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Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem

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Article

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Article 2 of the U.C.C. directed courts to look to business norms as a primary means of interpreting contracts. Recently the new formalists have attacked this strategy of norm incorporation as a misguided one that will lead inevitably to significant error costs. Accordingly, they have embraced plain meaning as the preferred interpretive strategy. This Article argues that the strategy of rejecting trade usages unless they are part of the express contract is too rigid. The rejection is premised on an overly narrow cost/benefit analysis that fails to account for the functional role that such usages may play in curbing opportunistic behavior and thereby increasing gains from trade and overall welfare. Plain meaning and incorporation must each be evaluated to see how each one can achieve the parties' presumed instrumental goals of curbing opportunism—the "hold-up" game. Decision makers should also consider the particular reasons why parties failed to include the trade usages n their express contract. Some of the reasons for omission might argue for and some against norm incorporation. The incorporation decision should also depend on assessing the critical structural factors that make self-enforcement of trade practices possible. After proposing a taxonomy for assessing the normative issue of incorporation the Article examines case law. It suggests that the divergences can be explained by whether invocation would achieve the parties' functional goal of reduced opportunism. The Article concludes by suggesting that the taxonomy proposed here helps to overcome some past objections to incorporation strategy.

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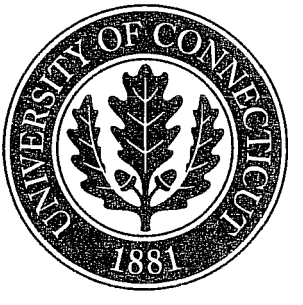

Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem

JULIET P. KOSTRITSKY*

I. INTRODUCTION

The role that business norms[1] have played in formulating legal rules has varied over time. Medieval jurists looked to commercial practices in

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Thanks are due to Professors Ronald J. Coffey and Peter M. Gerhart. Able research assistance was provided by Sara Busch, Michael Doty, Hannah Farber, Augustus Makris and Taylor Wesley. Errors are mine alone. Work on this Article was supported by the Dean's Summer Research Grant Program.

[1] "Business norm" is a general term that refers to practices that become a source for law. The more particular terminology includes custom as well as trade usage, course of dealing, and course of performance. Custom, the more traditional term, was thought to be obligatory while trade usage was not necessarily so. "Unlike practitioners of a trade usage, practitioners of a custom feel some sense of legal obligation." Jim C. Chen, *Code, Custom, and Contract: The Uniform Commercial Code as Law Merchant*, 27 TEX. INT'L L.J. 91, 97 (1992). Custom once played a pivotal role in the English common law since "English common law derived its rules from a single source: custom." Dale Beck Furnish, *Custom as a Source of Law*, 30 AM. J. COMP. L. 31, 31 (Supp. 1982). This Article will avoid the use of the word custom for two reasons: first, because "[c]ustom as a direct source of law in the United States has been overtaken by our extensive system of reported case precedents and the unrelenting trend towards legislative norms as the pre-eminent source of rules in this country," *id.* at 31 (citation omitted); and second, because the Uniform Commercial Code uses the terminology of "trade usage," "course of dealing," and "course of performance" rather than custom, *id.* at 40.

Since custom is not involved, some argue that there is no need to determine whether the "practitioners . . . feel some sense of legal obligation." Chen, *supra*, at 97. The emphasis is on objective evidence of regularly observed practices rather than a subjective sense of obligation that was required to show a custom. *Id.*

This Article avoids talking about social norms that arise in social contexts disconnected with any production function or commerce for several reasons explored below. Examples of such social norms are rife in life and in the literature. They include norms against wearing animal fur, rudeness, not bathing, smoking, littering, etc.

In the context of commerce, trade, and production, it can be assumed (using models of average behavior) that parties will attempt to satisfy the objective of maximizing welfare or gains from trade. A trade in this context will occur when there is welfare improvement in the sense that the trade will make one party better off, without making the other party worse off, since "people are inherently hungry for improvements in their welfare." ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 170 (1991). This is known as "Pareto optimality." People of course start with different preferences, which affect the "range of prices at which they are willing to deal." E-mail from Ronald J. Coffey Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (Apr. 30, 2004, 8:54 PM) (on file with Connecticut Law Review) [hereinafter Coffey, Apr. 30, 2004 E-mail]. Each party has a "limit number," *id.*, and these "limit numbers for each side are a function of the alternatives (to this exchange)," *id.* When parties are engaged in commerce in the production function, whether as medieval merchants or cattlemen, see *infra* Part IV, we can safely assume that when parties develop practices in such settings, they will be either deliberately designed or spontaneously arise to maximize the parties' gains from trade. In such situations, when a court is called upon to enforce the contract or commercial norm because the private means of enforcement are non-existent or weak, enforcement of the contract or of the commercial norm will promote the parties' achievement of their own welfare goals, making the court's role an easy one to accept.

deciding what common law rule should govern a dispute.[2] Eighteenth century rationalists, however, rejected custom as a source of law since it was not the product of deliberate planning.[3] They embraced statutes as a superior source of law because of their greater perceived rationality.[4]

In the 20th century, Karl Llewellyn reversed course and re-elevated the importance of commercial practices in the rules of Article 2 of the Uniform Commercial Code (U.C.C.).[5] Rather than imposing legal rules derived from logic or by a central planner, Llewellyn provided a statutory framework reflecting the legal realist philosophy that laws should reflect commercial realities.[6] Accordingly, Article 2 of the U.C.C. directs courts

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However, in norms in social contexts, without any connection to production or commerce, norms might develop (such as not wearing animal fur or not smoking) without such norms necessarily being about efficiency. In such cases, if the law were to intervene to incorporate such a social norm, it would be favoring one set of values or preferences over another without any "calculus for saying which of the tastes or preferences involved should take precedence over the other." E-mail from Peter M. Gerhart, Professor of Law, Case Western Reserve University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (July 5, 2005, 12:13 PM) (on file with Connecticut Law Review). If the law intervenes to favor one preference over another, it may be more difficult to find a value-neutral, efficiency ground for intervention. As a result, it may make more sense to be more circumscribed about intervening to implement social norms "when we are not ready to say that one actor's preferences are clearly superior to another's preferences," *id.*, and thus the law may therefore decline to intervene unless it is convinced that favoring one party's preference also has spillover effects that need to be controlled for efficiency reasons, such as a norm against wearing fur when such a practice leads to a problem of over-killing certain animals.

[2] Justice Mansfield is thought of as the principal architect of a *lex mercatoria*. *See* Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L. REV. L. & ECON. 215, 216 (1994) (discussing Mansfield's role in reviewing business practices as the source for developing rules for bills and notes).

[3] Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1650–51 (1996).

[4] The embrace of codes and statutes reflected the "reforming spirit" on the continent that rejected the common law because of its association "with the losing side in the revolution that brought Napoleon and his followers to power." *Id.* at 1650.

[5] There are three types of commercial usages recognized under the Code: course of performance, course of dealing, and usage of trade. These range from the most particular and narrow (i.e., how parties have acted in this contract) to the more general (i.e., how contractual parties have acted in prior dealings with one another) to the most general (i.e., how all parties in the trade treat a particular matter). U.C.C. § 1-303(e) lays out the hierarchy of preference given to these types of commercial practices. U.C.C. § 1-303(e) (2006). Section 1-303 displaces former sections 1-205 and 2-208. U.C.C. § 1-303 also expressly directs a court to construe commercial practices and express contractual language as consistent; where they are inconsistent, the express language governs. U.C.C. § 1-303(e)(1) (2006). *See* Chen, *supra* note 1, at 116–17 (analyzing the complicated issues of whether a trade practice is consistent with express language and arguing that the test of consistency formulated by courts results in too much exclusion of evidence from the fact finder); *see also* Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1714 (1997) (questioning this hierarchy of preference and suggesting "an inverted hierarchy" in which the written contract, rather than being afforded primacy, should be, and is in fact, subservient to the standards of reasonableness and good faith).

[6] *See generally* Roger W. Kirst, *Usage of Trade and Course of Dealing: Subversion of the U.C.C. Theory*, 1977 U. ILL. L.F. 811, 812 (1977) (discussing Llewellyn's insistence that courts deemphasize the language of written agreements and logic and instead should read them in light of their commercial contexts). *See also* Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. CHI. L. REV. 781, 781–82 & n.4 (1999) (discussing the impact of legal realism on the jurisprudence of Llewellyn and the Code). Looking at the actual practice of parties to find the rule is a "bottom-up" decentralized method of lawmaking, rather than a "top-down" centralized method of lawmaking, which

to search for "immanent business norms"[7] to interpret parties' contracts[8] and, more broadly, to decide disputes.[9] Business norms recognized by the U.C.C. include: trade usages (applying across a wide range of counterparties); course of dealing (focusing on how parties to a current transaction have behaved in prior dealing); and course of performance (covering conduct between parties to a current contract that takes place over a period of time).[10] Such business norms are essentially patterns of behavior amounting to substantive agreements that certain contingencies will be dealt with in a specified manner. Under the norm incorporation strategy of the U.C.C. these patterns are part of the actual agreement[11] unless the parties carefully negate them.[12]

The new formalists have attacked the norm incorporation strategy of Article 2 as misguided.[13] They have championed plain meaning and literal

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relies on centrally imposed legal rules. *See* Cooter, *supra* note 3, at 1643–44 (noting that "[d]ecentralized law begins with customs and contracts" and differs from regulatory law imposed by a central planner).

[7] Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1766 & n.1 (1996). *See also* Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 635 (1975) (suggesting "that the animating theory of Article II is that law is immanent.").

[8] Such commercial norms are also used to fill gaps in and interpret contracts. *See* Jody S. Kraus & Steven D. Walt, *In Defense of the Incorporation Strategy*, *in* JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 193, 193, 219–20 (Jody S. Kraus & Steven D. Walt eds., 2000) (explaining the U.C.C.'s rules regarding the use of extrinsic evidence to fill contractual gaps).

[9] Bernstein, *supra* note 7, at 1766.

[10] *See supra* note 5.

[11] U.C.C. § 1-201(b)(3) (2006); *see also* Amy H. Kastely, *Stock Equipment for the Bargain in Fact: Trade Usage, "Express Terms," and Consistency under Section 1-205 of the Uniform Commercial Code*, 64 N.C. L. REV. 777, 779 & n.10 (1986).

[12] *See* U.C.C. § 2-202, cmt. 2 (2003) ("Unless carefully negated they have become an element of the meaning of the words used.") There are complicated questions about whether the norms should be admitted if they contradict the express terms of the contract and how one decides if the usage does contradict the contract.

[13] The formalists embrace the Restatement and common law which evidence a more literal minded, "plain meaning" approach to interpretation. *See* Clayton P. Gillette, *The Law Merchant in the Modern Age: Institutional Design and International Usages under the CISG*, 5 CHI. J. INT'L L. 157 (2004). There are several categories of criticism of the more flexible incorporation strategy of the U.C.C. Lisa Bernstein uses empirical data to argue that such widespread customary practices in fact do not exist, at least in certain industries in a certain time period. *See* Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999).

Other criticism focuses on the process by which the norms themselves arise and finds that nonoptimal, inefficient norms may arise that do not warrant recognition. *See* Eric A. Posner, *Law, Economics and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1724 (1996). These critics argue that the incorporation of norms should not be automatic since some conditions favor the development of inefficient norms. *See* Cooter, *supra* note 3, at 1655–56 (arguing that the "incentive structure" present when a custom arises influences the efficiency or inefficiency of the resultant norm, and that efficient norms should be enforced); *see also* Gillette, *supra*, at 160–61 (delineating conditions for developing norms that warrant recognition).

The third criticism argues that the costs of incorporation will outweigh the benefits under the conditions that exist for most contracting parties. *See* Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847 (2000). Professor Scott argues that under a realistic view of conditions that are likely to prevail, namely "competent parties and incompetent courts," formalism is a better interpretive methodology for maximizing value for the parties. *Id.* at 875. This Article

interpretation[14] as the preferred methodology[15] and rejected an interventionist role for courts in favor of a more circumscribed one.[16]

Scholars evaluating norm incorporation argue that the choice between these competing interpretive strategies (plain meaning versus incorporation)[17] should depend on an analysis of which strategy "maximizes the value of the contract [while] minimizing the sum of all contracting"[18] and other costs that reduce gains from trade. Though in agreement on a cost/benefit framework, different scholars emphasize varying costs that arise with each strategy.[19] Incorporationists argue that a plain meaning strategy will increase specification costs since parties cannot rely on courts to incorporate common usages into their contracts.[20] Plain meaning advocates argue that interpretive and error costs[21] would necessarily be greater with an incorporationist strategy.[22] In fact, anti-incorporationists postulate that the error costs of incorporation are so "excessive that almost any plain meaning regime would be preferable."[23]

This Article posits that the anti-incorporation strategy view that business practices should be denied all legal enforcement unless they are

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develops a cost benefit analysis for determining whether intervention will enhance welfare. Current cost benefit analysis assumes, unlike Professor Bernstein's paper, that norms do exist, but that it is always too costly to prove the relevant norms. This Article disagrees, arguing that there is no categorical answer to the cost issue. Both this Article and current cost benefit analysis would accept Bernstein's argument that if norms could not be proven and did not exist, they should not be incorporated. This Article accepts Cooter's argument that not all norms are efficient since the efficiency of a norm depends on structural factors. However, this Article demonstrates that many norms promote efficiency by solving problems, which, if left unsolved, would create a drag on gains from trade. This Article implicitly admits, however, that where norms are dysfunctional and inefficient, they should not be incorporated.

[14] It is not clear that "plain meaning" has an identifiable meaning.

[15] *See, e.g.*, Scott, *supra* note 13, at 848.

[16] The question of how broadly a court should intervene is most likely to arise in incomplete contracts. There the new formalists argue that where the parties have left the contract incomplete by failing to condition on certain variables (which will become known once the future happens), those parties will not adopt such variables and will be reluctant to have the court supply such variables since they are not verifiable. *See* Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE WES. L. REV. 187, 195 (2005); *see also* Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 100 (2000) (explaining verifiability limitation and its role in incompleteness).

[17] This Article assumes that all contracts are incomplete and therefore courts must be involved in gap filling to "resolve alleged uncertainties." *See* Gillette, *supra* note 13, at 157.

[18] *Id.* at 157. Such a strategy would serve the parties' own interests.

[19] *Id.* at 158.

[20] Other costs would arise since "the use of terms with idiosyncratic meanings, understood within a trade but not by outsiders, would give rise to judicial interpretations not intended by the parties." *Id.* Incorporation permits the ready incorporation of these meanings without requiring express inclusion.

[21] Error costs are the market inefficiencies and economic losses that occur when judicial decisions improperly interpret business norms. *See* Kraus & Walt, *supra* note 8, at 199–200 (discussing error costs).

[22] *Id.* Error costs arise because the "contextual significance of trade usages requires adjudicators to discover the alleged usage, define its scope, and determine its application to the issue at hand—all in all, a costly and error-prone process." Gillette, *supra* note 13, at 158.

[23] *Id.* at 193; *see also* Scott, *supra* note 13, at 848 (noting a contrasting advantage of formalized approach in promoting certainty and "expanding the menu of legally blessed standard-form terms").

part of the express contract is too rigid. Current cost/benefit comparisons of plain meaning and incorporation strategies are incomplete because they fail to assess the functional role[24] that privately developed trade usages play in achieving parties' goals, such as the control of opportunistic behavior and other hazards that might be difficult to control ex ante by express contract. What is missing is a functional goal-oriented view.

The supposed error costs of incorporating trade usages cannot be ascertained without first determining what function the trade usage is serving. The likelihood or magnitude of judicial error costs might decrease once the purpose of the trade usage is identified, at least in cases where opportunistic behavior by the defendant is clear, the trade usage is designed to deter that type of opportunism, and enforcement of the trade usage will not promote parallel opportunistic behavior by the plaintiff.

The plain meaning strategy, employing a default approach that would deny legal effect to trade usage,[25] and the incorporation strategy must each be evaluated to see how, if at all, they can help parties achieve specific goals. Current analyses are incorrect in suggesting that categorical answers to the question of the normative desirability of a norm incorporation strategy can be reached[26] solely by comparing the projected theoretical[27] increased costs of specification (from plain meaning)[28] against error costs (from contextualized norm incorporation) in the abstract.[29]

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[24] There is no necessary assumption that these trade usages have been deliberately designed to achieve certain goals; they may have evolved spontaneously over time and survived because of their capacity to remain "serviceable to the individuals which move within such order," and to protect the group. 1 F.A. HAYEK, LAW, LEGISLATION AND LIBERTY 39 (1973).

[25] Parties could opt out of the default rule of plain meaning by specifically indicating that they preferred that the court resort to and invoke trade meanings and commercial practices.

[26] *See also* Gillette, *supra* note 13, at 159 (rejecting an "all-or-nothing" approach in evaluating an interpretive strategy).

[27] *Id.* at 159.

[28] Presumably, plain meaning strategy would increase drafting burdens on parties who could no longer rely on courts to supply terms for them. *See, e.g.*, Kraus & Walt, *supra* note 8, at 199.

[29] Another cost of a contextualized approach to interpretation is "encrustation." Encrustation occurs when courts give undue weight to implied terms making it difficult for parties to persuade a court to recognize that the parties have opted out of the standard implied term with an express term. This reluctance creates "barriers to innovative forms of contractual agreement." *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interaction Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 264 (1985); *see also* Kraus & Walt, *supra* note 8, at 217.

Comparing the costs looks at these competing methodologies to see which "has a theoretical advantage." Gillette, *supra* note 13, at 157–58. Others have used empirical data to demonstrate that parties themselves opt out of the more informal rules of the U.C.C. preferring to subscribe to a more formalistic "private legal system." Professor Bernstein uses such data to suggest that the U.C.C.'s informal contextualized approach should be rejected since it interferes with the U.C.C.'s avowed aim of promoting flexibility and with the parties' ability to renegotiate contracts. Bernstein, *supra* note 7, at 1769–71; *see also* Richard A. Epstein, *Confusion About Custom: Disentangling Informal Customs from Standard Contractual Provisions*, 66 U. CHI. L. REV. 821, 822 (1999) (noting the beneficial role of trade associations in crafting optimal rules that "deviate . . . from the discordant set of customary practices").

A plain meaning specific approach, with its narrow focus on what the parties included in the contract, will often fail to help the parties achieve their instrumental goal of controlling opportunism. This is because many contracts remain incomplete due to bargaining impediments. Literalistic enforcement of the contract, therefore, will not achieve the parties' functional goals unless one also assumes the parties can effectively self-enforce the trade usages designed to control opportunistic behavior and supplement the incomplete express contract. Of course, the additional benefit to the parties from controlling opportunism would have to be weighed against error costs that still occurred when courts incorporated norms in such a way that it increased opportunism or led to incorrect conclusions about who was in fact acting opportunistically. A plain meaning approach may be costly in terms of unremedied opportunism.

To decide the incorporation issue, a multi-factored approach should be used. The functions trade usages are intended to serve, including control of opportunistic behavior and the increased incentive a party has to engage in opportunistic behavior when there is a potential windfall to a party seeking to deviate from the trade usage should be considered.[30] The decision-maker should ask whether the substantive practice would advance the welfare of the parties. The decision-maker should also consider reasons why parties might fail to include the practice in their express contract and whether the failure is understandable in terms of structural barriers to bargaining or other reasons.[31] Some of these reasons for omission might argue for and some against norm incorporation and should be examined in detail.[32]

The correct analytical starting point for evaluating the incorporation strategy for trade usages begins with a recognition that incorporation of norms is a form of collective legal intervention to solve the incomplete contract problem.[33] As such, it must be justified in instrumental terms as a means to increase gains from trade, projecting the ex ante and ex post.

Resolving the welfare issue requires courts to recognize the behavioral assumption that parties in transactional settings will attempt to maximize the gains from trade. Trade usages, especially those that are designed to control a counterparty's propensity to act opportunistically during performance, act as private strategies to maximize gains from trade when

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[30] Presumably the error costs of incorporating trade usages associated with discerning the correct usage and the correct domain of the usage are less problematic if the function of the usage is designed to control a universal and recurring problem of opportunism.

[31] *See generally* Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What to Do When the Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WIS. L. REV. 323 (2004) (discussing role of bargaining impediments in assessing private and public strategies in incomplete contracts).

[32] For a discussion of these other reasons see *infra* text at pp. 503–04.

[33] Because the U.C.C. incorporates the trade usages by supplementing the agreement or by using them to interpret the contract, structures justifying legal intervention in incomplete contracts may be helpful.

parties face barriers to including general terms to control opportunism in their express contractual arrangement.[34] Without some means of controlling the omnipresent "incentives to cheat,"[35] the parties (and society) would be worse off since parties would be reluctant to invest or contract with other parties.[36] When the self-interest of the individual diverges from greater overall welfare, some "foundation of mechanisms" is needed to control that divergence.[37] The problem is one of "deter[ring] socially costly but privately beneficial behavior, or, put differently, to solve collective action problems that arise among citizens."[38]

Besides the structural barriers to bargaining that interfere with express incorporation parties may fail to include trade usages in their express contracts for other reasons. Each of these reasons for non-inclusion might have different implications for the question of whether judicial enforcement would be justified as welfare-maximizing. Parties might omit the practice because they might want the flexibility to decide later whether to honor a practice in a particular case.[39] This Article will identify the

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[34] E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (July 16, 1996, 1:37 PM) (on file with Connecticut Law Review). The existence of such impediments to bargaining suggests that the parties may not be able to achieve their first best objective of maximizing gains from trade. The further question that then arises when such impediments exist is whether the parties could devise strategies on their own to overcome such impediments for welfare improvement or whether some further legal intervention might be required.

Parties may resort to private strategies not only because the problem may be difficult to solve by a contract but also because the weakness of the state and the legal system make contractual solutions impracticable. The existence of such impediments to bargaining suggests that the parties may not be able to achieve their first best objectives of maximizing gains from trade. The further question that then arises when such impediments exist is whether the parties could devise strategies on their own to overcome such impediments for welfare improvement or whether some further legal intervention might be required. *See, e.g.*, Avner Greif et al., *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745, 746–48 (1994) (examining privately developed and enforced trade embargo mechanism in the face of a weak state and undeveloped legal remedies).

Recognizing that commercial norms exist as one private solution to the incomplete contracting problem means that an evaluation of whether legal enforcement of private norms would enhance welfare must consider some of the relative advantages and disadvantages of other arrangements for solving opportunism problems, as well as the costs of and likely success of private informal enforcement of the trade usages.

[35] ERIC A. POSNER, LAW AND SOCIAL NORMS 149 (2000) (detailing merchants' private efforts to control such cheating).

[36] While "everyone can potentially benefit from the creation or addition of economic value . . . each participant in the process usually has available to him various actions that increase his own gain, while lowering the others' gain by a greater amount." AVINASH K. DIXIT, LAWLESSNESS AND ECONOMICS ALTERNATIVE MODES OF GOVERNANCE 1 (2004) (attributing success of market economies to successful efforts to deter opportunism). Douglas North explains the problem for society of such divergence as follows: "without institutional constraints, self-interested behavior will foreclose complex exchange, because of the uncertainty that the other party will find it is his or her interest to live up to the agreement." DOUGLAS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 33 (1990).

[37] DIXIT, *supra* note 36, at 2.

[38] POSNER, *supra* note 35, at 4.

[39] The parties might want to dishonor the practice if circumstances materialize that might affect whether the practice should be honored and a party, rather than a court, might be in a better position to

circumstances in which parties might be better equipped to make those judgments. Such circumstances include cases where the possibility of opportunistic behavior exists for both parties, making the ready determination of opportunistic behavior difficult to judge.[40] Judicial non-enforcement of commercial practice might also be warranted where the prime reason for omitting to incorporate is that the custom functions as a signaling device of superior attributes.[41] In that case judicial enforcement of the custom might detract from its signaling capability, as parties would no longer adhere to the practice to signal their worth but because of judicial enforcement.

