And Then There Were None: Requirements Contracts and the Buyer Who Does Not Buy

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AND THEN THERE WERE NONE: REQUIREMENTS CONTRACTS AND THE BUYER WHO DOES NOT BUY

Abstract: In requirements contract cases where buyer has significantly reduced—or no—requirements, courts employ inconsistent reasoning, resulting in legal uncertainty and economically inefficient exchanges. This Comment proposes a more predictable, efficient rule that would allow buyer to reduce its requirements after giving seller a business reason for the reduction, placing the risk of reduced requirements explicitly on seller.

A car manufacturer agreed to buy all its tires from one tire maker. Their four-year contract estimated that the manufacturer would need 500,000 tires. But after the tire maker had delivered only 25,000 tires, oil prices rose drastically and demand for large cars dropped. The manufacturer stopped car production and told the tire maker that it had no more requirements for tires.

Courts deciding what remedy should be available to a disappointed seller under a requirements contract have employed inconsistent reasoning, rendering contracts more costly. Different courts have emphasized various factors to determine if buyer may reduce its requirements, thus depriving contracting parties of a clear guide to their rights and obligations under such contracts if reduced requirements occur. At the time of contracting, both buyer and seller are unable to predict what circumstances justify a reduction and are forced to expend resources bargaining for a more predictable allocation of the risk of reduced requirements. As a result, the cost of contracting increases, and the value of contracting declines.

This Comment proposes a “business reason” rule that would provide contracting parties the desired predictability. The rule would allow buyer to reduce its requirements orders after giving seller a business reason for the reduction, allocating the risk of reduced requirements explicitly to seller. “Business reason” means an economic reason, such as business losses or the opportunity to net a higher profit in an alternative enterprise. At the time of contracting, parties would know that buyer may reduce its requirements after giving seller a business reason. Only parties who prefer a different allocation of the risk of reduced requirements would bargain for an alternative contract term; more economically efficient exchanges will result. This Comment shows that the proposed business reason rule is both legally sound and economically efficient, thus facilitating exchanges by making them less costly, preserving valuable court resources, and enhancing the advantages of requirements contracts.
I. THE LAW OF REQUIREMENTS CONTRACTS

A. Requirements Contracts Provide Flexible Agreements

Requirements contracts are unique in that quantity is determined by buyer's actual requirements for the contract good.\(^1\) Buyer agrees to buy all of its requirements of the good from seller during the contract period. Seller agrees to sell to buyer all of buyer's requirements. For example, if seller manufactures shoelaces and buyer manufactures shoes, they might decide to enter into a requirements contract. Buyer agrees to purchase all of its shoelace requirements from seller, and seller agrees to sell all the shoelaces buyer requires.

U.C.C. § 2-306(1) governs all requirements contracts for the sale of goods.\(^2\) The Section provides:

(1) A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.

A contract that provides either a stated maximum or minimum quantity that may be demanded, or an estimate of requirements, is within the definition of a requirements contract.\(^3\)

Early common law courts held requirements contracts void as illusory and lacking in mutuality because such contracts give buyer broad discretion in the performance of the contract: buyer may or may not have any requirements.\(^4\) If buyer manufactures only tennis shoes and a change in the consumer market renders laced tennis shoes obsolete in favor of shoes with velcro tape, buyer may choose to produce tennis shoes with velcro tape. As a result, buyer would have no requirements for shoelaces and would place no orders with seller.

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1. An output contract is similar to a requirements contract. In an output contract, quantity is determined by seller's output of the contract good. Buyer agrees to purchase all of seller's output for the contract period. U.C.C. § 2-306(1) (1987) governs both requirements and output contracts. This Comment does not discuss output contracts. It deals only with the particular situation where a requirements buyer has substantially reduced—or no—requirements.


4. E.g., Bailey v. Austrian, 19 Minn. 535 (1873) (requirements contract void as lacking in mutuality because buyer not obligated to “want” or purchase any of the contract good).
Today, courts and commentators agree that requirements contracts are valid and enforceable. Seller is obligated to provide buyer's actual requirements. If buyer has requirements, it must purchase those requirements from that seller. Buyer has obligated itself to exclusive dealing with seller during the contract period, giving up its freedom to go into the market and obtain its requirements from the seller of its choice. In addition, whether buyer in fact has any requirements is not left completely to buyer's whim; the U.C.C. imposes on buyer a good faith obligation in the performance of the contract.

A requirements contract offers advantages to both buyer and seller that a fixed quantity contract generally cannot. A buyer may prefer a requirements contract for three reasons. First, a requirements contract allows production flexibility by enabling buyer to shift to seller the risk of demand fluctuations in the market for buyer's final product. Buyer may adjust its orders for the contract good to reflect variations in demand for the final product. When demand is high, buyer places large orders with seller; when demand is low, buyer places small orders with seller. Second, a requirements contract offers buyer a guaranteed supply of the contract item. A guaranteed supply is especially valuable if the item is either scarce or in high demand. Third, if the contract is a fixed price contract, buyer shifts to seller the risk of a price increase in the contract good.

The advantages of a requirements contract exist under a fixed quantity contract only if buyer can predict accurately its need for the contract item. If the market for buyer's final product is uncertain, or if the product enjoys only sporadic demand, a requirements contract offers flexibility not found in a fixed quantity contract.

