
1992

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Recommended Citation

Laurie Fisher Humphrey, *Default Rules in the Guaranty Context*, 42 Case W. Rsrv. L. Rev. 1229 (1992)
Available at: <https://scholarlycommons.law.case.edu/caselrev/vol42/iss4/6>

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NOTES

DEFAULT RULES IN THE GUARANTY CONTEXT

I. INTRODUCTION

Commercial creditors employ the guaranty to lower the risk of nonpayment by debtors.¹ While courts enforce guaranty agreements routinely,² they often face disputes involving events or occurrences about which the guaranty agreement is silent.³ Scholars have provided little assistance as they rarely have addressed the theoretical justifications for enforcement of guaranty agreements, let alone rules of construction for gaps in the guaranty agreements.⁴

This note addresses and resolves three issues: (i) whether enforcement of guaranty agreements is justified in the model guaranty situation; (ii) whether the occurrence of events not specifically addressed in an agreement affects the justifications for general enforcement; and (iii) what default rule best serves specific situations.

1. HERSCHEL W. ARANT, *HANDBOOK OF THE LAW OF SURETYSHIP AND GUARANTY* § 1, cmt. at 1-3 (1931).

2. JAMES L. ELDER, *THE LAW OF SURETYSHIP* § 4.1 (5th ed. 1951).

3. *See, e.g.*, *First Wisconsin Fin. Corp. v. Yamaguchi*, 812 F.2d 370, 373 (7th Cir. 1987) (finding that termination of guarantor's employment with the debtor limits liability if the guarantor revokes the guarantee and is granted a release); *United States Shoe Corp. v. Hackett*, 793 F.2d 161, 162-63 (7th Cir. 1986) (holding that a guaranty must be revoked if the guarantor would be responsible for increased risk as a result of the debtor's merger with another corporation).

4. *See* Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 743-44 (1982) [hereinafter Eisenberg, *Bargain Principle*] (discussing half-completed performance of bargain); Melvin Aron Eisenberg, *The Principles of Consideration*, 67 CORNELL L. REV. 640, 655-56 (1982) [hereinafter Eisenberg, *Consideration*] (asserting that a guaranty as a "collateral"/"ancillary" document should be enforced because of fairness and social interest in certainty of planning).

This note examines the special, continuing guaranty, which addresses a specific person and contemplates a series of transactions to which the guaranty applies.⁵ Specifically, this note discusses the theoretical justifications for enforcing a special, continuing guaranty executed by an officer, director, or shareholder of a corporate debtor in a model guaranty situation. Additionally, the note analyzes the inadequacies of current contract theory when gaps exist in the guaranty agreement. After reviewing general theories of default rules, the note presents a model default rule to be applied by the courts when certain situations arise which are not specifically addressed in the guaranty agreement.

Part II of the note discusses briefly the modern uses for the guaranty and reviews judicial treatment of guaranties. Part II also defines a model guaranty situation and uses the model to justify general enforcement of guaranties.

Applying contract theories to the model guaranty situation, Part III explains why enforcement of the guaranty is justified in the model situation. It further explains why those same theories fail to resolve the issue of enforcement when events occur which are not specifically addressed in the guaranty agreement.

Finally, general theories of default rules are applied in Part IV to fashion an optimal default rule for liability upon the occurrence of three events in the absence of express terms in the agreement addressing the events: (1) termination of the guarantor's relationship with the debtor; (2) change of the debtor's name; and (3) merger by the debtor.

5. A special guaranty is addressed to a specific party, and that party is the only person who can enforce the guaranty. ELDER, *supra* note 2, § 4.4. *But see* Essex Int'l, Inc. v. Clamage, 440 F.2d 547, 550-51 (7th Cir. 1971) (holding that a creditor's successor can enforce guaranty so long as relationship between debtor and successor is substantially similar to that between debtor and creditor, even though special guarantees are not assignable); ITT Diversified Credit Corp. v. Kimmel, 508 F. Supp. 140, 142-43 (N.D. Ill. 1981) (construing guaranty to include liability to creditor's successor where the guaranty contract allows the assignment and modifications to the loan agreements without affecting the guaranty). A continuing guaranty is an agreement which contemplates a future course of dealing covering a series of transactions. ELDER, *supra* note 2, § 4.7; *see also* Cargill, Inc. v. Buis, 543 F.2d 584, 587 (7th Cir. 1976) (finding that absent an express contrary intent, a guaranty is presumed to be continuing).

II. CURRENT TREATMENT OF THE GUARANTY AND THE MODEL GUARANTY SITUATION

A. Purposes and Judicial Treatment of the Guaranty

A guaranty serves "to secure a creditor . . . against loss caused by the failure of [the] debtor . . . to perform [the debtor's] duties."⁶ Most commonly, the guaranty consists of a promise to pay if the principal debtor fails to pay.⁷ Presumably, a creditor resorts to the guaranty when the principal debtor has insufficient security or reputation to justify extending credit.⁸ The guaranty provides the creditor recourse against two separate parties, thus reducing the creditor's risk of loss.⁹

Special rules apply to guaranty agreements which that benefit and protect guarantors.¹⁰ First, where the guaranty is a continuing

6. ARANT, *supra* note 1, § 1. The concept of guaranty "antedates the Christian era," and was historically used to ensure performance by another. Willis D. Morgan, *The History and Economics of Suretyship*, 12 CORNELL L.Q. 153, 153 (1927). Roman law favored the surety because the relationship emanated from friendship and was normally gratuitous. Phillip K. Jones, Jr., *Roman Law Bases of Suretyship in Some Modern Civil Codes*, 52 TUL. L. REV. 129, 129 (1977); *see also* Morgan, *supra*, at 159 (discussing the many rules benefitting sureties in ancient Rome). While both Morgan and Jones use the term "surety," the Roman concept of surety resembles the present-day guaranty as the Roman surety was only secondarily liable. *See* Jones, *supra*, at 129 (likening the popular relationship of ancient Rome to contemporary western ideas). For various discussions of the historical developments of surety, *see generally* Jones, *supra* (exploring Roman bases of suretyship); Morgan, *supra* (discussing development of surety idea from 2750 B.C. to beginning of 20th century); Max Radin, *Guaranty and Suretyship*, 17 CAL. L. REV. 605 (1929) (examining the history of the terms "guaranty" and "surety" and discussing whether they can be used interchangeably).

7. *See* ARANT, *supra* note 1, § 7 cmt. (asserting that a guarantor's promise is always subject to the default by the principal obligor).

8. *Id.* § 1 cmt.

9. *Id.*

10. *See generally* ARANT, *supra* note 1, §§ 7-14, §§ 22-26 (categorizing rules applicable to guaranty agreements). Some of these rules impose secondary liability. *See, e.g.*, IIT Diversified Credit Corp. v. Kimmel, 508 F. Supp. 140, 143 (N.D. Ill. 1981) (holding guarantor liable upon default of debtor); ARANT, *supra* note 1, § 6 ("A guarantor is one who promises . . . that, if another does not perform his duty, [the guarantor] will . . ."); ELDER, *supra* note 2, § 4.1. A general rule of strict construction applies to guarantees. *See, e.g.*, Bernardi Bros., Inc. v. Great Lakes Distrib., Inc., 712 F.2d 1205, 1206-07 (7th Cir. 1983) (holding that a guarantor was not liable for anything to which he did not agree and that material change in debtor-creditor relationship relieves guarantor); International Paper Co. v. Grossman, 541 F. Supp. 1236, 1240 (N.D. Ill. 1982) (relieving guarantor of obligation where the guaranty agreement referred to one corporation as debtor and that corporation merged out of existence); Kimmel, 508 F. Supp. at 142-43 (plain

guaranty, which contemplates a series of credit transactions, the guarantor may revoke the guaranty as to future liability at any time upon notice to the creditor.¹¹ Second, a guarantor is relieved of liability if an event occurs that materially increases the guarantor's risk.¹² Both rules protect the guarantor from being exposed to potentially unlimited liability.

To revoke a continuing guaranty with respect to future transactions, the guarantor need only notify the creditor of its intent to revoke.¹³ A unilateral act by guarantor is sufficient. The creditor's acceptance is not necessary.¹⁴ The notice given to the creditor must definitely and unequivocally communicate the guarantor's intent to revoke.¹⁵ Particular words, however, are not required, as

language of the guaranty agreement controlled); *ELDER*, *supra* note 2, § 4.2 ("rule[s] of strict construction app[ly] . . . where the intent of the parties is clearly expressed in the instrument . . ."). When language is ambiguous, some courts construe the guaranty against the party who drafted it — usually the creditor. *See International Paper Co.*, 541 F. Supp. at 1240 (construing the guaranty against International Paper, the party who prepared it); *cf. ELDER*, *supra* note 2, § 4.2 cmt. (suggesting construction according to the intent of the parties as agreements are often drawn up without assistance of counsel).

11. *ARANT*, *supra* note 1, § 22; *see also* *First Wisconsin Fin. Corp. v. Yamaguchi*, 812 F.2d 370, 373 (7th Cir. 1987) (finding that "under Wisconsin law any clearly communicated revocation of a guaranty is effective"); *United States Shoe Corp. v. Hackett*, 793 F.2d 161, 163 (7th Cir. 1986) (noting that the guarantor was free to revoke at any time, but failed to do so). Upon revoking the agreement, the guarantor is relieved of liability for credit extended to the debtor after the date of revocation. *ARANT*, *supra* note 1, § 22; *see also, e.g., Yamaguchi*, 812 F.2d at 374 (finding a letter to creditor served as notice of guarantor's revocation as to *future* extensions of credit); *Union Carbide Corp. v. Katz*, 489 F.2d 1374, 1376 (7th Cir. 1973) (releasing guarantor from liability for all credit extended *after* notice of revocation given).

