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# Contract Law, Party Sophistication and the New Formalism

Meredith R. Miller\*

## I. INTRODUCTION

An ever growing body of case law<sup>1</sup> and scholarship<sup>2</sup> has fashioned a rigid dichotomy between sophisticated and unsophisticated parties in a wide

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1. There is ample evidence that the relevance (or at least mention) of party sophistication is a growing trend. Westlaw's "allstates" database includes all state cases dating back to 1658. Conducted in February 2009, a search for "sophisticated /7 party or parties or entity or entities /20 contract or agreement" before 1990 yielded 108 cases. The same search for cases after 1990 yielded 813 cases. Because the terms are limited to parties or entities described as "sophisticated," the search results are potentially over and under inclusive. Nevertheless, even accounting for some potential over inclusivity, there is evidence of a considerable trend. *See infra* Section IV.

2. *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 547 (2003) (arguing for formalist interpretation of contracts between sophisticated economic actors); Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J. L. ECON. & ORG. 230, 233 (1993) ("We first show that, if the private parties are sophisticated and are symmetrically informed *at the time of contracting*, then there is no benefit to the courts' mandating the terms of private contracts."); Paul Mitchell, *Illiteracy, Sophistication and Contract Law*, 31 QUEEN'S L.J. 311, 326 (2005) (arguing that illiteracy should create a rebuttable presumption that a party is not sophisticated); Mark Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 IND. L. J. 45, 45 (1995) ("The doctrines of impracticability[] [and] mistake[] . . . share a feature that is unusual in contract law. They give courts the power to excuse or modify terms in contracts between sophisticated parties who bargained over terms of the contract with equal power and information."); Allen Blair, *A Matter of Trust: Should No-Reliance Clauses Bar Claims for Fraudulent Inducement of Contract?*, 92 MARQ. L. REV. 423, 428 n.17, 430 (2009) (advocating for enforcement of no-reliance clauses but limiting focus exclusively to contracts between "sophisticated parties with relatively equal bargaining power").

array of contract inquiries. Courts mention party sophistication in determining whether the parties intended to form a contract<sup>3</sup> and what they meant by the terms they used.<sup>4</sup> They determine the enforceability of reliance disclaimers,<sup>5</sup> exculpatory clauses<sup>6</sup> and liquidated damages provisions<sup>7</sup> based, at least in part, on party sophistication. Courts also reference sophistication in determining whether a party can avoid a contract on the grounds of mistake or fraud.<sup>8</sup> While consumers are commonly contrasted with sophisticated parties,<sup>9</sup> the relevance of party sophistication is not limited to consumer transactions. Its relevance transcends any one area of substantive law – arising in commercial, business, employment, franchise, insurance, family and property disputes, among others.

For its ubiquity, party sophistication remains an unstudied and largely unaddressed question in contract law. Although they often mention sophistication, the extensive contract treatises of Williston, Corbin and Farnsworth do not dedicate a section to clarifying what is meant by the terminology.<sup>10</sup> This Article begins the discussion.

It is not certain why the dichotomy between sophisticated and unsophisticated parties has grown in significance. To be sure, courts often use “sophistication” as code for socio-economic status – wealth and education are

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3. See *infra* Part III.G (discussing relevance of party sophistication to contract formation).

4. See *infra* Part III.A (discussing relevance of party sophistication to contract interpretation).

5. See *infra* Part III.B (discussing relevance of party sophistication to reliance disclaimers).

6. See *infra* Part III.C (discussing relevance of party sophistication to exculpatory clauses).

7. See *infra* Part III.D (discussing relevance of party sophistication to economic loss rule, limitations on damages and liquidated damages).

8. See *infra* Part III.E (discussing relevance of party sophistication to mistake); Section III.B (discussing relevance of party sophistication to claim of fraud).

9. See, e.g., *Green v. Select Portfolio Servicing, Inc.*, No. 5:08-CV-00198, 2008 WL 2622917, at \*1 (S.D.W.Va. Jun. 30, 2008) (The plaintiffs described themselves as “unsophisticated consumers” who “did not understand the details of the transaction.”); *Warner v. Ford Motor Co.*, No. 06-CV-02443-JLK-MEH, 2008 WL 4452338, at \*15 (D. Colo. Sept. 30, 2008) (The purchasers of a car “were likely relatively unsophisticated consumers with little bargaining power . . . .”); *Leonard v. Terminix Int’l Co., L.P.*, 854 So. 2d 529, 538 (Ala. 2002) (Homeowners were “not sophisticated or wealthy consumers with equal bargaining power.”).

10. Likewise, the Restatement (Second) of Contracts does not use the term “sophistication” in the text of any of its provisions. However, in addressing the interpretation of standardized forms, section 211, comment e, does acknowledge the appropriateness of a more restrictive reading of the “reasonable expectations” of “sophisticated customers who contracted with knowledge of an ambiguity or dispute.” RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. e (1981). See also *infra* Part III.E.

common attributes of individuals that are deemed sophisticated.<sup>11</sup> “Sophisticated” parties, whether individuals or business entities, are presumed to have access to information, resources to allocate risk and experience or predisposition to counteract cognitive bias.<sup>12</sup> Often, a court’s indication that a party is “sophisticated” is used to signal that, even though the result may seem harsh, it should be interpreted as fair. But none of these descriptions elucidates the trend of increased reference to sophistication. The trend appears to be best explained by examining what is happening in contract law on a theoretical level.

Scholars have observed that contract law is experiencing a period of renewed formalism – which has been variably described as “neoformalism” and “anti-anti-formalism.”<sup>13</sup> However, this new formalism, which values the literal content of a contract and the autonomy of the parties, has not completely abandoned the normative concerns characteristic of the realist period. At least nominally, through the dichotomy based on party sophistication, the law has attempted to preserve concern about the context of a transaction.

In the new formalism, sophisticated parties are held to a different set of rules,<sup>14</sup> grounded in freedom of contract. It is presumed *ex post* that a sophisticated party was aware of what to bargain for<sup>15</sup> and read (or should have read) and understood (or should have understood) the terms of a written agreement.<sup>16</sup> Sophisticated parties are expected to negotiate ably and order contract risks sensibly. It is, therefore, now an accepted tenet of contract law that “[f]reedom of contract prevails in an arm’s-length transaction between sophisticated parties . . . and in the absence of countervailing public policy concerns there is no reason to relieve them of the consequences of their bar-

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11. See *infra* Part III.E.

12. See Larry T. Garvin, *Small Business and the False Dichotomies of Contract Law*, 40 WAKE FOREST L. REV. 295, 298 (2005) (discussing merchants and consumers as status-based dichotomies in contract law and assumptions about consumers and merchants that explain why the law treats them differently).

13. See *infra* notes 32-34 and accompanying text.

14. One treatise notes that “equity often deals a harsher hand to the more sophisticated party.” 28 WILLISTON ON CONTRACTS § 70:153 (4th ed. 2009) (discussing *Farash v. Sykes Datatronics, Inc.*, 452 N.E.2d 1245, 1251 (N.Y. 1983)).

15. *Oppenheimer & Co., Inc. v. Oppenheim, Appel, Dixon & Co.*, 660 N.E.2d 415, 421 (N.Y. 1995) (“If [sophisticated parties] are dissatisfied with the consequences of their agreement, ‘the time to say so [was] at the bargaining table.’”) (requiring strict compliance with express condition precedent to formation of sub-lease of commercial real estate).

16. *Cara’s Notions, Inc. v. Hallmark Cards, Inc.*, 140 F.3d 566 (4th Cir. 1998) (“The Gibsons are sophisticated business people and Cara’s Notions, Inc., dealt with Hallmark at arm’s length. Both parties to such a commercial contract have a duty to read the contract carefully and are presumed to understand it.”); see also 3 CORBIN ON CONTRACTS § 28.38 (“The more sophisticated the party, the greater the burden to read.”).

gain.”<sup>17</sup> Courts frequently state that it is not their role to interfere with or “rewrite” the terms of a deal for sophisticated parties.<sup>18</sup>

This Article does not advocate abandoning this status-based dichotomy; rather, it argues that courts need to define sophistication, which cannot be done with ready, bright lines. As currently used, “sophistication” is a slippery word. Courts have not established clear, meaningful criteria for sophistication and often presume without analysis that parties to a commercial transaction are sophisticated.<sup>19</sup> In this regard, party sophistication has served as a pretense of concern for context that allows courts to avoid more difficult questions about the relative positions of the contracting parties. Often, labeling the parties “sophisticated” allows the court to avoid further discussion of any disparities in the parties’ bargaining positions. However, the label should not lead; rather, the court should apply a rigorous fact-driven analysis to determine whether assignment of the sophistication label is appropriate.

Absent evidence of a deliberative approach to assessing sophistication, and for want of the guidance a definition would provide, some cases have been wrongly decided. It is evident that, in at least some instances, courts have erroneously deemed parties sophisticated and, in so doing, denied those parties the benefits of certain defenses or arguments.<sup>20</sup> For example, where a party is not sophisticated, she will more likely be able to establish a mistake of fact or fraud in the inducement. Similarly, for unsophisticated parties, a relaxed parol evidence rule is often applied.

Of course, the meaning of party sophistication is of significance to the contracting parties when they find themselves litigating a dispute; it is important to them that the case is appropriately and fairly decided. Further, to the

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17. *Oppenheimer*, 660 N.E.2d at 421; *see also* *Purcell Tire & Rubber Co., Inc. v. Executive Beechcraft, Inc.*, 59 S.W.3d 505, 509 (Mo. 2001) (en banc) (“Sophisticated parties have freedom of contract – even to make a bad bargain, or to relinquish fundamental rights.”).

18. *Oppenheimer*, 660 N.E.2d at 421; *AccuSoft Corp. v. Palo*, 237 F.3d 31, 41 (1st Cir. 2001) (“[W]e do not consider it our place to ‘rewrite contracts freely entered into between sophisticated business entities.’”) (quoting *Mathewson Corp. v. Allied Marine Indus., Inc.*, 827 F.2d 850, 855 (1st Cir.1987)); *Nelson v. Elway*, 908 P.2d 102, 107 (Colo. 1995) (Where a contract is between two sophisticated parties involved in a complex transaction, the court will not rewrite the contract to circumvent the clear intent of the parties.); *LaSociete Generale Immobiliere v. Minneapolis Cmty. Dev. Agency*, 44 F.3d 629, 637 (8th Cir. 1994) (Where “two sophisticated parties negotiate[] a commercial contract which was executed in the absence of fraud, duress, or any other form of unconscionability, we will not rewrite the contract in order to save a contracting party from its own poor decisions.”).

19. *See infra* Part IV.

20. Conversely, though even much less frequently the case, courts could be deeming parties unsophisticated when, in fact, they were savvy about the deal and should be held to it.



extent that sophistication is treated as a question of fact,<sup>21</sup> the issue is conclusively decided in the trial court and is reversible only if “clearly erroneous.”<sup>22</sup> But the importance of defining sophistication is not limited to the handful of questionable cases where a trial court may have erred in rashly deeming a party sophisticated.

Party sophistication has even broader significance for contracting parties and for the goals of formalism – certainty and predictability in the law. A deliberative approach to sophistication would enable courts to reach fair decisions for just and identifiable reasons, which would develop the law in a way that enables parties to contract with more certainty about their obligations and better ability to predict whether their deals will be enforced as written.

Part II of this Article positions the discussion in a theoretical context and describes the significance of party sophistication as a compromise between formalist and realist concerns. Part III collects examples of settings in which courts have used party sophistication as a tool to organize the world of contracting parties and, with that, the applicable legal principles. For sophisticated parties, in answering a wide array of contract questions, courts employ a formalist approach. Part IV begins descriptively and addresses the general lack of meaningful assessment of party sophistication. Drawing upon the review of hundreds of cases, Part IV identifies what appears to be germane to courts as they apply the label of sophistication and details the attributes common among parties that courts have deemed sophisticated.

Finally, Part V presents the central normative claim of this Article: courts should undertake a more exacting, fact-driven approach in addressing party sophistication. Drawing upon the extensive review of case law, Part V provides a definition of sophistication that assesses information and resource asymmetries among the contracting parties. The proposed standard assesses whether a party, relative to the other parties to the contract, has sufficient experience and access to information and resources that the person or entity understands or should understand the intricacies, risks and consequences of the transaction. This standard takes into account the theoretical underpin-

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21. See *McGeorge v. Van Benschoten*, No. 87-1050 PHX CAM, 1988 WL 163063, at \*7 (D. Ariz. Dec. 8, 1988) (“[T]he McGeorges’ lack of sophistication raises a question of fact.”); *First Midwest Bank, N.A. v. Stewart Title Guar. Co.*, 823 N.E.2d 168, 181 (Ill. App. Ct. 2005) (“[T]he plaintiff’s level of sophistication and the degree to which it relied upon the commitment are questions of fact for the trier of fact to determine.”); *Appletree Square I Ltd. P’ship v. Investmark, Inc.*, 494 N.W.2d 889, 894 (Minn. App. 1993) (“The unique qualifications of the buyers and sellers in this case create questions of fact regarding the relative sophistication of the parties.”).

22. See *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 575 (1985) (“[R]eview of factual findings under the clearly-erroneous standard – with its deference to the trier of fact – is the rule, not the exception.”); *Klingman v. Levinson*, 114 F.3d 620, 626 (7th Cir. 1997); see also CONN. GEN. STAT. ANN. § 52-80 (2005); MONT. R. CIV. P. 52(a).

nings of applying the sophistication label: for knowledgeable and experienced parties dealing in familiar industries, private autonomy should prevail over normative concerns. However, where a party lacks relative knowledge and experience, normative concerns may outbalance the literalism and private autonomy championed by formalism.

In the absence of a meaningful definition of sophistication, however, courts are not actually addressing the context of the deal. Rather, they are simply reciting well-worn clichés about “sophisticated parties dealing at arms’ length.”

## II. THE NEW FORMALISM AND THE RISE OF SOPHISTICATION

In *The Death of Contract*, Grant Gilmore eloquently describes how literature and the arts have endured “alternating rhythms of classicism and romanticism.”<sup>23</sup> Gilmore contemplated the “possibility of such alternating rhythms in the process of the law.”<sup>24</sup> Contract law’s rhythms appear to alternate between the poles of formalism and realism (or “anti-formalism”).

The term “formalism” escapes exact definition.<sup>25</sup> Here, it is intended to refer to a theory of contract law that, above all else, elevates the content of the parties’ written contract (its form) over any concerns for normative values or societal notions of fairness. It is an acontextual and rules-driven approach dedicated to literalism. With these priorities, formalism is ideologically justified by freedom of contract.<sup>26</sup> It is committed to the ideal of voluntary, private actors creating their own legally binding obligations, free from judicial interference. As a rules-based approach,<sup>27</sup> formalism permits certainty and predictability in the marketplace but leaves little room for case-by-case inquir-

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23. GRANT GILMORE, *THE DEATH OF CONTRACT* 111-12 (Ronald K.L. Collins ed., 2d ed. 1995). Gilmore observed that the “classical aesthetic, once it has been formulated, regularly breaks down in a protracted romantic agony.” *Id.* at 111. But, “[t]hen, the romantic energy having spent itself, there is a new classical reformation and the rhythms continue.” *Id.* at 112. See also Curtis Bridgeman, *Why Contract Scholars Should Read Legal Philosophy: Positivism, Formalism and the Specification of Rules in Contract Law*, 29 *CARDOZO L. REV.* 1443, 1483-84 (2008) (discussing Gilmore’s description of “alternating rhythms of classicism and romanticism”).

