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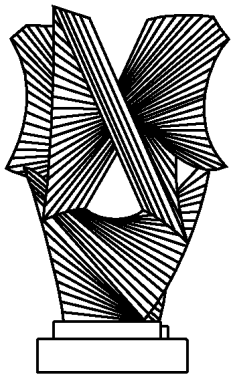

A Theory of Contract Law under Conditions of Radical Judicial Error

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Ian Macneil famously argued that earlier contracts scholarship followed a "neoclassical model," according to which contracts are understood to be discrete, one-shot exchanges. Two strangers approach each other, bargain, exchange promises, and either discharge those promises or breach. If a dispute occurs, and a lawsuit is filed, the court determines whether a breach has occurred, and awards damages, based strictly on the contract, together with any evidence of negotiations that sheds light on the parties' contractual intentions. Macneil introduced a new model, the "relational model," under which contracts are analyzed as elements of existing relationships. The relationships are not governed by contractual intentions, but reflect a variety of influences, including social norms and the norms of conduct that develop within the relationship. The parties understand their contracts within the context of their relationship, and it seems that courts do too, whether or not they make this explicit. Macneil has argued that the relational model is the more accurate and useful method, and has urged other scholars to adopt this view.[2]

To some extent, events have vindicated Macneil's views, but the reality is complex.[3] Initially, it must be stressed that the earlier

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[1] Professor of Law, University of Chicago. Thanks to Richard Craswell and to participants at a conference in honor of Ian Macneil, Northwestern University Law School, and for the financial support of the John M. Olin Fund, the Sarah Scaife Foundation Fund, and the Ameritech Fund in Law and Economics.

[2] Ian R. Macneil, Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law, 72 Northwestern University Law Review 854 (1978).

[3] In particular, it is hard to believe that the neoclassical model, to the extent that it overlaps the standard economic approach, has been exhausted. A sample of recent work along these lines includes Ian Ayres and Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 94 Yale Law Journal 97 (1989); Lucian Arye Bebchuk and Steven Shavell, Information and the Scope of Liability for Breach of Contract: The Rule of Hadley v. Baxendale, 7 J.L.

scholarship was not monolithic. Legal realists like Karl Llewellyn understood that contracts occurred within relationships, and that powerful social norms may play a greater role in regulating contracts than the law does,[4] an idea illustrated by a well-known article published by Macauley some years later.[5] In addition, much modern contracts scholarship, while not explicitly embracing Macneil's approach, clearly shared his concerns.

To illustrate, consider some of the law and economics work of the 1970s. Goldberg argues that the relational contract approach differed from the neoclassical approach by acknowledging that: (1) information is imperfect and costly; (2) people engage in opportunism; and (3) outsiders (the courts) will not necessarily enforce agreements accurately.[6] Now these ideas were all firmly

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Econ. & Org. 284 (1991) (same); Jason Scott Johnston, Strategic Bargaining and the Economic Theory of Contract Default Rules, 100 Yale L.J. 615 (1990); Ian Ayres and Robert Gertner, Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules, 101 Yale L.J. 729 (1992) (same); Alan Schwartz, The Default Rule Paradigm and the Limits of Contract Law, 3 S. Cal. Interdisc. L.J. 389 (1994) (same); Christine Jolls, Contracts as Bilateral Commitments: A New Perspective on Contract Modification, 26 J. Legal Stud. 203. (1997) (contract modification); Alexander J. Triantis and George G. Triantis, Timing Problems in Contract Breach Decisions, 41 J. Law & Econ. 163 (1998) (options approach to contract damages); Paul G. Mahoney, Contract Remedies and Options Pricing, 24 J. Legal Stud. 139 (1995) (same); Eric A. Posner, Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom of Contract, 24 J. Legal Stud. 283 (1995) (restrictions on contractual freedom); Lars A. Stole, The economics of Liquidated Damage Clauses in Contractual Environments with Private Information, 8 J. Law, Econ. & Org. 582 (1992) (penalty doctrine); Eric Talley, Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule, 46 Stan. L. Rev. 1195 (1994); Avery Wiener Katz, An Economic Analysis of the Guaranty Contract, 66 U. Chi. L. Rev. 47 (1999) (guaranty contracts); Thomas J. Miceli, Contract Modification When Litigating for Damages Is Costly, 15 Int'l Rev. L. & Econ. 87 (1995); Aaron Edlin & Stefan Reichelstein, Holdups, Standard Breach Remedies, and Optimal Investment, 86 Am. Econ. Rev. 478 (1996). Some other examples are cited below.