5. See Merlite Land, Sea & Sky, Inc. v. Palm Beach Inv. Properties, Inc., 426 F.2d 495, 498 (5th Cir. 1970) (mutuality of obligation supplied by reference to supplying the "needs" of the promisor); see also A. Corbin, Corbin on Contracts § 156 (1963) (promise to purchase requirements is not illusory and is sufficient consideration for a return promise).

6. See A. Corbin, supra note 5, at § 156.

7. U.C.C. § 1-203 provides: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."


9. Under a fixed quantity contract, buyer must speculate about future demand for its final product and, therefore, the contract item. If buyer overestimates its needs, it will incur increased inventory and storage costs and possibly resale costs. If buyer underestimates its needs, it must negotiate for the purchase of additional items, perhaps at a higher price. Whether the new contract is with the same seller or another one, buyer will incur additional transaction costs. See id. at 610. Transaction costs include locating a willing seller and negotiating a new contract. See infra notes 66–72 and accompanying text for a more complete discussion of transaction costs.

10. Weistart, supra note 2, at 615. Buyer assumes the risk of any decrease in the price of the contract item, as the requirements contract prohibits buyer from purchasing the item from another seller.
A seller may prefer a requirements contract for four reasons. First, the contract ensures a market for seller's product. Specifically, the contract excludes other sellers from sharing or winning the contracting buyer's business. A guaranteed market is particularly valuable to a new seller in the business, providing an opportunity to establish name recognition and a reputation for reliability. A new seller may be willing to assume the risk of fluctuations in the market for buyer's final product in exchange for these advantages. Second, a requirements contract enables seller to decrease its selling expenses. With a guaranteed market for its product, seller may decrease its investment in marketing and sales and reallocate these resources. Third, if buyer's needs are reasonably predictable, seller's practical risk may be small. If buyer has been in its business for many years, or if seller has worked with buyer for several years, seller may be able to predict accurately buyer's needs. Seller will be able to schedule its production and allocate its resources efficiently. Fourth, seller may charge a higher price for its product to compensate for the risk incident to a requirements contract.

Buyer's actual requirements may be significantly less than either a stated estimate or prior years' requirements, resulting in a disappointed seller. The remaining sections examine buyer's obligations in situations of reduced requirements.

B. Courts Employ Diverse Reasoning to Determine Whether Buyer Reduced Its Requirements in Good Faith

1. Good Faith

To determine parties' rights and obligations after a decrease in requirements, courts must decide whether buyer acted in good faith. Good faith is the sole constraint on a requirements buyer whose actual

11. Id. at 611. There may be antitrust implications involved, depending on the market power enjoyed by seller. For an early case recognizing this potential problem, see Standard Oil Co. of Cal. & Standard Stations, Inc. v. United States, 337 U.S. 293 (1949).

12. Weistart, supra note 2, at 611.

13. Id.
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requirements are substantially less than either a stated estimate or normal prior requirements. The extent of the decrease does not determine the issue of good faith. Indeed, courts have found complete cessation of requirements to be in good faith. If buyer acts in good faith, and if the contract does not contain a minimum quantity term, buyer may reduce its requirements—even to zero.

Good faith varies with the circumstances of each case. Courts have adopted a variety of means to determine whether buyer reduced its requirements in good faith. Buyer must have a reason for reduction and may not scale down arbitrarily its requirements; something "more than whim is required." It is uncertain how much more than whim is required to justify buyer's reduction in requirements.

Courts place the risk of good faith variation in buyer's requirements on seller, reasoning that if seller wished to limit its risk, it would have bargained for a minimum requirements term. Seller does not, however, assume the risk of bad faith variation in requirements. The burden of proving bad faith is on the complaining seller. In cases of decreased requirements, seller usually is unable to meet its burden.

14. Although U.C.C. § 2-306(1) prohibits buyer from demanding a quantity unreasonably disproportionate to either a stated estimate or normal prior requirements; courts and commentators have determined that this clause applies to increases in requirements, but not to decreases. E.g., Empire Gas Corp. v. American Bakeries Co., 840 F.2d 1333, 1338 (7th Cir. 1988); R.A. Weaver & Assocs., Inc. v. Asphalt Constr., Inc., 587 F.2d 1315, 1322 (D.C. Cir. 1978); Finch, Output and Requirements Contracts: The Scope of the Duty to Remain in Business, 14 U.C.C. L.J. 347, 351 (1982). This Comment accepts this determination.

15. Note, supra note 3, at 115.

16. E.g., Wilsonville Concrete Prods. v. Todd Bldg. Co., 281 Or. 345, 574 P.2d 1112 (1978); see also Note, supra note 3, at 115.

17. See Weistart, supra note 2, at 634.

18. Note, supra note 3, at 113. The U.C.C. defines "good faith" as "honesty in fact in the conduct or transaction concerned." U.C.C. § 1-201(19). In contracts between merchants, good faith also includes "the observance of reasonable commercial standards of fair dealing in the trade." Id. § 2-103(1)(b). A merchant is, in essence, a buyer or seller who regularly deals in the contract good. Id. § 2-104(1). Typically, a party involved in a requirements contract is a merchant, because the contract form itself assumes an ongoing relationship. Weistart, supra note 2, at 622 n.49.


