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CONTRACTUAL INCOMPLETENESS: A TRANSACTIONAL PERSPECTIVE

Avery W. Katz[†]

I. INTRODUCTION

Recent scholarship in the field of contract law has concentrated on contractual incompleteness—that is, on the fact that except in the simplest and most basic transactions, contracting parties do not work out all of the relevant details and contingencies of their relationship at the outset. The reasons for incomplete contracts are varied. Sometimes parties deliberately leave terms unresolved, trusting future negotiations or social norms to fill in any problems that emerge. Other times, they leave terms unresolved without realizing they have done so, in part because they devote limited attention or resources to their negotiations and in part because contracts are expressed in ordinary language with all its ambiguities. In any event, it is routine for contracting parties not to focus on the fact that their agreements contain interpretative gaps until after a difference of opinion arises.

Most of this recent scholarship has focused on the question of what courts should do when faced with the problem of enforcing an apparently incomplete contract.¹ For example, the literature on default rules addresses the question of what terms courts should apply when the contract is silent on a particular issue,² the literature on the battle of

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¹ See generally Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 316–18 (1992); Alan Schwartz, *Incomplete Contracts*, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (Peter Newman ed., 1998) [hereinafter NEW PALGRAVE DICTIONARY].

² See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) [hereinafter Ayers & Gertner, *Filling Gaps*] (arguing that default rules should be employed as a mechanism to encourage informationally advantaged parties to reveal their type before contracting); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992) [hereinafter Ayers & Gertner, *Strategic Contractual Inefficiency*] (same); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Be-*

the forms discusses what courts should do when the parties' writings disagree,³ and the literature on interpretation discusses how courts should determine whether either of these events has arisen.⁴ Focusing on such questions is sensible because when legal disputes arise over an issue of contractual interpretation, courts must decide what to do. On the other hand, focusing exclusively on such questions overlooks the facts that most contractual relationships do not result in disputes and that much of what lawyers do when designing contracts can be understood as managing the problem of incompleteness so that the parties can settle their affairs without resorting to costly litigation.

As I have argued elsewhere, such a court-centered perspective is characteristic of academic legal scholarship in general.⁵ Elite legal scholarship, for various historical and sociological reasons, usually tends to address a hypothetical audience of public lawmakers. Scholarship focusing on transactional design, in contrast, tends to be left to practitioner literature or to continuing legal education materials. Tellingly, even scholars coming from a law-and-economics perspective and those who strongly advocate freedom of contract tend largely to address themselves to public lawmakers.

In this Essay, I offer a somewhat different perspective on the topic of incomplete contracts, and in so doing, advocate, more generally, a

tween Express and Implied Contract Terms, 73 CAL. L. REV. 261 (1985) (arguing that default rules should be chosen to provide terms that would minimize the cumulative transaction costs incurred by parties contracting around them); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997) (arguing that in situations where network externalities prevent parties from choosing optimal individual terms, default terms should be centrally chosen for their substantive efficiency); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003) (noting that default rules should be set to the terms, usually simple rules, that are easiest for the parties to escape). For a survey of this literature by one of its leading contributors, see Ian Ayres, *Default Rules for Incomplete Contracts*, in 1 NEW PALGRAVE DICTIONARY, *supra* note 1, at 585.

³ See, e.g., Douglas G. Baird & Robert Weisberg, *Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217, 1252-57 (1982) (arguing for the use of the mirror image rule over the use of section 2-207); Omri Ben-Shahar, *An Ex-Ante View of the Battle of the Forms: Inducing Parties to Draft Reasonable Terms*, 25 INT'L REV. L. & ECON. (forthcoming 2005); Victor P. Goldberg, *The "Battle of the Forms": Fairness, Efficiency, and the Best-Shot Rule*, 76 OR. L. REV. 155, 156 (1997) (urging courts to take a fairer approach in interpreting individual contracts); John E. Murray, Jr., *The Chaos of the "Battle of the Forms": Solutions*, 39 VAND. L. REV. 1307, 1311 (1986) (arguing that section 2-207 may have a critical defect).

⁴ See generally Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 534 (1998) (discussing different ways courts use the parol evidence rule); Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583-84 (2005) (discussing transaction costs of contracts being minimized through judicial interpretation). But see Avery Wiener Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496 (2004) (advocating a transactional approach to the problem of interpretation).

⁵ Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745 (1996).

particular methodological approach to contracts scholarship and teaching. Specifically, I argue that legal scholars should focus more on addressing the contractual decisions of private lawmakers (that is, transactional lawyers and their clients) and less on the decisions of public lawmakers (that is, courts and legislatures). Stated alternatively, in the language of law-and-economics, scholars should pay greater attention to considerations of private transactional efficiency as opposed to larger issues of social efficiency.

