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Explaining Adversarial Boilerplate Language in the Battle of the Forms: Are Consequential Damages in the U.C.C. Gap Fillers a Penalty Default Rule?

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EXPLAINING ADVERSARIAL BOILERPLATE LANGUAGE IN THE BATTLE OF THE FORMS: ARE CONSEQUENTIAL DAMAGES IN THE U.C.C. GAP FILLERS A PENALTY DEFAULT RULE?

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ABSTRACT

In this article, game theory is applied to the battle of the forms and related scenarios to explain Daniel Keating's observations, reported in the article "Exploring the Battle of the Forms in Action," 98 MICH. L. REV. 2678 (2000). The first of the two major findings in this article is that there is a game-theoretic reason drafters of boilerplate language should use adversarial, U.C.C. § 2-207(1) proviso-conforming language, namely, to ensure that clients receive terms that are no worse than the default U.C.C. gap fillers. The second major finding is that there is a penalty default rule in contract law. This has been debated by academics including Ian Ayres, Robert Gertner, and Eric Posner. Under the U.C.C., consequential damages are part of the gap fillers, and thus part of the Nash Equilibrium default in the Battle of the Forms. This default gap filler is applied even though a majority of parties do not include this term in their negotiated, functionally complete contracts.

INTRODUCTION

A perception among some scholars is that Uniform Commercial Code ("U.C.C") § 2-207 adds mud to the already murky battle of the forms.[1] Professor Daniel Keating undertook original research exploring the real world application of the battle of the forms under the U.C.C. by conducting interviews with the agents and attorneys of various companies.[2] Professor Keating's excellent article, which resulted from these interviews, led to more questions than answers.[3] Nevertheless, it provides observations that suggest Section 2-207 is preferable to alternative approaches to the battle of the forms.[4] In this article, I will show that Section 2-207 is perfectly workable and assert that it should remain largely unaltered. To do

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[1] U.C.C. § 2-207 (2004). The "battle of the forms" refers to the situation arising when parties exchange forms with non-matching terms. Some academics believe drafters are "left without a clear resolution in the case of a true battle of forms. The UCC is a disaster when it comes to dealing with the battle of the forms." ROBERT A. FELDMAN & RAYMOND T. NIMMER, DRAFTING EFFECTIVE CONTRACTS §4.07[E] at 4-50 (2d ed. Supp. 2008).

[2] Daniel Keating, *Exploring the Battle of the Forms in Action*, 98 MICH. L. REV. 2678, 2693 (2000).

[3] *Id.* at 2714-15 (acknowledging that the information is presented without an overarching theory: "[h]aving spent many hours on the phone in interviews that enabled me to see only the tip of a very large iceberg, I am left not with radical suggestions for change but instead with a few modest observations.").

[4] Keating's interviews show that practitioners would agree that only minimal changes to Section 2-207, if any, would be desirable. *Id*. at 2715.

this, I will apply game theory[5] to create a model to explain how the U.C.C. affects the strategies drafters should use to navigate the battle of the forms and related scenarios.[6]

The model supports two findings. The first is that adversarial boilerplate language should not be seen as unnecessarily creating ambiguity in the battle of the forms situation.[7] This is important because courts have misinterpreted this strategic language as an underhanded attempt by parties to secure one-sided terms without taking on the costs of negotiation ex ante. Instead, adversarial boilerplate language should be understood as allowing participants in the battle of the forms to reach a sustainable default position, the U.C.C. gap fillers. When participating in the battle of the forms, clients with forms containing strategic language will be better off than their counterparts who do not have such forms.

The second finding is that there is a penalty default rule in American contract

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[5] Game theory is subject to imprecise assumptions:

> [G]ame theory highlights the problems of cooperation and explores specific strategies that alter the payoffs [of] players. But there is a vast gap between the relatively clean, precise, and simple world of game theory and the complex, imprecise, and fumbling way by which human beings have gone about structuring human interaction. Moreover, game theoretic models, like neoclassical models, assume wealth-maximizing players. But as some of the experimental economics literature demonstrates, human behavior is clearly more complicated than can be encompassed in such a simple behavioral assumption.

David McGowan, *Legal Implications of Open-Source Software*, 2001 U. ILL. L. REV. 241, 304 n.196 (2001) (quoting DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 15 (1991)).

[6] For an application of game theory to offer and acceptance, see Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215 (1990). Undertaking the present article, I heed Katz's urge to promote "a particular research program; namely, the use of game theory to analyze the law of contract formation." *Id*. at 216. *See also* DOUGLAS BAIRD ET AL., GAME THEORY AND THE LAW (1994). Professor Baird wrote a comment on Keating's battle-of-the-forms article. Baird discussed the portion of Keating's article regarding the Baird-Weisberg Model (a suggestion for changing Section 2-207). Baird's article explains, among other things, why boilerplate language is not meant to be sneaky, an important point, but one that is distinct from the ideas presented in this paper. Consider Baird's statement: "A vision of commercial law that worries excessively about the ability of parties to sneak terms past each other distracts us from the things that matter." Douglas G. Baird, *Commercial Norms and the Fine Art of the Small Con*, 98 MICH. L. REV. 2716, 2717 (2000). Baird asserts that parties would put less one-sided language in their boilerplate language under the Baird-Weisberg Model because reputation would be on the line, not because sneakiness would be more difficult (given incentives to read the boilerplate language). *Id.* at 2718. Baird was probably responding to Keating's statement: "[i]f a party persists in writing one-sided terms on its form, it will risk losing business since the other side is more likely to read a form that it knows it might be bound by." Keating, *supra* note 2, at 2706. This statement could be understood to mean that one could not "get away with" one-sided boilerplate language *if only* it were read. For further information regarding the importance of reputation in this context see Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827, 827 (2006). *See also infra* Part IV Section 1, and Part VI Section 2, on the take-it-or-leave-it game and reputation curve. For more information on the importance of virtues in capitalism see, JOHN MUELLER, CAPITALISM DEMOCRACY & RALPH'S PRETTY GOOD GROCERY 21-56 (1999). "As the Better Business Bureau puts it, 'Honesty is the best policy. It's also the most profitable.'" *Id.* at 23.

[7] For a discussion of the courts' understanding of the use of this language, see *infra* Part VI Section 1, *The Courts' Misunderstanding of Strategic Language*. Sometimes phrases that are inserted into a form to conform to a rule are referred to as magic language. I prefer to call it adversarial or strategic because the outcome of inserting this language is predictable and expected once the strategy of its use is exposed. This is about forethought, not sleight of hand.

law.[8] Consequential damages in the U.C.C.,[9] functioning as part of the gap fillers, are a default under the battle of the forms. This particular gap filler acts as a penalty default, causing parties to participate in some negotiations ex ante to get around them, rather than save costs and rest on gap fillers wholesale as one might otherwise expect.[10] Any changes to the U.C.C. should streamline the process of getting to the gap fillers, not displace them. Displacing them would be counterproductive for the operation of the consequential-damages gap filler, and its effect as a penalty default rule,[11] which encourages sellers to negotiate consequential damages ex ante.

Part I of this Article provides some basic background legal information. Part II discusses Professor Keating's article and its findings. Part III lays out the assumptions underlying the model, and Part IV gives a basic overview of game theory. The model is presented in Part V. Part VI examines the results of applying the model, including a critique of the courts' policy explanations for applying Section 2-207(3), a description of the role accommodating terms have in a take-it-or-leave-it form, and an argument for the presence of a penalty default rule in contract law. I conclude the paper with suggestions for future empirical research and further development of this game-theoretic approach to contract negotiations.

I. BACKGROUND

1. Contract Formation: Completeness, Boilerplate Language, and the Battle of the Forms

A contract is never "complete,"[12] because no contract can describe the obligations of parties for every potential state of the world.[13] Where a more complete contract accounts for many future contingencies, a less complete contract might simply state the price and date of performance.[14] Nevertheless, completeness does matter; courts seem to be more willing to aggressively interpret

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[8] A penalty default rule is a rule that courts apply ex post as a default, but unlike other default rules, it is not set at what the majority of parties would have negotiated. Thus it is a penalty, the existence of which encourages negotiation ex ante. The existence of a penalty default rule in practice has been debated.

[9] *See* U.C.C. § 2-715 (2004).

[10] The model presented in this article should alleviate the concern of some scholars, such as Professor Craswell, that Keating did not address whether it *should* be easier for sellers to displace the U.C.C.'s standard default rules. Richard Craswell, *The Sound of One Form Battling*, 98 MICH. L. REV. 2727, 2728 (2000). Craswell's article mostly pertains to partially negotiated and take-it-or-leave-it contracts. *See infra* note 67 and accompanying text.

[11] A penalty default rule is one that is followed by courts when parties do not negotiate a term and the default is purposefully set against the wants of the parties to encourage them to reveal information, i.e. negotiate that term.

[12] Complete in the "real world" sense, rather than the legal sense (as when a court denies introduction of evidence for new terms under the parol evidence rule because it assumes certain contracts are legally complete).

[13] Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91 (2000).

[14] *Id.* at 91.

incomplete contracts than complete contracts.[15] Although it may be desirable to create a complete contract,[16] parties must consider the cost of negotiating and drafting such a contract.[17] Many find it prudent to forgo negotiating some (or many) potentially pertinent terms of a contract. Those who deem it more efficient to be incomplete only negotiate the "big" terms (e.g., date, price, quantity) and leave the rest to be settled later,[18] if at all.[19] Unless a contract is of substantial or unique worth to parties, they may not find it worthwhile to negotiate many of the smaller, non-immediate terms.[20]

Potential non-immediate terms are often supplied by "small print" or boilerplate language, typically located on the back of forms. Boilerplates often contain language regarding warranty and liability. Since boilerplate language is not negotiated, it must be drafted with forethought. A lawyer must make assumptions about the future use of the forms when drafting boilerplate language to maximize the probable outcome of such use for a client. To do this, the lawyer will need to consider the worst-case scenario. If the client uses the form, without regard to what the form says and merely sends it off, the lawyer must consider what language would best serve this "automaton" client. Recognizing that the boilerplate language will, by definition, be used in contracts that are not fully negotiated,[21] one can discover the assumptions a drafter must make and see how this informs the language that is used. In other words, one can see what strategy a drafter must employ to ensure clients are as well off as possible.[22] First, however, it is necessary to understand the context in which issues regarding boilerplate language arise and are settled.

In the cases where parties do not negotiate every term of their agreement, they may end up sending one another forms, after which point, they believe there is a contract. When the boilerplate language of the exchanged forms conflict and a problem arises, the contents of the forms may need reconciliation. If litigated, courts must decide which form will be controlling for each aspect of the agreement and interpret the results of this decision. This question has come to be known as

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[15] *Id.* at 92.

[16] Or at least one that is "functionally complete." *See* Karen Eggleston, Eric A. Posner, & Richard Zeckhauser, *Simplicity and Complexity in Contracts* 10 (U. Chi. Law Sch. John M. Olin Law & Econ, Working Paper No. 93, 2000).

[17] Eggleston et al., *supra* note 13, at 92.

[18] For a discussion on shifting the costs of contracting ex post *see* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 127-28 (1989) ("When parties fail to contract because they want to shift the ex ante transaction cost to a subsidized ex post court determination, a penalty default of non-enforcement may be appropriate.").

[19] The relatively smaller terms may also be called the non-immediate terms.

[20] Keating, *supra* note 2, at 2699-700. The word "*term*" is defined in U.C.C. § 1-201: "'[t]erm' means a portion of an agreement that relates to a particular matter." Because boilerplate contents do not line up cleanly with this definition, I will say that the language used in boilerplates are potential terms. Nevertheless, I ask for the reader to forgive me if I slip into the less accurate, colloquial use of the word, term.

[21] Logically, if a contract were fully negotiated, no prefabricated language would be used.

[22] For an argument that boilerplates can be strategic *see* Robert B. Ahdieh, *The Strategy of Boilerplate*, 104 Mich. L. Rev. 1033, 1036-37 (2006) (providing arguments that use of boilerplates can have signaling and coordination functions).

the battle of the forms.[23] Over time, the battle has been resolved in different ways, but not without criticism.[24]

2. Transition to the U.C.C.

Under the common law, the "mirror image" rule[25] and the "last-shot" doctrine applied.[26] The Uniform Commercial Code's Section 2-207,[27] however, has done away with these approaches.[28] Black's Law Dictionary explains that: "In its original version, U.C.C. § 2-207 attempted to resolve battles of the forms by abandoning the common law requirement of mirror-image acceptance and providing that a definite expression of acceptance may create a contract for the sale of goods even though it contains different or additional terms."[29] The section

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[23] Keating, *supra* note 2, at 2681 n.7 ("When I refer to 'the battle-of-the-forms situation' or engaging in the battle of forms, I don't mean to imply the existence of a dispute, but merely that forms were exchanged that had non-matching terms."). Black's Dictionary defines the battle of the forms as follows: "[t]he conflict between the terms of standard forms exchanged between a buyer and a seller during contract negotiations." BLACK'S LAW DICTIONARY 162 (8th ed. 2004).

[24] " BLACK'S LAW DICTIONARY 162 (8th ed. 2004) ("The rules of offer and acceptance are difficult to apply in certain circumstances known as the 'battle of the forms' where parties want to ensure that the contract is on terms of their choosing.") *Id.* (quoting P.S. ATIYAH, AN INTRODUCTION TO THE LAW OF CONTRACT 54 (3d ed. 1981)); *see also* Keating, *supra* note 2, at 2684 ("[One] source of complaint about the common law approach was the arbitrariness of the all-or-nothing nature of the last-shot doctrine.").

[25] Mirror-image rule:

> [In contracts it is the] doctrine that the acceptance of a contractual offer must be positive, unconditional, unequivocal, and unambiguous, and must not change, add to, or qualify the terms of the offer; the common-law principle that for a contract to be formed, the terms of an acceptance must correspond exactly with those of the offer.

BLACK'S LAW DICTIONARY 1018 (8th ed. 2004).

Prior to the enactment of the U.C.C., the common law followed what became known as the 'mirror image' and 'last shot' doctrines, the former governing formation and the latter dictating terms. What the mirror-image rule says is that when an offer is made, a purported acceptance whose terms are not the 'mirror image' of the offer will not count as an acceptance, but instead will be treated as a counteroffer. Keating, *supra* note 2, at 2683.

[26] Last-shot doctrine:

> This is where the 'last shot doctrine' comes into play. Because a purported acceptance such as [a] seller's is treated as a counteroffer that is then accepted by the buyer's performance, the seller's terms will govern by virtue of its having fired the 'last shot.' Thus, under the common law approach, the contract would be formed upon the buyer's payment, and the seller would get the benefit of its presumably more limited warranties and remedies when the machine malfunctioned in the buyer's hands.