When understandable barriers prevent express inclusion of a trade usage designed to increase wealth by policing opportunism in the express contract, or when the trade usage serves an important signaling function, or parties wish to retain flexibility, the framework provided here will provide a partial answer as to whether incorporation of the substantive trade usage will increase welfare.

The cost/benefit welfare calculus of the alternate approaches must also examine the means by which the particular substantive norms could be enforced and at what cost. Business norms could be enforced by relying solely on private compulsions, informal enforcement, a coordinated merchant network, or by court sanction (or perhaps by some combination of these systems).[42] Structural conditions that would contribute to successful non-legal enforcement of the practice, including the presence of a closely-knit group, the observability of deviance from the norm, ready transmission of information about breaches and defections, opportunities for repeat dealing,[43] and varied opportunities for interaction that allow parties to punish defection in a number of different ways, should be considered in a comparative assessment of these systems for norm enforcement.[44] Thus, this Article is in the tradition of scholarship that seeks not to "deal comprehensively with all the variables that may be relevant in predicting the efficacy or prevalence of private ordering"[45] but

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judge whether the circumstances merit a departure from custom. Then the reason for omission might counsel prudence in enforcing the custom.

[40] Parties might wish to retain that flexibility when they think that they will be able to judge the meaning of a practice in the context of later arising circumstances better than a court.

[41] *See* POSNER, *supra* note 35, at 5 (explaining conformity to dress norms as a signal).

[42] *See* Sergio G. Lazzarini et al., *Order with Some Law: Complementarity versus Substitution of Formal and Informal Arrangements*, 20 J.L. ECON. & ORG. 261 (2004).

[43] This factor of repeat dealing with its "prospects for future transactions inducing compliance with current contractual obligations—is a mainstay in the literature on private ordering." Barak D. Richman, Essay, *Firms, Courts, and Reputational Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2339 (2004).

[44] ELLICKSON, *supra* note 1, at 179. Professor Ellickson finds that when there are many opportunities to interact, there is a "multiplex relationship" with an opportunity to "deal with each other along many different fronts. The prospect of a continuing multiplex relationship guarantees a rich menu of future opportunities to render self-help sanctions." *Id.* at 179 n.44.

[45] Richman, *supra* note 43, at 2332.

rather to classify the types of business norms, the reasons for omission and the structural factors that would determine the comparative efficacy of private and judicial ordering. Whether informal societal pressure can be effective in securing self-enforcement of the commercial norms depends on a variety of structural factors.[46] If the structural factors that make self-enforcement possible are not present and self-interest dictates a divergence from commercial norms, or specialization demands that performance be delegated to agents, thereby subjecting the principal to the risks of cheating,[47] then other forms of organized community pressure may be required as a supplement to self-enforcement.

Several factors are relevant in assessing which of these systems would have a comparative advantage in providing the "transactional assurance" needed for economic prosperity and growth.[48] These include: (1) whether a legal system or coordinated merchant system exists at all; (2) whether the substantive legal rules require technical expertise or a particularized need for speed in resolution; (3) whether instead the matter concerns behavior that would be transparent to an outsider or whether the parties would have information not available to outsiders;[49] and (4) whether there might be scale economies from legal intervention.[50] Presumably, if the substantive norm can be justified as value maximizing, and legal enforcement is likely to be more effective or less costly than private enforcement based on the factors referred to above, then judicial enforcement could be justified as the best means to increase value for the parties.

That framework should be applied to see whether informal reputational enforcement of commercial norms, private compulsion, or a coordinated merchant network exist or would be effective or whether government intervention would be required or desirable. Thus, even if the substantive content of a trade usage can be justified on the grounds that it allows parties to overcome impediments to the express inclusion of a term in a contract to increase gains from trade, a final question remains as to the choice of an enforcer for the particular substantive norms in particular settings.

The choice of an enforcer must include the possibility that courts are imperfect, but also recognize that courts might have a comparative

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[46] These include the observability of deviance from the norm and the effectiveness of social sanctions which depends on the existence of such factors as a close-knit community and the ready transmission of knowledge about the deviance.

[47] *See* NORTH, *supra* note 36, at 55 (linking rise of delegation to agents to problems of increased opportunism); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (analyzing theories of agency and ownership structure).

[48] Richman, *supra* note 43, at 2329.

[49] *See id.* at 2341–42; *see also supra* note 46 and accompanying text.

[50] *See* Avery W. Katz, *Contractual Incompleteness: A Transactional Perspective*, 56 CASE W. RES. L. REV. 169, 176 (2005) (noting that economies of scale may justify litigation costs).

advantage in policing against opportunism in certain circumstances,[51] especially when there is clear evidence of opportunistic behavior by one party, large sunk costs, and no possibility for parallel opportunistic behavior by the other party.[52]

Government intervention may be required not only when there is a misalignment between the personal preference and the social welfare but in addition when parties fail to account for the harms on others outside the group. When social norms benefit group members, but harm those outside the group, an externality problem is created.[53]

There are ordinarily no external effects with contractual agreements, but there are likely to be divergences and defections; therefore, the resolution of government intervention should depend on the prior framework.

The stakes of the incorporation decision are high. Unless the court enforces the private usage or private enforcement devices are effective, the problem of opportunistic behavior may go uncontrolled and parties may defect. If private enforcement is ineffective or more costly, then the failure of courts to enforce will lead to deadweight losses[54] as parties react to the uncontrolled hazard of opportunism.[55] Reactions could include decreased investment and an unwillingness to contract at all.[56]

If trade usages are specifically devised to control a potential hazard and maximize benefits, then a strategy of incorporating those usages may

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[51] POSNER, *supra* note 35, at 154 (recognizing that the threat of legal enforcement can deter opportunism even though the court is unable to distinguish when a breach has occurred); *see also* ELLICKSON, *supra* note 1, at 249–53 (suggesting differences in relative competence of enforcers in reducing deadweight losses and suggesting comparative advantage to government where there are "[g]roups with large or transitory memberships" or "social imperfections").

[52] This may be because only one party has sunk costs and is therefore vulnerable to holdup.

[53] I am using externality here to "refer to the *fact* that a *loss was not bargained into an agreement* prior to the occurrence of the loss" which raises an efficiency issue. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (June 28, 2005, 3:49 PM) (on file with Connecticut Law Review).

[54] The phrase "deadweight losses" refers to the "objective aggregate shortfall members would suffer were they to fail to exploit all potential gains from trade." ELLICKSON, *supra* note 1, at 172.

[55] Parties can use a variety of private mechanisms to overcome such problems given the inherent difficulties with contractual solutions when sunk costs, opportunism and behavioral uncertainty are present. One such solution is vertical integration or property ownership. *See* OLIVER HART, FIRMS CONTRACTS, AND FINANCIAL STRUCTURE 23–33 (1995) (exploring why barriers to ex ante contracting and problems of ex post negotiation costs, including the possibility of the hold up of the party who has invested transaction specific costs, may be partly solved by property ownership of a firm). Francesco Parisi explains that conventions may also help mitigate the defection problem that results in non-optimal outcomes that would otherwise materialize when "defection promises higher payoffs and there is no contract enforcement mechanism." Francesco Parisi, *Customary Law*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 572, 575 (Peter Newman ed., 1998). Parties' control mechanisms to manage opportunism will increase joint surplus beyond what would exist if such opportunism were uncontrolled. *See* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 60 (1996) (asserting that "the mitigation of hazards can be the source of mutual gain"); *see also* Lazzarini et al., *supra* note 42, at 289–90 (arguing that enforcement of formal contracts can be beneficial when contracts are incomplete on non-contractible dimensions).

[56] DIXIT, *supra* note 36, at 2.

provide significant advantages over a plain meaning strategy that automatically excludes them from legal enforcement. When a court intervenes by enforcing private usages to curb opportunistic behavior, the court's enforcement of private usage will curb a deadweight loss.[57]

Parties often cannot curb opportunistic behavior by detailed controls ex ante in part because they cannot anticipate all the myriad forms of opportunism. Generalized clauses that might be negotiated as an alternative means of controlling opportunism under conditions of bounded rationality and that might obligate the parties to act in their joint best interests may not be sufficient to assure parties that they will not be taken advantage of because they will either be disbelieved or too vague to be enforceable and thus will not be effective.[58] Parties may accord little weight to such generalized clauses because the clause means nothing if subscribed to by parties with a proclivity for opportunism—a matter that will remain unknown until it is too late. Commercial usages, on the other hand, have the advantage of being developed by a wide group of parties and subscribed and adhered to as the best practice for dealing with certain unaddressed contingencies, many of which would control opportunism, if enforced, but facilitate opportunism if denied enforcement. The development of trade usages gives the court a clear benchmark against which to measure opportunistic behavior when one party seeks to deviate.

Recent attacks on the norm incorporation strategy[59] stem from the failure to situate it squarely within the context of structural impediments (that include uncertainty about the probabilities of opportunism) and the failure to develop a particularized comparative functional cost/benefit analysis that takes account of the kind of opportunism that many trade usages are designed to overcome. Those failures have led to a number of analytical errors in the criticisms launched against the norm incorporation strategy. Ignoring bargaining impediments has caused critics of incorporation to reject a default rule that incorporates commercial practices and to assume mistakenly that gains from trade will be maximized when commercial practices remain legally unenforceable. They argue that parties intentionally operate in two parallel universes or domains, the

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[57] The intervention question here is different than the one presented when courts are asked to supply terms that parties have studiously avoided incorporating in their contract because their noncontractible nature will increase the chance for opportunistic claims. If parties have avoided making the buyer's price contingent on the future realization of the unverifiable state of demand, courts should decline to later condition obligations on such demand. Doing so would give one party the unbargained-for opportunity to falsely claim low demand to get a better price, thereby promoting a moral hazard problem.

Professor Alan Schwartz addresses the moral hazard problem in discussing the verifiability problem in contracting. *See* Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 272 (1992).

[58] *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 47–49 (1985).

[59] *See supra* pp. 455–56.

formal and informal, and do not intend for commercial practices outside the express contract to be enforced.[60] Understanding the functional role of trade usages in curbing opportunism and increasing joint gains mitigates the critics' unqualified arguments for plain meaning and informal enforcement.

Part II of the Article argues that the norm incorporation strategy is a form of legal intervention that should be justified in instrumental terms and that many current analyses of norms, in both social and commercial contexts, incompletely analyze that issue.

Part III outlines a structure for clarifying the meaning and the source of business norms. It examines different sources for norms including private compulsions that develop without interaction with others. It also examines norms that arise through interaction between parties to an exchange.

Part IV argues that the key to understanding the role that the court should assume with norms is to understand the parties' goals. In the context of communities and contracts, parties will work to control defection and opportunism to increase gains from trade. Parties may work to internalize externalities so that the pursuit of private gain does not adversely impact the community and efficiencies can be achieved.[61] Part IV looks at private strategies that parties can use to minimize deadweight losses and maximize gains in the hypothetical context of the stylized prisoner's dilemma. Part IV concludes by looking at two empirical settings illustrating successful private efforts to promote cooperative behavior and control deviant behavior: Shasta County cattlemen[62] and medieval merchant guilds.

Part V identifies the critical structural factors that facilitate informal norm enforcement. Part V argues that if such robust self-enforcement mechanisms do not exist, it may be beneficial if the law enforces such norms.

Part VI suggests a taxonomy for assessing the business norm incorporation strategy. The taxonomy starts with the parties' presumed goals of curbing opportunism to maximize gains from trade. It then explains the various reasons why parties might not "situate a custom's

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[60] Critics argue that incorporation will have other negative effects, including the increase of moral hazard and interpretive error, and the misguided incorporation of relationship preserving norms into an end game situation. *See* Bernstein, *supra* note 7, at 1796–1802.

[61] When a contractual agreement benefits the parties, but visits significant harms or losses on those not a party to the agreement, an externality occurs. Examples include the Mafia code of silence, and race discrimination. Both of these practices benefit parties who engage in them, but significantly harm parties outside the agreement. *See* Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 349, 389 (1997).

[62] *See* Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986).

substantive content in their main contractual communication."[63] These reasons include structural impediments that interfere with ex ante contractual controls of opportunism hazards. It is important that such hazards be mitigated either informally through the parties or through legal enforcement. Legal enforcement should depend on a number of factors. Rather than rejecting the strategy of incorporation as invariably flawed,[64] courts should look at how strong the factors are that would support informal enforcement. Courts should also consider the benefit that legal enforcement has when it can be invoked by parties as a way of establishing one's reputation and deterring large scale defections.[65] Finally, because there are logical explanations for omitting a commercial trade practice, courts should be willing to incorporate such business norms if doing so would achieve greater net benefits for the parties than the strategy of denying enforcement. Part VI outlines a number of factors that determine whether the "nature of the substantive issue"[66] warrants legal enforcement.

Part VI also examines case law in which courts routinely incorporate trade usages to curb opportunistic behavior. It offers contrasting cases in which courts deny that a trade usage exists or refuse to apply it, most often when the party seeking relief is acting opportunistically by trying to shield himself from contractually assumed risk or when recognition of the trade usage would permit the claimant to act opportunistically by shifting his own losses to the other party. The varying results in the case law can be explained by whether invocation of and recognition of the trade usage would achieve the functional purpose of reduced opportunism, the structural impediments to express incorporation of trade usage and the relative cost of legal enforcement when compared to informal enforcement mechanisms. Legal enforcement costs might rise when a court might have a difficult time judging which party is guilty of opportunistic behavior. The difficulty of verification could, for reasons to be explained later, be particularly vexing and is likely to arise in contexts in which one party claims that another's course of dealing or course of performance has permanently altered contractual rights, making it impossible to insist on enforcement of those rights.[67] The case law illustrates the operation of the taxonomy for deciding the incorporation question. Part VII utilizes the framework suggested here to reexamine criticisms of norm incorporation strategy. Part VIII concludes the Article.

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[63] E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (June 28, 2003, 4:23 PM) (on file with Connecticut Law Review) [hereinafter Coffey, June 28, 2003 E-mail].

[64] *See* Bernstein, *supra* note 7, at 1768–69.

[65] *Cf.* POSNER, *supra* note 35, at 158.

[66] Katz, *supra* note 50.

[67] Omri Ben-Shahar argues that where uncertainty makes it difficult for a promisee to detect breaches, the current flexible approach of the U.C.C. will make a promisee worse off by necessitating "more expenditure on monitoring." Ben-Shahar, *supra* note 6, at 812.

II. LEGAL INTERVENTION THROUGH NORM INCORPORATION: EXPANDING THE INCORPORATION QUESTION TO INCLUDE FUNCTIONAL ANALYSIS

Whether the law should incorporate a business norm[68] into a contract should depend on whether legal incorporation of that norm can be justified in efficiency terms.[69]

If the parties enter into a complete contract and specifically add all of the relevant trade usages controlling behavior and terms of art[70] that they want to govern their contract and its interpretation, the efficiency question would be easy. There would be no need to confront the normative question of whether trade usages that are not part of the express contract should be recognized.

Because of structural impediments, however, it may be difficult for the parties to reach a completely contingent contract that solves all of their problems. One of the ways that courts may respond to the incompleteness in a contract is by incorporating parties' trade usages and business norms into the contract.

Of course, when courts enforce business norms, through the U.C.C., that were not included in the express terms of the contract, they are intervening.[71] The law could decide to limit enforcement to the express terms of the contract.[72] Alternatively, courts could intervene by adding terms to supplement the parties' agreement.[73] However, the particular type

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[68] The commercial norm could take the form of a course of dealing, course of performance or usage of trade. *See* U.C.C. § 1-303 (2006). Most of the case law examples will involve usages of trade. *See infra* Part VI.

[69] Some scholars argue that norms are likely to be efficient and norm incorporation will automatically result in efficient results. Others argue that under certain circumstances norms are likely to be inefficient and the efficiency of the incorporation decision must therefore depend on the circumstances in which the norm was developed. *See, e.g.*, Cooter, *supra* note 3, at 1691 (pointing to negative spillover effects or externalities as indicating structural deficiency that may yield inefficient customary norms).

I will assume that efficiency is an appropriate norm for contract rules to pursue. Moreover, failure to give legal effect to utilitarian commercial norms may cause parties to devise other means to achieve their goals that could be more costly. *See supra* note 55.

For an intent based argument that custom and course of performance should be incorporated because they form part of the parties' language and thus reflect the parties' assent to such incorporation, see *infra* text accompanying notes 77–83.

[70] Kraus & Walt, *supra* note 8, at 199. The Kraus and Walt article discusses efficiencies in parties being able to use terms of art that courts will recognize as "analogous to the efficiency of terms of art within academic and technical disciplines." *Id.* By enforcing the contract and incorporating trade specific meanings between the parties, the court would implement optimal outcomes and avoiding the translation costs incurred when parties convert "understandings already carried by domain-specific meanings of available specialized terms into an equivalent using the plain-meaning' of terms . . . ." *Id.*

[71] This Article will use intervention as the financial and institutional economists do to refer to instances in which courts add terms beyond the ordinary meaning attached to express words. However, as Professor Craswell points out, even questions of interpretation of express terms may require a court to choose to assign them an ordinary meaning or some other approach. *See* Richard Craswell, *The "Incomplete Contracts" Literature and Efficient Precautions*, 56 CASE W. RES. L. REV. 151, 154 (2005).

[72] *See, e.g.*, Ben-Shahar, *supra* note 6, at 786.

[73] These include default terms of price, delivery date, etc. *See* U.C.C. § 2-305 (2003).

of intervention involved in the norm incorporation strategy is of a peculiar type of governmental intervention. Instead of formulating a common law rule on its own or drafting a law or term to govern, the legal decision maker gives legal effect to substantive practices already formulated and adhered to by private parties.[74]

With this peculiar "hybrid" type of legal intervention in which the court enforces, supplements and interprets private agreements using business norms,[75] the court's role may remain hidden. The intervention implicit in the legal incorporation of parties' norms does not seem obvious, especially when one considers that scholars and judges consistently repeat the adage that norm incorporation involves finding the parties' own business norms rather than making law.[76] But the decision to give legal effect to those norms still requires an instrumental justification.

Professor David Snyder confronts the intervention question by arguing that because business norms are in effect part of the parties' language as much as express words are, they should be given similar effect.[77] Professor Snyder justifies intervention based on protecting the intention of the parties to the deal, an intention that can be reflected both in the express bargain and in the trade usages or business norms followed by the parties.[78]

The argument is that business custom is part of the parties' language and should be given the same effect as the parties' express words.[79] "[C]ustom and usage (across sets of counter parties) and prior course of dealing . . . *are really express terms*," not part of the substantive contract but yet not completely "unspoken."[80] Instead, nonverbal conduct exists in the form of a pattern of conduct. "A custom might be a pattern that exhibits the following express content: 'If such-and-such a contingency occurs, parties will respond thus-and-so.'"[81]

The language-based rationalization for the incorporation of custom and conduct is in essence a "linguistic" argument. "Language, as Wittgenstein taught and as the drafters of the original Code knew, consists of more than words."[82] Under this approach the justification for using business norms and conduct rests on a definitional argument. Since contract is based on language, if we can expand the definition of language to include custom

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[74] The decision to recognize norms in the formulation of law can arise in other contexts as well. In deciding negligence questions in tort law, a court may look to operative norms to determine whether conduct is negligent. *See* Richard A. Epstein, *The Path to* The T.J. Hooper*: The Theory and History of Custom in the Law of Tort*, 21 J. LEGAL STUD. 1, 1 (1992).

[75] Ben-Shahar, *supra* note 6, at 786.

[76] Parisi, *supra* note 55, at 572.

[77] David V. Snyder, *Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct*, 54 SMU L. REV. 617, 617–18, 629–30 (2001).

[78] *Id.* at 632.

[79] *Id.* at 617–18.

[80] Coffey, June 28, 2003 E-mail, *supra* note 63.

[81] *Id.*

[82] Snyder, *supra* note 77, at 618.

and conduct, then it, too, should be given effect. Implementation of custom can then be justified in assent-based terms since "[n]onverbal conduct may be a better indicator of assent than verbal conduct."[83]

The linguistic defense for including commercial norms is implicitly based on the justification that if the parties' bargain includes non-contractual practices, the practices must be wealth-improving. If the bargain includes both the express contract and the trade usage, then presumably enforcement of both will improve the parties' wealth.

This Article argues that we would be more secure in our assessment of whether incorporation of business norms advanced wealth if we better understood the goals of the parties and how certain obstacles can prevent the development of a complete contract that can achieve those instrumental goals. The effort to subsume custom and conduct under the large umbrella of the word "language" does not fully address whether the law *should* use this form of express communication (nonverbal conduct-based) to modify or interpret the express contract terms. Deciding that issue requires that courts advert to the central issue of why the parties failed to include the usages or norms in their express contract (structural barriers), and when the conditions are ripe for the parties to self-enforce the privately developed usages. Whether the law's supplying them through incorporation would serve the instrumental goals of maximizing welfare for the parties depends on assessing these matters.

III. CLARIFYING THE SOURCE AND TYPES OF BUSINESS NORMS

This Part will outline a structure for clarifying the meaning and the source of norms. Without that clarification, resolution of the central question of whether intervention by the government will be needed to help the parties achieve their desired goals to implement trade norms will remain clouded.

Clarification should first illuminate whether the norm is the source of and "input" that forms the basis for the governmental intervention. A statutory norm that developed in the wake of a governmental intervention in the form of a law would not be an *input* for a governmental intervention but would itself be the *product* of the intervention.[84] A governmental intervention requiring by statute that a corporation be governed by the Board of Directors rather than by individual shareholders would then lead to a statutory norm that was itself the product of the legislation.[85]

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[83] *Id.*

[84] E-mail from Professor Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (June 27, 2005, 2:52 PM) (on file with Connecticut Law Review) [hereinafter Coffey, June 27, 2005 E-mail]. I am grateful to Professor Coffey for clarifying this distinction.

[85] *Id.* Of course, in some instances, there is an interaction between norms that pre-date the passage of a governmental prohibition (inputs) and a governmental intervention in the form of a statute.

In other cases there are norms that precede any governmental intervention by statute or common law and these would constitute a different type of norm, an *input* that would affect the decision to intervene. Since such norms may exist in different settings, a governmental decision to intervene in some fashion will depend on a comparison of the utility and cost amongst these different types of norms for achieving the parties' overall goals (such as welfare improvement). These norms are one type of institution that may shed light on how costly enforcement is likely to be.[86] Since enforcement is a component of the costs of transacting, it is important to pay attention to the means of enforcement, both formal and informal, and to the degree to which the means of enforcement are working effectively.[87] Economies will prosper when the costs of contract enforcement are low and conversely, economies will stagnate when enforcement costs are high.[88]

Norms can consist of "private compulsions," or norms or morality that develop without interactions with others and are not a result of a bilateral give and take.[89] One could as an individual be predisposed to act or refrain from acting in certain ways as a result of biological or cultural influences.[90] The predispositions could arise spontaneously. Alternatively, some of these compulsions could be *taught*, as in a family or tribal setting. A compulsion persists if it constitutes a "maximum of cohesive social behavior that survives the test of time."[91] Those that survive over time "must necessarily be, or are in the process of becoming, rational: they serve the fitness needs of those who unintentionally created them."[92] Sometimes individuals will react to the "manner in which their environment represents itself."[93] As a result of each individual reacting to the environment in a similar manner, substantive rules along with particular means of enforcement may develop.[94] When these norms or rules are violated, then often the individual's own conscience serves to self-sanction, obviating the need for governmental enforcement. Self-

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In some cases the passage of a statute may strengthen a pre-existing norm and unleash norms of enforcement by empowering people to become unpaid norm enforcers. *See* Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1613 (2000).

[86] *See* NORTH, *supra* note 36, at 33 (discussing different means of enforcement as "institutional constraints").

[87] *See id.* at 54 (pointing out that effectiveness in enforcement varies and that such variations contribute to differences in transaction costs).