There are two main reasons to advocate such an approach; one reason is pedagogical, and one is substantive. From a pedagogical standpoint, relatively few law students will become judges or legislators, but most will operate as private lawmakers in a contractual setting. Even those who specialize in litigation will regularly create private law in the course of negotiating settlements, which are far more common than litigated trials. To do a good job at private lawmaking, just as in public lawmaking, it is necessary to pay attention to policy considerations, such as efficiency and incentives. But teachers who emphasize policy issues only in the context of social planning fail to deliver this lesson.

There is also a substantive reason—directly connected to the subject of this Symposium—for advocating a transactional approach to contracts scholarship. The central lesson of the literature on incomplete contracts stresses that courts are not in a position to effectively supervise many of the things that the parties know and do in negotiating and performing their agreement; rather, the parties have more information than the courts. This informational discrepancy underlies the claim that freedom of contract is desirable from a consequentialist standpoint as opposed to just a libertarian one.

More specifically, from an economic viewpoint, maximizing contractual value requires drawing a proper balance among various decisional margins and trading off reduced efficiency along one margin to achieve enhanced efficiency along another. Richard Craswell's contribution to this Symposium indicates, for instance, that transactional efficiency depends not just on incentives for contractual performance, but also on the parties' investment in *ex ante* precautions.⁶ One should add that it also depends on mitigation behavior, allocation of contractual risks, acquisition and exchange of information, negotiation, as well as the parties' internal organizational arrangements. To make the appropriate tradeoffs among these various dimensions of efficiency, however, one must have detailed information about a variety of fac-

⁶ Richard Craswell, *The "Incomplete Contracts" Literature and Efficient Precautions*, 56 CASE W. RES. L. REV. 151 (2005).

tors, such as relative elasticities of demand, expected returns on investment, the discount rates the parties attach to future costs and benefits, relative bargaining power, costs of renegotiation, and the like. But, most of this information is local knowledge; it varies among contracting parties and is much more likely to be accessible to them in the context of planning than to a court in the context of adjudicating a dispute or to a legislature in the context of policy making.⁷

As a result, the economic analysis of contracts is likely to be more useful for private parties than for public officials, especially in a legal regime such as ours that both permits and relies on broad freedom of contract. Despite important limitations on private contracting, such as the doctrine of unconscionability, most contract law is private and there is much that private parties can do to implement their preferred arrangement. In the following Sections, I outline some of the main options and strategies available to private transactional planners in the context of incomplete contracts.

II. DEFINING THE PROBLEM OF CONTRACTUAL INCOMPLETENESS

To identify the appropriate approach to the problem of contractual incompleteness, one must first isolate its causes. The term “incomplete contracts,” however, like the term “transaction costs,” encompasses several distinct issues that suggest quite different policy and planning responses.⁸ Some of the reasons contracts are incomplete arise out of *ex ante* contract-writing costs, such as the direct costs of time and effort spent negotiating. These costs would exist even in the absence of any market or transactional failure and the parties may be capable of directly economizing on them. But, other sources of contractual incompleteness are more problematic. Bounded rationality may lead the parties to ignore contingencies that have low probability or that produce cognitive dissonance for them. If the parties have asymmetric information regarding some aspects of their exchange, the better informed party may prefer to leave an issue unraised for strategic reasons.⁹ If negotiations are conducted by subordinate agents

⁷ Cf. F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945) (arguing that such local knowledge is pervasive and renders central state planning inherently less efficient than decentralized economic exchange).

⁸ See, e.g., Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What To Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WIS. L. REV. 323 (2004) (providing a discussion and taxonomy on such issues).

⁹ This is the explanation stressed by Ayres & Gertner, *Strategic Contractual Inefficiency*, *supra* note 2.

whose incentives are not well aligned with the interests of their principals, the agents may negotiate with less care.¹⁰

These various possibilities can be illustrated through an imaginative reading of the classic case of *Sherwood v. Walker*,¹¹ in which the parties neglected to specify explicitly what would happen in the event that the subject of the contract, the apparently barren cow, Rose 2d of Aberlone, turned out to be fertile. While the case report does not make entirely clear why this failure occurred, the majority opinion suggests that the cause was bounded rationality: the parties simply did not consider that the cow might be fertile, and so they suffered from mutual mistake.¹² The dissenting opinion, on the other hand, suggests that the contract was not incomplete at all and that at least the buyer understood that the transaction was a speculative one.¹³ But other interpretations of the case are also possible. The fact that the buyer understood the risks does not imply either that the seller did or that the contract was complete. Perhaps the buyer, who had the opportunity to inspect the cow more recently than the seller, had inside information regarding her condition that he should have disclosed. Perhaps the seller's agent breached a duty of loyalty by disclosing proprietary information to the buyer so that the contract needed to be rescinded to avoid unjust enrichment.