20. Id. at 1340.


23. See Empire Gas, 840 F.2d at 1341.

24. Note, supra note 3, at 118.


2. Courts' Application of U.C.C. § 2-306(1)

In determining whether buyer reduced its requirements in good faith, courts have focused on a variety of factors and employed significantly different reasoning. While courts generally decide in favor of buyer, different courts have emphasized variously buyer's business reason, the degree of potential loss to buyer if it continues the contract, and the absence of a minimum quantity term.

The Seventh Circuit's decision in Empire Gas Corp. v. American Bakeries Co.,25 one of the few to provide a remedy to a disappointed seller, emphasized buyer's failure to provide a reason for the reduction in requirements. Plaintiff seller distributed propane gas and converters that enable gasoline-powered motor vehicles to operate on propane. Defendant buyer operated a large fleet of vehicles and wanted to convert its fleet to propane use. The parties agreed to a four-year requirements contract containing an estimate of approximately 3,000 units.26 Within days after signing the contract, buyer repudiated.27 Although buyer had decided not to convert its fleet to propane, it gave no reason for its change of heart.28 The court held that a reasonable jury could not fail to find bad faith, because buyer had given no reason for its refusal to order converters.29

In discussing when buyer may scale down its requirements, the Empire Gas court focused on the potential degree of loss to buyer if it continued the contract, stating that seller assumes the risk of a change

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25. 840 F.2d at 1333 (Posner, J.).
26. Id. at 1335.
27. Buyer American Bakeries disputed this finding. Buyer contended that ten days after the contract was signed, it notified seller that it was having budget problems and would delay making purchases until it solved these problems. Brief for Appellant at 8, Empire Gas (No. 87-1411). Seller Empire Gas admitted that buyer telephoned regarding budget problems and that buyer said it did not have conversion money "available at that time." Brief for Appellee at 5, Empire Gas (No. 87-1411). The trial court found that buyer notified seller of its budget problems, that seller accepted this explanation, and that telephone contact between the parties regarding buyer's budget problems and intent to perform the contract continued for over one year. Empire Gas Corp. v. American Bakeries Co., 646 F. Supp. 269, 270–71 (N.D. Ill. 1986), aff'd, 840 F.2d 1333 (7th Cir. 1988). Buyer then notified seller it had no requirements. Id. at 271.
28. Empire Gas, 840 F.2d at 1335. But see supra note 27. The appellate court dismissed buyer's budget problems as an unacceptable business reason for the lack of orders. "There is no evidence in the record on why [buyer] changed its mind beyond vague references to 'budget problems' that, so far as appears, may have been nothing more than a euphemism for a decision by [buyer] not to allocate funds for conversion to propane." 840 F.2d at 1339.
29. Id. at 1341. The dissent disagreed with the majority's conclusion that no reasonable jury could fail to find bad faith on the part of buyer. Id. at 1343 (Kanne, J., dissenting). No evidence on the issue of bad faith was offered at trial. The dissent concluded that "[t]he majority thus transforms the seller's theoretical burden of proof on bad faith . . . into an actual presumption of the buyer's bad faith . . . ." Id.
in buyer's business that makes continuation of the contract unduly costly, but buyer assumes the risk of a less urgent change in circumstances.\textsuperscript{30} The court noted that how urgent the change in buyer's circumstances must be to justify a reduction in requirements is unclear, but it is necessary for buyer to provide some reason for the change other than pure whim.\textsuperscript{31}

In three government contract disputes, courts reached the more common result—though based on diverse reasoning—in deciding that the buyers acted in good faith when they drastically reduced their requirements. In \textit{R.A. Weaver \\& Associates v. Asphalt Construction, Inc.},\textsuperscript{32} plaintiff seller contracted with defendant buyer to supply all the crushed limestone required for a National Parks Service project for which buyer was a subcontractor. The National Parks Service, pursuant to changes and termination clauses in the contract with buyer's prime contractor, deleted the provision calling for limestone. After learning of the change, but before placing any orders, buyer notified seller it had no requirements for limestone.\textsuperscript{33} The \textit{R.A. Weaver} court held that buyer had not breached the contract when it directed seller not to send any limestone.\textsuperscript{34} The court never explicitly found that buyer acted in good faith or that seller failed to prove bad faith. In fact, the court failed to provide any reason for its decision.

In \textit{Wilsonville Concrete Products v. Todd Building Co.},\textsuperscript{35} the court relied on three factors to decide in favor of buyer: Buyer's business reason, the lack of a contract term specifying a minimum quantity requirement, and buyer's lack of responsibility for termination of requirements. Plaintiff seller contracted with defendant buyer to supply all the concrete buyer required for a government contract. Had the contract been performed, buyer would have required approximately 3,058 cubic yards of concrete.\textsuperscript{36} However, after seller had supplied 245 cubic yards, the State of Oregon terminated its contract with buyer. Buyer notified seller that it had no requirements.\textsuperscript{37} In holding that buyer had not breached the contract, the \textit{Wilsonville} court reasoned that once the project was terminated, buyer had no good faith