[88] *Id.*

[89] *See supra* note 83.

[90] Vernon L. Smith, *Constructivist and Ecological Rationality in Economics*, 93 AM. ECON. REV. 465, 469 (2003).

[91] *Id.* at 470 n.19 (2003).

[92] *Id.* at 471.

[93] HAYEK, *supra* note 24, at 45.

[94] The peculiarities of a market of fish wholesalers whose product (fish) could quickly deteriorate in value helps to explain the wholesalers' avoidance of judicial enforcement of their sales contracts where such courts could not "assure transactional security" given the time constraints under which the fish wholesalers were operating. Richman, *supra* note 43, at 2343, 2366.

enforcement may also occur when "people impose constraints upon themselves"[95] because of the fact that parties are living in primitive or tribal or other close knit-societies characterized by parties having "a great deal of knowledge about each other and [being] involved in repeat dealings."[96] In those cases, defection or opportunistic behavior is unlikely to occur because in such cases, parties are better off complying with the norms of behavior. "[F]ormal contracting does not exist" in such groups.[97]

When the temptation to defect increases, other norms or informal constraints could arise as a result of interactions between transactors to temper such behavior. Some may arise through an overture and response by transactors in the context of an exchange. Other types of informal constraints may result not from response and overture as in a tit-for-tat but as a spontaneous effort to lower certain costs of exchange, such as measurement costs.[98] One such informal constraint/device would be standardized weights and measurements without which parties would devote "excessive resources to measurement" costs or perhaps discourage parties from contracting.[99]

In the context of such exchanges, we will first assume there are common assumptions that one can make about the parties' goals.

> In a modern society based on exchange, one of the chief regularities in individual behavior will result from the similarity of situations in which most individuals find themselves in working to earn an income; which means that they will normally prefer a larger return from their efforts to a smaller one . . . .[100]

At the same time in exchange transactions, in which parties are engaged in commerce or production and interacting with others, the potential exists that parties will relentlessly pursue their self-interest and act in opportunistic ways at the expense of the other party. Despite this potential, parties in tight-knit settings may develop cooperative wealth maximizing norms that will contribute importantly to social order[101] while at the same time shielding the parties from the coordination, negotiation, and administrative costs necessary if they had to solve their problems by individually negotiated contracts.[102] Many of these norms arise because of the possibility that defections by one party will be resolutely punished by

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[95] NORTH, *supra* note 36, at 36.
[96] *Id.* at 55.
[97] *Id.*
[98] *Id.* at 41.
[99] *Id.*
[100] HAYEK, *supra* note 24, at 45.
[101] *See* ELLICKSON, *supra* note 1, at 168.
[102] *See* Richman, *supra* note 43, at 2357 (calling such costs "prohibitive").

the other party;[103] hence the terms "overture" and "response" to describe such practices. The likelihood that parties will actually have to resort to punishments against deviants in such tight-knit settings may be very slim. The success of such institutional responses may in fact preclude the need to resort to sanctioning as parties will be aware that the consequences of deviant behavior will be swift and effective and far-reaching, given all of the potential social and business consequences of non-compliance.

The other non-governmental means in which parties can achieve their goals is the collective intervention of a non-governmental body such as a merchant group that both develops rules and enforces them. Modern examples include the FASB and NASD for policing the accounting and securities industries. These collective institutional responses develop partially in response to the problems of information—that it is difficult and costly to know information about the behavior of other parties. Whenever such information is unavailable or costly to acquire, institutions of some kind are going to be required because "self-enforcing cooperative solutions"[104] will only be possible when that information is available. Institutions may have advantages over the individual sanctioning process. First, institutions become repositories of information about past behavior of merchants that makes it less costly for the participating transactors to acquire information about past opportunistic behavior. Second, without a collective means of punishment, enforcement might not be achieved. Individual merchants might decide to trade with an offending party even after that party had engaged in opportunistic behavior because he could secure favorable terms for trading, even though everyone would be better off if all parties participated in a collective punishment action. In these kinds of circumstances a collective intervention may be necessary to "provide incentives for those individuals to carry out punishments when called on to do so."[105]

IV. WELFARE MAXIMIZATION AND TWO ILLUSTRATIONS FOR PRIVATE STRATEGIES TO ACHIEVE WELFARE MAXIMIZATION: SOCIAL COOPERATIVE NORMS AMONG CATTLEMEN IN SHASTA COUNTY AND THE MERCHANT GUILD

This Part will first examine the substantive explanation for why rational actors will seek to control opportunism and promote cooperation to maximize welfare. It will then look at private means that parties can use to achieve such goals in the hypothetical prisoner's dilemma. Two empirical

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[103] *See* ELLICKSON, *supra* note 1, at 164–65 (discussing a tit-for-tat strategy).
[104] POSNER, *supra* note 35, at 57.
[105] *Id.*

cases will then demonstrate how the parties' drive to promote cooperation, control defections and achieve transactional security is accomplished outside a legal framework.[106] In the first example, involving Shasta County cattlemen, parties operated almost totally outside of the law through social norms.[107] In the other case of the medieval merchant guild parties responding to the absence of state courts and strong legal authorities devised merchant guilds and other private institutional structures to enforce contracts, secure commitments and promote trade and security.[108]

In a subsequent Part, the Article will draw on these empirical examples to identify the structural factors that make informal enforcement of substantive norms possible. It then proposes a taxonomy for judging whether and when courts can improve welfare by incorporating trade usages in commercial contracts.

A. *The Substantive Norms of Cooperation: The Key Problem for Contractual Players and Others*

Before looking at the trade usages and norms in contractual settings and the role that the state should play in enforcing trade usages, it would be useful to look at the basic problem that parties have when dealing with one another in a variety of settings to observe what kind of substantive norms evolve and what functions they serve. The section will then address the separate issue of determining who enforces such substantive norms, after examining alternative mechanisms for sanctioning deviations from the norms, their effectiveness, and the conditions that make particular types of self-sanctioning mechanisms or structures cost effective.

1. *The Prisoner's Dilemma: Parties Overcome the Dilemma by Private Tit-for-Tat Strategy*

One problem that parties face is the potential that one party might defect and lower the gains from trade that would result from cooperation.[109] It is a key assumption that in this prisoner's dilemma,[110] both parties would be better off by cooperating. Yet, if each party pursues rational self-interest in a series of decisions in which he is unsure about the choices of the other party, mutual defection would result, "an outcome . . .

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[106] *See* Richman, *supra* note 43, at 2329 (discussing the need for "transactional assurance" as opposed to contractual assurance).

[107] They do, in rare cases, resort to the law to settle cases involving collisions on the highway between cars and cattle. ELLICKSON, *supra* note 1, at 94 (exploring factors associated with the legalistic approach to such collisions).

[108] Greif et al., *supra* note 34, at 746, 758, 771–72.

[109] *See* DIXIT, *supra* note 36, at 1.

[110] The prisoner's dilemma is often illustrated by the "example in which two, separately confined, prisoners accused of a joint crime each had to decide whether or not to confess . . . ." ELLICKSON, *supra* note 1, at 160 n.14.

worse for both players than [if] . . . they would have obtained had both [c]ooperated."[111] The prisoner's dilemma examines how one player would likely react to another player, given certain assumptions, including the inability to communicate with each other beforehand.[112]

Despite the potential of maximizing gains from trade, the rational actor theory and game theory suggest that parties will pursue their own self-interest relentlessly, even if that results in fewer overall gains from trade. Game theorists, who analyze how parties are likely to act, predict that "the rational pursuit of self-interest seems destined to be an engine of Hobbesian impoverishment rather than of welfare production."[113] However, such theorists suggest that the results in practice are the opposite; the parties often cooperate at times when the prisoner's dilemma theory might suggest that they would "rationally" pursue a strategy that yields fewer gains from trade.[114]

The key to overcoming the mutual defection outcome and achieving cooperation in the prisoner's dilemma rests on the possibility of repeat play and access to information about the other party's past behavior.[115] If one player has information about another party's past opportunistic behavior, then that player can, if repeat play is contemplated, punish the uncooperative behavior in future rounds. The party who threatens to punish defections engages in a tit-for-tat strategy.[116] This strategy actually encourages cooperation because it signals to the potential non-cooperator that the gains from bad behavior will be reduced in the future as a result of past bad behavior. Thus, each party knows there will be fewer gains in the future once bad behavior is revealed and, therefore, the party will have an incentive to cooperate from the start.[117]

This model of the repeat play game, in which parties resort to tit-for-tat strategies to punish the non-cooperative player, encourages cooperation without the intervention of the law. These norms arise through the interaction of players. If one party defects, the norm is to punish that behavior immediately but to resume dealings subsequently. The prisoner's dilemma is an example of an overture and response mechanism that arises when there is interaction between parties. It contains insights for identifying situations in which parties can effectively secure cooperation and punish defections on their own. It may also be useful in explaining the substantive norms of cooperation that evolve in the context of contractual relationships. It further helps to identify the relevant criteria for evaluating

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[111] *Id.* at 161.

[112] *Id.* The only form of communication is making an actual choice. *Id.* at 159.

[113] *Id.*

[114] *See id.* at 167.

[115] *Id.* at 164–65.

[116] *Id.* at 165. "As [Axelrod] presented it, tit-for-tat is a second-party system of social control. It is a strategy that is simple for a player to administer and for an opponent to recognize." *Id.*

[117] *See id.*

and comparing (1) the likely costs of and potential for successful achievement of the parties' goals through completely private reputational sanctions administered through a tit-for-tat strategy with (2) the conditions necessitating and facilitating private institutional enforcement (the merchant guild example) of norms with (3) the cost of a legal system enforcing a private substantive cooperation norm.

2. *Shasta County: Achieving Welfare Maximization Goals Through Social Norms Outside of the Law*

Parties can achieve cooperation and punish deviant behavior through the development of neighborliness norms in a closely-knit community by utilizing information about another party's behavior to punish non-cooperators. Bob Ellickson's study of Shasta County cattlemen demonstrates this cooperative norm development.[118] It is a real world example of an input[119] developed through interactions.

The incentive to develop particular substantive norms arises from the fundamental assessment that "people by nature want more satisfactions."[120] In any setting involving multiple parties who are interested in maximizing their own welfare, members of closely-knit social groups will "encourage each other to engage in cooperative behavior" as a way of maximizing total welfare.[121] If parties fail to cooperate, there will be fewer total gains from trade,[122] resulting in "deadweight loss[es]."[123]

The norms developed in Shasta County among cattlemen were cooperative and therefore welfare-maximizing.[124] Because the cattlemen were involved in the production of cattle, one can assume that their norms

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[118] *See generally*, ELLICKSON, *supra* note 1.

[119] *See* Coffey, June 27, 2005 E-mail, *supra* note 84.

[120] ELLICKSON, *supra* note 1, at 170 (reflecting utilitarian theory of value maximization).

[121] Ellickson refers to norm makers maximizing welfare rather than utility since evidence of personal tastes is not available to the norm maker. *Id.* at 167, 171–72.

[122] *See id.* at 167 (describing how informal social norms encouraging cooperation will maximize welfare).

[123] *Id.* at 172.

[124] In most cases concerns about one's reputation would be effective in securing compliance. This was especially true because neighbors could count on a variety of other interactions with each other. If one's reputation were sullied by failure to adhere to the norm requiring one to control one's livestock, one would be likely to suffer in other types of dealings. They would also be induced to comply because of the likely "average reciprocity of advantage." *Id.* at 55. One would be induced to comply not only because of negative consequences from deviating, but also because one would directly benefit from the norm when in the position of being a victim rather than the perpetrator of the trespass.

When norms of the kind described by Ellickson are involved, they are developed by parties in the society (Ellickson describes them as "third party enforcers"). *Id.* at 231–32. There is no actual bargained-for agreement that demonstrates that a norm would make both parties subject to it better off. Nonetheless, there are indications that individual parties do subjectively value the norms because they may be willing to offer services for cooperative behavior from another neighbor. The evidence that parties in certain social settings are driven to develop welfare-maximizing norms is hard to prove when there are no contracts to evidence those parties consider themselves better off. The way that one is assured that a transaction is optimal is that the willingness to enter the deal signals a determination that the deal has increased each person's utility, based on subjective preferences as they are revealed in the terms negotiated. *See id.* at 171–72.

included what steps to take to control errant cattle or maintain cattle boundary fences, as well as how to enforce the practices[125] would arise or be designed to increase "shareable welfare."[126] A number of such cooperative norms existed. For example, adjoining landowners shared the cost in proportion to the livestock kept.[127] Each bore responsibility for the acts of wandering cattle but also "put up with ('lump') minor damage stemming from isolated trespass incidents."[128]

The cost norm that made adjoining landowners responsible for sharing the costs of a boundary fence presumably made both parties better off. Each secured the advantages of a fence often by shouldering less than the full cost of the fence.[129] The norm also saved contract negotiation costs.[130] The norm that made livestock owners responsible for the acts and damage of their animals clarified the liability issue and protected neighbors from the persistent ravages of errant cattle. In the case of isolated cattle trespass, the neighborly norm suggested that parties tolerate the behavior. Because the risk of such trespass was thought to be relatively symmetrical, "if victims bear all trespass losses, accounts balance in the long run."[131] Parties thereby saved the costs of lawsuits to settle disputes. Although one cattleman might suffer by reputational sanction if he had cows that trespassed, in other cases, he would benefit because a trespass by cattle of other cattlemen would subject that owner to a similar reputational harm.

Cattlemen had a variety of other neighborly sanctions to apply when one neighbor deviated from a norm. When cattle trespassed, a neighbor with the facts called to alert the owner and offer assistance in rounding up the cattle.[132] Cattlemen also resorted to "truthful negative gossip" and relied on concerns about harm to one's reputation to induce adherence to the norm.[133] If lesser self-help sanctions such as gossip were not effective, parties could resort to a graduated spectrum of self-help sanctions that included "herding the offending animals to a location extremely

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[125] *See* ELLICKSON, *supra* note 1, at 126–27 (identifying "*controllers* that may be sources of both rules of behavior and sanctions that back up those rules").

[126] *Id.* at 170.

[127] *See id.* at 25–28 (explaining the "benefits and costs of boundary fences"). Under the proportionality norm espoused by Ellickson, "adjoining landowners . . . share fencing costs in rough proportion to the average density of livestock present on the respective sides of the boundary line." *Id.* at 71. In reality, the costs of close monitoring of the livestock caused them to resort to "'focal point' allocations of fence costs, such as fifty-fifty, all-or-nothing, you-materials/me-labor." *Id.* at 72.

[128] *Id.* at 53. "The neighborly response to an isolated infraction is an exchange of civilities." *Id.*

[129] The all-or-nothing rule would sometimes require ranchers to bear 100% of the costs "when an active rancher's pasture abuts a ranchette whose owner has few or no livestock; in these situations the proportionality norm requires the rancher to bear all the fencing expenses." *Id.* at 72.

[130] *Id.* at 246.

[131] *Id.* at 54.

[132] *Id.* at 53.

[133] *Id.* at 57.

inconvenient for their owner."[134] Violence to the cow was resorted to if other lesser self-help sanctions failed.[135]

Although some cattle owners resorted to complaints to public authorities, informal norms more often governed behavior.[136] Claims for monetary compensation were rare.[137] Instead, there was a norm of refraining from pressing claims for compensation and in most cases this policy of restraint "live-and-let-live" saved "the costs of going through the formal claims process."[138] Moreover, "[a]djoining landowners who practice the live-and-let-live approach are both better off whenever the negative externalities from their activities are roughly in equipoise."[139]

Because the cattlemen formed a tightly knit non-hierarchical social group, they successfully developed and informally enforced these norms.[140] To prevent welfare losses they were motivated to encourage cooperation while trying to minimize the transaction costs (including the transaction costs of enforcement).

Other structural factors contributed to the development and successful enforcement of the norms themselves. These included: the availability of information about the norm (advertising what the norm is), consensus and means of detecting defections and publicity about such behavior.[141]

While the reputational and informal enforcement of social norms developed by cattle owners were largely effective without legal enforcement, there were instances in which the reputational sanctions were not effective and there were deviants from the social norms. Deviance might take many forms including the behavior of failing to control animals; such deviants might be impervious to concerns about reputation[142] or they might be less susceptible to neighborly pressures because of the shorter duration of relationships with the victims.[143] To control such deviants, a graduated system developed that went beyond informal gossip and social punishments. The punishments included legal means both through reporting violations to relevant authorities and actually instituting lawsuits for compensation against offenders.[144]

Reputational sanctions may be less effective in inducing compliance when disparities in how many cattle individual ranchers own exist and the

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[134] *Id.* at 58.

[135] *Id.* at 58–59.

[136] *Id.* (noting that ranchette owners are more willing to report trespass incidents to public officials).

[137] *Id.* at 61.

[138] *Id.*

[139] *Id.*

[140] *See id.* at 168.

[141] *Id.* at 180.

[142] *Id.* at 56.

[143] *Id.* at 56–57 (explaining how "traditionalists" do not put as much stock in neighborliness as compared with "modernists").

[144] *Id.* at 57.

risks of harm are not symmetrical.[145] A rancher with only a few cattle might not see how the "live-and-let-live approach" would help him.[146] He might suffer many incursions and significant damage but since he owns few cattle of his own, he would not benefit from the "live-and-let-live" approach. The norm will redound mainly to the benefit of cattlemen with large herds and the small cattle owner will suffer without having that many cattle of his own that could benefit from others having to allow his cattle to trespass.

For these cattle owners the lack of equality in ownership would dilute the incentive of large herd owners to comply with cattle control against smaller, ranchette owners who could not retaliate for a norm infraction by letting their own large herd run loose. To account for that diluted incentive a particular norm arose of creating mental accountings of infringements that could be traded off against other inter-neighbor transactions.[147] If A has been the victim of many cattle trespasses, then he could expect another neighbor to contribute to erasing this deficit in the account by acting in other ways that benefit the injured party who lacks a reciprocal opportunity to have his cattle wander. The perpetrator could, for example, contribute to A's volunteer fire department service requirements.[148]

3. *A Private Alternative to Deterring Deviant Behavior: The Institutional Response of the Medieval Merchant Guild*

An awareness of how informal norms can evolve to solve problems, achieve cooperation, sanction non-cooperative behavior and achieve effective enforcement in closely-knit groups without the intervention of the law, suggests that enforcement of norms need not always be judicialized.[149]

However, in some settings the punishment of defectors through the possibility of future dealings and reputational sanctions (iterated play in the prisoner's dilemma) may not be effective in maximizing gains from trade. Instead, a formal, collective institution may be needed to achieve the parties' goals. When there are significant threats of conduct by one party that would discourage trade and reduce gains, and "undermin[e] the

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[145] *Cf. id.* at 54 (explaining that the presence of symmetrical risks will balance accounts).

[146] *Id.* at 55.

[147] *Id.* (discussing norm of "mental" accounting trading off and "keep[ing] track of minor losses" for an eventual accounting).

[148] *Id.*

[149] Scott, *supra* note 13, at 861. Moreover, judicial non-enforcement of such norms might be preferred by the parties in cases where judicial enforcement undermines the informal norms themselves. Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1645 (2003) ("[L]egal liability can increase moral hazard and it may also 'crowd out' the parties' self-enforcing mechanisms."). *See infra* Part VII.A.3 (suggesting that effect of legal liability rule on moral hazard will depend on nature of liability rule, purpose it serves and context in which it is applied).

foundations of the market economy . . . countervailing power" may be needed.[150]

The medieval merchant guild, a private institution in which parties devised an institutional enforcement solution outside of law to enforce contracts, control deviant behavior and promote cooperation, constituted one such collective, institutional response to a potentially serious problem.[151]

In medieval Europe, to encourage trade, a ruler would pledge not to appropriate merchants' property.[152] However, once trade was established and the merchant incurred substantial sunk costs, the ruler was tempted to renege on his commitment and appropriate merchant property "by using his coercive power."[153] In fact, rulers regularly reneged on their pledges and appropriated the property of individual merchants and subcategories of merchants.[154] Thus, contractual arrangements (the pledge) in and of themselves were not adequate to curb opportunistic behavior and allow trade to expand to its optimal level.[155]

To discourage such behavior by rulers, individual merchants could rely on a number of mechanisms. The repeat play of the prisoner's dilemma suggests that rulers concerned about possible future punishment by merchants and the loss of trade would be deterred from appropriating merchants' property and other similar acts.[156] However, the ability of individual merchants, or a small group, to effectively deter opportunistic behaviors by using threats of a loss of future trade, was limited.[157] They could engage in bilateral reputation mechanisms in which merchants who were victims would sanction the offending ruler by withholding trade from the trading center of the opportunistic ruler. However, as long as other merchants still traded with the center, the bilateral mechanism was not likely to be particularly effective since the loss from any individual merchant's trade was likely to be inconsequential.[158]

Multilateral mechanisms were also likely to be ineffective. In multilateral trading sanctions, an entire group of merchants reacts to an abuse by a ruler of a city of one trader. In such cases there would be "a collective punishment imposed on the city that included participation by merchants who had not been directly injured."[159] When the Muslim ruler

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[150] Greif et al., *supra* note 34, at 746.
[151] *Id.* at 748.
[152] *Id.* at 747.
[153] *Id.*
[154] *See id.* at 750–51.
[155] *Id.* at 747–48.
[156] *See id.* at 751.
[157] *Id.*
[158] *Id.* ("In our formal theory, the reason is that, at the efficient volume of trade, the value of the stream of future rents collected by the ruler from an individual marginal trader is almost zero and is therefore smaller than the value of the goods that can be seized.").
[159] *Id.* at 752.

of Sicily imposed a 10% tariff against Jewish traders in Sicily, the traders diverted trade from Sicily, the offending city, to other trading centers.[160]

Despite the potential for multilateral trade sanctions, they too are unlikely to be effective. First, in order for the other merchants not directly harmed by ruler abuses to participate in a multilateral sanction, they have to know about the abuse. This knowledge may be difficult to come by.[161] As Avner Greif points out, "[i]nformation asymmetry, slow communication and different interpretations of the facts among merchants imply that without an organization that coordinates responses, it was not likely that all the merchants would respond to the abuse of any group of merchants."[162] The second problem hindering multilateral mechanisms was that rulers could continue to ignore the threatened withdrawal of trade if the trade by the enforcing group was not significant enough.[163]

As long as the means of controlling the appropriation danger were not effective, trade "would not expand to its efficient level."[164] Merchants and rulers both needed a method for assuring adequate security; otherwise merchants would be reluctant to trade in a city. Consequently, merchants developed institutions such as the merchant guild which imposed embargoes to secure compliance with contractual commitments (made by the ruler). These mechanisms made up for deficiencies in the contractual arrangements and in the bilateral and multilateral mechanisms used to control the opportunistic behavior of rulers. The merchant guild was able to provide the security needed for economic expansion.[165]

Merchant guilds were able to play that role because they had monopoly power in their localities.[166] This meant that merchants associated with the guild could count on "streams of rents in their hometown"[167] so long as the merchants followed the guild's dictates. Thus, merchant guilds were able to use their collective power to punish rulers who appropriated the goods of individual merchants by issuing embargo edicts. The guilds "all shared the common function of ensuring the coordination and internal enforcement required to surmount the commitment problem [of rulers] by permitting effective collective action."[168] Those merchants who disobeyed the embargo would be subject to sanctions and possible expulsion from the guild and would lose the income generated by being a merchant in good

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[160] *Id.*
[161] *Id.*
[162] *Id.*
[163] *Id.* at 752–53.
[164] *Id.* at 748.
[165] *See id.* at 760.
[166] *See id.* at 757.
[167] *Id.*
[168] *Id.* at 748.

standing.[169] That would ensure ruler compliance because the threatened withdrawal of trade by the guild would be significant.

