C. L. Rev. 631, 674 (1988).

[110] See generally, Pauline T. Kim, Bargaining with Imperfect Information: A Study of Worker Perception of Legal Protection in an At-Will World, 83 Cornell L. Rev. 105 (1997).

[111] See id. at 133.

[112] See id, at 110.

reporting internal wrongdoing by another employee.[113] The survey indicated employers have less or mis-information about the legal effect of employment-at-will rule. Their expectations in employment-at-will are far away from the traditional employment-at-will rules. Meanwhile, the full-informed employers might choose not to reveal the information to their at-will employees in order to have a higher risk employment relationship with an ordinary cost. In such circumstance, the employees have some reasonable expectations as to the job security while entering into employment contract. Meanwhile, the employers' intentions are specific and real, and supported by the traditional default rule. What should be used to fill the gap of termination term? The question is whether these "bad faith" intentions should be protected. The modern trend is, in such

[113] Id, at 133-34.

circumstance, the principle of good faith and reasonableness prevails.[114]

[114] See e.g. Robert A. Hillman, An Analysis of the Cessation of Contractual Relations, 68 Cornell L. Rev. 617 (1983); Lorraine K. Phillips, The Legal Chokehold: Professional Employment in Ohio under the Employment-At-Will Doctrine, 24 Akron L. Rev. 581 (1991); Anthony W. Livoti, Court of Appeals Recognizes Action for Breach of the Implied Covenant of Good Faith and Fair Dealing in Employment Contract, 48 S. C. L. Rev. 123 (1996); Frank Vickory, the Erosion of the Employment-At-Will Doctrine and the Statute of Frauds: Time to Amend the Statute, 30 Am. Bus. L. J. 97 (1992).

CHAPTER V

GAP-FILLING AS FAIRNESS: LEADING OPINIONS

1. *Wood* Case: Classic Illustration of Implied Good Faith Clause in the Field of Gap-Filling

In *Wood v. Lucy Lady Duff-Gordon*,[115] the defendant, Lucy, Lady Duff Gordon, was a fashion designer. She made an agreement with the plaintiff, a businessman, whereby the latter was to have the right to place the Lucy, Lady Duff-Gordon endorsement on fashion designs. Lucy agreed that the plaintiff would be the only person to have this right, and the plaintiff agreed to give Lucy one-half of any profits derived from the sales of such endorsed designs. Lucy then put her endorsement on the designs of third persons (without sharing the profits with plaintiff) and plaintiff sued for breach of the agreement. Lucy asserted that the contract failed for lack of consideration, on the ground that the plaintiff did not bind himself to do anything, since he was not obligated under the contract to sell any endorsed designs at all. In this case, the contract was silent to the plaintiff's consideration. Even though the plaintiff had not

[115] 118 N. E. 214 (1917).

expressly promised to do anything, Judge Cardozo found an implied obligation on the plaintiff's part to use reasonable efforts, reasoning that Lucy would not otherwise have given the plaintiff an exclusive right in which her only compensation was half the profits. This implied obligation was a sufficient "detriment" to the plaintiff to constitute consideration for Lucy's counter-promise that she would not place her endorsement upon anyone else's designs. Therefore, the contract was binding, and Lucy had breached it. In its decision, Judge Cardozo expressed his concern was the judicial need to balance freedom of contract with other social values.

"We are not to suppose that one party was to be placed at the mercy of the other .... The implication [of language in the agreement] is that the [plaintiff's] business organization will be used for the purpose for which it is adapted. But the terms of the [defendant's] compensation are even more significant. Her sole compensation for the grant of an exclusive agency is to be one-half of all the profits resulting from the [plaintiff's] efforts. Unless he gave his efforts, she could never get anything. Without an implied promise, the transaction cannot have such business "efficacy as both parties must have intended that at all events it should have."[116]

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[116] Wood, supra note 115, at 214-15.