Keating, *supra* note 2, at 2684. Some authors have argued that instead of Section 2-207, a "best-shot," or "reasonable-shot" rule should be followed. *See, e.g.*, Omri Ben-Shahar, *An Ex-Ante View of the Battle of the Forms: Inducing Parties to Draft Reasonable Terms*, 25 INT'L REV. L. & ECON. 350 (2005).

[27] *See infra* p. 36-45, U.C.C. Appendix A § 2-207.

[28] Keating, *supra* note 2, at 2684-85. ("[S]ubsection (1) of section 2-207 marked the end to the common law's mirror-image rule."). Keating, *supra* note 2, at 2684. Black's Dictionary adds a notice that: "[i]n modern commercial contexts, the mirror-image rule has been replaced by a U.C.C. provision that allows parties to enforce their agreement despite minor discrepancies between the offer and the acceptance." BLACK'S LAW DICTIONARY 1018 (8th ed. 2004).

[29] BLACK'S LAW DICTIONARY 162 (8th ed. 2004).

reads:

> U.C.C. § 2-207. Additional Terms in Acceptance or Confirmation.
>
> A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
>
> The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
>
> > the offer expressly limits acceptance to the terms of the offer;
> >
> > they materially alter it; or
> >
> > notification of objection to them has already been given or is given within a reasonable time after notice of them is received.
>
> (3)Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.

For the purposes of this article, Subsection 3 is the most pertinent.[30] Section 2-207(3) comes into play when the writings of parties do not establish a contract, but both parties still act as if there were a contract.[31] Under Subsection 3, the terms that are in agreement between the forms make part of the contract, but the conflicting terms are knocked out (the "knock-out rule"). The knocked-out terms are supplied with "gap fillers" from elsewhere in the U.C.C., such as § 2-715. Notably, the gap fillers provide for consequential damages for the buyer and a good warranty.[32] The former is significantly different from the latter in that it is not typically found in a functionally complete, negotiated contract.[33]

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[30] *See* Keating, *supra* note 2. It is expected that buyers would include language in their forms that conforms to Section 2-207(2)(a) and (c). I believe the jurisdictional differences in application of Section 2-207(2) could be used to further study this topic, including the prevalence of Section 2-207(1) proviso conforming language as a strategy for getting to the gap fillers.

[31] This scenario is not that uncommon. *See infra* Part I, Section 3.

[32] *Id. See* Jom, Inc. v. Adell Plastics, Inc., 151 F.3d 15 (1st Cir. 1998), UCC § 2-715 (Buyer's Incidental and Consequential Damages); *see also* RICHARD A. POSNER, ECONIC ANALYSIS OF THE LAW 126-27 (2007) (discussing consequential damages). "In a battle of forms context, a buyer whose form fails to signify that certain terms by the seller would be objectionable may not be able to rely on gap fillers to [automatically take effect]" if the buyer omits language on a given point. *See* FELDMAN, *supra* note 1, § 4.04[C][1], 4-20 n.32.2 (2d ed. 2006 Supp.); *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 126-27 (2007) (discussing consequential damages); § 4.04[C][1], 4-20 n.32.2 (2d ed. 2006 Supp.); Jom, Inc. v. Adell Plastics, Inc., 151 F.3d 15 (1st Cir. 1998).

[33] Keating, *supra* note 2, at 2689-90; *see also infra* note 181 and accompanying text.

3. Case Law: Section 2-207(3)

Consider a common business scenario. In a business-to-business deal, Buyer sends a standard form purchase order to Seller for widgets. Seller prints out its standard acknowledgement form and sends it to Buyer.[34] Without reading over the forms, or understanding the implications of the legalese contained thereon,[35] the widgets are then shipped and paid for.

There is no problem here, even under the common law mirror-image rule, so long as the purchase order and acknowledgement form match term-for-term. But, if they do not match,[36] and a dispute arises, courts must determine which terms, if any, are controlling. Following the U.C.C., courts apply Section 2-207. The following cases, decided in federal court, illustrate the evolution of the application of Section 2-207(3), including how it is reached and what the result of reaching it will be.

In 1977, the Seventh Circuit, in *C. Itoh & Co. (America) Inc. v. Jordan International Co.*,[37] laid out the analysis courts have subsequently performed under Section 2-207. A buyer, C. Itoh & Co. (America) Inc. ("Itoh"), submitted a purchase order for steel coils to a seller, Jordan International Company ("Jordan"), and Jordan responded by sending its acknowledgment form to Itoh.[38] Jordan's acknowledgment form contained the following statement: "Seller's acceptance is . . . expressly conditional on Buyer's assent to the additional or different terms and conditions set forth below and printed on the reverse side. If these terms and conditions are not acceptable, Buyer should notify Seller at once."[39] The pertinent additional-or-different term in the acknowledgment form was an arbitration provision that was printed on the reverse side of Jordan's acknowledgment, which Itoh never expressly assented to nor objected to until the dispute arose.[40] Despite this difference in form terms, "both parties proceeded to performance[;] Jordan by delivering and Itoh by paying for the steel coils."[41] When a dispute arose, Jordan wanted to take it to arbitration – Itoh did not.

The court determined that Jordan's acknowledgment-form language came within the Section 2-207(1) proviso, because "acceptance [was] expressly made conditional on assent to the additional . . . terms."[42] The court explained that, as a result, no contract had been formed under Section 2-207(1): "Hence, the exchange of forms between Jordan and Itoh did not result in the formation of a contract under Section 2-207(1)."[43]

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[34] Of course it could be the buyer's form that does not comport or conform.

[35] In other words, these are automaton clients. *See supra* p.4.

[36] Which, given the business choice to send boilerplate forms instead of negotiating every single term, could easily happen in a smaller sale. *See supra* notes 13-20 and accompanying text.

[37] *C. Itoh & Co. (Am.) Inc. v. Jordan Int'l Co.*, 552 F.2d 1228 (7th Cir. 1977).

[38] *Id.* at 1230.

[39] *Id.* at 1232.

[40] *Id.* at 1230.

[41] *Id.* at 1236.

[42] *C. Itoh & Co.*, 552 F.2d 1235.

[43] *Id.* at 1236.

The court stated that if a contract had been formed under Section 2-207(1), the question of whether a particular additional term would be included in the contract between the parties would have been answered under Section 2-207(2).[44] But the court found no contract formed under Section 2-207(1), so Section 2-207(2) was inapplicable. The court turned to whether a contract was formed under Section 2-207(3) through conduct of both parties that recognized the existence of a contract.[45] The court determined that Section 2-207(3) did operate to create a contract through the subsequent performance by both parties (i.e., both parties recognized the existence of a contract through their actions).[46]

The court explained that as Section 2-207(3) operates to create a contract, it also defines which terms will constitute the contract so formed.[47] Section 2-207(3) defines "the terms of the particular contract [as] those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act." Applying Section 2-207(3) the court saw that it was clear the Jordan and Itoh forms did not "agree" on arbitration,[48] and moved on to ask if the Code provided an arbitration supplementary term, and determined it did not.[49]

In a similar scenario arising in 1986, the Ninth Circuit, in *Diamond Fruit Growers, Inc. v. Krack Corp.*,[50] explained that under Subsection (3), "the disputed additional items on which the parties do not agree simply 'drop out' and are trimmed from the contract."[51] For a contract to be formed under 2-207(1) with conflicting forms, the assent to the counteroffer must be "specific and unequivocal."[52]

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[44] *Id*. at 1236 n.7. Even under Section 2-207(2) it is possible that, in some jurisdictions, the knockout rule would be applied as to *different* terms. *See, e.g.*, Diatom, Inc. v. Pennwalt Corp., 741 F.2d 1569, 1579-80 (10th Cir. 1984) (holding that a contract was formed by the swapping of forms under Section 2-207(1), but that the conflicting terms in the forms regarding a period of limitations and warranties were cancelled out and that the missing terms were to be supplied by the U.C.C.'s gap filler provisions, thereby precluding summary judgment). Still, drafters would probably prefer to skip Section 2-207(2) by simply inserting the explicit conditional acceptance language so as not to leave the outcome to chance. Astute drafters know that forms bearing proviso-conforming language ensure clients will get the least-worst possible outcome, i.e. the U.C.C. gap-fillers. *See infra* notes 71-73 and accompanying text.

[45] *C. Itoh & Co.*, 552 F.2d 1228 at 1236. Section 2-207(3) reads: "[*c*]*onduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale* although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act." (emphasis added).

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.* at 1237. The court goes on to explain why it is "convinced that this conclusion does not result in any unfair prejudice," *Id.*, but a discussion of court explanations is reserved for another section below. *See infra* Part VI Section 1.

[50] Diamond Fruit Growers, Inc. v. Krack Corp., 794 F.2d 1440 (9th Cir. 1986). Summers and White are conflicted about this case: Summers believes that the approach of this case does not allow an "anti-last shot policy" to be applied under 2-207(1), while White believes "that the seller could have declined to ship in the face of buyer's silence." JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 1-3, at 40 (5th ed. 2000).

[51] Textile Unlimited, Inc. v. A. BMH & Co., 240 F.3d 781, 788 (9th Cir. 2001).

[52] Diamond, 794 F.2d at 1445.

Nevertheless, in 1992, the Seventh Circuit, in *Dresser Industries, Inc., Waukesha Engine Division v. Gradall Co.*,[53] decided that "the district court acted appropriately in allowing the jury to consider the parties' course of performance, course of dealing, and usage in the trade in deciding whether Dresser's warranty became part of the contract under § 2-207(3)" thereby expanding the interpretation to the meaning of "supplementary terms" given in *C. Itoh*.[54]

Although the courts have properly followed Section 2-207 for resolving the battle-of-the-forms under the U.C.C., their explanation for the policy behind the section has been, understandably,[55] off.[56] The courts have not fully grasped what parties are doing when they deal via form contracts. Judges erroneously believe that parties are being sloppy (at best) or nefarious when they are merely acting in an economically rational manner—and in a way that is actually dictated by Section 2-207's legal framework. The seed of the courts' confusion may lie within the academic debates, as evidenced by their sharing similar assumptions to those that Keating challenged, which will be discussed in Part II, below. The court's assumptions will be revisited in Part VI.

II. KEATING'S PAPER

Many articles have been written on Section 2-207. Professor Keating boiled down the concerns academics have with 2-207 into three issues: (1) the current Section 2-207 is too technical, arbitrary, and uncertain in its outcomes; (2) the default terms to which Section 2-207 directs the parties are too favorable to the buyer and may not be terms that either side would have chosen in an arms-length bargain; and (3) the Current Section 2-207 encourages parties to draft completely one-sided forms.[57] My model will show that the first issue is wrong, Section 2-207 is less arbitrary and uncertain in its outcomes than many of its critics would admit; the second issue misses the purpose, there is a place for penalty default rules in the contract law; and finally that the third issue is not a bad thing, but a reasonable strategy in the battle of the forms. This third issue will be directly addressed in the next section.

To test whether common academic assumptions about the section were held in common with those who worked with the issue in practice, Professor Keating conducted telephone interviews to gather information on the battle of the forms

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[53] Dresser Indus., Inc., Waukesha Engine Div. v. Gradall Co., 965 F.2d 1442 (7th Cir. 1992).

[54] *Id.* at 1452. "Bear in mind that the agreement of the parties is used to mean not only express language, but also trade usage, course of dealing, and course of performance." FELDMAN, *supra* note 1, at § 4.04[C] Gap Fillers 4-19 (2d ed. 2006 Supp.); *see, e.g.*, U.C.C § 2-308 Official Cmt. 4.

[55] Even in 1963 it was acknowledged that Section 2-207 probably addresses "the most technical concept Article 2 assails . . . [namely,] the attack made upon . . . the common law concept that the terms of an acceptance must match those of the offer exactly." William B. Davenport, *How to Handle Sales of Goods*, 19 BUS. LAW. 75 (1963-1964). When it has been lamented that "[i]t is a sad fact that many sales contracts are not fully bargained," by the likes of White and Summers, how can we expect courts not to think similarly, focusing on the lack of negotiation rather than the efficiency of standard-form exchanges? *See* WHITE, *supra* note 50 at § 1-3.

[56] *See infra* Part VI.

[57] Keating, *supra* note 2.

under 2-207.[58] Although he sought people that he felt should have the most experience with the battle of the forms,[59] he found that most of the people he talked to had surprisingly little experience dealing with the issue.[60] This fact goes to the heart of the first assumption, that "The Battle-of-the-Forms Provision Is a Significant Issue for Companies That Buy and Sell Goods."[61] The second assumption, which was agreed to by the interviewees, is that "When Companies Do Engage in the Battle of the Forms, They Do So Because It Is Efficient."[62] The third assumption, that "Parties Uniformly Draft Their Forms to Be as One-Sided as Possible in Their Favor"[63] is the most similar assumption to one of the academic concerns identified above by Keating, and will be addressed in the next section and the model below. The fourth and final assumption is that "Nobody Reads the Forms."[64] The varied response to this final assumption will also play a role in the model below (perfect versus incomplete information).[65]

Critically, the interviewees asserted three major points. First, one reason the battle of the forms is not very common is that some mega retailers (e.g. Wal-Mart)[66] are so powerful that they can make one-sided, "take it or leave it" contracts.[67] Second, people prefer a straightforward, quick defaulting rule to get to the U.C.C. gap-fillers.[68] (And parties actually did read the boilerplate language in certain situations).[69] Third, and most importantly, if there was a term that was

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[58] *Id.* at 2681.

[59] For who Keating chose to interview and why, *see id.* at 2692-95.

[60] *Id.* at 2696.

[61] Keating, *supra* note 2.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *See infra* n.82 and accompanying text.