24. GILMORE, *supra* note 23, at 112.

25. See Legal Theory Lexicon, <http://legaltheorylexicon.blogspot.com/2005/05/legal-theory-lexicon-043-formalism-and.html> (May 22, 2005, 14:10); Amy Schmitz, *Embracing Unconscionability’s Safety Net Function*, 58 *ALA. L. REV.* 73, 74 n.5 (2006); Bridgeman, *supra* note 23, at 1443-44.

26. “Freedom of contract” describes the view that the content of the parties’ agreement should be determined by the parties, not the courts or legislature. See STEPHEN A. SMITH, *CONTRACT THEORY* 59 (2004) (defining freedom of contract as “the idea, fundamental in the orthodox understanding of contract law, that the *content* of a contractual obligation is a matter for the parties, not the law”).

27. Legal Theory Lexicon, <http://legaltheorylexicon.blogspot.com/2005/05/legal-theory-lexicon-043-formalism-and.html> (May 22, 2005, 14:10).

ries that consider the context of the deal, the behavior of the parties and their relative bargaining positions.

By the conventional account, formalism reigned in United States contract law until the mid-twentieth century.<sup>28</sup> At this time, the realist trend in contract law began a shift away from formalism's "context insensitivity."<sup>29</sup> Realism demonstrated concern for the particular circumstances of the parties;<sup>30</sup> standards-based approaches emerged, with reasonableness and fairness as guiding principles. The realist movement was met with the criticism that adherence to fairness norms curtailed the certainty and predictability that contract law allows in the marketplace.<sup>31</sup>

In reaction to the concerns about preserving certainty and stability in the law, some scholars have noted generally, and in contract law more specifically, that the theoretical pendulum appears to be swinging back in the direction of formalism<sup>32</sup> (which has been termed "neoformalism"<sup>33</sup> or "anti-anti-formalism"<sup>34</sup>). In contract law, the new formalism is evidenced by the resilience of the bargain principle,<sup>35</sup> the reluctance of courts to interfere with the

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28. Mark Movsesian, *Formalism in American Contract Law: Classical and Contemporary*, 12 IUS GENTIUM 115, 116 (2006) (realist era of contract began in mid 1900s).

29. Bridgeman, *supra* note 23, at 1448 (Professor Bridgeman uses the term "context insensitivity" to describe "a case where the application of a rule leads to injustice for particular parties in their situation, perhaps despite justification for the rule in most cases.").

30. *Id.*

31. *Id.* at 1448-49.

32. See Mark Movsesian, *Two Cheers for Freedom of Contract*, 23 CARDOZO L. REV. 1529, 1530 (2002) ("[D]evelopments [in contract law] reflect a new formalism."); Thomas C. Grey, *The New Formalism* (Stanford Law Sch. Pub. Law & Legal Series, Working Paper No. 4, 1999), available at <http://ssrn.com/abstract=200732>; Jay M. Feinman, *Un-making Law: The Classical Revival in the Common Law*, 28 SEATTLE U. L. REV. 1, 1-7 (2004); David Charny, *New Formalism in Contract*, 66 U. CHI. L. REV. 842, 842 (1999) (observing a return to formalism in contracts scholarship); Bridgeman, *supra* note 23, at 1484.

33. John E. Murray, Jr., *Contract Theories and the Rise of Neoformalism*, 71 FORDHAM L. REV. 869, 891 (2002) (describing trend of neoformalism in contracts scholarship). Professor Murray did note that "it seems unnecessary to refer to this school as 'neoformalism' notwithstanding differences between their rationale and the underlying philosophy of classical formalism. The results are essentially identical." *Id.* at 913 n.115.

34. Charny, *supra* note 32, at 842.

35. See Melvin Aaron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 742 (1982) (defining the "bargain principle" as "the common law rule that, in the absence of a traditional defense relating to the quality of consent (such as duress, incapacity, misrepresentation, or mutual mistake), the courts will enforce a bargain according to its terms, with the object of putting a bargain-promisee in as good a position as if the bargain had been performed").



substance of the parties' contract and the prominence of literalism.<sup>36</sup> However, these trends, which have been described as a renewed tendency toward formalism, have not developed without regard for the concerns addressed during the realist period.<sup>37</sup>

For example, courts have not abandoned the doctrine of unconscionability, with its focus on the procedural and substantive fairness of the deal.<sup>38</sup> Rather, this standards-based doctrine survives to preserve the realists' normative concerns<sup>39</sup> – as readily evidenced by frequent judicial application of unconscionability to temper strict enforcement of adhesion contracts in the consumer context.<sup>40</sup> Moreover, courts have not rejected reliance-based theories, and they continue to interpret contracts contextually by reference to trade usage, course of performance and course of dealing.<sup>41</sup>

Thus, assuming that contract law is rebounding from what Gilmore called a "protracted romantic agony"<sup>42</sup> and returning to a rules-based formalism, it is not doing so with the contextual insensitivity characteristic of the previous period of formalism. In addition to maintaining the unconscionability doctrine to police the marketplace for procedural and substantive unfairness, a common law principle has preserved fairness norms in an increasing

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36. Movsesian, *supra* note 32, at 1530.

37. The trend may not be appropriately characterized as a new formalism because it retains normative concerns. Perhaps the trend now, which is pragmatic, is more aptly described as born of the influential law and economics movement, with its concern for efficiency.

38. The unconscionability doctrine allows courts to deny enforcement of a contract (or a term of a contract) where that contract (or a term thereof) is, on balance, unfair. See RESTATEMENT (SECOND) CONTRACTS § 208 cmt. c.; U.C.C. § 2-303 cmt. 1 (2003).

39. Schmitz, *supra* note 25, at 74.

40. See, e.g., Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757, 761-62 (2004).

41. See, e.g., Kiely v. Raytheon Co., 105 F.3d 734, 736 (1st Cir. 1997) (applying doctrine of promissory estoppel); Caterpillar, Inc. v. Usinor Industeel, 393 F. Supp. 2d 659, 679-80 (N.D. Ill. 2005) (applying doctrine of promissory estoppel); Coca-Cola Bottling Co. v. Coca-Cola Co., 654 F. Supp. 1419, 1429 (D. Del. 1987) (looking to course of performance to interpret parties' agreement); Prenger v. Baumhoer, 939 S.W.2d 23, 24-27 (Mo. App. W.D. 1997) (applying doctrine of promissory estoppel); Penn. Eng'g Corp. v. McGraw-Edison Co., 459 A.2d 329, 332 (Pa. 1983) (court looked to course of performance to interpret parties' agreement); Adams v. Johns-Manville Corp., 876 F.2d 702, 704-05 (9th Cir. 1989) (referencing course of dealing); Smith-Scharff Paper Co. v. P.N. Hirsch & Co. Stores, Inc., 754 S.W.2d 928, 930 (Mo. App. E.D. 1988) (referencing course of dealing); Practical Prods. Corp. v. Brightmire, 864 P.2d 330, 333 (Okla. 1992) (general trade usage supplemented the contract terms); Century Ready-Mix Co. v. Lower & Co., 770 P.2d 692, 696-97 (Wyo. 1989) (referencing trade usage).

42. GILMORE, *supra* note 23, at 111.

number of inquiries, where courts justify their conclusions, at least in part, based upon the “sophistication” of the parties.

As contract law enters a new period of formalism, at least nominally through the dichotomy based on party sophistication, it has attempted to uphold some of the normative concerns of realism. Increasingly, sophisticated parties are held to a different set of rules, grounded in freedom of contract. For them, formalism prevails. For all other parties, a contextual and standards-based approach continues to apply.

### III. SOPHISTICATION MATTERS: EXAMPLES

The dichotomy between sophisticated and unsophisticated parties arises in a wide array of contract inquiries. The following discussion is intended to demonstrate the considerable and growing significance of this dichotomy and to ground the theory in specific examples. This Section begins with a discussion of the general relevance of sophistication to contract interpretation. It then provides examples of situations where courts have drawn a distinction between sophisticated and unsophisticated parties – for example, in the context of fraud, reliance disclaimers, exculpatory clauses, procedural matters and formation, among others.

The discussion of specific case examples will show that a determination of sophistication leads to a formalist approach to contract law questions. For sophisticated parties, the principles of literalism and freedom of contract are usually elevated over normative concerns. Some of these specific case examples will also demonstrate, however, that the concept of sophistication is undefined and that, most often, courts apply the label of sophistication without any meaningful analysis.<sup>43</sup>

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43. Specific discussion of enforceability questions based on duress, undue influence and unconscionability is omitted from this Article. Party sophistication is often discussed in these contexts. *See, e.g.*, *Foster v. Chesapeake Ins. Co.*, 933 F.2d 1207, 1219 (3d Cir. 1991) (“[T]he agreement . . . was clearly an arms’-length deal, between sophisticated commercial entities, ‘unaffected by fraud, undue influence, or overweening bargaining power.’”) (citing *M/S Bremen v. Zapata Off-Shore, Co.*, 407 U.S. 1, 12 (1972)); *Cont’l Airlines, Inc. v. Goodyear Tire & Rubber Co.*, 819 F.2d 1519, 1527 (9th Cir. 1987) (“The doctrine of unconscionability cannot be invoked by so sophisticated a party as Continental in reference to a contract so laboriously negotiated.”); *Am. Software v. Ali*, 54 Cal. Rptr. 2d 477, 482 (Cal. Ct. App. 1996) (Parties to an employment contract were sophisticated parties, and, therefore, the contract was not unconscionable.); *Frame v. Booth, Wade & Campbell*, 519 S.E.2d 237, 239-40 (Ga. 1999) (sophisticated party cannot establish duress); *RIV VIL, Inc. v. Tucker*, 979 F. Supp. 645, 655 (N.D. Ill. 1997) (party sophistication relevant to claim of duress); *Dunes Hospitality, L.L.C. v. Country Kitchen Intern., Inc.*, 623 N.W.2d 484, 492 (S.D. 2001) (sophisticated investors would not be heard to claim economic duress). However, compared to the examples discussed herein, courts are, on balance, much better about actually analyzing the relative positions of the parties and the nature of

*A. Interpretation Generally and the Parol Evidence Rule*

Party sophistication has tremendous, increasing significance in the interpretation of the express terms of a contract. Where parties are not sophisticated, a more relaxed, less literal approach is applied. Courts generally refer to party sophistication when determining whether to consider alleged additional terms that were not included in the written contract and when determining whether to consider extrinsic evidence in interpreting the written terms.

Courts refer to sophistication when applying the parol evidence rule. The first step in the parol evidence rule analysis is determining whether the parties intended to have an integrated agreement – that is, a final, written statement of the terms of the deal.<sup>44</sup> If the contract is fully integrated, the parol evidence rule does not allow a party to add terms to the contract with evidence of communications prior to or contemporaneous with the execution of the written deal.<sup>45</sup> If the contract is partially integrated, the parol evidence rule does not allow the court to consider prior or contemporaneous evidence that is inconsistent with the written terms of the contract.<sup>46</sup> The presence of a merger clause<sup>47</sup> is key to the determination of whether the parties intended their contract to be integrated. Party sophistication is also a factor in determining the parties' intent.<sup>48</sup>

Jurisdictions tend to vary in how much weight they will accord a merger clause as evidence of the parties' intent to have a complete and final written statement of the terms of their deal. Some courts treat the clause as conclusive evidence of the parties' intent to have a fully integrated agreement, while others treat a merger clause as presumptive but not dispositive evidence of the parties' intent.<sup>49</sup> The first approach has been described as the traditional "four corners" approach,<sup>50</sup> while the latter, which is a contextual approach, has been described as the modern trend.<sup>51</sup> In determining whether to use a formalist, "four corners" approach or a contextual approach to determine

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the transaction – as they necessarily must be to explain whether the facts meet the definitional concerns of these doctrines.

44. RESTATEMENT (SECOND) CONTRACTS §§ 209, 210, 213 (1981).

45. *Id.* § 213(2).

46. *Id.* § 213(1).

47. A merger clause, also known as an integration clause, is "[a] contractual provision stating that the contract represents the parties' complete and final agreement and supersedes all informal understandings and oral agreements relating to the subject matter of the contract." BLACK'S LAW DICTIONARY (8th ed. 2004).

48. *Sierra Diesel Injections Serv., Inc. v. Burroughs Corp.*, 890 F.2d 108, 112 (9th Cir. 1989).

49. 11 WILLISTON ON CONTRACTS § 33:21 (4th ed. 2009).

50. *Nelson v. Elway*, 908 P.2d 102, 116 (Co. 1995) (Lohr, J., dissenting) (describing approach of confining judges to terms of the contract to determine integration as the "four corners" approach to contract interpretation).

51. *Id.*

integration, courts have noted party sophistication as a relevant fact.<sup>52</sup> Courts have mentioned sophistication in determining whether the merger clause should be accorded weight as evidence of the parties' intent to memorialize the final terms of their negotiations.<sup>53</sup> If the parties are deemed sophisticated, the merger clause controls. That is to say, where parties to a contract are sophisticated, courts will take a formalist approach in according weight to the merger clause and, with that, a formalist approach in determining the meaning of the contract's terms. For sophisticated parties, literalism outweighs any consideration of the context of the deal or its fairness.

Further, a well-established exception to the parol evidence rule arises when the written document contains an ambiguity – language that is susceptible to more than one reasonable interpretation.<sup>54</sup> When an ambiguity exists, courts will consider extrinsic evidence to interpret the ambiguous term. In determining whether the language of a contract is ambiguous, courts have also looked to the sophistication of the parties.<sup>55</sup>

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52. *Id.* at 107 (majority opinion) (“Where . . . *sophisticated* parties who are represented by counsel have consummated a complex transaction and embodied the terms of that transaction in a detailed written document, it would be improper for this court to rewrite that transaction by looking to evidence outside the four corners of the contract to determine the intent of the parties.” (emphasis added)).

53. *Betaco, Inc. v. Cessna Aircraft Co.*, 103 F.3d 1281 (7th Cir. 1996) (purchase agreement for jet was fully integrated and could not be contradicted by parol evidence of purported warranty that jet had “more range” than previous model where purchase agreement contained integration clause; principal provisions of agreement occupied single sheet of paper; agreement incorporated written specifications as to jet’s expected performance, including range, and expressly disclaimed any other warranties; and agreement was presented to sophisticated purchaser, who read and understood terms and who signed contract at moment of his own choosing, after making modifications); *Franklin v. White*, 493 N.E.2d 161, 166 (Ind. 1986) (“[W]here two sophisticated parties engage in extensive preliminary negotiations, an integration clause may, in fact, reflect their mutual intention to abandon preliminary negotiations in favor of a complete and final statement of the terms of their agreement.”).

