

Desperately Seeking Consideration: The Unfortunate Impact of U.C.C. Section 2-306 on Contract Interpretation

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In Section 2-306, the Uniform Commercial Code's drafters intended to assure that two classes of agreements would be enforceable, even though they might appear on their face to be illusory. Variable quantity (output and requirements) contracts were buttressed by reading in a good faith standard (§ 2-306(1)) and exclusive dealing contracts were made enforceable by reading in a best efforts standard (§ 2-306(2)). This was a big mistake. In this paper I show how these two fixes create problems for interpreting contracts. I use two well-known cases, Feld v. Henry S. Levy & Sons, Inc. and Wood v. Lucy, to illustrate the point.

Illusory contracts—I will do it if I want to—have long been held to be non-enforceable due to the lack of consideration. In section 2-306, the drafters of the Uniform Commercial Code (Code) intended to assure that two classes of agreements would be enforceable, even though they might appear on their face to be illusory. Variable quantity (output and requirements) contracts were buttressed by reading in a “good faith” standard¹ and exclusive dealing contracts were made enforceable by reading in a “best efforts” standard.² Neither was necessary for the narrow purpose of finding consideration; there are plenty of techniques available to contracting parties who want their agreement to be enforceable. The significant question is not whether the agreement is enforceable, but what is to be enforced. By imposing a near-mandatory “good faith” or “best efforts” duty on the promisor, the law raises barriers to efficient contracting. Courts’ atheoretical interpretations of both phrases have not helped.

I will turn first to variable quantity contracts. While in the pre-Code era these were on occasion found lacking in consideration, variable quantity contracts would usually pass muster if they limited one party’s discretion in some way by, for example, requiring the buyer to purchase all its requirements for an input at a particular plant. The contracts could add additional constraints on the buyer’s discretion, perhaps in the form of a maximum or minimum quantity. Notwithstanding the ability of the parties to contractually delimit the quantity discretion, the courts have under section 2-306(1) taken to using good

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¹ U.C.C. § 2-306(1) (2002).

² U.C.C. § 2-306(2) (2002).

faith to impose different limits, often undoing the allocation worked out by the parties.

The relevant theory is hardly esoteric. The core notion is that, in long-term agreements, adaptation to changed circumstances is often best achieved by granting one party considerable discretion in determining quantity. The discretion will not be unbounded; the contracts will typically relate the quantity to a physical constraint, like the capacity of a particular plant of the buyer or seller. Moreover, the contracts will often go further than that. If the opposite party is vulnerable to quantity variation, it will want to convey the contours of its reliance by, in effect, confronting the decision maker with a price reflecting the extent of its reliance. The buyer in a requirements contract has a set of options, and the seller's reliance establishes a set of prices for the exercise of the options. If the seller has no relation-specific investments, the option price is likely to be quite low, perhaps even zero.

The courts, in interpreting section 2-306(1), have used good faith as a blunt instrument for providing protection to one party's reliance, without asking whether that party would have been willing to pay for such protection in the first place. In effect, the seller in a requirements contract wants to confront the buyer with a price reflecting the extent of its reliance. If the price for protecting that reliance is set too high, both parties lose. After all, the higher the expected cost to the buyer of exercising its discretion, the less it would be willing to pay in the initial price. It is in the parties' joint interest to fine-tune the protection of the reliance. If *Y* is the party with discretion, other things being equal, the greater *X*'s reliance, the greater the price *Y* must pay for quantity adjustments adversely affecting *X*. The Code exhibits a lack of faith in the ability of the contracting parties to fine-tune the protection of the counterparty's reliance. In fact, their ability to fine-tune is quite impressive—much better, I would assert, than that of a court's invocation of good faith after the fact.