In *Wood*, by emphasizing the necessity to achieve the business efficacy of the transaction, Judge Cardozo underscored the role of freedom of contract.[117] To achieve the balance between freedom of contract and social order in *Wood*, he found an implied promise by the plaintiff to use reasonable efforts. Judge Cardozo stated that, “a promise may be lacking, and yet the whole writing may be ‘instinct with an obligation,’ imperfectly expressed.”[118]

The *Wood* opinion may be seen as a common-law attempt to protect the reasonable expectations of contracting parties with the principle of good faith and reasonableness while those expectations are contractual gaps. It reflected the court’s willingness to harmonize the value of private preferences and the need for social control. In order to achieve the contractual justice, the court found there was a gap in the contractual provisions and creatively filled the gap with the reasonable expectations of the parties. Moreover, Judge Cardozo’s “instinct language” opinion provided a rationale for the courts to do what they believed they were supposed to do, that is, enforce the parties’ intention when they were “imperfectly expressed.” As a matter of fact, “instinct language” opinion provide the courts a tool when they supply a missing term according to

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[117] See Wood, supra note 115, at 214.

[118] Id. at 214.

their understanding of reasonableness and fairness. It is another expression of reasonable expectations. It camouflaged the court's flexibility by claiming the obligation filled by the courts arose "naturally" from the environment.[119]

On the other hand, the *Wood* opinion reflected the evolution of contractual relationships required by a changing society. In response to the changing circumstances earlier in this century, courts began more directly to use the principle of good faith and reasonableness to support their decisions.[120]

2. *Orange and Rockland Utility Inc. v. Amerada Hess Corp.*

In *Orange and Rockland Utilities Inc. v. Amerada Hess Corp.*,[121] the plaintiff, a utility, signed a contract with the defendant, an oil company, under which the defendant was to supply the plaintiff's oil requirements for running a generating plant at a fixed price for four years. The contract contained an estimate for each year's consumption. The estimate assumed that gas, not oil, would be used for

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[119] See Robert A. Hillman, "Instinct with An Obligation" and the "Normative Ambiguity of Rhetorical Power", 56 Ohio St. L. J. 775, 785 (1995).

[120] Id. at 785-787.

[121] 59 A. D. 2d 110, 397 N. Y. S. 2d 814 (App. Div. 1977).

most of the plant's fuel generation. Soon after the contract began, the prices of oil and gas climbed sharply. Within one year and 4 months of the execution of the contract, the lowest market price was more than double the price fixed in the requirements contract. The plaintiff began burning much less gas and much more oil than called for in the estimate, and sold the leftover gas to third parties for a substantial profit. In fact, the plaintiff eventually used oil more than twice the contract estimate. The plaintiff sued when the defendant refused to supply any more oil than the contract estimate plus 10%.[122]

The court held that the UCC § 2-306(1) applied to the contract and a good deal of pre-code case law required "good faith" in the requirements contract. "It is well settled that a buyer in a rising market cannot use the fixed price in a requirements contract for speculation ...."[123] As the requirements contract insured a steady flow of cheap oil despite swiftly rising prices, the plaintiff's costs of producing electricity with oil would have been lower than those on the open market. Therefore, by using the contract and changing the mix of gas and oil, then propelling itself suddenly and dramatically into the position of a large

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[122] See Orange and Rockland Utilities, supra note 121, 110-14, 397, 814-18.

[123] Id. 114-15, 397, 818.

seller of power to the third parties, the plaintiff was acting in bad faith.[124] Even apart from the bad faith issue, The plaintiff's demand for more than double its contract estimate was "unreasonably disproportionate to [the] stated estimates."[125]

In its decision, the court stated that the unreasonably disproportionate standard must depend upon the reasonable expectations of the parties rather than be expressed as a fixed quantity. The court held that, under the facts of this case, requirements in excess of two times of the estimate were unreasonably disproportionate as a matter of law, but the court stated that this factor was not an inflexible measure. Rather, the determination was based on the following events: first, that the plaintiff's requirements were more than double the estimate; second, that the seller could not anticipate this increase; third, that the market price for oil doubled; fourth, that the increase was due to sales to other utilities which the court characterized as an arbitrary change in conditions to take advantage of market conditions at the seller's expense, and a net shift in

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[124] See Orange and Rockland Utilities, supra note 121, 116-17, 397, 819-20.