54. *See Random House, Inc. v. Rosetta Books LLC*, 150 F. Supp. 2d 613, 618 (2001) (“[C]ontract language is ambiguous if it is capable of more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business.”); *see also* U.C.C. § 2-202 cmt. 1 (2003).

55. *See, e.g., Purcell Tire & Rubber, Co. v. Executive Beechcraft, Inc.*, 59 S.W.3d 505, 510 (Mo. 2001) (en banc) (“Language that is ambiguous to an unsophisticated party may not be ambiguous to a sophisticated commercial entity.”); *Harris Corp. v. Giesting & Assocs.*, 297 F.3d 1270 (11th Cir. 2002) (termination for convenience clause was not ambiguous, especially in contract between sophisticated parties); *Energy Partners, Ltd. v. Stone Energy Corp.*, Nos. 2402-N, 2374-N, 2006 WL 4782288, at \*1 (Del. Ch. Oct. 17, 2006) (“If a contract is unambiguous, evidence beyond the language of the contract may not be used to interpret the intent of the parties or to create an ambiguity. This is certainly the case where sophisticated par-

Likewise, once a court determines that an ambiguity exists, it generally applies the traditional canon of interpretation – *contra proferentum*.<sup>56</sup> However, many courts will not construe ambiguous language against the drafter of the contract where both parties are sophisticated.<sup>57</sup> One example of the extensive use of this exception arises in the interpretation of insurance contracts, where the “sophisticated policyholder” doctrine has emerged. In that context, when an insured is deemed to be sophisticated, courts will not necessarily construe ambiguous language against the insurer that drafted the contract. This exception to the traditional canon of interpretation is justified on the theory that the law should not apply interpretative principles to favor a policyholder who has ample experience and resources.<sup>58</sup> So, again, the dichotomy between sophisticated and unsophisticated dictates whether a literalist approach applies. Courts are less likely to find language ambiguous when parties are sophisticated, and, when there is an ambiguity, they will not necessarily construe it against the drafter.<sup>59</sup>

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ties are involved.”) (citing *Progressive Int’l Corp. v. E.I. du Pont de Nemours & Co.*, 2002 WL 1558382, at \*1 (Del. Ch. July 9, 2002) (“Sophisticated parties are bound by the unambiguous language of the contracts they sign.”)).

56. RESTATEMENT (SECOND) CONTRACTS § 206 (1981) (“In choosing among the reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds.”).

57. *See* 11 WILLISTON ON CONTRACTS § 32:12 (4th ed. 2009); 3 CORBIN ON CONTRACTS § 24.27; RESTATEMENT (SECOND) CONTRACTS § 206, Reporter’s Note to cmt. a (1981) (doctrine “has less force when the other party . . . is particularly knowledgeable”); *see also* *Western Sling & Cable Co., Inc. v. Hamilton*, 545 So. 2d 29, 32 (Ala. 1989) (“Where both parties to a contract are sophisticated business persons advised by counsel and the contract is a product of negotiations at arm’s length between the parties, we find no reason to automatically construe ambiguities in the contract against the drafter.”); *Dawn Equip. Co. v. Micro-Trak Sys., Inc.*, 186 F.3d 981, 989 n.3 (7th Cir. 1999) (The principle that ambiguity should be construed against the drafter does not control where the contract was negotiated by “sophisticated commercial clients, who were advised by counsel and [had] equal bargaining power.”).

58. *See generally* Hazel Glenn Beh, *Reassessing the Sophisticated Insured Exception*, 39 TORT TRIAL & INS. PRAC. L. J. 85 (2003); Jeffrey W. Stempel, *Reassessing the “Sophisticated” Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993).

59. Further, in matters of interpretation, sophistication may dictate the standard of review on appeal. At least one court has looked to party sophistication to determine whether an issue of interpretation was treated as a matter of law or fact and, consequently, whether appellate review should be de novo. *See Tallmadge Bros., Inc. v. Iroquois Gas Transmission Sys., L.P.*, 746 A.2d 1277, 1287 (Conn. 2000) (interpretation was a question of law because agreement was between sophisticated parties).



### B. Fraud and Disclaimers of Reliance

A more specific example of the importance of party sophistication arises where contract and tort law intersect: reliance disclaimers. A reliance disclaimer is an express provision stating that the contracting parties are not relying on each other's representations in entering into the deal. Where the party against whom enforcement is sought is sophisticated, it is more likely that a court will take a formalist approach that recognizes the parties' autonomy and interprets the reliance disclaimer literally.<sup>60</sup>

Consider the decision of the Supreme Court of Texas in *Forest Oil Corp. v. McAllen*.<sup>61</sup> After a week-long mediation, Forest Oil Corporation ("Forest Oil") and James McAllen settled a long-running dispute over oil and gas royalties.<sup>62</sup> McAllen, a rancher, had claimed that Forest Oil, a publicly traded corporation, owed oil and gas royalties based on a lease of surface rights to Forest Oil.<sup>63</sup> As part of the settlement, McAllen released Forest Oil from "any and all" claims "of any type known or unknown" that related "in any manner" to the leases and lands that were the subject of the parties' dispute.<sup>64</sup> The settlement also included an agreement to arbitrate any future disputes concerning environmental damage on McAllen's land.<sup>65</sup> Most importantly, the settlement agreement specifically disclaimed reliance "upon any statement or any representation of any agent of the parties" in executing the releases contained in the agreement.<sup>66</sup>

About five years later, McAllen sued Forest Oil to recover for environmental damages caused when Forest Oil allegedly buried "highly toxic mercury-contaminated material" on McAllen's land.<sup>67</sup> Forest Oil sought to compel arbitration pursuant to the settlement agreement.<sup>68</sup> McAllen argued that the arbitration provision was procured by fraud and should not be enforced — namely, McAllen alleged that Forest Oil falsely assured McAllen during the settlement talks that no environmental pollutants or contaminants existed on the property.<sup>69</sup>

In *Forest Oil*, the question before the court was whether the reliance disclaimer precluded McAllen's claim that he was fraudulently induced to enter into the settlement agreement.<sup>70</sup> A majority of the Supreme Court of

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60. See Blair, *supra* note 2, at 451-52 (discussing courts that enforce reliance disclaimers when parties are sophisticated).

61. 268 S.W.3d 51 (Tex. 2008).

62. *Id.* at 53.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.* at 54.

67. *Id.*

68. *Id.* at 55.

69. *Id.*

70. *Id.*

Texas held that the waiver of reliance provision conclusively negated McAllen's alleged reliance on representations made by Forest Oil.<sup>71</sup> McAllen was foreclosed from challenging the enforceability of the settlement agreement and was compelled to arbitrate the environmental damage claims. The court rested its holding on the "paramount principle" that courts should not interfere with contracts "negotiated at arm's length by 'knowledgeable and sophisticated business players' represented by 'highly competent and able legal counsel[.]'"<sup>72</sup>

The *Forest Oil* court "decline[d] to adopt a *per se* rule that a reliance disclaimer automatically precludes a fraudulent-inducement claim" and limited its holding to the record before it.<sup>73</sup> While the Texas court attempted to avoid blanket pronouncements, it did create a dichotomy based on party sophistication. The court essentially held that a contracting party may intentionally misrepresent material facts to induce a sophisticated party to agree to a deal, so long as the sophisticated party has disclaimed reliance. Because the court in *Forest Oil* deemed the parties "sophisticated," freedom of contract prevailed over any concerns about the fairness of allowing a party to use a contract provision to perpetrate a fraud with impunity.

The *Forest Oil* decision was simply cast as an application of the rule enunciated in *Schlumberger Technology Corp. v. Swanson*,<sup>74</sup> which held that a disclaimer of reliance on the other party's representations conclusively negated a claim of fraudulent inducement. There, too, the court justified the result based on the sophistication and knowledge of the parties and the principle of party autonomy.<sup>75</sup> The decision was founded on freedom of contract: "[p]arties should be able to bargain for and execute a release barring all further dispute."<sup>76</sup> *Schlumberger* and *Forest Oil* draw a dichotomy based on party sophistication and invite future arguments that reliance disclaimers should not be enforced because the party who disclaimed reliance was not sophisticated.<sup>77</sup> In short, the enforcement of reliance disclaimers turns on

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71. *Id.* at 56.

72. *Id.* at 58 (quoting *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 180 (Tex. 1997)).

73. *Id.* at 61.

74. 959 S.W.2d 171 (Tex. 1997).

75. *Id.* at 180.

76. *Id.* at 179.

77. Indeed, in one dispute between an automobile insurer and its insured, the insured attempted to challenge a settlement of a claim based on fraudulent inducement. *Garza v. State & County Mut. Fire Ins. Co.*, 2007 WL 1168468 (Tex. App. Fort Worth May 24, 2007). The court noted the difference in sophistication and knowledge levels of the insured and the insurer, who dealt with insurance claims on a daily basis. *Id.* at \*6. Thus, it seems that this court at least recognized the relativity of the sophistication question; however, it went on to see representation by counsel as a great equalizer and held that, because the insured was represented by counsel, the waiver would be enforced. *Id.*

party sophistication.<sup>78</sup> Where the parties are deemed sophisticated, a formalist approach applies; otherwise, courts will subordinate the literal language of the parties' contracts to normative concerns.

Moreover, in *Forest Oil*, while the decision to enforce the disclaimer turned on the determination that McAllen was a sophisticated party,<sup>79</sup> the Texas court took no time to explain why McAllen, a rancher, was a sophisticated party for the purposes of that contract with Forest Oil, a large publicly traded company. The ready application of the label "sophistication" was substituted for an assessment of the relative bargaining positions of the parties and their experience in the relevant type of transaction. Sure, both parties were represented by counsel, but is that fact alone sufficient to suggest that they had meaningful experience in these disputes and comparable resources at their disposal when entering into the settlement?<sup>80</sup>

Further, even absent a contractual provision expressly disclaiming reliance, courts have looked to sophistication to determine whether a party was fraudulently induced to enter into a contract – on the theory that sophisticated parties are too seasoned or knowledgeable to get "roped into" a deal.<sup>81</sup> On this basis, sophisticated parties would not reasonably and justifiably rely on statements that appeared false or unsupportable. In this vein, where the parties to the contract have "equal means and opportunity" to acquire information through the exercise of ordinary diligence, courts will presume that they have done so.<sup>82</sup> Thus, "where sophisticated commercial parties are engaged in major transactions and have access to critical information but fail to take advantage of it, courts are especially reluctant to accept claims of justifiable reliance."<sup>83</sup>

This principle was applied in a recent New York trial court case where an employer countersued a former employee, seeking rescission of the em-

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78. See generally Blair, *supra* note 2 (arguing for an approach to reliance disclaimers that only applies to sophisticated parties).

79. *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51, 52-53 (Tex. 2008).

80. See, e.g., *Gregg v. San Dieguito P'ship*, No. GIC803609, 2005 WL 5748867, \*1 (Cal. Super. Ct. Oct. 14, 2006) (In certain instances, even parties represented by counsel may be entitled to relief based upon misrepresentations made by another party.).

81. *Avila Group, Inc. v. Norma J.*, 426 F. Supp. 537 (S.D.N.Y. 1977) (A textile buyer was bound by an arbitration provision on the reverse side of the seller's order forms, despite a claim that there was no notice of the provisions and that the buyer did not read them; since both parties were sophisticated parties, there was no claim that the orders were signed or induced under fraudulent circumstances.); *Lawler v. Schumacher Filters Am., Inc.*, 832 F. Supp. 1044, 1052 (E.D. Va. 1993) ("[B]ecause the parties were sophisticated in the ways of international business, plaintiff's reliance on an alleged oral side agreement (itself prohibited by the terms of the written contract), does not strike the Court as being reasonable.").

82. 27 WILLISTON ON CONTRACTS § 69.33 (4th ed. 2009).

83. *Id.* (citing *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531 (2d Cir. 1997)).

ployment contract based on certain misrepresentations the employee made on his resume and during the interview process for the job.<sup>84</sup> The court held that the employer was not fraudulently induced to hire the employee.<sup>85</sup> Although it was well demonstrated that the employee had lied about his past work experience, the court placed the onus on the employer to exercise due diligence, which would have uncovered the falsehoods.<sup>86</sup> The court reasoned that, “[w]here sophisticated businessman engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance.”<sup>87</sup> Thus, we essentially see a side of that old battle axe of formalism – caveat emptor – applying only to sophisticated parties, whose autonomy trumps all other concerns.<sup>88</sup> A different, gentler set of transactional axioms apparently applies to unsophisticated parties; for them, fairness norms outbalance the ideology of freedom of contract.

### C. Exculpatory Clauses

The same dichotomy has developed in another place where tort and contract overlap: exculpatory clauses. Exculpatory clauses are contractual limits on liability resulting from future negligent or wrongful acts.<sup>89</sup> As a matter of policy, these clauses are problematic to the extent they allow parties to contract around acceptable standards of care.<sup>90</sup> Yet courts have generally allowed discharges of future claims based on tortious or wrongful conduct, absent countervailing public policy concerns.<sup>91</sup> However, exculpatory clauses are generally strictly construed. For example, the Supreme Court of Mis-

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84. *Nat'l Med. Health Card Sys. v. Fallarino*, 21 Misc. 3d 304, 311 (N.Y. Sup. Ct. Nassau County 2008).

85. *Id.* at 312-13.

86. *Id.* at 311-12.

87. *Id.* at 312 (citing *Siemens Westinghouse Power Corp. v. Dick Corp.*, 299 F. Supp. 2d 242, 247 (S.D.N.Y. 2004) & quoting *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 (2d Cir. 1984)).

88. Likewise, courts have referred to party sophistication to determine whether the other contracting party had a duty to disclose certain facts or information before entering into the deal. *Duquesne Light Co. v. Westinghouse Elec. Corp.*, 66 F.3d 604, 612 (3d Cir. 1995) (party did not have duty to speak when both parties were “sophisticated business entities, entrusted with equal knowledge of the facts”). Sophisticated parties are much more likely to be held to a “caveat emptor” standard – that is, courts assume that sophisticated parties require a lower level of disclosure, perhaps because they are assumed to have access to the information or tools to discover the information themselves. *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1543 (2d Cir. 1997) (“As a substantial and sophisticated player in the bank debt market, [defendant] was under a further duty to protect itself from misrepresentation.”).

89. BLACK'S LAW DICTIONARY 608 (8th ed. 2004).

90. 8 WILLISTON ON CONTRACTS § 19:21 (4th ed. 2009).