Such problems of ex ante negotiation have been reasonably well discussed by legal commentators and do not require any unfamiliar theoretical concepts. More recently, however, economists have put forward additional and novel explanations for contractual incompleteness that turn not on negotiation costs ex ante, but on enforcement costs ex post. For example, one explanation that has attracted particular attention in the economic literature can be denoted *strategic renegotiation design*. This explanation starts with the observation that rational parties, when negotiating a contract, should anticipate that they may need to renegotiate later. Indeed, they cannot preclude later renegotiation, because the law of contracts does not allow the parties to create a contract that cannot later be modified.¹⁴ As a result, the parties have an incentive to choose terms that will structure the subsequent rounds of bargaining.¹⁵ For instance, it may pay to leave

¹⁰ Of course, depending on the agent's reward structure, the agent might also spend too much time and effort on contract negotiation, as when business lawyers are accused of "over-lawyering" a deal.

¹¹ 33 N.W. 919 (1887).

¹² *Id.* at 923.

¹³ *Id.* at 924-25 (Sherwood, J., dissenting).

¹⁴ See Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203 (1997).

¹⁵ See, e.g., Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership*:

some terms open in order to leave room for subsequent bargaining later.¹⁶

A second explanation that has also received significant attention in the recent economic literature, and on which the other participants in this Symposium have focused, relates to problems of asymmetric information *ex post*. Specifically, because the parties have better information about the contract than courts or third party enforcers do, it may not be possible for an adjudicating tribunal to determine, at a reasonable cost, what the contract provided, whether the parties complied with their duties, or what the resulting damages might be. And because of these *ex post* costs of adjudication, it does not pay to undertake the costs of contract completion *ex ante*.

Such informational asymmetries can be of two sorts. In some situations, the asymmetry lies between the two parties, so that even the victim of a contract breach cannot determine its existence or consequences (as in the case of a consumer who does not know whether an auto mechanic has correctly repaired a defective part). In other cases, the asymmetry lies only between the two parties on the one hand and a third-party enforcer, such as a court, on the other (as when an experienced trader can tell that its supplier has delivered nonconforming goods, but the nonconformity is not apparent to a nonspecialist). In either event, however, the promise in question is effectively unenforceable and, therefore, not worthwhile to the parties to spell out (although in the case of two-party asymmetries, it may be possible to use the prospect of repeat dealing as an inducement mechanism). We can call this the problem of *unverifiable information*, or *unverifiability*.¹⁷

A familiar example from the law of contract damages illustrates the problem of unverifiability. Consider the concept of opportunity reliance, that is, reliance on a promise that takes the form of lost opportunities. Fuller and Perdue famously argued that in a competitive market setting, the expenditure and reliance measures of contract damages are equivalent because the promisee's reliance includes the

A Theory of Vertical and Lateral Integration, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988).

¹⁶ See generally B. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 AM. ECON. REV. 902 (1998); Oliver Hart & John Moore, *Agreeing Now To Agree Later: Contracts that Rule Out but Do Not Rule In* 1-54 (Nat'l Bureau of Econ. Research, Working Paper No. 10397, 2004).

¹⁷ The economic theory literature uses the term "observability" to denote informational asymmetries between the parties, and reserves the term "verifiability" to denote informational asymmetries between the parties and a third-party enforcer, but this terminology is more conventional than functional. Instead, this Essay will use the two-party/three-party terminology for the sake of functional clarity.

lost opportunity to enter into a contract with another party who would not have breached.¹⁸ But in a nonmarket setting, such opportunities do not exist and the equivalence need not hold, so that expectation damages will generally overcompensate the reliance interest. On the other hand, a reliance measure is likely to undercompensate the reliance interest because of the practical difficulties of proving reliance that takes the form of inaction. Many courts will choose overcompensation as the lesser of two evils in this regard, but the nonverifiability of the underlying reliance renders the remedy imperfect.

As indicated above, the appropriate response to incomplete contracts depends on which of these determinants are at work. For example, consider the situations in which there are no informational asymmetries, but contracts are incomplete as a result of the simple costs of time and negotiating effort. In this case, if it is costly to add a term to the contract and the event with which it deals is of sufficiently low probability, it is optimal for the parties to leave the problem unaddressed until later. Suppose, for example, that it costs \$500 in lawyers' fees to add a contractual term that specifies what happens if trade is disrupted by a cyber-terrorist incident that shuts down electronic payment mechanisms. Also, suppose that it would cost \$500,000 ex post to litigate a dispute over the matter. If the chances of the incident are less than 1/1000, it is cheaper for the parties to run the risk of contractual failure, even if the result is litigation.