The story of the merchant guild and its function in overcoming opportunistic behavior of rulers is instructive for several reasons. First, the guild effectively enhanced trading and allowed it to expand to the optimal level. It benefited both rulers and merchants, which may have explained the rulers' willingness to establish merchant guilds in their trading centers.[170] Further, the guild, an administrative mechanism that operated through enforced embargoes, effectively discouraged defections from the embargo. The guild became a necessary construct after neither pledge alone (contract) nor bilateral or multilateral reputation mechanisms were effective in achieving adequate security.[171] Moreover, because the state was not capable of offering adequate legal enforcement of contracts, there was the need for some other device that could curb opportunistic behavior by rulers.

The merchant guild was an administrative apparatus that was developed by merchants to curb the potential for rulers to opportunistically exploit traders. Unless curbed, the opportunism would harm both rulers and their cities (who would suffer from decreased trade) and the merchants themselves (who would have their goods appropriated).[172] The guild provided an enforcement mechanism by a collective that punished violations of the contractual commitments extended to merchants. It was effective in overcoming the weaknesses in alternative devices for curbing such opportunism, including the simple contractual pledge by the ruler and the simple bilateral or multilateral reputation mechanism.

V. WHEN DOES EXTRA-LEGAL ENFORCEMENT OF NORMS OR CONTRACTS WORK EFFECTIVELY? ASSESSING "STRUCTURAL CONDITIONS"[173] FOR SUCCESS

The development of the informally enforced utilitarian norms of Shasta County and merchant guilds both demonstrate that parties can devise and use extra-legal enforcement mechanisms to achieve their goals through collectively-orchestrated and centrally-administered embargo sanctions that promote cooperative solutions and control opportunism. In the case of the merchant guild, the parties turned to a coordinated institutional structure for enforcement because other means of controlling opportunistic behavior, bilateral and multilateral reputational mechanisms and legal remedies, were unavailable or ineffective. In the cattle country, the parties

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[169] *Id.* at 758.

[170] *Id.* at 746 (documenting rulers' receptivity to merchant guilds).

[171] *See id.* at 747–49 (explaining superiority of guild over reputational sanctions individually administered).

[172] *Id.* at 747 (noting possible losses to both merchants and rulers from lack of security).

[173] ELLICKSON, *supra* note 1, at 178.

developed extra-legal mechanisms for enforcing norms and shunned reliance on public authorities, presumably because it was unnecessary or more costly to do so.

However, "neither self-enforcement by parties nor trust can be completely successful."[174] Moreover, "the returns on opportunism, cheating, and shirking rise in complex societies."[175] Therefore, determining whether there is a role for state intervention through legal enforcement of norms should depend on how effective the private compulsions are at self-controlling deviant behavior, whether the informal mechanisms are operative and functioning taking into account the structural factors that make such informal enforcement possible, how complex the society is and whether a coordinated merchant organization exists for disseminating information about and punishing defectors.

Private extra-legal enforcement mechanisms operate through reputational sanctions.[176] According to Professor Ellickson, the likelihood of successful informal or formal extra-legal enforcement mechanisms depends on the convergence of three "structural conditions" that are "conducive to the emergence of cooperation:"[177] the existence of a "close-knit group";[178] the presence of accurate information about the past behavior of their counterparty;[179] and the opportunity to "administer sanctions" by withholding future business or "retribution" in cases where there are future opportunities for repeat business.[180] Success of such group norms also depends on the existence of reciprocal opportunities for sanctioning others who depart from the norms. Social settings, where power is decentralized, offer the possibility of many opportunities for sanctioning.[181]

The presence of a close-knit social group is a key factor in judging whether welfare-maximizing cooperative norms will develop.[182] A closely-knit social group has several characteristics that facilitate the development and enforcement of cooperation and other such norms including: "reciprocal power, ready sanctioning opportunities, and adequate information."[183] On the other hand, members of parties that are transient populations without a closely-knit group have an increased temptation to defect because there is unlikely to be any ongoing

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[174] NORTH, *supra* note 36, at 35.

[175] *Id.* This is so even though the parties attempt to control such behavior through trying to "personalize exchange." *Id.* at 34.

[176] Richman, *supra* note 43, at 2328 ("The typical enforcement mechanism associated with private ordering is the reputation mechanism, in which a merchant community punishes parties in breach of contract by denying them future business.").

[177] ELLICKSON, *supra* note 1, at 178.

[178] *Id.* at 177–78.

[179] *Id.* 180.

[180] *Id.* at 178–79. Although Ellickson explored these conditions in the context of Shasta County, they are also applicable to and explain the success of the merchant guild.

[181] *Id.* at 179 & n.42.

[182] *Id.* at 167.

[183] *Id.* at 181.

relationship that would suffer from future sanctions. If they do not have adequate information about defections by others, then effective informal sanctioning by parties also would not be possible.

Because a close-knit social group is often non-hierarchical in nature, "informal power" is distributed amongst all members of the group,[184] creating a type of "reciprocal power."[185] "[E]ach member [of the group has] . . . enough power ultimately to punish the worst possible misconduct" and thus absolute equality of power is not necessary for group members to be able to achieve cooperative norms.[186] Ellickson's illustrative example is that if each party had a revolver, that power in itself would be enough to deter extremely bad behavior by members of the group.[187] It would not be necessary that each member have absolutely equivalent shooting skills in order for the power to be considered widely dispersed.[188]

A closely-knit group can easily and cheaply transmit information about past deviant behavior to other group members. In a closely-knit group, there is a greater likelihood that gossip networks and other such information transmission devices already exist that can relay information.[189] Closely-knit groups seem ideally suited to passing on information to others in the group through gossip about parties' past behaviors. There are often "interlinkages [that] help members share information about previous consensual economic and social exchanges."[190] When parties take on the task of sharing information and gossip, the costs are likely to be less than if a formal information network had to be established outside the closely-knit group. Reputational monitoring can work in close knit social groups if there is adequate information about the way in which another party in the group has acted in the past. If one party has acted in a non-cooperative way, then another group member may wish to punish that failure of cooperation. This immediate willingness to punish defections is described as the tit-for-tat strategy and it is one that can lead to "strings of mutually cooperative outcomes."[191] The tit-for-tat strategy can discourage parties from defecting from a cooperative strategy because they know that they will be punished in future dealings for doing so by a party who learns of that defection.[192]

In these closely-knit groups, power is decentralized so that each group member has the ability and opportunity to sanction others who deviate from the norms. Continuing relationships of a social nature or a business

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[184] *Id.* at 177. To be able to exercise that power, individuals need personal security. *Id.* at 179.
[185] *Id.* at 181.
[186] *Id.* at 179 n.42.
[187] *Id.*
[188] *Id.*
[189] *Id.* at 181.
[190] *Id.*
[191] *Id.* at 165.
[192] *Id.* at 164.

relationship may offer that opportunity.[193] Those members who fail to cooperate or who engage in bad conduct may be subject to expulsion or other lesser forms of punishment by individual members or by those considered "allies." That information is important in allowing parties to hold out the possibility of "future retribution" for past bad acts.[194]

Even beyond the confines of a closely-knit social group, in the context of impersonal sales transactions, the same phenomenon of sanctioning defectors or outliers may hold true. A potential purchaser's uncertainty about a particular seller may be mitigated by reputational monitoring or information built on past behavior to other buyers and the purchaser may make adjustments accordingly. Furthermore, the market itself may decide whether a party has acted opportunistically and will impose its own sanctions in the form of a poor reputation for a deviant seller. If a party sells an unreliable product, then that information may adversely affect that party's reputation and future buyers will then demand more guarantees or discounts.[195]

The reputational monitoring device in impersonal sales contexts depends on the presence of a market to detect past instances of opportunistic behavior and then spreading that information.[196] Because a party who behaves opportunistically may wish to sell other products to other consumers or seek repeat business, concerns about reputation may deter opportunistic behavior.

VI. A TAXONOMY FOR THE NORM INCORPORATION STRATEGY QUESTION: WHEN SHOULD THE LAW INTERVENE TO ENFORCE COMMERCIAL NORMS?

The previous parts of this Article have demonstrated that powerful substantive norms of cooperation may exist and that parties may effectively self-sanction or sanction deviations from those norms outside the framework of legal rules if certain conditions are met.[197] In addition, markets can use reputation to sanction deviant or opportunistic behavior.

There are many different "methods through which individuals control themselves and one another."[198] The key point is that rational parties will select control mechanisms, either by deliberate design or evolution, that maximize welfare by minimizing transaction costs and controlling the

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[193] *Id.* at 179 n.44 (discussing how opportunities for sanctioning differ depending on the nature of the relationship).

[194] *Id.* at 179.

[195] David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 413 (1990).

[196] *Id.*

[197] ELLICKSON, *supra* note 1, at 169 ("Because it implies that much order can emerge without law, it challenges Hobbes and the other legal centralists who have exaggerated the role of the Leviathan."). Parties rarely resorted to reporting violations to legal authorities. *See, e.g., id.* at 59 (noting that Shasta County ranchers prefer "to resolve their problems on their own").

[198] *Id.* at 123.

"*deadweight loss* arising from a failure to cooperate."[199] There will be more gains from trade to share if parties can curb behavior that minimizes gains, such as the tendency to defect or engage in other opportunistic behavior that minimize gains from trade, by self-sanctioning and reputational informal enforcement (assuming the means for transmitting information already exist because of an established community).

The fact that there are some tightly-knit communities in which robust self-sanctioning and reputational controls prevent defections and promote cooperation almost wholly outside of the law does not resolve what approach the law should take in different types of settings that might not share all of the characteristics of those communities. The existence of norms or private commercial trade usages in communities of traders suggests one possible answer to the norm incorporation strategy: the law should take a laissez-faire attitude and rely on the parties themselves to sanction deviations from the norms where there is already a highly developed system of social control (as in Shasta County) or rely on an already existing institutional structure for doing so.[200]

However, the fact that substantive norms and self-sanctioning methods have been developed by a particular community in particular settings does not resolve the general question of whether the law should ever intervene by enforcing a privately developed norm when called upon by one party to do so. The fact that parties have subscribed to a practice by following it does not resolve the question of whether departures from the practice should be enforced *exclusively* by reputational or other negative sanctions administered by the adversely affected party and others who learn of the defection from the norm.

As a party's personal interest in a norm varies and the divergence between one's personal preference and the social norms grows, the likelihood of substantial noncompliance is great.[201] Thus, a person who has followed a norm may decide, because of opportunistic reasons, that he would like to deviate. If private compulsions do not work to prevent the defection, forms of outside pressure are needed to enforce the norm. The community, after being informed of the defection, may bring external reputational sanctions to bear on the offender either through informal gossip or through a coordinated merchant network, if one exists.[202] This Article suggests that the normative aspect of incorporation strategy can thus only be resolved by examining the particular context in which the

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[199] *Id.* at 172.

[200] *See supra* Part IV.

[201] *See* Parisi, *supra* note 55, at 575 (discussing circumstances for defection, including cases "[w]hen unilateral defection promises higher payoffs and there is *no contract enforcement mechanism*") (emphasis added).

[202] *Id.*

trade usages arise to see whether the structural factors, that make informal enforcement successful, exist in that particular trade context.

The distinct issue at the heart of the norm incorporation strategy is, considering the myriad of ways that parties have for minimizing deadweight losses and controlling opportunistic behavior, whether the law should intervene to incorporate and sanction breaches of privately developed commercial norms. When the law does so, unless the parties carefully negate such norms,[203] it is in effect completing an incomplete contract for the parties. The question of the "power of the state"[204] in private contract is directly implicated and efficiency concerns should guide that decision.

To determine whether the law should intervene by incorporating trade usages developed by contracting parties, one first needs a taxonomy that can help explain the impediments that parties face in negotiating and policing contracts. Without that understanding one would naturally assume that the absence of any specific incorporation of trade norms would signal a deliberate choice that such norms were to remain without legal effect. The implicit argument might be: if the parties had wanted to legally enforce the norms, then they would have placed the norms in the contract.

A normative justification should start by considering what obstacles (if any) prevent parties from achieving a completely contingent contract; such a justification must also explain why the parties themselves may not be likely to expressly incorporate all relevant trade usages and customs in their contracts. If obstacles exist, then legal intervention incorporating a norm as a term would be justifiable as a means of optimizing the presumed goal of maximizing joint gains from trade but only if legal enforcement of commercial usages would be more effective and less costly than informal or self-sanctioning mechanisms.

Once the structural impediments to bargaining are fully explored, it becomes possible to understand that courts should enforce trade norms for the same reason that they enforce private agreements—to enhance the parties' gains from trade if legal enforcement of the private trade usages would be more efficient and effective than relying on the parties to self-sanction or informally police deviant behavior.[205] If the conditions necessary for informal sanctioning of group norm violations do not exist (no repeat play, no close-knit group, inadequate transmission of

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[203] *See supra* note 12.

[204] Greif et al., *supra* note 34, at 745.

[205] Parties could also seek to control potential opportunistic behavior by prescreening their contractual partners, a private non-contractual device that they self-enforce. They could also choose to exit contract altogether and vertically integrate rather than continue to be subject to frictions with a contractual partner. They could also choose to avoid legally enforceable contracts by belonging to an organization with its own set of formal rules, administered and enforced outside of legal sanctions, perhaps through arbitrators. *See, e.g.*, ELLICKSON, *supra* note 1, at 131, 135 (describing alternate forms of social control including sources of rules and methods for sanctioning).

information) and if no institutional structure exists for enforcement of the norms outside the legal structure, then legal intervention through enforcement would be beneficial, at least in certain types of cases later discussed.

One must first explore why the norm might have been omitted from the contract, and whether the norm is welfare maximizing. Then the issue of whom or what institution should enforce the norm may be addressed. Under ideal conditions there would be no structural impediments to prevent parties from reaching reciprocal bargains and complete contracts that achieve first-best outcomes. Courts could simply enforce agreements that had been negotiated by the parties. However, a variety of impediments hinder parties from achieving complete first-best contracts. If parties who are transacting with one another are not able to achieve their goals on their own through contract, they may then search for other devices to achieve their goals including the control of the central problem of opportunistic behavior.[206]

A. *Taxonomy for Bargaining Problems*

The first element that affects parties and makes complete contracting impossible is the problem of uncertainty. Uncertainty exists both with respect to (1) uncertainty about the world and events that have occurred or will occur and (2) uncertainty about how one's counterparty has behaved (the adverse selection problem) or will behave (the moral hazard problem).[207]

Opportunism is a facet of human behavior, endemic to mankind that necessarily complicates contracting. If uncontrolled, opportunism will lead to a loss in value for the parties. Uncertainty about one's proclivities for opportunism will prompt transactors to screen for this negative trait. Parties will try to control this hazard of contracting ex ante so that when disruptions occur, one is not subject to rent seeking by the other party.[208]

When uncertainty regarding the degree of the propensity for deviant behavior and opportunism exist, the difficulties for contracting are apparent. If one takes away either factor, complete contracting would be possible. If opportunism were present but each party knew the exact facts of the other party's past behavior as well as their propensity to act

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[206] *See* WILLIAMSON, *supra* note 58, at 63.

[207] *See id.* at 47, 63; E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (Feb. 15, 2004, 3:10 PM) (on file with Connecticut Law Review).

[208] Rent seeking is also referred to as transfer seeking. Robert D. Tollison, *Rent Seeking*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 55, at 315, 316 ("Transfer seeking is at best a zero-sum activity in that it simply shuffles dollars among people and groups, and is negative-sum if traditional deadweight costs result as a byproduct of such activities.").

opportunistically in the future, asymmetry would not be present and a fully contingent contract would be achieved and priced.

The third element—sunk costs—often occurs in conjunction with the other two elements and contributes to obstacles in contracting. When parties invest in assets or knowledge that is specifically tailored to a transaction and cannot be resold on the market without a loss, they generate sunk costs. Sunk costs matter when analyzing whether contracts alone can solve the parties' problems. If parties have no sunk costs, it will not matter if uncertainty about behavior exists and opportunism is present. When a contract fails to adequately control moral hazard, and one's counterparty attempts to exploit a disruption in the relationship, one may simply sell the investment on the market at no loss. The contractual inadequacy would not matter, as there would be no adverse consequences.

When all three of these factors converge in contracting relationships, explicitly reciprocal contracts to control opportunistic behavior will not be achieved. Thus, the contract alone will not allow the parties to maximize gains from trade on their own. The contract will not adequately control contractual hazards because each party harbors uncertainty about the other party's propensity for opportunism. It will not be possible to detail in advance all the myriad forms of opportunism that might take place. If there were no impediments, frictions or transaction costs, parties could freely negotiate or subscribe to whatever combination of norms, contract or other control mechanisms to achieve their goals of increased cooperation and welfare maximization. Even simplified solutions—such as a general clause promising to maximize joint gains—an alternative solution that does not require unbounded rationality—will not be effective because parties will not trust such a clause.[209] In the presence of such an incomplete contract, an opportunistic party will have the chance to hold up the other party when sunk costs have been invested, as there is no ready exit to the market.

B. *Taxonomy: Implications for Trade Usages*

Once these impediments to contract bargaining are recognized, it becomes possible to outline an appropriate framework for evaluating whether the law should enforce private business norms.

If parties transacting in an exchange relationship are not able to achieve their goals entirely through contract, they may still search for alternative cost-effective private strategies for achieving their goals.

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[209] *See* WILLIAMSON, *supra* note 58, at 63.

Norms or trade usages may be thought of as private strategies for achieving parties' goals of welfare maximization.[210] In some groups with all of the structural characteristics outlined above in Part IV (repeat play, access to information, close-knit group), legal enforcement of such substantive norms may be unnecessary because the private sanctions administered by individuals or a group render it superfluous. In cases where the costs of reliance on informal enforcement may be higher, or produce a less efficient result, and formal enforcement of the norms would increase the overall welfare of the parties because the court is able to easily adjudge the presence of opportunism, courts should supplement informal enforcement mechanisms. The decision should depend on (1) why the parties did not include the substantive content of the norm in their express contract; (2) the result of denying legal effect to the commercial norm (would refusal to incorporate facilitate or hinder opportunism); (3) the parties' expectations regarding enforcement; and (4) the role of "unseen processes" in developing the norms.[211]

To decide whether a particular trade usage should be incorporated, one should first grapple with why the parties did not include the substantive content of the trade usage or commercial practice in their express contract. After resolving the sources of incompleteness in the contract on the trade usage issue, one can address whether the source of enforcement for violations of the substantive norm should be the courts or the parties, or some combination of both.

The first explanation for the failure to include the trade usages in the contract is that parties often develop rules "without being able to articulate them."[212] In addition, they often develop such practices through the "workings of unseen processes."[213] If the parties are not able to articulate the norm if asked to do so, the likelihood that they would include these norms within their express contract would be low. However, the fact that the norms are not included does not tell us much about whether the parties formed an intention as to whether a court or the parties themselves would be the exclusive source of enforcement or whether the parties and the courts would act jointly to enforce the norms. Even if the parties were aware of the trade usage and could articulate it, there would be several reasons for not including it that might lead to different conclusions about whether a court should enforce the business norm.

One reason for not including the trade usage in the contract is that the parties might conjecture, "Why should we bother to talk about this in a

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[210] E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School (June 10, 2003, 3:52 PM) (on file with Connecticut Law Review).

[211] Smith, *supra* note 90, at 470–71 (noting the possible "intelligence" in norms and practices that are not deliberately constructed, but that evolve through "unseen processes").

[212] *Id.* at 470.

[213] *Id.*

formal way?"[214] Since we have encountered this contingency in the past, and we are certain that it will be dealt with in a certain way, there is no need to expend resources to actually draft it into the contract. This transaction cost explanation for the omission might easily explain the failure of parties to include all possible terms of art, such as the meaning of "superstore"[215] or a "gross" in their contract. The transaction cost explanation becomes even more powerful if there are a number of trade usages to deal with a number of possible contingencies, some of which might never arise. Parties contemplating that possibility would then fail to include the norms because the transaction costs would not be worth incurring for lower probability events. Transaction cost explanations for omission thus might cut in favor of the court intervening to supply the usage as a way of saving the parties transaction costs.

Another reason for including the trade usage by legal incorporation is that the parties have come to expect that, under the U.C.C., the court will give legal effect to the trade usages unless the parties carefully negate them. Failure to enforce trade usages would upset parties' expectations and cause a loss to parties who would have negotiated different terms had they known that a court would deny effect to the trade usage. They might have demanded a higher price from the other party were the court to deny effect to the usage since it might subject them to a higher risk of opportunistic behavior by the party.

Parties' expectations might also cut against legal incorporation.[216] Parties might not want a court to enforce a commercial practice in a particular case. Sometimes the parties' expectations regarding enforcement will clearly be articulated in the nature of the practice as a legally nonbinding one. In other cases where such direct evidence is lacking, a court should construct a model that would allow it to decide whether the parties would have wanted legal enforcement of the practice. Modeling those expectations will be more complicated when the trade usage deals with a practice that governs parties' behavior under the contract rather than a simple term of art. A party may not have included a practice because he wanted to hedge his bets as to how to deal with a contingency in the future. The example that Professors Kraus and Walt give is of a trade practice of allowing the buyer of a lame horse to return it to the seller.[217] In some cases, despite the fact that a trade practice exists of a return policy, the seller might not want a court to enforce the trade practice. Kraus and Walt explain that, in fact, "every horse seller will testify that this practice constitutes a *legally optional* accommodation

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[214] Coffey, June 28, 2003 E-mail, *supra* note 63.

[215] *See, e.g.*, Acme Mkts. v. Wharton Hardware & Supply Corp., 890 F. Supp. 1230, 1239, 1243 (D. N.J. 1995) (showing that the parties disputed the clarity of the term "super food store").

[216] *See* Kraus & Walt, *supra* note 8, at 207.

[217] *Id.* at 208.

rather than a legally binding obligation."[218] Kraus and Walt explain the desire to keep the practice *legally* unenforceable in terms of the desires to "invoke their stricter, contractual rights whenever they consider their contracting partner to be behaving opportunistically."[219]

There are different ways of looking at the lame horse policy. The first interpretation is that the trade usage that underlies the lame horse policy is a slightly different one than the one articulated by Professors Kraus and Walt. The articulated policy might indeed be that there is a policy of sellers accepting lame horses back, but that this policy does not apply when a particular buyer is acting opportunistically and a court decides that issue. In such cases, the seller will insist on the strict contractual terms which did not include a return privilege.[220] Under this interpretation of the trade usage, a court might admit evidence of the trade usage but find that since a particular buyer was acting opportunistically, he was not entitled to return the horse under the usage. A nuanced reading of the trade usage by a court might facilitate legal recognition of the usage at the same time it denied a particular party relief, reasoning that he was not protected by a careful interpretation of the parameters of the trade usage.

One could interpret the omission in a different way altogether, arguing, as Kraus and Walt do, that the parties wanted to keep the practice (of accommodating unhappy buyers complaining about lame horses) enforceable only through informal enforcement mechanisms. Therefore, such practice should be denied any legal effect. However, the fact that parties may not want practices of accommodation and waivers of their strict contractual rights to be legally enforced may be because the practice itself is not designed to curb opportunistic behavior, and thus does not act in the same value maximizing fashion that norms specifically designed to curb opportunism do.[221] Moreover, where the practice concerns allowing a waiver of strict contractual rights, there is the likelihood that parties would not necessarily want the waiver to be enforced in all cases. Because it is possible that another party might behave opportunistically, the victim of such behavior might want to insist on strict contract rights to curb such behavior. Until a party can discern how the other party behaves in the future, the party who holds the right to insist on strict contract rights would be reluctant to relinquish that right for the future and allow the court to enforce the waiver of strict rights regardless of the future circumstances, especially where the court might be less informed about opportunism because there are fewer clear benchmarks for judging it.[222] Where it may

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[218] *Id.* (emphasis added).

[219] *Id.*

[220] *Id.*

[221] The nature of the substantive practice is one of the factors that may influence the benefits of a collective intervention by the government on behalf of a business norm.