In some instances, the contract would allow the seller to operate the plant at any level at all without taking into account any adverse effects on the buyer. Usually, this is not by accident; the buyer's ability to hold a large inventory would mean that its reliance costs would be very low. That was the case, for example, for calcining contracts between oil refineries selling a waste product (petroleum coke) to Great Lakes Carbon, which treated the coke in calciners; the "full output" contracts gave the refineries complete discretion as to how much coke, if any, they should produce.³

For an example of how the courts have misused the good faith standard,

³ Victor P. Goldberg & John Erickson, *Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke*, 30 J. L. & ECON. 369, 369-98 (1987).

consider the leading New York case, *Feld v. Henry S. Levy & Sons, Inc.*⁴ The court invoked good faith to deny summary judgment to a seller in a full output contract that had reduced its output to zero.⁵ Levy operated a “wholesale bread baking business.”⁶ As part of its operations, it generated considerable waste product in the form of “stale or imperfectly appearing loaves.”⁷ One method for disposing of this material was to convert it into bread crumbs by removing the labels, processing the loaves through two grinders, toasting the product in an oven, and bagging it. That required that Levy purchase the oven; it did so, and entered into a one year evergreen (automatically renewed) contract with the Crushed Toast Company.⁸ The Crushed Toast Company agreed to purchase all bread crumbs produced by Levy in its factory at a price of six cents per pound. Either party could cancel on six months’ notice. The Crushed Toast Company was required to deliver a “faithful performance bond,” presumably to provide assurance to Levy of timely removal of the waste.⁹ Apparently, the operation was not profitable for Levy. It attempted to renegotiate the contract price up to seven cents, but was rebuffed. One month before the end of the first year, Levy dismantled the toasting oven and ceased production of bread crumbs. The waste was then sold to animal food manufacturers. The Crushed Toast Company sued, arguing that reducing output to zero constituted a breach.¹⁰ If Levy had reinstalled the oven, I presume that it would have remained bound to deliver all its waste to the Crushed Toast Company, because it had not given its six months notice.

The New York Court of Appeals held that good faith constrained how the seller was required to conduct its business.¹¹ The seller was not free to decide whether it should produce any bread crumbs. “The seller’s duty to remain in crumb production is a matter calling for close scrutiny of its motives.”¹² However, the court had no data on “the actual cost of the finished bread crumbs to defendant, statements as to the profits derived or the losses

⁴ 335 N.E.2d 320 (N.Y. 1975). I examine this case and other variable quantity cases in more detail in VICTOR P. GOLDBERG, FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE (2006) [hereinafter GOLDBERG, FRAMING CONTRACT LAW] and Victor P. Goldberg, *Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith*, 35 U.C. DAVIS L. REV. 319, 319–85 (2002).

⁵ *Feld*, 335 N.E.2d at 323.

⁶ *Id.* at 321.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Feld*, 335 N.E.2d at 321.

¹² *Id.*

sustained, or data specifying the net or gross return realized from the animal food transactions.”¹³ The court concluded:

[s]ince bread crumbs were but a part of defendant’s enterprise and since there was a contractual right of cancellation, good faith required continued production until cancellation, even if there be no profit. In circumstances such as these and without more, defendant would be justified, in good faith, in ceasing production of the single item prior to cancellation only if its losses from continuance would be more than trivial, which, overall, is a question of fact.¹⁴

The court failed to recognize that, in its own statement of the facts, it had already provided the relevant economic data. The contract price was six cents per pound and Levy’s actions (dismantling the oven) indicate that this amount would not even cover the variable costs; it was cheaper to shut the project down. However, Levy indicated that a price of seven cents per pound would have been sufficient to warrant its continued operation of the toaster oven. So the fight was over one penny.¹⁵ The court gave no hint as to how that information would help answer the question it had posed. Further, it glossed over the question of why Levy’s termination of an operation that did not cover variable costs was in bad faith. Given the incoherence of the question, the elusiveness of the answer is hardly surprising.