[125] Id. 120, 397, 822.

consumption from gas to oil which the buyer failed to explain.[126]

The court held that the reasonableness standard was not an inflexible measure. It must be decided in the specific environment of contracting. Reasonableness standard was used as a specific tool to make ad hoc determinations of fairness and justice, and therefore to disallow the plaintiff's requirements where justice requires.[127]

3. *Fortune v. National Cash Register Co.*

In *Fortune v. National Cash Register Co.*, [128] a former salesman brought action against former employer to recover a commission on a sale due to him while he was employed by the former employer. The plaintiff was employed by the defendant under a written "salesman's contract" which was terminable at will by either party on written notice. Under the employment contract, the plaintiff would receive a weekly salary in a fixed amount plus a bonus for sales made within his "territory" (i.e. customer accounts or stores). The contract indicated that the bonus credit would be paid only for an eighteen-month period following the date of the

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[126] Id. 120, 397, 822.

[127] See Stacy A. Silkworth, Quantity Variation in Open Quantity Contracts, 51 U. Pitt. L. Rev. 235, 275(1990).

[128] 373 Mass. 96, 364 N. E. 2d 1251 (1977).

order. In 1968, the plaintiff's territory included First National which had been part of his territory for the preceding six years, and from which he had been successful in obtaining several orders. On November 29, 1968, First National signed an $5,000, 000 order, on which the amount of bonus credit was $92,079.99. On December 2, 1968 (the next business day), a termination notice issued from the defendant to the plaintiff. After that, the plaintiff remained to work for the defendant as a "sales support" and received 75% of the applicable bonus due on the sale. On June of 1970, approximately eighteen months after receiving the termination notice, the plaintiff was fired after he refused the retirement proposal from the defendant.[129]

The Supreme Judicial Court of Massachusetts held that because the salesman's contract was at-will contract, through a literal reading of the contract, the employer is correct to terminate its employee. However, "good faith and fair dealing between the parties are pervasive requirement in our law, it can be said fairly that parties to contracts or commercial transactions are bound by this standard."[130] The court believed that good faith is implied in contracts terminable at will by reference to recent decisions in other

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[129] See Fortune, supra note 128, 96-99, 364, 1251-54.

[130] Id. 102, 364, 1256.

jurisdiction.[131] In this case, the defendant sought to deprive the plaintiff of all compensation by terminating twenty-five-year employment relationship with the plaintiff when the plaintiff was on the brink of successfully completing the sale. The defendant acted in bad faith. A

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[131] See id. 103-104, 364, 1256-57. One of the cases the court referred to was Monge v. Beebe Rubber Co., 316 A. 2d 549 (1974). In Monge, the plaintiff, a married woman, alleged and presented evidence to show that she was discharged because she refused to date with her foreman after completing work of the night shift. The New Hampshire Supreme Court claimed that it could not ignore "the new climate prevailing general in the relationship of employer and employee." The court held that "a termination by the employer of contract of employment-at-will which is motivated by bad faith or malice or based on relation is not in the best interest of the economic system or the public good and constitutes a breach of the employment contract. … Such a rule … does not interfere with the employer's normal exercise of his right to discharge, which is necessary to permit him to operate his business efficiently and profitably."

termination made in bad faith constituted a breach of contract.[132] This case indicated the court's willingness not only in giving priority to the principle of good faith and reasonableness, but also in using this principle to modify the existing default rules based on the standard of reasonableness and fairness.

[132] See Fortune, supra note 128, 104-05, 364, 1255-57.