[222] Coffey, June 28, 2003 E-mail, *supra* note 63.

be difficult for a court to ascertain whether a party offering to prove a trade usage is acting opportunistically in light of the circumstances, the court should be more reluctant to intervene in the trade practice dispute.

In addition, parties might want to keep accommodation practices informal, because doing so would provide positive value to the parties—it would allow the seller to signal to the buyer that he is a trustworthy partner who will make good in cases of lame horses. Enforcing the practice would reduce the ability of the seller to signal his trustworthiness. That interpretation also suggests that judicial enforcement should perhaps be denied.

The nature of the practice and the purpose it serves might be relevant factors in whether the judiciary should be a supplemental source of enforcement. In the case of trade practices that are *specifically designed to deter opportunistic behavior*, the purpose of the practice is to provide a means of the parties overcoming the imperfections that stand in the way of their achieving a first-best outcome. Faced with the prospect of opportunistic behavior in their counterparty, and with the fact that proclivities for such opportunism are often unknown, parties may seek to develop trade usages that curb such practices. This is especially true when one party must incur large sunk costs that make exit impossible or costly. In these cases, although the type of opportunism may be unknowable and uncertain at the time of contracting, the parties have not omitted the practice in order to see whether they honor the custom or not based on "what is going on in the future,"[223] and on whether the other party has acted opportunistically in such a way that he or she should be denied the benefit of the usage. In the cases where the court does intervene to enforce the trade usage, such as in *Midwest*, *Gord* and *Dixon*,[224] the trade practice itself seems designed to curb opportunism and there appears to be no reason to allow a party to have the discretion to not honor the trade usage. The structural circumstances are such that a party violating the usage is acting opportunistically and the court can readily use that as a benchmark. For example, future circumstances really should not have any bearing on whether a party is allowed to appropriate the sunk costs in the form of engineering costs devoted to plastic molds, as in the case of *Gord*, and thus there seems to be no reason to make the usage discretionary or optional. However, agreement on the substance of the norm, with its purpose of deterring opportunism as a means of increasing joint gains from trade, does not by itself resolve how the court should treat the norm: either as legally enforceable or as enforceable only through informal mechanisms.

There are certainly several plausible reasons why the court should intervene to enforce norms designed to curb opportunism. First, if one

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[223] *Id.*

[224] *See infra* Part VI.C.1.

party seeks the court's help, it may indicate that the informal mechanisms are not working or are not likely to work, since otherwise the party bringing the lawsuit would not undertake the additional costs of legal enforcement. If informal mechanisms were working, presumably the party injured would prefer to rely on the least costly mechanisms for deterring opportunistic behavior.

Second, especially in the case where there may be large scale rewards to defection, which outweigh the costs to reputation and future business,[225] it may make sense to give the injured party an additional mechanism for enforcement. In fact, permitting a party to sue when there is a defection from a trade usage allows a party to develop a reputation for toughness, which can help cut down on defections where there are large gains to be made from defection. [226]

Third, it makes sense for courts to intervene to enforce trade usages designed to curb opportunistic behavior, even if courts would be imperfectly able to identify opportunistic behavior when it occurs in the abstract. The practice itself serves as a ready benchmark for identifying the opportunistic behavior. When one recognizes that the main function of giving effect to many trade usages and practices is to deter opportunistic behavior, then the oft-voiced objection to incorporation strategy—that it will "lead[] to misinterpretation of the express terms of the contract"[227]—seems misplaced. The court's role in interpreting a trade usage is guided by its understanding of the role of the usage in curbing opportunism, and it seems less about possible errors in translating the express terms and more about detecting opportunism—a potentially easier task—made easier by the benchmark.

C. *How the Case Law of Trade Usages Demonstrates the Role of Welfare Maximizing Norms Designed to Control Problems Not Easily Solved by Contract*

Once the impediments to bargaining that interfere with achieving a first best outcome are recognized, it becomes easier to outline a framework for thinking about the incorporation of norms into contracts.

If parties in an exchange relationship are not able to achieve their goals on their own through contract, they may search for other private strategies to achieve their goals. Norms may be thought of as private strategies

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[225] Eric Posner points out: "If a small change in prices occurs—whether to the advantage of a buyer or a seller—neither party defects, because the gain is less than the discounted value of continuation of the relationship." POSNER, *supra* note 35, at 157.

[226] *Id.* at 158.

[227] Scott, *supra* note 13, at 854.

designed to achieve the party's goals in the face of obstacles to express contracting.[228]

Many of the cases involving trade usages arising in the context of assent-based transactions seem consistent with this explanation for trade usages and norms.[229] These transactions are beset by the structural impediments, which interfere with completely explicit arrangements. Consequently, the bargains that are reached cannot solve all of the problems that the parties face, including uncertainty about the proclivities for opportunism in one's transacting partner.

Trade usages or norms (as noted above) can act as a private device to control the detrimental effects of opportunism. Were such controls not devised by the parties, there would be less gain in the exchange. When parties were pricing contracts, they would pay less for contractual services to be furnished by someone whose proclivities for opportunism were unknown, particularly when the party must incur sunk costs that would make a costless exit impossible. On the other hand, if that hazard could be controlled or mitigated through trade usages developed outside of the express contract, there would be more gain from the exchange to be divided between the parties. Parties could contract secure in the knowledge that trade usages would be devised that could be enforced *either* through self-sanctions, informal sanctioning, or through legal enforcement if necessary.

The development of trade usages that function to curb opportunistic behavior can be seen in a number of different contexts discussed below. In each of these cases, two parties enter into a contract with lingering performance obligations that cannot be discharged all at once. As in many contracts, bounded rationality exists and limits the ability of each party to judge the proclivities for opportunism that may exist in the other party. One party (A) often has discretion as to some matter involving performance, and that discretion could adversely affect the other party (B) under the contract if the discretion were exercised in an opportunistic fashion, because the party subject to discretionary choices (B) to be made by (A) has invested large sunk costs in the project. Unless the discretion can be constrained in some fashion, (B) may be reluctant to invest ex ante or to enter into the contract at all. One mechanism for discouraging such opportunism is for a court to enforce trade usages whose function is to curb opportunism. The cases discussed seem to be particularly strong cases for legal enforcement of the trade usages for several reasons. First, there is the

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[228] Epstein draws this connection between trade customs and the difficulty of bargaining. He explains that "custom will become the key to the success of the business because bilateral contracts are not feasible, because of the number of transactors and the difficulty of monitoring behavior." Epstein, *supra* note 29, at 834.

[229] Note, *Custom and Trade Usage: Its Application to Commercial Dealings and the Common Law*, 55 COLUM. L. REV. 1192, 1208–09 (1955).

distinct possibility that informal enforcement would not work. The usages do not arise in small, closely-knit homogeneous communities, so the structural factors that would both encourage development of the norm and its subsequent enforcement by members of the community are not present. Nor is there a strong collective organization that has arisen to systematically enforce the usages through extra-legal means. Courts appear ready to enforce such usages where there is opportunistic behavior on one side that is easy to judge, particularly in cases where enforcement would not facilitate opportunism by the other side.[230] Third, the cases do

[230] Examples of this abound in our case law. In *Century Ready-Mix Co. v. Lower & Co.*, for example, the court held that a contract without a quantity term was understood to be a requirements contract in the concrete business, and it refused to apply the statute of frauds to a contract with a blank quantity term. 770 P.2d 692, 696–97 (Wyo. 1989). In this particular case, the defendant general contractor refused to accept delivery of concrete that met independent, objective standards of quality after their school district client ordered them to stop pouring and find a new supplier. *Id.* at 695. By forcing the defendant to accept the plaintiff's concrete, the defendant's discretion to reject the plaintiff's concrete was constrained, and expenditures made by the plaintiff in reliance on the contract were protected. In *Den Norske Bank AS v. First Nat'l Bank of Boston*, the plaintiff was the minority owner of a loan that was in default. 75 F.3d 49, 51 (1st Cir. 1996). While the defendant wished to restructure the debt, the plaintiff wanted to foreclose, and the defendant argued that the industry custom was to grant minority owners veto power. *Id.* at 52, 56. The court ruled that sufficient evidence of this custom was shown and overturned the lower court's summary judgment ruling in favor of the defendants. *Id.* at 59. This ruling effectively prevented the majority owner from using its discretion to the detriment of its minority partner, and protected the minority owner's interest in the loan. At the same time, the custom did not create a parallel opportunity for the minority owner to engage in opportunistic behavior at the majority owner's expense. In *Acme Markets v. Wharton Hardware & Supply Corp.*, the plaintiff sought to enforce a restrictive building covenant that prohibited the construction of a "super food store" on adjacent land. 890 F. Supp. 1230, 1234 (D.N.J. 1995). The defendant was attempting to build a supermarket, and the court ruled that the explicit contractual language must be interpreted according to the meaning that those in the industry would have accorded it at the time it was made. *Id.* at 1243. By interpreting the covenant in such a way, the court protected the plaintiff's reliance on the covenant, and prevented defendant from opportunistically attempting to void the covenant by insisting on a strict, formalist reading of the agreement. In *New England Rock Services. v. Empire Paving*, the defendant general contractor hired the plaintiff subcontractor to engage in drilling below the water table on a sewer project. 731 A.2d 784, 785 (Conn. App. Ct. 1999). A trade usage existed that made control of the water table the general contractor's responsibility. *Id.* at 788–89. However, when the plaintiff commenced drilling, the general contractor failed to control the water table, making drilling more expensive. *Id.* at 785. Although the contract was renegotiated, in the plaintiff's favor to take into account the extra expenses, the defendant refused to pay more than the original price when the drilling was done. *Id.* at 785–86. By giving effect to the trade usage, the court constrained the defendant's ability to act opportunistically by shifting the burden of dealing with the water table onto an unsuspecting driller, when a basic assumption made by both parties entering the contract was that the defendant would be responsible for the water on the job site. There was no parallel opportunity for the plaintiff to engage in opportunistic behavior because the defendant had the best opportunity to gather information about the water table, and since the defendant ran the whole project, it was also in the best position to control the water table. A further example of courts enforcing trade usages to curb opportunistic behavior and protect the sunk costs of parties is found in *Hurst v. W. J. Lake & Co.*, 16 P.2d 627, 631 (Or. 1932). In *Hurst*, the plaintiff delivered horse meat scraps to the defendant. *Id.* at 628. The contract stated that a lower amount would be paid for scraps containing less than "50% protein." *Id.* Some of the scraps contained 49.53%, and 49.96% protein, and the defendant refused to pay more than the lower amount, asserting that the scraps contained less than 50% protein. *Id.* The court accepted a trade usage that stated that a protein content of 49.5% or greater was equal to a protein content of 50%. *Id.* The parties bargained with this particular trade usage in mind, and the plaintiff relied on it when it shipped the goods to the defendant buyer. By accepting the trade usage, the court prevented the defendant from opportunistically refusing to pay full price once the horse meat had been delivered. Another case involving a dispute over the permissible fat content in meat is *A.J.*

Cunningham Packing Corp. v. Florence Beef Co. 785 F.2d 348, 349 (1st Cir. 1986). The court in *A.J. Cunningham* relied on the trade usage as expressed in "Guidelines for the Settlement of Fat Claims," published by the Meat Importers Council of America, to enforce a contract for the sale of beef. *Id.* at 349, 351. The guidelines stated that a tolerance of 0.5% leanness in 85% lean beef would be permitted, and below that the buyer would have to accept the meat, but would be entitled to a specific reduction in price. *Id.* 349 n.1. If the beef was less than 80% lean, the buyer was entitled to refuse shipment. *Id.* The plaintiff shipped beef that tested between 83.5% and 84.7% lean. *Id.* at 349. During the period between the ordering and receipt of the meat, the price of beef fell precipitously. *Id.* The defendant argued that the plaintiff knew it was shipping meat that was less than 85% lean, and because of this the trade usages should not apply. *Id.* at 350. The court rejected this argument and applied the trade usages. *Id.* In this case, the decision curbs opportunism by protecting the plaintiff's sunk costs in shipping the meat, and prevents the defendant from opportunistically refusing the meat when the price has fallen and a better deal could be had elsewhere. The trade usage also constrains potential opportunism on the plaintiff's side, by allowing the buyer to refuse shipment of beef less than 80% lean. The trade usage allows for the fact that it may not be possible to know the exact leanness of beef in any particular package, but prohibits the seller from sending categorically unacceptable (less than 80% lean) beef. In *Haeberle v. Texas International Airlines*, the defendant leased aircraft from the plaintiff. 738 F.2d 1434, 1436 (5th Cir. 1984). Rather than maintain and overhaul the planes, the defendant simply stored the airframes and parts, a practice that made the aircraft less valuable than they would have been if they had been used continuously and maintained throughout the lease. *Id.* at 1437. The literal terms of the lease merely required the defendant to return the planes in a "zero time condition." *Id.* The plaintiff argued that the phrase "zero time" did not refer simply to the same condition the planes were leased in; rather in the airline industry "zero time" essentially meant "freshly overhauled." *Id.* The court of appeals reversed the trial court and ordered a new trial taking this trade usage into consideration. *Id.* at 1442. This decision constrains opportunistic behavior on the part of the defendant. Once the plaintiff has delivered the planes to the defendant, it has incurred a massive sunk cost, and if the trade usage is not enforced, the capital the plaintiff has invested in the agreement could be greatly reduced by the defendant's behavior. In yet another example of the incorporation doctrine curbing opportunistic behavior and protecting sunk costs, the court in *Thomas v. Gusto Records,* reaffirmed that custom is to be used to clarify any ambiguities in written contracts. 939 F.2d 395, 398 (6th Cir. 1991). The court recognized a custom in the recording industry granting a recording artist half of the fees received when the owner of a master recording licenses the recording to an unaffiliated third party, absent specific wording to the contrary. *Id.* at 397, 402. In this particular case, the defendant licensed the use of the plaintiff artists' songs to third parties. *Id.* at 397. The recording contracts were silent on the issue of what (if any) royalties the artist would be owed from domestic licensing contracts. *Id.* at 398. The court accepted the customary term, despite contractual silence on the issue. *Id.* Doing so prohibited the defendant record company from opportunistically depriving the artists of expected royalties, and protected the substantial sunk costs the artists incurred in creating their works.

Courts have also used the same framework of curbing opportunistic behavior when interpreting cases involving the course of performance. In *Cutter Laboratories v. Twining*, the defendant managed a trust that included stock in the plaintiff's corporation. 34 Cal. Rptr. 317, 319 (Cal. Dist. Ct. App. 1963). At the time the agreement was executed, the plaintiff's corporation was "substantially indebted." *Id.* The stock had been specifically set-aside in the form of a fixed asset so that it would not be subject to the risks of the business world. *Id.* The defendant was given chances to rescind or modify the agreement over the course of eighteen years. *Id.* at 320. When the stock split multiple times and dramatically rose in value, the defendant attempted to rescind the agreement and cash in on the increased value of the stock. *Id.* at 320–21. The plaintiff sought declaratory relief and enforcement of the agreement. *Id.* at 319. The court enforced the agreement. *Id.* at 326. The ruling prevented the defendant from opportunistically seeking more than it bargained for by arguing that the parties' prior course of performance demonstrated that the parties intended that the plaintiff would not bear market risks, and in return would not be able to take advantage later of market increases. The agreement was set up so that the defendant could avoid business risk. *Id.* at 319. The defendant managed to do so, and then attempted to cash in on the results of the risk it sought to avoid. In effect, the defendant attempted to place all of the business risk on the plaintiff, while reserving all of the reward for itself.

The court also turned to the parties' course of performance in *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 779 (9th Cir. 1981). In *Nanakuli*, the court turned to the parties' course of performance and an existing trade usage in interpreting a contract for the sale of asphalt. *Id.* The long-term supply contract called for the defendant to sell asphalt to the plaintiff contractor in Hawaii at $44 per ton in 1969. *Id.* at 777. There was a trade usage in the Hawaiian asphalt trade, which provided that

not seem to be situations where the parties may have omitted mentioning the usage because they wanted to await further developments which the parties themselves, rather than courts, would be uniquely suited to judging whether the usage should apply in particular situations (as might be the case with practices giving rise to waivers or grace periods).

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asphalt suppliers would protect their customers from price increases. *Id.* at 784. The purpose of the trade usage was to protect contractors from price increases after they had already bid on contracts relying on a particular price for materials. *Id.* The defendant honored the trade usage and protected the plaintiff from price increases twice between 1969 and 1974. *Id.* at 785. In 1974, the defendant refused to protect the plaintiff from another price increase, and the plaintiff sued. *Id.* at 786. The court looked at the course of performance of the two parties, and the usage of trade in the asphalt industry in Hawaii, and determined that both indicated the presence of a trade usage. *Id.* at 779. Incorporation of the parties' course of performance prevents the defendant from opportunistically raising prices after the plaintiff has already committed to supplying asphalt at a set price. The need to enforce the trade usage is especially strong in this case because the State of Hawaii refused to allow escalation clauses in state contracts, subjecting suppliers to tremendous losses if a price increase occurred. *Id.* at 779. There was only one other major paving company on the island Hawaiian Bitumuls (H.B.), and one other asphalt supplier (Chevron); these two worked closely with one another, and Chevron routinely price protected H.B. *Id.* at 779. The defendant wanted to break into the asphalt market in Hawaii, and the plaintiff wanted to become a serious competitor for large contracts. *Id.* The plaintiff relied on receiving the same sort of price protection H.B. received, and it incurred large sunk costs in doing so. A situation such as this, where (1) the success of the supplier and the success of the paving company are so intimately linked, (2) a party refuses to grant price protection in the face of a local custom, and (3) such refusal goes against the parties' own course of performance, is especially opportunistic.

Courts have also manipulated the doctrine of trade usage itself to curb opportunistic behavior. For instance, in the case of *Foster v. Longa*, the court declined to admit a "trade usage" asserted by the plaintiffs. No. CV990425745S, 2003 WL 1090592, at *3 (Conn. Super. Ct. Feb. 25, 2003). The defendant made a settlement offer. *Id.* at *1. Plaintiffs made a counteroffer. *Id.* at 2. The defendant declined, and plaintiffs then attempted to accept the original offer, only to find that the defendant had withdrawn it. *Id.* The plaintiffs argued that it was customary for a settlement offer to remain open until specifically revoked. *Id.* The court declined to admit the usage, and held that the doctrine of trade usages could not be used to prove that a contract existed, but instead was limited to helping interpret an existing agreement. *Id.* at *3. Had the court decided otherwise, the plaintiff would be able to make a counteroffer without risking a revocation of the original offer. In effect, the court would be allowing the plaintiff to negotiate "risk free" once a settlement offer had been made. Another case in which the court has manipulated the doctrine of trade usages to curb opportunistic behavior is *Sweet v. United States*, 53 Fed. Cl. 208, 220 (2002). In *Sweet*, the defendants conducted experimental medical procedures involving the use of radiation. *Id.* at 210. The procedures caused death and severe pain in some of the patients, and their families sued. *Id.* The federal government had passed the Price-Anderson Act to encourage research in atomic radiation. *Id.* at 211. The Act indemnified institutions with nuclear reactors from liability and litigation costs arising out of "incidents." *Id.* at 212. The government attempted to argue that "occurrence" had a trade meaning in the insurance industry encompassing only unexpected behavior, and since the defendant's behavior was intentional, the Act did not apply. *Id.* at 220. The court rejected this argument. *Id.* at 221. The court would not apply the trade usage doctrine to the government, because the government is presumed to use plain language when enacting a statute, and even if it did not, the trade usage was not in effect when the act was passed. *Id.* at 220–21. This enunciation of trade usage principles helps prevent opportunism by forcing parties to use only the customs of the trade they are engaged in (preventing parties from "borrowing" terms from trades they are not engaged in), and by protecting their reliance on the trade usage at the time the contract was negotiated (by not allowing the ex post evolution of a custom to change the meaning of the contract).

1. *Case Law: Where Trade Practice Admissibility or Exclusion Acts to Curb Opportunism*

In *Dixon, Irmaos & CIA, Ltd. v. Chase National Bank of New York*, the court had to evaluate a business norm that had developed in the banking community to solve a problem that occurs when one of the bills of lading—evidencing the shipment of the goods and entitling the seller to payment under a buyer's letter of credit—is delayed in transit.[231] In such cases, the custom among New York banks provided that the seller be allowed to draw down on the letter of credit and receive payment by presenting an indemnity to cover any losses sustained by a bank's paying on the letter of credit without the bill of lading.[232] In *Dixon*, the seller, who was the beneficiary of a letter of credit, sent goods to a Belgian buyer who had arranged with its local Belgian bank to request a New York City bank to establish two letters of credit in honor of the seller.[233] The seller then had the letter of credit confirmed by Chase Bank.[234] As was customary, the letter of credit provided that after the bank received the "full set of bills of lading," the seller could draw down on the letter of credit.[235]

Once the goods were shipped, the seller received duplicate sets of bills of lading and sent one set by air and one by ship.[236] Because one bill of lading was in transit and had not arrived by the letter of credit's expiration date, the seller (through its representative) could present only one bill of lading.[237] Thus, the seller could not satisfy the technical requirements of the letter of credit.

However, in accord with trade practice, the seller offered an indemnity from another bank to cover the issuing bank in the event that there were any losses associated with its honoring the letter of credit.[238] This action corresponded with the traditional practice (universally honored by commercial parties), which provided that if a bill of lading could not be presented, a seller could present an indemnity to a letter of credit issuer to cover that bank for any losses.[239]

The confirming bank (Chase) refused to accept the indemnity in lieu of the missing bill of lading, and refused to pay the seller the amounts due

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[231] Dixon, Irmaos & CIA, Ltd. v. Chase Nat'l Bank of N.Y., 144 F.2d 759, 760 (2d Cir. 1944). *Dixon* is the subject of a spirited colloquy in the law reviews. *See* Dana Converse Backus & Henry Harfield, *Custom and Letters of Credit: The* Dixon, Irmaos *Case*, 52 COLUM. L. REV. 589, 594–600 (1952); John Honnold, *Letters of Credit, Custom, Missing Documents and the* Dixon *Case: A Reply to Backus and Harfield*, 53 COLUM. L. REV. 504 (1953).

[232] *Dixon*, 144 F.2d at 761.

[233] *Id.* at 760.

[234] Backus & Harfield, *supra* note 231, at 595.

[235] *Dixon*, 144 F.2d at 760.

[236] *Id.* at 762.

[237] The Guaranty Trust Company acted as a representative who presented the relevant documents on behalf of the seller. *Id.* at 761.