[4] As Macneil acknowledges; see Ian R. Macneil, The Many Futures of Contract, 47 S. Cal.L.Rev. 691, 734 n. 131 (1974).

[5] Karl Llewellyn, What Price Contract? — An Essay in Perspective, 40 Yale Law Journal 704 (1931); Stewart Macauley, Non-Contractual Relations in Business: A Preliminary Study, 28 American Sociological Review 55 (1963).

[6] Victor P. Goldberg, Relational Contract, in The New Palgrave Dictionary of

established in the law and economics work of the late 1970s and early 1980s. The work on contract damages by Shavell and others generally assumed that the parties could not anticipate at zero cost every contractual contingency, and that is why courts must fill in contractual gaps by awarding damages.[7] All law and economics work assumed that people would engage in opportunism, for example, breaching rather than performing if their gains from breach exceeded their costs of performance, regardless of the loss imposed on the promisee. The debate between Kronman, Schwartz, and others about the desirability of specific performance turned, in part, on how accurately courts could determine the promisee's loss as a result of the breach of contract.[8] So the debate was explicitly about the accuracy or inaccuracy of the courts.[9]

Still, this work has a different flavor from the more recent work by scholars involved in law and economics. The recent work, more so than earlier work, reflects Macneil's focus on problems arising from long-term or relational contracts. Long-term contracts raise a straightforward, but seemingly intractable problem: in the long term, events are so hard to predict, that parties will not be able to allocate future obligations and payments in a way that maximizes the value of their contract. They will have to anticipate renegotiation as the future reveals itself, but if the parties expect to renegotiate, then they cannot bind themselves to a contract, in which case the party whom events throw in the vulnerable position will be at the mercy of the

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Economics and the Law 288 (Peter Newman ed. 1998).

[7] See, e.g., Steven Shavell, Damage Measures for Breach of Contract, 11 Bell J. Econ. 466 (1980).

[8] See, e.g., Anthony Kronman, Specific Performance, 45 U. Chi. L. Rev. 351 (1978); Alan Schwartz, The Case for Specific Performance, 89 Yale L.J. 271 (1979).

[9] In fact, all of these ideas appeared in articles by economists going back into the early 1970s, work from which much of the law and economics literature derives. The economic literature on "incomplete contracts," which parallels the legal work on relational contracts, has its roots in this earlier work. See Oliver Hart and Bengt Holmstrom, The Theory of Contracts, in Advances in Economic Theory 5th World Congress 71-155, T. Bewley, ed. (London: Cambridge University Press). See also Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975). For Macneil's views, see Ian R. Macneil, Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus," 75 Nw. U.L. Rev. 1018, 1039ff. (1981).

party whom events favor. Yet somehow parties in the real world manage to overcome these problems. Relational contracts are popular and effective, yet not (apparently) because parties can draft a relatively complete contract that a court will be able to enforce. On the contrary, if the parties have a dispute, and go to court, they cannot expect the court to enforce contractual obligations on the basis of the initial contract, given that the initial contract will most likely have nothing to say about events occurring many years later.

