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**TAXONOMY FOR JUSTIFYING LEGAL INTERVENTION
IN AN IMPERFECT WORLD: WHAT TO DO WHEN
PARTIES HAVE NOT ACHIEVED BARGAINS OR HAVE
DRAFTED INCOMPLETE CONTRACTS**

JULIET P. KOSTRITSKY*

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* John Homer Kapp Professor of Law, Case Western University, School of Law; A.B., Harvard College, 1976; J.D., University of Wisconsin, 1980. I am indebted to my colleague, Professor Ronald J. Coffey, for valuable insights provided on this project and many others. I am grateful for the helpful comments of participants of the *Wisconsin Law Review* Symposium on *Freedom from Contract* (Feb. 6–8, 2004). I also wish to thank Professors Brian Bix, Peter M. Gerhart, Robert W. Gordon, Dale A. Nance, Robert E. Scott, and Robert N. Strassfeld for their generous comments. Errors are mine alone. Able research assistance provided by Matthew G. Rich (J.D., Case Western Reserve University School of Law, 2004). Expert computer and technical assistance provided by Eleanore Ettinger.

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INTRODUCTION

In a perfect world, contract law would not require courts to go beyond enforcement of the contract that the parties expressly agreed to; courts would not have to intervene in any other way or perform any more of an active role than to ascertain the intention of the parties and ensure that it is carried out. In a perfect world, the terms of the bargain would be in the hands of the parties; for the parties to the contract are in the best position to know how to make a perfect world even better through their exchange.

Yet we know that the world is imperfect in ways that hinder the parties' ability to achieve bargains or complete contracts. Courts may intervene in contracts by interpreting them, by filling in the terms left unspecified by the parties, and by imposing liability on parties who have not reached a bargain. When a court intervenes in these ways, the key issue is methodological: what states of our imperfect world explain and justify such judicial intervention? When can courts outperform the parties in improving welfare, and what opportunities and risks do they face when they attempt to shape the exchange in ways that the parties could not? This methodological issue is the holy grail of contract scholarship and provides a basis for understanding how contract law is shaped and how it has evolved.

Stripped to its essentials, this issue is fundamental to all of law; it is the question faced by courts and legislatures whenever they intervene by adopting or revising any common-law rule if the effect is to provide terms that are not explicitly agreed to by the parties. Whether a court awards a property right, allocates a loss under tort law, imposes a particular liability rule in contract law,¹ or supplies terms in incomplete contracts,² the issue is a methodological one of when and how courts should intervene.³

1. Thus, the court "intervenes" when it provides expectation damages for a contract breach since those remedial terms were not explicitly agreed to by the parties or when it imposes liability to govern precontractual negotiation obligations.

2. See Richard E. Speidel, Restatement Second: *Omitted Terms and Contract Method*, 67 CORNELL L. REV. 785, 803 (1982).

3. This Article will use "interventions" in the sense that institutional, financial, and behavioral economics use it: "adding to or subtracting from what, realistically (that is, giving the express terms their ordinary meaning), parties have said explicitly in their arrangement." E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Feb. 17, 2003) [hereinafter Coffey e-mail (Feb. 17, 2003)] (on file with author).

The subject of this Symposium, *Freedom from Contract*, also raises methodological issues of legal intervention. In answering the question of how free parties are to negotiate without contractual consequences and when the parties' exercise of the freedom to contract should be respected, the "freedoms" should be considered together. Viewing them as separate freedoms (freedom *not* to contract versus freedom *to* contract) will impair an instrumental understanding of contractual freedom.

Resolving the scope of the freedom to or not to contract really poses the question of whether courts should intervene by adding terms or imposing liability rules when parties have not used the orthodox signals for manifesting consent, even if that approach results in more instances of contract liability.

Thus far, most accounts examining the legal intervention question have analyzed the issue by examining the relative capacity of the parties or the courts to acquire information about future events and states of the world in the context of adding terms to a contract.⁴ One strand of the dominant scholarship has emphasized the costs and difficulty that the parties have in fully specifying their intentions. Within this tradition, judicial intervention is justified because it saves the parties the transaction costs of bargaining over terms that are unknowable or expensive to ascertain and negotiate *ex ante*.

That meaning of legal intervention in the sense of adding terms not explicitly agreed on is to be distinguished from the ordinary meaning of courts intervening only when asked to do so by one of the parties. *Id.* (stating that "they do not 'intervene' (normally) in the sense of officiously poking their noses, unmasked into settling controversies"). The party-based call for legal intervention, usually initiated by a lawsuit, does not necessarily involve the court in legal intervention in the sense of adding to or subtracting from terms if the agreement is complete and unambiguous.

Of course, the particular methodological justifications for intervention will differ in the context of torts and contracts, for example, since "the structure and content of explanatory justifications of interventions (or abstentions therefrom) may be dependent on whether a dispute is within the contemplation of precontroversy, assent-originated relationships or whether instead, the conflict arises in the externalities setting where actors have not, before the dispute-causing conduct, bargained over the matter in controversy." Ronald J. Coffey, *Methodological Perspective 1–2* (2002) (unpublished manuscript, on file with author). For a trenchant analysis of when and on what basis courts should intervene in the torts context, see generally Peter M. Gerhart, *Tort Duty to Protect Others: A Synthesis* (unpublished manuscript, on file with author). Once this broad understanding of legal intervention is understood, one can conclude that "there is no 'non-interventionist' option ever." E-mail from Robert W. Gordon, Professor of Law, Yale Law School, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Feb. 14, 2003) [hereinafter Gordon e-mail (Feb. 14, 2003)] (on file with the author).

4. Recent commentators have emphasized the need to explicitly confront a different source of uncertainty involving behavior. There is a distinction drawn between the failure of contracts to completely account for external states of the world and for parties' behaviors. See, e.g., Pierpaolo Battigalli & Giovanni Maggi, *Rigidity, Discretion, and the Costs of Writing Contracts*, 92 AMER. ECON. REV. 798, 799 (2002).

Another strand of the literature, represented by the new formalists, emphasizes the difficulties associated with terms that depend on unobservable or unverifiable information. This approach suggests that while *ex ante* there is uncertainty about the future state of the world, and parties therefore “must write a contract that measures performance based on an incomplete specification of future circumstances,”⁵ courts should be modest about intervening. They should not do so if it would contravene the parties’ own intentions not to solve an *ex ante* uncertainty problem with a solution or term that depends on unobservable or unverifiable information. Relying on the implicit assumption that many law-supplied rules and interventions are misguided because they depend on courts supplying terms that depend on types of information that are either unverifiable or unobservable, they eschew law-supplied rules and advocate a return to plain-meaning contract interpretation.⁶

Each strand of the literature contains rich and valid points. Neither one, however, provides a complete understanding of when and why courts should intervene to supply terms or liability rules or of how precisely such intervention would advance or hinder the parties’ welfare when certain factors such as uncertainty, opportunism, and sunk costs are present. Thus, they cannot resolve whether intervention, with its concomitant reduction in freedom from contract, advances welfare or not. Each strand seems to focus on uncertainty about the future state of the world or nature that afflicts the parties. The first approach, the hypothetical bargain, assumes that while parties often lack needed information to negotiate a complete contract, the courts can supply the information needed to maximize the joint gains for the parties by hypothesizing the bargain that the parties would have reached under ideal conditions without the informational deficits. The hypothetical bargain advocates assume that judicial intervention will increase the parties’ welfare despite the relatively narrower scope of the freedom not to contract.

The competing methodology of the new formalists assumes that the information problem should not be solved by courts because doing so would involve the court in supplying terms *ex post* that the parties themselves would not have agreed to *ex ante* due to its inaccessible nature. Such an intervention would lead to reversal costs in the future as parties attempted to opt out of such rules that ignored the parties’ own

5. E-mail from Robert E. Scott, Professor of Law, University of Virginia School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Feb. 11, 2004) [hereinafter Scott e-mail (Feb. 11, 2004)] (on file with author).

6. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 550 (2003) (embracing a default approach based on “textualist” interpretation). Sometimes this refusal results in freedom from contract liability by increasing the number of unenforceable contracts.

preferences. Courts themselves should therefore not supply rules that depend on verifying information about what state of world has developed.⁷ Consequently, they argue that courts should generally decline to intervene with law-supplied default rules as they will be “useless or inefficient.”⁸ They view the increased willingness of courts to intervene with terms and the concomitant reduction in the freedom not to contract as detrimental to the parties’ welfare.

This Article develops a model of legal intervention that focuses on structural barriers that make it difficult for parties to solve a key problem of contracting: opportunism. The uncertainty of anticipating the particular ways in which parties have a “propensity to diverge”⁹ or to act opportunistically explains why parties are not able to achieve fully contingent contracts to control such behaviors. To date, the full implications of this type of uncertainty about parties’ behavior (behavioral uncertainty) have not been sufficiently incorporated into models assessing legal intervention nor into models demarcating the appropriate realms for freedom from contract and freedom to contract.

Were it not for uncertainty about the likelihood of and propensity for opportunistic behavior by a party, the parties could fully solve and control by contract the propensity of parties to be opportunistic. Absent uncertainty, there would be complete knowledge about the probability of opportunism and the myriad forms it would take. “There could be no asymmetry and opportunism would be known and adequately dealt with by an explicit, fully contingent contract.”¹⁰ However, because of uncertainty about the types of behavior affecting one’s counterparty and because of bounded rationality and cost issues, parties do not effectively deal with opportunism by contract.

The parties’ inability to deal with the behavioral uncertainty problem issue by explicit contract may pose particular problems when parties invest sunk costs that are nonrecoverable. Absent sunk costs, parties could easily arrange an alternative exchange, and a contract would not be

7. It is a new formalism because it is based on instrumental justifications. Traditional formalism lacked an instrumental focus; its proponents tended “to deduce rules from first principles that characterized classical formalism as practiced by the late-19th century Langdellians.” Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. REV. 847, 851 n.11 (2000) [hereinafter Scott, *Formalism*].

8. Schwartz & Scott, *supra* note 6, at 594.

9. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (May 2, 1996) [hereinafter Coffey e-mail (May 2, 1996)] (on file with author).

10. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University Law School, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University Law School, (June 10, 2003) [hereinafter Coffey e-mail (June 10, 2003)] (on file with author); see also OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* § 2.2, at 56–59 (1985) [hereinafter WILLIAMSON, *CAPITALISM*].

necessary. However, the presence of sunk costs and the behavioral uncertainties make it important to find some means of controlling opportunism, because the consequence of not dealing with it is the loss of an investment.

Where parties have invested sunk costs and cannot readily sell the investment, there is opportunism, and it is uncertain *ex ante* what the probabilities are about the likelihood that one party may act opportunistically. Parties may not be able to devise contract terms that control such opportunism. Yet the possibility of such opportunistic behavior limits the value of exchange by raising the risks for the other party. If such opportunistic behavior is not controlled, some deals that could have improved welfare will not be made and other deals will have benefits reduced from the levels that might have otherwise been achieved.¹¹

As a result, it is in the interests of the parties and of society to successfully control such opportunistic behavior. When parties succeed, they are better off; the gains from exchange increase and the benefits of exchange to society are maximized.

Often, the parties are able to deal with opportunistic behavior without court intervention.¹² When the parties are able to structure their relationships to reduce opportunistic behavior, they improve gains from trade on their own. Thus, there is reason to respect the parties' contractual choices. The parties may rely on nonlegal sanctions to curb opportunistic behavior. In such cases, the need for legal intervention may be reduced.

Legal intervention may be called for, however, when the sunk costs—uncertainty about the likelihood of and the presence of opportunistic behavior—are present and the parties' costs of reducing opportunism on their own are more costly than a judicial alternative.¹³

11. These losses amount to deadweight losses. See ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* 172 (1991).

12. For a discussion of how trust may sometimes curb opportunistic behavior but only when the payoff is low enough, see Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 115–16 (2000).

13. Courts might merely supplement private devices as when courts enforce trade usages that reduce opportunism. In other instances, courts more broadly may intervene by supplying terms or liability rules. If intervention is called for, the parties' freedom not to contract may be reduced.

The problem with treating freedom as an intrinsic goal is that it is often used to set up the dichotomy that you seek to avoid—to set up the kind of ultimacy that seems to trump most other goals or that can only be trumped by dichotomous goals. That is, one might say that freedom from contract has intrinsic value—that is an ultimacy—that can . . . only be invaded in order to reach some other value—some other ultimacy. That is a common form of legal argument but runs into the objection that . . . no intrinsic value is

One must approach the issue of legal intervention in incomplete contracts from a broad perspective and must articulate a general theory of judicial intervention in a way that can resolve issues from the general to the particular, from the law's decision to supply performance obligations, formulate the good-faith doctrine, and add particular terms. Courts must consider whether a particular intervention will achieve certain instrumental goals, such as an increase in social welfare, given general assumptions as to how parties behave on average.¹⁴

Judicial intervention allows parties to reduce the risk and facilitate exchanges where sunk costs may be high, opportunistic behavior is a risk and there is uncertainty about the likelihood of opportunism. Parties can then enter into bargains with the assurance that they can call on the court to intervene if opportunistic behavior occurs. That knowledge improves the welfare of both parties and of society as a whole.

The guiding principle for legal intervention is thus whether the law can increase gains from trade by overcoming barriers that prevent the parties from devising complete contracts to control opportunism in advance on their own.¹⁵ Courts should decide whether legal intervention will increase gains from trade by projecting what consequences, both *ex ante* and *ex post*, legal intervention will produce.¹⁶

Naturally, even when judicial intervention is justified under the behavioral uncertainty, sunk cost, and opportunism rationale, courts must be sensitive to the difficulty of such intervention and the institutional factors that make such intervention costly. Courts must also consider the possibility that a default rule policing opportunism by one party could actually increase opportunism by the other party in future cases.¹⁷ The courts must therefore consider the information dynamics that affect intervention strategies, and the possibilities of counteropportunism, but they may find those considerations outweighed by the substantive value of the intervention for increasing gains from trade.

The Article proceeds as follows. Part I examines the role of contract law in private exchange. Part II summarizes the existing literature on

absolute. The problem with arguing from ultimacies is that the analytical framework for knowing when intrinsic values sacrificed for other values is generally poorly worked out.

E-mail from Peter M. Gerhart, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Apr. 30, 2004).

14. The formalists have neglected to consider the characteristics that are common to individuals by focusing exclusively on the heterogeneity of parties. See Scott, *Formalism*, *supra* note 7, at 848.

15. Coffey e-mail (May 2, 1996), *supra* note 9. I will not revisit the issue of whether maximizing welfare is an appropriate goal for contract law in this Article.