Conversely, suppose that contractual incompleteness is caused by strategic withholding of information ex ante, along the lines of Ayres and Gertner's analysis.¹⁹ In this case, it is possible, in principle, to improve the efficiency of exchange by adopting a penalty default term. Such a penalty will better promote precontractual disclosure if the private value of the information is not too large. But, the prospect of such efficient interventions is not generally applicable to all contractual settings. For instance, if the private value of information is large, the informed party will prefer to suffer the penalty of inefficient contractual terms in order to enjoy the informational advantage.²⁰

¹⁸ L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936). *But see* Robert D. Cooter & Melvin A. Eisenberg, *Damages for Breach of Contract*, 73 CAL. L. REV. 1432 (1985) (pointing out that this equivalence is only an approximation and must be adjusted to account for the probability that the alternate contractual partner would have breached).

¹⁹ See Ayres & Gertner, *Filling Gaps*, *supra* note 2.

²⁰ See Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615, 648-64 (1990) (demonstrating that penalty defaults are inefficient if the informed party lacks bargaining power in a situation of bilateral monopoly); *see also* Barry E. Adler, *The Questionable Ascent of Hadley v. Baxendale*, 51 STAN. L. REV. 1547,

The nature and origin of contractual incompleteness (and the nature of the substantive issue) can determine whether the best policy response comes from state intervention or from private transactional planning. To return to the cyber-terrorism example, if litigation is costly and insurance is available, it may be best to send the disputes over failed payments to a neutral arbitrator who will decide the issue on unreviewable grounds. On the other hand, if there are economies of scale or coordination in resolving *ex post* disputes, as may be the case if the payment system fails for a large number of parties, and losses are minimized by treating back-to-back transactions consistently, then it may be worth bearing the costs of litigation in the public courts. It may even be worth state subsidy if that is the only way to take advantage of the scale economies.

Each of the various causes of contractual incompleteness mentioned above leads to different policy implications. If parties leave contracts open in order to improve renegotiation incentives, for instance, it does them no good for courts to step in after the fact and fill gaps. Conversely, if contracts are left open because of shirking by subordinate agents, *ex post* gap filling by courts, assuming they are better and more faithful than the original subordinates, may improve the principal's monitoring capacities. Relaxing the assumption, if courts' policy preferences diverge from those of the parties, there will be an incentive for the parties to exit the public enforcement system through private arbitration or otherwise.

Accordingly, economic theory affords ample opportunity to discuss how courts or legislatures should respond to the phenomenon of incomplete contracts. As explained earlier, however, the purpose of this Essay is to investigate private approaches to the problem; and in the next Section, I identify some typical strategies that are available to contractual planners as well as the kinds of considerations that help determine which of these strategies are worth pursuing.

III. TRANSACTIONAL STRATEGIES FOR MANAGING CONTRACTUAL INCOMPLETENESS

In this Section, I identify and discuss four types of strategies for managing contractual incompleteness: (1) investing *ex ante* to lower the cost of contract completion *ex post*, (2) contracting *ex ante* over

1589 (1999) (demonstrating that penalty defaults may be inefficient if asymmetric information is multidimensional and revelation along one dimension would allow the recipient to draw inferences about another); Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 *YALE L.J.* 1885, 1886 (2000) (arguing that penalty defaults may be inefficient when the information would reveal trade secrets valuable beyond the instant contract).

the methods of interpretation to be applied *ex post*, (3) delegating authority to complete the contract to either one of the principal parties or to a third party, and (4) designing contractual provisions that make the agreement self-enforcing or that encourage efficient renegotiation. In practice, these four categories will overlap and serve as complements as well as substitutes. For instance, establishing clearer guidelines for contract interpretation will promote smoother renegotiation. Accordingly, the discussion, though it should be understood as illustrative rather than systematic, makes it possible to draw some general lessons regarding when these strategies can be profitably used.

A. Ex Ante Investment in Lowering the Cost of Contract Completion

The formal literature on incomplete contracting usually treats verifiability as a discrete variable, implicitly assuming that a contractual term is either verifiable or not. This assumption, however, is typically made for expositional purposes, not descriptive accuracy. In reality, verifiability is an endogenous function of the choices parties make in the contract. Parties can make various investments up front that will lower the cost of information *ex post*. Most obviously, they can spend more time and resources adding written terms to their agreement, though the possibilities go beyond this obvious step. A related strategy is to incorporate terms by reference to existing documents or commercial practice; this can be done in various ways and, in the context of contracts for the sale of goods, is specifically authorized by provisions of the Uniform Commercial Code. For example, U.C.C. section 2-306, which governs requirement and output contracts, directs courts to use any stated estimate provided by the parties as the basis for judging the reasonableness of quantity variations.²¹ More generally, U.C.C. section 1-102(3) empowers contracting parties to give more specific content to the general duties of care, diligence, reasonableness, and good faith that are implied in the performance of every contract.²²

Perhaps more interesting for our purposes here, however, are investment strategies that are better described as managerial rather than legal. Lawyers may not be accustomed to thinking of such strategies as being within the scope of their professional expertise. Because managerial approaches to problem solving often operate as substitutes or complements to legal ones, however, good commercial lawyers need to be familiar with their use and design.