[66] Keating, *supra* note 2, at 2702, 2714. "What is interesting about . . . large companies is that [they] have a more or less take-it-or-leave-it approach to their forms. Thus, the battle of the forms ends up being not very relevant to a company . . . that has the leverage to insist on the other side signing its form." *Id.* at 2702. This is true, and Baird would probably agree, *see supra* note 5; however, the reason that these large companies use less adversarial language is not because "the other side is [more] likely to read the form," instead (to agree with Keating's interviewee) the reason for the more reasonable terms in the boilerplate language is to gain efficiency, "namely [this] saves the company time arguing over things that you are going to end up losing anyway in negotiations." *Id.*

[67] Extreme examples such as this overcome or sidestep the battle of the forms because they do not involve conflicting forms. Instead, they require the use of a "master agreement" over which there can be no conflicting language. *Id.* at 2697. *See also* Craswell, *supra* note 8 (discussing partially negotiated and take-it-or-leave-it contracts). Nevertheless, the strategy of a take-it-or-leave-it boilerplate will not be the same for a party who does not have the bargaining power to demand such terms. Because some scholars have not accounted for the variation in bargaining power of boilerplate-language users, they recognized the "more reasonable" (i.e. less one sided, or less adversarial) language of the take-it-or-leave-it contract as a trend towards more reasonable language being used overall in the battle of the forms. In reality what has occurred is that firms with suitable bargaining power have been able to offer more reasonable terms when they are removed from the battle-of-the-forms game because of their bargaining power, *see infra* Part III, and pp. 120-122, regarding the take-it-or-leave-it game. Those still embroiled in the battle of the forms, on the other hand, are left subject to different incentives, *see infra* Part IV, Section 3. For a discussion of bargaining power in exchange relations *see* WERNER Z. HIRSCH, LAW AND ECONOMICS 124-26 (3d ed. 1999).

[68] Keating, *supra* note 2, at 2712.

[69] *Id.* at 2703.

negotiated, that would normally be found in the boilerplate language, it was Consequential Damages.[70] These findings provide valuable insight into the workings of Section 2-207 as shall be seen below.

III. ADVERSARIAL STRATEGY

A question raised by some scholars is: Why is there adversarial boilerplate language?[71] A lot of boilerplate language is designed to induce the other party to accept its terms. In acknowledgement forms, this strategy gets forms automatically into the Subsection (1) proviso (and past Subsection [2]) of 2-207, and ensures that a client is *never* "accepting" unfavorable, one-sided terms. The process perpetuates the making of counter offers. In other words, parties are intentionally defaulting to Subsection (3) of Section 2-207 and the gap fillers, and not allowing their contracts to be interpreted under Subsection (2), ensuring they are put in the least-worst outcome possible.

Parties are trying to act optimally under Section 2-207. Drafters of boilerplate language implement strategy to ensure that their clients do not "lose," or are at least put in the least-worst position for all possible future outcomes. Keating has a good notion of what it means to 'win' the battle of the forms:[72]

> [A]ny commercial lawyer who stepped back for a minute and assessed the practical impact of [Section 2-207] vis-à-vis the common law would quickly come to a number of conclusions. First, whether you represent the offeror or the offeree, you can (and arguably should) include the magic language [e.g., language matching the 2-207(1) proviso] in your form that will greatly limit the likelihood that you will get stuck with the other side's boilerplate terms . . . .
>
> . . . .
>
> By using the magic language, you put yourself in a position where the worst place you end up regarding the boilerplate terms, should you choose to perform, is with the U.C.C. gap-fillers. But that brings you to your second conclusion: this whole new approach, compared to the common law, raises the stakes on the U.C.C. gap-fillers, so you had better know what they are in order to determine whether you are truly comfortable with them . . . .
>
> . . . .

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[70] *Id.* at 2698, 2704. "[T]he company will insist on a limitation of liability that is appropriate to the relatively small benefit that it is getting out of the sale." *Id.* at 2702.

[71] For the purposes of Section 2-207, I define adversarial boilerplate language as, subsection (1) proviso-conforming language for sellers, and subsection (2)(a) and (c) conforming language for buyers. Reasonable language in this case would mean forms which do not include such 2-207 subsection satisfying language, but which may otherwise still be drafted with preferential terms. For the purposes of the take-it-or-leave-it game, where Section 2-207 does not apply, I define adversarial language as one-sided, unaccommodating terms. Reasonable language in this case would mean accommodating or less-preferential terms.

[72] "[D]efine 'winning' as making the other side be held to your nondickered terms. By the same token, it is easy with good drafting never to *lose* the battle of the forms, at least if 'losing' equals letting your side get stuck with the other party's boilerplate terms." Keating, *supra* note 2, at 2682. *See infra* note 74 and accompanying text.

> The third practical conclusion that a thoughtful commercial lawyer would reach about the U.C.C.'s approach to the battle of the forms is that there is simply no way for either side to ensure victory in this fight, at least if victory is defined as getting the other side to be bound by your boilerplate terms rather than theirs.[73]

Thus, the outcomes of this game can be thought of as follows: **Win,** have your preferential terms used; **Lose,** have the other party's terms applied; or **Default,** using the Subsection (1) proviso to get to Subsection (3), so that matching boilerplate language forms the contract, and non-matching terms are knocked out and replaced with the U.C.C. gap fillers.[74]

Of course, no one can do worse than defaulting to the gap fillers, if the parties play their cards correctly. Using backwards induction, one can see the parties' payoffs, and infer from them how these players' decisions inform the results.[75] In creating the model described below in Part V, values were assigned to certain outcomes, which largely align with these win, lose, and default situations.

IV. GAME THEORY

It is impossible to teach game theory from scratch in a few pages. Readers familiar with game theory, or who have an intermediate text on the subject readily available should move ahead to the model, in Part V below. This following is only

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[73] *Id.* at 2686.

> If you are the offeror, you can specifically limit the terms of your offer to the terms that are included therein, and while you are at it, you can object in advance to any additional or different terms that the offeree might include in its purported acceptance of your offer. If you are the offeree, you can mimic the language of Section 2-207(1) and expressly condition your acceptance on the offeror's assent to any additional or different terms that you have included in your acceptance.

Id. "If you represent buyers, this is probably not a bad place to be since the U.C.C. gap-fillers include fairly broad warranty and remedy provisions, including implied warranty of merchantability, [U.C.C. § 2-314], and generous consequential damages [U.C.C. § 2-715(2)]." Keating, *supra* note 2, at 2686.

> You can, of course, try to ensure victory by refusing to perform your side of the contract until the other side signs on to the terms of your form. At that point, though, you would end up with a real negotiated contract and it would no longer be a true battle of the forms.

Id.

> [N]either side is ultimately forced to play by the other side's terms in this battle. . . . by insisting on a fully negotiated contract signed by both sides, or by [refusing to act]. . . [N]ot playing the game has its own costs. Perhaps this is a sale that you really want to make, albeit not on the buyer's terms. Or perhaps you feel that it would be too expensive, given the fairly small size of the deal or the limited risk involved, to sit down and negotiate about nonimmediate terms that are unlikely to matter in the end anyway.

Id. at 2687.

[74] Keating, *supra* note 2, at 2682-85. Although Keating states that one may think of the battle of the forms as a game, and in so doing provides these as the win, lose, and default strategies, he does not, it would seem, mean a game in the same way that game theorists do; "[i]f you think of the battle of the forms as a game, it is much more analogous to tic-tac-toe than it is to chess." *Id.* at 2682. Nevertheless, chess, from a game theory perspective, is basically impossible to model, and although tic-tac-toe may be a good example of a game demonstrating a 'default,' it would be more accurate to compare the battle of the forms to the prisoner's dilemma with a Nash Equilibrium and strategic behavior.

[75] For an example of backward induction see POSNER, *infra* note 186, at 19.

meant to provide a brief tour of the subject matter as addressed in this article.

"Game theory is the study of multiperson decision problems."[76] An example of a multiperson decision problem is whether, when exchanging forms, it is better for each party to use adversarial or reasonable language in their respective standard forms. Consider the following game in which two players exchange forms simultaneously: [77]

	Player 2 A'	R'
Player 1 A	1 , 1 (NE)	2 , 0
R	1 , 1	0 , 2

In this game, Player 1's payoff is always the first of the two numbers in each box, while the second number goes to Player 2. Player 1 can only choose between *A* and *R*, while Player 2 can only choose between *A'* or *R'*. Each player can only make one choice, and the players must make their move simultaneously. What will be the outcome of the game? Consider Player 1's options. If Player 1 chooses *A*, and Player 2 chooses *A'*, Player 1 will receive 1; however, if Player 2 chooses *R'*, Player 1 will receive 2. If Player 1 chooses *R*, and Player 2 chooses *A'*, Player 1 will receive 1; however, if Player 2 chooses *R'*, Player 1 will receive 0. Keeping in mind that Player 1 does not get to tell Player 2 what to choose, compare Player 1's options of moving *A* versus moving *R*, regardless of what Player 2 does. You'll notice that if Player 2 chooses *A'*, Player 1 is indifferent as to its strategy, since playing both *A* and *R* would result in the same payoff for Player 1: 1. If, however, Player 2 picks *R'*, Player 1 would be better off playing *A'* and, receiving

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[76] ROBERT GIBBONS, GAME THEORY FOR APPLIED ECONOMISTS at xi-xii (1992).

[77] When two or more people ("players") face a decision problem (i.e., they must make a "move" in a "game"), we can classify the game as "static" (i.e., the game requires simultaneous decision making) or "dynamic" (consecutive decision making). Each game in this paper has "complete" information, which means that each player knows the possible outcomes ("payoffs") for all the players. Information in a game is further characterized as either "perfect" or "imperfect". Perfect information means that each player knows what moves have been made by all other players at every given point in the game, whereas in an imperfect information type of game, this is not the case (such as in a one-shot simultaneous swapping of forms). One can depict games with "game trees" or rubrics. When one draws a game tree, he is said to have drawn the game in its "extensive" form. When the game is presented in a rubric, it is said to be in its "normal" form. The model in this paper is presented in both forms in appendices C and D. *See infra* Appendices C-D. Unfortunately there is no way to show the difference between perfect and imperfect information in a normal form representation, so I have only included extensive form representations in the text itself. Some of the more advanced terminology I use in the next section of the paper (sub games, information sets, singleton information sets) is not necessary to follow the basic outcomes of the model, and therefore will be left to other dedicated texts. For this paper, one need only know how to solve a normal form game to discover the outcomes of the model. Backwards induction is a method of solving games, which just means that one starts at the end, looking at payoffs, and works back to the beginning, looking at the potential moves, to solve the game.

a payoff of 2, instead of 0, which would result from playing *R*. With this in mind, consider Player 2's possible strategies. If Player 1 were to select *A*, Player 2 would definitely be better off having played *A'* and receiving 1 than if it played *R'* and received a payoff of 0. Conversely if Player 1 played *R*, Player 2 would definitely be better off having played *R'* and receiving 2, rather than playing *A'* and receiving 1. Examining the two player's strategy reveals only one overlapping strategy between the two. If Player 1 plays *A* and Player 2 plays *A'*, each player will receive 1, and neither player could make a unilaterally different move and achieve a better outcome. Furthermore, there is no Pareto dominant position that they could move to. Keep in mind that Player 2 does not get to tell Player 1 what to choose, and vice versa. Since we know that each player has a move in mind that—regardless of the other players' move—will give it the least-worst payoff, there is a predicable outcome to the game; we call the congruence of these strategies the equilibrium solution to the game, or Nash Equilibrium. For your convenience, I have underlined the players' best moves above. Notice that only one box has both payoffs underlined. Keep in mind that Player 1 only gets to choose the row, and Player 2 only gets to choose the column. I have provided normal form representations of my model in Appendix D for your convenience.

V. MODEL[78]

For the purposes of this model, in all situations involving two forms, let us define adversarial language for the buyer as meaning inclusion of subsection (2)(a) and (c) language, whereas for the seller, adversarial language means inclusion of subsection (1) proviso-conforming language. In these situations, reasonable forms are defined as those that do not contain this adversarial language. Because there is only one form in the take-it-or-leave-it scenario, Section 2-207 does not apply, and for this reason, in a take-it-or-leave-it situation alone, adversarial simply means one-sided, preferential terms and reasonable means accommodating.

1. Setting Up the Game: Payoffs and Assumptions

To assign payoffs to the various outcomes of the battle of the forms and related scenarios, I have made a number of assumptions that I will lay out in this section. To begin, let us assume that in each of the games, when no contract is formed, each player receives a naught payoff of 0. Assume that a contract can only be formed when both players negotiate or both players send forms. When one player negotiates and the other sends a form, no contract is formed.

With regards to negotiations, assume that there are two types of contracts. One type has a high potential benefit for each player of 4, $B_H = 4$, while the other type has a lower potential benefit of only 1, $B_L = 1$. If negotiations always cost 2 for each player, $C_N = 2$, parties will only choose to negotiate when the potential benefit is high, and the outcome will provide a utility level of 2 for each party: $B_H - C_N = 2$. If the parties choose to negotiate a contract with low-worth potential, then

[78] *See infra* pp. 56-57 and accompanying illustrations.

taking the cost of negotiating away from the lower benefit would leave each party with a utility level of -1: $B_L - C_N = -1$. Thus, negotiating can lead to three possible payoffs: 2, 0, or -1.

Under the battle of the forms, parties save the costs of negotiation and merely trade forms (which have a sunk cost), so they can achieve a benefit even with the lower potential benefit type of contract since, $B_L - 0 = 1$. Let us assume that if a player could win the battle of the forms, that player would capture the other player's benefit, and receive a payoff of 2. Thus the loser of the battle of the forms would receive a naught benefit of 0. Thus there are three potential payoffs in the battle of the forms: 2, 1, or 0.

When could these payoffs be reached in the battle of the forms? As will be shown, the players could only win the battle of the forms if the other player used an irrational strategy. When a seller includes adversarial language in the acknowledgment form, let us assume that no contract is formed under Section 2-207(1), but that the parties perform as though there is a contract such that a court would apply subsection (3), and a relatively neutral contract would be formed under the knock-out rule and gap fillers. In this default situation, neither party wins or loses; both parties share the benefit of the bargain, so each receives a basic payoff of 1. If the seller sends a reasonable-language form, a contract would be formed under Section 2-207(1) and interpreted under Section 2-207(2). If a buyer used adversarial language and the seller did not, the buyer would get its preferential terms [under Sections 2-207(2)(a) and (2)(c)] and would capture the winning payoff, 2, while the seller, being subjected to the buyer's terms would still lose the benefit of the bargain, getting the losing payoff, 0. If the buyer did not include the adversarial language in its form, the seller would be able to have some terms enter the contract via Section 2-207(2), so long as they do not materially alter the contract as interpreted under Section 2-207(2)(b). Official comment five of Section 2-207 gives examples of some terms that are considered non-material, but which would nevertheless constitute a victory for the seller if included in the contract, such as shifting the responsibilities and thus the costs of inspection onto the buyer when the goods are for a sub-sale and reasonably limit remedies. For this reason, in that situation, I assign a winning payoff of 2 for the seller, and a losing payoff of 0 for the buyer.