That this was an output contract rather than a requirements contract matters not. It can be viewed as a requirements contract for a service—waste removal. The deformed loaves and day-old bread were waste products that happened, by chance, to have a positive market value for various uses. Suppose instead that they were of no value and that Levy had entered into a contract to have all its trash hauled away at a price of, say, three cents per pound. The only difference is that the net flow of cash now would be from Levy to the Crushed Toast Company. Can one seriously argue that Levy has a duty to stay in business to produce garbage for the Crushed Toast Company to haul away? Yet that is precisely what the court has done.

It is conceivable that a producer would, under certain circumstances, promise to produce a specific level of a waste product. There are unusual circumstances in which the parties might want to give substantial protection to the trash remover’s reliance interest. For example, the trash remover might have constructed a capital-intensive incinerator that required a steady flow of trash to be economically viable. But, in general, the reverse would be true. Did the unusual circumstances exist in this particular case? Certainly not. The

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

Crushed Toast Company was in existence prior to the formation of this contract and had other suppliers; toasted bread crumbs could be held in inventory at less expense and for a greater period of time than unsold loaves of bread—hence its willingness both to subject itself to Levy’s discretion in determining the bread crumb production and to post a faithful performance bond. Levy was the party that had carefully protected its reliance, because it had purchased a specific asset—the oven—and had a clear need to assure the removal of unsold loaves. The fact that it had dismantled the oven should have been sufficient to end the inquiry. Instead, the court, under the banner of good faith, encouraged a fruitless inquiry into the costs and revenues associated with the two alternative ways of disposing of the waste.¹⁶ Levy’s self-interest (it had bought a toaster oven that appeared to have no other economic use) provided sufficient protection of the Crushed Toast Company’s reliance, which was almost certainly minimal.

The other party’s self-interest is not always enough. Contracting parties have numerous devices for constraining the exercise of discretion. For one, by incorporating flexible pricing, the contract could decrease the rewards for opportunistic behavior by the quantity-determining party. If prices remained fixed during an agreement, and if circumstances changed so that the contract price was substantially below the current market price, a buyer in a requirements contract would have an incentive to increase its requirements to take advantage of the favorable price. This is one of the concerns voiced by those who invoke good faith to restrain the buyer. Price adjustment mechanisms like indexing or meeting competition clauses could, if well-designed, serve this purpose.

Consider a seller who enters into a requirements contract and has to make substantial relation-specific investments to perform. In order to protect its reliance, the seller will sometimes incorporate a complex multi-part pricing scheme. The seller might insist upon assurances so that even if the buyer takes nothing, the seller will still receive some compensation. There are numerous devices for reaching this outcome: take-or-pay, minimum quantity, standby charges, or liquidated damages (and variations on these), all of which set the marginal price at zero for low quantities. The assured payment provides some protection for the seller’s reliance. Because protecting reliance can be costly, the parties have a further incentive to economize by not insisting upon too much protection. Remedies for the repudiation or breach of a take-or-pay contract are complicated, and my impression is that the courts have not been very good on that score, but that is beyond the scope of this essay.¹⁷

¹⁶ *Feld*, 335 N.E.2d at 323.

¹⁷ See, e.g., *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731, 2005 WL 1863853, at *12–16 (S.D.N.Y. Aug. 8, 2005); *Roye Realty & Developing, Inc. v.*

My point is a simple one. Sophisticated parties and their lawyers have a rich array of tools for customizing their relations to reflect their particular circumstances. They write variable quantity contracts because such contracts give one party a valuable real option; they want the flexibility to adapt to changed circumstances. However, they also want to constrain the discretion of the party with the decision rights by conveying the concerns of the other party by confronting the decision maker with financial consequences. The tailoring need not always be wise, either *ex ante* or *ex post*, but the important point is that the parties have an incentive to allocate discretion and protect reliance. There is no reason to believe that a court, using a theoretically ungrounded good faith standard, could do better.