[238] *Id.*

[239] *Id.* at 762.

under the letter of credit.[240] Chase relied on the technical defense that the provision calling for two bills of lading had not been complied with.[241] Chase also argued that the decision as to whether to accept the indemnity as a valid substitute was not mandatory, and that the bank retained the discretion to reject the indemnity.[242]

The Second Circuit ruled in favor of the seller.[243] Because the court accepted the trade usage in lieu of the plain meaning of "full set of bills of lading[,]" it read "full set" to mean one of the two bills of lading plus the indemnity.[244] Under the court's reading of the letter of credit, the seller had complied with the contract provisions and was entitled to payment.[245]

In a case such as *Dixon*, an issuing or a confirming bank may act opportunistically and the seller, who pays a fee to a bank to have it confirm a letter of credit, is uncertain about the confirming bank's relative probability of acting in such a manner. The confirming bank is more aware of its own proclivities for such behavior than the seller. A confirming bank may decide to seize upon a technical noncompliance with the bill of lading requirement and ignore the custom of accepting an indemnity as a substitute for opportunistic reasons—i.e., to shield itself from a risk that it undertook by confirming the letter of credit initially.[246] Outside the arguments presented in court, the situation surrounding the *Dixon* case suggests that the issuing bank refused to accept the customary indemnity because doing so would allow them to avoid paying on a letter of credit in a case where changed circumstances—namely, the invasion of Belgium—would make it difficult to collect reimbursement from the buyer's bank in Belgium.[247]

Although the case has been criticized as "a frustration of freedom of contract,"[248] arguably the result of the court can be understood as the court's incorporation of the custom of accepting indemnity as a private strategy that the parties had developed to address the problem of opportunistic behavior by one of the parties. When the buyer directed its Belgian bank to contact a New York bank to issue a letter of credit on behalf of the seller, the buyer faced uncertainty as to whether and with what probability the issuing bank would act opportunistically. Because of that uncertainty, it would be hard to deal with the matter by a fully contingent contract. The buyer of the letter of credit could not anticipate

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[240] *Id.* at 761.
[241] *Id.*
[242] *Id.* at 761–62.
[243] *Id.* at 763.
[244] *Id.* at 761–62.
[245] *Id.* at 763.
[246] Honnold, *supra* note 231, at 510–11.
[247] *Id.* at 505.
[248] Backus & Harfield, *supra* note 231, at 598.

all the various ways in which the bank issuing the letter of credit might act opportunistically, thus leaving the contract incomplete.[249]

In this case, Chase, the confirming bank, may well have chosen to insist on the strict provisions in the letter of credit because doing so would avoid a risk that had developed as a result of the German invasion of Belgium.[250] The invasion may have caused the Belgian bank, which had dealt with and acted on behalf of the buyer, to lack funds. Thus, if Chase paid the seller and then—as would ordinarily occur under a letter of credit—sought reimbursement from the buyer's bank, Chase Bank might well be unable to collect.

The use of custom shielded the seller against such opportunistic behavior by the confirming bank. Presumably, the parties ex ante would want to maximize the joint gains from trade and, for that reason, would want to mitigate the hazards of opportunism. Otherwise, buyers would be reluctant to buy letters of credit or sellers would hesitate to accept them without some further protection against opportunistic action of the issuing bank. Because of uncertainty about the ways in which the bank may have a proclivity for diverging or acting opportunistically, the problem will be difficult to solve by explicit contract. Yet, if the problem is not solved by contract, the parties will search for or devise other ways of dealing with the opportunism problem in an efficient manner. In this case, the custom of accepting indemnities solved the practical problem of delayed bills of lading and simultaneously insured that the bank could not seize on a technical failure to opportunistically shield itself from the risk that a foreign bank, which had taken payment from the buyer, would become insolvent. The seller's very purpose in requiring a letter of credit to be opened on its behalf is to avoid having to depend on the unknown finances of a foreign buyer. By having a letter of credit confirmed in its favor in a more convenient jurisdiction by a bank with which it presumably had an existing relationship, the seller could insure payment readily once the bills of lading assured a lender of delivery. This confirmation by Chase protected it against the "difficulty in securing reimbursement from its Belgian correspondent . . . which made its confirmation valuable to the seller."[251]

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[249] This Article is using incompleteness to mean a failure of the parties to provide mechanisms for controlling behavior that will arise during a contract. There are many ways in which lawyers and economists talk about the incompleteness of contracts. The issue is complex and goes beyond simply identifying whether a gap exists in a contract. Economists use a different approach to incompleteness, finding contracts to be incomplete if they fail to differentiate outcomes for particular contingencies when an optimal contract would do so. *See* Scott & Triantis, *supra* note 16 at 190–91; *see also* Symposium, *Incomplete Contracts: Judicial Responses, Transactional Planning, and Litigation Strategies*, 56 CASE W. RES. L. REV. 135 (2005).

[250] Honnold, *supra* note 231, at 510–11 & n.24.

[251] *Id.* at 510–11.

In this particular case, had the Second Circuit *refused* to admit the custom and, instead, insisted that the term "full set" of bills of lading had an ordinary meaning or that the meaning was unambiguous, the court would have upset a private strategy that the parties had devised for curbing possible opportunistic behavior that could not easily be dealt with by contract.[252]

In *Douglas & Mizell v. Ham Turpentine Co.*, the plaintiff contracted to sell the defendant 300 barrels of turpentine and 1000 barrels of rosin.[253] The contract provided that defendant/buyer would furnish the tank cars to ship the goods within ten days of the plaintiff's/seller's request.[254] Because the buyer agreed to furnish the tank cars, the seller agreed to sell the turpentine at a discount of eight cents below the market price.[255] If, however, the defendant/buyer refused to supply the tank cars when requested by the seller, the price would be based on the market price ten days after the written request.[256] Thus, the buyer had an incentive to supply tank cars when they were requested, otherwise the buyer would not benefit from the discount. The buyer was obligated to buy the output of the seller since the buyer "agree[d] to receive all turpentine . . . delivered" by seller.[257]

After the seller had ninety barrels of turpentine for shipment, the seller requested that buyer furnish a tank car.[258] The buyer declined to do so, arguing that it did not have tank cars with such a low barrel capacity.[259]

Several months later, the seller delivered turpentine to the buyer, more than half of which consisted of the disputed ninety barrels,[260] and the parties disagreed about what price buyer was obligated to pay for the ninety barrels.[261] The seller insisted that the price (for the first ninety barrels) furnished under the contract was the market price ten days after the buyer's refusal to furnish tank cars for the ninety barrels.[262] On the other hand, the buyer offered a significantly lower price based on the eight-cent discount.

The court had to parse the contract provision that obligated the defendant/buyer to furnish tank cars within ten days of the plaintiff's/seller's request. Did that provision obligate the defendant to furnish a tank car even if the shipment prepared by plaintiff (ninety barrels)

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[252] *See supra* note 58 (describing problems with general form clauses prohibiting opportunistic behavior).

[253] Douglas & Mizell v. Ham Turpentine Co., 97 So. 650, 650–51 (Ala. 1923).

[254] *Id.* at 651.

[255] *Id.*

[256] *Id.*

[257] *Id.*

[258] *Id.* at 650–51

[259] *Id.*

[260] *Id.*

[261] *Id.*

[262] *Id.*

was below the normal capacity of a tank car (125–160 barrels)? If the defendant was obligated to furnish tank cars, regardless of the amount to be supplied by the seller, then the defendant/buyer's refusal to furnish the tank car would have triggered the price pegged to the market price ten days after the refusal. Subsequent events made the market price after ten days desirable for the seller, but undesirable for buyer.[263]

To resolve the issue of how to interpret the plaintiff's/seller's obligation, the court turned to trade usage.[264] In the turpentine industry, a tank car had an understood capacity of 125–160 barrels.[265] Because the contract was silent on the meaning of the words "tank car" and the trade usage did not contradict the written contract, the court found that the trade usage should be incorporated into the contract.[266]

To understand the court's reliance on trade usage and the role trade usage played in solving problems that the parties faced and maximizing gains from trade, it is important to understand the context of the contractual agreement. The parties contracted under conditions of uncertainty both with respect to when the seller would be able to produce the turpentine and in what amounts, the market price at the time that the seller would demand a tank car, the possible proclivities for opportunistic behavior by either party, and uncertainties about the particular context in which such opportunistic behavior might manifest itself.

The arrangement allowed the parties to deal with the uncertainty of the seller's production schedule (by allowing the seller to request tank cars as production occurred), and it benefited the buyer by allowing him to avoid paying the higher market price if he furnished tank cars in a timely fashion. However, the arrangement also allowed for opportunism by the seller, who could request tank cars whenever the price was high.

In other words, if the court interpreted the contract without the trade usage, the seller could request the buyer to furnish tank cars regardless of the available barrels. The seller could act opportunistically to exploit high prices to the buyer's disadvantage by requesting a tank car whenever the price was high, regardless of how little the production was. Since the defendant/buyer was obligated to pay the freight charges,[267] it was particularly important to the buyer that the seller/plaintiff request only fully loaded tank cars.

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[263] *Id.*

[264] *Id.* at 651–52 ("If there is a general usage applicable to a particular profession or business, parties employing an individual in that profession are supposed to deal with him according to that usage. All trades have their usages, and when a contract is made with a man about the business of his craft, it is framed on the basis of its usage, which becomes a part of it, except when its place is occupied by particular stipulations.").

[265] *Id.* at 651.

[266] *Id.* at 651–52.

[267] *Id.* at 651.

The trade usage arguably served to deter the particular form of opportunism that would arise when the seller would make demands for less than full tank capacity merely to exploit a temporary rise in prices.[268] If the seller could request tank cars for any quantity, then the seller would be in control of a factor that would allow it to maximize the price charged. By pegging demand to the capacity of an ordinary tank car, the seller would only be able to make demands for tank cars as production equaled that capacity. The seller could still decide to refrain from making demands and to accumulate the product (in lots of 125–160 barrels) on the hope that the price would go up.[269] But the seller's effort to exploit that price would be offset by the chance that the price would go down, subjecting the seller to a significant loss.

The incorporation doctrine also served to deter opportunistic behavior and to protect the sunk costs of a television station. In *Midwest Television v. Scott, Lancaster, Mills & Atha, Inc.*, after the television station (plaintiff) had run ads for the defendant (ad agency's client), the company client declared bankruptcy.[270] In this case, because the company was bankrupt, the ad agency never received payment from the client. The television station then sued the ad agency to collect for the unpaid bill.[271]

Ad agencies procure ad space on behalf of their client companies by negotiating with television stations.[272] The ad agency and the television station sign a contract negotiating the price for the airtime and reserving a specific block of time. The ad agency signs a separate contract with the client governing the fee arrangement, and acts as the company's agent in procuring the television time.[273] In the typical case, the station would receive payment in the following way: the ad agency bills its client for the airtime, receives payment, deducts its fee, and remits payment to the television station.[274]

The defendant ad agency in *Midwest* argued that it was not liable for the airtime because it was acting on behalf of a disclosed principal (the

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[268] Other forms of opportunism were solved by the contract. Since the buyer was obligated to take the turpentine when the seller made a demand for a tank car, the buyer could not simply refuse to take the turpentine because prices were high. Doing so would obligate it to lose the discount.

[269] Thus, if the seller could accumulate 125 barrels and hold on to those barrels until the price rose again before requesting a tank car, then the seller would have some ability to manipulate the price. However, that ability would be reduced by the fact that the market price could fluctuate in a way that would not be favorable to seller (holding on to the product might turn out to be a bad bet), and by the fact that sellers might need to be constantly receiving and shipping out barrels (in order to receive payment) and, thus, sellers would not have that much control over the timing of the request of the tank car.

[270] Midwest Tel. v. Scott, Lancaster, Mills & Atha, Inc., 252 Cal. Rptr. 573, 575 (Cal. Ct. App. 1988).

[271] *Id.*

[272] *Id.*

[273] *Id.* at 575–77.

[274] *Id.* at 576.

client).[275] The effect of the ad agency's disclosure of the identity of the principal, absent other circumstances, results in a contract between the client and television station.[276]

However, other circumstances dictated a different result in *Midwest*. The court found that the contract should be interpreted to include a custom in the industry under which the ad agency would be liable to the television station for the unpaid bill of the client/company "absent other prior arrangements."[277] In order to escape responsibility for this customary means of payment, the ad agency would have been required to opt out of the custom at the time it entered into the contract with the station, and to alert the station that it was disclaiming liability.[278] Since no such arrangements existed and no disclaimer of liability had been made, the court interpreted the contract to incorporate the custom, making the ad agency responsible for the bankrupt company's bill.[279]

The ad agency has direct information about the client and its credit risks, while the television station has no information. The ad agency could act opportunistically by concealing this information to sell more advertising spots. All of the negative effects of this concealment would fall on the station. Thus, the television station faces uncertainty about the agency's propensity for opportunistic behavior.

Uncertainty about the agent's proclivities for concealment makes it difficult for the principal to control such conduct by express contract. The station is, in effect, offering discretion to the ad agency to pick the clients who will advertise on the station. The station would have a difficult time anticipating the various ways that the agency will exercise its discretion, so a detailed contract controlling all possible exercises of discretion would be difficult to achieve. A general clause promising to act to maximize joint profits might have been possible, but it would likely be disbelieved.[280]

Without some mechanism for controlling opportunistic behavior by the agency, the station would be at risk. Upon entering into the contract with the agency, the station will reserve specific blocks of time in advance and presumably turn down other opportunities for those time slots. These time slots would be difficult to resell if the client canceled. Moreover, once the ads have aired, the station has sunk costs that will be an irretrievable loss.

The importation of a trade usage, which renders the ad agency liable for those sunk costs unless the agency denies any liability, will deter agencies from opportunistically passing on the negative effects of poor credit risks to the station while immunizing itself from liability. The trade

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[275] *Id.* at 577.

[276] *Id.* at 577 n.4.

[277] *Id.* at 579.

[278] *Id.* That disclaimer would have prompted the station to take the appropriate measures to check out the credit of the third party client/company. *Id.* at 576.

[279] *Id.* at 579.

[280] WILLIAMSON, *supra* note 58, at 63.

usage is utilitarian, and arguably one that both parties would prefer ex ante. The trade usage would prevent ad agencies from selling time without checking and disclosing the credit of the client. Without the trade usage, stations will be reluctant to enter into contracts with ad agencies because of the risk of opportunistic behavior, and will either be deterred from entering such contracts, extract other provisions, or raise prices to protect their interests in getting paid for their sunk costs.

At the same time, such a trade usage would act as a private device to overcome the difficulties the station may face in controlling behavior through express contract. The routine enforcement of trade provisions—making ad agencies responsible for payment when their client goes bankrupt—will curb the ability of the ad agencies to engage in opportunistic behavior and enhance gains from trade. It will also promote gains from trade by allocating the risk of nonpayment to the ad agency that already has the information regarding their clients and their credit worthiness.[281]

The role that the incorporation of trade usages can play in deterring opportunism can be seen in *Gord Industrial Plastics v. Aubrey Manufacturing*.[282] The dispute in this case involved whether the defendant owed the plaintiff a fee to remove a plastic mold from the defendant (mold removal fee).[283] In *Gord*, the defendant ordered the plaintiff to produce a plastic mold and also agreed to buy plastics from the plaintiff. Such plastics were to be made from the mold.

Although there was no written contract provision on the removal of the mold, a trade usage in the industry customarily charged buyers up to 50% of the cost of the mold for its removal.[284] The court admitted the trade usage and charged the defendant with the mold removal fee.[285]

In *Gord*, the parties faced the confluence of factors that afflict many bargaining parties ex ante. A party may face the prospect that its counterparty will act opportunistically over the course of the contract. The mold manufacturer does not know a buyer's proclivities for opportunism in advance. In the plastics industry, the mold manufacturer incurs considerable expense in time and engineering costs to produce the mold.[286]

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[281] If the television station had been made aware that the ad agency was not assuming the risk that the purchaser of the airtime would not pay, then the station could have priced the advertising to take account of that risk. The key is understanding which risks each party assumed. If the station had knowingly assumed the risk of default of the ad agency's client, they would have charged a premium or might have declined the risk altogether. The trade usage eliminates the ambiguity and insures that the station will have the information needed for pricing, or it will not be liable at all.

[282] Gord Indus. Plastics v. Aubrey Mfg., 469 N.E.2d 389 (Ill. App. Ct. 1984).

[283] *Id.* at 391.

[284] *Id.*

[285] *Id.* at 392.

[286] *Id.* A publication of the Society of Plastics indicated that because molds are quoted at cost and do not include engineering costs, a trade usage exists to allow the manufacturer to recoup those costs. *Id.*

If the buyer of the mold could retain it, he could produce more plastic parts from the mold without bearing any of the engineering costs. Such behavior would amount to opportunism at the expense of the manufacturer.

It is critical that the potential for such opportunism be checked as it will reduce gains from trade:

> If there are such threats regarding what will be received by any party from the other (and there will be uncertainty regarding the failing, shirking, or diverting attributes of the other party), the first best gain from trade is reduced by one means or another: (1) by allowing unchecked the full effects of failing, shirking, or diverting or, alternatively, (2) by engaging in costly preventive efforts, that is, costly private strategies or costly intervention.[287]

The mold manufacturer could undertake the costly process of trying to screen the trustworthiness of all of his potential contracting partners or put a mold removal fee into the contract. He could also include a general clause that would obligate the buyer to act in good faith and to maximize joint profits, but it is likely that this would not be believed.

The trade usage itself constitutes one means of controlling opportunistic behavior and maximizing the benefits of the exchange. The custom of charging the buyer a mold removal fee acts to discourage such opportunistic behavior. It is in both parties' interest since without the custom (and its anticipated incorporation into the parties' agreement), the manufacturer's incentive to engage in the trade decreases as the potential gain from trade is reduced. He may have to charge the buyer up front for an amount to represent the likelihood that the buyer will seize the mold. If the parties could devise a strategy that would control the costs from the opportunistic behavior and the costs of that strategy were less than the potential loss from uncontrolled opportunism, the parties would have an incentive to engage in such a strategy.[288] The trade usage is one such device that might require legal enforcement if the other means of private enforcement through private compulsion, reputational sanctioning, or organizational response are unavailable or more costly. Moreover, because the criticisms have tended to treat the incorporation doctrine as an all or nothing strategy, they have failed to assess whether the substantive norm requires technical expertise or speed in resolution, and whether the conduct governed by the norm would be transparent to outsiders. All these factors might affect the efficacy of private versus public enforcement of a business norm.

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[287] Coffey, Apr. 30, 2004 E-mail, *supra* note 1.

[288] "What we really mean is that, where the costs of preventive means are less than costs of the failing, shirking, or diverting prevented thereby, attempts will be made to minimize the reductions from the first best amount of gain." *Id.*

2. *Where Legal Enforcement of Trade Usage May Be Problematic*

Courts are willing to enforce trade usages when they control opportunistic behavior, the party seeking to enforce the trade usage is not behaving opportunistically, and the parties understandably omitted the trade usage from the contract because of the potential for limitless specification costs. Courts are also more receptive to enforcing trade usages where structural factors would hinder private enforcement through reputational sanction, and other forms of private enforcement (such as private compulsion or organizational mechanism) do not exist or are unlikely to work. In the cases in which the court intervenes to recognize or deny a trade usage in a manner that constrains opportunistic behavior, one party often retains discretion to make decisions during the performance of the contract that may adversely affect the other party.[289] The trade usage itself is designed to constrain an opportunistic exercise of discretion by one party, often when one party has invested sunk costs that might be appropriated by the non-investing party. That would have been the case in *Gord*, where the non-investing party might have appropriated the sunk costs in the form of engineering costs for the plastic molds had the court not applied a trade usage specifically designed to prevent that behavior.[290] In *Midwest*, the court protected the sunk costs of television stations by applying a trade usage requiring ad agencies to pay in the event that their client went bankrupt (unless liability was specifically disclaimed).[291] In *Douglas*, the court enforced a trade usage that had arisen to constrain a seller from opportunistically timing its request for a tank car from the buyer to insure high prices at the expense of the buyer.[292] In all of these cases, the structure of the transaction is such that one party will incur sunk costs unilaterally before the other party performs. Consequently, the

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[289] Sometimes the decision made by one party that may adversely affect the other does not involve opportunistic appropriation of sunk costs or a clear effort to avoid contractual risks already undertaken. Instead, one party may have to make a decision (one that could be made negligently) that could expose the other party to loss. One such example is *Provident Tradesmen Bank & Trust Co. v. Pemberton*, 24 Pa. D. & C.2d 720 (1961). In *Provident*, the court applied customary practice (course of dealing) to impose on a bank a duty to warn a dealer that had guaranteed obligations of a customer. *Id.* at 728. This warning would allow the dealer to protect himself in the event that the customer dropped the insurance, and would force the bank to share information so that all parties could maximize wealth. *Id.* Otherwise, if the bank does not share information, the dealership cannot protect itself and is exposed to a risk of significant loss in making good on the guaranty. Sharing the information would presumably be in the interest of the bank as well because doing so would insure that there was insurance to cover some of the losses, and the guaranty by the dealer would then be available to cover any non-insured losses.

Applying the course of dealing against the bank would assign duties in such a way as to maximize wealth. Moreover, there is little reason to suppose that a party would not want the practice applied because it might risk the other party acting opportunistically, as there might be in the waiver cases discussed *infra* Part VI.C.2.

[290] Gord Indus. Plastics, v. Aubrey Mfg., 469 N.E.2d 389, 392 (Ill. App. Ct. 1984).

[291] Midwest Tel. v. Scott, Lancaster, Mills & Atha, Inc., 252 Cal. Rptr. 573, 579 (Cal. Ct. App. 1988).

[292] Douglas & Mizell v. Ham Turpentine Co., 97 So. 650, 651–52 (Ala. 1923).

substance of the trade usage operated to the benefit of both parties when viewed ex ante.

Without some kind of enforcement of the constraint—such as that afforded by the trade usage—the parties might have to impose a higher price on the other party to make up for the possibility of uncontrolled opportunism, or decline to contract altogether. If the court decides that the strong private compulsions or structural factors that would make informal enforcement possible do not exist or are weak, then judicial enforcement is warranted.

In another class of cases, particularly those in which the business norm is offered to vary the terms of an express contract by conduct amounting to a waiver, the business practice that is pleaded by one party is often one that is *not* expressly designed to constrain opportunistic behavior. Rather, the practice is designed to vary or excuse some express terms of a contract that the parties agreed to. These often involve cases where the contract specifies certain quantities or specific engineering requirements for a product, and one party seeks to demonstrate that the specific quantity was only an estimate or that there can be reasonable variation from the specific requirements. These types of cases are similar to the lame horse case, in which one party insists on strict adherence to the terms of the contract, while the other side offers to show a business practice that varies the strict language.[293] The initial party then argues that the variation is only an informal accommodation, but one which was not intended to be legally enforceable.

These decisions have been subject to criticism on a number of grounds, including a lack of clear guidance to the courts. According to scholars, courts have made a number of doctrinal errors in applying the U.C.C. law on business custom. They have incorrectly used the parole evidence rule to exclude trade custom,[294] relied on overly liberal definitions of contradiction that permitted courts to rationalize as consistent "almost any usage of trade,"[295] misguidedly refused to admit business custom under the guise of protecting plain meaning[296] and made the doctrinal mistake of "equat[ing] inconsistency and admissibility."[297]

This Article argues that where the usage acts as a waiver of strict rights rather than an express usage designed to control opportunism (see cases discussed above in Part VI.C.1), a court may be less willing to intervene for a number of reasons. First, where the usage takes the form of an accommodation, the parties may have omitted the practice from the

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[293] Kraus & Walt, *supra* note 8, at 208.

[294] Kirst, *supra* note 6, at 832–36 (discussing misguided effort by courts to exclude evidence of business custom under the parol evidence rule).

[295] *Id.* at 850.

[296] *Id.* at 836.

[297] *Id.* at 842.

contract because they want to await further information and that information might be more readily accessible to the parties than to a court. Courts also seem to be hesitant to enforce trade usages when it appears as though doing so will simply shift the potential for one-sided opportunism from one party to another, and do nothing to eliminate it. That factor might explain an unwillingness of a court to admit evidence of a trade usage requiring just cause modifying an express contract term that permitted termination of the contract on ninety days' notice.[298] In *Triple T Services v. Mobil Oil Corp.*, the plaintiff operator of a franchised service station sued the defendant oil company for terminating their franchising agreement in bad faith.[299] The plaintiff sought an injunction prohibiting the termination of the lease, and argued that there was a custom in the franchising agreements prohibiting the franchisor from canceling them without just cause. The court refused to admit the custom.[300]

Incorporating the trade usage in this case would not serve the goals of the incorporation doctrine. The decision in *Triple T* does leave room for one-sided opportunistic behavior. As a result of this decision, the defendant could continue to force the franchisee to incur substantial sunk costs and end the agreement at its leisure. However, admitting the trade usage would have done nothing to cure this defect. Incorporation would simply shift the potential for one-sided opportunistic behavior from the defendant to the plaintiff. If the trade usage were accepted, the defendant may be forced to remain in a franchisor/franchisee relationship, even where there may be good cause to terminate the agreement, if the good cause is difficult for a court to verify. It is not clear that admitting the trade usage would serve the goal of maximizing gains from trade either. Incorporation would at best reduce the cost of opportunistic behavior, and do nothing to eliminate it. At its worst, incorporation could actually cause a net loss to contracting parties if the cost of franchisee opportunism outweighed the cost of allowing opportunism by the franchisor.