In the model below, there are four sub-games that are divided vertically by bargaining power and horizontally by the cost-benefit analysis of negotiation.[79] Assume that Player 1 is a buyer, and Player 2 is a seller, of widgets. In the extensive form of the model,[80] P1 > P2 means that the bargaining power of Player 1 exceeds that of Player 2; P1 = P2 means that the bargaining power of the players is comparable; $B_{N1} > C_{N1}$ means that for Player 1 the benefit of negotiation outweighs the cost of negotiation; $B_{N1} < C_{N1}$ means that for Player 1 the benefit of

[79] At least for some sales contracts, the costs of reviewing and then negotiating about nonimmediate terms are simply not worth the benefit, given the low likelihood of a future dispute about these terms and the relatively low cost of losing such a dispute if there is one. The overwhelming majority of company representatives with whom I spoke would agree with the academics on this one. Keating, *supra* note 2, at 2699.

[80] Presented in full form in Appendix C.

negotiation does not outweigh the cost of negotiation; $B_{N1,2} > C_{N1,2}$ means that for both players, the benefit of negotiation outweighs the cost of negotiation; finally, $B_{N1,2} < C_{N1,2}$ means that for both players, the benefit of negotiation does not outweigh the cost of negotiation.[81] Each player has limited actions: negotiate, N; send a form that is reasonable, R, or adversarial, A; or Player 1 could send a form that is one-sided, A, or not, R, and then Player 2 can take, T, or leave, L, the other player's form; and each only gets one opportunity to move.

Please keep in mind that when two forms are exchanged, adversarial language, A, is defined for Player 1 as language which comports with Section 2-207(2)(a) and (c), and for Player 2 as language which conforms to the Subsection (1) proviso. R does not include the strategic language of subsection (2)(a) and (c) for Player 1, or the subsection (1) proviso for Player 2 when there are two forms involved. When only one form is in play, and Section 2-207 is not being applied, adversarial language, A, means that one-sided preferential terms are used, and reasonable language, R, means that accommodating terms are used. If the players exchange forms, it will be assumed that they are sent simultaneously (or, equivalently, not read) and acted upon such that, if necessary, a court would be able to apply Subsection (3) of Section 2-207 to determine what terms form the contract.[82]

2. Take it or leave it

In the take-it-or-leave-it game,[83] Player 1 submits a form, as an offer, to Player 2, which Player 2 may then accept or reject, i.e., take or leave. The take-it-or-leave-it scenario occurs when Player 1 has greater bargaining power than Player 2, and the contract is not of a high enough value to make the benefit of negotiating outweigh the cost of negotiating, i.e., when P1 > P2, and $B_{N1} < C_{N1}$. The take-it-or-leave-it game is a *dynamic* game of *complete* and *perfect* information (so the strongest equilibrium concept that can be applied is a subgame-perfect Nash equilibrium).[84] The game has three singleton information sets.

The game, G, has two players with actions, A, and payoffs, u:

$G = \{A_1, A_2 ; u_1, u_2\}$.

The set of possible actions for Player 1: $A_1 = \{N, R, A\}$.

The set of possible actions for Player 2: $A_2 = \{N', T', L'\}$.

The possible payoffs for are u_1 (-1, 0, 1) for Player 1 and u_2 (-1, 0, 1) for Player 2. The game proceeds as follows:

1. Player 1 chooses an action a_1 from the feasible set $A_1 = \{N, R, A\}$.

2. Player 2 observes a_1,[85] and then P2 chooses a_2 from the feasible set $A_2 =$

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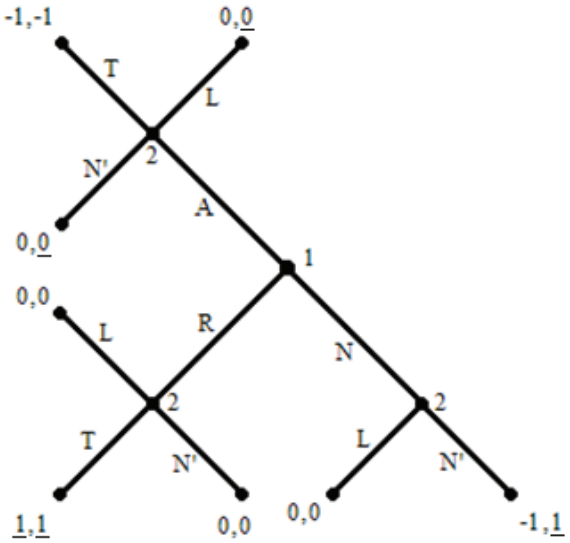
[81] Where $B_N = \{B_H, B_L\}$; if $B_N > C_N$, $B_N = B_H$; if $B_N < C_N$, $B_N = B_L$.

[82] A reasonable form will accept (or be agreeable to) the terms of its counterpart. An adversarial term will not. Therefore, the court will only have to apply the gap fillers when two adversarial terms are sent.

[83] *See infra* Appendix C. The take-it-or-leave-it game is represented in quadrant III of the normal form illustration.

[84] *See generally* GIBBONS, *supra* note 72, at 57-71 (1992).

[85] By reading the form P1 sends (or seeing that P1 is willing to negotiate, which P1 would not



{N', T', L'}.

To compute the backwards-induction outcome of the take-it-or-leave-it game, begin at the second stage (i.e., Player 2's move). Player 2 has three singleton information sets. Player 1 must anticipate what Player 2 will select to do upon reaching each of these information sets. If Player 1 chooses A, Player 2 faces a choice between a payoff of 0 from N' and L', or a payoff of -1 from T', so N' or L' is optimal. If Player 1 plays A, and Player 2 plays N' or L', Player 1 would yield a payoff of 0. If Player 1 chooses R, Player 2 faces a choice between a payoff of 0 from N' and L', or 1 from T', so T' is optimal. If Player 1 chooses R and Player 2 plays T', Player 1 would yield a payoff of 1. If Player 1 chooses N, Player 2 faces a choice between a payoff of 0 from T' and L', or 1 from N', so N' is optimal. If Player 1 chooses N and Player 2 plays N', Player 1 would yield a payoff of -1. The first-stage choice for Player 1 therefore is between payoffs of 0 from A, 1 from R, and -1 from N, so R is optimal. (R, T'; 1, 1) is the *Pareto dominant* Nash equilibrium over (A, N'; 0, 0) and (A, L'; 0, 0) Nash equilibria.[86]

Thus in the take-it-or-leave-it scenario, it is efficient for a powerful buyer, such as Wal-Mart, to offer a purchase order with reasonable, less-one sided terms to less-powerful sellers when the bargain is of insufficient value to carry the costs of negotiation.

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since that would only occur in a negotiating game), P2 can tell whether P1's form is reasonable or adversarial. P2 can read P1's form because only P1 can send a form in this game, which P2 can take or leave. Thus, simultaneity of form exchange is not an issue. *See infra* text accompanying note 90.

[86] For some readers, these three equilibria can be easily derived from the normal form representation of the game, see quadrant III of the normal form representation of the game, *see infra* p. 48. Please note that the definition of adversarial language in the take-it-or-leave-it scenario does not require the magic language of Section 2-207 because there is only one form.

3. Negotiations

Negotiations occur when the benefit of the bargain would sustain the costs of negotiation, allowing Player 1 and Player 2 to negotiate the terms of their contracts.[87] The negotiation-based games are *dynamic* games of *complete* but *imperfect* information,[88] which have one singleton and one nonsingleton information set, and occur when $B_{N1} > C_N$.[89]

The game is: $G = \{A_1, A_2 ; u_1, u_2\}$.

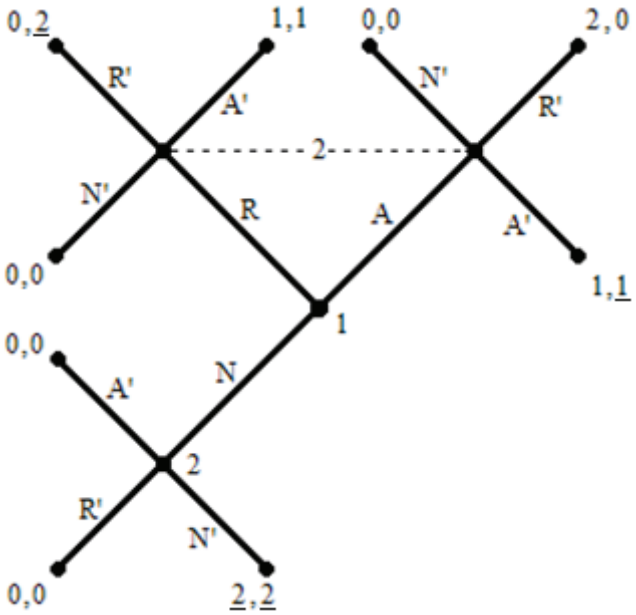
The set of possible actions for Player 1: $A_1 = \{N, R, A\}$.

The set of possible actions for Player 2: $A_2 = \{N', R', A'\}$.

The possible payoffs for Player 1 are u_1 (0, 1, 2) and u_2 (0, 1, 2) for Player 2. The game proceeds as follows:

1. Player 1 chooses an action a_1 from the feasible set $A_1 = \{N, R, A\}$.

2. Player 2 observes whether $(a_1) = (N)$ or not,[90] and then chooses a_2 from the feasible set $A_2 = \{N', R', A'\}$.



To compute the backwards-induction outcome for the negotiation games, begin at the second stage (i.e., Player 2's move). Player 2 has one singleton and

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[87] *See infra* p. 48. The negotiations games occur in the first and second quadrants of the normal form illustration.

[88] Therefore, the strongest equilibrium concept that can be applied to them is a subgame-perfect Nash equilibrium. *See generally* GIBBONS, *supra* note 84, at 115-29.

[89] Because these games end in negotiated contracts, these contracts are functionally complete, *See* Eggleston, *supra* note 16.

[90] Player 2 can tell if Player 1 wants to negotiate, but will not have an opportunity to read Player 1's form if Player 1 sends a form. Form exchange is simultaneous. *See supra* text accompanying note 85.

one nonsingleton information set. There is only one subgame; it begins at Player 2's decision node following N by Player 1. If Player 1 does not choose N, Player 2 will know that Player 1 has chosen either R or A, but will not know which was played. Player 2 then chooses between three actions: N', R', or A', after which the game ends. If Player 2 reaches the decision node following N by Player 1, then 2's best response is to play N' (which yields payoffs of 2) rather than to play A' or R' (which yields a payoff of 0). If Player 1 does not play N, Player 2 will need to make a decision without knowing whether Player 1 chose A or R. Using a process of iteration elimination of strictly dominated strategies, Player 2 can determine that Player 1 would play A, since Player 1 can do better, but not worse, regardless of what Player 2 plays, under A than under R. Therefore, using a process of iterated elimination of strictly dominated strategies, choosing A' dominates picking R' or N'. Since Player 1 can anticipate Player 2's payoffs and can solve Player 2's problem just as well as Player 2, Player 1's problem at the outset will be to decide between playing A (which would yield a payoff of 1, after Player 2 plays A'), R (which would yield a payoff of 0, after Player 2 plays A'), or N (which would yield a payoff of 2, after Player 2 plays N'). Thus Player 1's best response to the anticipated behavior of Player 2 is to play N, so the backwards-induction outcome of the game is (N, N'; 2, 2).

Accordingly, regardless of the relative bargaining powers of the two parties, they should negotiate contracts rather than exchange forms when the benefits of the negotiation would outweigh the costs.

4. Battle of the forms

The battle of the forms arises when the parties exchange forms.[91] For the purposes of the model, it is assumed that the forms themselves do not create a contract when adversarial language is used, but that the parties still act as if a contract has been formed. Thus no contract is formed under Subsection (1) of Section 2-207; however, assuming they fall within the Section 2-207(1) proviso, a contract is formed by the court under Section 2-207(3). The battle-of-the-forms game is a *dynamic* game of *complete* but *imperfect* information (and so the strongest equilibrium concept that can be applied is a subgame-perfect Nash equilibrium),[92] which has one singleton and one nonsingleton information set, and occurs when P1 = P2, and $B_N < C_N$.

The game is: G= $\{A_1, A_2 ; u_1, u_2\}$.

The set of possible actions for Player 1: $A_1 = \{N, R, A\}$.

The set of possible actions for Player 2: $A_2 = \{N', R', A'\}$.

The possible payoffs for Player 1 are u_1 (-1, 0, 1, 2) and u_2 (-1, 0, 1, 2) for Player 2. The game proceeds as follows:

Player 1 chooses an action a_1 from the feasible set $A_1 = \{N, R, A\}$.

Player 2 observes whether $(a_1) = (N)$ or not,[93] and then chooses a_2 from the

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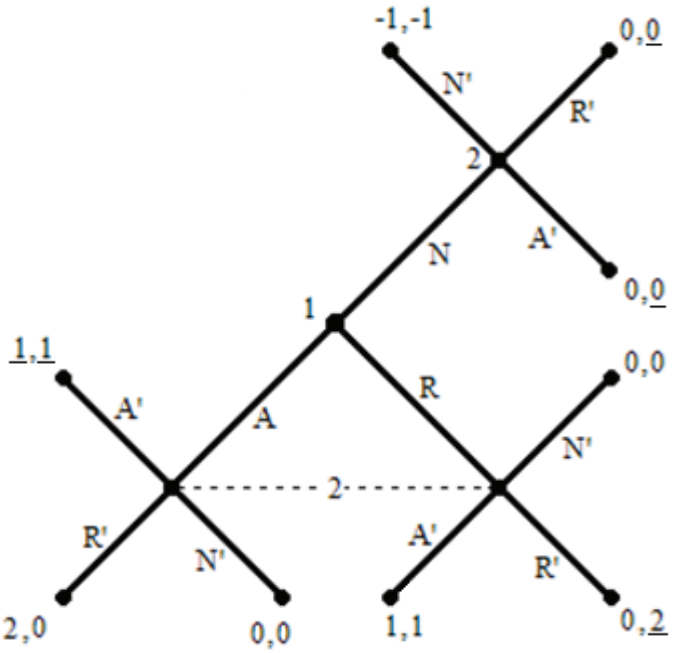
[91] *See infra* p. 48. The battle of the forms occurs in quadrant IV of the normal form illustration.

[92] *See generally* GIBBONS, *supra* note 84, at 115-29.

[93] As in the negotiation game, Player 2 can tell whether Player 1 has played N, but, since form

feasible set $A_2 = \{N', R', A'\}$.