\textsuperscript{30} \textit{Id.} at 1340. A less urgent change in circumstances might be a decision by buyer's management that its capital would be more profitably employed in an alternative investment. \textit{See id.}
\textsuperscript{31} \textit{Id.}
\textsuperscript{32} 587 F.2d 1315 (D.C. Cir. 1978).
\textsuperscript{33} \textit{Id.} at 1316–17.
\textsuperscript{34} \textit{Id.} at 1321.
\textsuperscript{35} 281 Or. 345, 574 P.2d 1112 (1978).
\textsuperscript{36} 574 P.2d at 1113.
\textsuperscript{37} \textit{Id.} at 1115 n.1.
requirements for concrete and was not obligated to buy any more concrete from seller. The court noted that it is not bad faith for buyer to reduce its requirements for a business reason. The court also noted that the contract did not contain a minimum quantity term, seller did not prove bad faith on the part of buyer, and buyer was not responsible for cancellation of the project.

In *Tennessee Valley Authority v. Imperial Professional Coatings* ("TVA"), the court decided for buyer and emphasized the absence of a contract term specifying a minimum quantity requirement. Plaintiff seller contracted with defendant buyer to supply protective coating paint for proposed nuclear reactors. The parties signed a requirements contract that specifically stated that buyer did not guarantee to purchase any maximum or minimum amount. After seller had shipped paint worth approximately $1.4 million, buyer deferred construction on the reactors, determining that it had overestimated the anticipated growth in demand for electricity. The *TVA* court stated that the terms of the contract, specifically the absence of a minimum quantity term, allocated the risk of cancellation of the contract to seller. If seller intended a contrary result, the court reasoned, it could have protected itself by bargaining for a minimum quantity term.

### II. A BUSINESS REASON RULE SHOULD REPLACE COURTS’ RELIANCE ON INCONSISTENT FACTORS TO DETERMINE GOOD FAITH REDUCTIONS IN REQUIREMENTS

Parties to a requirements contract lack clear guidelines for their rights and obligations because courts focus on several inconsistent factors in distinguishing good from bad faith reductions in requirements. The U.C.C. provides, and courts agree, that parties must act in good faith, but analysis of comments to the U.C.C. and cases applying section 2-306(1) shows that good faith reductions remain ill-defined by the Code and courts. A predictable rule would clearly delineate the parties’ rights and duties under a requirements contract. A "business reason" rule, which defines good faith as buyer providing seller with a

38. Id. at 1115.
39. See id.
40. Id. at nn.1–2.
42. Id. at 438.
43. Id. at 437–38.
44. Id. at 439.
business reason for a reduction, placing the risk of reduced requirements explicitly on seller, offers the desired predictability.

A. U.C.C. § 2-306(1), Comment 2 Provides No Practical Guidelines to Requirements Contract Parties

The proliferation of various means of distinguishing good from bad faith reductions in requirements may be due in part to the ambiguity of section 2-306(1) and its comments. Courts have turned to section 2-306(1), comment 2 ("comment 2") for guidance, because it purports to provide practical guidelines for distinguishing good from bad faith. The example in comment 2 distinguishes between a shutdown for lack of orders which might be permissible and a shutdown to curtail losses which would not. This distinction is not useful because it is unclear how it should be applied in many cases.

Based on the distinction in comment 2, parties could predict a court's ruling in only two situations: If buyer experienced no demand for its final product, or if buyer had constant demand but chose to reduce its orders to gain a larger profit. Assume buyer manufactures denim jeans and seller manufactures buttons. At a time when all jeans are made with buttons, buyer and seller enter into a long-term contract for all of buyer's requirements for buttons. If there is a drastic change in the consumer market and all consumers want jeans with zippers, there will be no orders for jeans with buttons. Courts applying the example in comment 2 would find buyer justified in ordering no buttons from seller. Parties could also predict the outcome if buyer chooses to have no requirements in order to take advantage of the opportunity to earn a higher profit. This might occur if demand for buyer's jeans remains constant, but buyer decides to employ its production resources in a more profitable product, denim tennis shoes. Because there is no lack of orders, or even losses to curtail, courts applying comment 2 would hold buyer liable to seller for breach of contract.

Most cases are not as predictable as the extreme examples above and defy application of comment 2. Suppose, instead of a drastic change in the market for jeans, there is a gradual change of preferences to favor jeans with zippers. Comment 2 fails to provide a

45. The comments to the U.C.C. are not legislative history and have not been adopted as law in the states. Courts have, however, considered the comments to be persuasive in interpreting the text of the Code. Weistart, supra note 2, at 606 n.17; see also Empire Gas Corp. v. American Bakeries Co., 840 F.2d 1333, 1339 (7th Cir. 1988).

46. Buyer experiences additional "opportunity costs"; the value of the opportunity given up. For an economic analysis of this situation, see infra note 66.
method for determining how insufficient the orders must be to justify a reduction in requirements. If buyer's orders decrease by fifty percent, but buyer can still cover its variable costs, it is unclear whether this is a sufficient lack of orders to justify buyer having no requirements for buttons—even though buyer is not experiencing losses.