16. Coffey e-mail (Feb. 17, 2003), *supra* note 3.

17. Scott e-mail (Feb. 11, 2004), *supra* note 5.

court-supplied terms. The arguments for and against intervention turn on the comparative ability of the parties (and the court) to get the information they need to improve the exchange. Part III shows how this information-driven account of intervention is incomplete because it focuses on particular solutions to the *ex ante* uncertainty problem that are themselves fraught with difficulties. Part III focuses on the fact of uncertainties about the state of the world and about one's counterparty (involving both the adverse-selection problem and the moral-hazard problem) and then explains how parties or courts might seek to mitigate the effects of costs of opportunism and maximize joint surplus by a variety of strategies. The Section looks broadly at an array of solutions to the *ex ante* uncertainty problem given the behavioral uncertainties that can also impair the profitability of exchange in incomplete contracts. Part IV assesses nonlegal strategies for dealing with such behavior, for those nonlegal strategies may make judicial intervention less pressing and therefore less justified. A rigorous comparative analysis of legal and nonlegal sanctions, including commercial norms and alternative private strategies, is needed to determine whether parties could solve their problems and constrain behavior by private means (whether contractual or otherwise) or whether legal intervention would be justified as the most efficient solution to certain contractual problems. Part V shows how courts can combine the insights about information deficiencies and sunk cost attributes to develop a coherent and welfare-improving methodology of intervention to supply terms and liability rules in the context of precontractual negotiations. Part VI explores the implications of the framework for supplying liability rules or terms in the preliminary negotiation setting, Section 45 option contracts¹⁸ and the subcontracting context. Part VII of the Article suggests several constituent factors to help determine when legal intervention is justified.

I. THE ROLE OF CONTRACT LAW, CONSENT, AND WELFARE PROMOTION IN PRIVATE EXCHANGE

To understand the justification for the law's intervening with liability rules or terms in incomplete contracts, it is first important to understand how a need for a law of contract arose to mediate what are essentially private exchanges.

When parties exchange items simultaneously, the need for contract law is slight.¹⁹ The need for a system to mediate exchanges²⁰ between

18. Section 45 option contracts make offers irrevocable upon part performance by the offeree. See RESTATEMENT (SECOND) OF CONTRACTS § 45 (1981).

19. "[I]f all transactions took place instantaneously, as in the case of an everyday retail purchase, the need for enforcement rules would be slight." MARVIN A. CHIRELSTEIN, CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS 3 (3d ed. 1998).

private parties arises when parties exchange goods or services on a nonsimultaneous basis. The party delaying performance may offer a promise of future performance. Contract law then becomes important; it lends state sanction to the enforcement of private promises.²¹

The justification for contract law rests on the assent of the parties. Contract facilitates autonomy²² by enforcing duties voluntarily assumed by the parties.²³ It is a key means by which the state intervenes to “facilitate . . . human freedom.”²⁴

The enforcement of contract law also promotes efficient exchanges and gains from trade.²⁵ Without the threat of a sanction for breach, the parties might avoid a contract altogether.²⁶ Equally important, the

20. Oliver Hart & Bengt Holmstrom, *The Theory of Contracts*, in *ADVANCES IN ECONOMIC THEORY*, FIFTH WORLD CONGRESS 71 (Truman F. Bewley ed., 1987).

21. State enforcement of contracts encourages beneficial reliance in which parties rely in advance of the contractual performance date because they are secure that their reliance will be protected. Were state sanctions not offered, parties would be reluctant to rely in advance of the performance date even when it was more efficient or advantageous to take steps in advance of that time. Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 *YALE L.J.* 1261, 1277–78 (1980). Of course, enforcement of promises may also cause detrimental effects as enforcement may cause parties to curtail their promising in order to avoid liability. *Id.* at 1265. Contract law must carefully weigh these effects to “provide[] the optimal balance between the beneficial and harmful effects of promising.” *Id.*

22. Theories of contract law that emphasize autonomy and moral issues associated with consent are referred to as “deontological.” See, e.g., Jody Kraus, *The Methodological Commitments of Contract Law* 82 (Univ. of Va. Sch. of Law, Law & Econ. Research Paper Series, Working Paper No. 01-2, 2001), available at http://papers.ssrn.com/paper.taf?abstract_id=269975 (on file with author). Autonomy concerns play a central role in the contract theories of Charles Fried but will not be a focus of this Article. E.g., CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 2 (1981); see also AMARTYA SEN, *DEVELOPMENT AS FREEDOM* 4, 17, 60–63 (1999) (focusing on the core value of freedom as a way of bridging the utilitarian, consequentialist, and rights approaches).

23. As Professor Jules Coleman points out, parties’ consent to a private agreement does not mean that “they have agreed thereby to have their obligations to one another enforced by the state (or by any other third party).” Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 *HARV. J.L. & PUB. POL’Y* 639, 639–40 (1989).

24. *Id.* at 639. Coleman refers to H.L.A. Hart’s distinction between different types of law: those which “facilitate as well as constrain human freedom Primary rules impose obligations and thereby constrain behavior. Secondary rules empower individuals to create relations that confer rights and impose duties. Thus, the criminal law constrains individual liberty; the law of contracts enhances it.” *Id.* (footnotes omitted).

25. Parties “engage in trading one thing for another . . . up to the point where such activity produces no further *mutual* advantage.” CHIRELSTEIN, *supra* note 19, at 2.

26. Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 *Nw. U. L. REV.* 749, 759 (2000) (discussing neoclassical assumptions underlying legal sanctions and their effects on contract formation and investment but suggesting legal sanctions do not achieve these positive effects because “courts are radically incompetent”).

assurance of a sanction and the prospect of a remedy encourage both parties to invest in a contract.²⁷

27. As Posner posits, “[w]ith this assurance, Seller has the proper incentive to invest in the customized widget, and Buyer has the proper incentive to invest in anticipation of delivery.” *Id.*; see also Avery Katz, *When Should An Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 *YALE L.J.* 1249, 1267 (1996).

Concern about providing proper incentives extends to the precontractual period as well. See Avery Wiener Katz, *Contract Formation and Interpretation*, in 1 *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 425, 427–28 (Peter Newman ed., 1998); see also Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 *STAN. L. REV.* 481, 491–94 (1996); Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 *HASTINGS L.J.* 621, 680–81 (1993) (examining importance of providing liability default rule in precontractual context to encourage investment).

II. INCOMPLETE CONTRACTS AND THE ARGUMENTS FOR AND AGAINST
JUDICIAL INTERVENTION BASED ON THE FEASIBLE SOLUTIONS TO
INFORMATIONAL DEFICITS

A. *Ignoring Informational Deficits*

The role for contract law outlined above presents little controversy. The court simply gives effect to the terms expressly agreed upon by the parties and in so doing simultaneously facilitates both autonomy and efficiency goals. However, because the world is imperfect, there are significant obstacles to the parties achieving complete bargained-for contracts that are fully specified.

Early courts and commentators ignored the problem of incompleteness in contracting in ways that had various implications for what role a court should play in intervening with terms not expressly agreed to.

Contract law avoided directly grappling with the methodology underlying judicial intervention in incomplete contracts. Courts were not concerned with why contracts might be incomplete, and their response was simple. Courts purportedly declined to complete contracts for the parties²⁸ because they assumed that court-supplied terms would violate the central premise of contract law—that only contracts voluntarily assented to by the parties should be enforced.²⁹

Limiting judicial enforcement to the privately agreed-upon terms could be justified on moral grounds and contractual intent. The parties' explicit consent provided evidence of intention and a moral basis for enforcement.³⁰

Neoclassical economics similarly ignored any barriers to contractual completeness. It unrealistically assumed that the contracts entered into by the parties would be complete and efficient³¹ because they posited an

28. See E. ALLAN FARNSWORTH, 1 FARNSWORTH ON CONTRACTS §§ 3.27–.29 (2d ed. 1998). However, the reality was quite otherwise since “if the terms aren’t specified, and they often are not, the court has to put them in—expectation damages, what is a ‘reasonable time’ for delivery, whether a party has ‘substantially performed.’” Gordon e-mail (Feb. 14, 2003), *supra* note 3.

29. Law-and-economics scholars face this difficulty when they attempt to provide a rationale providing for terms that parties would have agreed to. Coleman et al., *supra* note 23, at 639–40.

30. Without express terms, there was no guarantee that terms supplied by a court would reflect the parties' contractual intent and thus, such terms would lack moral force under autonomy principles.

31. “The outer limits of hyperrationality reasoning are reached by the Arrow-Debreu model of comprehensive contracting, according to which contracts for all goods and services across all future contingencies are made among all agents at the outset.” OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 8 n.4 (1996) [hereinafter WILLIAMSON, MECHANISMS].

idealized world of no transaction costs.³² In this world, contracting parties would foresee all possible future contingencies³³ regarding the future state of the world affecting the payoff from the contract and completely provide for them.³⁴ The contract price would reflect and account for different future events and states of the world, and the parties' contracts would thereby maximize gains from trade. These neoclassical economists assumed that "complete contracting is both feasible and desirable."³⁵ Such assumptions fostered the conclusion that it was unnecessary for courts to intervene.

A complete contract in the context of the sale of goods would tailor the price the seller would charge according to differing states of the seller's costs that were actually realized.³⁶ A low cost would trigger a lower price charged to the buyer; a higher cost would force the buyer to pay a higher price. In an ideal world, the parties could envision and anticipate each state of the world that could materialize and provide a tailored payoff amount for it. The court could simply enforce the agreed-upon contract.

Complete contracts are Pareto efficient³⁷ and obviate the need for judicial intervention. Efficient contracts are "self-enforcing"³⁸ because

32. The possibility of a complete contract was more realistic in a simple, one-shot transaction where it was not necessary to anticipate events occurring over a long period of time. The realization that such one-shot transactions are relatively rare in certain economies can be traced to Professor Ian Macneil's work. See, e.g., Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 856–57 (1978); see also Jay M. Feinman, *Relational Contract Theory in Context: Unanswered Questions*, 94 NW. U. L. REV. 737, 737 ("Symposium, commemorating Ian Macneil's four decades as a contract law teacher and scholar . . .").

33. "A contract is said to be *complete* if the list of conditions on which actions are based is exhaustive, that is, if the contract provides explicitly for all possible conditions." Steven Shavell, *Contracts*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW *supra* note 27, at 436. "In the economics literature, a contract is complete when it differentiates among all relevant future states of the world, and a third party, such as a court, can verify, when necessary, which state has occurred." Eggleston et al., *supra* note 12, at 100.

34. Eggleston et al., *supra* note 12, at 103.

35. George M. Cohen, *Implied Terms and Interpretation in Contract Law: The Law and Economics Approach*, in 3 ENCYCLOPEDIA OF LAW & ECONOMICS: THE REGULATION OF CONTRACTS 78, 82 (Boudewijn Bouckaert & Gerrit De Geest eds., 1999), available at <http://encyclo.findlaw.com/4400book.pdf> [hereinafter Cohen, *Implied Terms*].

36. Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Contracts and Judicial Strategies*, 21 J. LEGAL STUD. 271, 283 [hereinafter Schwartz, *Relational Contracts*].

37. "One state of affairs is a Pareto improvement over another if at least one person benefits from the change and no one is hurt." Daniel A. Farber, *Economic Efficiency and the Ex Ante Perspective*, in THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 54, 58 (Jody S. Kraus & Steven D. Walt eds., 2000). The complete contract would be considered optimal because by carefully graduating the

once a Pareto-optimal contract has been achieved, presumably neither party would want to “defect” from such an arrangement since the contract would benefit both parties.³⁹

B. Informational Deficits Recognized

Because parties cannot predict uncertain future events or states of the world,⁴⁰ *ex ante*, they lack information needed for complete contracts,⁴¹ especially in long-term relational contracts.⁴² Consequently, parties cannot realistically achieve complete contracts, and many contracts remain inefficiently incomplete.⁴³ For example, parties may lack the foresight to anticipate what quantities will be needed several years hence⁴⁴ and so they leave the quantity term open and at the same time they delegate discretion to the buyer to determine its requirements. The lack of completeness in long-term contracts raises the question of whether and when a court should seek to complete a contract for the parties.⁴⁵

payoffs to the possible different states of the world, the parties would have “assign[ed] obligations efficiently across all possible future states.” Eggleston et al., *supra* note 12, at 103.

38. Coleman et al., *supra* note 23, at 640; *see also* Bernard Black & Reiner Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1912, 1912 (1996) (discussing elements of self-enforcing corporate structures which permit “outside shareholders to protect themselves from insider opportunism with minimal resort to legal authority”).

39. Coleman et al., *supra* note 23, at 640 (“A fully specified contract is also an equilibrium . . .”).

40. “We cannot know the future (at any cost) and some of the present (at costs that are equal to benefits) . . .” E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostriksky, Professor of Law, Case Western Reserve University School of Law (June 30, 2003) [hereinafter Coffey, e-mail (June 30, 2003)].

41. Informational constraints include bounded rationality and asymmetries of information.

42. Recognition that long-term relational contracts pose particular problems in contracting rests on the assumption that parties cannot “allocate future obligations and payments in a way that maximizes the value of their contract.” Posner, *supra* note 26, at 751. Early recognition of the peculiar characteristics of relational contracts and the difficulties that they posed for contracting can be traced to Macneil. *See supra* note 32.

43. For example, while it might be more efficient to condition the price of a good and tailor it to the yet to be realized demand, the contract is likely to remain undifferentiated. Schwartz, *Relational Contracts*, *supra* note 36, at 272.

44. *Id.* at 295 (explaining that future demand is uncertain since it “is partly a function of economic factors that can vary with time”).

45. Of course, it would still be possible to treat these incomplete contracts as obviating any need for court intervention, as economists did. They could read the contract’s failure to address the contingency as meaning that the obligation was absolute, or they could choose to treat the failure to cover the contingency as providing a total “absence of legal consequence in the event the contingency materializes.” Gillian K.

The different ways that scholars have analyzed the completeness issue provide important elements for understanding how courts should analyze the need for judicial intervention. The first step for a court is to decide whether a contract is complete. Parties could include a clause, lessening the burden on the court. The parties could state that the legal obligations and rights of the parties stated in the contract would continue to apply no matter what state of the world actually materialized. An example of such a “catchall clause” might state “[t]he price term will be x, and will apply regardless of any change in circumstances or conduct by either party.”⁴⁶ If parties include such a clause, they are contracting in the face of contractual uncertainty and deciding to take a risk to adhere to their original contractual obligations no matter what state of the world materializes. Judicial intervention—in the sense of adding terms for the parties—in such cases would be unnecessary because the court would apply the extant terms of the contract in all states of the world, regardless of any hardship it caused.

Since parties, however, often do not state unequivocally that the contract obligations would apply in all circumstances,⁴⁷ courts must decide whether a contract that fails to address certain events specifically is complete or whether the failure renders the contract incomplete.⁴⁸ If a contract has a clause requiring delivery by a seller at a fixed price, the court must decide if the price terms apply in all states of the world. Exogenous events may make it difficult or impossible for a party to perform. Government regulations, embargoes, or strikes (or the closing of a canal) might all relate to the uncertainty of events in the future and affect a party’s ability to perform its contractual obligations, yet the contract might be silent on how such events affect the parties’ contract obligations.

If a court interprets a contract with a price term (seemingly complete) to obligate the buyer to buy at that price in all states of the world, then the court, in effect, decides that the contract is complete. If a court takes the opposite approach and refuses to enforce the price term in a particular state of the world, then the court has decided the contract has incompletely dealt with a state of the world which has materialized.⁴⁹

Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159, 160 (1994).