91. *Id.*

souri has required “[c]lear, unambiguous, unmistakable, and conspicuous language” that effectively notifies a contracting party that it releases the other party from liability for its own negligence.<sup>92</sup> To meet this standard, the court announced a requirement that the exculpatory clause expressly mention “negligence,” “fault” or “an equivalent.”<sup>93</sup>

The same court, however, later enunciated a different standard for sophisticated parties. In *Purcell Tire and Rubber Co. v. Executive Beechcraft, Inc.*,<sup>94</sup> plaintiff Purcell contracted to have Beechcraft perform a pre-purchase inspection of an airplane. Based on Beechcraft’s report, Purcell purchased the airplane, later discovering an oil leak that was not mentioned in the report.<sup>95</sup> Purcell sued Beechcraft; however, the contract for the inspection provided that Beechcraft’s liability was “limited to the cost of services performed hereunder.”<sup>96</sup> The provision, which the court characterized as an exculpatory clause, did not expressly mention “negligence,” “fault” or “an equivalent.”<sup>97</sup> Nevertheless, the court limited Beechcraft’s liability pursuant to the parties’ contract. The court reasoned,

Sophisticated parties have freedom of contract – even to make a bad bargain, or to relinquish fundamental rights. Sophisticated parties may contractually limit future remedies. For example, commercial entities at arm’s length may waive the right to a jury trial, or agree to forum selection (unless unfair or unreasonable).<sup>98</sup>

Under *Purcell*, for sophisticated parties (loosely equated with “commercial entities”), less precise language will effectuate an exculpatory clause. The *Purcell* court draws a rigid dichotomy between sophisticated and ordinary parties,<sup>99</sup> and it is not the only court that takes this approach with respect

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92. *Alack v. Vic Tanny Int’l of Mo., Inc.*, 923 S.W.2d 330, 334 (Mo. 1996) (en banc).

93. *Id.*

94. *Purcell Tire & Rubber Co. v. Executive Beechcraft, Inc.*, 59 S.W.3d 505, 509 (Mo. 2001) (en banc).

95. *Id.* at 508.

96. *Id.*

97. *Id.* at 509.

98. *Id.* at 508-09. Notably, the concurrence states that *Purcell* is a “textbook example of a sophisticated party.” *Id.* at 511 (White, J., concurring). This may very well be true, but the court provides no further analysis of why this is the case. Instead, it takes something akin to judicial notice of the fact. *See id.*

99. *Caballero v. Stafford*, 202 S.W.3d 683, 696 n.2 (Mo. App. S.D. 2006) (“We do not ignore the principal [sic] that less precise language may be effective in agreements negotiated at arms length. However, we can find nothing in the record to support the proposition that *Caballero* is a sophisticated commercial entity.” (citations omitted)).



to exculpatory clauses.<sup>100</sup> Although these clauses raise normative concerns, for sophisticated parties, these concerns are outweighed by formalist principles of party autonomy and freedom of contract.

*D. Economic Loss Rule, Limits on Damages and Liquidated Damages*

One might also characterize *Purcell* as a case about the economic loss rule.<sup>101</sup> This judicially developed rule bars the plaintiff from recovering economic damages sounding in tort when that plaintiff has a contractual relationship with the defendant.<sup>102</sup> The rule is said to serve the purpose of maintaining the fundamental distinction between tort and contract law.<sup>103</sup> It purports to do so by refusing to compensate a plaintiff for risks that are or could have been addressed by the contracting parties. This is apparently intended to encourage parties to privately order their economic risks by contract, on the assumption that the parties are in a better position than society (generally through tort law) to understand and predict the risks of their relationship.<sup>104</sup> It should not be surprising then that, pursuing a formalist approach, courts are more likely to limit damages awarded to sophisticated parties based upon the economic loss rule<sup>105</sup> because they are presumed to have the knowledge and

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100. See *Town of New Hartford v. Conn. Resources Res. Recovery Auth.*, No. UWYCV0401855802X02, 2006 WL 2730965, at \*3 (Conn. Super. Ct. Sept. 11, 2006) (“When applied to contracts to which the parties are *sophisticated business entities*, the law, reflecting the economic realities, will recognize an agreement to relieve one party from the consequences of his negligence on the strength of a broadly worded clause framed in less precise language than would normally be required, though even then it must evince the unmistakable intent of the parties.”) (quoting *B&D Assoc. v. Russell*, 807 A.2d 1001, 1006 (Conn. App. 2002) (emphasis added)); *Rhino Fund v. Hutchins*, No. 06CA1172, 2008 Colo. App. LEXIS 1078, at \*9 (Colo. Ct. App. June 26, 2008) (Exculpatory agreements between sophisticated parties dealing at arm’s length are enforceable.).

101. See Jason A. Dunn, Comment, *Too Sophisticated for Your Own Good: Missouri, Sophisticated Parties and . . . the Economic Loss Rule?*, 68 MO. L. REV. 195 (2003).

102. Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE. L. REV. 523, 528-29 (2009).

103. *Id.* at 546-50; see also Jay M. Feinman, *The Economic Loss Rule and Private Ordering*, 48 ARIZ. L. REV. 813, 813-26 (2006).

104. Feinman, *supra* note 103, at 814.

105. *Detroit Edison Co. v. NABCO, Inc.*, 35 F.3d 236 (6th Cir. 1996) (Electric utility’s products liability claim against pipe suppliers, arising from pipe explosion, was barred by the economic loss doctrine. The parties were sophisticated commercial entities of equivalent bargaining power and, therefore, were in a position to fully negotiate issues of potential liability and consequences of inherent hazards); *Farmers Alliance Mut. Ins. Co. v. Naylor*, 452 F. Supp. 2d 1167 (D.N.M. 2006) (When the parties to an agreement are sophisticated commercial entities, the economic loss rule applies both to contracts for services and to contracts for

experience concerning the liabilities that should be addressed by contract. If they have not done so, the content (or lack thereof) of the contract will be elevated over any concerns about limiting the parties' recovery.

Further, the *Purcell* decision could also be cast as a case about limitations on the measure of damages. While the economic loss rule concentrates on risks that a plaintiff could have expressly addressed when drafting the contract, it is worth discussing how courts approach these express terms when they are used. Take, for example, the Uniform Commercial Code's treatment of express limitations on the buyer's remedies. In the sale of goods context, the Uniform Commercial Code allows the seller to limit or alter the measure of damages recoverable by the buyer and to exclude or limit the buyer's consequential damages.<sup>106</sup> These limits or exclusions are generally enforceable, so long as they are not unconscionable, which is an especially rare case in a contract between sophisticated parties.<sup>107</sup> Further, the Uniform Commercial Code allows the seller to limit the buyer's available remedies (for example, to repair or replacement of the goods).<sup>108</sup> The court will enforce an exclusive or limited remedy unless that remedy "fail[s] of its essential purpose" – that is, serves to deprive the buyer of the value of the bargain.<sup>109</sup> Courts have mentioned a buyer's sophistication in determining whether a limited remedy has failed of its essential purpose.<sup>110</sup> In these cases, a literalist, formalist ap-

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the sale of goods.); LARY LAWRENCE, LAWRENCE'S ANDERSON ON THE UNIFORM COMMERCIAL CODE § 2-715:224 (2009) ("The economic loss doctrine bars the recovery, in a tort action, of economic loss based on a claim arising out of a commercial transaction between sophisticated commercial entities.").

Further, Connecticut courts have applied the economic loss doctrine to bar tort claims arising from disputes between sophisticated parties when the same conduct underlies the tort and contract claims. *Am. Progressive Life & Health Ins. Co. v. Better Benefits, LLC*, No. X10UWYCV02401221S, 2007 WL 125073, at \*2 (Conn. Super. Ct. Jan. 4, 2007); *Panolam Indus. Int'l, Inc. v. Neste Resins Corp.*, No. Civ.A.3:03CV2174, 2005 WL 925661, at \*3 (D. Conn. Apr. 12, 2005).

106. U.C.C. § 2-719(1), (3) (2003).

107. *See Rotorex Co. v. Kingsbury Corp.*, 42 F. Supp. 2d 563, 577 (D. Md. 1999) ("Since Rotorex is a sophisticated business entity which sought and received clarification of the terms in question before accepting the contract, it cannot claim that Kingsbury's consequential damage limitation was unconscionable."); LAWRENCE, *supra* note 105, at § 2-719:66 ("Certainly, where the contract is between two sophisticated commercial entities, an exclusion of consequential damages will seldom be unconscionable."); *id.* ("A limitation of remedies to repairing and replacement and excluding incidental and consequential damages is valid and not unconscionable when made between sophisticated entities dealing at arm's length.").

108. U.C.C. § 2-719(1).

109. *Id.* § 2-719(2) & cmt. 1.

110. LAWRENCE, *supra* note 105, at § 2-719:138 ("Given that both parties were aware that there was a substantial risk of delay when they entered into the contract, and that the parties, both of which are sophisticated companies, allocated the risk of that delay to the buyer, [the] buyer was not deprived of the substantial value of the

proach is more likely to apply to sophisticated buyers – elevating the content of the contract over any normative concerns about limitations on a buyer's fundamental right to remedies and damages.

On a related note, courts give a strong presumption of reasonableness to a liquidated damages provision in a contract between sophisticated parties.<sup>111</sup> Sophisticated parties are thought to be in a better position than the court to determine reasonable compensation for breach of contract, and the liquidated damages provision is more likely to be enforced as written.<sup>112</sup>

### *E. Mistake, The Duty to Read and Reasonable Expectations*

In light of the realities of modern commerce and the prevalence of standardized form contracts, it is generally recognized that many deals do not follow the classical model of the fully negotiated contract.<sup>113</sup> Indeed, the *Restatement (Second) of Contracts* recognizes that, when a party is presented

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bargain by enforcing the limitation of liability clause.”); *id.* (“Where the buyer and seller were both experienced, sophisticated, commercial business parties, who routinely negotiated these types of contracts and where the goods sold (a system for producing electricity for a power plant) were not a simple consumer product that could be expected to work immediately or without some reasonable repair and modification, the exclusive remedy did not fail of its essential purpose where, despite, numerous good faith attempts on the part of the seller to fix problems, other problems surfaced.”).

111. *See, e.g.,* *Lynch v. Andrew*, 481 N.E.2d 1383, 1386 (Mass. App. Ct. 1985) (court noted party sophistication in determining whether to enforce liquidated damages provision); *MetLife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P.*, 732 A.2d 493, 499-500 (N.J. 1999) (Liquidated damages provisions in commercial contracts between sophisticated parties are presumptively reasonable, and the party challenging such clauses bears the burden of proving their unreasonableness.); *Wallace Real Estate Inv., Inc. v. Groves*, 881 P.2d 1010, 1015-18 (Wash. 1994) (“[P]arty sophistication will often be relevant in determining the fairness of a stipulated damages provision.”); *Wasserman’s, Inc. v. Township of Middleton*, 645 A.2d 100, 108 (N.J. 1994) (applying a strong presumption of reasonableness to liquidated damages clause negotiated between sophisticated parties).

112. *E. Carolina Internal Med., P.A. v. Faidas*, 564 S.E.2d 53, 57 (N.C. App. 2002) (“Considering the nature of the Contract, the intention of the parties, the sophistication of the parties, the stipulation of the parties, the fact that the parties are better able than anyone to determine a reasonable compensation for a breach, and the fact that the damages were difficult to ascertain, we hold that the liquidated damages stipulated were a reasonable estimate of damages and not a penalty.”).

113. *RESTATEMENT (SECOND) CONTRACTS* § 21 (1981); *see also* William J. Woodward, Jr., “Sale” of Law and Forum and the Widening Gulf Between “Consumer” and “Nonconsumer” Contracts in the UCC, 75 WASH. U. L.Q. 243, 244 (1997) (“Nobody doubts any longer that ‘consumer contracts’ are different from fully negotiated contracts of the classical model. Consumers are seldom represented by lawyers in their contractual dealings, and we tend to think that, as a group, they have a lower level of legal sophistication than those with whom they typically make contracts.”).

with a standardized form, the appropriate assumption is that she will not read or understand its terms.<sup>114</sup> With standardized contracts, the *Restatement (Second) of Contracts* section 211 would not bind adherents to terms that “are beyond the range of reasonable expectation.”<sup>115</sup> The reporters’ comments suggest, however, that the “range of reasonable expectation” of a “sophisticated customer” is broader and, therefore, allows a wider range of binding, standardized terms.<sup>116</sup>

However, the traditional “duty to read” generally survives and places an even greater burden on a party that a court deems sophisticated.<sup>117</sup> A sophisticated party will not be heard to argue that the document was in a foreign language, that she was too rushed or too busy to read it or that she did not have her reading glasses.<sup>118</sup> Based on the duty to read, a sophisticated party will be bound by the contents of a signed writing and will not have a viable defense based on mistake as to its contents, regardless of fairness.<sup>119</sup> Similarly, a sophisticated party will be expected to investigate the law carefully before entering into the contract and, therefore, will not be able to avoid it on grounds of mistake of law, again, regardless of context or notions of fairness.<sup>120</sup>

The duty to read is especially salient for attorneys, who are commonly described as sophisticated.<sup>121</sup> Courts generally will not hear an attorney argue that she did not read, understand or reasonably expect the terms of an agreement. For example, in *Feldman v. Google, Inc.*,<sup>122</sup> an attorney advertised through Google’s AdWords program and found himself with a bill that exceeded \$100,000.<sup>123</sup> The bill was based on “pay per click advertising” – the attorney was charged whenever a search engine user clicked on his advertisement. The attorney claimed that he was the victim of “click fraud” –

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114. RESTATEMENT (SECOND) CONTRACTS § 211 cmt. b (consumers and employees accepted standardized terms and were not expected to have read or understood them).

115. *Id.* at cmt. f.

116. *Id.* at cmt. e.

117. 3 CORBIN ON CONTRACTS § 28.38 (“The more sophisticated the party, the greater the burden to read.”).

118. *Id.* §§ 28.38, 29.9 (citing *Daniel Gale Assocs. v. Hillcrest Estates, Ltd.*, 724 N.Y.S.2d 201, 202 (N.Y. App. Div. 2001)).

119. *Id.*; see also *La Gloria Oil & Gas Co. v. United States*, 72 Fed. Cl. 544, 575 (Fed. Cl. 2006) (The plaintiff did not state a claim for mutual or unilateral mistake, at least in part, because, as sophisticated parties that set contract terms regarding price measurement, the parties bore the risk that the measurement resulted in a price that was more or less than they had hoped.).

120. 3 CORBIN ON CONTRACTS § 28.49 (citing *Thompson v. Volini*, 849 S.W.2d 48 (Mo. App. W.D. 1993)).

121. See *infra* Part III.B.

122. 513 F. Supp. 2d 229 (E.D. Pa. 2007).

123. *Id.* at 232.

people repeatedly clicking on the ad with the intent to drive up his advertising costs. When the attorney sued to correct his bill, Google moved to dismiss or, in the alternative, to transfer from the Eastern District of Pennsylvania to the Northern District of California, the venue in the AdWords agreement's forum selection clause.