The result is equally unclear in situations where there is no lack of orders, but there are significant losses to curtail. Suppose buyer receives approximately the same number of orders for jeans as in prior years, but production costs increase due to rising labor costs. If the increase in production costs is significant, buyer could experience losses certain to put it out of business. In this case, buyer's refusal to require buttons will not be due to lack of orders, but to losses it wishes to curtail. The example in comment 2 implies that buyer ought to be held to the contract at the expense of its business.

The hardship is comparable between a buyer who is lacking orders and a buyer who is experiencing losses fairly certain to put it out of business. In both situations, buyer's business may be threatened. A buyer is not likely to bargain away its right to exercise its best business judgment. Thus, not only is it often difficult to determine how the suggested distinction in comment 2 would apply to a set of facts, but the difference in results could be unjustified.

B. The Business Reason Rule

A predictable rule governing requirements contracts would place the risk of good faith reductions in requirements explicitly on seller, unless the parties bargain for another allocation. It would define good faith as buyer providing seller with a business reason for a reduction. "Business reason" means an economic reason, such as business losses or a more profitable alternative investment. The very nature of requirements contracts suggests an ongoing relationship between buyer and seller where communication is important. Requiring buyer to provide a business reason for a reduction would fulfill buyer's duty

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47. Variable costs fluctuate with the amount of a producer's output and include the costs of inputs. Fixed costs remain constant regardless of the amount of a producer's output and are often referred to as "overhead." If a producer cannot cover its variable costs, it makes no profit and will cease production even though it can still cover its fixed costs. See W. Baumol & A. Blinder, Economics Principles and Policy Microeconomics 115-47 (4th ed. 1988).

48. Weistart, supra note 2, at 629.

49. Business reason would not include, for example, a sudden dislike for seller or a change in management.
of fair dealing and might dispel seller's fear that buyer will act arbitrarily. Seller would retain the option of proving buyer acted in bad faith, that is, dishonestly.

The business reason rule's advantages are numerous. First, parties to a requirements contract would know their rights and obligations. For buyer to reduce its requirements, assuming the parties did not reallocate the risk of a reduction, buyer must provide seller with a business reason for the change. Second, the rule would enhance the advantages a requirements contract has over a fixed quantity contract. It would maintain the business and production flexibility so important to buyer, and provide seller with some security in knowing that buyer will not decrease its orders unless there is a business reason to do so. Third, the rule would not require courts to draw fine, often unfounded, distinctions between curtailing losses and lacking orders, or between changes in circumstances that make continuation of the contract unduly costly and changes that are less urgent. Instead, courts need only determine whether the parties contracted for a reallocation of the risk of reduced requirements, and, if not, whether buyer gave seller a business reason for the reduction. Fourth, because seller may prove buyer acted dishonestly or contrary to notions of fair dealing in the given industry, the rule comports with the definition of good faith adopted by the drafters of the U.C.C.. Fifth, the rule preserves seller's judicially-imposed burden of proving bad faith. With the proliferation of vague rationales to determine if buyer acted in good faith, courts may easily, perhaps unknowingly, shift this burden. Finally, the rule is compatible with the idea of flexible quantity contracts. The requirements buyer agrees only to buy its actual good faith requirements from seller. Buyer does not agree to buy an amount equaling or approximating the stated estimate. If seller wants more protection, it is free to bargain for a minimum requirements term.

C. Applying the Business Reason Rule

The business reason rule would permit courts to replace their inconsistent and often vague approaches to reduced requirements cases with

50. See supra note 29.

51. Adoption of the business reason rule may lead to fewer requirements contracts. Some sellers may refuse to assume the risk of a reduction in requirements when buyers' obligation is merely to provide a business reason for the reduction. This result would not necessarily be undesirable. It is preferable for sellers to bargain for contracts that express their true intent rather than to bargain for a requirements contract with the expectation that it will be treated like a fixed quantity contract.
more consistent and reasoned analysis. Analysis of each case previously discussed in light of the proposed rule shows that a decision based on the rule would allow parties to requirements contracts to predict their rights and responsibilities if reduced requirements occur.

The distinction between good and bad faith reductions in requirements that the Seventh Circuit adopted in Empire Gas is of no more practical use than that set forth in comment 2. The court stated that seller assumes the risk of changes in buyer's circumstances that make continuation of the contract unduly costly, but does not assume the risk of less urgent changes. It is unclear when a change in circumstances makes performance of the contract unduly costly and when a change is less urgent. The court offered no guidelines other than that something more than whim is required. Like the example in comment 2, this distinction leaves an expansive middle ground where a court's application of the distinction would be wholly unpredictable.

If the Empire Gas court had applied the business reason rule, it would have decided in favor of buyer. First, after examining the contract, the court would have found that the parties did not allocate the risk of reduced requirements to buyer. Second, buyer did provide seller with a business reason for its lack of requirements: budget problems. Although the court dismissed budget problems as an inadequate business reason, they would suffice under the suggested rule. An investigation into the type or degree of potential loss to buyer if it continues the contract is inappropriate. Had buyer wished to bind itself to purchase approximately the stated estimate, absent extreme business losses, it would have bargained for a fixed quantity contract and relied on such doctrines as impossibility, impracticability, and frustration of purpose for relief from performance. Finally, seller in Empire Gas did not prove bad faith on the part of buyer.