12. *ARANT*, *supra* note 1, § 25; *see also, e.g., Bernardi Bros.*, 712 F.2d at 1207 (recognizing material changes in terms discharges a guarantor's liability, but finding debtor's change of name and incorporation to be non-material changes); *Gritz Harvestore, Inc. v. A.O. Smith Harvestore Prod., Inc.*, 769 F.2d 1225, 1230 (7th Cir. 1985) (holding that both compensated and uncompensated guarantors may be discharged if a material change works to the detriment of the guarantor); *Hackett*, 793 F.2d at 162; *Essex Int'l, Inc. v. Clamage*, 440 F.2d 547, 550 (7th Cir. 1971) (holding that the sale of assets, in order to consolidate two businesses, did not effect a material change in the obligation of the guarantor).

13. *ARANT*, *supra* note 1, § 22; *ELDER*, *supra* note 2, § 4.20; *see also Cargill, Inc. v. Buis*, 543 F.2d 584, 586 (7th Cir. 1976) (implying that the guarantor's right of termination exists pursuant to law); *Mountain States Tel. & Tel. v. Lee*, 504 P.2d 807, 809 (Idaho 1972) (noting that guarantor could have revoked agreement, but did not); *Alton Banking & Trust Co. v. Sweeney*, 481 N.E.2d 769, 774 (Ill. App. Ct. 1985) (same). *But see United States Shoe Corp. v. Hackett*, 793 F.2d 161, 163 (7th Cir. 1986) (noting that the right to termination specifically provided by most guarantees may suggest that no such right is provided by law).

14. *First Wisconsin Fin. Corp. v. Yamaguchi*, 812 F.2d 370, 373 (7th Cir. 1987).

15. *Id.*

long as the intent to revoke is reasonably communicated.¹⁶

Similarly, the guarantor is relieved of liability if an event occurs that materially increases the risk involved with the transaction.¹⁷ The guarantor is released because such a risk-altering event undercuts the assumptions upon which the contract was bargained.¹⁸ Prior to entering the contract, the guarantor calculates the risk involved with a potential debtor, considering both the financial condition of the debtor and the extent of anticipated exposure.¹⁹ Some jurisdictions refuse to apply this rule when the guarantor participates in the event which increases the risk.²⁰ In other jurisdictions, relief depends on whether the creditor knows about the risk-altering event.²¹ Nonetheless a material increase in risk of default by the primary debtor frequently relieves the guarantor of liability.

B. The Model Guaranty Situation

The following is a model guaranty situation. Party X is in a position to extend credit to Y, a corporation. X will not extend credit to Y, however, unless Z (an officer, director or shareholder of Y) executes a guaranty in favor of X which covers all of the debts incurred by Y to X. Z executes the guaranty. No event occurs that is not expressly provided for in the guaranty agreement. Y fails to pay X. X demands payment from Z pursuant to the guaranty. The issue raised in this model guaranty situation is whether Z should be liable to X for the debt Y incurred.

Certain assumptions support the model guaranty situation and

16. *Id.* at 372-73.

17. *See, e.g.,* United States Shoe Corp. v. Hackett, 793 F.2d 161, 162 (7th Cir. 1986) (finding that a merger did not materially increase risk so as to allow discharge of liability); Bernardi Bros., Inc. v. Great Lakes Distrib. Inc., 712 F.2d 1205, 1207-08 (7th Cir. 1983) (disallowing discharge since company name change and incorporation were not material changes in business dealings).

18. *Hackett*, 793 F.2d at 162.

19. *Id.*; ARANT, *supra* note 1, § 25 cmt.

20. *Hackett*, 793 F.2d at 163; *see also* Mountain States Tel. & Tel. v. Lee, 504 P.2d 807, 808 (Idaho 1972) (finding guarantor estopped from claiming relief under rule since president participated in the change of business which altered the risk); Metzger v. Entman, 584 S.W.2d 512, 514 (Tex. Civ. App. 1979) (declining to release a guarantor who knew about a corporate dissolution).

21. *See* ARANT, *supra* note 1, § 25; International Paper Co. v. Grossman, 712 F.2d 1236, 1240 (creditor's awareness of event was one ground for release of guarantor); *Mountain States Tel. & Tel.*, 504 P.2d at 808 (noting no indication creditor was aware of event).

are necessary to an analysis justifying the model. First, X would have refused to extend credit to Y if Z had not executed the guaranty.²² Second, extending credit benefits both Y, by increasing or preserving its currently available cash, and Z, because of Z's connection with Y.²³ Third, Z has access to information which will assist Z in evaluating the risk of Y's nonpayment.²⁴ Fourth, Z can review and negotiate the terms of the guaranty agreement before executing it.²⁵ Finally, Z is in a position to (i) re-evaluate regularly the risk of Y's nonpayment, (ii) control the risk either by limiting the amount of debt Y incurs or compelling payment, and (iii) revoke the guaranty if the risk becomes too great.²⁶

The next section of this note discusses the theoretical justification for enforcing the guaranty in the model guaranty situation²⁷ and the inadequacy of existing theories for resolving the enforcement issue when the occurrence of one or more events causes deviation from the model.²⁸

III. CONTRACT THEORIES SUPPORT ENFORCEMENT OF A GUARANTY IN THE MODEL SITUATION BUT NOT IN SITUATIONS DEVIATING FROM THE MODEL

Commentators have developed a number of theories to justify enforcement of contracts.²⁹ This section discusses four contract

22. See ARANT, *supra* note 1, § 1 cmt.

23. See Hackett, 793 F.2d at 162 (involving benefit to shareholder-guarantor realized by appreciation of debtor corporation's stock).

24. *Id.* at 163.

25. See Ivy v. Grenada Bank, 401 So.2d 1302, 1303 (Miss. 1981) (holding failure to review a guaranty prior to execution not a defense to guarantor liability). But see Peter A. Alces, *The Efficacy of Guaranty Agreements in Sophisticated Commercial Transactions*, 61 N.C. L. REV. 655, 660 (1983) (suggesting guarantors are generally in a weaker bargaining position and, therefore, unable to amend through negotiation terms requested by the creditor).

26. See Hackett, 793 F.2d at 163 (noting that guarantors in influential positions in a debtor corporation are usually aware of events which will increase the risk under the guaranty and can control that risk); see also *supra* text accompanying notes 13-16.

27. See *infra* notes 29-62 and accompanying text.

28. See *infra* notes 63-90 and accompanying text.

29. See, e.g., Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986) (including critique of earlier theories and proposal of a theory based on consent); Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 575-80 (1933) (presenting the will theory and injurious reliance theory); Eisenberg, *Bargain Principle*, *supra* note 4 (discussing the bargain theory of contract); Eisenberg, *Consideration*, *supra* note 4 (reviewing the consideration doctrine); Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. CHI. L.

theories — the Will Theory, the Bargain Theory, the Consent Theory, and the Reliance Theory³⁰ — and applies them to the model guaranty situation. Each theory justifies enforcement of the guaranty in the model situation. However, none resolves the problem of enforcement when events occur that are not expressly addressed in the guaranty occur.

A. Contract Theories Justify Enforcement of the Guaranty in the Model Situation

1. The Will Theory

The Will Theory posits that “the law of contract gives expression to and protects the will of the parties,” as something that is “inherently worthy of respect.”³¹ This theory assumes that parties voluntarily enter into contracts.³² It also assumes that individual responsibility for voluntary acts should be enforced because each party has chosen to be bound.³³ Pursuant to this theory, the parties’ subjective intent regarding the binding nature of the contract must be ascertained³⁴ before the contract can be enforced.³⁵

The Will Theory supports enforcement of Z’s promise to pay in the model guaranty situation. The guarantor, Z, voluntarily expressed an intent to be liable for Y’s debts to X.³⁶ When Y fails to pay, the condition precedent to Z’s liability has occurred.³⁷ Because Z’s will is “inherently worthy of respect”³⁸ and Z’s individ-

REV. 903 (1985) (reporting the emergence of a judicial trend expanding promissory estoppel and proposing that every commercially-related promise be enforced); Jay M. Feinman, *Promissory Estoppel and Judicial Method*, 97 HARV. L. REV. 678 (1984) (relating promissory estoppel to other contract theories); Stanley D. Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 YALE L.J. 343 (1969) (discussing expanded judicial use of promissory estoppel to include bargain transactions as well as gratuitous transfers).

30. The Reliance Theory section addresses only the traditional use of promissory estoppel.

31. Cohen, *supra* note 29, at 575. Cohen criticizes the Will Theory because the rights and duties imposed often may not be truly voluntary. *Id.* at 576-77.

32. *Id.* at 555. *But see id.* at 569 (suggesting that when one party effectively cannot refuse, the contract is not truly voluntary).

33. Barnett, *supra* note 29, at 272; Cohen, *supra* note 29, at 556-57 (tracing this concept to religious canons).

34. Barnett, *supra* note 29, at 272.

35. Cohen, *supra* note 29, at 575.

36. *See id.* at 556-57.

37. *See* ARANT, *supra* note 1, § 6; ELDER, *supra* note 2, § 4.1.

38. Cohen, *supra* note 29, at 575.

ual responsibility should be enforced,³⁹ the courts should enforce Z's promise to pay X.