²¹ U.C.C. § 2-306 (amended 2005).

²² U.C.C. § 1-102(3) (amended 2005).

Three examples illustrate this point. First, parties can increase their investments in record-keeping systems, such as computerized databases for tracking inventory or correspondence. Such systems make it easier to produce evidence relating to performance, either in court or in *ex post* negotiation with a counterparty, and thus, lower the chances of a dispute over the date of shipment. Second, parties can invest in systems that generate information about performance once underway, as is the case with inspection clauses that appear in most long-distance shipment contracts. Such early-warning systems allow potential difficulties to be identified while they can still be corrected or mitigated. Third, parties can invest in improving the incentives of their negotiating agents so that the agents are less motivated to shirk when forming contracts initially. Such incentives could be achieved by restructuring compensation (for example, docking a salesperson's commission following sales that generate a contractual dispute) or by assigning the job of bargaining to more senior agents whose incentives are presumably better aligned with the organization as a whole.

All these strategies have disadvantages, the up-front expense being the most obvious. Writing and negotiating an additional term incurs a certain and immediate cost that may not be justified if the contingency it covers is sufficiently remote. Restructuring systemic practices, such as record keeping or employee compensation, entails overhead costs that are less worth incurring for contracts that have low value or that are idiosyncratic in nature. But for repeat players who can amortize the costs over multiple related transactions, such investments make more sense.

B. Contracting Ex Ante Over the Methods of Ex Post Interpretation

A second and related strategy is to agree in advance that if an apparent contractual gap arises, it will be dealt with using low-cost interpretative methods. An illustrative and familiar example is provided by the classic liquidated damages clause that directs courts not to look into actual damages even if there is reason to think that the inquiry will provide a more accurate measure of the promisee's loss.

More generally, parties can limit the *ex post* costs of contract completion by including clauses that direct courts to apply relatively formal standards when interpreting the parties' contract. For example, they can attempt to prevent courts from investigating the history of their negotiations by including in their contract a so-called merger clause stating that the writing expresses their entire agreement and that all prior understandings or agreements have been merged into it.

This tactic will not prevent a sufficiently determined court from entering into such an investigation, as there are various doctrinal tools that a court can use to justify striking the merger clause. But the tactic will reduce the chances of such an inquiry because all common-law courts follow at least a liberal version of the parol evidence rule.²³ Similarly, parties to sales transactions can provide, pursuant to U.C.C. section 2-209, that any modifications to their contract must be in writing.²⁴ These types of terms reduce the likelihood that a court will inquire into oral, postcontractual communications when interpreting an agreement. Parties can also embed their agreements in the form of specialized devices, such as negotiable instruments or letters of credit that are governed by distinct bodies of law that apply a more formalist interpretive regime than does the common law of contracts generally.²⁵

Contracting parties can also opt into relatively formalistic interpretive regimes by designating the tribunal or rule of law that will hear any dispute that arises under their agreement; and again there are various ways to achieve such a result. Choice of law clauses, which direct courts to apply the substantive rules of a particular jurisdiction, are a particularly common device in this regard, as jurisdictions can vary considerably in their level of formalism.²⁶ Other possibilities include forum selection clauses, which specify a particular location where any litigation must be brought, and arbitration clauses, which require disputes to be heard in the first instance before a private rather than a public tribunal. Even when the substantive rule of interpretation is the same, differences in local legal culture, procedural and evidentiary rules, or other resource constraints may make one tribunal considerably less inclined to take an open-ended approach to gap filling than another.

²³ See Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW* 149, 167 (Jody S. Kraus & Steven D. Walt eds., 2000) (providing a survey of case law comparing common-law jurisdictions taking liberal and strict approaches to the parol evidence rule).

²⁴ U.C.C. § 2-209 (amended 2005).

²⁵ See Peter A. Alces, *An Essay on Independence, Interdependence, and the Suretyship Principle*, 1993 U. ILL. L. REV. 447, 465-76 (1993) (discussing formal interpretive regime of the law of letters of credit); Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 445-61 (1979) (discussing and also critiquing the formal interpretive regime of negotiable instrument law).

²⁶ See Scott, *supra* note 23, at 164 (pointing out that some courts apply activist interpretive methodology while others continue to utilize the restrained approach of the common law). See generally Erin Ann O'Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 VAND. L. REV. 1549, 1559 (2000) (discussing the use of choice-of-law clauses and observing that courts routinely enforce them).