One of Macneil's contributions was to help legal scholars to see that the traditional model, however convenient it was from a methodological perspective, was inadequate for analyzing this important side of contractual behavior. But having acknowledged this, we must proceed with some sort of analysis. If Macneil is right, and courts cannot resolve contractual disputes by discovering initial contractual intentions on the basis of documents and other evidence, cannot use such intentions (even if they exist) to guide behavior late in the life of a relational contract, cannot enforce contracts in a way that maximizes their value ex ante, cannot fill in gaps by imagining the hypothetical bargain—then, what should the courts do?

There are now three main answers in the literature. Macneil's original answer was the most ambitious. He argued that courts should enforce relational contracts by determining what the norms of the relationship are, and enforcing those norms. Macneil clearly had in mind something different from, say, the norms that maximize the value of the contract or the relationship, appealing instead both to generalized norms of fairness and the particular norms of behavior that develop within the relationship.[10]

Goetz and Scott argued that courts should enforce relational contracts by filling the gaps with whatever terms would maximize the value of the contractual relationship.[11] This may sometimes be

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[10] See, e.g., Macneil, Economic Analysis, supra note __; Ian R. Macneil, The New Social Contract (1980); Ian R. Macneil, Values in Contract: Internal and External, 78 Nw. U. L. Rev. 340, 383-89 (1983). An interesting application is Speidel, Court-Imposed Price Adjustments Under Long-Term Supply Contracts, 76 Nw. U.L.Rev. 369, 370-81 (1981). There is also a flavor of this approach in Gillian Hadfield, Problematic Relations: Franchising and the Law of Incomplete Contracts, 42 Stanford Law Review 927 (1990).

[11] See Charles Goetz and Robert Scott, Principles of Relational Contracts, 67 Virginia Law Review 1089 (1981); Robert E. Scott, A Relational Theory of

straightforward. When there is a good market for substitute performances at the time of breach, the court can determine damages correctly by using market price as a measuring rod. But more often, this would be highly complicated. Everything has changed since the contract was signed, the parties have relied on each other in various ways—having made investments specific to the relationship—and understandings have changed. If the seller has made a large relationship-specific investment in the manufacture of a particular widget, and the buyer refuses to pay for it, the fact that the market in the meantime has developed a cheap substitute is irrelevant for determining the proper damages.

Schwartz has recently argued that courts should, on the contrary, enforce long-term (or relational) contracts in a literal or "passive" way.[12] Suppose that a contract says that the seller must deliver at time X, and the buyer must pay price Y, every month over the course of years, with no provisions for change in circumstances. But circumstances change radically, so that continued performance is disastrous for one party, a windfall for the other. Schwartz argues that nonetheless the courts should enforce the contract as written (indeed, should enforce it through specific performance, not damages). The parties, after all, know that circumstances might change. But if they expect to have private information, so that courts cannot reliably enforce the value-maximizing terms, then allowing judges to try to figure out these terms would simply produce error. Literal enforcement also produces error, in the sense that judges would not enforce the hypothetical value-maximizing terms. But at least this error would be predictable. And predicting it, the parties

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Default Rules for Commercial Contracts, 19 J. Legal Stud. 597 (1990). Robert Cooter, Structural Adjudication and the New Law Merchant: A Model of Decentralized Law, 14 International Review of Law and Economics 215 (1994), takes a position midway between Goetz and Scott, and Macneil, arguing that courts should, under certain conditions, identify and apply prevailing commercial customs in order to resolve contractual disputes, and that these customs will generally be efficient.

[12] See Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 Journal of Legal Studies 271 (1992); Alan Schwartz, Incomplete Contracts. In Peter Newman, ed., The New Palgrave Dictionary of Economics and the Law (London: Macmillan Reference 1998).

will design the contract in such a way that provides each side with the best incentives to engage in value-maximizing *renegotiation* when events finally change. In particular, the parties will choose terms that are based on information that they believe the court will be able to verify (such as market prices of inputs) rather than on information that, even if economically more relevant, they anticipate the court will not be able to verify (such as the seller's costs or the buyer's demand). Courts 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.