2. The Bargain Theory

The Bargain Theory argues that "each party views the performance that he undertakes as the price of the performance undertaken by the other."⁴⁰ The theory favors adherence to the terms of the bargain unless a defense relating to the quality of the consent, such as duress, mental mistake, misrepresentation or incapacity, exists.⁴¹ When one party has already performed,⁴² fairness and predictability warrant enforcement of the other party's promise to perform.⁴³ Therefore, the bargain, as expressed by the parties, is enforced.⁴⁴

The Bargain Theory supports enforcement of the guaranty in the model situation. Z executes the guaranty in exchange for X extending credit to Y. Because X already performed under the contract by extending credit to Y, the bargain between Z and X should be enforced.⁴⁵

3. The Consent Theory

The Consent Theory supports enforcement of consensual transfers of alienable rights.⁴⁶ To find consent, the courts should look for "a manifestation of an intention to be legally bound."⁴⁷ Intent can be manifested in words or conduct.⁴⁸ A written agreement serves as evidence of an intent to be bound.⁴⁹ These requirements

39. *Id.* at 556-57.

40. Eisenberg, *Bargain Principle*, *supra* note 4, at 742.

41. *Id.*

42. For example, X has already extended credit to Y Corporation.

43. Eisenberg, *Bargain Principle*, *supra* note 4, at 744. Credit transactions, in particular, are viable only if the promisee is held liable. *Id.* at 746. However, enforcement of the debtor's promise relates more directly to the viability of credit transactions.

44. *See id.* at 744 (indicating that extent to which promises should be enforced remains unresolved).

45. *See id.* at 743-44 (discussing justification for half-completed-bargain promises).

46. Barnett, *supra* note 29, at 293, 299. In order to find a contract enforceable, the subject matter must deal with an alienable right. For example, a contract regarding slavery would not be enforceable. *Id.* at 293.

47. *Id.* at 304.

48. *Id.* at 305-06. In this way, the promisor is "harmed" only when his conduct and words are contrary to his intent. *Id.* Also, the person who relies on the plain words and conduct (and with no access to the promisor's true intent) is protected. *Id.* Therefore, the interests of both parties are served.

49. *Id.* at 310-11. Consideration and reliance can also serve as evidence of intent. *Id.*

help determine which contracts should be enforced.⁵⁰

Consent Theory supports enforcement in the model guaranty situation. Ownership of money is an alienable right,⁵¹ and the express terms of the guaranty manifest Z's intent to be legally bound by Z's promise to pay X in the event Y defaults.⁵² Z's acquiescence in X's extension of credit to Y comports with Z's intent as expressed in the guaranty. Since Z manifested an intent to be bound, Z is bound.⁵³ Thus, Z's consensual promise to transfer money to X is enforceable under the Consent Theory.⁵⁴ Z's consensual promise creates a moral and legally enforceable contractual obligation.

4. The Reliance Theory

The Reliance Theory presents an alternative theory for contract enforcement. Reliance Theory holds that "[a] promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise."⁵⁵ Promissory estoppel was originally intended to apply only to gratuitous promises.⁵⁶ Like the bargain element of the Bargain Theory, the Reliance Theory includes inducement of a response.⁵⁷ However, under the Reliance Theory, the party seeking to bind a party by a promise did not bargain for the promise.⁵⁸ A promise is enforced under the Reliance Theory because reliance on the promise was reasonably foreseeable and injustice would occur if the promise were not enforced.⁵⁹

Although the existence of a bargain in commercial settings

at 312-17.

50. *Id.* at 319.

51. *See id.* at 293 (only contractual transfers involving alienable rights should be enforced).

52. *See id.* at 306, 310 (discussing formal, objective, written consent as the binding expression of contractual obligations).

53. *See id.* at 306. Clear intent is binding. In addition, "[V]olitional acts — words or deeds — that manifest assent to transfer entitlements presumptively bind the actor regardless of subjective intent." *Id.* at 306.

54. *See id.* at 293, 296.

55. *See* RESTATEMENT (SECOND) OF CONTRACTS § 90(1) (1979).

56. Henderson, *supra* note 29, at 343-44.

57. *Id.* at 348.

58. *Id.*

59. RESTATEMENT (SECOND) OF CONTRACTS § 90(1) cmt. b.

removes the need for analysis under the Reliance Theory (because traditional contract theory would apply), courts have nonetheless expanded application of promissory estoppel beyond gratuitous promises to commercial contracts.⁶⁰

The Reliance Theory supports enforcement of the guaranty in the model guaranty context. Z promised X that Z would pay, upon default, the debt Y owes to X. X extended credit to Y in reliance on Z's promise.⁶¹ Z knew X would rely on the promise because X informed Z that it would only extend credit to Y if Z executed the guaranty. Assuming injustice would result in the absence of enforcement,⁶² Z's promise is enforced.

Thus, basic contract theory supports enforcement of the guaranty in the model guaranty situation. Uncertainty remains, however, as to whether the guaranty should be enforced when events cause deviations from the model guaranty situation. As the next section demonstrates, contract theories fail to resolve this issue.

B. Contract Theories Fail to Resolve Enforcement Issue When Events Not Expressly Addressed in the Guaranty Agreement Occur

The foregoing contract theories fail to resolve the enforcement issue when an event not expressly addressed in the guaranty occurs. For purposes of this discussion, this note posits three hypothetical situations. First, suppose Z is no longer employed by Y.⁶³ Next, suppose (i) Y changes its name to ABC⁶⁴ or (ii) Y merges

60. Henderson, *supra* note 29, at 368-69; *see also* Farber & Matheson, *supra* note 29, at 929 (proposing that every commercially-related promise be enforced).

61. The model guaranty situation assumes that X would not have extended credit to Y if Z had not made such a promise. *See supra* note 22 and accompanying text.

62. The credit extended must be of a sufficient dollar amount for a court to find injustice in the absence of enforcement of the promise. *See* ELDER, *supra* note 2, § 4.2 (ignoring potential injustices and suggesting that, regardless of the promisor's intent, the promisee's interpretation of an ambiguous term should govern if the promisee acted upon the interpretation).

63. *See, e.g.*, First Wisconsin Fin. Corp. v. Yamaguchi, 812 F.2d 370, 372 (7th Cir. 1987); Gritz Harvestore, Inc. v. A.O. Smith Harvestore Prod., Inc., 769 F.2d 1225, 1226-27 (7th Cir. 1985); Union Carbide Corp. v. Katz, 489 F.2d 1374, 1376 (7th Cir. 1973) (holding former president of corporation liable under guaranty); Pascoe Steel Corp. v. Shannon, 298 S.E.2d 97, 97 (Va. 1982) (seeking to enforce guaranty after guarantor/stockholder sold his stock).

64. *See, e.g.*, United States Shoe Corp. v. Hackett, 793 F.2d 161, 164 (7th Cir. 1986) (suggesting that if there is no increase in risk, a merger of corporations might be treated as nothing more than a name change).

with CD Corp.⁶⁵ Since the model guaranty does not address how to deal with these events, the contract theories fail to resolve them.

As previously discussed, the Will Theory is based on the belief that the parties' true intent should be enforced.⁶⁶ Therefore, the Will Theory necessitates a subjective inquiry into the parties' agreement.⁶⁷ First, any subjective intent should prevail over a contrary objective expression of intent.⁶⁸ Therefore, if Z intended the guaranty to apply only during the period of his employment with Y (or only so long as Y retained its name or corporate structure), then Z should be relieved of liability under the guaranty after Z's employment terminates (or an event contrary to Z's expectation occurs).⁶⁹ Under this analysis, however, X would be harmed by enforcement of the guaranty according to Z's subjective intent. This result is especially troubling because Z's subjective desires may have been unknown to X, who would therefore have been unable to rely on Z's objective expression.⁷⁰ On the other hand, allowing X to prevail could not be squared with Z's subjective intent not to be bound after the unstated event occurs.⁷¹

Second, the Will Theory posits that the parties should be bound by the words of the contract.⁷² No contract terms exist, however, in the hypothetical posed for resolution here; the contract is silent with regard to the occurrence of certain events. Should silence regarding the occurrence of an event be interpreted as an intent to be bound notwithstanding the occurrence of any event not specifically mentioned, or an indication that the intent to be bound did not extend beyond the occurrence of the event?⁷³ The Will

65. See, e.g., *id.* (holding that merger will cause cancellation of guaranty only if it fundamentally alters risk of guaranty); *Cargill, Inc. v. Buis*, 543 F.2d 584, 587 (7th Cir. 1976) (addressing the issue of whether a guaranty survived the corporate merger of the guarantee).

66. See *supra* text accompanying notes 31-39.

67. See, e.g., *Barnett, supra* note 29, at 272 (when determining whether to enforce subjective intent, inquiry as to that intent is required).

68. See *id.* Consider, however, the difficulty a party would encounter in attempting to demonstrate subjective intent contrary to the objective expression. See *Cohen, supra* note 29, at 576 (noting that, practically, if one's expressed will differs from subjective intent, the expression will probably be enforced).

69. See, e.g., *Cohen, supra* note 29, at 576.

70. See, e.g., *Barnett, supra* note 29, at 273 (acknowledging that enforcement of purely subjective intent opens the door for promisors to fraudulently induce others to contract by concealing true intent).

71. See *id.* at 273-74.

72. See *Cohen, supra* note 29, at 575-76 (showing how objective manifestations of intent will be enforced even if no meeting of the minds actually takes place).

73. See *id.* at 576-77 (recognizing that litigation often results when unforeseen events

Theory does not resolve this dilemma.⁷⁴

Similarly, the Bargain Theory,⁷⁵ which is premised upon a mutual inducement by the parties, does not provide a basis for enforcing the guaranty.⁷⁶ Under this theory, the "price" of performance by one party counterbalances the "price" of performance by the other party.⁷⁷ Giving effect to the terms of the express agreement enforces the bargain.⁷⁸ The problem with the Bargain Theory in the guaranty context is that it focuses on whether or not bargain exists. The theory offers no basis for determining the content of the bargain.⁷⁹ Therefore, the Bargain Theory is inadequate to resolve guaranty disputes spawned by occurrences not addressed in the guaranty.