In a case such as this, the court may be reluctant to intervene, because there is no clear way for the court to eliminate potential opportunism, and the parties themselves are probably in the best position to guard against it.

Another type of case that presents difficulties for a court involves a party attempting to argue that a quantity specified in a contract should be treated only as a "fair estimate."[301] One such case famous in the lexicon of trade usage cases is *Columbia Nitrogen Corp. v. Royster Co.*[302] The focus

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[298] *See* Triple T Serv. v. Mobil Oil Corp., 304 N.Y.S.2d 191 (1969).

[299] *Id.* at 195. The defendant gave notice that it was terminating the lease despite the plaintiff's "more than satisfactory" performance during the lease period, and planned to open a diagnostic and repair service center on the site. *Id.* at 194. The plaintiff alleged that the defendant was attempting to benefit from the good will developed by the plaintiff over the course of the lease. *Id.* at 195.

[300] *Id.* at 204.

[301] Kirst, *supra* note 6, at 845.

[302] Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3 (4th Cir. 1971).

of the dispute was a three-year contract to sell phosphate at a fixed price. The contract obligated the buyer to purchase a minimum tonnage of 31,000 tons.[303] After the price suffered a sharp drop, the buyer and seller attempted to renegotiate the price; however, the price that the seller agreed to in renegotiation still exceeded the market price.[304] As a result the buyer took delivery of only one-tenth of the contract amount.[305]

The buyer sought to introduce evidence of usage of trade and course of dealing to demonstrate that the buyer was not obligated to purchase the stated minimum quantities in the contract. The buyer cited a pattern of mutual adjustment in which the parties had not adhered to the contract price or amount but had acted to take account of changed conditions.[306] The buyer in *Columbia Nitrogen* argued that that pattern of conduct amounted to a course of dealing that took place in other contracts between the buyer and the seller in which their roles were reversed.[307] That pattern of mutual adjustment comprised a trade usage as well.[308] The district court refused to admit that evidence offered by the buyer, citing the inadmissibility of such evidence when it contradicts the plain meaning of the contract[309] but the district court was overruled and the evidence was subsequently admitted.[310]

The difficulty with cases such as *Columbia Nitrogen*, in which one party alleges a business norm that will allow it to deviate from a quantity specified in the contract, is that parties can seek to deviate from a quantity specified in the contract whenever the market conditions make such purchases inconvenient or more costly than purchases on the market. A buyer could always seek to deviate from whatever quantities were specified by refusing delivery whenever the buyer could procure the goods on the market at a below-contract price. The seller would conversely seek to avoid delivery whenever the market price had risen. Unlike the factual situations of the cases discussed in Part VI.C.1, where the business norm is designed to constrain opportunistic behavior and there is little opportunity for parallel opportunistic behavior by the other party, these quantity deviation cases are inherently more ambiguous on the issue of who is acting opportunistically under the contract. In every fixed price/fixed quantity contract, a purported effort to deviate from the quantity or the price may involve an effort by one party who would be advantaged by a deviation from the express terms to reallocate the risks that were allocated in the contract. Therefore, a court should be reluctant to intervene to upset

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[303] *Id.* at 6.
[304] *Id.* at 7.
[305] *Id.*
[306] *Id.* at 8.
[307] *Id.*
[308] *Id.* at 10.
[309] *Id.* at 7–8.
[310] *Id.* at 11.

that risk allocation because doing so may well fail to improve welfare for the parties. This insight into the inherent potential for one party to opportunistically use deviations from express terms can explain in part why courts may be reluctant to allow such deviations under the guise of trade usage or course of dealing or course of performance.[311]

In quantity deviation cases where one party alleges that a deviation from a specified quantity and the nature of the trade usage itself seems to police the possibility of opportunism, the courts seem more willing to embrace the use of a business norm to vary a quantity term. For example, in *Michael Schiavone & Sons v. Securalloy Co.*, where the parties agreed on the defendant delivering 500 gross tons of stainless steel, the court actually allowed the defendant to introduce trade usage evidence that showed "500 Gross Ton" meant "up to 500 tons."[312]

In *Schiavone*, the parties faced the problem of uncertainty about the availability of steel. This could have led to both parties acting opportunistically. The buyer could have contracted for 500 tons and demanded damages when the seller failed to obtain the materials. This would have given the buyer damages for the seller failing to deliver materials that both parties anticipated ex ante might be unavailable. Under the trade usage, however, the buyer cannot demand damages for the seller's failure to deliver if the seller cannot obtain the materials. So the buyer cannot use the uncertainty surrounding availability to saddle the seller with damages. On the other hand, the seller too is constrained by the trade usage because if the seller obtains the materials, he must sell them to the buyer. He cannot simply decide that he would like to sell some of the 500 tons to another buyer who will pay more money. Thus, the trade usage constrains opportunism by both parties and the court can admit the trade usage without having to make difficult judgments about whether a party's deviation from a stated quantity is a form of opportunistic behavior on the particular facts of a case.

In other cases where the parties agreed on stipulated quantities ex ante and one party seeks to deviate from the express terms, alleging as in *Columbia Nitrogen* that the terms were not mandatory and were subject to renegotiation by the parties, the trade usage is not on its face designed to constrain opportunistic behavior. In such cases, one must ask why the parties omitted trade usages that made quantity terms flexible. The quantity variation may signal opportunistic behavior by one party trying to take advantage of shifting market conditions. Consequently, this is the kind of trade usage that parties may have omitted from the express contract. This is because the operation of the quantity variation should depend on how the parties have behaved, and they may be awaiting further

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[311] *See* S. Concrete Servs. v. Mableton Contractors, 407 F. Supp. 581, 584–85 (N.D. Ga. 1975).

[312] Michael Schiavone & Sons v. Securalloy Co., 312 F. Supp. 801, 804 (D. Conn. 1970).

information to see if the other party's conduct justifies a departure from the stipulated amounts. That may depend on whether the party seeking a concession has himself acted opportunistically in the past. Because courts may not have that information readily available, or may be unable to judge such information, courts will be more hesitant to excuse such deviations. However, where the evidence suggests that the party seeking a concession on quantity has himself acted opportunistically in the past, a court may be more willing to admit such evidence. One example is the *Columbia Nitrogen* case.[313] Courts have also demonstrated a reluctance to incorporate trade usages when there is the potential for one-sided opportunistic behavior by the party seeking to incorporate the trade usage, especially in situations where the court may have difficulty verifying the good faith of the party seeking to invoke the practice.

A seminal case illustrating this principle is *Albus v. Toomey*.[314] In *Albus*, the plaintiff purchased cloth from the defendant and attempted to return the goods two months later.[315] The plaintiff tried to show that it was customary for buyers to purchase cloth in advance, warehouse the merchandise, and examine the goods only when the buyer was ready to use them.[316]

In this case there is great potential for the buyer to engage in one-sided opportunistic behavior if the trade usage is admitted, as the buyer could purchase cloth speculatively and invoke the trade usage if the price fell, or an anticipated order for clothing never materialized. This would allow the buyer to shift all of the risks of a speculative transaction to the seller. The courts are also in a poor position to recognize opportunism when it does occur in situations like *Albus*. The cloth was sold two months before the buyer attempted to return it. If the cloth was defective, the court will have a difficult time discerning whether it was sold in a defective state, or if the buyer (either through neglect or deliberate actions) ruined it.

In situations such as the one presented in *Albus*, courts are rightfully hesitant to incorporate a trade usage. Where there is clear potential for one-sided opportunistic behavior, and the courts are in a poor position to determine whether a party has acted opportunistically, courts will not incorporate a trade usage. Instead the parties themselves are in the best position to determine whether or not opportunistic behavior is occurring. The one-sided nature of the potential opportunism is the reason that

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[313] The court cited a pattern of conduct by the parties in previous contracts where the quantity term was readjusted, including at least four instances where the roles were reversed and the defendant, acting as the seller, allowed the plaintiff to avoid taking delivery of any of the contracted goods. Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3, 8 (4th Cir. 1971).

[314] Albus v. Toomey, 116 A. 917 (Pa. 1922).

[315] *Id.* at 917.

[316] *Id.* at 918.

vulnerable parties must have recourse to "their stricter contractual rights whenever they consider their contracting partner to be acting opportunistically."[317] To take away the seller's discretion in this case would leave him defenseless in the event that the purchaser acted opportunistically, and would reduce the seller's willingness to contract. Thus, the trade usage at issue in *Albus* is similar to the custom allowing for the return of lame horses cited by Professors Kraus and Walt.[318]

VII. HOW THE REFRAMED DEBATE SOFTENS SOME OF THE CRITICISMS AGAINST THE INCORPORATION STRATEGY

Understanding the taxonomy of bargaining impediments, as well as the functional purpose of trade usages, provides a useful background for understanding how trade usages may be beneficial in solving problems (including the control of opportunism) that cannot otherwise be solved by contract. Yet, in recent years, the neoformalists have launched a sustained attack against the norm incorporation strategy underlying Article 2 of the U.C.C.[319] These critics have failed to situate the debate within the context of the taxonomy of bargaining constraints. They have failed to view trade customs as a private response designed to maximize gains from trade by controlling the effects of opportunism that might require legal enforcement if other means of enforcement (private compulsion, sanctioning based on reputation, or an organizational response) are unavailable. Moreover, because the criticisms have tended to treat the incorporation strategy as an all-or-nothing proposition, they have failed to assess the particular reasons for the omission of a substantive norm, or to assess whether the conduct governed by the norm would be transparent to outsiders or whether courts would have difficulty assessing the conduct. These factors, along with the structural factors discussed earlier, might affect the efficacy of private, versus public enforcement of a business norm. These failures have led critics assessing the normative value of the strategy of incorporation to undervalue the benefits of norm incorporation and to overestimate the possibility of private enforcement. Their criticisms are not as compelling after accounting for the role that private norms play in the context of controlling for opportunistic behavior in incomplete contracts.

A. *The Criticisms*

The criticisms of incorporation fall into several distinct categories.[320] Some critics argue that a norm incorporation strategy is too costly because

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[317] Kraus & Walt, *supra* note 8, at 208.

[318] *See id.* at 207–08.

[319] *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 585 (2003); Scott, *supra* note 13, at 870–71.

[320] Kraus & Walt, *supra* note 8, at 226 n.2.

it requires courts to make difficult determinations about the relevant norm, and results in interpretive errors by courts,[321] as well as departures from the parties' intended meaning.[322] Professor Bernstein's critique of incorporation strategy posits that courts often mistakenly incorporate norms that were never intended to govern relationships if they dissolved into litigation.[323] The trade group critique of incorporation strategy suggests that the rejection by many trade groups of contextualized norm based strategy in favor of formalistic rules demonstrates the superiority of formal rules.[324] Other critics argue that courts should not automatically incorporate norms, because the process of norm development is flawed and often results in inefficient norms.[325] The empirical critique of norm incorporation argues that because norms simply do not exist, a strategy premised on norm incorporation is impracticable and misguided.[326] The two domains critique argues that legal enforcement of informal norms is harmful, because it causes parties who never intended the informal norms to be legally enforceable to be bound by them. This last argument is based on the idea that informal norms and legal agreements should remain in separate spheres, and that if courts enforce informal norms, then parties will avoid using them for fear that they will be given legal effect (sometimes referred to as the "rigidity effect").[327] The moral hazard critique posits that the incorporation approach will increase strategic efforts by parties to claim a private trade meaning whenever it results in a more favorable outcome than the ordinary meaning.[328] This final Part argues that these critiques should be reassessed in light of the functional approach suggested by this Article.

1. *Interpretive Error*

The current debate regarding the wisdom of the incorporation strategy is premised on its comparison with the alternative, interpretive technique of plain meaning.[329] Its proponents look at each strategy as a mechanism

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[321] Courts make many kinds of errors, including failing to understand the correct norm and applying it incorrectly. They may also fail to give effect to the parties' express terms, finding that the implied norms "trump" the parties' express terms. This may hinder contractual innovation. Scott, *supra* note 13, at 857.

[322] *See* Goetz & Scott, *supra* note 29, at 298.

[323] *See infra* text accompanying note 371.

[324] Bernstein, *supra* note 7, at 1771 (indicating a tendency of NGFA arbitrators to "give far less weight to these indicia of immanent business norms than do generalist courts[,]" and arguing that empirical data suggests that parties would prefer to opt out of a legal system that gives legal recognition to commercial norms).

[325] *See* Posner, *supra* note 13, at 1724.

[326] I do not address the empirical arguments made against the norm incorporation strategy. Professor Lisa Bernstein dealt exhaustively with several instances that negated the existence of universal trade norms in the cotton and grain and feed industries. *See* Bernstein, *supra* note 7, at 1766–87.

[327] *See* Ben-Shahar, *supra* note 6, at 784 (discussing rigidity effect).

[328] *See* Schwartz & Scott, *supra* note 319, at 587.

[329] "Plain meaning is literal sentence meaning." Kraus & Walt, *supra* note 8, at 194.

that will allow the parties to "secure their desired interpretation at the lowest cost."[330]

The two different strategies are associated with competing and irreconcilable goals. The plain meaning strategy enables courts to correctly interpret express terms, while incorporation strategy allows the court to incorporate "privately developed prototypes into the stock of useful default rules . . . ."[331] Professors Schwartz and Scott see these goals as conflicting. If courts give effect to the plain meaning, they may negate the default rules incorporating trade usages.[332] If courts give effect to the default rule, and incorporate stock prototypes, they may end up ignoring the parties' express terms, allowing trade usages to trump conflicting, express terms.[333]

The normative debate addresses the various costs associated with each strategy as a means of determining which one will generate the lowest costs. The plain meaning strategy is thought to generate low interpretive error costs by courts because of the "fairly clear set of non-domain-specific, common meanings associated with most terms . . . ."[334] Critics tout the plain meaning approach as a strategy that can more easily achieve "reliable interpretation" of the parties' express terms.[335] By contrast, the incorporation strategy necessarily generates errors since courts must not only identify the domain in which a commercial practice arises, but must also offer a correct interpretation.[336] Because of the possibility that there will be two opportunities for errors,[337] "incorporation regimes would be expected to have a higher rate of interpretive error than plain meaning regimes."[338]

On the other hand, a prime advantage of the incorporation strategy is that it saves parties transaction costs. Parties do not have to translate all specialized usages into plain meaning in an express contract. They can count on the domain-specific meanings without having to expressly incorporate them or translate them into terms with a plain meaning.

The current debate on interpretive error portrays the strategies for contract interpretation in a way that is divorced from the parties' own goals in negotiating contracts to solve problems and maximize gains from trade by controlling discretion and behavior. Those goals should remain central to any approach to contract interpretation. Excluding those goals from a cost/benefit analysis causes current scholars to ignore two matters that

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[330] *Id.* at 196.
[331] Scott, *supra* note 13, at 856.
[332] Schwartz & Scott, *supra* note 319, at 585–86.
[333] *Id.* at 586.
[334] Kraus & Walt, *supra* note 8, at 198.
[335] *See, e.g.*, Scott, *supra* note 13, at 857.
[336] Kraus & Walt, *supra* note 8, at 198.
[337] *See id.*
[338] Kraus & Walt, *supra* note 8, at 198.

might affect the analysis of whether a plain meaning or incorporationist strategy would be preferable. First, the plain meaning approach assumes that "most terms have a relatively clear, objective 'plain' meaning, which consists of their most common interpretation."[339] Yet, the prior taxonomy suggests that a menu of terms available under plain meaning will not be of any use to parties trying to control behavioral opportunism in the face of uncertainty.[340] When the failure of the parties to incorporate trade usages into their contracts is due to barriers to effective bargaining, we may not be able to look to the plain meaning of the contract to interpret it, and we have to inquire whether the trade usage was established or developed to increase gains from trade. Where barriers exist, a menu of terms with plain meanings simply will not help the parties achieve their goals and may undercut any possible advantage of such a regime in avoiding error costs.

The current plain meaning approach thus ignores considerable obstacles that parties face in negotiating express contracts to control behavior. Insisting that parties solve their problems through express contractual language adds to the drafting burdens of the parties, and ignores another large cost: that parties who are unable to draft express contract clauses to mitigate contractual hazards will have far fewer gains from trade to share.[341]

Two champions of this plain meaning approach, Professors Scott and Schwartz, discount the drafting cost that would burden parties who would have to specifically opt in and affirmatively signal to the court that they want their contracts to be interpreted in specialized trade meanings called "party talk," not "majority talk."[342] They argue that the costs would be low for two reasons. First, the parties would not have to undertake a detailed description of all of the customs but could rely on a generalized clause such as a clause that "[t]his agreement is to be read in light of the customs of the widget trade."[343] Second, because many of the provisions of any contract have a majority talk meaning and only a small portion of the terms have a specialized party talk meaning, having a default rule based on private trade meanings would be costly, as it would require parties to specifically opt out and specify all of the instances where a majority plain meaning is intended.[344]

Requiring the parties to generally opt into all trade customs or trade language would provide some evidence to a court of the parties' decision that customs would form part of their contract. Such a requirement would be beneficial because it would deprive one party of the ability to argue,

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[339] *Id.* at 197.
[340] *See supra* Part I.
[341] *See* WILLIAMSON, *supra* note 58, at 63.
[342] Schwartz & Scott, *supra* note 319, at 585.
[343] *Id.*
[344] *Id.*

perhaps strategically, that the contract should be governed by "majority" talk rather than customary trade practices.[345]

However, an approach requiring a generalized opting into commercial practices has limitations. First, since many practices may arise spontaneously, through evolution, blanket consent to these practices beforehand may not be meaningful.

Second, where the usage is extremely common, widespread, and well known, the parties may not even think about actually explicitly including an opt-in term. Third, there may be difficulties in getting parties to engage in a wholesale adoption of all customs and usages because there are different types of usages, some relating to terms of art, some to controlling behavior (such as opportunism) and some amounting to waivers of express terms through conduct. The possibility that a party may invoke a trade usage opportunistically could deter parties from opting to incorporate all trade usages. Fourth, these opt-in clauses would not be particularly helpful, because when one party is trying to determine whether the other party will act opportunistically, general assurances might not be believed by a party who is uncertain about the other party's proclivities for opportunism.[346]

The absence of a ritualistic pledge to follow custom should not necessarily be determinative of whether the court should resort to business norms to interpret a contract. This is especially true when the norm was designed to benefit both parties by curbing opportunistic behavior, there are large sunk costs on the part of one party, and there is no reason to believe that the parties omitted the trade usage to allow further information to develop about conditions that could best be judged by the parties as opposed to a court.

Thus, if I contract for the delivery of milk in 1930 and fail to mention that I want my milk delivered cold and in the morning,[347] and there is a business custom that milk is delivered cold and in the morning, the court should incorporate that custom even if the parties fail to regularly promise to abide by the custom.

The situation is emblematic of an agency problem where one party has discretion over some aspect of performance during the course of a contract. The custom serves to constrain this discretion in a way that benefits both parties, and it may have been difficult for the parties to see a need for explicitly negotiating a term on the time of delivery and the temperature, because these terms are obvious to anyone in the trade. The failure to enforce the contract, as supplemented by trade custom, even if the parties

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[345] *Id.* at 585–86.

[346] Even parties with a past penchant for acting opportunistically are likely to pledge to abide by all trade customs, so the ritualistic pledge may not offer adequate security needed for encouraging transactions and contracts to take place.

[347] Augustis Makris supplied this example.

failed to abide by a ritualistic pledge, would allow one party to escape responsibility for a risk that both parties would have assumed fell on the milk seller. This would be detrimental to future contracting parties as well. Failure to enforce the trade usage would signal to potential contracting parties that when one party retains discretion to act, they would not be prevented from doing so opportunistically. This would cause parties to discount what they are willing to pay on contracts where the other party retains some discretion to act.

The problem with insisting on a ritualistic pledge to trade custom is that the parties may not understand why such a pledge would be needed, because the trade usage is so obvious to the parties that they may consider it to be the "plain meaning" of the contract. This can be seen in the *Hurst v. W. J. Lake & Co.* case.[348] The seller in *Hurst* contracted to deliver horse scraps to the buyer. If the protein content of the meat was below 50%, the buyer would receive a discount on the price.[349] A portion of the delivered horsemeat had a protein content of 49.53% and another portion had a protein content of 49.96%.[350] Accordingly, the buyer paid the discounted price on those portions. The seller sued for the difference between the original and discounted price, relying on a trade usage that "50% protein" was understood to mean anything above "49.5% protein."[351] The court admitted the trade usage and ruled in favor of the seller on the defendant's motion for judgment on the pleadings.[352]

It seemed clear—given the court's findings of fact—that the defendant buyer was acting opportunistically. Having contracted and understood the meaning that 50% meant anything 49.5% or above, the defendant then tried to receive an opportunity (a lower price) that it had bargained away when it made the contract.[353] By admitting the trade usage, the court was able to translate the language of the parties into common English in which 50% meant 49.5% or above, thereby preventing one party from acting opportunistically.

Rather than requiring parties to ritualistically pledge adherence to trade custom, the court should ascertain why parties develop these customs, then determine whether courts should intervene to enforce them, or whether parties should police defections through private sanctions.

Giving a party the ability to decide whether to pursue a cause of action in court or to pursue reptuational sanctioning as the ideal means of enforcement, even if they had not ritualistically agreed that custom would govern, would provide value and enhance choices for the parties.

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[348] Hurst v. W. J. Lake & Co., 16 P.2d 627, 631 (Or. 1932).

[349] *Id.* at 628.

[350] *Id.*

[351] *Id.* at 629.

[352] *Id.* at 631.

[353] *See* Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA. L. REV. 1, 3 (1981) (discussing opportunity foregone).

Plain meaning advocates, in addition to mistakenly assuming that a plain meaning approach can solve behavioral opportunism problems, may have also exaggerated the interpretive error costs associated with incorporation strategies that require courts to assess various domains and commercial contexts for the existence of norms.[354] If courts considered the structural barriers (uncertainty, opportunism and sunk costs) that prevent the parties from bargaining to control the myriad forms of opportunism, the futility of generalized clauses to cooperate, and the ability of private parties to self-enforce, there would be fewer judicial errors when applying customs. Once courts considered this structure and analyzed private commercial norms accordingly, courts could more readily discern whether a norm would advance the parties' goals. Courts could more quickly grasp the function of the norm and perhaps facilitate a better recognition of the contours or parameters of the norm, and thus avoid the interpretative difficulties that some cases might otherwise present.

The current cost/benefit analysis of the two strategies may also be inaccurate not only because the error costs are misestimated, but also because the advantages of the incorporation strategy are underestimated. Not only does the incorporation strategy save parties the specification costs of translation, but it also permits parties to maximize the gains from trade by allowing the parties to mitigate contractual hazards.[355] In assessing the merits of an incorporation strategy, the comparison must include not only an evaluation of the plain meaning strategy, with its ability to offer predictable meanings to parties using terms, but also its ability to solve problems "that even in principle it cannot be used properly to resolve."[356] Since the success of a plain meaning strategy depends on selecting a term with a plain meaning, it will not help when the problems of uncertainty, opportunism and sunk costs converge to hinder a complete bargain with express terms to which a plain meaning strategy can be applied. The question then becomes: "What should the court do when clear bargaining impediments exist, and the parties have devised strategies outside the contract for solving problems and maximizing gains?" Plain meaning limited to enforcing the express terms of the contract will simply not be able to resolve that question, nor will a ritualistic invocation of trade practices.

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[354] The presence of the customs themselves might serve as benchmarks to more closely define the outlawed opportunistic behavior, and thus mitigate another criticism—namely, the fact that "standard rules . . . designed for general application . . . are often incongruent with the shifting needs of various classes of specialized contractors." Goetz & Scott, *supra* note 29, at 276.