52. 840 F.2d 1333 (7th Cir. 1988). For a discussion of the facts of the case, see supra text accompanying notes 25–31.
53. Indeed, such unpredictability is manifest in the court's refusal to accept the trial court's finding that budget problems, surely something more than whim, were shown. See supra notes 27–28.
54. See 840 F.2d at 1335.
55. See supra note 27.
56. "Impossibility" applies when performance of the contract is physically impossible. Posner & Rosenfield, Impossibility and Related Doctrines in Contract Law: An Economic Analysis, 6 J. LEGAL STUD. 83, 85 (1977). "Impracticability" applies when performance would entail a much higher cost than originally anticipated. Id. at 86. "Frustration of purpose" applies when performance is possible, but the underlying purpose of the contract is no longer attainable. Id. at 85.
Use of the business reason rule in *R.A. Weaver* and *Wilsonville* would not have altered the results, but would have permitted more reasoned analyses. In *R.A. Weaver*, the Court of Appeals for the District of Columbia found good faith in buyer's complete elimination of limestone requirements. The court failed to state its reasoning, moving from a statement that the law requires good faith and does not prohibit good faith reductions in requirements, to the conclusion that buyer did not breach the contract. Although the court did not explicitly find that buyer acted in good faith, this conclusion is implicit in the holding. The absence of a stated reason behind the court's decision leaves contracting parties in the District of Columbia Circuit without a clear guide to their obligations under requirements contracts.

The Oregon Supreme Court's analysis in *Wilsonville* is ambiguous. The court appeared to rely on several factors when deciding whether buyer acted in good faith, but did not explicitly include any of the factors in its analysis. Two of the factors, the absence of a contract term specifying a minimum quantity of concrete and buyer's lack of responsibility for the government contract termination, the court mentioned only in footnotes. The third factor, buyer's business reason, appeared in a quotation without explanation of its importance. After *Wilsonville*, Oregon parties to requirements contracts can only speculate about which of the three factors actually influenced the court's decision.

Applying the business reason rule to both *R.A. Weaver* and *Wilsonville* would provide contracting parties with definite guidelines. In both cases, buyers acted in good faith. Both buyers notified the sellers of the reduced requirements upon learning of the change. Both buyers gave a business reason for the reduction: the change in, or cancellation of, a government contract. In addition, neither buyer was responsible for the reduction, and neither seller proved bad faith. The courts' ambiguous analyses could have been avoided by simply stating that buyers acted in good faith by providing sellers with a business reason for reducing their orders.

57. 587 F.2d 1315 (D.C. Cir. 1978). For a discussion of the facts of the case, see supra text accompanying notes 32-34.
59. "Thus, it is not bad faith for a buyer to reduce his orders where his own business needs have actually fallen off..." 574 P.2d at 1115 (quoting WHITE & SUMMERS, UNIFORM COMMERCIAL CODE §§ 3-8, at 108-09 (1972)).
The *TVA* court's conclusion is compatible with the rule suggested here. As in *R.A. Weaver*, the *TVA* court stated that buyer reduced its requirements in good faith, but the court did not give any reason for finding good faith. In fact, because buyer's reduced requirements for protective coating paint was the result of its own mistaken projection of future energy needs, a finding of good faith is less obvious than in cases like *R.A. Weaver* and *Wilsonville* where the reduction was not the fault of buyer, but due to a third party's actions. The *TVA* court did not rely on buyer's good faith in reaching its decision, but rather on the notion that if seller had wanted more protection, it could have bargained for a minimum quantity term.

Application of the business reason rule produces the same result in *TVA*, yet allows for a more complete and reasoned analysis. First, when buyer determined that it had overestimated the demand for electricity, it had a business reason for deferring construction of the reactors. If the energy was not needed, buyer would experience losses if it built the plants at that time. Second, buyer notified seller and explained the reason for its decision. Finally, as the *TVA* court pointed out, seller could have bargained for a minimum requirements term if it wanted to alleviate the risk of good faith reductions in requirements.

### III. COURTS' DIVERSE INTERPRETATIONS OF THE GOOD FAITH OBLIGATION RESULT IN ECONOMIC INEFFICIENCY

The proposed business reason rule would not only enable parties to requirements contracts to predict their rights and obligations, but also would promote efficient exchanges between these parties. Courts and legislatures should adopt rules that most contracting parties

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61. Seller conceded that buyer acted in good faith in deferring production of the reactors. 599 F. Supp. at 438. The court did not discuss why seller conceded this issue.

62. *Id.* at 439.

63. Whether the rule is "fair" or "just" is considered separately from the economic analysis. *See infra* Part IV. The sole goal of this part of the Comment is to provide a positive economic analysis. A positive economic analysis considers the actual outcomes of a given rule as it exists, rather than whether a given rule based on efficiency is a "good" rule. *See Posner & Rosenfield, supra* note 56, at 89.

A given rule is efficient if it is "welfare-maximizing." That is, the rule is efficient if those who gain from it gain enough so they could compensate those who lose. This is referred to as "Kaldor-Hicks efficiency." Harrison, *A Case For Loss Sharing*, 56 S. CAL. L. REV. 573, 573 n.3 (1983). Another type of efficiency is "Pareto Optimality," which defines an efficient exchange as one which makes at least one party better off without making another party worse off. E.
would bargain for and adopt themselves; this will promote economically efficient exchanges by decreasing the costs of contracting and freeing up resources for more productive uses. Perpetuating an unpopular rule will increase contracting costs, because economic analysis shows that parties will bargain around such a rule.