The third theory, the Consent Theory,⁸⁰ distinguishes contracts which should be enforced from those which should not⁸¹ but it does not describe the content of the contract. According to this theory, the consensual bargain of the parties should be enforced if the court can find evidence of the parties' "manifestation" of intent to be legally bound.⁸² For example, execution of a document manifests such an intent.⁸³ The Consent Theory fails in the guaranty context for the same reason that the Bargain Theory fails. A finding that the parties intended to be bound advances neither the case for or against enforcement under circumstances upon which the guaranty is silent. While a guaranty evidences the parties intent to be legally bound, the parties' intent to remain bound if *Z* left the employ of *Y* or if *Y* ceases to be *Y* by changing its name or merging with another entity is questionable.⁸⁴ *Z*'s acquiescence to the loan can be equally ambiguous. If *Z* is no longer employed

occur about which no intent or will is expressed).

74. *See id.* at 577 ("[T]hese legal relations are determined by the courts and the jural system and not by the agreed will of the contesting parties.").

75. *See supra* text accompanying notes 40-45,

76. Barnett, *supra* note 29, at 287.

77. Eisenberg, *Bargain Principle*, *supra* note 4, at 742.

78. *Id.*

79. Barnett, *supra* note 29, at 289-90.

80. *See supra* text accompanying notes 46-54.

81. *See* Barnett, *supra* note 29, at 317 (suggesting that Consent Theory's role in distinguishing between which contracts should be enforced enables parties to structure their relationships by knowing when an obligation will be imposed).

82. *Id.* at 304.

83. *Id.* at 310-11.

84. *See id.* at 314-17 (discussing the effect of reliance when specifics of intent are ambiguous and noting that under the Consent Theory, reliance is only protected if there is manifestation to be legally bound).

by *Y*, *Z* will not observe *X* extending credit to *Y*. Similarly, if *Y* becomes ABC, *Z* witnesses the extension of credit to ABC, not to *Y*. Finally, if *Y* merges into CD Corporation, *Z* observes the credit extension to *Y*'s successor. In these scenarios, *Z*'s silence does not justify enforcement of the guaranty because silence may not include acquiescence.⁸⁵

Under the last theory, the Reliance Theory,⁸⁶ the promisor expects the promisee to rely on the promise.⁸⁷ Although execution of the contract in the model guaranty situation presumably renders the promisee's reliance reasonable, the theory fails to address whether reliance can ever be "reasonable" with respect to an unstated contingency such as one of the aforementioned events. For example, *Z* did not expressly promise that his liability would extend beyond the duration his employment with *Y*. In fact, the employment relationship is the reason *Z* is willing to assume secondary liability on the loan. Therefore, it may be reasonable to assume that *Z* would not be bound after that relationship ends. As a result, *X*'s argument for enforcing the guaranty would depend on the reasonableness of relying on a promise by *Z* which fails to address liability after employment terminates.

Whether or not reliance is reasonable also depends on what most people would do in the same circumstances.⁸⁸ What most people would do depends on whether they think the promise is enforceable.⁸⁹ Whether the promise is enforceable when, for example, *Z* leaves the employ of *Y*, depends on whether most people would believe that *Z*'s promise extended beyond the period of employment.⁹⁰

Thus, the foregoing contract theories do not resolve the hypothetical issue posited. Because current contract theory proves inadequate, Part IV of this note presents an economic approach

85. *See id.* (stating that a particular interpretation of a missing or ambiguous contract term can be enforceable if promisor stood by silently while promisee acted in reliance on the interpretation).

86. *See supra* text accompanying notes 55-61.

87. *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979); Henderson, *supra* note 29 (discussing promissory estoppel in contract theory).

88. Barnett, *supra* note 29, at 274-75; *see* Cohen, *supra* note 29, at 579-80 (noting that not all injuries deserve redress because there may not have been reliance).

89. Barnett, *supra* note 29, at 275 (recognizing the circular argument that results from again asking the initial question of whether this promise should be enforced).

90. *See id.* In a jurisdiction which has addressed the issue and resolved it in favor of the creditor, reliance based on precedent would seem reasonable. However, the first case in each jurisdiction must be addressed and rationally decided and supported.

which provides optimal default rules to be applied in the three situations presented.

IV. ECONOMIC APPROACH PROVIDES OPTIMAL DEFAULT RULES

The guaranty agreement between Z and X does not address the parties' intentions regarding the occurrence of one or more of the following events: 1) termination of Z's employment with Y; 2) merger of Y with another corporation; and 3) name change by Y. This section discusses how the courts should address and resolve this dilemma.

The first issue is whether a gap exists in the contract. Silence regarding the effect of the occurrence of an event does not necessarily mean that the parties did not contemplate occurrence of the event or negotiate which party should bear any burden caused by the event.⁹¹ If a gap exists, a court must decide what default rule should apply.

Commentators have suggested various gap-filling theories. One view advocates filling the gap according to what the parties would have done had they negotiated the issue.⁹² If a court chooses this approach, it must also decide whether the default rule should be tailored to the preferences of specific parties or should be based on the assumed preferences of most parties in similar situations.⁹³ A second view suggests imposing a default rule to which neither party would agree, a "penalty default rule," in order to discourage less than thorough bargaining practices between the parties.⁹⁴ Regardless of the approach to be followed, courts announcing default rules must also decide whether a rule should be immutable, or whether parties can contract freely around the rule.⁹⁵

91. Clayton P. Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521, 534 (1985) (noting that risks not expressly allocated in the contract may be implicitly allocated according to the given circumstances or custom).

92. Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 707 (1989) (explaining that courts often fill in the gaps in contracts by determining what the parties would have consented to "ex ante"); Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535, 541 (1990); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 639-91 (1990).

93. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 108-18 (1989).

94. *Id.* at 96-99.

95. *See id.* at 88-89.

Because default rules are required only if a gap exists, the court must determine the existence of a gap. Therefore, the factors pertinent to a gap analysis are discussed here first. Next, the theories underlying default rules are analyzed. Finally, an appropriate default rule is developed for each of the three contingencies described above.

A. Existence Of A Gap

The first issue is whether a gap exists. Absence of an express provision regarding the event does not necessarily mean that the parties neither addressed the possibility of its occurrence nor agreed who would bear the burden of its occurrence.⁹⁶ The parties may have intended an existing default rule to resolve the conflict.⁹⁷ Or, the parties may have intended to circumvent an existing default rule by providing a more general assignment of risks between them.⁹⁸

Ayres and Gertner suggest that a gap filling analysis should involve three inquiries:⁹⁹ first, whether a current default rule applicable to the situation exists; second, if a default rule exists, whether the rule is immutable or can be circumvented by contract; third, if the rule can be circumvented, whether the parties expressed sufficient intent to circumvent the rule. An immutable default rule governs the situation regardless of any attempt by the parties to circumvent it.¹⁰⁰ However, if no default rule exists the court must create one.

For a court to find that the parties successfully circumvented an existing default rule, the parties must show some evidence of intent to avoid application of the rule.¹⁰¹ The amount of evidence sufficient to prove intent may vary. According to one theory, silence regarding circumvention should be construed as acceptance of

96. On the other hand, silence may mean precisely that the parties did not even address the issue and, as a result, cannot necessarily be interpreted as intent to accept a default rule. See Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1445 (1989) ("[I]t is costly for the parties . . . to ponder unusual situations and dicker for the adoption of terms.").

97. Ayres & Gertner, *supra* note 93, at 119.

98. Gillette, *supra* note 92, at 538 (positing that terms regarding good faith or renegotiation may express intent to cooperate when unforeseen event occurs).

99. Ayres & Gertner, *supra* note 93, at 119.

100. *Id.* at 87.

101. *Id.* at 119.

the default rule.¹⁰² Absence of a *clear* intent to circumvent may also convey acceptance of the default position.¹⁰³ According to another view, circumvention may be implied by express terms regarding rights and duties of the party that are inconsistent with the default rule.¹⁰⁴ The higher the burden the courts place on parties to evidence their intent, the more likely it is that a default rule will be immutable in practice if not in theory.¹⁰⁵

Since the gap analysis is fact-driven, some examples related to the model guaranty situation may be helpful. First, assume that the guaranty agreement contains *Z*'s simple promise to pay *X* in the event that *Y* fails to pay *X*. In a jurisdiction that has fashioned a default rule which states that termination of employment does not terminate the guarantor's liability,¹⁰⁶ a court may interpret the parties' silence as acceptance of the default rule. Similarly, in a jurisdiction that has decided that a merger between the debtor and a third party does not automatically relieve the guarantor of liability,¹⁰⁷ silence may be interpreted as acceptance of that rule. If circumvention cannot be implied from other contract terms, the contract might be viewed as complete because the parties intended to include the default rule,¹⁰⁸ or incomplete because the parties never addressed the issue. For purposes of the remaining discussion,

102. *Id.*

103. *Id.* (discussing Judge Easterbrook's majority opinion in *Jordan v. Duff & Phelps*, 815 F.2d 429 (7th Cir. 1987), a dispute regarding an employment/shareholder agreement).

104. *Id.* (discussing Judge Posner's dissent in *Jordan*); see also Gillette, *supra* note 92, at 537-538 (stating that ambiguous terms may evidence intent to share risks caused by event).

105. Ayres & Gertner, *supra* note 93, at 120-25. As the potential methods of circumvention dictate the ease with which parties can by-pass a default rule, a court should specify those methods when it chooses a particular default rule. *Id.* See also *infra* note 177.