Formalistic regimes of interpretation, however, have their own characteristic disadvantages.²⁷ They can introduce unnecessary risk into the parties' relationship if judges vary in their experiences with regard to commercial matters. They can encourage parties to expend extra resources in negotiation, on one hand by attempting to manipulate the formal text of the agreement in their favor, and on the other hand by attempting to prevent the counterparty from doing so. They take power to set the terms of the agreement away from sales and purchasing agents, and confer it on lawyers and other drafting agents who control the production of formal contractual documents—even when the former agents are better placed to promote overall organizational interests than the latter agents. They may make it more difficult or risky for third parties to provide complementary services, such as financing or brokerage, if such service providers find it harder to observe the details of the written contract than the contracting parties' ordinary business practices.

Balancing these rival considerations will depend on the particular circumstances, but it is still possible to draw some generalizations in this regard. For example, small and inexperienced traders are relatively less well placed to monitor the counterparty's standard-form contracts for inefficient terms. Such traders are likely to do their own contract negotiating but to contract out when acquiring legal services, and they are less likely able to spread interpretation risk over a large number of transactions. Contracting for formalistic interpretation is likely to be a relatively costly strategy for them, other things being equal. Conversely, large and experienced mercantile traders are more likely to have the ability to monitor and control the texts of their contractual documents but are less likely to have good control over far-flung sales and purchasing agents. And, given their size, these traders are likely to face more risk from biased decision-makers than they are from ordinary interpretative variance.

C. Delegating Discretion to Complete the Contract

A third strategy is to authorize one of the parties to fill in any contractual gaps that may arise during performance. For example, the proverbial "blank check" allows a seller of goods or services to choose the contract price.²⁸ Requirements contracts authorize a buyer

²⁷ See generally Katz, *supra* note 4, at 508-12 (cataloguing the stereotypical advantages and disadvantages of interpretative formalism).

²⁸ Under Article 3 of the U.C.C., an incomplete negotiable instrument that is completed in a manner authorized by the signer may be enforced according to its terms as augmented by completion. U.C.C. § 3-115 (amended 2005).

of goods to specify the contract quantity, while output contracts confer that authority upon the seller.²⁹ Option contracts empower one of the parties to elect whether the proposed exchange will be completed while satisfaction clauses provide a softer option that allows a buyer to withdraw from the exchange based on the buyer's subjective valuation of the seller's performance.³⁰

The doctrine of waiver, as applied to contractual conditions, plays a similar role. Quite often it is possible for the parties to identify some verifiable event or action that, while not of substantive importance to the value of the transaction, is correlated with some unverifiable event that is of substantive importance. The former event is, thus, useful as a proxy for the latter in the event of a dispute but can be waived if all goes well. For example, in the well-known case of *Clark v. West*,³¹ a publisher conditioned an author's royalty rate on the author's abstaining from the consumption of alcohol and although the author failed to so abstain, successfully recovered the full royalty on the grounds that the manuscript met the desired standard of quality and the publisher's agent waived the condition.³² In that case, as the majority opinion indicated, it is most likely that the publisher was interested in the author's temperance as a proxy for quality rather than for its own sake and, because there was no real dispute over quality, the proxy no longer had any separate purpose.³³

Conferring such discretion to complete the contract does not eliminate the need for ex post involvement by a court or other tribunal. It does limit the scope of such supervision, however, because the tribunal need not conduct a gap-filling inquiry from scratch. Instead, it can sit in review of the authorized party's original decision, which is likely to be a less costly enterprise.

²⁹ See *id.* § 2-306.

³⁰ See RESTATEMENT (SECOND) OF CONTRACTS § 25 (1981) ("Option Contracts"); *id.* § 45 ("Option Contract Created by Part Performance or Tender"); *id.* § 228 ("Satisfaction of the Obligor as a Condition").

³¹ 86 N.E. 1 (1908).

³² *Id.* at 5.

³³ As the court explained:

It is not a contract to write books in order that the plaintiff shall keep sober, but a contract containing a stipulation that he shall keep sober so that he may write satisfactory books. When we view the contract from this standpoint, it will readily be perceived that the particular stipulation is not the consideration for the contract, but simply one of its conditions

Id. at 3-4. A more modern (and commercially much more important) illustration of this strategy can be found in the specialized area of letters of credit in which it is apparently routine for payors to waive technical defects in presentation that, as a matter of formal legal obligation, would render a letter unenforceable. Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494, 2513 (2000); see also Avery Wiener Katz, *Informality as a Bilateral Assurance Mechanism*, 98 MICH. L. REV. 2554, 2554-55 (2000) (commenting on Mann's theoretical account of letters of credit).