These theories can be compared according to the attitude they take toward the competence of the courts. Macneil's theory places great confidence in the courts. He assumes not only that they will be able to understand the nature of the dispute, but also that they will be able to do a kind of sociological analysis of the parties' relationship. Goetz and Scott place less confidence in the courts, but still give them a difficult task. They must be able to determine what actions are value-maximizing when the dispute arises, a determination that would require quite an exhaustive understanding of the relationship, including who made relationship-specific investments, and how much they contributed to the value generated by the relationship, and so on. Finally, Schwartz places little confidence in the courts. They only have to enforce the contract literally, which means reading the meaning of the contract off its face while ignoring evidence from the prior and subsequent relationship.

Among these authors, Schwartz is most explicit about the assumptions one must make about judicial competence. He points out that identifying the value-maximizing action in any contractual relationship is likely to require information that is not available to the court. One or both of the parties may understand that the seller should slow down production or the buyer should accept a delay, but courts, which are complete foreigners to the industry and to the relationship, are not likely to have, or be able to obtain, the information that is necessary for this understanding. That is why Schwartz limits the role of courts when enforcing relational

contracts.

But one might have doubts about whether Schwartz goes far enough. Having relieved the court of the impossible burden of choosing the optimal terms ex post, he places this burden squarely on the shoulders of the parties ex ante. There is a literature on the design of contracts that describes the optimal terms in cases such as this. Schwartz himself relies on this literature in order to justify his proposal. But the optimal terms identified by the literature are far more complex than those used in real contracts, and the reason may be that the problem for which these terms are a solution is too complex for real people to solve.[13]

This leaves us with two possibilities. The first is that there are relatively simple ways for parties to design relational contracts in a way that exploits courts without putting too big a burden on them. The second is that parties lack the clairvoyance needed to give courts the proper guidance if a dispute arises, and courts lack the genius that would be needed to enforce contracts properly in the absence of such guidance. The latter possibility is the one that I will explore in this paper. In a phrase, I assume that courts are *radically incompetent* given the demands that are placed on them by relational contracts. They cannot even engage, reliably, in the minimalist enforcement that Schwartz assigns to them.

Some might argue that because contract law exists, and parties freely take steps to ensure that their agreements are legally enforceable, it must be the case that courts are not radically incompetent. If they were, people would abandon the formal legal system. In this paper, I argue, on the contrary, that even if courts are radically incompetent, people would voluntarily enter legally enforceable contracts. Indeed, I go farther and argue that many elements of our legal system make most sense if we understand them to be a response to the regrettable but unavoidable fact that our courts are incompetent when it comes to enforcing contracts.

I should immediately add some words of caution. I do not believe that courts always misunderstand contracts, though I do believe that they often do. But it is useful, for analytic and expository purposes, to take the extreme case, and then generalize by relaxing

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[13] See Karen Eggleston, Eric A. Posner, and Richard Zeckhauser, Simplicity and Complexity in Contracts (manuscript, 1999).

the assumption that the extreme case is always true.

I. Empirical Motivation

Merchants must cooperate with each other in order to make profits, but cooperation is hampered as always by incentives to cheat. The long history of commercial behavior is powerful evidence that merchants can overcome these incentives much of the time—enough of the time, anyway, to be able to prosper—despite the absence of legal intervention. One might mention the Lombard and Jewish bankers in the early modern period, the Maghribi traders, the Genoese and the Venetians, ethnic Chinese merchants in foreign countries, Korean and other immigrant groups in the United States, the successful exploitation of common pools by local groups, and so on.[14] In all of these cases, merchants and others cooperate and prosper in a lawless environment at the international level or even in a hostile local legal environment. So one might ask, why is a state necessary at all for commercial cooperation?