106. See, e.g., *Gritz Harvestore, Inc. v. A.O. Smith Harvestore Products*, 769 F.2d 1225, 1231-32 (7th Cir. 1985) (involuntary termination of employment is "insufficient as a matter of law to establish the defense of material changes in circumstances"); *Bledsoe v. Cargill, Inc.*, 452 So. 2d 1334, 1337 (Ala. Civ. App. 1984) (holding guarantor liable even after the sale of his interest in the principal company); *Pascoe Steel Corp. v. Shannon*, 298 So. 2d 97, 101 (Va. 1982) (holding guarantor liable for corporate debt after the sale of his stock and termination of his administrative positions).

107. See, e.g., *United States Shoe Corp. v. Hackett*, 793 F.2d 161, 164 (7th Cir. 1986) (applying Illinois law); *Cargill, Inc. v. Buis*, 543 F.2d 584, 588 (7th Cir. 1976) (applying Indiana law); *International Paper Co. v. Grossman*, 541 F. Supp. 1236, 1241 (N.D. Ill. 1982) (applying Illinois and New York law and concluding that the facts of specific merger constituted material change which resulted in release of the guarantor), *aff'd*, 725 F.2d 687 (7th Cir. 1983).

108. Ayres & Gertner, *supra* note 107, at 120.

the existence of a gap and the absence of an existing default rule are assumed.

B. Potential Default Rules

Once the court finds that a gap exists, the court must determine how to fill the gap based on one of two theories.¹⁰⁹ First, the court can fill the gap with a term to which neither party would have agreed by imposing a penalty default rule.¹¹⁰ Second, the court can fill the gap with the term to which the parties or most parties similarly situated would have agreed.¹¹¹ The nature of the contract and the manner in which it is negotiated should influence the court's choice.

1. Penalty Default Rule

A penalty default rule induces at least one party to contract around the default rule¹¹² by either placing the burden on the party whose behavior the court seeks to modify or giving neither party what it wants.¹¹³ Several situations justify a penalty default rule. For example, one party may withhold information for strategic purposes.¹¹⁴ When warranted, a penalty default rule limits this practice by encouraging the informed party to disclose the information to the other party.¹¹⁵ In addition, a penalty default rule is justified when the parties can fill in the term more cheaply than the court.¹¹⁶ The rule thus motivates at least one party to fill the gap.

109. A guarantor may argue for release from liability upon the occurrence of a material change which substantially increases the risk. *See supra* notes 17-21 and accompanying text. The factual orientation of such an inquiry, however, does not give the parties notice of the effect on liability either before the event has occurred or after occurrence but before judicial decision.

110. Ayres & Gertner, *supra* note 93, at 91, 97-107; *see also* Gillette, *supra* note 92, at 575.

111. Ayres & Gertner, *supra* note 93, at 91; *see also supra* text accompanying notes 92-95.

112. Ayres & Gertner, *supra* note 93, at 91.

113. *Id.*

114. *Id.* at 94.

115. *Id.* at 94, 97. Compare *id.* with Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13-14 (1978) (warning that rules which force parties to disclose information obtained at some cost may be a disincentive to obtaining such information).

116. Ayres & Gertner, *supra* note 93, at 96. When such a determination is made, one should inquire whether standard information exists regarding such a transaction or whether the court would be forced to determine the preferences of each party.

The penalty default rule can place the burden on both parties or on only one party. One penalty, non-enforcement, generally harms both parties.¹¹⁷ Both sides would then be motivated to fill in the gap.¹¹⁸ On the other hand, placing the burden on one party provides incentive to that party to address and resolve the issue.¹¹⁹ When a rule burdens one party, however, the court must be sensitive to the potential for opportunism by the unburdened party.¹²⁰ For example, a non-burdened party aware of a default rule in its favor can exact significant costs from the burdened party to negotiate an allocation of risk preferable to both parties.¹²¹ The burdened party may bear higher negotiation costs even though courts intended the rule merely to promote dissemination of information.

Once the court decides to place the burden on one party, the court must decide which party should bear the burden.¹²² Since one objective of a penalty default rule is dissemination of information, the court should consider the parties' relative access to information. One commentator suggests imposing the burden on the party best able to obtain relevant information at the lowest cost.¹²³ This party would be encouraged to collect the relevant information and transmit it to the other party. The cheapest information-gatherer could choose to accept liability or disclose the information relevant to negotiating potential alternative terms.¹²⁴

117. *Id.* at 97. Uniform Commercial Code § 2-201 is one example. If the parties fail to specify the quantity in a sales contract, a court will not complete the term. *Id.* at 96 n.43. Note, however, that non-enforcement of the guaranty is exactly what the guarantor is requesting in our scenario. In this respect, the creditor is harmed, while the guarantor receives a benefit.

118. *Id.* at 98 ("By taking each party back to her ex ante welfare, the non-enforcement default eliminates this potential for opportunism.").

119. *See id.* The law should place the burden on one party, the relatively informed party, when the rationale is to inform the relatively uninformed party, especially if that party is uninformed about the default rule itself. *Id.*

120. *Id.* ("The non-penalized buyer . . . would have incentives to induce sellers to enter indefinite contracts in order to extract the penalty . . .").

121. *Id.*; *see also* Scott, *supra* note 92, at 613-614 (the default rule will inevitably invite cooperative responses from the burdened party and evasive responses from the non-burdened party).

122. *See* Ayres & Gertner, *supra* note 93, at 98-99 (giving an example of how to allocate earnest money between the broker and the seller when a buyer defaults on a real estate transaction).

123. Kronman, *supra* note 115, at 2-4. Kronman defines "mistake" as any error which would not have been made if all information were available. *Id.* at 2 n.1. Since "[i]nformation is the antidote to mistake," Kronman suggests imposing the risk on the party that can most cheaply obtain and deliver the information. *Id.* at 4.

124. *See* Ayres & Gertner, *supra* note 93, at 98 ("[I]n some situations it is reasonable

Other commentators believe that the burden should be placed on the party that engages repeatedly in similar transactions.¹²⁵ That party presumably has superior knowledge about contingencies, probabilities and applicable default rules. The penalty default rule in this context encourages the burdened party to convey its superior knowledge to the less informed party.¹²⁶ While placing the burden on one party seems unfair, if the default rule is mutable, the rule merely forces the burdened party (or parties) to negotiate and resolve the issue to avoid liability.¹²⁷

2. What the Parties Want

A court can choose to fill a gap in a contract with the term to which the parties would have agreed.¹²⁸ The cost of negotiating terms to deal with certain contingencies may prohibit negotiation of those terms.¹²⁹ By implementing a rule which the parties would have wanted, the court provides the solution the parties would have provided without necessitating unduly high negotiation costs.¹³⁰ The court must decide, however, whether to shape a rule that the particular parties would prefer (a "tailored" rule) or to shape a rule that most parties similarly situated would select (an "untailored" rule).¹³¹

A tailored default rule presumably better resolves the particular

to expect one party to the contract to be systematically informed about the default rule and the probability of the relevant contingency arising.").

125. *Id.* at 98-99. In real estate transactions the broker has experience in similar transactions and thus should bear the burden instead of the relatively inexperienced seller. *Id.*

126. *Id.* at 99 ("[I]f the efficient contract would allocate [resources] . . . to the seller, the default rule should be set against the broker to induce her to raise the issue.") Knowledge of the default rule is as relevant as information regarding probability because knowledge of consequences can help avoid a breach. *Id.* at 104. For example, a consumer entering a sales contract, if informed about the default rule for a breach, will internalize the cost of breaching and will therefore take precautions against breaching. *Id.* This decision is not concerned with which party bears the risk better because the goal is dissemination of information. *Id.* at 101. In addition, Kronman's concern regarding rules reducing incentive to obtain information is not relevant when the information concerns content of a default rule or potential contingencies which may harm both parties. Kronman, *supra* note 115, at 13-14.

127. Ayres & Gertner, *supra* note 93, at 91.

128. Scott, *supra* note 92, at 598-99 (suggesting that the law should insert the terms that would have been specified by the parties).

129. Ayres & Gertner, *supra* note 93, at 90 (suggesting that negotiation costs are not always low enough to provide for every detail).

130. *Id.* (citing RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 372 (3d ed. 1986)).

131. *Id.* at 91; Scott, *supra* note 92, at 606-07 (referring to individualistic default rules versus majoritarian default rules).

conflict before the court because the court attempts to re-create the circumstances under which the parties contracted and to analyze the role played by each party.¹³² This in-depth judicial analysis, however, also constitutes one of the strongest objections to tailored default rules. Litigation costs increase when courts inquire into the circumstances surrounding each transaction.¹³³ In effect, the costs of completing the gaps in the contract shift from the negotiation stage to the litigation stage, and governmental resources subsidize contract negotiations.¹³⁴ Further, the parties risk judicial misconstruction of the relationship and judicial error regarding the parties' preferences.¹³⁵ The cost of litigation and the risk of judicial misconstruction affect adversely the value of the contract.

Another problem with a tailored default rule relates to parties strategically withholding information. Since the court supplies the term to which the parties would agree if perfectly informed, a party possessing superior information withheld for strategic purposes has a disincentive to supply the information during negotiation.¹³⁶ This reduces the efficiency of the contract.¹³⁷ Therefore, on balance, the disadvantages of a tailored default rule outweigh the advantages.