46. Cohen, *Implied Terms*, *supra* note 35, at 80 (discussing catchall phrases).

47. *Id.*

48. Under one view, the contract is one in which the parties “unavoidably fail to include terms that the parties would prefer to include . . .” Hadfield, *supra* note 45, at 161. Courts sometimes hide their “choice” behind “rhetorical strategies” which “conceal the existence of this discretion.” Schwartz, *Relational Contracts*, *supra* note 36, at 273.

49. Schwartz, *Relational Contracts*, *supra* note 36, at 273 (“A court that wants to excuse the buyer will supply a term and stress the parties’ failure to consider the situation at hand . . .”).

A contract may be incomplete in the sense that the parties fail to provide for a term and leave a literal gap.⁵⁰ Parties may fail to agree on a price of the goods to be delivered under a sales contract or they may fail to agree on the quantity.

Many instances of contractual incompleteness derive from the parties' inability to predict future states of the world or the costs of ascertaining the uncertain future. Because of those cognitive limitations, the parties may fail to provide for different payoffs contingent on different future states of the world.⁵¹ The world is complicated, uncertain, and there are many possible future states of the world, and a contract may fail to account for such differing states.⁵²

Contracts thus remain incomplete and coarsely partitioned for cost considerations.⁵³ Parties must weigh the costs of writing a provision against the private gains to the parties in providing specifically for the contingencies.⁵⁴ This may be referred to subsequently as the "budget constraint."⁵⁵ Although there has been a shift toward a greater recognition of the fact of incompleteness, the accounts so far have focused too narrowly on informational impediments that affect the parties either in the *ex ante* phase of contracting, or on the particular problems of observability or verifiability that may affect the parties' ability to deal with the *ex ante* uncertainty by postponing the identification of the contours of performance until the state of the world has actually materialized. Under certain circumstances, the parties' ability to get around the *ex ante* contracting difficulties and devise solutions to the *ex ante* uncertainty problem are themselves beset with problems. For example, as Hart and Moore explain, it may be difficult to specify in advance the investment that one party should make.⁵⁶ Even if one

50. *Id.* at 272.

51. Eggleston et al., *supra* note 12, at 91. "In practice, however, many contracts are quite simple. They divide the future into very crude partitions; they provide for constant or close to constant payments across different outcomes; and the terms are easy to understand." *Id.* They are "insufficiently state-contingent." Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 92 n.29 (1989).

52. Such a contract is incomplete because it "partitions future states or potential contracting partners too coarsely." Schwartz, *Relational Contracts*, *supra* note 36, at 272 (internal quotations omitted).

53. OLIVER D. HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 23 (1995).

54. Of course, in some instances the gain to the parties of drafting a provision will be low as "when there are a large number of low-probability contingencies that could affect the value of contractual performance, and the efficient response to those contingencies vary greatly and so cannot easily be specified in advance." Cohen, *Implied Terms*, *supra* note 35, at 81.

55. Coffey e-mail (May 2, 1996), *supra* note 9.

56. See Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 *REV. ECON. STUD.* 115, 115, 121 (1999).

postpones the investment aspect of the contract until later on when circumstances that affect the specialized investment have materialized, it may be difficult to verify that the specialized investment has in fact occurred.

Although it is important to understand that verifiability problems might cause parties to avoid particular solutions to *ex ante* uncertainty problems that depend on verifying inaccessible information, a key insight that has been somewhat neglected is that at the heart of many contracting problems is opportunism. The new formalists stress the impediments that parties face in contracting in an uncertain world. They stress the fact that parties who are confronted with such uncertainties about the future state of the world will look for other ways to “measure performance based on an incomplete specification of the future circumstances.”⁵⁷ What is evident to the architects of the new formalism is that parties striving to come up with ways to measure whether the parties have performed their obligations devised under *ex ante* uncertainty will avoid variables that are themselves unverifiable or unobservable. For that reason, courts should also avoid solutions that involve such unknowable variables.

While it is helpful to understand particular solutions that parties will avoid—and that, therefore, courts should as well—to deal with the problems of obligations crafted in an uncertain world, it is also important to realize that when parties do encounter these uncertainties about the future, particularly uncertainties about behavior, the parties will have an incentive to control opportunistic behavior. The parties themselves may craft solutions to the problem or the courts may do so. Presumably, the preferred solution is the one that solves the problem at the least cost in the sense that it has the lowest combination of losses from the opportunism and the preventive costs undertaken to reduce the losses from uncontrolled opportunism. Parties may decide that they can deal with uncertainty about the future by postponing decisions that will be affected by yet-to-materialize events until a future point in time. The party who will be investing resources (seller) will be afforded an option at the later point in time to present a take-it-or-leave-it offer to the noninvesting party (buyer). Then, even if the events are nonverifiable, if they are observable to the affected parties, then the option device may give the seller the correct incentive to invest. In these imagined option scenarios, there must be a commitment not to renegotiate or the parties will lack the correct incentive to invest. The option device gives the parties the ability to overcome *ex ante* uncertainty by postponing decisions until a later point in time. This option, however, may only work if there is no ability to renegotiate.⁵⁸

57. Scott e-mail (Feb. 11, 2004), *supra* note 5.

58. See *infra* note 192.

Incomplete contracts present a particular challenge for courts. Unlike the situation of a complete contract where the parties' agreement provides tangible evidence of a value-maximizing trade, the incomplete contract leaves courts in a quandary about what role they should play. It is not clear which strategy, one of nonintervention or of judicial intervention to complete the contract, will best maximize the parties' welfare and gains from trade,⁵⁹ assuming the efficiency rationale for contract enforcement.

The second major cause of contractual incompleteness stems from behavioral uncertainty or strategic behavior.⁶⁰ This uncertainty stems not from uncertainty about what states of the world will materialize but about how parties will act in withholding information *ex ante* about their past and in withholding information about the one's proclivities for opportunistic behavior.⁶¹ Any party seeking to negotiate a favorable price may choose to withhold damaging information about himself and the risks he poses.⁶² Even though disclosure would result in efficiencies and permit the counterparty to take efficient precautions to deal accurately with the risks of the contract relationship, the party with damaging information will conceal it. The resulting contract will not differentiate between different types of transactors posing different risks. Uncertainty about performance can also arise if the party requesting performance cannot observe how much the performer (the agent) has diverged from an ideal standard of performance. That is the moral hazard problem.

Uncertainties surrounding the parties' potential for behaving opportunistically, especially if one or both parties has invested sunk costs and the contract remains incomplete, have been neglected. The verifiability and observability problems may impact the parties' ability to solve certain problems in particular ways, but the focus should remain on imagining the various ways that parties can solve problems and achieve their goals, given certain endemic uncertainty problems, and on how judicial interventions would compare to private solutions in solving parties' problems.

59. For a thoughtful analysis of the variety of approaches that could be used to maximize welfare using a hypothetical bargain standard, see David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1820–23 (1991) [hereinafter Charny, *Hypothetical Bargains*].

60. WILLIAMSON, CAPITALISM, *supra* note 10, at 57–58.

61. This is the “adverse selection” problem and is often used to refer to the propensity of insureds to conceal damaging information about themselves to insurers. See *id.* at 47.

62. The famous *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854), case on consequential damages also illustrates strategic withholding of information as the miller with the potential for higher damages would prefer not to disclose that information in order to get a “subsidized” lower shipping price. See Ayres & Gertner, *supra* note 51, at 101–03.

Because parties cannot anticipate the myriad ways in which opportunism will occur over the course of a contract, providing specific contract provisions to control such behavior may be costly and difficult to specify, so the contract remains incomplete.⁶³ The opposite is also true. If there were no uncertainty about one's counterparty's "propensity to diverge," a contract could effectively control for all possible manifestations of the opportunistic tendency.

Concerns about strategic behavior contribute to incompleteness in contract terms.⁶⁴ In the example discussed above, the seller may refuse to agree to a more complete contract with a more complex pricing scheme because doing so would facilitate strategic behavior by the buyer. If the price the buyer paid depended on the state of demand being low or high, the buyer might falsely and strategically claim that he should pay a low price because of low demand.⁶⁵ Because the seller would not wish to subject itself to such strategic opportunism, contracts would set a fixed price and thus incompletely take account of the state of demand.⁶⁶

Sometimes the two types of uncertainty—about the future state of the world and about the propensity for opportunism—can both affect the negotiation of a contract and the degree of completeness that is achieved. The following example is illustrative. In a hypothetical sales contract, the contract could be fixed so that a seller offers a buyer (a wholesaler) only one price, though the worth of the goods to the buyer depends on market demand that could be high or low.⁶⁷ The buyer might prefer to have price terms not only for the present state of demand but also alternative pricing to meet changes in the market demand. Presumably, the more complex pricing scheme would enhance efficiency. Ideally, the contract should set a lower price for the buyer if the demand is low and, if the demand is low enough, the contract should excuse the buyer's obligation.⁶⁸ In the typical case, however, the contract will often have only one fixed price.

63. WILLIAMSON, *CAPITALISM*, *supra* note 10, at 58–59; *see also* Battigalli & Maggi, *supra* note 4, at 811 (discussing “all the possible ways that each party can take advantage of the other, so that these actions can be prohibited by the contract”).

This problem of opportunism may also arise in precontractual negotiations. *See* text accompanying *infra* notes 219–20.

64. *See* Hadfield, *supra* note 45, at 159 (identifying “strategic behavior” as factor contributing to incompleteness).

65. *See* Schwartz, *Relational Contracts*, *supra* note 36, at 273. That claim would not be verifiable.

66. *Id.*

67. *Id.* at 272.

68. Eggleston et al., *supra* note 12, at 104 (“[E]fficiency requires a complex contract that releases one or both parties from their obligations if certain future states prevail.”).

Although it appears complete, the contract is incomplete because “it has a one-state partition in a two-state world.”⁶⁹

C. *Responses to Incomplete Contracts that Stress Informational Deficits by Parties or Courts*

Although there is a greater recognition of the inevitability of incompleteness in contracts, the two current dominant strands for assessing whether legal intervention in contracts is justified turn on (in the hypothetical bargain) the comparative ability of the courts and the parties to acquire the information they need to improve the exchange or on an assessment of whether the court’s intervention would require it to supply a term that required unverifiable or unobservable information (with the new formalists).

Neither strand of scholarship differentiates sufficiently between the two types of uncertainty concerning external states or the likelihood of counterparty opportunism. Nor do such strands deal directly with the “natural affliction”⁷⁰ of opportunism or sunk costs in conjunction with uncertainty about propensities to diverge. The tendency towards opportunism is endemic in human nature. Thus, I suggest that the problem occurs in many different contexts. It may, as Professor Robert Scott suggests, be a byproduct of the inability of the parties to completely specify what they want from their counterparty because of reasons of uncertainty.⁷¹ In any case, it exists and the failure to make opportunism a central concern means that, to date, theories of legal intervention remain incompletely justified.

The activist response to incompleteness emphasizes the transaction costs that affect the parties and negatively impair their ability to get information needed for a complete contract that takes account of future states.⁷² It looks at the comparative ability of the state and the parties to get the information and posits that when the cost of the state’s providing for a contingency with a law-supplied rule is lower than the private costs

69. Schwartz, *Relational Contracts*, *supra* note 36, at 272. Consumer warranties are also incomplete because they do not differentiate between types of buyers according to the probability that some buyers will use the product unreasonably and make a disproportionate number of warranty claims. Such contracts are incomplete since they fail to distinguish between different types of buyers. A complete contract would vary the terms of the warranty based on the buyer’s type. *Id.* at 273 n.3. The finding that contracts are often simpler and less complete than one would expect has attracted notice. See Eggleston et al., *supra* note 12, at 91–97; see also HART, *supra* note 53, at 2.

70. Coffey e-mail (June 30, 2003), *supra* note 40.

71. Scott e-mail (Feb. 11, 2004), *supra* note 5.

72. See Ayres & Gertner, *supra* note 51, at 93 (emphasizing link between theories emphasizing transaction costs as a source of incompleteness and willingness to intervene with law-supplied terms).

to the parties' overall transaction costs, the state should intervene with law-supplied rule. The aggregate costs of forcing many sets of contracting parties to explicitly provide for a term may exceed the cost of the state creating a one-time default rule that can be supplied across the board.⁷³

Judicial intervention is justified by an efficiency rationale based on using a transaction-costs approach. Scholars suggest that courts should supply default rules that mimic what "similarly situated" parties⁷⁴ would have consented to absent transaction costs.⁷⁵ Supplying such default rules would minimize the transaction costs for the parties by allowing them to forego negotiation of every term by agreement. Such rules would be preferred by the parties, since minimizing transaction costs would increase the surplus available to the parties.⁷⁶ This approach for filling gaps results in majoritarian default rules.⁷⁷ The technique saves the majority of parties the transaction costs of having to explicitly specify the terms and is designed to enhance *ex ante* efficiency.⁷⁸

The Uniform Commercial Code (the "Code") and the *Restatement (Second) of Contracts* (the "Second Restatement") accept the efficiency rationale for intervention and reflect an expansive role for courts in incomplete private agreements. The Code invites courts to intervene through law-supplied default rules that govern absent an express contrary agreement by the parties.⁷⁹ Courts play a role in incomplete contracts,

73. When parties are dissimilar or heterogeneous, intervention by the state may not be cost effective. See Schwartz, *Relational Contracts*, *supra* note 36, at 282.

74. See Scott, *Formalism*, *supra* note 7, at 849. In embracing default rules based on "similarly situated" parties the courts are actually directed to make determinations of hypothetical consent and "to ignore the litigating parties' subjective intentions . . ." *Id.*

75. This method of supplying terms based on the parties' hypothetical consent is illustrated by Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (justifying fiduciary duties in hypothetical bargain terms as "the rules the parties themselves would have chosen in a transaction-cost-free world").

76. These hypothetical majoritarian default rules have occasioned a variety of criticisms including the problem of how to justify the imposition of terms without the parties' actual consent. See Coleman et al., *supra* note 23, at 641. Ayres and Gertner have provided a different critique suggesting that in some instances where one party is strategically concealing information, the hypothetical majoritarian default rule should be rejected in favor of a penalty default rule "set at what the parties would not want" to force the disclosure of information. Ayres & Gertner, *supra* note 51, at 91.

77. There are other techniques courts could utilize for filling in gaps or interpreting contracts. Instead of supplying terms that the majority of parties would have preferred, the court could supply terms which the particular parties to the contract would have chosen. These are known as tailored default rules. See Ayres & Gertner, *supra* note 51, at 91 (discussing "tailored defaults").

78. Of course, if there were no transaction costs, presumably the parties would be indifferent to the rule specified. See R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960).

79. Article 2 of the Code suggests that commercial norms will provide the source both "for interpreting the meaning of express terms and default rules for filling contractual

since the absence of terms will not necessarily be fatal if the parties intended to contract and the court has a basis for finding a remedy.⁸⁰ In some instances, courts intervene by gap filling when the parties have obviously failed to select a term, such as the delivery date for the goods or the price.⁸¹ In other instances, courts intervene by implying an excuse from performance, such as that based on impracticability.⁸² In such cases, courts implement a law-supplied rule to deal with unforeseen exogenous events.⁸³ Courts also intervene by devising rules that incorporate commercial norms to interpret terms in contracts. Both the Code and the Second Restatement also imply generalized performance obligations—such as good faith⁸⁴—to govern behavior in contractual agreements.