The attorney in *Feldman* did not want to remove the case to California, citing health issues. The court enforced the forum selection clause. The court held that the attorney assented to this contract online through a "click-wrap agreement." That is, he was presented with the terms in a scrollable text box, and he manifested his assent by clicking on a "Yes" button.<sup>124</sup> The court noted that any failure to read the agreement would not excuse the attorney from being bound.<sup>125</sup>

In particular, when later rejecting any argument that the agreement was unconscionable, the *Feldman* court noted that the attorney "was a sophisticated purchaser" and "was capable of understanding the Agreement's terms."<sup>126</sup> Further, in connection with a provision of the agreement that essentially shortened the statute of limitations to sixty days, the court again observed that the "[p]laintiff is an attorney and sophisticated purchaser capable of understanding the limitations provision."<sup>127</sup> However, the court undertook next to no analysis concerning how the attorney's practice experience was relevant to the AdWords contract or even his bargaining position relative to Google. The lesson, in sum, is that attorneys will be considered sophisticated (and subject to a formalist approach) in all of their dealings; they should be cautious about manifesting their assent, as they will be expected to have read and understood the terms of their contracts.

### F. Contract and Procedure

Just as the attorney in *Feldman* was held to a forum selection clause, sophisticated parties dealing at arm's length may generally waive the right to a jury trial or agree to forum selection.<sup>128</sup> The sophistication of a party is significant in interpreting and enforcing provisions governing procedures for resolution of disputes that may arise under the parties' contract. Courts have looked to party sophistication in assessing forum selection, choice of law and arbitration clauses. Indeed, in these contexts, courts have expanded greatly the validity of these clauses<sup>129</sup> in a way that falls consistently within the theoretical observation that the law is in a period of formalism.

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124. *Id.* at 237.

125. *Id.* at 238.

126. *Id.* at 241.

127. *Id.* at 243.

128. *Purcell Tire & Rubber Co. v. Executive Beechcraft, Inc.*, 59 S.W.3d 505, 508-09 (Mo. 2001) (en banc).

129. 7 WILLISTON ON CONTRACTS §§ 15:15, 15:11 (4th ed. 2009).



Forum selection clauses are *prima facie* valid in arm's-length deals between sophisticated parties.<sup>130</sup> It has also been noted that, at least in New York, courts show "almost absolute respect" for choice of law clauses in commercial contracts between sophisticated parties.<sup>131</sup> And, to the extent that the validity of arbitration clauses is policed largely by the unconscionability doctrine,<sup>132</sup> courts often mention the sophistication of the parties in determining whether to compel them to arbitrate their dispute.<sup>133</sup> For sophisticated parties, forum selection, choice of law and arbitration clauses are more likely to be interpreted and enforced in a manner that advances the literal language of the clause.

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130. *Gen. Elec. Co. v. G. Siempelkamp GmbH & Co.*, 29 F.3d 1095, 1099 (6th Cir. 1994) (enforcing forum selection clause against General Electric because it is a "sophisticated party" familiar with complex international business transactions); *In re D.E. Frey Group, Inc.*, 387 B.R. 799, 804 (D. Colo. 2008) (forum selection clause between sophisticated parties dealing at arm's length is presumptively valid) (citing *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10 (1972); *Milk 'N' More, Inc. v. Beavert*, 963 F.2d 1342, 1346 (10th Cir. 1992); *ADT Sec. Servs., Inc. v. Apex Alarm, LLC*, 430 F. Supp. 2d 1199, 1201 (D. Colo. 2006)).

131. Theodore Eisenberg & Geoffrey P. Miller, *The Market for Contracts* 3-4 (N.Y.U. Center for Law and Econ., Working Paper No. 06-45, 2007), available at <http://ssrn.com/abstract=938557>.

132. See generally Stempel, *supra* note 40; Aaron-Andrew P. Bruhl, *The Unconscionability Game: Strategic Judging and the Evolution of Federal Arbitration Law*, 83 N.Y.U. L. REV. 1420 (2008).

133. *Dime Group Int'l v. Soyuz-Victan USA, LLC*, No. 07 C 4178, 2008 WL 450825, at \*3 (N.D. Ill. Feb. 13, 2008) ("The record indicates that the arbitration provision was created in furtherance of an international commercial relationship through negotiations between sophisticated parties with a relative balance of bargaining power."); *Fensterstock v. Educ. Fin. Partners*, 618 F. Supp. 2d 276, 279-80 (S.D.N.Y. 2009) (While sophistication is a consideration in determining whether an arbitration provision is enforceable, "the sophistication of a party, alone, cannot defeat a procedural unconscionability claim."); *In re Managed Care Litigation*, No. 00-1334-MD, 2009 WL 855963, at \*4 (S.D. Fla. Mar. 30, 2009) (recognizing that courts distinguish between average consumers and more sophisticated parties in assessing whether arbitration agreements should be enforced); *Shapiro v. Baker & Taylor, Inc.*, No. 07-3153, 2009 WL 1617927, at \*11 (D.N.J. June 9, 2009) (arbitration provision was negotiated by "sophisticated business people"); *Brown v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 664 F. Supp. 969, 974 (E.D. Pa. 1987) (stock brokerage employment agreement with arbitration clause was not adhesion contract because of sophistication of employee).

### *G. Contract Formation and Implied Terms*

In addition to interpretation and enforcement questions, courts mention party sophistication as relevant to whether a contract has been formed under the classic model of bargained-for exchange.<sup>134</sup> Courts discuss party sophistication in connection with the question of whether the agreement was supported by consideration. Where a party is sophisticated, the courts are particularly unwilling to question the adequacy of consideration. Consistent with formalism, this is especially the case where an agreement recites that consideration, however meager, is adequate – even if not actually received.<sup>135</sup>

Likewise, a court may reference sophistication to determine whether a party's behavior, objectively viewed, manifested her intent (or lack thereof)

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134. Moreover, even where there is no contract because there is no bargain, sophistication may have relevance to whether a party can successfully assert liability on the basis of promissory estoppel. Promissory estoppel requires a promise and reasonable reliance by the promisee on that promise. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981). Courts have referenced the sophistication of a party as a reason why reliance on a promise, or even interpretation of a communication as a promise, would not be reasonable for purposes of a promissory estoppel claim. *See, e.g.,* Garwood Packaging, Inc. v. Allen & Co., 378 F.3d 698, 705 (7th Cir. 2004) (sophisticated party could not have reasonably understood investment company's predictive statements as binding promises); Gruen Indus., Inc. v. Biller, 608 F.2d 274, 281 (7th Cir. 1979) (addressing promissory estoppel claim, court held that buyers, who were represented in negotiations by sophisticated businessmen, would not be reasonable in relying on conditional promise to sell stock); G & M Oil Co. v. Glenfed Fin. Corp., 782 F. Supp. 1085, 1090 (D. Md. 1991), *aff'd*, 1991 WL 227802 (4th Cir. 1991) (in abstaining from seeking alternate financing, plaintiff could not have reasonably relied on defendant for loan because plaintiff was sophisticated entity represented by counsel throughout loan application process); 168th & Dodge, LP v. Rave Reviews Cinemas, LLC, 501 F.3d 945, 957 (8th Cir. 2007) (plaintiff did not reasonably rely on oral assurances that deal would go forward because plaintiff was a sophisticated business entity charged with knowledge of the requirements of the statute of frauds).

135. *See, e.g.,* Deschaine v. Cent. Sys., Inc., No. 05-CV-388-WDS, 2006 WL 1663731, at \*4 (S.D. Ill. June 13, 2006) ("As law professors are fond of saying, even a 'peppercorn' is sufficient. CSI, a sophisticated party, signed a contract that stated it was acting 'pursuant to adequate and sufficient consideration.' . . . The Court will not second guess the reasoned determination of a sophisticated party."); Omaha Nat'l Bank v. Goddard Realty, Inc., 316 N.W.2d 306, 310 (Neb. 1982) ("We are unable to say that, as a matter of law, an agreement knowingly entered into by and between two sophisticated parties should now be set aside because the consideration given for the agreement was not what one of the parties considers of particular value."); Long Bus. Sys., Inc. v. Bable, No. 2001-L-058, 2002 WL 606281, at \*3 (Ohio Ct. App. Apr. 9, 2002) (mentioning sophistication of employee in connection with determination of whether continued employment was sufficient consideration to support a covenant not to compete).

to enter into a contract.<sup>136</sup> Where a party is sophisticated, a court may impute her intent based on course of dealing or industry norms.<sup>137</sup> This may seem like a theoretical departure from the interpretation and enforcement cases, but it is not.

In the interpretation cases, for sophisticated parties, the courts determine intent based largely (and often exclusively) upon the express terms of the contract – subordinating context and normative considerations to the literal content of the document. When it comes to formation, however, sophisticated parties may have their intent imputed based upon contextual and normative markers. For instance, in a case where an agreement was not signed, the court found that the parties had nevertheless formed a contract because the intent to be bound could be imputed from their course of dealing.<sup>138</sup>

This contextual approach to contract formation is consistent with the interpretation and enforcement cases discussed. The label of “sophisticated” indicates that a party has experience and knowledge to inform the process and substance of the bargain. In this context, a sophisticated party should have known that, absent express language in the document stating that it was “not binding until signed,” other objective manifestations of intent would serve to bind that party to the deal. In other words, sophisticated parties know (or should know) how to avoid contractual liability. The theme is a consistent one: courts will not rewrite or renegotiate deals for sophisticated parties.

This theme is also demonstrated in cases where a contract has been formed but a party argues that the court should imply certain terms as part of that contract. While courts might impute a sophisticated party’s intent to enter into a contract, they are less willing to imply terms for sophisticated parties. Courts have refused to imply a reasonableness requirement<sup>139</sup> or a covenant of good faith and fair dealing<sup>140</sup> where the parties were sophisti-

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136. *See, e.g.,* Caterpillar Overseas, S.A. v. Marine Transp. Inc., 900 F.2d 714, 719 (4th Cir. 1990) (In a shipping case, although a bill of lading prepared by a freight forwarder was not actually delivered or formally executed by the shipper, the terms were held to form a contract because the parties were “sophisticated” and their intent to be bound could be imputed by their course of dealing.).

137. *Id.*

138. *Id.* at 719-20.

139. *See, e.g.,* Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co., No. Civ.A 1668-N, 2006 WL 2521426, at \*6 (Del. Ch. Aug. 25, 2006) (“A court should not read a reasonableness requirement into a contract entered into by two sophisticated parties.”); Gildor v. Optical Solutions, Inc., No. 1416-N, 2006 WL 1596678, at \*7 n.17 (Del. Ch. June 5, 2006) (same) (citing *Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1059-60 (Del. Ch. 2006); *Libeau v. Fox*, 880 A.2d 1049, 1056-57 (Del. Ch. 2005), *aff’d in pertinent part*, 892 A.2d 1068 (Del. 2006)).

140. *See, e.g.,* Aleuvich v. Harrah’s, 660 P.2d 986, 989 (Nev. 1983) (implied covenant of good faith and fair dealing did not extend to commercial leases between sophisticated parties). *Cf. Keiter v. Penn Mut. Ins. Co.*, 900 F. Supp. 1339, 1344 (D. Haw. 1995) (duty to negotiate contract modification in good faith arises even between sophisticated parties).

cated. For sophisticated parties, under a formalist approach, the content (or lack thereof) of the contract prevails; courts will not rewrite the terms of the deal.

In sum, in a varied set of circumstances, courts look to party sophistication to determine whether a formalist or realist approach is appropriate – a theoretical compromise that represents a key feature of the “new formalism.”

#### IV. WHO IS SOPHISTICATED FOR PURPOSES OF CONTRACT LAW? WHY DRAW THE CONTOURS OF A STANDARD FOR SOPHISTICATION?

Party sophistication is of increasing importance and represents a significant aspect of the new formalist trend in contract law. But just what do courts mean when they categorize a contracting party as “sophisticated”? Other status-based dichotomies that feature prominently in contract doctrine have statutory definitions – for example, “merchant” and “consumer.”<sup>141</sup> However, to the extent that “sophistication” is born of a common law trend, there is no legislative guidance in its definition.

Courts and scholars have not established instructive criteria and often presume that parties to a commercial transaction are sophisticated. Widely cited and highly regarded works in the area of contract law have stated that their theories only apply to sophisticated parties without a serious attempt to explain who falls into that category. All too often, courts label parties “sophisticated” without any discussion of why the parties are sophisticated. This Section begins with a discussion of the absence of analysis of sophistication. It then addresses why a meaningful definition of sophistication is important to contracting parties, the soundness of contract doctrine and the guiding principles of formalism. Finally, this Section deduces what, in the absence of analysis, courts appear to be considering in determining that a party is sophisticated.

##### *A. An Absence of Analysis*

Courts simply are not defining or analyzing sophistication. Students of civil procedure may already be familiar with this observation to the extent that it is exemplified by the Supreme Court of the United States’ assessment of jurisdiction in *Burger King Corp. v. Rudzewicz*.<sup>142</sup> There, Burger King Corporation, as franchisor, sued two franchisees in a United States District Court in Florida, alleging breach of the franchise agreement and trademark infringement.<sup>143</sup> The franchisees challenged the Florida court’s exercise of personal jurisdiction because they were both Michigan residents.<sup>144</sup> The

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141. See Garvin, *supra* note 12, at 299-302.

142. 471 U.S. 462 (1985).

143. *Id.* at 468-69.

144. *Id.* at 463-64, 469.

Court held that the district court properly exercised jurisdiction pursuant to Florida's long-arm statute, which extended jurisdiction to any person, whether or not a citizen or resident of Florida, who breaches a contract by failing to perform acts that a contract requires to be performed in Florida.<sup>145</sup>

One aspect of resolving the jurisdictional question in *Burger King* was the determination of whether the franchisees received fair notice that they might be subject to suit in Florida.<sup>146</sup> Throughout the case's appellate climb, the courts disagreed about whether the boilerplate franchise contracts provided the franchisees with notice of this possibility. As the Supreme Court tells it, "After a three-day bench trial, the District Court found that . . . [the franchisees] 'were and are experienced and sophisticated businessmen,' and 'at no time' did they '[act] under duress or disadvantage'" in dealing with Burger King.<sup>147</sup> On appeal, the United States Court of Appeals for the Eleventh Circuit concluded, however, that the dealings between the franchisees and Burger King involved "a characteristic disparity of bargaining power" and "elements of surprise."<sup>148</sup> The Eleventh Circuit held that "boilerplate declarations in a lengthy printed contract" did not provide the franchisees with fair notice of potential litigation in Florida.<sup>149</sup> The Supreme Court, however, reversed and, citing Federal Rule of Civil Procedure 52(a), held that the district court's factual findings should not be set aside unless clearly erroneous – reinstating the determination that the franchisees were sophisticated.<sup>150</sup>

In *Burger King*, the Supreme Court proceeded as though it were upholding a thoroughly vetted factual finding of the district court. However, the Supreme Court did not address the facts suggesting that the franchisees were sophisticated. Neither did the district court. At most, the district court suggested by comparison to another case that the franchisees were sophisticated.<sup>151</sup>

Further, a review of nearly two hundred state trial court decisions reveals that courts generally give short shrift to the factual determination of party sophistication. Most often, courts provide no discussion of the support for the determination that a party is sophisticated and no discussion of the relative knowledge and resources of the parties.<sup>152</sup>

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145. *Id.* at 487.