An untailed default rule has benefits which favor its implementation. First, similarly situated parties not before the court may avoid future negotiation costs because the default rule provides the term which they would have chosen.¹³⁸ Second, parties who wish to alter the burdens imposed by the untailed default rule can contract around the rule unless the rule is immutable.¹³⁹

Changing a rule midstream, however, can create additional problems. As Ayres & Gertner explain, "[p]arties who dislike a given default rule will contract around it; if we change the default rule to mimic the contracts these parties write, other types of par-

132. See Ayres & Gertner, *supra* note 93, at 117.

133. *Id.*

134. *Id.* ("Instead of contracting costs, the costs of ex post tailoring are the costs of distinguishing between types of contractual parties, where each type would have contracted for a different rule.").

135. *Id.* at 117-18.

136. *Id.* at 118 (pointing out that a party with private information thus will not reveal it to the court or other parties since the court will supply the terms that fully informed parties would want).

137. *Id.*

138. See *id.* at 112 (pointing out that untailed default rules that are applied to different classes of contracting parties act as a penalty to some); Scott, *supra* note 92, at 607.

139. *Id.*

ties may contract around the new default back to the original rule. This process could cycle forever."¹⁴⁰ Contract costs therefore increase. An analysis of an untailed rule must therefore consider what other parties would want, whether they can obtain what they want, and at what cost.¹⁴¹ As opposed to a tailored rule, however, the advantages of a carefully considered untailed default rule outweigh this disadvantage.¹⁴²

Regardless of whether a court chooses to fashion a tailored or an untailed default rule, the court must create the rule by referring to general notions regarding the purposes for and the processes by which parties contract.¹⁴³ First, the parties expect a mutual gain to inure from the contract.¹⁴⁴ If a mutual cost-efficient benefit is not perceived, the parties will not contract.¹⁴⁵ Once the parties agree that contracting seems to offer gains, they will negotiate the terms governing the contractual relationship.¹⁴⁶ If mutually satisfactory and cost-efficient terms cannot be agreed upon, the parties fail to contract.¹⁴⁷

In the guaranty context, since the creditor and the guarantor successfully reached an agreement, both parties presumably perceived mutual gains from the relationship and found the terms to which they agreed mutually satisfactory and cost-efficient. The terms to which they agreed can serve as a guide to the terms about which the contract was silent.¹⁴⁸

An analysis of the method by which parties negotiate express terms of a contract can guide an inquiry into the terms to which the parties would have agreed had such terms been the subject of negotiation.¹⁴⁹ Each material term of a contract maximizes the

140. Ayres & Gertner, *supra* note 93, at 115.

141. *Id.* at 116.

142. Precisely because of the onerous factual inquiry required to fashion a tailored default rule, Section C of Part IV presents untailed default rules.

143. *See generally* Ayres & Gertner, *supra* note 93 (taking an economic approach to determining what type of default rules are appropriate); Coleman et al., *supra* note 92; Gillette, *supra* note 92 (examining the bargaining theory of contracts); Scott, *supra* note 92.

144. Coleman et al., *supra* note 92, at 655, 656.

145. *See id.* at 655-58 (discussing potential pitfalls to contracting that may occur in the "pre-phase," the time before the parties enter the contract).

146. *Id.* at 655 (describing this as the "negotiation phase," where parties attempt to agree on the terms of their agreement).

147. *Id.*

148. Scott, *supra* note 92, at 603; *see also* Gillette, *supra* note 92, at 532-38 (ambiguous terms may evidence intention to share risks).

149. Scott, *supra* note 92, at 603.

expected value of the contract¹⁵⁰ by sharing risk,¹⁵¹ reducing risk,¹⁵² or allocating risk.¹⁵³ Parties first address foreseeable and controllable risks.¹⁵⁴

The manner in which parties negotiate express terms must be assumed to be rational.¹⁵⁵ Concessions regarding a term are rational even if the value of the contract is reduced as a result, as long as the cost continues to exceed the value of foregoing the contractual relationship.¹⁵⁶ Similarly, one party may rationally accept all risk related to an event if that party is in a position to prevent the risk and if the costs of shifting the risk to the other party render further negotiation inefficient.¹⁵⁷ Therefore, concessions by parties are expected.¹⁵⁸

Although the foregoing insights attempt to explain how parties decide express terms, they do not explain why parties do not address and resolve every contingency through concession. Two reasons prevent parties from addressing every possible contingency. First, parties may not be capable of contemplating every contingency,¹⁵⁹ and even if they could, identifying problems is costly.¹⁶⁰ Second, negotiation costs may prohibit resolution of certain identified contingencies.¹⁶¹ When a contingency is extremely unlikely to occur and the anticipated negotiation costs exceed any perceived benefit, the parties may prefer to deal with the problem if and when it arises, either through re-negotiation or through litigation.¹⁶² In addition, the parties may be willing to accept a less

150. *Id.* at 602.

151. Gillette, *supra* note 92, at 537-38.

152. Coleman et al., *supra* note 92, at 653; Scott, *supra* note 92, at 606.

153. Coleman et al., *supra* note 92, at 653. These commentators also define the terms as a method for allocating the gains and burdens associated with the contractual relationship. *Id.* at 655.

154. Scott, *supra* note 92, at 603.

155. *Id.* at 602.

156. Coleman et al., *supra* note 106, at 651, 660.

157. Scott, *supra* note 92, at 603.

158. *But see* Gillette, *supra* note 92, at 538-539 (noting egoistic parties who are willing merely to gamble on a belief that their predictions about the future are correct and other parties' contrary predictions are wrong).

159. *Id.* at 552-53; *see* Easterbrook & Fischel, *supra* note 96, at 1444-45 (suggesting that corporate law is needed to provide gap fillers in contracts when unanticipated problems arise).

160. *See* Easterbrook & Fischel, *supra* note 96, at 1445 (noting that this expense will have been wasted if the unusual event does not occur).

161. Coleman et al., *supra* note 92, at 641.

162. Gillette, *supra* note 92, at 535.

than optimal default rule if the perceived burden of the default rule is less than the negotiation costs of an optimum agreement.¹⁶³

In selecting a default rule, first, a court could choose to place the burden of the event on the person who bears the greater proportion of other risks.¹⁶⁴ Since the party conceded with respect to most of the risks, this approach assumes that the party would have conceded and accepted the burden of the particular disputed risk had they negotiated the issue.¹⁶⁵ However, parties usually accept risks because of risk-prevention status.¹⁶⁶ If the burdened party cannot prevent the risk more effectively than the other party, acceptance of the risk of the event is irrational.¹⁶⁷ Therefore, the default rule is not what the parties would want. Furthermore, accepting some stated risks does not necessarily indicate a general acceptance of risk, especially where the burden is significant.¹⁶⁸ Therefore, a court should not assume automatically that the party who bears the most risk should bear the particular risk at issue.

A second option would be to choose arbitrarily one party to whom the risk would be assigned.¹⁶⁹ This option presumes that the importance of certainty outweighs considerations of substance.¹⁷⁰ Clarity reduces negotiation costs because people accept inferior default rules if the event is sufficiently unlikely to occur.¹⁷¹ Parties preferring an assignment of risk different from the default rule remain free to contract around the rule.¹⁷² Since clear rules provide the parties with certainty, the parties assess whether they prefer the cheaper rule or the more expensive negotiated term, thereby reducing future litigation costs.¹⁷³ One problem with this

163. *Id.* at 542.

164. Scott, *supra* note 92, at 611.

165. *See id.*

166. *See id.* at 603.

167. *See id.* (explaining that when it is cost-effective for the parties to distribute risks by contract, the parties will benefit from assigning the risk of contingencies to the party who is best able to minimize the possibility of that risk).

168. Gillette, *supra* note 92, at 556 (suggesting that commercial actors "are unlikely to take low probability risks that threaten substantial losses, notwithstanding that the expected value justifies the investment.").

169. *See* Scott, *supra* note 92, at 606 (explaining that legal default rules demonstrate a preference to clear, categorical risk assignments as opposed to mutual cooperation which may require frequent negotiation).

170. *Id.* at 598.

171. Gillette, *supra* note 92, at 543, 574.

172. *See id.* at 574 (arguing that default rules are appropriate, even if only to provide some basic standard around which parties can negotiate).

173. *Id.* at 575.

second option is that the rule may unintentionally provide an advantage to one party; for example, he or she could make negotiation costs of a different term prohibitive for the other party.¹⁷⁴ However, since the parties successfully contracted as to some terms, presumably *both* parties perceive a benefit from the contractual relationship. The circumstances of each type of contractual setting may dictate which of the two options should be used by the court.

3. Immutability

When a court adopts a default rule, it must decide whether the default rule will be immutable. Because an immutable rule limits the parties' freedom to contract, courts should render default rules immutable only if society wishes to protect either a party to the contract or parties outside the contract.¹⁷⁵ Theoretically, immutable rules are desirable only if "unregulated contracting would be socially deleterious because parties internal or external to the contract cannot adequately protect themselves".¹⁷⁶ When such concerns are not present, a simple default rule should be applied so that parties can still contract as they wish.¹⁷⁷

The next section expands upon the foregoing analyses regarding penalty default rules, regular default rules and immutable rules by reviewing certain events which may arise in the context of a guarantor relationship. A satisfactory default rule based on the foregoing is developed for each of the contingent events.

174. See Scott, *supra* note 92, at 612 (explaining that in specialized commercial transactions, negotiation strategies become more complex and each party becomes increasingly vulnerable to the demands of the other party).