The interventionist approach solves the externality problem created when the parties leave a gap or leave the contract incomplete by failing to account for certain future world states or use terms whose meanings are unclear.⁸⁵ Had the parties devoted more transaction and resource costs to clarifying all the terms used or in completing the contracts, the job for the courts would have been far simpler. When parties fail to achieve complete or unambiguously clear contracts and a dispute arises, court action may occur. Because the costs of litigation do not fall entirely on the parties who engendered the dispute, an externality arises.⁸⁶ The dispute costs are partially defrayed by the court system.⁸⁷ State supplied

gaps.” Jody S. Kraus & Steven D. Walt, *In Defense of the Incorporation Strategy*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW*, *supra*, note 137 at 193 (Jody S. Kraus & Steven D. Walt eds., 2000) (defending the incorporation philosophy of the Code against the assault by the formalists).

80. See RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 18, §§ 33–34; U.C.C. § 2-204(3) (2001).

81. See U.C.C. §§ 2-305, 2-309.

82. For a discussion of the complex role the foreseeability of the event alleged to be the basis for an impracticability claim plays, see 2 FARNSWORTH, *supra* note 28, § 9.6; see also U.C.C. § 2-615 cmt. 8 (dealing with the foreshadowing issue in determining impracticability claims).

83. See RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 18, § 205; U.C.C. § 1-304. The implied term of good faith can be considered a mandatory rule. See Ayres & Gertner, *supra* note 51, at 87 (discussing immutable rules as including the duty of good faith). But see Cohen, *Implied Terms*, *supra* note 35, at 84 (questioning the characterization of the good faith terms as mandatory, explaining that “if one believes that parties may write incomplete contracts for which they expect courts to fill in the gaps, the duty of good faith or the duty of loyalty might easily be viewed as a default”).

84. See RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 18, § 205.

85. Schwartz, *Relational Contracts*, *supra* note 36, at 277. “Externalities exist whenever some person, say X, makes a decision about how to use resources without taking full account of the effects of the decision.” JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY* 48 (5th ed. 2002).

86. Schwartz explains “the parties do not bear the full costs of disputes; the state bears some of these costs because it subsidizes the judicial system.” Schwartz, *Relational Contracts*, *supra* note 36, at 277.

87. *Id.*

default rules can reduce this cost by putting into place efficient rules, which will obviate the need for litigation and thereby increase the gains from trade.⁸⁸ These rules are likely to be particularly efficient when they deal with “recurrent contracting problems.”⁸⁹

The new formalists echo the recognition that the future state of the world cannot be known in advance. However, they reach the opposite conclusion on the desirability of legal intervention. Certain proponents of this strand emphasize a cause of completeness not previously identified as an important component in decisions about judicial intervention: the costs of legal intervention where courts are incompetent.⁹⁰ These theorists focus on costly intervention by courts that would require them to fill in terms with what is essentially unknowable information at the time the court has to render a decision.

Other proponents in the new formalist school share the recognition that because parties will have uncertainty about the future, the contract that they negotiate will necessarily look to a postponement of certain aspects of the performance obligations until the state of the world has actually materialized. However, in postponing the measuring time and then calibrating obligations, these proponents argue that the courts should be wary of adopting any measurement techniques which depend on unverifiable or unobservable characteristics.⁹¹ Courts should avoid such techniques because the parties themselves would not have adopted them. Adoption would merely cause the reversal costs necessitated when parties opt out of such approaches.⁹² Thus, if a contract remains incomplete in certain ways—because the parties at the time they contract lack certain information about the future state of the world and deliberately choose not

88. *Id.* However, the practice of incorporation creates encrustation problems in which courts become increasingly wedded to the default rules with the result that parties find it difficult to opt out of the commercial norms. See Kraus & Walt, *supra* note 79, at 217–18.

89. Schwartz, *Relational Contracts*, *supra* note 36, at 277–78.

90. See Posner, *supra* note 26, at 754. Formalists have also focused on a second type of costly judicial intervention—when courts misguidedly incorporate commercial norms in interpret contracts and in doing so displace clear express terms.

Formalists oppose the legal recognition of such norms and assert that the courts should defer to extant norms but should resist incorporating them into contracts because of the likelihood that courts will err when they incorporate commercial norms as part of contract interpretation and gap filling. See Kraus & Walt, *supra* note 79, at 200.

In rejecting the incorporation of trade usages and other norms, the new formalists ignore the underlying idea that parties will seek to maximize the gain from exchange either by contractual means or, in the face of costly obstacles to contractual means to increase gains from trade, the parties may resort to informal norms or “private strategies” to achieve the same goal. Denying effect to those norms may actually make it more costly for parties to achieve their goals as they will be deprived of a cost effective alternative to an express contract.

91. Scott e-mail (Feb. 11, 2004), *supra* note 5.

92. *Id.*

to condition future performance on a particular realized state of the world—the court should decline to intervene *ex post* (at breach) with a rule that depends on that same inaccessible information.⁹³ This approach means that courts should generally adopt a “passive” stance when deciding contract disputes.⁹⁴ If there is no governing contract term, then the court should insist on compliance with the contract terms regardless of the circumstances and should decline to add terms not expressly agreed to by the parties.⁹⁵

Two primary instrumental justifications support literalism. The first is the belief that if the contract is incomplete because of private information about future states of the world,⁹⁶ then courts will lack the competence⁹⁷ to complete the contracts. Second, if courts craft rules parties themselves studiously declined to adopt, then the parties will opt out of such rules in the future.⁹⁸ If contracts are incomplete due to the asymmetric information⁹⁹ where one or both of the contracting parties cannot observe a fact or state of the world,¹⁰⁰ or alternatively, where the

93. The argument against judicial intervention is predicated on a peculiar cause of incompleteness which is tied solely to an asymmetry of information between the parties and the court *ex post*, that increases the cost of judicial enforcement. Schwartz, *Relational Contracts*, *supra* note 36, at 279. This formalists’ use of the term asymmetric information to refer to information disparities *ex post* that raise judicial enforcement costs differs from the use of asymmetric information to refer to the case that gives one party an advantage *ex ante* in the bargaining process. See, e.g., A. Postlewaite, *Asymmetric Information*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 133 (John Eatwell et al. eds., 1987) (discussing several examples of asymmetric information which focus on *ex ante* bargaining problems); see also George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 490–91 (1970).

94. Schwartz, *Relational Contracts*, *supra* note 36, at 280–83. “A contract which is as complete as possible given these verification constraints—that is, a contract which exploits all verifiable distinctions between states—has been labeled functionally complete, or f-complete.” George F. Triantis, *The Efficiency of Vague Contract Terms*, at 5 (Univ. of Va. Sch. of Law, Law and Econ. Research Paper Series No. 02-7, 2002), available at http://ssrn.com/abstract_id=311886. A contract which only incompletely takes account of external states is “rigid,” one which incompletely specifies behavior is characterized by “discretion.” Battigalli & Maggi, *supra* note 4, at 799.

95. See Scott, *Formalism*, *supra* note 7, at 848 (calling for “literalistic” interpretation by the courts and for curbing a more active judicial role).

96. Asymmetric information is a term of art used by the formalists to refer to the informational deficits affecting the courts and in some cases the parties as well.

97. For examples of a new scholarly concern with the issue of judicial competence in completing incomplete contracts, see generally Hadfield, *supra* note 45; Posner, *supra* note 26; Schwartz, *Relational Contracts*, *supra* note 36.

98. Schwartz & Scott, *supra* note 6, at 547–48.

99. See *supra* note 96.

100. “Briefly put, information is observable when it is worthwhile for the parties to know it, but the costs of proving it to a third party exceed the gains; information is verifiable when it is both observable and worth proving to outsiders.” Schwartz, *Relational Contracts*, *supra* note 36, at 279.

matter is observable by the parties but not verifiable to a court,¹⁰¹ then the matters are “noncontractible.”¹⁰²

An example of a matter that is not observable is the cost to the seller of producing a good. Parties could condition the price that the buyer would be willing to pay on the seller’s costs. If such information were available, then the parties presumably could achieve efficient contracts using cost as a payoff variable. However, because cost information is not readily observable, parties do not condition their obligation on such factors in their contracts.¹⁰³ The formalists argue that if the cause of incompleteness derives from such hidden information, that information will remain inaccessible *ex post*, so courts will be incompetent and should decline to intervene because intervention would be harmful.¹⁰⁴

In other instances, information may be observable but not verifiable to third parties. In employment contexts, the prime example of observable but unverifiable information involves shirking by an employee. “[A]n employer sometimes knows whether an e[m]ployee [has] shirked, but the costs of proving shirking to an arbitrator or a court are relatively high.”¹⁰⁵

The formalists argue that by classifying whether the gap is due to private information, one can determine whether or not the law’s intervention would be beneficial. If the incompleteness in a contract relates to information that is either unobservable or unverifiable, then courts should decline to intervene with an expansive interpretation or with law-supplied default rules because in such cases courts would be supplying a rule that the parties would opt out of or supplying a rule when they would be ill-equipped to decide what the optimal term would be.¹⁰⁶ If the information were unobservable, then the court could not improve

101. These formalists do not want to “have enforcement turn on facts that one or both could not observe or establish in court.” Scott, *Formalism*, *supra* note 7, at 863.

102. Schwartz, *Relational Contracts*, *supra* note 36, at 280.

103. *See id.* at 283. Another prime example of the unobservability problem and its effects on the types of contractual arrangements can be seen in the principal agent context. Because an agent’s effort cannot be directly observed by the principal but only the agent, the contract cannot be conditioned on the agent’s effort. This is so even though the optimal contract would be so conditioned. Consequently, the contract negotiated cannot be the first best arrangement “since it cannot be conditioned directly on variables like effort that are observed by only one party.” HART, *supra* note 53, at 22.

104. “This third strategy borrows from the physician’s classic injunction, ‘first, do no harm’ . . .” Scott, *Formalism*, *supra* note 7, at 851.

105. Schwartz, *Relational Contracts*, *supra* note 36, at 279; *see also* Andrew P. Morriss, *Bad Data, Bad Economics, and Bad Policy: Time to Fire Wrongful Discharge Law*, 74 TEX. L. REV. 1901, 1903 (1996). This nonverifiability factor has been cited as a justification for the at-will rule since a contrary just cause rule would require costly verification of the cause to a neutral court. *Id.*

106. *See* Posner, *supra* note 26, at 753 (stating that “identifying the value-maximizing action in any contractual relationship is likely to require information that is not available to the court”).

outcomes by intervening by filling the gap in the contract because it would not be in a position to obtain the information which caused the incompleteness. If, on the other hand, the information were observable by the parties but not verifiable to courts, then one would suppose that the court's role as an outsider would prevent it from gaining the information except at prohibitive cost. Consequently, courts should decline to intervene.

By highlighting judicial incompetence in ferreting out private information *ex post*, the new formalists have shown how judicial intervention, which depends on such private information, can be costly in particular instances. At the same time, that approach has unduly circumscribed analysis of the scope of the problem of judicial intervention. The focus is on the costs of judicial enforcement where the particular type of judicial intervention would depend on inaccessible information about the state of the world *ex post*. That narrow focus on costly errors by courts inevitably leads to the conclusion that judicial intervention would be unwarranted in the particular cases specified. However, it does not address the general issue of when judicial intervention might be warranted because it could increase gains from trade by controlling party opportunism. Because it does not account for the gains, but rather only accounts for the costs, it does not propose a complete and general theory of intervention.

The new formalists focus on a particular type of uncertainty regarding external states of the world, such as the demand for a product. Where parties do not condition on that variable, the court should decline to condition performance obligations using that variable. The new formalists have made a significant contribution in highlighting the particular difficulties that parties will have in contracting before they know what state of world will actually materialize. They have also given us a trenchant analysis of why parties might avoid particular solutions to the initial problem of uncertainty. If parties do not know what will happen to the seller's costs in the future, then they face uncertainty *ex ante*. However, despite that uncertainty, they would probably not condition performance on a contractual term "that states 'whenever [the seller's] costs rise unexpectedly, [the seller] can substitute a reasonable alternative.'"¹⁰⁷ Since the seller's costs are not a verifiable item, the buyer would presumably be reluctant to agree to such a term.

The exclusive focus on the particular strategies that parties may opt out of, and which thus do not present a welfare-improving solution to the uncertainty problems that parties face, interferes with an understanding of the circumstances that may warrant legal intervention. Given the uncertainty problems that parties face *ex ante* both with respect to

107. Scott e-mail (Feb. 11, 2004), *supra* note 5.

behavior and states of the world, and the inability of contract to anticipate and provide for solutions to that uncertainty, it is important to recognize that parties or courts could adopt a number of strategies to solve uncertainty problems that might not require the courts to decide matters based on inaccessible information.

D. An Example Illustrating Why the Analysis of Particular Strategies Parties Avoid to Solve Informational Deficits Cannot Resolve the Judicial Intervention Question

Professor Alan Schwartz uses an example to illustrate how case outcomes reflect the influence of the courts' reluctance to interfere with solutions that would force the courts into supplying a measurement term *ex post* that the parties themselves avoided adopting *ex ante*. While it is useful to identify such cases as a way of guiding courts away from particular intervention strategies that would be likely to decrease welfare by adopting rules that parties would later seek to overturn, one must also focus on situations where the *ex ante* uncertainties remain the same but the parties themselves can devise other strategies for overcoming those uncertainties in ways that do not pose verifiability problems or which can be solved by certain types of judicial intervention that do not raise institutional judicial capability problems.

A manufacturer and wholesaler are faced with a decision about whether to condition the price the wholesaler pays on the state of the demand (high or low). The parties could condition the price on the demand or instead agree to a unified price.¹⁰⁸

Schwartz explains that when faced with the choice, the manufacturer will be unwilling to enter a contract conditioned on demand if information about demand is not available to the manufacturer.¹⁰⁹ The reason is simple. A complete contract conditioned on the state of demand would prompt the buyer to claim a low demand to justify the lower price.¹¹⁰ Faced with this risk, the manufacturer prefers to agree to a contract that does not differentiate based on demand.

Schwartz concludes that in these cases “[c]ourts respond . . . by pursuing a ‘passive’ judicial strategy that permits them to avoid making substantive determinations.”¹¹¹ The court declines to interfere and refuses to add a term tailoring the price term to demand because the state of the demand cannot be known by the court.

The example seems to be consistent with a theory based on judicial informational deficits. Yet the illustration only resolves when it might be *inappropriate* for a court to intervene in a particular way. By focusing on a case in which the parties themselves opted *not* to base their obligations on certain hidden informational variables, formalists have provided easy target cases to demonstrate that judicial intervention would be unlikely to improve outcomes.

108. Schwartz, *Relational Contracts*, *supra* note 36, at 284.

109. *Id.*

110. *Id.* at 273–74.

111. *Id.* at 274.

Where the parties have deliberately chosen not to condition performance on certain unobservable information, the costs of judicial intervention conditioning performance on that same inaccessible information would be high. It seems almost a tautology to conclude that a court would decline to intervene if doing so would require the court to make a determination based on that same unobservable or unverifiable piece of information.