This strategy has one major and obvious disadvantage—namely, discretion creates room for opportunism. For instance, under a requirements contract, a buyer may attempt to take advantage of a favorable price in a tight market by purchasing for resale or stockpiling for future use. Similarly, if the majority opinion's assessment of the situation is to be credited, the publisher in *Clark* seems to have seized on the temperance condition as an excuse for reducing its payment obligation when the exchange went sour for unrelated reasons. This risk of opportunism explains why most of these doctrines were disfavored under the traditional common law and why, under modern doctrine, the exercise of discretion is regulated by doctrines such as good faith.³⁴ But this strategy is likely to be imperfect, in that some opportunistic actions are likely to escape review because of the costs of verifying their true nature.

Accordingly, the discretion-conferring strategy will not be useful when parties cannot reasonably assess the risk of such opportunism. No one, for instance, would hand a blank check to a stranger. But, a party with an established commercial reputation can be ceded discretion at relatively low cost because the reputation serves both as a benchmark for assessing risk and as an incentive for good performance.³⁵ In addition, ceding discretion may, in some situations, be an effective way for a party credibly to signal its reliability. A retail merchant might wish to establish liberal return policies (effectively granting discretion to the buyer whether to go through with the deal) in order to signal product quality or a merchant might grant the right to demand an open-ended quantity in order to signal adequate production capacity. A debtor might wish to grant a creditor the right to accelerate the debt upon insecurity to signal a low probability of default.³⁶

³⁴ See, e.g., U.C.C. § 2-305(2) (amended 2005) (instructing that a price to be fixed by buyer or seller is to be interpreted as a price to be set in good faith); *id.* § 2-306 (noting that the quantity demanded under requirements contract or supplied-under-output contract is limited by duty of good faith); *cf.* RESTATEMENT (SECOND) OF CONTRACTS § 84(1)(a) (1981) (pointing out that the waiver doctrine is not applicable to conditions that form a material part of a contract's consideration). *But see* U.C.C. § 5-108(a) (1995) (substituting a strict compliance principle as to conditions in letters of credit for the doctrines of waiver and estoppel that would otherwise apply under law and equity under section 1-103(b)).

³⁵ See Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 633-37 (1981) (explaining how reputational incentives can substitute for state-provided legal contract enforcement).

³⁶ See, e.g., Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730, 732, 747-48 (1989) (defending acceleration clauses, as well as other creditor remedial terms, on such grounds).

D. Designing Structural Provisions That Promote Cooperation or Channel Renegotiation

Finally, as suggested in the previous Section, it is often possible to design agreements with an eye toward influencing subsequent performance or renegotiation, for if the parties can complete the contract through voluntary cooperation, then arbitration or litigation will be unnecessary. This strategy is reflected by the commonplace letter of intent or agreement to agree; it is also evidenced in the large proportion of contracts that are performed or modified without incident, notwithstanding their incompleteness.

Much contractual cooperation is motivated by the prospect of repeat business or maintaining a good commercial reputation, but it is also possible to build structures into the contract that make it more likely that cooperation will work. Here, two alternate approaches are available. The first is to allocate one side or the other a property right to block certain substitute transactions. Such rights can alter the balance of bargaining power, with the resulting effect on the anticipated bargaining range serving to limit the scope of opportunism and thus the risk to the parties' investments in their relationship. For example, a term that grants one party control rights over a critical asset, such as a brand name or customer list, makes it less attractive for the other party to breach a contract or exit the relationship. The reduced value of the exit option makes the constrained party a softer bargainer and the protected party a harder one in any renegotiation that takes place, thereby committing the former not to take advantage of the latter's contractual reliance.³⁷ Similar incentives are provided by noncompete clauses, rights of first refusal, and the like.

Conversely, a second strategy motivates cooperation by making it easy for one or both parties to exit the relationship. In this case, the threat of exit can motivate a counterparty to behave cooperatively in order to protect any relational investments he or she has made. For example, consider a buyer of goods who wishes to motivate the producer to undertake costly investments that will enhance the value of the item being exchanged, but that are unverifiable by a third party tribunal.³⁸ Because of the unverifiability problem, it is not possible for

³⁷ See Hart & Moore, *supra* note 15 (detailing a formal model demonstrating that reallocating property rights can, by altering parties' anticipated outcome from noncooperation, influence their incentives to cooperate).