CHAPTER VI

CONCLUSION

The core of the contract is its content. The evolution of the gap-filing rules shows that the good faith and reasonableness plays more and more important role in this field. At the beginning, the courts refused to make the contract for the party. Then the courts tried to find out the actual intention of the parties, which sometimes proved rather difficult or even impossible. In order to support the freedom to make contracts without specifying all of the details of the relationship, the courts eventually turned to the “reasonable intention” standard in the field of gap-filling. Initially objective gap filling was a means of allowing enforcement of agreements which the parties intended to be binding as in *Wood v. Lucy Lady Duff-Gordon*. But now it has become a mechanism for adding content to an agreement which would not be have been consented to by one of the parties as in *Fortune v. National Cash Register*.
Of course, the courts still claim that they are protecting the freedom of contract.

Examining the totality of the law provisions, it is not difficult to indicate what the law prefers to fill the gap first. The CISG, as an international convention, clearly provides the reasonableness is the first source to fill the contractual gap, and after that is "all relevant circumstances of the case including the negotiations, any practices which parties have established between themselves, usages and any subsequent conduct of the parties".[133] That is a good evidence that the law places the principle of good faith and reasonableness at the top of the gap-filling rules. The Restatement (Second) clearly provides that the standard of gap-filling is reasonableness[134], which is known as "what the parties would have agreed to if the question had been brought to their attention,"[135] or what was the reasonable expectation the parties should have under this circumstance. Even if the UCC does not have such a clear provision on the face, a more careful reader will come to the conclusion that the essence of the law prefers to give the contract a reasonable meaning.

1. Good Faith and Reasonableness May Reflect Intentions at the Time of Contracting

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[133] See supra Chapter III, part 3.

[134] Restatement of Contract, § 204 (1979).

[135] Id. § 204, comment d.

At one level, filling gaps based on good faith and reasonableness can be defended as effectuating what ordinary parties intend and as therefore consistent with freedom of contract. At the time of contracting the parties recognize that they are leaving gaps and at that point they ordinarily expect – one could say that they empower – the courts to fill the gaps using good faith and reasonableness as standard. Of course, not all parties have the intend to give this power to the courts. An employer insisting on an at-will employment contract may not. But many will.

Research reveals that, when the parties make a contract, they usually focus on only a few contractual terms they think essential, and ignore the other terms in the hope that they are reasonable terms.[136] In many cases, the contract document is drafted by lawyers in legal language, using terminology that laymen - consumers and merchants alike - do not fully understand.[137] In the case of standard form contracts, customers frequently do not bother to read

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[136] See Ole Lando, Standards Contrats: A Proposal and A Perspective, 10 Sandinavian Stud. L. 127, 130-33 (1966).

[137] See Stewart Macaulay, Non-Contractual Relation in Business: A Preliminary Study, 28 Am. Soc. Rev. 55, 58 (1963)(research reveals that company sales and purchasing staff are generally not very familiar with the content of the standards forms they use); Hugh Beale & Tony Dugdale, Contracts between Business: Planing and the Use of Contractual Remedies, 2 Brit. J. Law & Soc'y 45, 50 (1975)(finding also that this is sometimes the case); See also Restatement (Second) of Contracts 211, Comment B (1979).

most of the provisions of the contract, focusing instead on a few essential issues such as price and time of delivery.[138] This phenomenon is also prevalent in cases where the formal contract is not drafted by either of the parties, but rather copied from existing forms originally drafted by lawyers. Even when the parties themselves drafted an agreement, they often use legal language, unaware of their exact meaning.