There would be no comparative advantage to the courts intervening in such cases and, in fact, every reason to enforce the literal terms of the contract. In such cases “[c]ourts benefit parties more . . . by submitting to their contractual instructions—instructions which are designed precisely with the courts’ abilities in mind—than by flailing away in a fruitless attempt at divining the parties’ contractual goals, or the optimal terms, or the norms of the relationship.”¹¹²

The formalists have neglected to consider the more difficult cases that arise when parties face the same intractable problems of uncertainty about the state of the world and about one’s counterparty’s proclivities for opportunistic behaviors. Even if the parties may have chosen not to adopt a particular strategy conditioned on certain noncontractible variables, a court may intervene if the parties’ own strategies to overcome the uncertainty barriers to express contract solutions are more costly than judicial intervention.

The hypothetical involving uncertainty about the state of demand can be looked at differently in ways that illuminate a different implicit underlying taxonomy that can be used to resolve judicial intervention questions. In the case just referred to, the parties have uncertainty about the future state of demand (or external state), and also uncertainty about the likelihood of opportunistic behavior by their counterpart. The seller will not know in advance what the buyer’s likely propensity for such behavior is, and therefore does not know if the buyer would falsely manipulate the terms of the contract and claim low demand to gain a low price.

Given that uncertainty, and given the parties’ joint interest in thwarting opportunistic behavior (since it limits the gains from trade),¹¹³ the court should decline to add a term qualifying price by the state of demand since it will not achieve the instrumental goal of mitigating the hazards of opportunism. In addition, as Schwartz rightly points out, the cost of judicial enforcement could be high were the court to have to supply a noncontractible piece of information.

Focusing on the *ex post* costs of judicial intervention fails to grapple with the bargaining problem elements of the uncertainty, sunk-cost

112. Posner, *supra* note 26, at 752–53.

113. WILLIAMSON, *CAPITALISM*, *supra* note 10, at 63.

opportunism taxonomy and for that reason remains incomplete. The parties may devise certain strategies on their own to solve the various uncertainties. An option contract¹¹⁴ that gives one party an option to make a take-it-or-leave-it offer on the date of trade might suffice to solve the uncertainty regarding future states of the world.¹¹⁵ The behavioral uncertainty may also call for other strategies to prevent opportunism. In fact, the agreement to a fixed price, rather than one that would allow for opportunistic manipulation of the supposed demand, could itself be a contractual device to discourage opportunism.

In focusing on particular solutions to the uncertainty problem that entail problems of verifiability and observability, formalists have neglected to confront why and how courts might intervene. The verifiability of an event does not by itself justify the court's intervention; it only helps to explain why the court might be more or less competent in assessing an event. Verifiability issues are part of the cost of judicial enforcement but are not a sufficient argument for or against intervention. The neglect of an open-ended inquiry into an intervention issue causes the formalists to ignore other instances of law-supplied performance obligations or terms that might be justifiable in terms of an instrumental rationale of controlling opportunistic behavior.

III. BEYOND PARTICULAR STRATEGIES TO SOLVE INFORMATIONAL DEFICITS: RECOGNIZING THAT UNCERTAINTY ABOUT BEHAVIOR CAN IMPAIR THE VALUE OF EXCHANGE AND CALL FOR PRIVATE SOLUTIONS OR JUDICIAL INTERVENTIONS

The formalists have developed a theory against judicial intervention based on a narrow typology of a particular strategy designed to respond to uncertainties about the future. If the parties have left the contract incomplete and deliberately failed to condition their obligations on variables because they do not know what the state of world on a given matter will be or cannot describe it adequately, then the factors are "noncontractible."¹¹⁶ In such cases, the court should decline to intervene with a term that conditions on those same unknowable factors. Intervention by courts would be undesirable because it would cause parties to opt out.

However, in overgeneralizing against intervention based on one sort of typology without recognizing the limits of the inquiry, the formalists have ignored the need for a more robust justification to explain and rationalize parties' own devices for solving uncertainty problems and also

114. See *infra* note 192.

115. This solution might, however, cause suboptimal investment.

116. Schwartz, *Relational Contracts*, *supra* note 36, at 278–80.

judicial decisions about when intervention may be indispensable. When one takes account of the parties' instrumental goals, including the need to control behavior by efficiently curbing opportunism to increase the surplus for the parties, there may be a reason to adopt a term or liability rule whose effect is to police opportunism.

The need for judicial intervention to police opportunism can be seen if one focuses on another example used by Schwartz. The example shows the limits of the verifiability factor in explaining and justifying judicial intervention. Since the verifiability analysis focuses on factors that parties have deliberately chosen to leave out of a contract, the analysis often leaves little justification for court intervention. Even in those cases where a factor such as the market price in the damages default rule is verifiable, verifiability alone is not a sufficient reason for justifying legal intervention because it does not take account of the parties' overall goals.

The example involves the open quantity cases in which the parties to a sale of goods contract leave the quantity term open. The parties cannot predict with perfect foresight what their demands in the future will be, since "[t]he amount that a party will find profitable to supply or demand is partly a function of economic factors that can vary with time."¹¹⁷

In these cases, the contract often affords one party discretion to choose a quantity to supply or to purchase. The seller may agree to supply the output he produces to a buyer, while a buyer may agree to buy all of the products that he needs in his business. These are known respectively as output or requirements contracts.¹¹⁸ During these contracts, one party may make demands or produce output that differs substantially from earlier output or demands.

Since the contract is incomplete in the sense that it does not specify the particular quantities to be supplied or demanded, the question becomes whether there is any role for the court to intervene by regulating the quantities supplied or demanded by the parties. Resolution of that question would be enhanced if the court recognized that the uncertainty about the quantity needed is accompanied by a different type of uncertainty—an uncertainty about the party afforded discretion. What is that person's likely predilection for acting opportunistically in the formulation of demands or the supply of output? The law intervenes in this context by implying a term in the form of a performance obligation of good faith to constrain one party's discretion. If a contract stipulates that the buyer will buy what it needs, then the good-faith obligation serves to regulate the amount that can actually be demanded. If a buyer demands a quantity that a court finds to be in bad faith, then the demand will not be

117. *Id.* at 295.

118. Output and requirement contracts are governed by Section 2-306 of the Code. U.C.C. § 2-306.

enforceable and the seller will not have to meet any demands made in bad faith.¹¹⁹ In other cases, the courts may find the demand to be in good faith and allow the quantity variation to stand.

To understand quantity variations by the seller and the courts' response, one must examine the possible reasons for the quantity variations *ex post*. In some cases, a seller may reduce the quantity supplied to the buyer because it is simply more profitable to sell on the open market. Prices may have gone up since the execution of the contract, making sales on the market more profitable than deliveries under the contract.¹²⁰ In other cases, there can be factors internal to the seller that affect output, such as a loss of key employees, which means that "[the seller] no longer can produce profitably at the contract price with her remaining labor force."¹²¹

According to Schwartz, the verifiability factor explains the differing results in the cases. The law intervenes and polices the seller reducing quantity to the buyer in a rising market because there is a factor which is verifiable—the rising market price that has made it more profitable to sell on the market than to the buyer.¹²² In the other case, where the internal changes in the individual seller's business are "noncontractible,"¹²³ the court takes a passive and therefore noninterventionist stance to the quantity variation.¹²⁴

Yet the open-quantity cases may be better explained by a broader framework than one based solely on whether the "regulatory term would have to condition on unverifiable information."¹²⁵ In these cases (as in many contracts), the parties face uncertainties about exogenous events such as the future demand for the good or output, and thus it is difficult to draft a complete contract that accounts for all possible states of demand or production costs. Because of the high transaction costs of a complete contract, the contract remains incomplete.

However, the parties also face another uncertainty problem but one which is endogenous to the parties—behavioral uncertainty that a party

119. See, e.g., *Orange & Rockland Utils., Inc. v. Amerada Hess Corp.*, 397 N.Y.S.2d 814, 818–19 (App. Div. 1977).

120. Schwartz, *Relational Contracts*, *supra* note 36, at 296. Of course, if the contract were exclusive, the seller would not have the discretion to sell to an alternative buyer. However, the seller retains discretion over the decision to keep producing.

121. *Id.* In other words, the seller may have to reduce output to maintain overall profitability.

122. *Id.* at 296–97. In some cases a court may actually regulate the right of a company to selectively decide to cease production. See, e.g., *Feld v. Levy & Sons, Inc.*, 335 N.E.2d 320, 322–23 (N.Y. 1975).

123. Schwartz, *Relational Contracts*, *supra* note 36, at 296.

124. *Id.* at 298. In this context the court will therefore find the seller's demands for the goods to be in good faith.

125. *Id.*

may behave opportunistically in the future. Once that factor is accounted for, the cases may be better explained in terms of a court policing contractual adjustments to control moral hazard.

In the case of the seller reducing output to a buyer or ceasing production because he can receive more by selling on the open market, the seller is acting opportunistically. The court intervenes by supplying a term of good faith (not in the contract) to constrain the seller's conduct. The court does not intervene with an implied term of good faith because the conduct is verifiable, although it uses the rising market price as a verifiable factor in its determination that bad faith has occurred.

In the other case involving quantity changes to reflect individual changes in the seller's business,¹²⁶ the court declines to intervene or to find bad faith. Since the case does not seem to present an instance of opportunistic behavior but rather changes in production necessitated by business developments, there seems to be no justification for the courts' intervening.

Thus, while the verifiability of certain events may play a role in determining the costs and feasibility of a court's intervention,¹²⁷ verifiability does not explain why the law chooses to imply a law-supplied term of good-faith to constrain discretion in a requirements or output contract, which in itself does not contain such an express term. Rather, the intervention can be explained in instrumental terms. In these cases there is the risk that a party will act opportunistically in adjusting his output or demand. To control that risk and to maximize the surplus for the parties,¹²⁸ the law implies a term of good faith and intervenes in order to protect parties against a recurring problem of opportunism.¹²⁹ Verifiability is not the reason for the intervention even though, in the application of the good faith test, the verifiability of a rising market price will affect the costs of judicial enforcement of the implied term.

IV. NONLEGAL STRATEGIES FOR MITIGATING THE EFFECTS OF OPPORTUNISM

Given the limits on the parties' ability to craft complete contracts that can resolve frictions arising in a relationship involving specialized investments and to control opportunism, the parties may pursue private options control opportunism. In deciding if legal intervention is

126. Schwartz explains "that [these reasons] affect her much more than they affect otherwise similarly situated firms." *Id.* at 296.

127. Schwartz calls this the "institutional constraint." *Id.* at 274.

128. WILLIAMSON, *MECHANISMS*, *supra* note 31, at 60.

129. Were the problem not a recurring one but an individualized problem, the cost of a court's intervening would be more costly as it would necessitate crafting a term for use on a one-time basis only.

warranted, the court should examine the feasibility and probable cost of such devices. It should also determine whether the parties have resorted to such devices and also whether there are transactional characteristics in place preventing the achievement of nonlegal sanctions or rendering them ineffective before it makes a decision about intervening to add terms to a party's contract or impose a liability rule.

A. Vertical Integration

One way parties may try to manage frictions and to mitigate opportunism is through vertical integration. Vertical integration provides advantages over parties having to rely on contractual agreements between separate firms to resolve disputes and make adjustments.

Parties will trade off the advantages of vertical integration against possible costs. The possible costs may include the sacrifice of economies of scale that sometimes accrue to outside suppliers specializing in one product.¹³⁰ In relationships involving idiosyncratic specialized investments, however, the economies of scale are not likely to be great. Because outside suppliers would have to gear up to make unique investments, and because of their uniqueness, would not be able to spread the cost of product development over many transactions, such suppliers will not be able to achieve the efficiencies that are possible when non-unique goods are involved. Parties will also weigh the "serious incentive and bureaucratic disabilities"¹³¹ inherent in vertically integrated companies.

In deciding how to facilitate governance and streamline adjustments and curb opportunism, parties will consider not only the costs and benefits of vertical integration¹³² but also other possible strategies "located between discrete market contracting at the one extreme and hierarchical organization at the other, whereby the hazards of bilateral contracting are attenuated with less severe sacrifices in the aforementioned incentive and scale/slope economy respects . . ."¹³³ If parties decide not to integrate, they may wish to devise other strategies *ex ante* to deter undesirable (opportunistic) behavior by the other party.

B. Nonlegal Sanctions

In deciding how to achieve their overall goals, parties themselves have a variety of tools (beyond the change in property ownership brought about by vertical integration) for enforcing their commitments and

130. WILLIAMSON, *CAPITALISM*, *supra* note 10, at 92.

131. *Id.* at 163.

132. *Id.* (discussing the trade-offs in vertical integration).

133. *Id.*

curbing opportunistic behavior of the other party.¹³⁴ These include both nonlegal and legal sanctions.¹³⁵ A close analysis of why and when parties choose to rely on different types of sanctions or combinations of sanctions (including legal and nonlegal) in different settings may help to shed light on the ultimate question of when legal intervention through law-supplied rules is likely to be beneficial by increasing gains from trade.

Nonlegal sanctions may consist of bonds or other types of hostages, the “loss of *reputation* among market participants” and the “sacrifice of *psychic and social goods*.”¹³⁶ A party may post a bond, which he automatically forfeits upon breach. Banks typically require collateral for loans, which will be forfeited upon a breach by the debtor. The contract provision for forfeiture of debtor collateral is an *ex ante* device for assuring debtor compliance in future behavior.¹³⁷ Franchisees, in effect, post a bond when they agree to contract to sell goods specific to the franchise at a loss if there is early termination.¹³⁸ Franchisees make transaction-specific investments including an upfront nonrefundable franchisee fee as well as brand-name products specific to the franchisor. In addition, typical franchise arrangements may provide for leases rather than ownership of franchise property.¹³⁹ These specific investments by franchisees may all be sacrificed and the franchisee may incur a loss if the franchise is terminated, thereby helping to deter cheating.¹⁴⁰

Cheating in the franchise context could include “quality shading”¹⁴¹ in which franchisees fail to maintain the high quality of product required by the franchisor. Although this behavior might save the franchisee in costs expended, it will harm the reputation of the franchisor and thereby reduce overall revenues.

Where the possibility of opportunistic behavior exists, a device for curbing this type of behavior may be required. The “hostage” created when the franchisee invests in specialized assets whose cost cannot be fully recouped in the event of a premature termination of the franchise provides a means for the franchisor to control bad behavior by

134. The anterior decision is whether to make “any commitment” to the other party at all. David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 375, 398 (1990) [hereinafter Charny, *Nonlegal Sanctions*] (discussing manufacturer’s decision as to whether to make a commitment or to sell “gray market” goods).

135. Charny’s article on this subject of nonlegal sanctions remains a powerful treatment of the subject over a decade after it was written. *See id.*

136. *Id.* at 393.

137. *Id.* at 392–93.

138. WILLIAMSON, CAPITALISM, *supra* note 10, at 181.

139. *Id.*

140. *Id.*; Benjamin Klein, *Transaction Cost Determinants of “Unfair” Contractual Arrangements*, 70 AM. ECON. REV. 356, 359 (1980).

141. WILLIAMSON, CAPITALISM, *supra* note 10, at 181.

franchisees. Without the mechanism, “franchisees will bid less for the right to a territory than they otherwise would”¹⁴² because outlier franchisees may act in ways that debase the value of the franchise.