A common answer is that relatively small and homogenous groups of people can cooperate, whereas strangers in a populous state cannot. This answer cannot be the whole story. Most people who belong to the majority population in a state are able to cooperate without resorting to the threat of legal sanctions. In ordinary life, people constantly make and keep promises; and legal retaliation for cheating is never an option because the cost of invoking the law exceeds the amount at stake. The ordinary wisdom might be revised, then, to hold that nonlegal cooperation occurs among people in communities, where information flows freely and reputations are known, but not among strangers.

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[14] E.g., Elinor Ostrom, Governing the Commons: The Evolution of Institutions for Collective Action (Cambridge, England: Cambridge University Press 1990); Avner Greif, Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders Coalition, 83 American Economic Review 525 (1993); Avner Greif, Paul Milgrom, and Barry R. Weingast, Coordination, Commitment, and Enforcement: The Case of the Merchant Guild, 102 Journal of Political Economy 745 (1994); Janet T. Landa, Trust, Ethnicity and Identity: Beyond the New Institutional Economics of Ethnic Trading Networks, Contract Law, and Gift Exchange (Ann Arbor: University of Michigan Press 1994); Eric A. Posner, The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action, 63 University of Chicago Law Review 133 (1996).

Even so revised, however, this view is unsatisfactory. What are these contracts among strangers? When a consumer purchases a stereo at a retail outlet, the consumer and the "store"—whether we mean the salesclerk, the manager, or the shareholders—are strangers, but it is rare for a consumer to sue the store if the stereo is broken. No rational consumer would sue a store over an object worth a few hundred dollars, when the lawsuit would cost the consumer thousands of dollars. But a lawsuit is rarely an issue, anyway; the consumer will return the stereo and receive a refund or additional merchandise. Most retailers offer warranties and honor them because they fear damage to their reputation. If the consumer does not honor a promise to pay for the stereo, the retailer might sue the consumer, but more likely it will report him to a credit agency that will record the default on the consumer's credit report. Lawsuits do not occur, regardless of who breaches. So the retailer and the consumer are not really strangers, or if they are, then they embarrass the claim that nonlegal cooperation does not occur among strangers.

Perhaps, then, the "contracts among strangers" refer to arms'-length sales among merchants. Even here, however, reputation and other nonlegal mechanisms play an important role. Most merchants belong to trade associations, clubs, and other organizations, which enable them to meet each other and exchange gossip. A large company may have thousands of employees, but all the employees with major responsibilities will join clubs or attend conventions where they meet their counterparts in other firms. So what appears to be an arms'-length contract between two anonymous firms is often the result of negotiations between two friends who belong to the same social club or sit on the board of the same charitable organization. An enormous amount of business activity consists of making contacts, or "networking," and what does this mean if not revealing information about oneself to others, and obtaining information about them in return?

One can go farther. Parties to a contract are almost never anonymous. In almost all contracts, one party or both parties care deeply about their reputations. In ordinary commercial contracts between merchants, both merchants expect to do business with each other in the future, or at least with other merchants who are likely to learn about the behavior of the parties. Banks lend money to firms in

the expectation that the firms will return for credit in the future, an understanding often represented formally by a revolving credit contract. Employers and workers understand that employment contracts cannot describe all the behavior that will be required on each side. Workers behave properly in order to obtain bonuses and promotions and in order to avoid being penalized or fired. Employers behave properly in order to maintain the loyalty of their workers and to attract workers entering the market. Firms invest a vast amount of money in making themselves known to consumers, so if a consumer has a satisfactory experience he will come back, and he will tell his friends about it.[15] Airlines, department stores, and other businesses enable consumers to build up a reputation as a repeat player by offering frequent flyer programs (in the first case) and credit cards (in the second case) that allow the business to keep track of its customers and reward those who continue to patronize it. Museums offer memberships in order to distinguish repeat customers from transitory customers. Even something as transitory as a stock transaction is constrained by nonlegal sanctions. The buyer and seller in the secondary market do not deal with each other. They both deal with a middleman, the broker, who takes pains to develop a reputation for honesty, and who usually is employed by a firm with a brand name, built up over years.