In all of these cases, each party acts according to considerations and incentives of various kinds, these consist of short- and long-run self interest, including the expectation of reciprocity and the wish to enhance one's good reputation, moral notions of the obligation to keep one's promises and to make allowances for others, and the wish to attain social recognition and respect.[139] Mutual reliance, expectations, and commitments exist prior to the signing of the formal contract and continue to develop and change afterwards. Of course, each party expects similar treatment from the other party. Above all, the parties

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[138] See Todd D. Rakoff, Contracts of Adhesion: An essay in Reconstruction, 96 Harv. L. Rev. 1173,1275-83 (1982); J.H. Baker, From Sanction of Contract to Reasonable Expectation, 32 Current Legal Probs. 17, 23(1979). See also, Llewellyn, The Common Law Tradition: Deciding Appeals, 36271 (1960).

[139] See John Kidwell, A Caveat, 1985 Wis. L. Rev. 615; Robert E. Scott, Conflict and Cooperation in Long-term Contracts, 75 Cal. L. Rev. 2005, 2039-42(1987); Harold C. Havighurst, The Nature of Private Contract, 6386 (1961); E. Allen, The Past of Promise: An Historical Introduction to Contract, 69 Colum. L. Rev. 576, 604-05 (1969).

expect each other to behave fairly and reasonably, according to the principle of good faith. For instance, the buyer may expect seller to warrant the quality of goods and deliver them within a reasonable time even if they are not familiar with the relevant provisions of the UCC, even unaware of the existence of the UCC. “Being a reasonable person” is not only required by the law, but also expected by the parties. This conclusion is particularly applicable to the contract in modern times. As the contract relationship imports a good deal of standard form contracts, the transaction becomes more complicated, and the parties’ performances become more extended,[140] the ordinary parties have to rely on the their opposite parties' "good faith" and "reasonableness" to make a reasonable contract.

2. Eventual Judicial Specification of Duties May Be Inconsistent with What a Party Intended

When one gets to the point of how the courts actually fill gaps, then it becomes apparent that the courts may at

[140] See W. David Slawson, The New Meaning of Contract: The Transformation of Contract Law by Standard Form, 46 U. Pitt. L. Rev. 21, 21-25 (1984). The author demonstrated that the new meaning of contract is the parties’ reasonable expectation from whatever sources they may derive. This change is a logical response to the changing societal conditions and particularly to the increased use of standardized form.

times impose provisions in a way that is inconsistent with traditional notion of freedom of contract.

The moral force behind contract as promise is autonomy: the parties are bound to their contract because they have chosen to be. For this reason, freedom of contract has been the central principle of contract law. With the development of gap-filling rules, the content of a contract rests with not only the promises the parties have made, but also the external sources such as good faith, reasonableness, and social justice. As a result, some “surprising” duties may be imposed on the parties. Realistically speaking those duties may be inconsistent with the actual intentions of the parties. An employer’s intention to sign an at-will employment contract may be that he can terminate his employee at any time. A buyer entering into a requirements contract may want to have free choice of the quantity without assuming any duties. The developed gap-filling rules limit those free choices, thereby circumscribe the freedom of the parties in their contracts. The general understanding is that we have less freedom of contract than we had before.[141]

Professor Fried suggested an explanation to this “less freedom” situation. According to Professor Fried, “contracts

[141] Mark Pettit, Jr., supra note 5, at 266.

generally are a device for allocating risks."[142] When the parties to a contract leave a gap in the contract, the court should apply the principle of sharing to fill the gap, that is, allocate loss and gain based on reasonableness.[143] Because the parties to the contract become closer through entering a contract relation, they have some obligation to share unexpected benefits and losses in the course of performing the contract. When the actual intentions of the parties are missing, the courts respect the freedom of the parties so far as possible by construing an allocation of burden and benefits that reasonable persons would have made in this kind of transaction.[144]

In this century or even earlier,[145] the principle of freedom of contract has experienced "quite revolution" in response to the change in the societal conditions. Our society has experienced the dramatic transition from simple markets, characterized by face-to-face dealing and relative stability, to complex commercial society, impersonal economic exchange, greater uncertainty, and market volatility. In the process of this transition, standard form

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[142] Charles Fried, Contract as Promise, 59 (1982).