I will examine the exclusive dealing/best efforts problem section 2-306(2), by focusing on the fount of the doctrine, Judge Cardozo's opinion in *Wood v. Lucy, Lady Duff-Gordon*.¹⁸ His opinion is much more problematic than modern scholarship would have it. Because Wood had literally promised nothing, the contract appeared to lack consideration. To find an enforceable contract, Judge Cardozo needed to find something to get past that hurdle. The law does not require a whole lot; traditional doctrine held that even a peppercorn would do. All he did in *Wood* was find that there was enough of a promise by Wood to provide that peppercorn. For that, he invoked Wood's duty to use reasonable efforts.¹⁹ He noted that Lucy "was to have no right for at least a year to place her own indorsements or market her own designs except through the agency of the plaintiff. . . . We are not to suppose that one party was to be placed at the mercy of the other."²⁰ This argument has long seemed persuasive, indeed obvious, to contracts scholars. However, it could easily be turned on its head. Judge Cardozo could have reasoned that because we are not to suppose that Lucy would put herself at Wood's mercy, she had not in fact done so. She would only be at his mercy if it were a legally binding contract. Judge Cardozo could just as well have concluded, therefore, that there was not a legally binding contract.

Even if we accept the "mercy" argument, the opinion's context suggests another difficulty. Wood was perfectly capable of including an explicit best efforts clause in his contract—the template existed. Indeed, he had used it. At the time Wood entered into his contract with Lucy, he was involved in a dispute over another "exclusive contract" with Rose O'Neill, the inventor of the Kewpie doll. That contract had an explicit best efforts clause and,

Arkla, Inc., 863 P.2d 1150, 1153–60 (Okla. 1993).

¹⁸ 118 N.E. 214 (N.Y. 1917). I examine this in more detail in chapter 2 of GOLDBERG, *FRAMING CONTRACT LAW*, *supra* note 4.

¹⁹ *Wood*, 118 N.E. at 215.

²⁰ *Id.* at 214 (citation omitted).

moreover, recognized O'Neill's right to make sales on her own account. Indeed, in her counterclaim, O'Neill accused Wood of failing to use best efforts. If Judge Cardozo had been made aware of this other contract, he would have been hard pressed to explain why it would be necessary to imply best efforts and why he presumed that Lucy would not be able to perform even if Wood chose to sit around and do nothing.

The effect of *Wood v. Lucy, Lady Duff-Gordon* in its primary role is likely modest. Courts will reduce one category of errors (failing to find an enforceable agreement when the parties meant to have one but were careless about it) and increase a second (finding an enforceable agreement when at least one of the parties did not intend it to be so). Because it is so easy for parties to provide explicit consideration, and it is not too difficult for parties to make clear that they do not mean for their agreement to be enforceable, I would be surprised to find it having a dramatic effect in either direction. Given the modern judicial propensity to err on the side of enforceability, the rule probably does a bit more harm than good, but not much.

Wood's mischief is in its secondary role, defining the extent of the promisor's obligation. I want to consider two aspects: the effort level required and the domain of the rule. First, how much effort is enough? While Judge Cardozo only said "reasonable efforts,"²¹ the Restatement and the Code upped the ante, requiring "best efforts." To the extent that "best efforts" means more than the minimal amount of effort necessary to provide a peppercorn, it constitutes an unnecessary extension of Judge Cardozo's holding. The law is far from clear on the differences, if any, between the many explicit effort standards: best efforts, reasonable efforts, reasonable best efforts, commercially reasonable efforts, due diligence, and, no doubt, others. Perhaps, as is suggested by the interchangeability of best and reasonable efforts in many discussions of *Wood v. Lucy, Lady Duff-Gordon*, these are all synonyms. The Code appears to treat them as such. While section 2-306(2) refers to "best efforts," the comment refers to "reasonable diligence" and "reasonable effort and due diligence."²² However, not all courts view all levels of effort as the same. "While the phrase 'best efforts' is often used to describe the extent of the implied undertaking, this has properly been termed an 'extravagant' phrase and it should not be literally interpreted. A more accurate description of the obligation owed would be the exercise of 'due diligence' or 'good faith.'"²³

It is hard enough for courts to determine what is required when the contract expressly states a particular level of effort. Indeed, in a minority of jurisdictions, express best efforts clauses have been held to be too vague to be

²¹ *Id.* at 215.