To compute the backwards-induction outcome of the battle of the forms, one begins at the second stage (i.e., Player 2's move). Player 2 has one singleton and one nonsingleton information set. There is only one subgame; it begins at Player 2's decision node following N by Player 1. If Player 1 does not choose N, Player 2 will know that Player 1 has chosen either R or A, but will not know which was played. Player 2 then chooses between three actions: N', R', or A', after which the game ends. If Player 2 reaches the decision node following N by Player 1, then 2's best response is to play R' or A' (which yields payoffs of 0) rather than to play N' (which yields a payoff of -1). Player 1 would not play N, because A strictly dominates N as a strategy. Since Player 1 does not play N, Player 2 will need to make a decision without knowing whether Player 1 chose A or R. This constitutes a static subgame of complete but imperfect information. In this subgame, Player 1 has two strategies and Player 2 has three: $S_1 = \{A, R\}$ and $S_2 = \{A', R', N'\}$. Using iterated elimination of strictly dominated strategies, Player 2 can see that R' strictly dominates N', so no rational player would play N'. Knowing Player 2 is rational, Player 1 can eliminate N' from Player 2's strategy space. Looking at the remaining game, each player can see what the best play would be given the other players remaining strategies. Since Player 2 can anticipate Player 1's payoffs and can solve Player 1's problem just as well as Player 1, Player 2's problem at the outset will be to decide between playing A' (which would yield a payoff of 1,

exchange is simultaneous, Player 2 cannot read Player 1's form before sending the exchange form. *See supra* note 90.

regardless of what Player 1 plays), or R' (which would yield a payoff of 2, if Player 1 plays R, or 0 if Player 1 plays A). Since Player 1 can anticipate Player 2's payoffs and can solve Player 2's problem just as well as Player 2, Player 1's problem at the outset will be to decide between playing A (which would yield a payoff of 1, if Player 2 plays A', or 2 if Player 2 plays R'), or R (which would yield a payoff of 0, after Player 2 plays R', or 1 if Player 2 plays A'). Player 1's best response to the anticipated behavior of Player 2 is to play A, since Player 2 would play A' in that case, because Player 2 could not improve its payoff by changing its move, and thus would give Player 1 a payoff of 1. Player 2's best response to the anticipated behavior of Player 1 is to play A', since Player 1 would play A in response, since Player 1 could not improve its position by playing a different move when Player 2 plays A'. Even though neither A nor A' strictly dominates R or R', neither player has an incentive to change its move given the other players best strategy. If each player plays this best response to the other's, there is no move which could be played that would be Pareto dominant, thus there is a unique Nash Equilibrium to the subgame: (A, A'; 1, 1); this is also the sub-game perfect Nash Equilibrium of the Battle of the Forms.

Therefore, when the parties have relatively similar bargaining power, and the costs of negotiation outweigh the benefits, the parties should exchange forms containing adversarial, proviso-conforming language.

VI. IMPACT

1. The Courts' Misunderstanding of Strategic Language

This section presents the argument that courts have mistaken the use of strategic language by parties in battle-of-the-form disputes as an attempt to gain an uneven advantage and push costs onto the courts. The language of the courts is examined to infer underlying assumptions, in part to see where those assumptions line up with assumptions made by academics, and in part to show that if the courts adopted the understanding presented in this paper – that the gap fillers are an equilibrium default for the battle of the forms – the application of Section 2-207 could be more predictable.

The Seventh Circuit, in *C. Itoh*, implies that the reader might find that its conclusion results as unfairly prejudicial to the seller.[94] It begins to offer its position by pointing out that the seller "elects"[95] to "insert into his standard sales acknowledgement form[96] the statement that acceptance is expressly conditional on

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[94] *C. Itoh & Co.*, 552 F.2d at 1237.

[95] *Id.* Use of the word "elects" points to the court's belief that use of the proviso-conforming language is a voluntary attempt to have one's cake and eat it too. *See infra* note 100 and accompanying text. As has been shown, however, the use of the adversarial language is the best strategy and not a choice for a drafter whose clients are partaking in lower value contracts that could result in the battle of the forms. That the court puts weight on the "voluntary" aspect of this matter is validated a few sentences down on the next page: "whether or not a seller will be disadvantaged under Subsection (3) as a *consequence of inserting* an 'expressly conditional' clause in his standard form is *within his control*." *C. Itoh & Co.*, 552 F.2d at 1238 (emphasis added).

[96] One wonders if this statement would be made if the court considered that the acknowledgment form was drafted under the belief that the form would be used in a battle-of-the-forms scenario. If the

buyer's assent to additional terms contained therein."[97] The court asserts that the seller obtains a substantial benefit under Section 2-207(1) by including the clause.[98] The court also states that: "If the seller does intend to close a deal irrespective of whether or not the buyer assents to the additional terms,[99] he can hardly complain" when Section 2-207(3) is applied, thus knocking out the conflicting terms.[100] The court pointed out that "a seller . . . would undoubtedly appreciate the dual advantage" of falling under proviso of Section 2-207(1) and getting preferential treatment under Section 2-207(3).[101] Finally, the court says that the seller may take "advantage of an 'expressly conditional' clause under Section 2-207(1) when he elects not to perform[; therefore,] he must accept the potential risk under Subsection (3) of not getting his additional terms when he elects to proceed with performance without first obtaining buyer's assent to those terms."[102] Using this line of argument the court determines that "[s]ince the seller injected ambiguity into the transaction by inserting the 'expressly conditional' clause in his form, he, and not the buyer, should bear the consequence of that ambiguity under Subsection (3)."[103] In short, the court believes that, by using a form with adversarial and proviso-conforming language the seller's drafter is trying to have his cake and eat it too; therefore, the seller should bear the brunt of the gap fillers.

As has been shown, however, the use of the proviso-conforming language is not an attempt to gain dual benefits; to the contrary, by using the clause, the drafter actually sought certainty in the contract. Application of Section 2-207(3) should not be seen as a punishment for not negotiating (except as to consequential damages, which I will distinguish in Part VI, Section 4, below). There is no "consequence" to "bear";[104] there is just a default result that is reached. The

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court assumed, as this article suggests, that a drafter must (out of a duty to the client) include the language (*see supra* note 95), the tenor of the statement would likely be different.

[97] *Id.* at 1237. Keep in mind the end of including this language, to ensure that the client's form falls into the 2-207(1) proviso and to get the least-worst available contract under Section 2-207(3).

[98] *Id.* 1237-38. Of course, there is a benefit. However, the benefit they get is *certitude*, not just a benefit of backing out. A good drafter must assume that his form will be used by the client without consideration of what it says or means, and so must make sure that an automaton client, that just sends forms off is put into a position with the most certain and least-worst outcome. *See supra* note 35.

[99] This is something an automaton client with a drafter's form would want to do. *See supra* note 98.

[100] The court points out that a party should not expect to have its cake and eat it too. Again one wonders if the court would approach this differently if it considered that the drafter had Section 2-207 in mind when creating the boilerplate language. Such a party would not complain about this judgment. Perhaps as the courts and business parties (and their lawyers) learn about the Section and the strategies that are best under different business scenarios, (inferred and actual) complaints would be dropped.

[101] *C. Itoh & Co.*, 552 F.2d at 1238. Of course this would be great for the seller, but again, the prudent drafter would know that this would not be the outcome, and would not change the strategic language.

[102] *Id*. This argument mistakes Section 2-207(3) as a risk to the seller, when instead, it is a certain backstop. Section 2-207(3) provides the endpoint in the game from which the seller can use backwards induction to determine which "move" is best to make; send a friendly form or one that demands acceptance. The court did not mention that a drafter could employ such language to ensure that other worse scenarios did not arise for the automaton client.

[103] *Id.*

[104] *But see* discussion *infra* p. 144 (arguing that consequential damages are a penalty default rule in

drafter has ensured that the Gap Fillers would be used, and that the client would do no worse than that. Had the drafter not used the adversarial language, the parties could have ended up with an ambiguous contract and would have been at the mercy of the court to apply the knockout rule and subsequent gap fillers under a different theory, e.g. under Section 2-207(2).[105] So regardless of whether the outcome in *C. Itoh* was correct, the argument that bias against the seller is appropriate, because the insertion of ambiguity into the contract is wrong. The seller's drafter did just the opposite. The drafter ensured the outcome before the first move of the game had been made. Furthermore, the reason for ambiguity comes not from the drafting of the boilerplates, but rather the insufficient worth of the sale, which was not important enough to warrant a fully negotiated contract. The use of the boilerplate is a safety mechanism meant to protect the client. It does this by ensuring the least-worst outcome. This outcome is not ambiguous—it is specific.

In 1986, the Ninth Circuit, in *Diamond Fruit Growers, Inc. v. Krack Corp.*,[106] applied the reasoning in *C. Itoh* to another case in which it was necessary to determine whether a term was part of a contract formed under Section 2-207(3).[107] The Ninth Circuit followed the U.C.C. drafters' belief that "[b]ecause the [purchase order and acknowledgment] forms are oriented to the thinking of the respective drafting parties, the terms contained in them often do not correspond."[108] Although this statement may be true, it misses two fundamental issues. First, it is, arguably, the drafters' duty to write the standard form for the benefit of the client. Drafting a form to be "one-sided" or oriented to one's client is strategic, given the structure of Section 2-207, and not merely a foregone conclusion. This is not the simple case of narrow, self-centered drafting. This is a matter of understanding the ambiguity of the future and ensuring that the client is put in the least-worst possible and most predictable situation. Second, that the terms do not coincide is just as attributable to the lack of term-by-term negotiation as it is to the absence of certainty (about the future with regard to the parties with whom forms would be exchanged and what terms would be contained on their boilerplates) when the forms were drafted.

The Ninth Circuit stated that "[g]enerally, this result is fair because both parties are responsible for the ambiguity in their contract."[109] As mentioned in the

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contract law, whereas the other gap fillers are efficient and probably majoritarian).

[105] It is possible that in some jurisdictions, a court will apply the knockout rule even if Subsection (3) is not reached by the Subsection (1) proviso, *see, e.g. Diatom, Inc.*, supra note 42 at 1579-80 (holding that a contract was formed under 2-207(1) but that the conflicting terms in offer and acceptance regarding period of limitations and applicable warranties cancelled one another out, thereby precluding summary judgment), but that does not mean a good drafter would want to leave the client in this less-certain position. Some jurisdictions do not apply the knock-out rule and gap fillers under Subsection (2). White and Summers have disagreed about when the rules should apply: White would look to Comment 6 to have the knock out rule and gap fillers applied to Subsection (2); Summers disagrees and says Subsection (2) only applies to additional terms, not different. *See* WHITE, *supra* note 50, at 34.

[106] *Diamond Fruit Growers, Inc. v. Krack Corp.*, 794 F.2d 1440 (9th Cir. 1986).

[107] *Id.* at 1442.

[108] *Id.* at 1442-43. *See also*, U.C.C. § 2-207 cmt. 1, *infra* p. 45.

[109] *Id.* at 1444.

discussion of the *C. Itoh* justification, the parties are not injecting ambiguity into the transaction by drafting adversarial contracts, they are, rather, covering their losses by making certain that the endgame result is the least-worst default scenario. The Ninth Circuit continued: "The parties could have negotiated a contract and agreed on its terms, but for whatever reason, they failed to do so. Therefore, neither party should get its terms."[110] As to this proposition, there are three issues.

First, the Court presupposes that the reason for not negotiating is unimportant and that form exchanging is the reason for the supposed ambiguity. If the courts wish to encourage economically efficient transactions, then they must recognize that for many transactions the cost of negotiating term-by-term will outweigh the benefits of having a "clear" contract.[111] It is evidenced by their choice of words that the court incorrectly saw the outcome of Section 2-207(3) as a type of "penalty".[112] This is mistaken from the strategic, game-theoretic point of view. Under the automaton-client theory of drafting, the court is actually doing the drafters' bidding, and is merely effectuating the true purpose of the drafter's adversarial language, reaching the default position.

Courts do not need to justify the application of this law as fair, because they are simply applying a working rule that parties knowingly draft under. The parties, or at least their lawyers, should know that this endgame is the logical outcome. Reaching that end has no significant moral implication—it is merely a matter of fact for business conducted under the U.C.C. There is no reason to say, "you *should* have negotiated, but since you did not, neither of you gets what you wanted." Instead, the courts should assert that the parties' drafters should know that there would be times when their clients could not economically justify term-by-term negotiations, and when that happens the U.C.C. supplies a default for an efficiency-driven strategic game. If the drafters have done their job, then that endgame will be reached, and the court will merely facilitate the endgame.

Second, the Ninth Circuit explained that Subsection (3) "will often work to the disadvantage of the seller because he will 'wish to undertake less responsibility for the quality of his goods than the Code imposes or else wish to limit his damages liability more narrowly than would the Code.'"[113] Though it is true that the Code may be buyer biased in some respects, it is still the least-worst that a seller can do.[114] The Court goes on to say that the application of the section is more equitable than the last-shot doctrine, and should be considered preferable given the statutory imposition of them (as opposed to imposition arising in

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[110] *Id.*

[111] Transaction costs "can be reduced by using standard forms." HIRSCH *supra* note 67, at 126.

[112] It is as though the court had said, "if you can't get along, then neither of you will get your way." Again, to avoid ambiguity, the gap-fillers in general are not a penalty default position. The only gap-filler that I currently believe to be a penalty default is consequential damages, as discussed below in Part VI, Section 4.

[113] *Diamond Fruit*, 794 F.2d at 1444.

[114] That the application of the gap fillers may be a disadvantage to sellers is important to the idea that consequential damages are a penalty default rule, since the application is an incentive to negotiate as to that term, but parties can and do negotiate around this one gap filler, and the remaining gap fillers are largely efficient. (Again, the consequential damages conversation, as the exception to the efficiency of the gap fillers, is reserved to Part VI, Sections 3-4, *infra*).

common law).[115] Common law versus statutes aside, the equity of the matter again points to the Court's apparent need to justify its holding rather than merely applying the law as it understands it. With the model presented above in hand, courts can go forth, confidently understanding that this is meant to happen: this is what the parties expect and want. Parties' actions are predicated on the court applying this law—no further rationale should be necessary.

Finally, the Ninth Circuit declared:

> [I]n a case such as this one, requiring the seller to assume more liability than it intends is not altogether inappropriate. The seller is most responsible for the ambiguity because it inserts a term in its form that requires assent to additional terms and then does not enforce that requirement. If the seller truly does not want to be bound unless the buyer assents to its terms, it can protect itself by not shipping until it obtains that assent.[116]

This again illustrates the court's confusion as to why a drafter would include the adversarial language conforming to the Section 2-207(1) proviso in the automaton-client's form. On its face, it may appear the drafter wants to have his cake and eat it too, but in reality, the adversarial language is the drafter's mechanism for reaching Section 2-207(3) and ensuring that the endgame is played out in the manner predicted, fulfilling the duty to the client keeping them in the least-worst position possible.