Thus, the parties may opt for a hostage system because it promotes efficiencies.¹⁴³ Franchisees will pay higher bids for the franchise secure in the knowledge that the franchisor will have a means of policing franchisees who debase the value of the franchise for everyone.

Threats to the loss of one’s good reputation can also serve as a nonlegal sanction that deters breach.¹⁴⁴ Credit ratings for borrowers constitute a type of reputational sanction.¹⁴⁵ Without having to resort to legal proceedings, a credit rating agency can induce borrowers to honor their obligations or risk an adverse impact on the borrowers’ credit rating.¹⁴⁶

Nonlegal reputational sanctions may be quite effective and provide the “perfect substitute[s] for legal enforcement.”¹⁴⁷ In certain settings, parties may “recognize[] an authoritative nonlegal decisionmaker” to enforce such nonlegal sanctions.¹⁴⁸ Such a decision-maker operates well in contexts where the parties are “close-knit, ethnically or professionally homogeneous communities.”¹⁴⁹ Professor Lisa Bernstein’s study of the diamond industry amongst a group of Orthodox Jews confirms the effective use of such nonlegal sanctions in certain communities.¹⁵⁰ Noncompliant traders in the diamond industry suffer the severe sanction of being frozen out of future trading. This sanction assures compliance despite the fact that legal sanction does not back up the decisions of the decision-makers.

Nonlegal reputational sanctions can also operate effectively outside of homogeneous communities in organized markets when a “system for transmitting relevant information to market participants and for providing the expertise necessary to evaluate that information”¹⁵¹ exists. In the bond market, for example, the holders of bonds worry that the debtor will incur additional debt or otherwise act in ways that threaten the security of the bondholders’ expectations. Bondholders have a variety of options to discourage behavior that will adversely impact them. Some of them are

142. *Id.* at 182.

143. *Id.*

144. Charny, *Nonlegal Sanctions*, *supra* note 134, at 393.

145. *Id.*

146. *Id.*

147. *Id.* at 412.

148. *Id.* at 409.

149. *Id.* at 412.

150. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 129 (1992) (detailing expulsion and readmission of bankrupt members).

151. Charny, *Nonlegal Sanctions*, *supra* note 134, at 418.

legally enforceable and others operate outside the legal system. Bondholders can draft restrictive covenants prohibiting certain behavior, and breaches of such covenants would be legally enforceable. Of course, there are costs associated with very detailed covenants both in terms of resource costs and in sacrifices to flexibility.¹⁵² Bondholders could also demand a higher interest rate to compensate for the uncertainties associated with the issuer's potential future opportunistic behavior or extract more rigorous security for the debt.¹⁵³ Some of these provisions would require bondholders to resort to the legal system in the event of breach. Others, such as the collateral required, are simply private mechanisms in which the bondholder has required that the debtor post a bond. In the event of default, the bondholder can simply cause a forfeiture of the collateral.¹⁵⁴

The most powerful nonlegal sanction is the reputational one.¹⁵⁵ If a borrower is to successfully enter the capital market again, he must carefully uphold his reputation by protecting bondholders' security by refraining from opportunistically incurring additional debt, for example. The failure to act in such a manner will affect the debtor's ability to raise capital again, since "[i]nvestors can easily learn from business reports, SEC filings, credit reports, and other documents that the firm has incurred new debt or embarked upon high-risk projects."¹⁵⁶

Nonlegal sanctions may offer advantages over legal sanctions, including the greater admissibility of a broad range of evidence not admissible in court,¹⁵⁷ greater expertise by investors over courts in judging opportunistic behavior, and greater accuracy in decision-making because of the way in which "the market pools the judgments of many individual participants."¹⁵⁸

In many cases, the reputational controls through vehicles such as monitoring devices are sunk costs that are already in place.¹⁵⁹ Adding legal sanctions in such cases may be unnecessarily duplicative.¹⁶⁰

Finally, breaches of commitments to others may result in personal losses. Family members who renege on commitments may be shunned at future gatherings. Such consequences operating outside the legal system may act as a powerful deterrent to breach.¹⁶¹

152. *Id.* at 414.

153. *Id.*

154. *Id.*

155. *Id.* at 414–15.

156. *Id.* at 415.

157. *Id.*

158. *Id.*

159. *Id.* at 416.

160. *Id.*

161. *Id.* at 393.

In judging whether nonlegal sanctions can effectively substitute for legal sanctions it is important to consider whether the kinds of structures that make reputational monitoring effective such as close-knit communities, mechanisms for assessing and distributing information, possibilities of repeat business, and the existence of organized markets and sophisticated investors who can evaluate and price the available information exist. These factors will become relevant in assessing whether legal intervention should be used to supplement private mechanisms.

C. Option Contracts

Another private device parties may rely on to encourage investment and contracting by controlling for the potential of party opportunism or other risks in an uncertain environment is the option mechanism.¹⁶² Mergers between two separate companies present a variety of uncertain risks that can be partially controlled through options. Mergers are complicated transactions involving many uncertainties. One uncertainty is the uncertainty surrounding the potential success or failure of the merger since there is at least “anecdotal evidence suggesting that half of all mergers fail to meet their objectives.”¹⁶³ There is also the risk of uncertainty about whether valuable employees of the target will defect after the merger.¹⁶⁴ Uncertainty about the accuracy of the target’s representations and financial reports and about the melding of two separate corporate cultures may also be present. All of these uncertainties may inhibit mergers, at least if protective safeguards are not in place.

Options operate in a merger context—whose uncertainties make complete express contracts difficult to achieve—to control “propensities to diverge”¹⁶⁵ and opportunistic behavior. In a recent case reported in the *Wall Street Journal*, Building Materials Holding Corp. (BMHC) designed a deal in which it, the acquirer, initially purchased fifty-one percent of the target, KBI Norcal, and formed a joint venture with the target owners.¹⁶⁶ The acquiring company also held an option to acquire the remainder of the forty-nine percent interest after two years, and after two more years,

162. My insights here build on the original insights of Ronald J. Coffey. *See infra* note 168.

163. Janet Whitman, *Company Finds Joint Ventures Ease Transitions*, WALL ST. J., July 3, 2002, at B10.

164. *Id.*

165. E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (June 10, 2002) [hereinafter Coffey e-mail (June 10, 2002)].

166. Whitman, *supra* note 163, at B10.

the contract permitted the target to insist that the acquiring company purchase that forty-nine percent interest.¹⁶⁷

The structure of the deal with the option device “gives the parties a way of breaking through the inhibitions. It causes B [Buyer] to be willing to invest in the first step. Without the partial-purchase with options mechanism, the null contract might have prevailed.”¹⁶⁸ The option device insures that the target management stays around for at least two years (and perhaps longer), giving the target and the acquirer time to meld their companies and thereby maximize the chances of success. The design of the option under which the target retains a forty-nine percent interest for two years also provides an incentive for the target to keep performing at a high level in order to continue to meet the buyer’s expectations and to encourage the seller to exercise the option after two years. Seller is thus encouraged to continue to invest in the joint venture in order to facilitate the early exercise of the option by the seller. Further encouragement for the seller to act prudently and to maximize the value of the joint venture may also derive from the way in which the option price is set.¹⁶⁹ If the option price is dependent on the future state of the firm, then “such provisions would give Seller a chance to show that the deal is good for B and to get a price dependent upon that showing.”¹⁷⁰

V. BUILDING A MODEL FOR LEGAL INTERVENTION

Before resolving the normative question of whether and how courts should intervene, and whether legal intervention would achieve certain goals, and if so at what cost, a broad analytical structure must be devised that goes beyond an assessment of nonlegal sanctions and the informational deficits affecting the parties and the courts. The structure must account for the various uncertainties that affect contracting parties.

The incomplete understanding of legal intervention stems from a failure to take sufficient account of a distinction between both incompleteness due to uncertainty regarding behavior and incompleteness due to uncertainty as to the future state of the world and exogenous events.¹⁷¹ Theories justifying judicial intervention must account for how the economizing drive by parties to mitigate conflict and control opportunistic behavior, maximize joint welfare, and encourage investment prompts parties to adopt private strategies to achieve those goals and thereby maximize gains from trade. Without a recognition of the parties’ need to control for such behavior, as well as an understanding of the barriers that interfere with such private controls, the court cannot engage

167. *Id.*

168. Coffey e-mail (June 10, 2002), *supra* note 165.

169. *Id.*

170. *Id.*

171. *See Battigalli & Maggi, supra* note 4, at 799.

in a cost comparison between legal and nonlegal strategies (contractual and otherwise) to control behavior and discretion in contracts,¹⁷² and any analysis rejecting legal intervention is premature.

The formalists focus on a particular problem that arises because parties are “asymmetrically informed”¹⁷³ about some matter such as the future state of demand. In these circumstances, the formalists allege that parties will avoid writing a contract that builds in a contract clause *ex ante* that will measure later performance that is based on an unverifiable factor. In such cases, courts should avoid supplying terms that the parties themselves eschewed since they will later contract out of such rules.

In focusing on a particular strategy for measuring performance that parties will avoid, in part because of the possibilities that such a strategy offers for strategic behavior,¹⁷⁴ the formalists have avoided looking at the wide range of solutions parties or courts might have for curbing opportunistic behavior in contract.¹⁷⁵ In adopting an overly narrow focus on a single strategy, the formalists have failed to provide a methodology for or against legal intervention in a broad array of cases.

To make the necessary cost-benefit comparisons, the structure must account for the common attributes of transactors,¹⁷⁶ the differential attributes of transactions, and the hazards or problems that affect contractual relationships, together with an analysis of the causes of incompleteness. Together these characteristics help provide realistic models of behavior and transactions critical to understanding how parties adapt to organize their transactions to achieve their goals, as well as the barriers parties face to contractually controlling for the ill effects of opportunistic behavior.

The analysis will proceed as follows. Section A will set forth a model for understanding how to understand human behavior that motivates transacting parties and why parties’ contracts incompletely solve for problems that arise in a contractual relationship.¹⁷⁷ Section B suggests a taxonomy.

A. Behavioral Economics

172. Controlling opportunism efficiently will provide value to the parties who would otherwise have to devote time and resources to guard against opportunism. See WILLIAMSON, *MECHANISMS*, *supra* note 10, at 60.

173. Schwartz, *Relational Contracts*, *supra* note 36, at 273.

174. *Id.*

175. Finally, the formalists have failed to look broadly at the many alternative ways in which courts or rulemakers choose to intervene in contracts. See *infra* Section VI.

176. WILLIAMSON, *CAPITALISM*, *supra* note 10, at 44–52.

177. The focus on a realistic model of how parties behave in contract is traceable to many scholars in economics, including Ronald Coase, who brought attention to frictions in contractual relationships. Economics scholars use such models “in assessing contract.” *Id.* at 43.

Understanding how parties bargain and why parties fail to achieve complete contracts and find it difficult to deal *ex ante* with the myriad frictions that will beset them over the course of a long-term relationship requires an understanding of something as fundamental as “human nature as we know it.”¹⁷⁸

Prior to the work of Oliver Williamson, economists had underestimated the importance of these behavioral assumptions.¹⁷⁹ Moreover, such economic theorists explained economic organizations narrowly in terms of “a response to technological features”¹⁸⁰ and did not address the effects of human behavior on organizational choices.

By suggesting that parties had choices in how they organized economic institutions and that such choices were not merely a response to technological aspects of production, institutional economics promoted a new purposive understanding of how parties made choices to promote certain goals.¹⁸¹ The central insight that rational parties organize to minimize transaction costs offered an important alternative explanation for various forms of corporate organization, including vertical integration.¹⁸² Instead of explaining a phenomenon such as vertical integration in monopoly terms, such internal organization could be rationalized as a means of minimizing conflict, especially where large sunk costs existed.¹⁸³

Understanding the purposeful desire of parties to minimize transaction costs permits legal decision-makers to understand why parties would structure their economic dealings and trades in particular ways and

178. FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 270 (1964). This focus on the implications of human nature began with Frank Knight in 1922, but the full importance of human nature in understanding how economic institutions were organized and in how parties interacted and resolved conflict was not fully realized until publication of Oliver Williamson’s seminal work, *The Economic Institutions of Capitalism* in 1985.

179. As Williamson points out, John R. Commons “recognized that economic organization . . . often has the purpose of harmonizing relations between parties who are otherwise in actual or potential conflict.” WILLIAMSON, *CAPITALISM*, *supra* note 10, at 3 (citing JOHN R. COMMONS, *INSTITUTIONAL ECONOMICS* 6 (1934)).

180. *Id.* at 3.

181. The primary focus was on the boundaries of the firm. Williamson’s instrumental focus is reflected in his statement that “[a] particular task is to be accomplished. It can be organized in any of several alternative ways. Explicit or implicit contract and support apparatus are associated with each.” *Id.* at 20.

182. *Id.* at 28 (citing “rebuttable presumption that nonstandard forms of contracting have efficiency purposes”).

183. Such sunk costs with the associated “lock in” effect are likely to make it difficult to depend on market trading since “the benefits [of the specialized investment] can be realized only so long as the relationship between the buyer and seller is maintained.” *Id.* at 62; *see also* HART, *supra* note 53, at 33 (suggesting other benefit of “increased incentive to make relationship-specific investments” where vertical integration replaced separate companies connected by contract).

how parties would react to certain legal interventions. The insight that parties are rational¹⁸⁴ and seek to minimize the costs of contracting consistent with solving their problems and maximizing the joint surplus suggests that parties would choose to structure their relationships and when to opt for contractual and noncontractual solutions. “[A] complete contract is only one form of ‘governance mechanism’ for guiding the behavior of contracting parties.”¹⁸⁵ Parties have a variety of mechanisms for achieving their goals. Such other “[a]lternative governance mechanisms include the courts and extralegal enforcement, such as social sanctions and reputation.”¹⁸⁶

Parties will weigh the costs inherent in negotiating complete express contracts with the costs of judicial enforcement and compare each of those costs to other private mechanisms and other nonlegal mechanisms for achieving these same goals. Whether courts should intervene in incomplete contracts with a term or remain passive should also be part of a comparative cost analysis to determine whether legal intervention would achieve certain goals with greater effectiveness. Williamson’s ideas help in two crucial ways. First, his insights into the common behavioral attributes of man and of the characteristics of transactions help to explain why parties cannot solve potential problems by express contract when there is a confluence of bounded rationality, sunk costs, and opportunism. Second, his insight that parties want to adopt the most efficacious means of solving their problems, including opportunism,¹⁸⁷ might suggest to a court interpreting a contract or grappling with an incomplete contract that the parties would want the court to intervene if such intervention were the most effective means of reducing transaction costs.

B. Taxonomy

Three attributes—uncertainty, sunk costs, and opportunism—make it very difficult for parties to resolve problems, such as party opportunism, or to achieve flexibility by contractual means. Because of the difficulty of achieving complete contractual solutions, parties may turn to private ordering and alternative mechanisms of private “governance structures”¹⁸⁸ as the most efficient means of solving their problems and maximizing the

184. Despite their increased recognition of the limits on rationality, the institutional economists continued to believe that parties were rational. See WILLIAMSON, *CAPITALISM*, *supra* note 10, at 45.