²² U.C.C. § 2-306(2) cmt. 5 (2002).

²³ *Perma Research & Dev. Co. v. Singer Co.*, 542 F.2d 111, 118 (2d Cir. 1976).

binding. Yet, in those same jurisdictions, thanks to section 2-306(2), an implied best efforts clause would be enforced. I am not making this up. How is a court supposed to determine what is required by an implicit efforts clause? Should it look to the interpretations of express efforts clauses? New York courts have interpreted good faith and best efforts as requiring a party to engage in activities that would lose money, just not too much money.²⁴ Would Wood and other agents have a duty to lose some money, but not too much, in representing their principals? For an agent with a portfolio of clients, most of whom will turn out to be losers, an implied efforts clause (best or otherwise) could mean imposing a promise of a greater level of effort than the agent would have agreed to. If the parties had wanted a soft standard, they could have written it in. No useful purpose is served by superimposing such a vague standard on parties who did not choose to include it in their agreement.

There are two issues regarding domain. First, does the rule apply if there is an explicit source of consideration? Second, does the rule apply for arrangements that fall a bit short of exclusivity? If the *Wood* rule were only a gap-filler, the problem should disappear if the contract provides another source of consideration, or otherwise expressly limits the promisor's responsibility. That raises the first question about the domain of the rule. The Code is ambiguous on this point. Section 2-306(2) says nothing about confining its application to cases in which there is no other source of consideration. The statute merely imposes the best efforts obligation "*unless otherwise agreed.*"²⁵ That could mean that any express consideration is sufficient to avoid implied best efforts, or it could require an explicit statement that there is no promise of any particular level of effort. There is at least some case law interpreting section 2-306(2) as imposing an implied duty to use best efforts regardless of the existence of adequate consideration elsewhere in the agreement.²⁶

In *Emerson Radio Corp. v. Orion Sales, Inc.*, the court referred to precedents regarding patent licenses which:

did not blindly apply *Wood* to a situation involving an exclusive agreement and the payment of royalties but rather examined the mutual obligations and intentions of the contracting parties. They found that a substantial advance or

²⁴ Recall that in *Feld v. Henry S. Levy & Sons, Inc.*, 335 N.E.2d 320, 323 (N.Y. 1975), the court held that Levy could cease production only if its losses "would be more than trivial." Similarly, in *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 615 (2d Cir. 1979), the court held that Falstaff would have to prove that "there was nothing significant it could have done to promote Ballantine sales that would not have been financially disastrous."

²⁵ U.C.C. § 2-306(2) (2002) (emphasis added).

²⁶ See, e.g., *MDC Corp. v. John H. Harland Co.*, 228 F. Supp. 2d 387, 394 (S.D.N.Y. 2002); *Tigg Corp. v. Dow Corning Corp.*, 962 F.2d 1119, 1125 (3d Cir. 1992).

minimum royalty payment serves to protect the licensor/supplier from the possibility of the failure of the licensee/buyer to use reasonable or best efforts, the concern in *Wood*.²⁷

Note that the court invoked a “*substantial advance*,” hardly the language of peppercorns. Other courts, recently in particular the Southern District of New York, have held to the contrary. In *New Paradigm Software Corp. v. New Era of Networks, Inc.*, the licensee paid two million dollars plus a five percent royalty for a software program.²⁸ After discussing *Wood v. Lucy, Lady Duff-Gordon* and its progeny, the court concluded:

[i]n short, the law in New York is far from clear. . . . The Court cannot rule as a matter of law that the Agreement may not contain an implicit obligation to use reasonable efforts to market the Copernicus software despite the absence of any express provision in the Agreement and despite the \$2 million up-front payment.²⁹

So, for at least some courts, the implication of good faith has been entirely freed from its let’s-find-consideration roots and is a potential constraint on all exclusive contracts.