³⁸ The example is based on the formal model presented by Georg Nöldeke & Klaus M. Schmidt in *Option Contracts and Renegotiation: A Solution to the Hold-Up Problem*, 26 RAND J. ECON. 163 (1995). See also Avery Wiener Katz, *The Option Element in Contracting*, 90 VA. L. REV. 2187, 2218 (2004) (explaining more generally how options can be used to promote contractual performance).

the seller to warrant the quality of investment. But, if the buyer is able to observe product quality, the exchange can be successfully concluded. To bring about such a situation, the parties only need to grant the buyer an option to buy and to set the exercise price at a high enough level that it will not be worth exercising the option unless the seller invests optimally. In this case, the seller will be motivated to invest in quality in order to make the sale and earn a profit, while the buyer will be motivated by a suitable up-front payment at the time that the option is granted.³⁹

Similar incentives can be provided through clauses that confer a right to terminate an agreement in response to unsatisfactory performance or to rescind/suspend one's own performance in the event of material breach—rights to reject nonconforming goods, to demand adequate assurances in the face of insecurity, or to declare repudiation work similarly. In each case, the threat that the contract will be ended and the relational investments will be destroyed operates to reinforce an investing party's incentives to act cooperatively.⁴⁰

Such institutional arrangements—both those that inhibit exit and those that facilitate it—can be viewed as a variant of the discretion-conferring strategy discussed in the previous Subsection. In the former case, the discretion consists of whether to assert rights to the critical asset and, in the latter, it consists of whether to maintain or end the relationship. Accordingly, all the risks of discretion apply to this strategy as well, rendering the strategy risky when the party granted the right cannot otherwise be deterred from opportunism. As before, the prospect of repeat business may be required as a countervailing incentive.⁴¹

This strategy will also be useful when verification costs are asymmetric—for example, when one party is a merchant whose behavior can be assessed by comparison to standards, such as trade usage or course of dealing, and the other is not. In this case, it will make sense to grant rights to the party whose performance is more easily measurable and, thus, enforceable.

³⁹ There are further complications that are suppressed in the text. The seller also needs to be assured that the buyer will not decline the option and then turn around and make a low-ball counteroffer that the seller, having sunk its investment, would then be unable credibly to decline. See Thomas P. Lyon & Eric Rasmusen, *Buyer-Option Contracts Restored: Renegotiation, Inefficient Threats, and the Hold-Up Problem*, 20 J.L. ECON. & ORG. 148, 161-62 (2004).

⁴⁰ Cf. George L. Priest, *Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach*, 91 HARV. L. REV. 960, 968 (1978) (analyzing the common-law perfect tender rule in such terms).

⁴¹ Cf. Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. (PAPERS & PROC.) 356, 361 (1980) (defending at-will termination clauses and similar terms as efficient responses to situations in which one party has sufficient reputational motives to act cooperatively while the other does not).

When verification costs are high on both sides, encouraging cooperation becomes a more difficult problem, yet there may still be ways to address it, depending on the circumstances. Two examples illustrate the possibilities as well as the difficulties involved in generalizing about them. First, in settings where both price and quantity are feasibly adjustable, the parties can balance the price term against the quantity term in their initial contract, in turn balancing the parties' bargaining power and promoting good bilateral investment incentives.⁴² Second, in settings where the parties' reliance investments are sequential (that is, where one side finishes investing before the other starts), then it is again possible to promote good bilateral incentives by arranging for a buyback option at the appropriate moment and at the appropriate strike price.⁴³ Given the complicated incentives created by such arrangements and their sensitivity to particular circumstances, however, it is hard to see how they could be implemented by anyone other than decentralized private decision-makers.

IV. CONCLUSION

Incomplete contracts are not just a problem for public lawmakers and adjudicators, but for the parties themselves, operating as private lawmakers in a transactional setting. There are many different legal and institutional arrangements that parties can devise to increase transactional value in the face of contractual incompleteness, but the advantages and disadvantages of these arrangements are subtle and complicated, and depend on individual circumstances in sensitive ways. Accordingly, in most instances, private actors will be much more likely to make effective use of such strategies than public officials. In our role as scholars and teachers, therefore, we can do our students and their future clients a considerable service if we spend as much time preparing them to be effective and sophisticated transac-

⁴² See Aaron S. Edlin & Stefan Reichelstein, *Holdups, Standard Breach Remedies, and Optimal Investment*, 86 AM. ECON. REV. 478, 479 (1996) ("[N]oncontingent fixed contracts can often provide efficient investment incentives by balancing 'holdup contingencies' where an investment is undercompensated against 'breach contingencies' where it is overcompensated."). For this arrangement to work, the contract must provide for a lower quantity than the parties expect to want to trade. The buyer's threat to counteroffer at a lower price is then counteracted by her desire to buy a larger quantity than originally contracted for. *Id.* at 482.

⁴³ See Aaron S. Edlin & Benjamin E. Hermalin, *Contract Renegotiation and Options in Agency Problems*, 16 J.L. ECON. & ORG. 395, 401-09 (2000) (discussing the need to set the exercise date for the option before the principal invests when renegotiation is taken into account). The buyback device works only in certain circumstances, but the authors give real-world examples that show that the assumptions of their model are realistic enough to make this a useful strategy in many common contracting situations. *Id.*

tional lawyers as we currently do preparing them for the role of judge, legislator, or other public official.