[143] See Fried, supra note 142, at 70.

[144] See id. at 73.

[145] According to Professor Atiyah, the freedom of contract began a slow decline after reaching an apogee in 1870. See Patrick S. Atiyah, supra note 3, at 716.

contracts become predominant in many areas of trade and commerce, large monopolistic companies emerge, products become more and more complicated to ordinary consumers. These factors completely changed the balance of power in negotiations. Based on the changed societal conditions, people realized that the law, in granting freedom of contract, did not guarantee that all the member of the society would be able to utilize it to the same extent.[146] On the contrary, the law, by protecting the unequal distribution of property, does not prevent freedom of contract from being a one-side privilege. For instance, by guaranteeing that it will not interfere with the exercise of power by contract, law has enable many an enterprise to legislate by contract in a substantially authoritarian manner. In this sense, the principle of freedom of contract as a justification for allowing one party to impose whatever terms it likes, even when the other party was not reasonably expected to read or understand those terms, is to apply the nominal “freedom” to what is essentially a license to defraud or, at least to mislead. "Unlimited freedom of contract, like unlimited freedom in other direction, does not necessarily lead to public or individual welfare."[147] It

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[146] See Jay M. Feinman, Book Review: Contract After the Fall: the Law of Contract. By Hugh Collins. London: Weiden Feld and Nicolson, 39 Stan L. Rev. 1537, 1541-42 (1987).

[147] Williston, supra note 5.

has been realized that contracting would be accorded the protections associated with freedom only when the parties engage in an honest effort to express what they both reasonably expect. Therefore, law attempts to protect the weaker contracting party against abuses of freedom of contract, for instance, by fixing minimum wages and maximum hours in employment, attempting to outlaw discrimination against union members and attempting to give special protection to the consumer. In this “silent revolution”, fairness has increasingly been accepted as a major principle of contract law.[148] Moreover, freedom of contract has never been considered as an unlimited right to have whatever content the parties want. Even in the past two hundred years, in which the freedom of contract has been of ensuring the voluntariness of the contract process while not interfere what its outcome, the doctrine of fraud, misrepresentation, duress, undue influence, and mistake have

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[148] See Larry A. Dimatteo, The CISG and the Presumption of Enforceability: Unintended Contractual Liability in International Business Dealings, 22 Yale J. Int’l L. 111, 148(1997). Some scholars indicated that, as contract law adopted fairness principle, it should become public law or quasi-public law. See Zamir, supra note 73, at 1777, Dimatteo, supra note 145, at 311:

> Twentieth century contract law has exhibited a willingness to imply reasonable terms not intended by the parties. Contract law has become, at least partially, to reflect what society believes is fair. The important jurisprudential result is that contract has moved from the domain of purely private law to a quasi-public law. The reasonable person has become its unelected constable.

frequently been used to police the fairness of transactions between parties.

Contract law is an evolution process and the rules and principles of contract law have been changing in response to the changing condition. As a part of our changing civilization, legal principles represent the prevailing mores of the times.[149] In the evolution process of the law, the meaning of freedom of contract, of course, has been changing in response to the changing societal situations. In modern times, the principle of freedom of contract requires the parties make a lawful and reasonable arrangement while they enjoy their freedom. Meanwhile, the judicial process of

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[149] "[L]aw does not consist of a series of unchangeable rules or principles ... every system of justice and of right is of human development, and the necessary corollary is that no known system is eternal. In the long history of the law can be observed the birth and death of legal principles ...The law is merely a part of our changing civilization. The history of law is the history of man and of society. Legal principles represent the prevailing mores of the times, and with the mores they must necessarily be born, survive for the appointed season, and perish." Corbin, Preface to W. Anson, Law of Contracts (A. Corbin ed. 1919).

recognizing and developing “gap-filling rules” produces rules that conform to prevailing conception of what is just, reasonable and efficient in contractual relationship.

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