The second question regarding the scope of the *Wood* rule concerns the role of exclusivity. The courts and drafters of the Code were motivated by the technical problem of finding a ground for enforceability rather than by any interest in the underlying economic function of exclusivity. As a result, they created an artificial distinction. What if the relationship were not completely exclusive? The “at the mercy” rhetoric no longer seems so compelling. Both section 2-306(2) and the Restatement only refer to exclusive arrangements. If the arrangement were less than exclusive, would these still apply, in determining either the existence of a promise or its content? In both *Harland* and *Tigg*, the court was faced with arrangements that were not purely exclusive. Whether they were exclusive enough to come under the statute would, apparently, be a fact question:

Harland must demonstrate that [the contract] puts Harland “at the mercy of” Artistic in a particular market. Although Harland may not be able to make this showing, this court cannot decide, based on the pleadings and the text of the Agreements alone, that the Agreements do not constitute an exclusive

²⁷ *Emerson Radio Corp. v. Orion Sales, Inc.*, 253 F.3d 159, 169 (3d Cir. 2001).

²⁸ *New Paradigm Software Corp. v. New Era of Networks, Inc.*, No. 99 Civ. 12409RMBAJP, 2002 WL 31749396, at *1 (S.D.N.Y. Dec. 9, 2002).

²⁹ *Id.* at *14.

dealing arrangement.³⁰

Ironically, at about the same time that the Code was being adopted, the courts, under the antitrust laws, were attacking vertical restraints of all sorts, including exclusive dealing. For reasons that need not concern us here, that was unwise policy, and the Supreme Court finally reversed itself in *GTE Sylvania* in 1977.³¹ The simplest explanation for the restraints was to provide the agent (or retailer) with some assurance that if it provided effort on behalf of the manufacturer, another retailer would not come along and reap the benefits of that effort—the so-called free rider problem. The judicial hostility to vertical restraints encouraged the development of clauses that had roughly the same effect, but gave the agent a less-than-exclusive right. The agent could have a “primary area of responsibility” or it might use a “profit pass through” clause (if another agent sells in the territory, it must pay some fraction of its earnings to the first agent). The antitrust air was full of cries for “less restrictive alternatives.” Sometimes these alternatives were adopted because the economically efficient arrangement entailed less than exclusive dealing (as with reliance, too much protection of the assurance would be inefficient); sometimes they were adopted as an end run around the antitrust policy. There is no good reason why the enforceability or the extent of the agent’s effort obligation in these contracts should hinge on the precise manner in which the parties chose to provide assurance to the agent. It seems clear that in the 1960s the left hand of contract law did not know what the right hand of antitrust law was doing. In a stunning display of consistency, they both got it wrong. Antitrust, unlike contract law, did eventually manage to clean up its act.

For both pieces of section 2-306, the Code drafters supplemented the contract language of serious commercial entities with mushy, feel-good language that seems innocuous, but has given courts license to undo the balancing of the parties’ concerns. The initial impetus for the language was to overcome the no-consideration hurdle, a barrier easily scalable by other means. The impact has been, in defining the obligations of the parties, constructing contracts that the parties did not intend. Unlike some Code sections for which the lineup of affected parties is clear, there is no natural constituency for challenging section 2-306. We will, sad to say, continue to plod along with this nonsense remaining on the books, every now and then coming alive to rewrite

³⁰ *Harland*, 228 F. Supp. 2d at 394–95.

³¹ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 59 (1977). For a summary of the development of the per se rule against exclusive territorial restrictions in the 1950s and 1960s by a fan, see LAWRENCE ANTHONY SULLIVAN, *HANDBOOK OF THE LAW OF ANTITRUST* 402–06 (1977). For why this attack on vertical restraints was a bad idea, see Victor P. Goldberg, *The Free Rider Problem, Imperfect Pricing, and the Economics of Retailing Services*, 79 *Nw. U. L. Rev.* 736 (1984).

some contested deal, all in the name of good faith, best efforts, and apple pie.