The Ninth Circuit got tantalizingly close to the nature of the issue when it said, "modern commercial transactions conducted under the U.C.C. are not a game of tag or musical chairs. Rather, if the parties exchange incompatible forms, 'all of the terms on which the parties' forms do not agree drop out, and the U.C.C. supplies the missing terms."[117] Modern commercial transactions are a game, but not a game of tag or musical chairs. They are a game of strategic positioning to ensure that the U.C.C. gap fillers are reliably reached on contracts that are not negotiated term by term.

2. The "Reputation" Continuum in the Take-It-Or-Leave-It Game: When is it Reasonable to be Accommodating?

The complete model in Appendix C includes two curves, provided to give a visual representation of the topics that follow, and are not part of the game-theoretic annotation. They were included to represent a continuum between certain nodes in the games that it is important to understand the relationship between. The *reputation* curve applies only to the take-it-or-leave-it situation.[118] In take it or leave it, Player 1 is uniquely situated to make an offer to Player 2 which is either accepted to form the contract or left on the table. This superior position, which Player 1 enjoys, provides the drafters of Player 1's form with information, which would be lacking in any other situation. Knowing that Player 1 has the superior

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[115] *Diamond Fruit*, 794 F.2d at 1445.

[116] *Id.*

[117] *Textile Unlimited, Inc.*, 240 F.3d at 788.

[118] *See infra* p. 47 and illustration.

position allows the drafters of Player 1's boilerplate language to take advantage of the long-term benefits that can come from using accommodating, less one-sided terms, namely a boost to reputation (or at least it will not contribute to a bad reputation, which may be even more important).[119] The model demonstrates the lose-lose situation that would arise if a seller accepted unreasonably one-sided boilerplate language from Player 1. This is shown through the payoffs, -1 to Player 1 (because of a drop in reputation that results from imposing an unfair contract), and -1 to Player 2 (resulting from the acceptance of losing terms). This outcome is not the equilibrium, and those who ignore this will in the long run gain poor reputations for not being reasonable to their suppliers. They will learn through lost business as they move to the sub-game equilibrium of no contract formation.[120] The reputation-leads-to-reasonableness argument is largely only applicable to the take-it-or-leave-it scenario.[121] The other games do not lend themselves to this argument because in those games, as a strategy, sending an accommodating form is not rational.

3. Are Penalty Default Rules at Play Here?

As has been shown in the model above, the gap fillers are a default, or equilibrium in the battle of the forms. The gap fillers are a mostly efficient equilibrium in the battle of the forms. Nevertheless, I will argue that there is a penalty that parties negotiate around in the gap fillers, and thus move away from the otherwise efficient Nash equilibrium of the battle of the forms. In their article *Filling Gaps in Incomplete Contracts*,[122] Ian Ayres and Robert Gertner introduced the influential idea of *penalty default rules*.[123] The existence of these rules was challenged by Eric Posner's article *There Are No Penalty Default Rules in Contract Law*.[124] This section will explain what penalty default rules are and why

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[119] For a discussion of the importance of reputation see Bebchuk, *supra* note 7, at 827.

[120] For commentary on the importance of fairness in capitalism see generally, JOHN MUELLER, CAPITALISM DEMOCRACY & RALPH'S PRETTY GOOD GROCERY Ch. 2 (Princeton University Press 1999). "[A]s [P.T.] Barnum puts it succinctly, '[m]en who drive sharp bargains with their customers, acting as if they never expected to see them again, will not be mistaken.'" *Id.* at 28.

[121] For a discussion of the effect of reputation and informational asymmetry in consumer contracts see Bebchuk, *supra* note 7, at 827.

[122] Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

[123] Robert Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1706 n.11 (1989) ("'[D]efault rules' are the rules that a program follows in 'default' of an explicit choice by the user to have some other principle apply."); *see also* Ayres, *supra* note 122, at 91 n.24; "Default rules have alternatively been termed background, backstop, enabling, fallback, *gap-filling*, off-the-rack, opt-in, opt-out, preformulated, preset, presumptive, standby, standard-form and suppletory rules." Ayres, *supra* note 122, at 91 (emphasis added). With respect to Section 2-207(3) the application of the rule is slightly buyer-biased, putting a "penalty default" on the seller, ex post, encouraging him to negotiate more than he would if the penalty default were different (or differently applied), thus the seller is encouraged to take on more cost, ex ante, than he would *but for* the subsection and its application.

[124] Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, U. CHI. LAW & ECON., Working Paper No. 237, http://ssrn.com/abstract=690403 (last modified March 19, 2009). Enrico Baffi provided commentary on these two articles in his own article, *Ayres and Gertner v. Posner*. Enrico Baffi, *Ayres and Gertner v. Posner: A Re-examination of the Theory of "Penalty Default Rules"*

Eric Posner believes they do not exist in contract law. The next section will show that the U.C.C. gap fillers contain a penalty default rule for sellers in Section 2-715(2).

A. What is a Penalty Default?

The Ayres and Gertner article, which introduced the concept of "penalty defaults,"[125] sought to provide "a theory of how courts and legislatures *should* set default rules."[126] The authors divide the legal rules of contracts and corporations into two groups.[127] "'[D]efault' rules that parties can contract around," and "'immutable' rules that parties cannot change."[128] Within the first group of rules, "penalty defaults are purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other or to third parties

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(Universitádegli Studi Roma Tre Faculty of Law, Working Paper, Dec. 2006), http://ssrn.com/abstract=948916. These articles revisit the classic *Hadley v. Baxendale* and *Lefkowitz v. Great Minneapolis Surplus Store, Inc.* cases. In this article only *Hadley* will be briefly discussed, to distinguish the *Hadley* rule from the role of consequential damages in the sale of goods. *See infra* note 171 and accompanying text.

[125] Ayres, *supra* note 122, at 87. Especially with regard to consequential damages, the gap fillers are buyer-favoring/seller-disfavoring. Keep in mind that the seller in most cases would logically have more information about the product being sold than the buyer since the seller is typically also in possession of that which is being sold and so is positioned to know more about the object or service offered. This information about asymmetry may make some wish to favor the buyer when considering an ideal default.

[126] *Id.* at 91 (emphasis added). Presumably the authors wrote the paper specifically because they believe that "academics have paid little attention about how to choose among possible default rules." *Id.* at 89.

[127] *Id.* at 87.

[128] *Id.* "Default rules fill the gaps in incomplete contracts; they govern unless the parties contract around them. Immutable rules cannot be contracted around; they govern even if the parties attempt to contract around them." *Id.* Ayres and Gertner explain that "immutable rules are justifiable if society wants to protect (1) parties within the contract, or (2) parties outside the contract. The former justification turns on parentalism; the latter on externalities." *Id.* at 88. Either way, these immutable rules are only justified "if unregulated contracting would be socially deleterious because parties internal or external to the contract cannot adequately protect themselves." *Id.* It is not hard to imagine such situations. As to protecting people *in* the contract, not all people are fit to contract, and keeping them from joining an enforceable contract is presumably better for society. As to protecting those outside of a contract, people do not contract in a vacuum; their actions affect others (even if it is only through the butterfly effect). Economists call these effects "externalities," because they affect parties *external* to the transaction. By raising the cost of a transaction, a regulator forces transacting parties to internalize (i.e. take into account by paying for) some of those externalities (i.e., costs that third parties would otherwise bear). Disagreement over immutable rules usually concerns, "whether in particular contexts parentalistic concerns or externalities are sufficiently great to justify the use of immutable rules." *Id.* at 88-89. For the purposes of the present paper, immutable rules will be largely set to the side. Nevertheless, to the extent that their analysis is profitably demonstrable, consider the following, regarding legal responses to contracting around immutable rules: "[f]rom an ex ante perspective the possibility of receiving this ex post penalty is just another expected cost of contracting around the default rule." *Id.* at 126. "[C]ourts remove the clauses that transgress the immutable rule and then choose a default to fill the gap." *Id.* "[C]ourts should choose the penalty that provide[s] 'least cost deterrence.'" *Id.* at 127. The authors assert that in the U.C.C., the "warranty of merchantability is simply a default rule that parties can waive by agreement." *Id.* at 87. When language such as "[u]nless otherwise unambiguously indicated" is used in the U.C.C., it is clear that a default is being set out. *Id.* at 88. *See also* U.C.C. § 2-314 (providing that "[u]nless excluded or modified [under § 2-316], a warranty that goods shall be merchantable is implied in a contract for their sale" if Seller is a merchant of such goods).

(especially the courts)."[129]

Reasonable people disagree about the efficacy of specific rules. Nevertheless, courts and legislatures must set defaults, "because contracts with gaps need to be interpreted."[130] Ayres and Gertner partially attribute incompleteness[131] in contracts to the fact that, "as transaction costs increase, so does the parties' willingness to accept a default that is not exactly what they would have contracted for."[132] Although "[p]rior theorists have argued that parties leave gaps in contracts because the cost of writing additional terms outweighs the benefit,"[133] a second cause of contractual incompleteness occurs:

> [W]hen one party to a contract knows more than another, the knowledgeable party may strategically decide not to contract around even an inefficient default. Because the process of contracting around a default can reveal information, the knowledgeable party may purposefully withhold information to get a larger piece of the small contractual pie.[134]

Therefore, Ayres and Gertner identify another "source of contractual incompleteness" as strategy:

> [P]arties may fail to contract around inefficient defaults for strategic as well as transaction cost reasons. When parties fail to contract because they want to shift the ex ante transaction cost to a subsidized ex post court determination, a penalty default of non-enforcement may be appropriate. When strategic considerations cause a more knowledgeable party not to raise issues that could improve contractual efficiency, a default that penalizes the more informed party may encourage the revelation of information.[135]

To fill the contractual gaps, "[c]ourts must do something—even if that

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[129] Ayres, *supra* note 122, at 91. Since the U.C.C. § 2-207(3) gap-fillers are buyer biased, the seller takes on an ex post cost that he otherwise would not and so must take on an extra ex ante cost of negotiating. Sellers do tend to negotiate one term, in particular, first, that being consequential damages. This negotiation is probably a representation of a penalty default rule in action.

[130] *Id.* at 89 n.14. It may not matter which default is chosen: "[e]conomists seem to believe that, even if lawmakers choose the wrong default, at worst there will be increased transaction costs of a second order of magnitude." *Id.* at 89.

[131] *Id.* at 95 (The "issue of whether a gap exists is identical to the issue of what is sufficient to contract around a particular default.").

[132] *Id.* at 93.

Scholars have primarily attributed incompleteness to costs of contracting. Contracts may be incomplete because the transaction costs of explicitly contracting for a given contingency are greater than the benefits. These transaction costs may include legal fees, negotiation 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. Rational parties will weigh these costs against the benefits of contractually addressing a particular contingency. If either the magnitude or the probability of a contingency is sufficiently low, a contract may be insensitive to that contingency even if transaction costs are quite low.

Id. at 92-93. Being sufficiently rationally "insensitive" to contingencies (following this through to its logical end) will lead to parties merely swapping boilerplate forms. For a discussion of exchanges and transaction costs with regard to economic considerations of contract law see HIRSCH *supra* note 67, at 120-24.

[133] *Id.* at 120.

[134] Ayres, *supra* note 122, at 120.

[135] *Id.* at 127-28.

something is non-enforcement[, because] defaults of non-enforcement can play an important role in efficient law."[136] Ayres and Gertner consider non-enforcement of some contracts (as another default position) as a safeguard against opportunism, e.g. where a "non-penalized buyer [could] have incentives to induce sellers to enter indefinite contracts in order to extract [a] penalty rent. By taking each party back to her ex ante welfare, the non-enforcement default eliminates this potential for opportunism."[137] Therefore, when the default enactment or application rationale is to encourage or promote symmetric information, "the penalty default should be against the relatively informed party."[138] The policy behind this is that "revealing information might simultaneously increase the total size of the pie and decrease the share of the pie that the relatively informed party receives. If the 'share-of-the-pie effect' dominates the 'size-of-the-pie effect,' informed parties might rationally choose to withhold relevant information."[139] "The knowledgeable party may not wish to reveal her information in negotiations if the information would give a bargaining advantage to the other side."[140]

To fill the gaps in a contract, some believe courts should look back to what the litigants "would have wanted."[141] Ayres and Gertner explain this "is analytically analogous to looking forward to what prospective contractors will want. It is to ask . . . 'who are the prospective parties rooting for?'"[142] The answer lies in ex ante incentives:

> While ex post each party will have economic incentives to shift costs to the other side, ex ante the parties have an incentive to place the risks on the least-cost avoider. If a court can identify that ex ante the parties to the contract had identical interest in allocating a certain risk or duty of performance, then it can, in a sense,

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[136] *Id.* at 89 n.14.

[137] *Id.* at 98.

[138] *Id.* Given that sellers usually have possession of goods before buyers, it would be expected that they would be considered the more knowledgeable party, and as such, were Section 2-207 an example of a penalty default rule, purposing to create more symmetric information, one would expect its ramifications to be buyer biased, which they are. *Id.*

[139] Ayres, *supra* note 116, at 99. "[E]fficiency corresponds to 'the size of the pie,' while equity has to do with how it is sliced." A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 (3d. ed. 2003).

[140] *Id.* at 100.

[141] According to Ayres and Gertner, the literature "has failed to question whether the 'would have wanted' standard is conceptually sound." *Id.* at 90 (referring to Charles Goetz and Robert Scott; Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985)). Ayres and Gertner bring others' points of view into consideration, starting with Frank Easterbrook and Daniel Fischel, who suggest that "corporate law should contain the [defaults] people would have negotiated, were the costs of negotiating at arms-length for every contingency sufficiently low." Ayres, *supra* note 122, at 90. Richard Posner "argued that default rules should 'economize on transaction costs by supplying standard contract terms that the parties would otherwise have to adopt by express agreement.'" *Id.* "Douglas Baird and Thomas Jackson have argued that the default rules governing the debtor–creditor relationship 'should provide all the parties with the type of contract that they would have agreed to if they had had the time and money to bargain over all the aspects of their deal.'" *Id.* "Charles Goetz and Robert Scott have proposed that courts should set untailored default rules by asking 'what arrangements would *most* bargainers prefer?'" *Id.* at 92.

[142] Ayres, *supra* note 122, at 89 n.18.