185. Cohen, *Implied Terms*, *supra* note 35, at 82 (citation omitted).

186. *Id.*

187. See WILLIAMSON, *CAPITALISM*, *supra* note 10, at 46 (discussing organizational preferences based on perceived differences in efficacy of curbing opportunism).

188. *Id.* at 63. Arbitration is one such private structure.

gains from trade which would otherwise be dissipated from the losses flowing from unfettered opportunism.¹⁸⁹

Parties negotiating contracts are beset by two types of uncertainty as well as cognitive limitations on their ability to detect future contingencies which will “affect the payoffs to the parties.”¹⁹⁰ The inability to foresee future contingencies (or to foresee them only with very costly expenditures of time and research) leads parties to enter into incomplete contracts. A simple example will suffice.

Imagine a buyer, *B*, who requires a good (or service) from a seller, *S*. Suppose that the exact nature of the good is uncertain; more precisely, it depends on a state of nature which is yet to be realized. In an ideal world, the parties would write a contingent contract specifying exactly which good is to be delivered in each state.¹⁹¹

In the real world, however, the resulting contract will be incomplete because of the expenses that the parties would have to assume to find out what the future state of the world will be.¹⁹²

189. *See id.*

190. James M. Malcolmson, *Contracts, Hold-Up, and Labor Markets*, 35 J. ECON. LIT. 1916, 1917 (1997); *see also* Eggleston et al., *supra* note 12, at 100 (“As a matter of theory, one can talk about contracts being fully state-contingent, allocating obligations efficiently for every payoff-relevant future state of the world.”). This assumption of bounded rationality is the operative assumption for transaction-cost economics, and it limits the ability of parties to achieve their goal of controlling opportunism.

191. Hart & Moore, *supra* note 56, at 115.

192. *See id.* To some extent the problems in describing the uncertain future state of the world *ex ante* by contract can be solved by giving an option to the party who is required to make an investment the right to make a “take-it-or-leave-it offer” at the date of the trade. *Id.* at 118. Then, even if the goods to be traded cannot be described *ex ante* since it depends on a yet to be realized state of nature, so long as the parties can actually observe and describe the state of nature at the trade date (even if it is not verifiable), the optimal contract can be achieved even without the goods being describable *ex ante*. *See* Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83 (1999). The take-it-or-leave-it option mechanism in effect overcomes the describability problem. *See* Hart & Moore, *supra* note 56, at 115–16, 119. The applicability of this substituted option mechanism, as a way of overcoming the describability problem, is a private device parties can use to overcome *ex ante* describability problems and is of limited usefulness here. First, it depends on there being no ability to renegotiate the contract. *See id.* at 120. Without that guarantee, the incentive to invest is diluted and a written contract is no better than a null contract (that is, no contract). *See id.* Second, the device of a contract with a built-in option to be exercised at the trade date, once the state of the world has been realized, is of limited usefulness when the uncertainty concerns behavioral uncertainty. In that case, although the exact nature of the way in which the opportunistic behavior will be realized must await the passage of time, it is certain that such divergence will occur. Moreover, postponement of the trade and price until a later juncture (as exists in the option contract) will not be effective

Uncertainty also means that *ex ante* parties cannot detect how the other party behaved in the past because of strategic behavior to conceal damaging information and there is uncertainty about the likelihood that they will act opportunistically in the future.¹⁹³

The true significance that the condition of uncertainty poses for contracting parties, however, cannot be understood without analyzing two other characteristics: opportunism and asset-specificity.

Opportunism is defined as “self-interest seeking with guile.”¹⁹⁴ It refers also to the “incomplete or distorted disclosure of information”¹⁹⁵ Parties to a relationship may have a propensity to act opportunistically and to act strategically by exploiting the relationship “in order to benefit from the relationship without conferring an equivalent benefit on the other party to the relationship.”¹⁹⁶ Such opportunism may arise when one party makes specialized investments. The person making such investments may be subject to “hold up” by the other party.¹⁹⁷

because at that point, the advantaged party has an incentive to exploit the sunk costs and to act strategically. Finally, the option mechanism that postpones a trade or an action until a later date will not work when the actor “must react quickly to contingencies, and playing a mechanism [with the other actors] before taking action is out of the question.” Battigalli & Maggi, *supra* note 4, at 801 n.6 (discussing the example of a babysitter or agent having to make a decision before consultation with the child’s parents).

Contract is replete with examples of incomplete contracts. Parties in requirements contracts who do not know what their future need for a good will be leave the contract incomplete, promising today to buy what their requirements turn out to be in the future. Similar uncertainty afflicts an employment contract since the employer does not know *ex ante* how much effort an employee or agent will exert; the level of amount of the effort is unknown at the time that the contract is negotiated. If there were perfect foresight about the employee’s projected level of effort, then the contract could condition payment on a certain level of effort being exerted. Many factors will interfere with such a complete contract including the fact that the employer cannot observe the employee’s actions or level of effort directly. See Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 38–39 (John W. Pratt & Richard J. Zeckhauser eds., 1985). Moreover, it might be difficult to verify the level of effort for a neutral court. For that reason many contracts between a principal employer and an agent remain less complex than might be expected.

193. Coffey e-mail (June 30, 2003), *supra* note 40.

194. WILLIAMSON, CAPITALISM, *supra* note 10, at 30.

195. *Id.* at 47. In the insurance context, opportunism of this kind refers specifically to the adverse-selection problem by insureds who do not wish to disclose their true propensities for risk.

196. Interview with Peter M. Gerhart, Professor of Law Case Western Reserve University School of Law, at Case Western Reserve University School of Law (June 26, 2003).

197. See Patrick W. Schmitz, *The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory*, 53 BULL. ECON. RES. 1, 4 (2001); see also WILLIAMSON, CAPITALISM, *supra* note 10, at 52–56; George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 987–88 (1992).

This “hold-up” problem may lessen the incentive to invest. Preserving the incentive to invest in contexts involving opportunism is explored in Tom K. Lee and I.P.L. Png, *The*

Sunk costs or asset specificity refers to investments made that cannot readily be redeployed except at great loss.¹⁹⁸ The presence of sunk costs and opportunism are critical for understanding how parties bargain and even organize their economic institutions. Their importance for contracting should not be underestimated.

In any transaction parties can choose between “special purpose and general purpose investments.”¹⁹⁹ To understand this concept, an example may be useful. Where *B* refers to buyer and *S* refers to seller, “[s]uppose that in order to realize the benefits of the input, *B* must first make an investment [*a*’] which is specific to *S*; for example, *B* might have to build a plant next to *S*.”²⁰⁰ The choice by buyer to invest in such assets will often have benefits to the parties; there may in fact be “cost savings afforded by the special purpose technology.”²⁰¹ For example, locating the plant next to the seller may result in greater efficiencies in terms of reduced transportation costs or other special advantages afforded by the particular location.²⁰²

The presence of such sunk costs, however, may foster opportunities for strategic behavior. In the above example before the investment by buyer, if problems or frictions develop during the trading relationship, then the buyer is free to simply buy products on the open market from another seller. Once asset-specific knowledge or investment has been made or acquired, “[p]arties engaged in a trade that is supported by nontrivial investments in transaction-specific assets are effectively operating in a bilateral trading relation.”²⁰³

Because of the specialized investments, the parties are locked into the relationship; they cannot recoup their investments if they exit the relationship.²⁰⁴ A long-term contract would provide the logical means of advance planning for situations that will involve the lock-in effect and possible monopoly power.²⁰⁵

If parties have unbounded rationality, the parties are opportunistic and the assets are specific, then the parties could solve their problems *ex*

Role of Installment Payments in Contracts for Services, 21 RAND. J. ECON. 83, 95 (1996) (exploring law-supplied installment payment scheme as a means of preserving incentive to invest).

198. Sunk costs refer to special purpose investments. See WILLIAMSON, CAPITALISM, *supra* note 10, at 54.

199. *Id.*

200. Hart & Holmstrom, *supra* note 20, at 129.

201. WILLIAMSON, CAPITALISM, *supra* note 10, at 54.

202. See Goetz & Scott, *supra* note 21, at 1267–68.

203. WILLIAMSON, CAPITALISM, *supra* note 10, at 30.

204. Hart & Holmstrom, *supra* note 20, at 72.

205. *Id.*

ante by contract.²⁰⁶ A prime example illustrating these assumptions is known as “mechanism design.”²⁰⁷ In principal-agent literature, economists recognize that agents will be prone to shirking and that the parties will invest specific assets in the relationship. Nevertheless, because it is assumed that parties have unbounded rationality, a contract can solve all potential problems in advance.

If one assumes, by contrast, that parties are subject to cognitive limitations and there is asset specificity but no opportunism, the presence of bounded rationality will inevitably lead to contractual gaps.²⁰⁸ However, the parties could still reach a private contract to solve potential frictions. They could adopt a simple “self-enforcing general clause”²⁰⁹ and “pledge[] at the outset to execute the contract efficiently (in a joint profit maximizing manner) and to seek only fair returns.”²¹⁰ Parties would proceed to execute the contract, and because parties were not opportunistic, they would abide by their promise to act fairly when problems arose.

The third scenario involves only two of the three characteristics and would consist of opportunistic parties with limits on rationality but no asset-specific investments. If sunk costs are absent, then even if parties cannot foresee potential problems and even if parties were to act opportunistically at a juncture in their relationship, it would not matter because parties could simply exit the relationship and sell or buy their products or services to another party.²¹¹

When there is a confluence of all three behavioral characteristics as is often the case in contractual relationships, it becomes difficult to solve problems by contract *ex ante*. Bounded rationality will mean that the contract will contain gaps as parties will not be able to foresee all contingencies affecting payoffs and provide for them by express contract. Uncertainty about parties’ proclivities for opportunism will also hamper express contractual solutions. The presence of opportunism itself means that even a general clause promising to act fairly will not be effective as a means of filling the incomplete contract because of “the unenforceability of general clauses [without intervention] and the proclivity of human

206. See WILLIAMSON, CAPITALISM, *supra* note 10, at 30–31 (“Given unbounded rationality, a comprehensive bargain is struck at the outset, according to which appropriate adaptations to subsequent (publicly observable) contingent events are fully described. Contract execution problems thus never arise Contract, in the context of unbounded rationality, is therefore described as a world of planning.”).

207. See Roger B. Myerson, *Incentive Compatibility and the Bargaining Problem*, 47 ECONOMETRICA 61 (1979).

208. WILLIAMSON, CAPITALISM, *supra* note 10, at 31.

209. *Id.* The simplicity of the clause is due to bounded rationality. Williamson calls this the “world of promise.” *Id.*

210. *Id.*

211. Williamson calls this the “world of competition.” *Id.* at 32.

agents to make false and misleading (self-disbelieved) statements”²¹² Finally, the presence of sunk costs and bilateral monopoly will mean that “both buyer and seller are strategically situated to bargain over the disposition of any incremental gain whenever a proposal to adapt is made by the other party.”²¹³ When these three characteristics converge, “[g]overnance structures that attenuate opportunism and otherwise infuse confidence are evidently needed,”²¹⁴ and *ex ante* the parties would want a structure in place that can most efficiently control contractual hazards.

C. *Will Judicial Intervention Foster More Opportunism?*

One potential concern with judicial intervention in incomplete contracts that is voiced by the new formalists is that courts could actually lead to opportunistic behavior and increase moral hazard.

The new formalists argue that “courts trying to solve information problems *ex post* create moral hazard (or opportunism) for future parties.”²¹⁵ This dynamic may arise if a court intervenes to condition parties’ obligations on nonverifiable factors (such as demand). Intervention by a court in such a case would give one party an opportunity, such as a buyer, to falsely claim low demand to get a price break. The cost of intervention, if it took the form of a default rule, would be too high and therefore should be avoided. Otherwise, parties would have to undertake the cost of opting out of such suboptimal rules in the future.

If courts act to police opportunism in a particular case using the taxonomy suggested in this Article, the fear is the emergence of a default rule that fosters opportunism in future cases.²¹⁶ Yet, the possibility that the legal interventions described here will backfire by fostering counteropportunism seems remote for several reasons.

The fact that a court supplying terms to fill in terms in incomplete contracts (as by conditioning the price on the demand even when not stated in the contract) might foster opportunism should not be used as a sustained logic against all types of legal intervention in incomplete contracts. The danger that courts can intervene in such a way as to unleash opportunistic behavior by the counterparty is a real possibility. However, the concern that a particular type of intervention-by-courts rule—to supply terms eschewed by the parties—could actually foster moral hazard by parties is predicated on a narrow example. While it may

212. *Id.* at 63. Such clauses may also face the problem that they may not be enforceable. *Id.*

213. *Id.*

214. *Id.*

215. Scott e-mail (Feb. 11, 2004), *supra* note 5.

216. *Id.*

be true for the particular circumstances described by the new formalists, the danger of counteropportunism from a law-supplied rule or term is not great across the board. In fact, the suggestion that the law should intervene with a law-supplied liability rule or term when the costs of doing so can more effectively curb opportunism than private mechanisms is one that would be preferred by the parties *ex ante* as a means of increasing gains from trade.

There are several reasons why the law-supplied liability rules or terms (governing precontractual negotiation, unilateral contracts, good-faith obligations, and subcontracting) may be desired by both parties *ex ante* and would not create moral hazard that would cause parties to opt out of such rules. First, the possibility of opportunism may be mitigated by the fact that the nature of the suggested grounds for legal intervention could serve to police opportunistic behavior by either party across a variety of transactional settings. If either party could demonstrate the structural impediments impairing complete bargains, including uncertainty, sunk costs, and opportunism, that party might be able to get the court to invoke a law-supplied rule if the private strategies for curbing opportunism were more costly. One example of legal intervention where either side could allege a breach of an obligation of the law-supplied term, arises with good faith. Either the buyer or the seller might be able to argue that the requirements demanded or the output supplied was made in bad faith. In such instances, the danger that one party could use the law's intervention to opportunistically exploit the other would be mitigated by the prospect of a countersuit.

In promissory estoppel cases, unlike the intervention by courts to supply nonverifiable terms that give one party a legal basis for acting opportunistically, the liability rule imposed on promisors in promissory estoppel cases curbs opportunistic behavior by promisors in a case where contractual solutions and private devices (such as monitoring, bonding, and screening) are costly solutions to a recurrent problem and increases social welfare. Without the liability rule, promisees will be reluctant to rely. Because they will be uncertain about the proclivities for opportunism by promisors, they will not be able to judge whether it is safe to rely without an enforceable contract. Without the liability rule, promisees will take account of the danger of moral hazard by withholding reliance since there is no way yet to account for the moral hazard in the price of the contract since there is not yet a contract.

Even if there is some potential for opportunistic behavior by promisees who are now protected, the danger of counteropportunism by the protected party is mitigated by the fact that reliance is only protected to the extent that it is reasonable. Moreover, because the promissory estoppel cases impose liability on promisors for expenditures that they requested to help them reduce uncertainty about the promisee, it is reasonable to suppose that promisors as a class *ex ante* would want to be

liable if the alternative were less reliance by promises and greater uncertainty for promisors.