[355] WILLIAMSON, *supra* note 55, at 60.

[356] Kraus & Walt, *supra* note 8, at 195.

2. *Norm Incorporation Does Not Lessen Burden on Courts and Therefore It is Too Costly*

One criticism that has been leveled against the norm incorporation strategy is that it will be too difficult for courts to identify norms and to apply them in specific cases. In fact, Professor Craswell argues that norm incorporation will force courts to shoulder the same burdens that they face in common law adjudication. Craswell's argument is that the statutory decision to resort to custom does not free the court from any burden, and thus, if we are going to continue to resort to incorporation as a strategy, it cannot be because doing so "can serve as a guide to something that courts would face great difficulty identifying on their own."[357] Additionally, courts will inevitably face stringent burdens in deciding if a norm exists and whether to apply it in a particular case.

Richard Craswell argues that the process of identifying and applying norms is akin to the process of common law adjudication. In both instances, courts must grapple with "issues of distinction and analogy."[358] With regard to common law cases, courts must decide whether the fact pattern at issue is similar enough to be covered by prior precedent, or whether there are relevant and important distinctions that call for a different result. Craswell finds that the process of jurisprudence or common law adjudication is such that the "judge's normative views will influence the rule he or she ultimately selects."[359]

Ascertaining norms involves many of the same questions of judgment that common law adjudication involves. Rather than simply finding a custom, a court must decide "how broadly or narrowly the custom ought to be framed."[360] That process of defining the custom then determines whether a particular case is covered by the custom. Craswell, therefore, finds the process of norm identification not an easy one. A court does not, and cannot, simply "find" the norms because the patterns on which they rest are ambiguous.

However, while the criticism suggests that there will be judicial burdens associated with applications of norms, this is not a compelling reason to reject norm incorporation as a strategy. First, the fact that there is some burden on courts seems to be a dispositive reason to reject norms only if one presupposes a false and unrealistic view that norm incorporation will be easy. In fact, in order to determine what norms should be incorporated into parties' contracts, courts may have to develop a model for understanding why parties develop norms and how those norms may facilitate the achievement of the parties' goals that may not be

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[357] Richard Craswell, *Do Trade Customs Exist?*, *in* THE JURISPRUDENTIAL FOUNDATIONS IN CORPORATE AND COMMERCIAL LAW, *supra* note 8, at 118, 123.

[358] *Id.*

[359] *Id.*

[360] *Id.*

possible through express contract. Although that initial process may require some effort on the part of courts, once that understanding is developed and honed, it will be possible for courts to more easily identify and apply some norms—those specifically designed to control opportunistic behavior. That understanding may help mitigate some concerns that have been raised about the burdens imposed by courts by the incorporation strategy.

The taxonomy presented in this Article will help courts to see the ways that business norms can serve to reduce costs for parties by mitigating hazards of opportunism. Thus, if the norm involved serves to mitigate hazards and increase gains from trade, there would be every reason for the court to enforce the norm. It may be easier for a court to decide if a norm exists, and if so, how it should be applied if the court can conceptualize the way in which particular norms serve certain goals of constraining opportunism under conditions of uncertainty. If a court simply incorporates norms that exist, without an understanding of why contracting parties did not expressly incorporate the norms and why incorporation might promote welfare maximization, then a court is likely to commit errors. A similar result might happen if a court tried to apply a statute without an understanding of the legislative purpose in crafting the statute.

In addition, the fact that there is a burden on the court presented by norm incorporation strategy may still be worth the cost, especially if judicial incorporation of norms can help to achieve the parties' strategies of mitigating the hazards of opportunism and thereby increasing gains from trade at a lower cost than informal, non-legal enforcement of such commercial practices.

3. *Increase in Moral Hazard*

Plain meaning advocates assert that allowing private, non-majority meanings for contract interpretation will foster moral hazard and is therefore undesirable. [361]

Professors Scott and Schwartz argue that incorporating trade meanings will foster moral hazard more than the alternative plain meaning strategy.[362] They posit that it will be harder for a party to use plain meaning for strategic purposes and thus it should be the preferred rule. If parties A and B were to write a contract in specialized "party talk,"[363] and it turned out that the contract was a bad deal for B, B might try to argue that the court should use majority talk to interpret the contract if that majority talk favored B more than the private trade language. Although such strategic behavior would be possible, it would be relatively rare since it would occur only when "words in a particular private language . . . have

[361] Schwartz & Scott, *supra* note 319, at 587.
[362] *Id.*
[363] *Id.* at 585.

a clear but different meaning in the majority language that also favored . . . B."[364]

On the other hand, Scott and Schwartz argue that if the parties could always argue private meanings—as they could under an incorporation regime—there would be such a multiplicity of private meanings to resort to that it would foster more instances of the strategic use of private meanings. If courts required that parties signal to each other and the court that the contract was written, and should be interpreted in a private language, the possibility that a party would "attempt to rescue itself from a bad deal by claiming that its contract was written in a mythical private language" would be reduced.[365]

This Article posits that contextualist interpretation rather than insistence on plain meaning will often reduce moral hazard rather than increasing it, especially in cases where the contextual incorporation is of a usage specifically designed to curb opportunistic behavior that might occur during the course of lingering performance obligations throughout the course of a contract.

Scott and Schwartz utilize *Southern Concrete Services v. Mableton Contractors,* to demonstrate that parties can invoke "a fictional favorable private meaning to a majority talk contract."[366] The buyer claimed that a contractual provision obligating the buyer to purchase "approximately 70,000 cubic yards" could be met when the buyer only needed and accepted 12,542 yards to complete the project.[367]

In *Southern Concrete*, the court rejected evidence that the specific quantities should be interpreted as estimates, and thereby insisted that the contract quantities should be interpreted in accordance with majority/plain meaning talk that would normally be ascribed to the words "70,000." The court rationalized the result by recognizing the need to prevent "a frontal assault on the essential terms of a clear and explicit contract."[368]

Despite the court's championing of plain meaning, it may have been the case that insisting on plain meaning was the preferred strategy to prevent opportunistic behavior by the buyer. It is not clear that plain meaning should always be the linguistic default that parties must opt out of. In some cases adherence to plain meaning or a dictionary definition, and a refusal to admit evidence of a trade usage, may actually foster opportunism, and parties would presumably no longer "prefer courts to assume that they wrote in majority talk."[369] In cases, such as *Dixon*,[370] a

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[364] *Id.* at 586.

[365] *Id.*

[366] *Id.* at 586 n.85 and accompanying text (discussing S. Concrete Servs. v. Mableton Contractors, 407 F. Supp. 581 (N.D. Ga. 1975)).

[367] *S. Concrete Servs.*, 407 F. Supp. at 582.

[368] *Id.* at 584.

[369] Schwartz & Scott, *supra* note 319, at 587.

[370] Dixon v. Irmaos & CIA, Ltd. v. Chase Nat'l Bank of N.Y., 144 F.2d 759 (2d Cir. 1944).

court admitting and enforcing the trade usage serves to increase value by allowing the parties to provide a means of enforcing a private strategy (trade usage) specifically designed to curb opportunism. In *Dixon*, had the court refused to admit the trade usage and insisted on plain meaning, it would be allowing the bank to opportunistically evade a risk that it had assumed in issuing the letter of credit. Thus, there is no single unitary strategy to be followed in order to curb opportunism and plain meaning interpretations can often serve to increase opportunism rather than curb it.

4. *The Two Domains Argument: Keeping Informal Norms Separate and Unenforceable*

The two domains argument separates legally enforceable formal norms and legally unenforceable informal norms. The argument posits that while parties may adhere to informal norms, they do not intend for those informal norms to be legally enforced by courts in a dispute.[371] The notion is that there are separate domains for informal norms and formal obligations and that each domain has its own means for sanctioning non-conforming or deviant behavior. Informal norms should be enforced by non-legal sanctions and formal legal obligations should be enforced by legal sanctions.

Arguments against "judicializing" parties' informal norms take several forms. Because each of these arguments against norm incorporation rests on distinct assumptions, it is critical to examine those assumptions to see if they are logical and if there are other assumptions that would be more consistent with current theories of how parties develop norms, how and why those norms are incorporated into law,[372] and what purposes such incorporation serves.

The model supposes that the parties have a variety of informal and formal norms at their disposal. In their contract, parties will deliberately choose "from a rich set of formal and informal norms an optimal combination of norms to regulate their conduct."[373] Incorporating informal norms and giving them legal effect upsets this deliberately constructed template. Erroneous legal incorporation of informal norms would undermine the informal norms and violate the parties' intention to give legal effect only to the formal norms.

However, the two domains criticism tends to ignore the bargaining context of commercial norms. If there were no bargaining impediments, then the failure to formally include the norms in a contract might tend to support the inference that the parties deliberately intended the informal norms to remain without legal effect. Presumably, absent such obstacles,

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[371] Bernstein argues that courts often make the mistake of enforcing practices that parties intended to remain as unenforceable "extralegal provisions." Bernstein, *supra* note 7, at 1802.

[372] *See* Smith, *supra* note 90, at 484.

[373] Kraus & Walt, *supra* note 8, at 208.

the parties could simply expressly incorporate any relevant trade usages. But given the obstacles to drafting contracts that expressly solve all of the parties' problems, and the disinclination of parties to believe ritualistic promises to refrain from opportunistic behavior, it is possible to conclude that the failure to expressly incorporate norms in contracts is not a result of deliberate omission and a desire to keep the norm legally unenforceable, but rather was of transaction costs. Even simple statements by the parties that they would incorporate all trade usages, course of dealing and course of performance would add transaction costs and in some instances parties might be reluctant to bind themselves to all commercial practices since they might open themselves up to the possibility of strategic invocation of the usage by the other party. The two domains argument is also less persuasive when one focuses on an actual example. That example will show that courts are unlikely to mistakenly incorporate the informal norm if it is examined in the context of the parties' goals and bargaining impediments. The example of a formal norm given by Kraus and Walt is the presence of a warranty disclaimer in 90% of horse sale contracts.[374] The example of an informal commercial norm given by Kraus and Walt is the right of return in horse sale contracts when the horse is found to be lame.[375] This norm was intended to remain an informal accommodation rather than a legally operative norm. Because horse sellers want to retain the right to insist on a strict contract right denying the right of return in cases where the buyer is "behaving opportunistically,"[376] courts should decline to legally incorporate the right of return for lame horses into a contract if the seller chose to insist on his contractual rights.

This example, however, does argue against the strategy of legal incorporation of informal norms. If one examines the context of the horse sale, including the impediments faced by the parties and the problems of behavioral uncertainty discussed earlier, one might decide that since guarding against and mitigating the effects of opportunistic behavior is a key goal of contracting parties, the informal norm was not a right of return of lame horses already accepted by buyers, but rather a right of return as long as the buyer is not acting opportunistically.

If the seller accepted the return of all horses when a buyer complained that the horse was lame, the seller could have some uncertainty about whether a particular buyer was responsible for the condition of the horse, and thus the seller would be reluctant to take the horse back. The informal norm that the seller would ordinarily take the horse back if it were lame but not mandating such a return privilege would help to guard against opportunistic behavior by the buyer.

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[374] *Id.* at 207–08.
[375] *Id.* at 208.
[376] *Id.*

Thus, looking at the context, it is possible to see that the parties might have difficulty putting an express term in the contract to mandate the return of lame horses if there were the possibility that the buyer could exercise the right in an opportunistic fashion. The seller would be reluctant to accept a mandated return in all cases if the buyer could behave opportunistically and there were asymmetries about that fact.

5. *Mistakenly Incorporating Informal Relationship Preserving Norms When at an End Game Situation*[377]

Another prime argument against norm incorporation is that courts incorporating commercial norms often look to and enforce relationship-preserving norms (RPNs) as the source for establishing the substantive norm. They often mistakenly do so at the end of a contractual relationship when RPNs should no longer govern and only end game norms (EGNs) should be applied.[378] Thus, the norm incorporation strategy is inherently flawed because when assessing trade usages for incorporation, courts will often legally recognize norms that were only meant to govern when the parties themselves were acting to "cooperatively resolve disputes among themselves" and still "want[ed] to preserve their relationship."[379]

This Article argues that two significant counterarguments may render this criticism of norm incorporation less compelling. The first is premised on the view that the content of all trade usages and other norms can be explained in terms of a bifurcated character. There are certain norms and practices to which parties informally adhere, but the assumption is that they intend to do so only so long as they "trust one another and/or value potential future dealings."[380] When the parties face an irrevocable end-game situation, they no longer want those norms to govern. It is not clear that all trade usages have this binary character, which Professor Bernstein ascribes to them.

Secondly, in deciding what the law should do about incorporating norms, courts should make decisions that will maximize joint gains from trade, considering the ex post and ex ante consequences. Where parties have devised certain norms or developed private strategies for solving problems that are difficult to control ex ante, it is important to incorporate those norms and not to carve out an exception or to routinely give parties an escape from the operation of the norm if the relationship ends. Doing so would be inefficient because it would deprive parties of the ability to overcome the structural barriers to negotiating a first best outcome.

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[377] Bernstein, *supra* note 7, at 1796–1807 (distinguishing end game norms from relationship preserving norms).

[378] *Id.* at 1796.

[379] *Id.*

[380] *Id.*

This efficiency loss allegedly occurs because when parties intend to relegate certain obligations to a non-legal realm, and courts mistakenly incorporate the wrong types of norms—RPNs rather than EGNs—imposing additional costs on the parties. This error may occur where the unwritten practices depend on unverifiable information.[381] It may also interfere with the parties' autonomy and choice by "prevent[ing] them from selecting their preferred mix of legal and extralegal provisions . . . ."[382] In addition, since the incorporation of a RPN is more complicated than an ENG—which is ordinarily associated with the strict enforcement of the contract's terms, the incorporation of RPNs will be more costly because of the likely interpretive errors.

The argument that courts should not incorporate norms "that the parties had developed to apply to their relationship when it was expected to last,"[383] after the relationship has broken down and that there is no reason to continue the customs when the trust has dissipated, has several flaws. It is premised on the idea that a trade usage exists only as a kind of an informal accommodation strategy to ongoing contractual disputes. An example might be a price adjustment that a merchant makes when the goods fall below the standard in the contract. Such a routine price adjustment is part of "the give and take of ordinary mercantile life,"[384] but at the same time, parties would not want that informal accommodation to be legally required. The anti-incorporationists argue that recognizing the general legitimacy of the incorporation strategy would require that the law also give effect to a variety of business norms that are not meant to be legally enforced, including the accommodation or grace strategy, in which one party forgives the non-performance of the other party but does not intend that forgiveness be required in future cases where there is a contract violation.

Narrowly conceptualizing the incorporation doctrine as one that necessarily results in judicializing accommodations that were meant to remain extra-legal fails as a basis for assessing the propriety of incorporation strategy for several reasons. It is not clear that a court would recognize a relationship-preserving norm and apply it as a trade practice to an endgame dispute. The desire of the parties to keep the practice informal and extra-legal would prevent courts from recognizing the practice as part of the parties' agreement.[385]

Thus, even if incorporation were recognized as theoretically sound, courts would not necessarily incorporate such accommodation practices.

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[381] *Id.* at 1803.

[382] *Id.* at 1802.

[383] David Charny, *The New Formalism in Contract*, 66 U. CHI. L. REV. 842, 852 (1999).

[384] Bernstein, *supra* note 7, at 1801 (quoting Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 525 (1987)).

[385] Kraus & Walt, *supra* note 8, at 208.

Legal decision makers would first have to situate the practice (of accommodation) into the larger context of problems that the parties are trying to solve to determine whether incorporation would advance efficiency by solving a problem for the parties at a cheaper cost than the other private strategies that the parties might devise to achieve their goals, given the obstacles that existed to express contracting on the matter. Without that context and a comparison of different legal and extra-legal strategies for solving the parties' problems, it is impossible to determine whether a strategy of norm incorporation would actually result in the incorporation of a particular set of practices. A court could conclude that because an incorporation of a norm would foster opportunistic behavior or lead to other losses, it should *not* be incorporated. Thus, it is hard to conclude that norm incorporation necessarily will result in efficiency losses. A party's decision to have certain extra-legal accommodation strategies remain legally unenforceable does not mean that courts should reject a norm incorporation strategy for all trade usages without an analysis of whether incorporation of the particular practices would advance parties' goals.

In the example given by Bernstein to illustrate the proposition that "merchants do not necessarily want RPNs to be applied by courts in end-game situations,"[386] the Code drafters faced the choice of either giving legal recognition to a practice of price adjustment that was informally subscribed to by the parties once a dispute arose or to insist on the contractual terms of perfect tender. Llewellyn had considered substantial performance as an alternative to the perfect tender rule to reflect the realities of merchants not insisting on perfect tender; however, the Code drafters settled on perfect tender as the Code rule.

The fact that the Code rejected the particular incorporation of price adjustment as a merchant response to flawed performance does not mean that the incorporation strategy itself is inherently flawed. Although the Code drafters rejected the substantial performance rule as an alternative to perfect tender, the decision to do so must be considered in the context of the goals that the strategy was designed to solve against the possible costs of an alternative strategy. In each case, of course, there is a risk that one party may act opportunistically. Because a departure from perfect tender would arguably promote opportunistic behavior by allowing sellers to "unload all of their shopworn and defective goods,"[387] and claim that they had substantially performed and "would also give juries a vast amount of discretion that would lead to erratic and error-prone decisions,"[388] the costs of incorporating such a strategy were perhaps thought not to be worth the costs of incorporation—at least where other extra-legal reputational

[386] Bernstein, *supra* note 7, at 1801.
[387] *Id.*
[388] *Id.*

sanctions existed that could curb the potential for opportunism by buyers who would otherwise use the perfect tender rule to escape their obligations in a declining market.[389] Thus, rejections of the incorporation of particular merchant practices that would foster opportunism could still be consistent with a policy of incorporation at least where a cost/benefit analysis would indicate that incorporation would be more efficient.

To the extent that Bernstein's criticism suggests that incorporating all parties' commercial norms or practices would be misguided because they are always intended to remain unenforceable, it should be rejected because it ignores a fundamental principle of contract. In deciding whether a particular rule would maximize the benefits of exchange for the parties, the issue should be whether value would be maximized considering the ex post and ex ante consequences of a legal incorporation decision. When parties have a dispute, one party may claim that incorporation of certain norms would violate his or her present desires and intentions. However, in crafting legal rules and deciding whether to incorporate norms, the decision maker must take account of the ex ante legal effect of rules on future parties. Using that calculation in order to maximize the joint gains from trade, courts may decide to incorporate certain norms even when one party may currently have an affirmative desire to break from that custom by claiming that only ENGs should govern.

The fact that the parties' interests diverge at the point of dispute and at least one party would prefer not to be governed by prior norms and seeks to escape from such norms to promote his/her own self-interest, does not necessarily mean that the court should refuse to apply relationship-preserving norms. In evaluating that question, the court should focus on whether the incorporation of such a norm when viewed ex ante would be one that the parties would want to govern their contract because it would serve their purpose of maximizing overall gains from trade. If so, the court should incorporate the norm.

6. *Alternatives to Informal Trade Customs: Trade Group Rules and What They Say About Legal Intervention*

The existence of informal trade norms raises the question of what role the U.C.C. approach should take toward those norms. Since informal trade practices could serve the goals of controlling deleterious conduct and enhancing joint gain, legal intervention through norm incorporation would seem justifiable as a means of enhancing the parties' welfare.

As an alternative to informal trade practices, the parties may subscribe to a set of formal trade organization rules. A question arises: "Does the existence of formal rules signal that the entire U.C.C. incorporation strategy is misplaced?" The question evokes two separate criticisms of the

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[389] *Id.*

norm incorporation strategy. First, since there is no evidence of national uniform norms in certain industries, the strategy is misguided. Since such norms do not exist, a strategy built on incorporating them must fail. The second contention is that since some industries have opted out of the U.C.C. rules and adopted alternative formal rules, the U.C.C.'s continued effort to look to informal norms is a misplaced strategy. The implication is that since the trade group rules address all-important matters, it demonstrates that complete contracting is possible, making the default rules of the U.C.C. with their resort to the parties' implicit customs unnecessary.

Although there are a number of criticisms that can be made about the trade group scholarship, this Article concentrates on whether the existence of formal group rules in certain industries casts doubt on the entire U.C.C. project of incorporating informal business practices.

If one accepts the model that parties will seek to solve key problems in order to maximize gains from trade, one way that members of a trade can achieve that goal is by negotiating an individualized fully contingent contract. However, parties can also achieve their welfare goals by belonging to trade associations that will draft a variety of express standard contract provisions covering all major contingencies. Epstein calls these standard contract provisions "customary commercial terms."[390]

Epstein thinks that these standard contract provisions—often originating with trade groups—should be given great deference for a variety of reasons. They are likely to be the product of reflection,[391] and are also likely to lessen the transaction costs of individually negotiating contract provisions to solve future contingencies. Group contract provisions solve the problem of the public goods/collective action problem. No one individual will want to undertake the enormous cost of the contract on his own because the costs cannot be recouped in limited number of transactions. However, the trade group can afford to shoulder the costs of developing contracts suitable for those in the industry.

The existence of standard contract provisions developed by trade groups does not by itself answer the question of how the law should treat implicit customs that do not take the form of standard contract provisions originating in trade groups.

If such standard contract provisions have not been made available through subscription to a trade group membership, then the court should decide whether to incorporate trade usages using a model. This Article

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[390] Epstein, *supra* note 29, at 823.

[391] However, the origination of trade group norms in deliberate design does not necessarily mean that the norms are superior to those that have evolved by spontaneous evolution. *See* Smith, *supra* note 90, at 470 (noting the "possible intelligence embodied in the rules, norms, and institutions of our cultural and biological heritage that are created from human interactions but not by deliberate human design").

suggests that in deciding whether to incorporate such norms, the court should consider (1) whether the problem is likely to be one that would be susceptible to a bilateral contractual solution; (2) whether express trade provisions have been adopted that deal comprehensively with all of the problems likely to confront the parties; and (3) whether the informal custom sought to be incorporated advances the parties' joint welfare goals.

Finally, one question that arises when considering what legal effect to give different problem-solving mechanisms—both contractual and informal—is whether the standard trade contract provisions are likely to solve the key problem of opportunistic behavior. The problem of controlling opportunistic behavior is complex and standard contract solutions are unlikely to exist in trade rules. Moreover, the opportunism problem would be difficult to control by a generalized clause promising to be cooperative or to act in their joint interest because parties would not believe such clauses and would discount them.

Thus, even in cases where highly developed trade organizations that deal with a wide variety of problems are present, it is unlikely that contractual solutions to the opportunism problem will be developed. Thus, the problem of opportunism seems to be one that would be particularly well suited to the development of informal norms that curb opportunistic behavior. The parties could then enforce such norms through tit-for-tat strategies, and retaliate against outliers *or* rely on the court to lend formal sanctions to such norms when the parties calculate that the retaliation strategies will be too costly or without effect.

VIII. CONCLUSION: HIERARCHY OF NORMS, ALL NORMS NOT EQUAL AND THE LEGAL INTERVENTION QUESTION

Hopefully, this Article's examination of trade usages has alerted the reader to the key role trade usages can play in solving endemic problems such as opportunism that are not easily controlled by a complete contract. Further the Article has alerted the reader to the helpful role courts can play in intervening to enforce such practices where the costs of legal enforcement may be less than alternative forms of self-sanctioning. An understanding of that context may help to distinguish different factual patterns in which trade usages arise that affect the analysis of whether the law should intervene to enforce the norms.

Where trade usages arise as a private strategy to solve serious problems endemic to contractual relationships and impediments exist to explicit contractual solutions, there is every reason to think that by enforcing the norms the court is maximizing gains from trade if it is less costly than the private tit-for-tat strategies and self-sanctioning techniques available to the parties, and if there are no negative externalities.