A. The Coase Theorem and Transaction Costs

A discussion of the desirability of a particular contract rule is incomplete without a discussion of the rule's efficiency. Commentators have begun to recognize economic efficiency as an important aspect of contract law. A primary function of contract law is to facilitate exchange. One way to facilitate exchange is to make it less costly. A rule that is predictable and generally preferred by contracting parties will make exchange less costly, because most parties will not expend resources bargaining for an alternate rule. Such a rule is economically efficient.

The Coase Theorem, the foundation of many "law and economics" discussions, demonstrates that parties will bargain around inefficient rules. The Coase Theorem provides that, given zero transaction costs, the law's assignments of rights and liabilities will not affect the allocation of resources. Applied to requirements contracts, the Coase Theorem shows that, absent transaction costs, which party bears the risk of reduced requirements has no effect on whether parties decide to contract, because parties will bargain around an inefficient allocation of risk.

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64. For various articles applying economic concepts to legal rules, see Journal of Law & Economics and Journal of Legal Studies.
66. R. Coase, The Firm, the Market, and the Law 106 (1988). The example often used to illustrate the Coase Theorem involves a rancher whose cattle strayed and destroyed the crops of a neighboring farmer. Whether or not the rancher is liable to the farmer for the damage caused by her straying cattle will not affect whether she continues to raise cattle. If the rancher were liable to the farmer, she would include these potential liability costs when calculating whether cattle ranching is profitable. But if the rancher were not liable to the farmer for the damage, the farmer would be willing to pay her a sum of money up to the amount of the damage to restrain her cattle. The rancher would consider this payment from the farmer when computing the costs of her cattle operation, because when her cattle strayed she would have to forgo the payment. This forgone money represents an "opportunity cost," an alternative the rancher must give up to pursue her activity. In both situations, therefore, the rancher will take the damage cost into account. Regardless of where the liability rests, if her profit from ranching exceeds her costs, either in the form of money paid to the farmer or money forgone, she will continue her operations.
Transaction costs do exist and can be so high that they preclude exchanges that would have occurred in the absence of such costs.\textsuperscript{67} Transaction costs in a contracts setting include the costs of locating another party, determining one's legal rights, and negotiating a contract. The costs of negotiating a contract decrease if parties reduce the number of contract terms for which they must bargain. The U.C.C. and other substantive contract laws provide default terms that become part of each contract unless parties specifically bargain for other terms.\textsuperscript{68} If parties are satisfied with the default term, they do not need to devote resources to negotiating a specific term for their contract. If parties are unsatisfied with the default term, they may negotiate around it.\textsuperscript{69}

According to the Coase Theorem, if this rearrangement of rights were without transaction costs, it would always take place if it would lead to a greater value of production.\textsuperscript{70} But such transactions are costly,\textsuperscript{71} and parties negotiate around a term only if the increase in the value of production that will result from the rearrangement of rights exceeds the costs of those negotiations.\textsuperscript{72}

\textbf{B. The Business Reason Rule Is Economically Efficient}

Economic analysis shows that the business reason rule is desirable because it would be more efficient for the contracting parties, would preserve court resources, and would further the advantages of requirements contracts. Existing rules are unclear. Although section 2-306(1) allows buyer to reduce its requirements in good faith, it does not indicate when a reduction is in good faith, and the example in comment 2 is without economic merit.\textsuperscript{73} In addition, courts' interpretations of section 2-306(1) result in inefficient bargains; parties need a clear, predictable rule to avoid expending resources bargaining for a more explicit allocation of the risk of reduced requirements.

\textsuperscript{67} R. Coase, \textit{supra} note 66, at 114.
\textsuperscript{68} U.C.C. Article 2 on Sales contains default rules governing various contract terms such as price, \textit{id.} § 2-305, place for delivery, \textit{id.} § 2-308, and time of performance, \textit{id.} § 2-309.
\textsuperscript{70} "Production" in this context means the value of output from the exchange.
\textsuperscript{71} In the case of requirements contracts, it is especially costly to bargain for a term allocating the risk of reductions in requirements. Quantity is dependent on a relatively unpredictable factor, buyer's future requirements, and it is impossible to foresee all events that may occur and affect the desirability of the contract. See R. Coase, \textit{supra} note 66, at 119.
\textsuperscript{72} See \textit{id.} at 114–15.
\textsuperscript{73} See infra text accompanying notes 77–78.
The following economic analysis is based on several simplifying assumptions. First, the contracting parties do business in a competitive market; second, all parties to requirements contracts are profit-maximizing and, therefore, prefer contract terms that will maximize the value of the exchange; third, the legal rights of the parties are well defined; fourth, parties are aware of the legal rules that govern their contractual relationship; and fifth, the distribution of wealth is given and held constant.