146. *Id.* at 485-87.

147. *Id.* at 484.

148. *Id.*

149. *Id.* (citing *Burger King Corp. v. Macshara*, 724 F.2d 1505, 1511-12 & n.10 (11th Cir. 1984)).

150. *Id.* at 484-87.

151. *Burger King Corp. v. Macshara*, No. 81-1145-CIV-K, 1982 WL 609125, at \*3 (S.D. Fla. Mar. 3, 1982).

152. In assessing how the courts addressed party sophistication, a review was done of every section of both Corbin's and Williston's treatises that mentioned sophistication and the cases discussed in that connection. Likewise, a review of nearly 200 trial court decisions was undertaken. A June 2008 search for "sophist! w/2 party



### *B. Why Draw the Contours of Sophistication?*

A more thoughtful treatment of party sophistication would serve to protect contracting parties from being labeled sophisticated in a cursory manner. This is significant because, once that label is applied, the party is presumed to have relevant knowledge and experience, justifying a formalist approach that denies certain arguments or defenses that otherwise might be available to that party. This is especially important because sophistication has been treated as a question of fact,<sup>153</sup> which is determined conclusively by the trial court. To the extent that sophistication is a fact-driven label, a more exacting analysis (rather than unstated presumptions) would provide sounder results.

Moreover, drawing the contours of sophistication is important beyond the parties to any given contract dispute – it has significance for other prospective litigants and, more broadly, all contracting parties. Formalism emphasizes certainty and predictability, and a discernible standard for party sophistication serves to guide the marketplace toward these aims.

### *C. Deducing the Contours of Sophistication*

Drawing the contours of sophistication would serve to protect parties that fall in the grey area of sophistication.<sup>154</sup> Certainly, there are parties who are unquestionably sophisticated. For example, large, publicly traded corporations or governmental bodies, with their collective institutional experience and dealings in familiar industries, will indisputably fall within the category of sophisticated parties. At the other end of the spectrum, the paradigmatic example of an unsophisticated party is likely someone who cannot read and does not have access to counsel or other third party advisors. However, grey areas exist between these extremes. There are actors in the marketplace who maintain the guise of a business entity but lack relative experience or resources and, therefore, might not be sophisticated for purposes of a particular

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or parties w/10 contract or agreement or transaction” in the Westlaw state “trial orders” database yielded these 178 results, which were each reviewed for their mention (and potential discussion) of party sophistication. The examination of the case law undertook to review trial court decisions because party sophistication is a finding of fact and, therefore, was most likely to be addressed at the trial level. A review of each of these cases revealed that very few of them (less than ten) actually provided an explanation for the determination that a party was sophisticated.

Moreover, it should be noted that a limitation of the search terms was underinclusivity. Because the search was limited to appearances of the root “sophist!” near the word “party” or “parties,” it did not necessarily yield those cases where, for example, a court describes a litigant as a “sophisticated plaintiff” or “sophisticated buyer.”

153. See sources cited *supra* note 21.

154. See Garvin, *supra* note 12, at 303 (in business transactions, describing consumer and merchant dichotomies as along a “continuum”).

deal. A commitment to formalism and freedom of contract is not always appropriately applied to these parties.

In their influential work, *Contract Theory and the Limits of Contract Law*, Professors Alan Schwartz and Robert E. Scott invoke party sophistication as a tool to draw the boundaries of their “efficiency theory” of contract law.<sup>155</sup> Recognizing that contract law has defied a universal normative or descriptive theory, Professors Schwartz and Scott draw on economic theory to posit “that contract law should facilitate the efforts of contracting parties to maximize the joint gains . . . from transactions.”<sup>156</sup> The concern here is not with the central thesis of Professors Schwartz and Scott. Rather, it is to note that they present their theory as applicable only to “sophisticated economic actors.”<sup>157</sup> In their explanation of these boundaries, they implicitly acknowledge the grey area of sophistication – providing as an example the “gift shop owned and run by a retired teacher.”<sup>158</sup>

Professors Schwartz and Scott partition the world of contracts between entities into two categories. The first category includes parties that are “obviously sophisticated economic actors,” providing General Electric as an example.<sup>159</sup> The second category includes parties that “function in commercial contexts but have many of the characteristics of ordinary persons.”<sup>160</sup> Professors Schwartz and Scott limit their “efficiency theory” of contract to those deals where both parties fall into category one – that is, where both parties are obviously sophisticated.<sup>161</sup> They then draw a boundary line for these obviously sophisticated parties by stating that the following firms fall into the first category: “(1) an entity that is organized in the corporate form that has five or more employees, (2) a limited partnership, (3) a professional partnership such as a law or accounting firm.”<sup>162</sup> They draw this categorical line on the reasoning that “these economic entities can be expected to understand how to make business contracts.”<sup>163</sup>

A definition of party sophistication was far from the central point of Professors Schwartz and Scott’s work, but whether a party is sophisticated dictates the applicability of their theory and, as has been discussed, the applicability of various contract doctrines.<sup>164</sup> In practice, courts often readily

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155. Schwartz & Scott, *supra* note 2, at 543.

156. *Id.*

157. *Id.* at 545.

158. *Id.*

159. *Id.* Indeed, in *General Electric Co. v. G. Siempelkamp GmbH & Co.*, 29 F.3d 1095, 1099 (6th Cir. 1994), the Sixth Circuit took “judicial notice that GE is a sophisticated party that is used to dealing with complex international business transactions.”

160. Schwartz & Scott, *supra* note 2, at 545.

161. *Id.*

162. *Id.*

163. *Id.*

164. See *infra* Part II.

deem as “sophisticated” parties that fall into Professors Schwartz and Scott’s second category – those actors that have a veneer of business characteristics but are actually acting as individuals in the marketplace or those who lack resources or significant, relevant business experience.

Moreover, Professors Schwartz and Scott’s line drawing suggests that party sophistication could reasonably be based on size and entity formation.<sup>165</sup> However, based on a review of hundreds of cases, size and entity formation do not appear to reliably separate the worlds of sophisticated and unsophisticated parties.<sup>166</sup> Courts rarely expressly mention the size of the firm or the number of employees as a measure of sophistication. While courts do appear implicitly to look to entity formation, it is not a reliable categorization tool. Rather, it seems that many incorporated or otherwise organized legal entities can fall into category two – those that “function in commercial contexts but have many of the characteristics of ordinary persons.” Indeed, as Professor Larry Garvin extensively explains of other status-based dichotomies, small businesses, even if organized to afford owners limited liability, may run into all of the pitfalls we would expect more experienced and knowledgeable firms to avoid – the pitfalls often associated with a lack of available resources, insufficient access to information and cognitive failings.<sup>167</sup>

What one can deduce about characteristics common to parties that courts deem sophisticated is based on the facts courts provide about those parties, even though courts rarely present those facts in relation to a statement that a party is sophisticated. The presence of the following facts appears most likely to result in a court deeming a party sophisticated:

- Corporate entity or other limited liability entity, or the party is an individual investor or partner in a limited liability entity;<sup>168</sup>

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165. “Entity formation” describes the type of business organization chosen by the parties and whether it is organized as a limited liability entity.

166. *See supra* note 152.

167. Garvin, *supra* note 12, at 304-68.

168. *See, e.g.,* Energy Partners, Ltd. v. Stone Energy Corp., Nos. 2402-N, 2374-N, 2006 WL 4782288 (Del. Ch. Oct. 17, 2006) (parties were both oil and gas exploration companies); Rohtstein Corp. v. KPMG, LLP, No. 04-3517, 2007 WL 4565135, at \*1 (Mass. Super. Dec. 7, 2007) (plaintiff organized as corporate entity, though one individual was president and sole shareholder); SB Belkin, LLC v. HTPA Holding Co., No. 266748-V, 2006 WL 4758025 (Md. Cir. Ct. June 14, 2006) (both parties were organized as LLCs); Middle M LLC v. Jenkins, No. 0101173/2008, 2008 WL 2328933 (N.Y. Sup. Ct. May 27, 2008) (parties formed LLC); Ver-Dick Builders, Inc. v. The Weitz Company, No. CV 03 10 6207, 2004 WL5528575 (Ohio Com. Pl. 2004) (contractor and subcontractor were incorporated entities); Flatrock Partners, L.P. v. Kasco-Chip Constr., J.V., No. 1194, 2007 WL 1453115 (Pa. Com. Pl. Feb. 14, 2007) (parties were limited partnership and corporation).

- Government or quasi-public entity;<sup>169</sup>
- Entity or person represented by counsel – or that has access to lawyers and accountants;<sup>170</sup>
- Educated – especially doctors and lawyers;<sup>171</sup>

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169. *See, e.g.,* Town of New Hartford v. Conn. Recovery Res. Auth., No. UWYCV0401855802X02, 2006 WL 2730965, at \*3 (Conn. Super. Ct. Sept. 11, 2006) (municipality and quasi-public entity described as “sophisticated business entities”); Science Applications Int’l Corp. v. State, 876 N.Y.S.2d 182, 184 (N.Y. App. Div. 2009) (“Claimant’s further contention that all ambiguities in the contractual documents should have been construed against [government agency] is unpersuasive. The record reflects that these are sophisticated parties and there is evidence that they engaged in negotiations as they worked out some of the details of the contract.”); MCI Constructors, Inc. v. City of Greensboro, 125 Fed. App’x 471, 476 (4th Cir. 2005) (The Fourth Circuit agreed with the statement of the district court that “the City and MCI are two sophisticated and competent parties who selected the City Manager to determine issues relating to payment for work performed and other issues relating to the fulfillment of the contract . . . . The court cannot act in contravention to the terms of the contract to let MCI out of what it perceives is a bad deal.”); Earth Tech, Inc. v. City of New London, No. CV075003858, 2008 WL 2252526, at \*4 (Conn. Super. Ct. May 9, 2008) (City of New London described as sophisticated party).

170. *See, e.g.,* Allison-Zongker, L.P. v. Chln, Inc., No. GIC 842475, 2006 WL 5674913 (Cal. Super. Ct. Aug. 10, 2006) (parties represented by counsel); PNC Bank v. Sills, Nos. 05J-01-076, 05J-01-077, 2006 WL 3587247 (Del. Super. Ct. Nov. 30, 2006) (defendant individuals had access to counsel); Homan v. Turoczy, No. 19220, 2005 WL 5756927, at \*6 (Del. Ch. Aug. 12, 2005) (plaintiffs were advised by an accountant); Frame v. Booth, Wade & Campbell, 519 S.E.2d 237, 239-40 (Ga. Ct. App. 1999) (party advised by counsel); Carr v. Entercom Boston, LLC, No. 072935BLS1, 2007 WL 2840363, at \*3, \*5 (Mass. Super. Ct. Sept. 19, 2007) (parties were represented by counsel); Fronk v. Fowler, No. 02-01216, 2006 WL 4756759 (Mass. Super. Jun. 6, 2006) (parties had access to and availed themselves of sophisticated accounting and legal advice); Parma Consulting, Inc. v. Nutrition Techs., L.L.C., No. 601233/03, 2005 WL 5351319 (N.Y. Sup. Ct. May 27, 2005) (buyer was represented by counsel and major accounting firm); RIV VIL, Inc. v. Tucker, 979 F. Supp. 645, 655 (N.D. Ill. 1997) (party represented by counsel).

171. *See, e.g.,* Fronk, 2006 WL 4756759 (parties held “advanced degrees”); Homan, 2005 WL 5756927, at \*2 (plaintiffs had advanced degrees in business administration); Ramirez v. Health Net of the Ne., Inc., No. CV020389700S, 2005 WL 3112871 (Conn. Super. Ct. Nov. 3, 2005) (plaintiff was a doctor); Ravski v. Conn. State Med. Soc., IPA, Inc., No. X01CV044000582S, 2005 WL 647570 (Conn. Super. Ct. Feb. 3, 2005) (plaintiff was a doctor); Greenwich Plaza, Inc. v. Whitman & Ransom, No. CVNO 95054081, 1996 WL 240458 (Conn. Super. Ct. Mar. 19, 1996) (defendant lessees were lawyers); *In re* Managed Care Litigation, No. 00-1334-MD, 2009 WL 855963, at \*4 (S.D. Fla. Mar. 30, 2009) (physician was a “sophisticated party”); Feldman v. Google, Inc., 513 F. Supp. 2d 229, 241 (E.D. Pa. 2007) (lawyer was sophisticated purchaser bound to online click-wrap agreement).

- Experienced in business or specific field or individual serving in management capacity;<sup>172</sup>
- Wealthy or significant market share in a given industry;<sup>173</sup> or
- The deal is complicated, long-term or expensive.<sup>174</sup>

These categories are not necessarily controversial in themselves. They may be germane indicators of the resources and information available to a party, though not the only indicators. It is the lack of analysis that is prob-

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172. See, e.g., *Fronk*, 2006 WL 4756759 (parties were experienced in business and respective fields); *Hartley v. Boyd*, No. X02CV034004679SCLD, 2008 WL 442142, at \*1-\*2 (Conn. Super. Ct. Feb. 4, 2008) (parties were experienced in corporate finance); *Homan*, 2005 WL 5756927, at \*2 (plaintiffs had years of experience as executives); *Progressive Int'l Corp. v. E.I. DuPont de Nemours & Co.*, No. C.A. 19209, 2002 WL 1558382, at \*1, \*3 (Del. Ch. Jun. 25, 2002) (parties to contract were experienced businesses that had history of contracting); *Carr*, 2007 WL 2840363, at \*1 (parties were experienced in broadcasting industry); *Mass. Mut. Life Ins. Co. v. O'Connell*, No. 06-4379 BLS1, 2007 WL 483345 (Mass. Super. Ct. Jan. 2, 2007) (defendant served as president, CEO and Chairman of Board for plaintiff corporation); *Philips S. Beach LLC v. Morgans Hotel Group Mgmt., LLC*, No. 600147/2006, 2006 WL 5112782 (N.Y. Sup. Ct. July 26, 2006) (both parties had "vast knowledge and understanding of hotel operations").

173. See, e.g., *Xerox Corp. v. Addressing Servs. Co.*, No. HHBCV075003896S, 2007 WL 4755009, at \*2 (Conn. Super. Ct. Dec. 6, 2007) (defendant was one of the top providers of direct-mail services in eastern Connecticut); *Flight Options Int'l, Inc. v. Flight Options, LLC*, No. 1459-N, 2005 WL 5756538 (Del. Ch. July 11, 2005) (defendant Flight Options LLC was second largest provider of fractional and aviation membership services); *AVX Corp. v. Cabot Corp.*, No. 053816BLS1, 2007 WL 4711495 (Mass. Super. Ct. Dec. 28, 2007) (shares of both corporations were publicly traded and had annual sales of more than one billion dollars).