> pierce the ex post adversarial veil.[143]

Although would-have-wanted ("majoritarian") defaults "seem to minimize the costs of contracting,"[144] Ayres and Gertner argue that the "majoritarian 'would have wanted' approach to default selection is . . . incomplete."[145] "[I]f the majority is more likely to contract around the minority's preferred default rule . . . then choosing the minority's may lead to a larger set of efficient contracts."[146] In fact:

> [T]he very costs of ex ante bargaining may encourage parties to inefficiently shift the process of gap filling to ex post court determination. If it is costly for the courts to determine what the parties would have wanted, it may be efficient to choose a default rule that induces the parties to contract explicitly [, i.e.] penalty defaults are appropriate when it is cheaper for the parties to negotiate a term ex ante than for the courts to estimate ex post what the parties would have wanted.[147]

Changing default rules, they explain, may "reduce the opportunities for this rent-seeking, strategic behavior. In particular, the possibility of strategic incompleteness." For this reason, "efficiency-minded lawmakers would sometimes choose penalty defaults that induce knowledgeable parties to reveal information by contracting around the default penalty."[148] After all, "[t]he strategic behavior of the parties in forming the contract can justify strategic contractual interpretations by courts."[149]

Ayres and Gertner explain that when "choosing among default rules, lawmakers should be sensitive to the costs of contracting around, and the costs of failing to contract around, particular defaults."[150] Of course, different parties will find some terms more problematic than others, so parties' actions will differ under different defaults. By observing the actions parties take, information can be inferred about the parties, and the parties, in giving this information, can be described as falling into different degrees of "separating" and "pooling":

> In 'separating' equilibria, the different types of contracting parties, by bearing the costs of contracting around unwanted defaults, separate themselves into distinct contractual relationships. In 'pooling' equilibria, different types of contracting parties fail to contract around defaults, thus avoiding transaction costs but bearing

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[143] *Id.* at 89 n.18 (referring to Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978)).

[144] Ayres, *supra* note 122, at 93.

[145] *Id.*

[146] *Id.* It might make sense, given the presumptive asymmetric information, to make the seller analogous to the majority (and compare the buyer to the minority).

[147] *Id.* Nevertheless, "[p]arties who contract around a standard-form clause will face the prospect that courts will interpret their contract in a manner that is inconsistent with the parties' initial intentions. Thus, parties who prefer an alternative to the standard-form may accept the latter for fear of misinterpretation." *Id.* at 90 n.23.

[148] *Id.* at 94.

[149] Ayres, *supra* note 122, at 94. Nevertheless, the courts have not been interpreting contractual incompleteness as strategic. *See* Part VI, Section 1, *supra* p. 126.

[150] Ayres, *supra* note 122, at 94.

> the inefficiencies of the substantive default provisions.[151]

As such, "[k]nowledgeable parties can leave holes in contracts for strategic reasons—they might prefer to remain in an undifferentiated pool than pay their full freight in an efficient but unsubsidized equilibrium."[152]

Ayres and Gertner use the "Zero-Quantity Default" as an example of the concept of penalty default rules:[153] "if the parties leave out the quantity, the U.C.C. refuses to enforce the contract. In essence, the U.C.C. mandates that the default quantity should be zero."[154] The policy behind this, according to the authors, is that "[i]t is not systematically easier for parties to figure out the quantity than the price ex ante, but it is systematically harder for the courts to figure out the quantity than the price ex post."[155] To get the parties to agree on that term, a quantity they would not like is set as a default, i.e. the zero-quantity defaults are considered penalty defaults since neither party would have wanted such a contract.[156]

As to the U.C.C. section this article is most concerned with, the authors wrote:

> U.C.C. § 2-207 is also inconsistent with 'would have wanted' default analysis. This section supplants the common-law mirror-image rule with the default that additional terms in an acceptance that do not materially alter the terms of the offer become part of a contract between merchants. This default cannot be reconciled with 'what the parties would have contracted for' analysis, because *there is no reason to think that the merchants would have wanted to include the additional terms of their contract*. Instead, the rule places an informational burden on the party with the last clear chance to come forward and notify the other side if the additional terms are objectionable.[157]

Ayres and Gertner propose that lawmakers "should sometimes protect the private incentives to become informed. In some instances forcing parties to reveal information will undermine their incentives to obtain the information in the first place."[158] The authors wrote:

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[151] *Id.* at 94-95.

[152] *Id.* at 118. For this reason "efficiency-minded lawmakers must therefore be attuned to the sources of contractual incompleteness and to the attendant costs of pooling and separating associated with their default choice." *Id.*

[153] *Id.* at 96. Where Ayres and Gertner are working toward an explanation for the zero-quantity default and they say that "a rationale can be found," but one must be careful with such after the fact rationalizations since the Supreme Court has said that they "cannot 'accept . . . *post hoc* rationalizations."' Fed. Power Comm'n v. Texaco Inc., 417 U.S. 380, 397 (1974) (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168-69 (1962)); *see also* SEC v. Chenery Corp., 332 U.S. 194, 196 (1947).

[154] Ayres, *supra* note 122, at 95-96.

[155] *Id.* at 96.

[156] *Id.* at 97.

[157] *Id.* at 107 n.92 (emphasis added). Although, on the surface, it may not seem that the "would have wanted" analysis applies to Section 2-207, the drafters that draft in full knowledge of the workings of the section may actually want, ex ante, to reach the gap fillers. *See* Keating, *supra* note 2, at 2712 (interviews with business lawyers asserting their wish that it be easier to reach the gap fillers).

[158] Ayres, *supra* note 122, at 107. "Indeed, one way to identify penalty defaults is to investigate the pervasiveness with which parties contract around them, as is done with the seemingly ubiquitous use of

> If the academy has been remiss in developing a theory of default choice, then to an even greater degree it has failed to address what the necessary and sufficient conditions for contracting around defaults should be. In determining these conditions, courts are determining the costs of contracting around a given default. The received wisdom that transaction costs are responsible for contractual incompleteness implicitly suggests that lawmakers should minimize the costs of contracting around defaults so that if any contracting parties do not like the off-the-rack standard, they can inexpensively tailor their corporate or contractual structure to suit themselves.[159]

B. Why Does Posner Say They Don't Exist?

In his paper, *There Are No Penalty Default Rules in Contract Law*, Eric Posner argues that the examples provided by Ayres, Gertner, and other authors in subsequent papers have failed to provide an example of an existing, clear penalty default rule, and suggests that penalty default rules simply do not exist or are not a distinctive doctrinal category from contract formation rules or interpretive presumptions.[160] Posner began his article as follows:

> Ayres and Gertner's influential article, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, introduced the concept of the "penalty default rule," which is a rule that fills a gap in a contract with a term that would not be chosen by a majority of parties similarly situated to the parties to the contract in question.[161] The purpose of penalty default rules, Ayres and Gertner argued, is to force parties to reveal private information, which enables their counterparts to perform more efficiently than they would if left uninformed.[162]

Posner's paper develops the following framework for the way in which a court must approach claims for damages for a breach of contract:

> Determine whether contract formalities are satisfied.
>
> If so, determine whether there was real consent (not fraud, duress, mistake).
>
> If so, determine what the contract says.
>
> If there is a gap, apply a default rule.

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limited warranty disclaimers." *Id.* at 107 n.92.

[159] *Id.* at 120.

[160] Posner, *supra* note 124, at 2.

[161] *See generally* Ayres, *supra* note 122. The characterization of the definition of penalty default rules is telling. It emphasizes the difference between a majority would-have-wanted rule and imposed gap fillers. This emphasis takes the focus of the reader away from the "why" and puts it on the "how." A why definition might read: penalty default rules are those which encourage the sharing of information by imposing a less favorable term on the relatively informed party when that party does not negotiate said term effectively. This, of course, is only a rough guess at how such a definition could be written, and though some issues may exist with it, please allow it to suffice for the current discussion.

[162] Posner, *supra* note 124 at 1. As to the first part, it is agreed that this is a viable purpose of the penalty default rules; however, as to the second part, it is not certain that this is the only reason for encouraging information disclosure. Consider, for instance, the ability of parties to shift costs from ex ante to ex post and to use up valuable court resources. A not-insignificant reason a penalty default rule may be imposed would be to shift information expression to the ex ante position, preventing the necessity of courts to discover such latent information ex post. *See* Ayres, *supra* note 122, at 126-27.

> If an explicit or implied term was violated, award a remedy.[163]

Both Posner and I focus on step four.[164] Posner asserts that courts determine the existence of gaps through interpretation.[165] He also believes the pooling concept is an issue with the Ayres and Gertner paper, and it is the pooling concept. Posner believes it is more plausible that contracting parties will fall along a continuum.[166]

Posner breaks up the ideas expounded in the Ayres-Gertner paper:

> The first idea is that courts use legal doctrines to encourage contracting parties to provide sufficient detail in their contract, so that judicial interpretation in case of a dispute will be guided by the ex ante intent of the parties, rather than by judicial guesswork. Ayres and Gertner acknowledge that this This idea was advanced [as acknowledged by A&G] by Lon Fuller,[167] who argued that legal formalities serve this evidentiary function.[168]

> The second idea is [the judicial externalization problem][169] that penalty default rules (in addition to legal formalities) serve the function of encouraging parties to produce specific rather than vague contracts.[170]

The first idea is plausible, but the second idea—that penalty default rules are the cure—is less persuasive. As to the diagnosis, there is no doubt that in a simple economic model, the parties have an incentive to externalize their costs on courts. One way of doing so may be to leave gaps in their contracts in the expectation that courts will fill them properly in case there is a dispute.[171]

Posner may have a misconception of what the parties are trying to accomplish. It may be in part a shift of costs toward the ex post position. Nevertheless, if the parties feel that there is a high likelihood that suits could follow a transaction, they are probably more likely to address a broader array of terms in their negotiations. One can imagine a probability tree in which, the riskier a transaction is, i.e. the more likely that if it fails it will result in costly litigation, the more a party will be willing to mitigate that risk by taking on ex ante costs of

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[163] Posner, *supra* note 124, at 3.

[164] *See id.*

[165] *See id.* at 6. However, when applying Section 2-207(3) the courts will actually create gaps in contracts through application of the knock-out rule.

[166] *See id.* at 8. Although it is true that different parties will attribute different values to different situations, it does not hold that these parties will not make decisions similarly, e.g. only negotiate terms when the expected benefit outweighs the expected costs of such negotiations.

[167] Lon Fuller, *Consideration and Form,* 41 COLUM. L. REV. 799 (1941) ("[T]he evidentiary function of legal formalities is to provide information to courts in order to lower the costs of subsequent decision making"); *see also* Ayres, *supra* note 122, at 124 (In Lon Fuller's classic, *Consideration and Form*, "the evidentiary function of legal formalities is to provide information to courts in order to lower the costs of subsequent decision making.").

[168] *See* Posner, *supra* note 124, at 9.

[169] *See id.* at 11.

[170] *See id.* at 9. *See also supra* Part VI, Section 1 (considering the courts' acceptance of this argument).

[171] This argument differs from mine in that here a gap is created and the expectation is that the court will fill them in predictably.

negotiation to avoid such nodes. There would likely be some equilibria that the parties find acceptable which could result in litigation; however, if the risk of such litigation is sufficiently low, the parties could efficiently overlook fresh negotiation of certain terms ex ante (which if they had negotiated, may have lowered the court's ex post costs). As it is, Posner suggests,[172] raising the fees for adjudication of contracts cases would lower the incentive to shift costs ex post. But this suggestion overlooks the marginal importance of fees compared to total litigation costs, which are often quite high. Courts would have to require an exorbitant fee to have a material effect make a material difference on which terms are being fully negotiated ex ante, and the final result would likely be inefficient for society as a whole. "The only difference between [a majoritarian rule and a penalty default rule] is that more parties opt out of—or would prefer to opt out of—a penalty default rule than out of a majoritarian default rule, everything else held equal."[173] Even if a court misidentifies the justification for applying section 2-207 as being the interpretive presumption, e.g., *contra proferentem* (that a contract should be construed against the drafter), this mistake does not mean that it is the true reason section 2-207 should be applied.[174] Knowing that the consequential damages gap filler is a penalty default, the courts can apply it as such, without looking for further justification. Application of the consequential damages gap filler only occurs when the gap is created, and so this application is unlike the interpretive presumptions that hold regardless of the existence of gaps.[175]

According to Enrico Baffi, Posner says that penalty default rules (1) are different from majoritarian, information-forcing, default rules,[176] and (2) are "inefficient rules that do not maximize the ex ante value of [a] contract and are destined to be contracted around in the majority of the cases."[177] Baffi declares:

> Lawmakers could significantly reduce the possibility for relatively more informed parties to engage in this strategic behavior that results in a gap in the contract: indeed, they could choose penalty default rules (like, for example, a rule that establishes no compensation for consequential damages) in order to induce the informed party to add an efficient overriding clause.[178]

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[172] *See* Posner, *supra* note 124, at 10.

[173] *Id.* at 11. Following this idea, most sellers would like to opt out of consequential damages, so the imposition of the consequential damages gap filler would be an example of a penalty default.

[174] *Id.* at 17. The value or power of information, as inherently acknowledged in the rule of interpreting against the drafter, is an intuitive part of contract theory that pulls from our concept of fairness. Informational asymmetry has been developed in game theory and legal contexts in the economic literature.

[175] *See id.* at 18.

[176] Baffi, *supra* note 124, at 22.

[177] *Id.* But even if this were so, U.C.C. gap filler consequential damages may be a penalty default rule, since, according to Keating, many parties do decide to contract around them ex ante, which they would not do but for the expected application of Section 2-207. *See supra* notes 32-33 and accompanying text.

[178] Baffi, *supra* note 124, at 7. Baffi's suggestion is interesting because he suggests that a lack of, rather than the inclusion of, consequential damages would constitute a penalty default rule. *Id.* He chose this example, presumably, because the court utilized similar reasoning for its subsequent use in the *Hadley* case, a case in which Posner disagreed that a lack of consequential damages constituted a penalty default in practice. *See* Posner, *supra* note 124, at 13-14. Nevertheless, consequential damages

The assertion that establishing a no-consequential-damages default would constitute a penalty default comes from academic discussion of the *Hadley* case. In *Hadley* the informed party was the buyer of the delivery service. The court held that the courier neither knew, nor had reason to know, that the company needed the broken crankshaft fixed immediately or would not be able to operate, and hence the courier was not liable for the resulting lost profits. Taking Ayres' and Gertner's assertion that informational asymmetry is an important (if not *the*) reason for penalty default rules, and assuming that Posner's argument that *Hadley* rule was not an example of the application of a penalty default rule,[179] there is a simple observation made by Keating which suggests that consequential damages—in the U.C.C.—may constitute a penalty default rule.