175. Ayres & Gertner, *supra* note 93, at 88.

176. *Id.*

177. *Id.* at 89 ("When the preconditions for immutability are not present, the normative legal analysis devolves to the choice of a default rule."). In practice, rules which are not literally immutable may become immutable through court application. *Id.* at 121-23; Scott, *supra* note 92, at 608. Since the default rule serves to resolve conflicts and provide cheap options, a court should not favor its default rule over alternatives created by the parties. *Id.* Yet courts have refused at times to give effect to private parties' attempts to circumvent default rules. Ayres & Gertner, *supra* note 93, at 121-23. Negotiation costs increase when circumvention becomes difficult. *Id.* One option suggested is that the court outline alternative methods of circumvention when it fashions a default rule. *Id.* Another option is to liberally construe contract terms which attempt to circumvent a rule. *Id.* at 123-24. One exception to these principles relates to penalty default rules. If a penalty default rule was fashioned to encourage production of information, circumvention attempts should be closely scrutinized to ensure that the information was produced. Ayres & Gertner, *supra* note 93, at 124.

C. Default Rules For Specific Situations

This section of the note considers and proposes specific default rules for the occurrence of three events when the guaranty agreement does not specifically address the contingency¹⁷⁸ Given the factual inquiry involved with tailored default rules, this section defines untailored default rules. First, the untailored default rule is developed for the occurrence of *Z*'s termination of a relationship with *Y* Next, a rule is proposed for a name change by debtor. Finally, a rule is developed to deal with a merger involving *Y* The discussion assumes that no existing default rule applies to each situation.

1. Termination of Employment

In the first scenario, *Z* executes a guaranty while *Z* is employed by *Y* The guaranty agreement does not state the parties' intentions regarding *Z*'s liability as guarantor should *Z*'s employment with *Y* be terminated. *Z* leaves the employ of *Y* The court can adopt a rule which either continues to hold *Z* liable under the guaranty or relieves *Z* of liability The court could also use a penalty default rule or a rule construing what the parties would have done had they negotiated the term. In addition, the court must decide whether the rule should be mutable or immutable.

Under a penalty default rule analysis, the court would place the burden on the party which neither party would wish to bear the burden to induce the burdened party to act in a certain way¹⁷⁹ One theory would place the burden on whichever party can more

178. Notes 11 through 21, *supra*, discuss the guarantor's right to revoke and to be relieved of liability upon the occurrence of an event which materially increases the guarantor's risk. While the occurrence of each event discussed in this section can be resolved by the guarantor pursuant to these rights, specific default rules are better than the general rules. First, revocation requires the guarantor to take action. *See supra* notes 13-19 and accompanying text. To take the required action, the guarantor must be aware of the right to revoke. The creditor may not tell the guarantor of this right. *See Ayres & Gertner, supra* note 93, at 99. Second, the "material increase in risk" is too vague a standard to guide the parties as to the allocation of risk upon the occurrence of an event. *See Scott, supra* note 92, at 606 (noting the importance of clarity in risk assignment). Thus, the parties cannot determine whether a court will deem an event a material change, or a risk increase substantial.

179. *See supra* notes 112-21 and accompanying text. The court could also choose not to enforce the guaranty. However, the guarantor seeks nonenforcement. Therefore, nonenforcement places the burden on the creditor. *See Ayres & Gertner, supra* note 93, at 96-97. Consequently, nonenforcement is not a realistic option.

cheaply obtain information regarding the event.¹⁸⁰ Even if this person cannot control or prevent the risk, and therefore would not normally accept the risk, the burden minimizes strategic withholding of information by the burdened party.¹⁸¹

In the employment termination scenario, neither party may have access to the information. *Y* may not welcome inquiries from *Z* regarding *Z*'s employment status. In addition, even if *Z* voluntarily leaves *Y*, that "information" is not likely to be known even to *Z* at the time the guaranty is executed.¹⁸² Conceivably, *X*'s influence over *Y* puts *X* in the better position to obtain information regarding *Z*'s employment. It is unclear, however, whether *Z* or *X* can obtain the information more cheaply. If neither party has access to the information because it is unavailable, strategic withholding is not a problem. Therefore, disclosure of information about how likely it is that *Z*'s employment will be terminated cannot justify the use of a penalty default rule.

A second theory places the burden on the more experienced party.¹⁸³ The party with superior knowledge regarding potential contingencies, probabilities, and applicable default rules may withhold the information from the other party.¹⁸⁴ By withholding the information, the more experienced party can avoid costly negotiations, including negotiation necessary to circumvent a default rule favorable to the experienced party, and preserve that advantage even though the parties never addressed the issue.¹⁸⁵

In the employment termination scenario, the creditor is usually the more experienced party. First, creditors do not generally extend credit without some experience in the field. Second, the creditor's cognizance of the risk is evidenced by the creditor's decision to require *Z* to execute a guaranty before lending to *Y*. Finally, the creditor typically drafts the guaranty¹⁸⁶ and would generally be knowledgeable about default rules. Thus the creditor is generally the more experienced party to a guaranty agreement. Given a choice between a penalty default rule which burdens the creditor,

180. See Kronman, *supra* note 115, at 2-4.

181. *Id.*

182. *Z* would probably not execute a guaranty for the debts of a corporation *Z* intends to leave.

183. Ayres & Gertner, *supra* note 93, at 99.

184. See *id.*

185. *Id.* at 119.

186. See *supra* note 10.

who is generally the more experienced party, and a regular default rule which burdens the guarantor, a court could reasonably conclude that the penalty default rule is justified to ensure that the creditor provides the guarantor information about the probabilities of employment termination and the legal consequences thereof.

The court could also develop a default rule which allocates the risk of the event the way the parties would have.¹⁸⁷ One view advocates placing the burden on the party who bears the greater risk, reasoning that the parties would have agreed to place this particular burden on the same party. However, Z would not likely assent to assume this risk if the parties negotiated the term. Once Z's relationship with Y is terminated, Z cannot monitor or control the level of risk. In addition, Z no longer derives any benefit from the extension of credit to Y. While the creditor would prefer that Z assume the risk of termination of employment, a fully informed guarantor would not want to accept it.

Another view places the burden on the best risk-preventer because that party could reasonably concede during negotiation to accept the risk.¹⁸⁸ The guarantor cannot prevent loss of employment, however. An employee can attempt to retain his or her job, but neither fool-proof preventive steps nor post-occurrence insurance exists. Z can prevent voluntary termination of his or her employment. Z's termination, however, does not in and of itself create a burden which needs to be allocated since Y is primarily liable on the debt. So long as Y continues to perform, the risk to be prevented is Y's non-payment. Therefore, risk prevention analysis does not advance the inquiry.

Alternatively, the court can adopt a clear and certain rule, regardless of which party bears the burden.¹⁸⁹ If the court places the burden on the guarantor, the guarantor's liability will extend beyond the guarantor's employment with the debtor. The costs associated with bargaining around the default rule could effectively prohibit circumvention. The guarantor will wish to limit his liability to the term of his or her employment. The guarantor will obtain

187. Scott, *supra* note 92, at 597-98. The relative positions of the parties to the agreement enable courts to predict whether the parties would have chosen the default rule if they had bargained for the term initially. *Id.*

188. See Scott, *supra* note 92, at 603 (stating that the first thing negotiating parties seek to do is allocate and thereby reduce their personal risk).

189. See Scott, *supra* note 92, at 606. This argument is based upon the assumption that even an inferior default rule reduces negotiation costs by not forcing the parties to reach specific agreement on minor contingencies before the agreement is signed. *Id.*

this limited liability term only if the creditor allows it at a cost lower than the benefit derived from the term. This is unlikely to occur. The creditor will discourage limited liability and raise the cost of negotiation. Because the creditor is generally in a better bargaining position than the guarantor, a default rule in favor of the creditor grants the creditor an undue advantage over the guarantor.

Conversely, if a court places the burden on the creditor, then the guarantor is relieved of liability unless the contract provides otherwise. The creditor then has three options: (1) bargain for liability beyond employment; (2) bargain for notice upon termination of employment; or (3) accept the default rule relieving the guarantor of liability upon termination of employment. It is unlikely that the creditor will accept the default rule. However, the creditor will generally be in a position to bargain for one of the other options. In view of the creditor's influence over the debtor and the guarantor, the creditor, at very little cost, will generally be able to extend the guarantor's liability beyond employment.¹⁹⁰ Thus the creditor will be able to achieve its optimum term at a fairly low cost.¹⁹¹

Both the penalty default rule analysis and the default rule analysis favor a rule terminating *Z*'s liability under the guaranty upon *Z*'s termination of employment. Since the default rule analysis demonstrates that the parties would accept that term, a penalty default rule is not necessary. Therefore, the court should establish a default rule which relieves *Z* of liability upon termination of *Z*'s employment relationship with *Y*.¹⁹²

2. Name Change by Debtor

Second, assume *Z* executes a guaranty covering credit extended by *X* to *Y*. Subsequently, *Y* changes its name to ABC. Should *Z* continue to be liable for credit extended to ABC, or should the guaranty be construed to hold *Z* liable only for credit extended to the corporation when its name was *Y*? The court could institute a penalty default rule or a regular default rule which places the burden on *X* or *Z*.