174. See, e.g., *Sea Hawk Seafoods, Inc. v. Valdez Fisheries Dev. Ass'n*, No. 3AN-95-3500, 1997 WL 34628731 (Alaska Super. Ct. June 11, 1997) (complex manufacturing agreement); *Earth Tech, Inc. v. City of New London*, No. CV075003858, 2008 WL 2252526 (Conn. Super. Ct. May 9, 2008) (contractor entered into \$4,583,136 yearly contract with municipality); *Pathmark Stores, Inc. v. Bernard Oster, Inc.*, No. BER-C-232-07, 2008 WL 2164286 (N.J. Super. Ct. Ch. Div. Mar. 28, 2008) (twenty-five-year lease); *First Union Nat'l Bank v. Portside Refrigerated Servs., Inc.*, Nos. 040996, 041105, 2002 WL 34097405 (Pa. Com. Pls. July 16, 2002) (significant amount of money at stake in guaranty agreement); LAWRENCE, *supra* note 105, at § 2-204:17 ("[I]t has been stated that 'it is presumed that in complex financial transactions in which millions of dollars are involved . . . every major participant (lender, borrower, and guarantor) has the capacity to comprehend loan documents, and is relatively sophisticated and reasonably well-versed in the business transaction experience.'" (citing *Resolution Trust Corp. v. Sw. Dev. Co.*, 807 F. Supp. 375 (E.D.N.C. 1992), *order amended*, 837 F. Supp. 122 (E.D.N.C. 1992), and *aff'd in part, rev'd in part on other grounds*, 14 F.3d 596 (4th Cir. 1993))).



lematic. Too often, courts are merely stating that parties that have these traits are sophisticated with no analysis of the qualities they might possess that would support such a judgment. Courts provide no connection between these facts and the determination that a party is sophisticated. The label of “sophistication” leads rather than the relevant knowledge and experience of the parties. As a consequence, it is not clear that courts are reaching the right decisions for the right reasons or developing a principled, consistent body of case law to guide litigants and contracting parties in future deals.

This absence of meaningful guidance suggests that any one of these listed facts leads to an automatic determination that a party is sophisticated – regardless of context and regardless of that party’s position in relation to the other contracting parties. Yet bright lines or automatic categorizations are too blunt an instrument to address a question that is a matter of degree.

Notably, significantly fewer contract cases describe a party as *unsophisticated*. The most common cases that describe a party as unsophisticated do so in order to contrast a consumer with a more experienced buyer.<sup>175</sup> Likewise, a couple of cases have held that non-profit entities – a church and an American Legion Post – were unsophisticated for purposes of an equipment lease and an insurance contract, respectively.<sup>176</sup> These cases, while fewer in number, are instructive because they are often accompanied by a more thorough analysis than the ones that label a party as sophisticated. The dearth of analysis in the sophistication cases is not simply explained, however, by the fact that the parties are usually obviously sophisticated – the analysis is routine and unreasoned in the vast majority of cases involving all types of parties, regardless of whether they arguably fall into the grey area.

While it cannot be said that numerous grave injustices have been uncovered in the review of nearly two hundred trial court decisions that mention the parties’ sophistication, to the extent the courts are inserting quotes about party sophistication in a perfunctory manner, the potential for injustice is certainly there. Indeed, there were a handful of trial court decisions where

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175. *See, e.g.*, Warner v. Ford Motor Co., No. 06-CV-02443-JLK-MEH, 2008 WL 4452338, at \*15 (D. Colo. Sept. 30, 2008); Tillman v. Commercial Credit Loans, Inc., 655 S.E.2d 362, 370 (N.C. 2008); Arnold v. United Cos. Lending Corp., 511 S.E.2d 854, 861 (W. Va. 1998).

176. Kaleb E. Lindquist Am. Legion Post #24 v. Lake of the Woods Agency, Inc., No. 03-926, 2003 U.S. Dist. LEXIS 15784, at \*10 (D. Minn. Sept. 3, 2003) (American Legion post “relatively unsophisticated” in insurance matters, giving rise to special duty to inform the post concerning coverage for sewage back up); Copelco Capital, Inc. v. St. Mark’s Presbyterian Church, No. 77633, 2001 WL 106328, at \*4 (Ohio Ct. App. Feb. 1, 2001) (in assessing whether forum selection clause in equipment rental contract was enforceable, court stated that church and reverend were “not sophisticated commercial entities engaged in [a] business for profit”).

the judge seemed to presume erroneously that parties were sophisticated – or, at least, certainly warranted discussion of this determination.<sup>177</sup>

For example, in *Sheldrake v. Skyline, Corp.*,<sup>178</sup> the court's suggestion that a contracting party was sophisticated warranted further discussion. There, mobile home purchasers sued the manufacturer on warranty and negligence claims because the mobile home had a leaky roof. In holding that the plaintiffs' negligence claims fell "squarely within the [economic loss rule]," the court implied that the plaintiffs were sophisticated parties.<sup>179</sup> Of course, characteristically, the court did not discuss this point. It only intimated that the case involved sophisticated parties to the extent that it cited and quoted a law review article that explained the economic loss doctrine as "encouraging sophisticated parties entering into contracts to bargain now rather than sue in tort later."<sup>180</sup> As in many consumer transactions, it is quite possible that the buyers were not sophisticated for the purposes of the mobile home purchase. The court did not explain why the plaintiffs had relevant knowledge and experience such that they were in a position to negotiate ably with the mobile home manufacturer in order to allocate the risks of the purchase appropriately. Although the economic loss rule does not hinge on whether a party is sophisticated, by tossing around the label, courts are losing sight of the stated justification for the rule.

Another example of a potentially erroneous determination of sophistication arises in *Mayer v. Pulte Homes, Inc.*<sup>181</sup> In *Mayer*, a real estate agent entered into an employment contract with a large, national real estate developer.<sup>182</sup> The parties agreed that the agent would be paid weekly compensa-

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177. See, e.g., *Ramirez v. Health Net of NorthEast, Inc.*, No. CV020389700S, 2005 WL 3112871, at \*3 (Conn. Super. Ct. Nov. 3, 2005) (implied that doctor was sophisticated for purposes of contract with health maintenance organization that terminated him from network); *Middle M LLC v. Jenkins*, No. 0101173/2008, 2008 WL 2328933, at \*7 (N.Y. Sup. Ct. May 27, 2008) (worthy of discussion whether fashion designer was really a sophisticated party for the purposes of settlement agreement); *Sheldrake v. Skyline Corp.*, No. S1269-01, 2005 WL 5895190 (Vt. Super. Ct. June 23, 2005) (questionable whether mobile home buyers were sophisticated, such that negligence claims based on leaky roof fell squarely within economic loss rule); *Mayer v. Pulte Homes of N.Y., Inc.*, No. 0030152/2003, 2007 WL 2236452 (N.Y. Sup. Ct. Mar. 14, 2007) (labeling real estate agent sophisticated in connection with employment agreement); *Ravski v. Conn. State Med. Soc'y IPA, Inc.*, No. X01CV044000582S, 2005 WL 647570, at \*4 (Conn. Super. Ct. Feb. 3, 2005) (doctor was sophisticated for purposes of release and settlement agreement in case against medical insurance company).

178. No. S1269-01, 2005 WL 5895190 (Vt. Super. Ct. June 23, 2005).

179. *Id.*

180. *Id.* (quoting Thomas R. Yocum & Charles F. Hollis, III, *The Economic Loss Rule in Kentucky: Will Contract Law Drown in a Sea of Tort?*, 28 N. KY. L. REV. 456, 459 (2001)).

181. No. 0030152/2003, 2007 WL 2236452 (N.Y. Sup. Ct. Mar. 14, 2007).

182. *Id.*

tion, plus a commission for each of the homes she sold in the developer's new complex.<sup>183</sup> The commission per sale was \$2000, one half payable upon execution of the contract of sale and the other payable upon closing of title.<sup>184</sup> A clause in the contract provided that, in the event the agent was no longer employed upon the closing of title, she would not receive the remaining half of the sales commission.<sup>185</sup> Additionally, the developer's employee handbook, which the agent expressly acknowledged receiving, stated that she could be terminated at any time, with or without cause and with or without advance notice.<sup>186</sup>

In *Mayer*, the agent sold seventeen homes, none of which closed before she was terminated from employment.<sup>187</sup> The developer did not pay her the remaining portion of the commissions for those sales.<sup>188</sup> The agent sued, appearing to argue that the contract was an unenforceable adhesion contract because she had to sign it as written if she wanted the job.<sup>189</sup> More compelling, however, was her argument that the employer had committed fraud because it only terminated her to avoid paying the remaining portion of the sales commissions.<sup>190</sup>

The *Mayer* court dismissed the action, enforcing the contract according to its clear and unambiguous terms.<sup>191</sup> The court reasoned that the contract "involved two sophisticated parties dealing with real estate matters with which each is concededly familiar."<sup>192</sup> The court then summarily rejected the fraud claim as duplicative of the contract argument.<sup>193</sup>

The *Mayer* opinion is a doctrinal mishmash, clumsily argued on the agent's behalf. But the court's dismissal of the contract and fraud arguments is colored by its determination that the agent was sophisticated. While the court noted that the agent was familiar with real estate matters, it did not compare her past commission or compensation arrangements or her experience and resources relative to a large, national real estate developer.<sup>194</sup>

It might be that, regardless of the sophistication label, the correct result was reached in *Mayer* and that the court properly enforced the unambiguous contract terms as written. However, the label of sophistication should not have prejudiced the agent's claim of fraud. The agent's purported sophistication should not have summarily defeated her argument that, in essence, the

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183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.*

developer breached a duty of good faith and fair dealing by terminating her before the closings took place in order to deprive her of the benefits of the commissions owed on those sales. Given the agent's relative lack of experience and resources, the court might have appropriately implied such a duty in that case. As will be discussed in the following section, the label of sophistication should not lead; rather, the analysis of parties' relative experience and knowledge in a given transaction warrants more thoughtful consideration before the label is applied.

## V. TOWARD A MORE MEANINGFUL ASSESSMENT OF SOPHISTICATION

Given the ubiquity of party sophistication and its important role of demarcation in the new formalism, it merits definition for the purposes of contract law. Rather than continuing to allow an unstated presumption of party sophistication, a defined standard would provide guidance to litigants and contracting parties and would, by reaching well-reasoned results, develop a sound and principled body of law. The standard for sophistication would require a rigorous, fact-driven analysis before the application of the label was applied. Before labeling a party sophisticated, the courts would be required to address facts that suggest the party has access to resources and information. Only then would the application of the sophistication label take into account its theoretical underpinnings: for knowledgeable and experienced parties dealing in familiar industries, private autonomy should prevail over normative concerns. However, where a party lacks relative knowledge and experience, normative concerns may outbalance the literalism and private autonomy championed by formalism.

This Section begins by discussing some cases that exemplify the type of analysis in which the courts should be engaging. It then uses these cases as a guide and proposes a standard for sophistication that both addresses the justifications for applying the label of sophistication and balances the concerns of the new formalism.

### A. *The Model Cases*

Unlike cases mentioning party sophistication, cases addressing a lack of party sophistication often take the necessary time to explain this conclusion. For example, the Supreme Court of Ohio, in *Reilly v. Richards*, recognized that attorneys are not necessarily sophisticated for the purposes of all legal dealings.<sup>195</sup>

In *Reilly*, a buyer and seller entered into a contract for the purchase of real property, where the buyer planned to build a family residence.<sup>196</sup> The

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195. 632 N.E.2d 507 (Ohio 1994).

196. *Id.* at 509.

buyer happened to be an attorney.<sup>197</sup> Subsequent to closing, the parties discovered that part of the property was in a flood hazard zone, which rendered the property untenable for the buyer's building plans.<sup>198</sup> Both the buyer and seller were unaware of the government's flood hazard designation, and the buyer sought rescission on the ground of mutual mistake.<sup>199</sup> The Supreme Court of Ohio allowed rescission of the contract, holding that the mutual mistake was material to the subject matter of the contract.<sup>200</sup>

In reaching this conclusion, the *Reilly* court observed that the contract of sale contained an inspection provision, allowing the buyer sixty days from signing the contract to conduct soil, engineering, utility and any other inspections.<sup>201</sup> The court held that this provision did not mean that the buyer assumed the risk of the mistake.<sup>202</sup> In that connection, the court commented that the buyer "was a lawyer but . . . had no experience in real estate law and, thus, was an unsophisticated party at the time of the transaction."<sup>203</sup> The court recognized that education – even in the law – might not bespeak a level of knowledge and experience in every type of transaction. Therefore, it was not appropriate to apply the formalist maxim of "buyer beware."

A reflective, fact-driven analysis has also been seen in some decisions finding that a party is sophisticated. For example, *Fronk v. Fowler*<sup>204</sup> provides another apt example of the type of discussion in which the courts should be engaging. *Fronk* involved a dispute among partners in a real estate limited partnership. The partnership was formed for the purposes of investing in one specific property. The plaintiff limited partners were upset that, among other things, the defendant general partners undertook investment in two other properties without first offering the plaintiff partners the opportunity to participate in these projects. These facts formed the basis of the plaintiffs' breach of contract and breach of fiduciary duty claims.

In *Fronk*, the parties' partnership agreement, however, specifically permitted the general partners to "engage in any other business or investment, including the ownership of or investment in real estate and . . . neither the partnership nor any of the partners thereof shall have any rights in and to said businesses or investments . . . ."<sup>205</sup> Based on this contract language, the court concluded that the defendants had not breached the contract or any fiduciary duties owed to the plaintiffs. The court found that "plaintiffs/limited partners were experienced, sophisticated businessmen, amply represented by expe-

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197. *Id.*

198. *Id.*

199. *Id.* at 508-09.

200. *Id.* at 509.

201. *Id.*

202. *Id.*

203. *Id.*

204. No. 02-01216, 2006 WL 4756759 (Mass. Super. Ct. June 6, 2006).

205. *Id.* ¶143.



rienced counsel.”<sup>206</sup> It reasoned that “[s]ophisticated parties may structure their relationships by contract. When they do so, the court must give effect to the agreement, reasonably read, in order to effect the intent of the parties.”<sup>207</sup>

This language is commonly seen in cases of this type, but *Fronk v. Fowler* stands as an illustration of an uncharacteristically reflective analysis of sophistication because the court provided, in detail, the facts that suggested that the plaintiffs were sophisticated for the purposes of the transaction – namely, the court took the time to discuss their advanced business degrees, years of experience in real estate and complex business transactions, representation by counsel and substantial recognition as experts in their respective fields.<sup>208</sup> The court did not simply presume that the plaintiffs were sophisticated because they were partners in a limited partnership. Rather, it described the relevant attributes that made the plaintiff partners sophisticated for the purposes of the partnership agreement and described their attributes in relation to those of the defendant partners (who were also deemed sophisticated), as well as in relation to the deal itself. Given these facts, adherence to literalism and freedom of contract was appropriate.