The equilibrium application of consequential damages, as a gap-filler in contracts for goods, forces sellers to negotiate that term ex ante, since reaching it by default tends to be buyer biased. When not participating in the battle of the forms, sellers are do not negotiate the term. It is not merely a majoritarian default rule because most parties would not include the term in their negotiated, functionally complete contracts.

4. The Continuum of Negotiations Under Equal Bargaining Power: Consequential Damages are the Penalty Default Rule in Contract Law

In the extensive game illustration,[180] a curve is drawn connecting the battle of the forms equilibrium to the conjoining negotiation game equilibrium. This curve depicts the continuum between the battle of the forms and a fully negotiated contract equilibria. Along the continuum, towards the equilibrium of the battle-of-the-forms game, consequential damages is written to show that this is the first term which is negotiated in moving away from the equilibrium. The players exchange adversarial forms [i.e., they reach (A, A')], in the battle of the forms as a result of strategy. Nevertheless, as the benefit of a bargain increases and offsets the costs of negotiation [i.e., as B(N) becomes equal to C(N)], some terms become worthwhile to negotiate, and the players move on the continuum toward the equal bargaining power negotiations game and its equilibrium, (N, N'). In other words, all else being equal, when parties have relatively equal bargaining power the predictor of whether adversarial boilerplate language will be used, or terms negotiated, turns on the relative benefit of the bargain as compared to the costs of negotiation. Not all terms are equally efficient, and the U.C.C. has made this clear, since its gap fillers act as the Nash Equilibrium under the battle of the forms; it defines the least-worst position that any player could take on in that game. The least similar term, as between the negotiations and battle-of-the-forms equilibria, is the consequential-damages gap filler, and therefore this is the term that tends to be negotiated before

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may constitute a penalty default rule in transactions for goods. *See infra* Part VI, Section 4

[179] *See* Ayres, *supra* note 122, at 91. Posner asserted that the *Hadley* rule was actually majoritarian because most carriers do not have an advantage over outsiders in the insurance business. *See* Posner, *supra* note 124, at 13.

[180] *See infra* p. 47.

all others when moving between these equilibria.

Since most sellers would not typically negotiate the consequential damages,[181] it can be inferred that most of them prefer not to have that term. Therefore, the application of this term by courts can be seen as a penalty for not negotiating consequential damages. According to Keating, parties are negotiating them ex ante, when exchanging forms, but not when setting out a negotiated, functionally complete contract, and it is probably true that they are doing this to bypass the inefficient part of the default gap-fillers. Thus, in action, the gap fillers are causing some sellers to change their course of action ex ante. Courts that apply the consequential damages gap filler are applying a penalty default, which encourages sellers to negotiate that term ex ante. Thus, consequential damages are a penalty default rule, which the majority of sellers would not want in their contracts and which they will contract around ex ante, especially in contracts that they would otherwise leave to ex post determinations. As a penalty default rule, the consequential damages gap filler reveals which sellers value a reduction in liability enough to negotiate the term rather than "raise the price, buy insurance, or—as a last resort—have an extra martini every evening and [] not capitalize the corporation too heavily."[182] By revealing this, sellers share information about the quality or character of the goods they are selling. I leave modeling of the signaling game between the negotiated fully functional contract, battle of the forms, and the battle of the forms plus consequential damages equilibria for future research.

CONCLUSION

Although legal and economic academicians reveal the conditions for maximizing the value of contractual exchange, they do so in different ways.[183] Legal scholars see the law, and its interpretation, as malleable, and therefore tend to make observations and suggestions about laws themselves.[184] Economists, however, often take laws as given and seek the optimal behavior under the law.[185] Of course the law is malleable, but it is still advantageous for the legal community to see that identifying the optimal behavior of parties working under a law is important. If judges ignored the costs and benefits that different strategies provided parties under laws, decisions could be biased against reasonable strategies that, at first glance, seem unnecessarily mean, selfish, or ambiguous. Upon finding the reasons behind strategic behavior,[186] the behavior can be

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[181] *See supra* notes 32-33 and accompanying text.

[182] WHITE, *supra* note 50, at 47-48.

[183] Eggleston, *supra* note 13, at 93.

[184] *Id.* "If you only have a hammer, every problem tends to become a nail." GARETH MORGAN, CREATIVE ORGANIZATION THEORY 14 (1989).

[185] Eggleston, *supra* note 13, at 93. In other words, the law is like a mathematical constraint, or condition, under which the maximum value of a function can be found. *See, e.g.*, JAMES STEWART, CALCULUS 965, 969 (5th ed. 2003). The economists' approach may be understood by analogy to astronomers, who can only make observations of the cosmos, and then build theories and make predictions based on these; rather than creating hypotheses and testing them in labs. CHARLES I. JONES, INTRODUCTION TO ECONOMIC GROWTH 2-3 (2d ed. 2002).

[186] Strategic behavior occurs when "a rational person in deciding how to act . . . consider[s] the probable reactions of others." POSNER, *supra* note 32, at 19.

understood and thus judged more accurately and, in turn, more predictably—two traits of legal analysis that any legal mind can appreciate.

Data and theories do not always arise contemporaneously.[187] Regarding Professor Keating's article, the information he collected and the observations he made preceded and excluded any theory to explain his findings.[188] Professor Keating wrote that drafters arguably should include proviso-conforming language in their boilerplates. The game theoretic approach of this paper supports that position. Eric Posner asserted that penalty default rules do not exist in contract law. The Keating interviewees' responses, and the manner in which courts justify their application of consequential damages (as an ex post penalty for injecting ambiguity, by not negotiating ex ante), suggest, however, that consequential damages are the penalty default rule of contracts law. Drafting boilerplate language is a strategic act. Keating wrote that "those who [drafted one sided forms] generally justified it on the grounds that this was probably what the other side was going to do, so it was as much a defensive move as anything else."[189]

When parties are in the battle of the forms, there is no belief that a drafter could hold about the strategies other parties' drafters could choose such that it would be optimal to draft without adversarial boilerplate language.[190] Therefore the use of adversarial language by boilerplate drafters is strategic when the parties involved have relatively equal bargaining power. Judges and others should consider this when they are confronted by the battle of the forms. That parties choose to negotiate consequential damages, and not other efficient default terms in their boilerplates, before exchanging forms is evidence that this gap filler is a penalty default rule, with respect to the sale of goods. Understanding these things should help courts to more adequately explain the policy behind the application of the gap fillers under Section 2-207, which in turn should lead to a more predictable application of the law, happier businesses, and fewer confounded standard-form drafters. In the near future I hope to undertake empirical research to further develop this game-theoretic approach to contract negotiations for the sale of goods and develop a signaling game which parties use to move between the battle of the forms and negotiated, fully functional contracts. I think that more of Keating's observations can be tested by surveys and comparing market consolidation information to shifts away from the battle of the forms over time. I also believe that a differential study could be performed comparing jurisdictional approaches to Section 2-207(2) to see how these differences are affecting the strategies drafters are employing across jurisdictions.

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[187] *E.g.*, Tycho Brahe accumulated data for which Johannes Kepler later supplied theories.

[188] *See* Keating, *supra* note 2, at 2714-15 (acknowledging that the data is preceding a theory: "[h]aving spent many hours on the phone in interviews that enabled me to see only the tip of a very large iceberg, I am left not with radical suggestions for change but instead with a few modest observations").

[189] Keating, *supra* note 2, at 2701.

[190] GIBBONS, *supra* note 84, ("Rational players do not play strictly dominated strategies, because there is no belief that a player could hold (about the strategies the other players will choose) such that it would be optimal to play such a strategy.") *Id.* at 5.

APPENDICES

A. U.C.C. § 2-207

U.C.C. § 2-207. Additional Terms in Acceptance or Confirmation

A definite and seasonable expression of acceptance or *a written confirmation* which is sent within a reasonable time *operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms*.

The additional* terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:

the offer expressly limits acceptance to the terms of the offer;

they materially alter it; or

notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.

[* I leave the debate over whether and how Subsection 2 should apply to different terms for another day.]

Comment 1:

This section is intended to deal with two typical situations. The one is the written confirmation, where an agreement has been reached either orally or by informal correspondence between the parties and is followed by one or both of the parties sending formal memoranda embodying the terms so far as agreed upon and adding terms not discussed. The other situation is offer and acceptance, in which a wire or letter expressed and intended as an acceptance or the closing of an agreement adds further minor suggestions or proposals. . . . A frequent example of the second situation is the exchange of printed purchase order and acceptance (sometimes called 'acknowledgment') forms. **Because the forms are oriented to the thinking of the respective drafting parties, the terms contained in them often do not correspond.** Often the seller's form contains terms different from or additional to those set forth in the buyer's form. Nevertheless, the parties proceed with the transaction. (emphasis added).

Comment 7:

In many cases, as where goods are shipped, accepted and paid for before any dispute arises, there is no question whether a contract has been made. In such cases, where the writings of the parties do not establish a contract, it is not necessary to determine which act or document constituted the offer and which the acceptance. . . . **The only question is what terms are included in the contract, and subsection (3) furnishes the governing rule.** (emphasis added).

B. U.C.C. § 2-715(2)

Sec. 2-715. Buyer's Incidental and Consequential Damages

(2) Consequential damages resulting from the seller's breach include

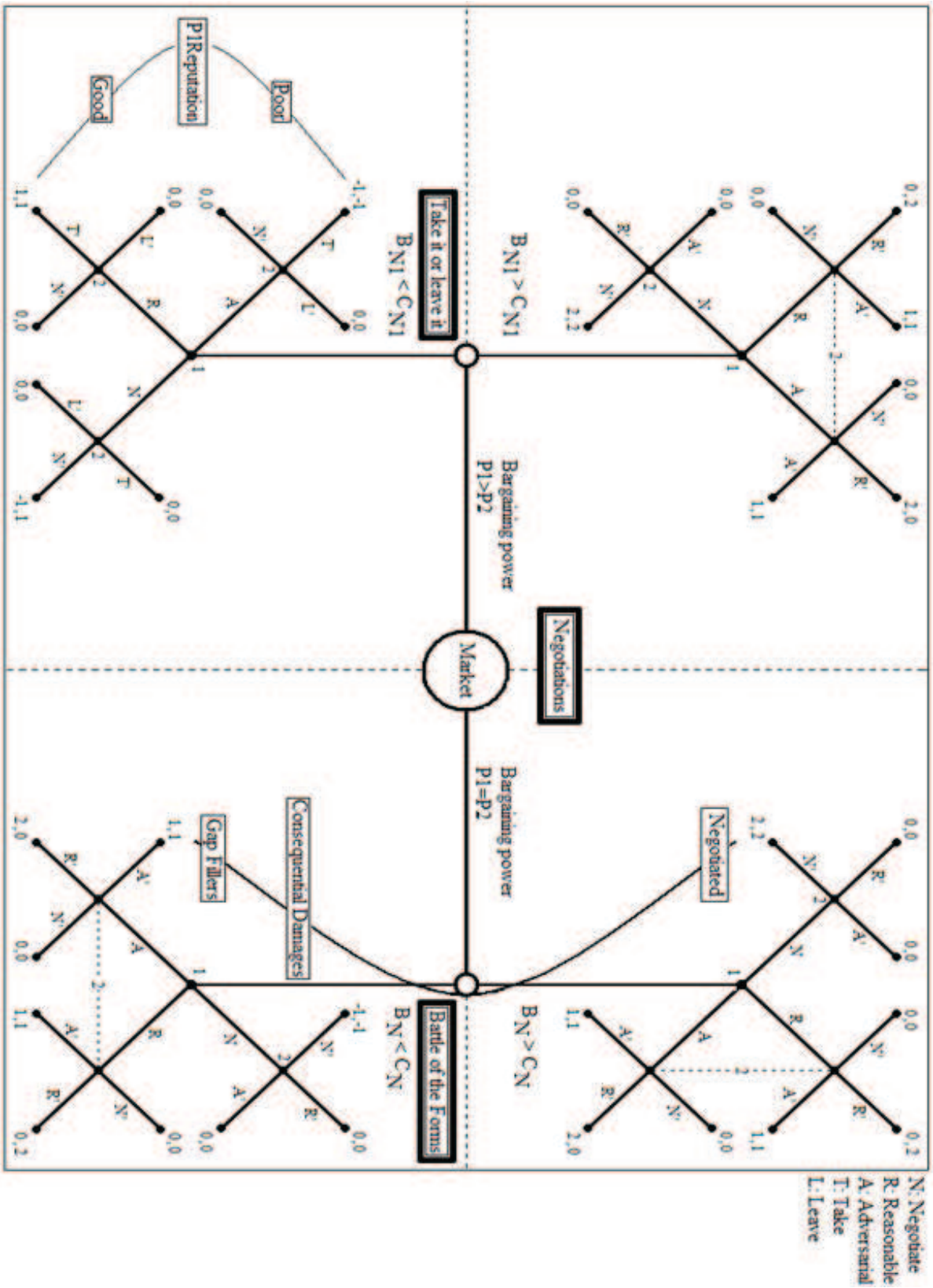
(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and

(b) injury to person or property proximately resulting from any breach of warranty.

Comment 2.

Subsection (2) operates to allow the buyer, in an appropriate case, any consequential damages which are the result of the seller's breach. The "tacit agreement" test for the recovery of consequential damages is rejected. Although the older rule at common law which made the seller liable for all consequential damages of which he had "reason to know" in advance is followed, the liberality of that rule is modified by refusing to permit recovery unless the buyer could not reasonably have prevented the loss by cover or otherwise.

C. Extensive Form



D. Normal Form

II. Negotiations				
		P2		
		A'	R'	N'
P1	A	(1, 1)	(2, 0)	(0, 0)
	R	(1, 1)	(0, 2)	(0, 0)
	N	(0, 0)	(0, 0)	(2, 2)

I. Negotiations				
		P2		
		A'	R'	N'
P1	A	(1, 1)	(2, 0)	(0, 0)
	R	(1, 1)	(0, 2)	(0, 0)
	N	(0, 0)	(0, 0)	(2, 2)

III. Take It or Leave It				
		P2		
		T	L	N'
P1	A	(-1, -1)	(0, 0)	(0, 0)
	R	(1, 1)	(0, 0)	(0, 0)
	N	(0, 0)	(0, 0)	(-1, 1)

IV. Battle of the Forms				
		P2		
		A'	R'	N'
P1	A	(1, 1)	(2, 0)	(0, 0)
	R	(1, 1)	(0, 2)	(0, 0)
	N	(0, 0)	(0, 0)	(-1, -1)