A penalty default rule is appropriate if the court believes that

190. When no negotiation is allowed by one party, no negotiation costs are incurred.

191. See Ayres & Gertner, *supra* note 93, at 116.

192. The courts should then liberally construe attempts to circumvent the rules.

one or both parties have information which should be released to the other party during negotiation.¹⁹³ The guarantor, because of his connection with the debtor, is more likely to have knowledge regarding the possibility of *Y* changing its name.¹⁹⁴ By placing the burden on *Z*, the court encourages *Z* either to accept continued liability when *Y* changes its name or to investigate and disclose the possibility of a name change to *X* to avoid liability.¹⁹⁵ Furthermore, *Z* may usually obtain this kind of information more cheaply than *X* because of *Z*'s relationship to *Y*.¹⁹⁶

Another penalty default theory favors placing the burden on *X*, the party more experienced or familiar with the guaranty relationship.¹⁹⁷ However, while *X* may know in the abstract the probability that a debtor changes names, *Z* can better calculate the particular probability of a name change by *Y*. Thus, if courts create a penalty default rule, the guarantor's liability under the guaranty should continue beyond a debtor's name change.¹⁹⁸

Under a regular default rule analysis, the court should place the burden on *Z* because the parties would place the burden on *Z*.¹⁹⁹ If the parties knew at the time of negotiation that *Y* might change its name, the parties would have addressed and allocated the risk involved.²⁰⁰ Since a name change does not increase *Z*'s

193. Ayres & Gertner, *supra* note 93, at 94.

194. Kronman's concerns do not affect this situation because the information is unlikely to involve acquisition costs. See Kronman, *supra* note 115, at 4.

195. See Ayres & Gertner, *supra* note 93, at 98 (stating that "when the rationale is to inform the relatively uninformed contracting party, the penalty default should be against the relatively informed party").

196. See Kronman, *supra* note 115, at 2-4 (arguing that one individual may be able to obtain information more cheaply than another and that a court concerned with economic efficiency should impose the risk on the better information gatherers).

197. See Ayres & Gertner, *supra* note 93, at 99 (asserting that setting the default rule in favor of the uninformed party will induce the informed party to reveal information and increase efficiency).

198. See Ayres & Gertner, *supra* note 93, at 94, 96-97 (maintaining efficiency demands that strategic incompleteness be avoided by inducing parties to reveal information and contract around default rules). A court need not strictly scrutinize circumvention attempts, as the creditor, in whose favor the rule operates, generally drafts the agreement and has more bargaining power to dictate terms. A debtor attempting to circumvent may not be able to dictate an exact term which clearly evidences an intent to circumvent.

199. Scott, *supra* note 92, at 598-99 (stating that an accepted tenet of commercial contract theory holds "in filling gaps in contracts, the law should devise strategies that replicate the agreement the particular disputants would have specified"). The courts have noted that a name change by the debtor does not represent a change which substantially increases the guarantor's liability so as to justify release. *E.g.*, United States Shoe Corp. v. Hackett, 793 F.2d 161, 164 (7th Cir. 1986) ("changes in the . . . name of the obligor do not affect a guaranty").

200. See Scott, *supra* note 92, at 603 (maintaining that parties can distribute the risk of

risk exposure as a guarantor, *Z* would rationally agree to concede to this term.²⁰¹ *Y* remains the debtor (albeit under a different name), and presumably *Y*'s financial situation will not be affected by a name change. Furthermore, if there is an added risk, *Z* is in a better position to know, and if possible reduce, such resultant risk.²⁰²

X, on the other hand, will try to avoid accepting the risk of an event occurring (i) over which *X* has no control, (ii) about which *X* would not have ready information, and (iii) by which *X* exposes itself to increased risk of *Z* being released from secondary liability as guarantor.²⁰³ Further, such a rule is clear and definite.²⁰⁴ Thus, courts should adopt a default rule which requires that the guarantor's liability continues regardless of a name change by the debtor.

Both the penalty default rule analysis and the regular default rule analysis favor the guarantor's continued liability. Because most parties would place the burden of a name change on *Z*, a penalty default rule is not required. The court should adopt a rule which states that the guarantor's liability continues despite the name change by the debtor.

3. Merger

In the third scenario, *Y* merges with a separate corporation to form CD Corporation. A court can terminate *Z*'s liability upon occurrence of the merger or continue *Z*'s liability despite the merger. The court should consider general bargaining strategies in selecting a rule.²⁰⁵ The court may choose a penalty default rule or a general default rule.

A penalty default rule serves to provide incentive to one party to fill the gap in the contract with an alternative term.²⁰⁶ Since

foreseeable contingencies and can contract to reduce the amount of risk).

201. See Coleman et al., *supra* note 92, at 651, 660.

202. See Scott, *supra* note 92, at 603 (positing that by assigning the entire risk to the party best able to reduce the amount of risk, the parties can contract to reduce the amount of risk each faces).

203. See *id.*

204. *Id.* at 606 (stating the default rules of contract law reveal a preference for clearly categorized assignments of risk).

205. For discussion and an analysis of theories concerning the use of default rules and their relation to contract formation, see Ayres & Gertner, *supra* note 93; Coleman et al., *supra* note 92; Gillette, *supra* note 92; Scott, *supra* note 92.

206. Ayres & Gertner, *supra* note 93, at 91.

one goal is the disclosure of information during negotiation,²⁰⁷ the parties' respective knowledge about the possibility of a merger is important. Since the creditor, X, is more experienced in this type of transaction, X presumably has superior knowledge about the likelihood of a merger.²⁰⁸ However, since the guarantor, Z, has a closer relationship with Y,²⁰⁹ Z presumably knows more about the probability of Y merging.²¹⁰ Unless the merger is foreseeable at the time the parties execute the guaranty, however, the court need not provide an incentive to either party to discuss the issue.

A court may decide, however, that X should disclose to Z the effect a merger would have on Z's liability. Information regarding any default rule is relevant to bargaining.²¹¹ Even if an existing rule does not decisively address the result of a merger, information regarding the "material increase in risk" rule is relevant, including the rule's shortcomings.²¹² Since a creditor is unlikely to inform the guarantor how existing contract provisions might be affected by default rules, a penalty default rule which terminates the guarantor's liability upon a merger involving the debtor might be justified.²¹³

In fashioning a regular default rule, the court should fill in the gap as the parties would have if they had negotiated about the occurrence of the risk.²¹⁴ If Z is in a position to control the risk, then the parties would likely agree to place the burden on Z.²¹⁵ Z's control is not absolute, however.

207. *See id.* at 97.

208. *See id.* at 98 ("If one side is repeatedly in the relevant contractual setting while the other side rarely is, it is a sensible presumption that the former is better informed than the latter.").

209. Z may actually be involved in deciding whether to merge, either as a director submitting the issue to the shareholders or as a shareholder casting a vote.

210. As mergers are relatively serious matters, even officers would likely be aware of any possibility of a merger at the time the parties execute the guaranty.

211. *See Ayres & Gertner, supra* note 93, at 99.

212. Shortcomings include the lack of clarity as to what changes a court will deem material and as to what a court will decide is a substantial increase in risk. *See Scott, supra* note 92, at 606.

213. *See Ayres & Gertner, supra* note 93, at 94-100.

214. *See Scott, supra* note 92, at 598. The court could also choose a clear and definite rule, even if it is not precisely what the parties would want. *See id.*

215. In a closely held corporation, a guarantor who is also a shareholder or director would be able to control to some extent the risk of a merger. *See HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS*, 696 (3d ed. 1983). A guarantor who is a director, however, may face a conflict of interest if the merger would be in the best interests of the corporation but would also increase the director's exposure under the guaranty. *See id.* at 637.

If neither party would necessarily accept the risk at the negotiation stage, the court should fashion a clear and definite rule.²¹⁶ The court must be sensitive, however, to any incidental advantage given to the unburdened party.²¹⁷ If the court places the burden on Z, X may amass further bargaining power and thereby obtain other terms favorable to X. If the court places the burden on X, X will presumably be able to circumvent the rule by contract, at a fairly low cost, because of X's power over Z who wants to procure the loan for Y.²¹⁸ Therefore, the default rule should place the burden of the occurrence of a merger on X.

V. CONCLUSION

A guaranty agreement provides that the guarantor will pay the debtor's obligation to the creditor if the debtor defaults. Creditors use guaranty agreements to reduce the risk of non-payment by the debtor. While courts routinely enforce guaranties, commentators have not addressed the justifications for enforcing the agreements.

The four contract theories addressed in this note justify enforcement of a guaranty in the model guaranty context. Yet, when an event occurs upon which the contract is silent, the theories fail to justify enforcement and offer no guidance for completing gaps in a contract.

Default theories attempt to formulate a method to fill in those gaps. This note proposes a default rule to relieve the guarantor of liability upon termination of the guarantor's employment relationship with the debtor. The creditor, as the more experienced party, presumably has superior knowledge regarding the probability of termination, and the result of an occurrence. Thus, a default rule should place the burden related to termination of the guarantor's relationship on the creditor.

This note also proposes a default rule which does not relieve the guarantor of liability upon a name change by the debtor. The guarantor would rationally concede to accept liability since the guarantor's risk remains unaffected. In addition, the typical creditor would not accept the risk since the creditor could not control it, might not have immediate notice, and would suffer an increased

216. Scott, *supra* note 92, at 606.

217. Gillette, *supra* note 92, at 574.

218. The creditor could add a term requiring notice of the merger or stating that liability continued despite any merger.

risk immediately upon the occurrence of the event.

Finally, this note suggests a default rule providing that a merger involving the debtor should relieve the guarantor of liability. A clear and definite assignment of risk notifies parties of the allocation which will be made upon the occurrence of a merger. Creditors remain free to contract around the rule. Since creditors generally command more bargaining power than guarantors, the creditor will be better able to dictate an alternative term efficiently.

This note proposes rules for guaranty contracts based on the intent of most parties regarding the occurrence of an event. The rules proposed in this note are clearer than existing rules for guaranty agreements, which often create results contrary to what the parties would decide had they negotiated every contingency. While commentators have addressed the creation of default rules in other contractual contexts, the law of guaranty agreements has remained virtually static. Thus, this note urges courts to analyze current and future default rules in the guaranty context to create bargaining in the optimal environment for guaranty agreements. That would be a default rule to benefit all parties.

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