Another example of a carefully reasoned discussion of party sophistication is the Delaware Court of Chancery decision in *All Pro Maids, Inc. v. Layton*.<sup>209</sup> The decision involved the plaintiff’s application for costs and fees after the court held the defendant liable for breach of contract and tortious interference with contractual and prospective business relations.<sup>210</sup> The court had ruled that defendant Layton, an employee, breached a covenant not to compete contained in her employment agreement with the corporate plaintiff, All Pro Maids, Inc. (“APM”).<sup>211</sup> That employment agreement provided that the “[e]mployee will be responsible for all court costs and attorney’s fees necessary to enforce this Agreement.”<sup>212</sup> The interpretation of the term “court costs” was the subject of the court’s decision.<sup>213</sup>

Defendant Layton argued that “court costs” should be interpreted narrowly and did not include expert fees, costs of transcripts or research costs.<sup>214</sup> The court found that the ordinary meaning of “court costs” supported Layton’s narrow interpretation.<sup>215</sup> Existing precedent, the *Comrie* case, also supported Layton’s interpretation to the extent that it held that the words “court costs” in a heavily negotiated contract between sophisticated parties should

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206. *Id.* ¶142.

207. *Id.* ¶144.

208. *Id.* ¶¶1-32, 142.

209. No. 058-N, 2004 WL 5388049 (Del. Ch. Dec. 27, 2004).

210. *Id.*

211. *Id.*

212. *Id.*

213. *See id.*

214. *Id.*

215. *Id.*

be interpreted consistently with its ordinary, narrow meaning.<sup>216</sup> The comparison to this existing precedent required the court to consider the sophistication of the parties:

Unlike the sophisticated parties in *Comrie*, APM is a small family owned business. Nevertheless, it is reasonable to infer that APM had the assistance of counsel in preparing the form Agreement that it required of all its employees to sign. Furthermore, while there may not have been a wide disparity in the bargaining positions of APM and Layton, the evidence suggests that APM enjoyed a slightly superior position and was responsible for the language used in the Agreement.<sup>217</sup>

Based on these factors, the court concluded that “court costs” should be construed to have its ordinary, more limited meaning.<sup>218</sup>

This case provides an example of a meaningful sophistication analysis because it actually addresses the relative positions of the parties and recognizes the nature of the transaction. This case involved interpretation of an employment contract, and the court recognized that, while the employer was a corporate entity, it was a family-run business. The court essentially held that APM was not a sophisticated party in all transactions but could be considered one for the purposes of this transaction because the other party was an employee and APM was in the position to seek the advice of counsel and draft the contract. Given this conclusion, principles of interpretation were employed to favor the employee.

### *B. Defining a Standard for Sophistication*

The law should aid courts in taking the principled and reflective approach displayed in the decisions used here as examples. These cases stand as models because they do not allow the label of “sophisticated” to lead but, rather, discuss the knowledge and experience of the parties in relation to each other and to the type of transaction at hand. These exemplary cases, together with the attributes that courts appear to find germane, inform the standard here proposed.

In setting a standard, it is important to consider the concern at the heart of the sophistication label. The justification for the dichotomy between sophisticated and unsophisticated parties is a concern about resource and information asymmetries among parties. In assessing whether there is a potential significant asymmetry among the parties, courts may take into account the

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216. *Id.*

217. *Id.*

218. *Id.*

factors that they already appear to consider germane – for example, for an individual, educational level and whether she had access to counsel.

Further, specific to a party's experience and resources, courts should take into account whether the parties are "repeat players."<sup>219</sup> Repeat players are those contracting parties that are experienced in the relevant market for the transaction, have resources and counsel at their disposal and, because they are often involved in such transactions, have every incentive to use their resources and seek out advice in a way that benefits them in the present deal, as well as in future deals. If the contract involves two repeat players, adherence to formalism is appropriate – it is sensible to hold them to a duty to read and to understand and uncover mistakes of fact. It is appropriate to interpret their deal literally and hold them to express limitations on damages, exculpatory clauses, reliance waivers and forum selection and arbitration clauses. In short, literalism and freedom of contract should prevail.

The standard for sophistication should not be so narrowly drawn – repeat players may be classic, readily identifiable sophisticated parties, but the assessment of sophistication must be based on the totality of the circumstances. Certainly, repeat players may not be sophisticated for the purposes

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219. The term "repeat player" is derived from Professor Marc Galanter's typology of litigating parties in *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95 (1974). There, roughly, he described the "repeat player" as one that anticipates litigation and has resources and experience to its advantage. *Id.* at 98. He compared the repeat player to the "one shotter," who is comparatively disadvantaged in terms of resources and has only occasionally experienced litigation. *Id.* at 97. Scholars have drawn on the "repeat player" as a contract typology, especially in the context of arbitration and adhesion contracts – those situations where the contract drafter is engaged in many similar (if not identical) contracts with many parties. By contrast, the other party to these contracts rarely has occasion to negotiate, draft and litigate contracts and has comparatively less resources and incentives to do so. *See, e.g.,* Lawrence Solan, Terri Rosenblatt & Daniel Osherson, *False Consensus Bias in Contract Interpretation*, 108 COLUM. L. REV. 1268, 1297 (2008) (in interpreting contracts, in light of cognitive biases, courts should be aware of significant advantages of repeat players); Jeffrey W. Stempel, *Mandating Minimum Quality in Mass Arbitration*, 76 U. CIN. L. REV. 383 (2008) (in negotiating standard-form contracts, repeat players have more experience in courts, have more experienced counsel and get overall more favorable outcomes); Shmuel I. Becher, *Asymmetric Information in Consumer Contracts: The Challenge That Is Yet to Be Met*, 45 AM. BUS. L. J. 723, 733 (2008) (consumers have asymmetric information compared to repeat players who draft standardized form contracts).

The term "repeat player" is used here to denote those individuals and firms that have significant experience contracting in a given industry and resources at their disposal to draft and negotiate optimal contract terms. Even where these contracts are standardized, the repeat player has enough of a stake in the industry to retain advisors and expend resources in contract drafting, negotiating and litigating. Thus, it would be reasonable in many cases to expect that such a party knew or should have known what to bargain for and how to structure the bargain.

of every transaction, and, on the flip side, sophisticated parties are not all repeat players.

Simply stated, if contracting parties are not fairly matched in terms of resources, the concerns about their comparative experience in the relevant type of transaction are heightened. Of course, no two parties are ever equally positioned, but there is a question of meaningful degree in terms of bargaining disparities. For example, even if an attorney is experienced in negotiating advertising contracts, for the purposes of Google's AdWords contract, it merits acknowledgment that, relative to Google, her resources are miniscule. Further, Google, as a repeat player with millions of AdWords subscribers subject to the same standard contract, has every incentive to dedicate resources to assessing, predicting and allocating risks in drafting the contract and, then, to litigate fiercely if disputes should arise.

Moreover, the definition of party sophistication should recognize that, just because a party has experience, knowledge and access to resources in the context of one transaction, it does not make her sophisticated for all transactions. For example, a criminal attorney may not be sophisticated for the purposes of a real estate deal. Yet, if she were an experienced labor and employment attorney, she would likely be considered sophisticated for the purposes of negotiating her own employment contract. Therefore, she might not have assumed the risk of a mistake in a contract for sale of real estate, but she likely would bear such a risk in the context of her employment contract.

An apt standard for party sophistication, then, would require the courts to assess the relative experience and resources of the parties to the contract in the context of the particular type of transaction. The standard would require courts to do a contextual, factual assessment of the (1) comparative attributes of the parties (2) as they relate to the nature of the transaction. In assessing the parties' attributes, courts should assess the totality of the circumstances, looking to, among other factors, education, experience, access to legal advice, entity form and size. As for the nature of the transaction, courts should consider the size and complexity of the deal, as well as its type – whether consumer, employment, franchise, insurance, etc. Courts should weigh the party and transaction attributes that appear to be relevant in these cases and ask whether a party, relative to the other parties to the contract, has sufficient experience and access to information and resources that the person or entity understands or should understand the intricacies, risks and consequences of the transaction. The burden of demonstrating sophistication would be on the party that benefits from that label.

The label of sophistication would not lead; rather, these characteristics and the nature of the transaction would inform whether the label of sophistication is aptly applied. In light of the nature of the transaction, if the party has sufficient knowledge, experience and access to resources such that she knows or should know what to bargain for, what the written terms mean and how to order contract risks, then a formalist approach to contract questions should prevail. But, until that analysis is done, the label of sophistication

should not allow an unchecked application of formalism, with the guise of contextualism.

In the easy cases – for example, where a contracting party is General Electric, a classic example of a sophisticated party<sup>220</sup> – the application of this definition is simple and does not require much more thought than courts are already giving to the question of party sophistication. However, in the grey areas – for example, the cases involving parties that “function in commercial contexts but have many of the characteristics of ordinary persons”<sup>221</sup> – the application of this definition prompts courts to ask the relevant questions before applying a formalist approach to contract formation, interpretation or enforceability.

For example, in *Sheldrake v. Skyline, Corp.*,<sup>222</sup> with the mobile home purchasers, if the court had applied the definition here proposed rather than presuming sophistication, it would have required the mobile home manufacturer to prove that the purchasers were experienced in these transactions and, relative to the manufacturer, had sufficient access to information and resources such that they understood or should have understood that the contract of sale would foreclose potential negligence claims. This could have been shown by reference to the purchasers’ level of education, experience in large consumer purchases, access to counsel or other advisors and the relative cost and complexity of the sale (and warranty provisions). If the court had paused to assess whether the plaintiff purchasers fell within this definition, it may have decided that the stated justification for the economic loss doctrine was not served by its application to this case.

Moreover, in the *Mayer*<sup>223</sup> decision, involving the real estate agent and the development company, the company should have had the burden of demonstrating that the agent had sufficient experience in that type of employment transaction so that she understood or should have understood that she could be fired unilaterally by the company for any reason at any time, which would result in a forfeit of any commissions owed. If that was not the case, a literal application of the contract as written was arguably inappropriate. Or, at the very least, there should have been room for an argument to imply a duty of good faith and fair dealing on the part of the developer.

Likewise, consider the application of this definition to the franchisees in *Burger King*.<sup>224</sup> There, Burger King Corporation, as franchisor, is a typical repeat player – with experience and every resource and incentive to advocate for its legal position. However, little is discussed about the experience and resources available to the franchisees. Did the franchisees, relative to Burger King, have sufficient experience and access to information and resources

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220. See *supra* note 159 and accompanying text.

221. See Schwartz & Scott, *supra* note 2, at 545.

222. No. S1269-01, 2005 WL 5895190 (Vt. Super. Ct. June 23, 2005).

223. No. 0030152/2003, 2007 WL 2236452 (N.Y. Sup. Ct. Mar. 14, 2007).

224. 471 U.S. 462 (1985).



such that they understood or should have understood the risk of being sued in Florida? Were they experienced in franchise ownership? Did they have resources to hire counsel to advise them in the execution of the franchise agreement? There is little factual information in the reported decisions to suggest the answer to these questions.

Further, consider application of this definition in *Forest Oil*, the Supreme Court of Texas decision upholding a reliance disclaimer in a settlement agreement.<sup>225</sup> The proposed definition would have required the court to explain why McAllen, a rancher, was a sophisticated party for the purposes of that contract with Forest Oil, a large publicly traded company. It would be relevant – but not conclusive – that the parties were represented by counsel. The court would also have to consider the level of experience the parties had in the underlying deal (a lease of land and surface rights to extract oil and gas) as well as the settlement of lawsuits. It is not a stretch to imagine that McAllen had considerably less experience in such contracts, and, therefore, a formalist approach, foreclosing McAllen from bringing a claim for fraudulent inducement, was not a fair result.

The proposed definition for sophistication is a standard, invoking the well-rehearsed debate concerning rules versus standards. The definition of sophistication that Professors Schwartz and Scott propose has the allure of ready, bright lines.<sup>226</sup> Of course, a bright-line test for sophistication could arguably lead to more predictability and certainty than the fact-sensitive, context-specific definition here proposed. After all, under Professors Schwartz and Scott's test, if a party to a contract is a corporation with five or more employees, a limited partnership or professional partnership, it is sophisticated. It is simple to apply, but it does not take into account the nuances and unique circumstances of each case. Sophistication is problematic to define because of its grey areas, and the use of a standard acknowledges this quandary. A context-specific standard allows for just results in a more varied array of circumstances. After all, as a vestige of realism, the reason for applying the "sophistication" label is a concern for context. Moreover, a standard may not lead to less predictability than a bright-line test (or, as is the present state of the law, no articulated test at all). Application of a rigid, rule-based definition to the grey areas of sophistication will force courts to bend or ignore the definition to avoid unjust results – only leading to less predictability, not more.

## VI. CONCLUSION

In *Ancient Law*, Sir Henry Maine famously remarked that the movement of progressive societies evolved from "[s]tatus to [c]ontract."<sup>227</sup> By this, he

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225. *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51, 61 (Tex. 2008).

226. See *supra* notes 155-63 and accompanying text.

227. HENRY SUMNER MAINE, *ANCIENT LAW* 151 (Maine Press 2008) (1861); see also Wayne R. Barnes, *Toward a Fairer Model of Consumer Assent to Standard*

meant that a dynamic society finds order in the associations that people choose by their own private agreements rather than by the status conferred upon them by membership in pre-ordained class stratifications. With the attention given to party sophistication, however, it appears that status does, to some measure, dictate who is held to principles of autonomy.

The distinction based on party sophistication is appropriate to the extent that deals between experienced parties with considerable resources should benefit from the expediencies of formalism. And, at the same time, deals with less evenly matched parties warrant heightened considerations of procedural and substantive fairness. Party sophistication is an appropriate consideration as contract law attempts to preserve normative concerns in the face of a new formalist shift. It needs, however, to be squarely defined and, with that, thoughtfully addressed.

Undoubtedly, there is a note of irony in the argument that courts should take a contextual, standards-based approach to determining whether formalist principles apply to, for example, issues of contract interpretation or enforceability. Certainly, there is room to argue that this approach only serves to undercut the certainty and predictability that formalism lends to the marketplace. However, the benefits of defining sophistication are far outweighed by the costs of not doing so. The present, complete absence of any definition at all leads to a system of post hoc rationalization, leading to even less certainty and predictability in contract drafting and litigation of contract disputes. Moreover, a standard has advantages over a bright-line rule because sophistication exists along a continuum. A fact and context-driven inquiry better serves the normative concerns that justify application of the sophistication label.

Sophistication should not be reduced to a charade, meant to provide a guise of context sensitivity but lacking a depth of analysis that shows any genuine concern for the relative positions of the parties. If the parties are truly sophisticated – relative to each other and to the nature of the transaction – literalism and autonomy should prevail. The law should not presume, however, that because the parties are engaged in a business deal or represented by counsel that they are “sophisticated.” Otherwise, the fairness concerns of the realist period are reduced to pretense.

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*Form Contracts: In Defense of Restatement Subsection 211(3)*, 82 WASH. L. REV. 227, 234 (2007) (“Maine meant that society had moved away from stratification based on fixed classes, as with feudalism, and had moved into the much revered ‘freedom of contract’ era, where people were free to transact with, and become obligated to, whomever they wished.”); David N. Mayer, *The Myth of “Laissez-Faire Constitutionalism”: Liberty of Contract During the Lochner Era*, 36 HASTINGS CONST. L.Q. 217, 235 (2009).