The U.C.C.'s example of the application of the good faith standard, set forth in comment 2, ignores the concept of opportunity costs and is a distinction without an economic difference. Comment 2 suggests that a shutdown due to a lack of orders is probably within the confines of good faith, whereas a shutdown to curtail losses probably is not. Analysis of two hypothetical situations shows that the economic result is the same in each case. Comment 2 suggests that in the first situation, where buyer experiences a total lack of orders, buyer could in good faith reduce its requirements, even to zero. However, in the second situation, where buyer has orders but could net a larger profit in an alternative enterprise, a reduction in orders would not be permitted because there is no lack of orders and no loss to curtail. Economic analysis reveals, however, that buyer may experience losses if it performs the contract, because it will incur the opportunity-costs of foregoing a higher profit from an alternative use of its resources. Whether buyer will experience an out-of-pocket loss of, say, $50 in the first situation or an additional opportunity cost of $50 in the second situation, buyer will consider the $50 a cost of business. Both cases decrease the value of the exchange. Each situation makes the transaction equally disadvantageous. The distinction in comment 2 is not economically justified; courts should disregard it.

The ambiguous allocation of the risk of reduced requirements under the present interpretation of good faith renders the rule inefficient because parties will expend resources bargaining for a more explicit allocation. Courts' interpretations of the obligation of good faith are

74. In a competitive market, price is determined by the interaction between supply of a given product and demand for that product.
75. The more efficient the exchange, the larger the potential profit from the contract which will be divided between the parties. Posner & Rosenfield, supra note 56, at 89.
76. A set distribution of wealth is necessary to the concept of opportunity costs. If parties are assumed to have only a given amount of resources, they must choose between various alternative investments. See supra note 66 for a discussion of opportunity costs.
77. See supra text accompanying notes 45–48 (discussion of hypothetical situations).
78. See supra note 66 regarding the effect of opportunity costs on the value of an exchange.
79. See Posner & Rosenfield, supra note 56, at 96.
so unpredictable that parties will not know their legal rights.\textsuperscript{80} Although courts generally decide in favor of buyers, requirements contract parties cannot know which reasons will justify a reduction in requirements. As a result of this uncertainty, there will be a tendency for all requirements contracts parties to bargain for a more predictable, explicit allocation, increasing the cost of contracting. As the cost of contracting increases, the value of the contract declines.

Economic analysis shows that the business reason rule is preferable for several reasons. First, it is efficient for the contracting parties. The bargaining process would be less difficult and less costly because the parties' rights and obligations would be clearly defined. Instead of all parties expending resources to clarify their rights in the face of a vague rule, only those parties opting to reallocate the risk of reductions in requirements would negotiate this term. Second, the proposed rule would preserve court resources. Instead of devising \textit{ad hoc} methods to determine when reductions are in good faith, courts, when faced with the issue of reduced requirements, need only determine if the parties reallocated the risk away from seller and, if not, whether buyer gave a business reason for the reduction. Finally, the business reason rule furthers the advantages of open quantity contracts. Specifically, the rule provides buyer with the desired flexibility which likely led buyer to choose a requirements contract while guaranteeing seller a market free of competitors.

IV. CONCLUSION

The business reason rule could alleviate the present problems of legal uncertainty and exchange inefficiency, which result from courts' varying interpretations of U.C.C. § 2-306(1) when buyer has reduced requirements. The rule would require buyer to give seller a business reason for a reduction in requirements. It would place the risk of reductions explicitly on seller, but allow parties to bargain for an alternative allocation. This rule would foster more efficient exchanges, provide legal predictability, preserve court resources, and further advantages inherent in requirements contracts.

Although the previous legal and economic analyses did not consider whether the proposed rule was "fair" or "just," these concepts will not be compromised by the proposed rule. Fairness and equality are not synonymous. A party should not be prohibited from, or penalized for, capitalizing on superior bargaining power, especially when both parties are merchants bargaining at arms length. "The principle is one of

\textsuperscript{80} See \textit{supra} text accompanying notes 45–48 (comment 2 applied to hypothetical situations).
prevention of oppression and unfair surprise . . . and not of disturbance of allocation of risks because of superior bargaining power."81 Under the proposed rule, seller remains free to prove buyer acted in bad faith, that is, dishonestly or contrary to notions of fair dealing in the trade. In addition, contract law provides remedies for specific abuses of the right to contract. U.C.C. § 2-302 polices contracts, or clauses in contracts, that are unconscionable. If a contract is procedurally or substantively unconscionable, or if it violates public policy, a court may refuse to enforce it. Parties also are protected by contract laws governing duress, fraud, and misrepresentation.82

If the bargaining process was fair and the contract is substantively fair, fairness in performance of the requirements contract requires no more than buyer providing seller with a business reason for a reduction. If seller seeks security, rather than simply fairness, seller should bargain for either a term specifying a minimum quantity or for a fixed quantity contract.

Requirements contracts offer parties a unique flexibility not found in fixed quantity contracts, and legal rules should facilitate the negotiation of such contracts. U.C.C. § 2-306(1), as inconsistently interpreted by courts, either discourages parties from choosing a requirements contract or forces parties to expend resources bargaining for explicit contract terms, increasing the cost of contracting. The business reason rule would remove the legal and economic barriers to requirements contracts by providing the predictability contracting parties desire.

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81. U.C.C. § 2-302, comment 1 (emphasis added).