In other cases, the danger of the law's intervention causing moral hazard also seems remote. Where sunk costs fall largely on one side, as in the Section 45 unilateral contract situation of the Second Restatement, the possibility that the party with sunk costs would be able to opportunistically exploit the other party who has minimal sunk costs would seem small. The party who has requested a performance can simply exit the relationship and buy alternative services or goods on the market. Thus, in certain cases the absence of parity in the degree of sunk costs may provide a natural barrier to counteropportunism possibilities.

Finally, the suggested taxonomy for assessing the merits of legal intervention merely posits that in cases where uncertainty, sunk costs, and opportunism interfere with the parties' own abilities to control for opportunism, and where the costs of a law-supplied rule or term are cheaper than the private strategies for achieving the same goals, then it makes sense to supply such a rule and thereby increase gains from trade. The suggested taxonomy is not inconsistent with the work of the new formalists who counsel against intervening with unverifiable terms that the parties avoided because of the possibilities such terms would offer for strategic behavior. In such cases, the taxonomy would agree and counsel against such forms of interpretation as it would not increase gains from trade.

VI. APPLICATIONS OF THE MODEL: PRECONTRACTUAL NEGOTIATION, SECTION 45 CONTRACTS, AND CONTRACTING

This model, in which behavioral uncertainty, opportunism, and sunk costs converge and make it difficult and costly to constrain, the effects of behavioral opportunism by contract can be seen in many different contexts. The model is useful in understanding recent doctrinal developments that have seemingly curbed the parties' freedom from contract by expanding liability in areas previously immune from contract. The increase in contractual liability in settings involving both uncertainty and behavior may begin to make sense if the effect of these matters on the "form of the incompleteness that is caused by unforeseen events"²¹⁷ is analyzed. If parties are uncertain about behavior that needs to be controlled, then they will omit sentences that effect such controls that will result in more "discretion to the agent."²¹⁸ This Article posits that the form of incompleteness associated with behavioral uncertainty—discretion—may need to be controlled by courts if private strategies are

217. Battigalli & Maggi, *supra* note 4, at 811.

218. *Id.* at 806.

too costly. The law has begun to intervene in several areas. The form of intervention is slightly different in each case but the effect of the intervention is to control or regulate unbridled discretion and thus to curb opportunism. The effect of such interventions may be to create a default rule to police opportunistic behavior.

The first example of intervention arises in precontractual negotiations. In such settings, uncertainty, moral hazard, and sunk costs converge. The promisee faces the prospect that the promisor will act opportunistically by exploiting sunk costs that the promisee invests on the advice and perhaps at the request of the promisor.²¹⁹ These sunk costs help to reduce uncertainty about the promisee and thus function as a screening device for the putative promisor. This problem, however, cannot easily be solved *ex ante* through contracting. The promisee cannot foresee all of the potential choices the promisor will face in the negotiations and thus bounded rationality constrains a detailed express contract. Even a general clause by which the promisor promises to act fairly is unfeasible. Although such clauses are easier to negotiate where bounded rationality limits the ability to agree on detailed contracts, the promisee will not believe the promisor and will not rely on such clauses.²²⁰

Another alternative would be for the parties to subdivide the various performance steps taken by the promisee and to price each of them in such a way as to be acceptable to both parties in the precontractual context. Achieving those sub-bargains for each phase of performance, however, is likely to be costly. Because of the costs of the private sub-bargains, the barriers and costs to controlling the promisor's behavior by detailed express contracts and the likely infeasibility of general clauses promising generalized cooperation, judicial intervention through a liability rule may be warranted as the least costly alternative and may help to explain why contract law chooses to impose a liability rule on promisors even when the parties have failed to achieve a completely explicit bargain.

The model presented here may be useful in identifying other circumstances in which a law-supplied rule may be the most efficacious solution to the opportunism problem. One such setting involves the partial performance doctrine applicable to unilateral contracts.²²¹ The Second Restatement provides that if an offeror requests performance as the exclusive means of acceptance and the offeree begins performance,

219. The promisor often seeks information from the promisee to screen the worth of the promisee's reliance investments. For a detailed discussion of the role of legal intervention in precontractual negotiation, see Kostritsky, *supra* note 27, at 641–44.

220. Such clauses may not be enforceable. See WILLIAMSON, CAPITALISM, *supra* note 10, at 63.

221. See RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 18, § 45.

the offer becomes irrevocable.²²² In effect, the law implies a term of irrevocability that is not expressly agreed to by the parties. That form of legal intervention may be justified by the framework suggested here. The transactional setting involves one-sided sunk costs invested by the offeree which heighten the danger that an offeror will act opportunistically by letting the offeree begin performance and then revoking the offer and offering less favorable terms or seeking an alternative contractual partner. The sunk costs will make it difficult for the offeree to pursue a simple exit strategy on the market with an alternative partner because the offeree's transaction specific assets may not be redeployable. Bounded rationality or limits on the ability to perceive the future may make it difficult to craft an express detailed contract controlling all the varieties of offeror opportunism.

The same taxonomy can be applied to the subcontracting cases. In these cases, the court confronts the issue of whether they should intervene by implying a term of irrevocability for the subcontractor's offer. The subcontracting context is subject to a variety of factors that interfere with the achievement of a fully contingent bargain that would protect the reliance by either party. There is uncertainty about future events: the general contractor cannot unconditionally promise to use the subcontractor because it is uncertain whether the general contractor will be awarded the overall contract. Yet, the general contractor must rely by using the subcontractor's bid, thereby leaving the general contractor vulnerable should the law impose liability only when there is a full-fledged reciprocal bargain. The court has decided to limit the subcontractor by eliminating his power to revoke.

Thus, transactional settings of precontractual negotiation, unilateral contracts, and subcontracting present a class of cases in which the recurring threat of opportunism is virtually the same threat throughout a class of transactions: those involving an offer followed by partial performance by the offeree. For that reason, a law-supplied rule controlling the opportunism with a law-supplied term of irrevocability may be the cheapest form of controlling the offeror's opportunism and thereby maximizing the surplus for the parties. If the threat presented in each case is of the same nature, then it would seem that a law-supplied rule which can be supplied uniformly by a one-time default rule is likely to be more efficient than requiring each party to draft specific contractual protections. It may also be more efficient than some of the private bonding mechanism since they would have to be negotiated individually.²²³

222. *Id.* at cmt. d.

223. It may also be possible to rationalize a law-supplied rule such as an implied reasonable notice provision for termination in franchise contracts that are silent on whether any notice is required. Arguably the transactional setting involves sunk costs by

VII. CONCLUSION: REASSESSING JUDICIAL INTERVENTION IN AN IMPERFECT WORLD

Legal intervention to supply terms (such as promises of irrevocability) or to impose liability in precontractual negotiations seemingly represent incursions on the parties' freedom from contract. Yet, it is possible to look at these "incursions" as efforts by courts to increase the parties' joint gains by successfully serving the instrumental goal of controlling opportunism when other methods remain more costly. Parties have a variety of means to control hazards in contractual relationships and thereby increase gains from trade. Because of the high costs associated with expressly controlling the opportunism by express contracts, parties use many devices, including nonlegal sanctions or vertical integration to control for opportunism.

The fundamental question for the legal system looks beyond these private devices to ask when, if ever, courts should intervene in resolving incomplete contracts, by supplying terms or performance obligations or liability rules, when the parties have failed to expressly bargain for them? Although neoclassical contract theory and the Code consciously embraced an activist approach to incomplete contracts, the new formalists have recently called for a retrenchment of judicial activism. Such formalists argue courts that can do more harm than good when they seek to intervene by supplying terms that depend on inaccessible information or when they seek to judicialize informal norms.

This Article has argued that the formalists have taken an unduly restrictive approach to determining whether law-supplied terms or liability rules can be justified. By focusing on instances where the parties themselves have chosen not to condition performance on certain inaccessible data, and condemning judicial intervention that seeks to supply such information, the formalists have avoided grappling with a comprehensive methodology for justifying law-supplied rules. That methodology should take an instrumental approach to determine whether

the franchisee (not redeployable) and that leaves the franchisee vulnerable to opportunistic behavior by franchisors. Contract clauses, either the specific kind or the more general cooperative clause, are unlikely to be effective because of the bounded rationality problem or because of the tendency to disbelieve general pledges to be cooperative. WILLIAMSON, CAPITALISM, *supra* note 10, at 63 n.23. However, the franchisee situation presents opportunism of another sort: shirking by franchisees, which may debase or dilute the value of the franchise name. *Id.* at 180–81. Thus, the reason that the court may decline to intervene with a reasonable-notice provision is that the specific investment acts as a kind of hostage provided by the franchisee, which will deter him from engaging in bad behavior which would subject him to early termination. *Id.*; *cf.* Schwartz, *Relational Contracts*, *supra* note 36, at 306 (explaining judicial disinclination to imply a reasonable-notice provision because doing so would require the court to award damages which depended on unverifiable information).

legal intervention would advance or hinder goals, such as maximizing joint surplus, controlling party opportunism, providing incentives to rely on and invest in contracts and maximizing welfare and at what cost. A full accounting of the costs and benefits of legal intervention must consider the feasibility of private strategies for achieving those goals. A broad methodology for justifying legal intervention, which also identifies specific constituent elements where legal intervention is likely to be welfare enhancing, would help to explain when judicial activism would be warranted and counter the formalists' calls for a retrenchment of judicial intervention. It would also reconceptualize incursions on the parties' freedom of contract as welfare enhancing.

In this Article, I have assumed that courts interpreting contracts will and ought to explicitly consider what rules will promote efficiency in contract formation. Specifically, courts should be concerned with implementing rules that maximize social wealth and minimize transaction costs for the parties. In reaching such conclusions about whether legal intervention would achieve such efficiency in incomplete contracts, rule-makers ought to advert to economic models of bargaining and to the behavioral attributes of the parties.

To determine whether and when courts should intervene one must begin with Ronald Coase's insight that absent transaction costs, it would not matter which legal rule were adopted.²²⁴ If a court adopts a legal rule that is in fact suboptimal, then the parties would simply bargain around the initial rule and achieve an optimal outcome on their own.²²⁵ With transaction costs, however, the parties may not be able to achieve an optimal outcome and thus, the choice of the initial legal rule may be important. To choose the rule that would be preferred by the particular parties to the transaction, the court may lack access to the data that would tell it which rule would be optimal. Nevertheless, to save the parties transaction costs, courts opt for default rules that the majority of parties would prefer. "Where transaction costs are too high for parties to fashion their own rule, it nonetheless is normatively correct to provide them with the rule that they probably would have chosen for themselves at the time of contracting had they been able to bargain."²²⁶ Idiosyncratic parties may of course opt out of the law-supplied rule.

Whether a court should intervene with a term or a law-supplied obligation should depend on a number of considerations. Some of these considerations relate to the characteristics of the transaction and to human behavior, some relate to the effectiveness and cost of nonlegal sanctions in the particular context, some relate to the nature of the legal intervention

224. Coase, *supra* note 78, at 15–16.

225. *Id.* at 15.

226. Scott, *Formalism*, *supra* note 7, at 850.

being called for, and some relate to whether the parties have opted for a comprehensive structure of nonlegal alternatives.

To determine whether legal intervention would be value-maximizing in any particular case, one must first grapple with whether there is a confluence of bounded rationality, sunk costs, and opportunism. Since bounded rationality and opportunistic tendencies are characteristic of human nature, the only question would be whether there are sunk costs. Absent sunk costs, a party encountering disruption in a relationship could simply resort to the market and it would not be necessary for the law to intervene in any way. With sunk costs and the presence of bounded rationality and opportunism, the possibility of completely contingent contracts is unrealistic, making the need for private alternative mechanisms or legal intervention a necessity for controlling the inevitable frictions in a contract.

The second constituent element in any determination of whether legal intervention is justified is the existence of and likely effectiveness of nonlegal sanctions. Determinations of effectiveness of such sanctions should consider three factors: (1) whether there are informational structures in place for disseminating information;²²⁷ (2) whether there are already sunk costs in place, which help to provide nonlegal sanctions;²²⁸ and (3) whether the context involves a homogeneous community that can effectively disseminate reputational information.²²⁹

The third element should consider whether there is a mechanism by which the price can be discounted to reflect the absence of private protective safeguards to control opportunism. If the context involves the sinking of costs before a price mechanism is negotiated, then a law-supplied obligation might be the only mechanism to induce parties to invest sunk costs. Without a law-supplied obligation, the party might be reluctant to invest any sunk costs which might be desired by the other party.

Fourth, in determining whether legal intervention would be beneficial, one should focus on the nature of the intervention being called for. Is the court asked to intervene in such a way that doing so would require the court to supply information about external states of the world which are noncontractible and which the parties themselves deliberately failed to condition on? If so, then the court should probably decline to intervene if intervention would require the court to supply such noncontractible information. If, on the other hand, the court is asked to intervene with a law-supplied obligation to curb a recurring problem of

227. The bond market provides one example of such a structure. *See supra* note 151.

228. Charny, *Nonlegal Sanctions*, *supra* note 134, at 416.

229. The close-knit diamond industry furnishes one such example. *See supra* note 150.

opportunism and it is clear that private devices would be more costly because they would have to be negotiated seriatim, then there is reason for the court to intervene to achieve welfare improvement.

Fifth, the court should determine whether the parties have opted out of legal sanctions by structuring their transaction to avoid incurring a legal commitment, or alternatively, subscribed to a comprehensive structure of nonlegal sanctions (as in the case of a centralized nonlegal arbitrator). The presence of a comprehensive structure of nonlegal sanctions lessens the reason for court intervention and the absence of such a structure or of the possibility of effective nonlegal sanctions suggests a potential role for judicial intervention.

Finally, the court should determine whether the parties have been able to achieve a finely crafted device to control for opportunism in an uncertain world. The option contract provides one example. The presence of such elaborate devices may indicate that judicial intervention is less necessary, at least in circumstances where the parties can structure an option that can help the parties overcome some of their reluctance to invest in an uncertain partner.

When a court is asked to add terms or liability rules beyond those expressly agreed to by the parties to a contract or not part of their usual meaning, it must decide whether legal intervention is justified. Because parties have often not signaled their intentions on the desirability of the law-supplied terms (or even mentally adverted to such terms) the court must decide, using models that will project consequences on *ex ante* and *ex post* behavior, whether the legal intervention will maximize gains from trade.

Current commentators—the new formalists—have suggested that courts reject legal intervention in incomplete contracts and instead limit their role to the literal enforcement of the express terms agreed to by the parties. Their argument for a modest judicial role is premised on the notion that in cases where the contract is incomplete because the information about external states of the world is not observable or not verifiable, the courts should decline to intervene because without access to the information, they cannot improve outcomes for the parties.

This Article has suggested that the current assault on judicial intervention in incomplete contracts with its concomitant narrowing of freedom from contract pays insufficient attention to behavioral sources of incompleteness and focuses too narrowly on one form of institutional incompetence. In so doing, the formalists have missed the central point that legal intervention may be indispensable as a means of curbing opportunistic behavior, rather than incursions on the freedom not to contract.

This Article has suggested methodology that identifies the characteristics of parties' relationships (sunk costs, opportunism, and uncertainty), which will make private efforts to control opportunism too

costly and also identifies constituent elements of an analysis that will allow the court to decide whether legal intervention is likely to be superior to nonlegal sanctions.