So when contracts are small, people do not sue each other because it is not worthwhile. When contracts are large, people do not sue each other because they depend on reputation. But if this is so, what is the role of the law? One can put this question differently. If the law were adequate for regulating relations among strangers, then why wouldn't people rely on the law rather than spending so much time and effort establishing their reputations for trustworthiness and learning the reputations of others?

The traditional or neoclassical paradigm of contractual behavior is not well-equipped to answer these questions.[16] This approach generally assumes that people make contracts because only legal sanctions will deter a party from cheating on the contract when it is

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[15] Benjamin Klein and Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 Journal of Political Economy 615 (1981).

[16] But see Louis A. Kornhauser, Reliance, Reputation, and Breach of Contract, 26 J.L. & Econ. 691 (1983).

profitable to do so. If each party expected the other to cheat under such conditions, parties would not enter a contract in the first place. The value-maximizing court enforces contracts in such a way that maximizes the ex ante value of the contract, which usually means allocating obligations in a way that places the risk of any contingency on the party that can most cheaply bear it and that gives the parties proper incentives to breach, invest, and engage in related behavior.

Other kinds of behavior are hard to explain if one assumes the traditional paradigm. Contracting parties are often friends. Friendships arise not as the natural byproduct of time spent together and mutual interest; on the contrary, parties spend a great deal of effort, time, and money trying to make friends. A book publisher might take a client out to lunch or dinner. Purchasing agents take suppliers to baseball games, plays and movies, even to strip-tease joints.[17] Business deals are everywhere forged in bars, restaurants, and private drinking clubs. Business is almost always conducted in a highly social manner. First, they talk about sports; then, about their families; and only *then*, perhaps when the dinner or golf game is almost over, do they shake hands on the deal.

In the cotton industry, "Merchants take mill buyers on hunting trips just like in any other business.... In the process, relationships ... develop[ ]. Over time a buyer gets the idea that he wants to deal with me not just because of our business relationship, but also because of our personal relationship. So you tell me, when you want to do business who will you call, the guy you like or the guy you don't like."[18] A major trade association "has sponsored the local debutante ball, an annual civic cotton carnival, golf tournaments, a Cotton Wives Club [sic], a well-known domino tournament, and numerous other civic events. To this day it continues to encourage social interaction among its members and their families by making its annual conventions family events."[19] Many businesses, trade associations, and other industry groups sponsor social and family events in order to enhance relationships among their employees or

[17] Robyn Meredith, Strip Clubs Under Siege as Salesman's Havens, The New York Times, September 20, 1997, p. A1.

[18] Lisa Bernstein, Private Commercial Law in the Cotton Industry: Value Creation Through Rules, Norms, and Institutions (unpublished manuscript), p. 16 (quoting merchant, brackets and ellipsis in original).

[19] Id., pp. 20-21.

members.

If, as I will shortly argue, these phenomena arise because merchants want nonlegal sanctions to substitute for the law, one must ask, what is wrong with the law? Scholars acknowledge the possibility that the law is just not very effective at regulating commercial transactions, but, as we have seen, they limit the consequences of this possibility by sharply distinguishing between relational contracts and one-shot contracts. If courts cannot determine obligations in long-term, "relational" contracts, contracts in which many terms are left out, they can determine obligations in shorter "one-shot" deals.[20]

This latter claim is difficult to confirm or deny, but let me mention two reasons why it might not be true. First, although the number of unpredictable contingencies that can change the value of a long-term relationship is no doubt enormous, the number of unpredictable contingencies that can change the value of one-shot deals is also enormous. The overwhelming variety of contingencies in the first case does not imply that courts can handle the variety of contingencies in the second case. The relatively "one-shot" sale of a house extends over months during which any number of things can happen, only a small fraction of which can adequately be treated in the contract. Short-term contracts almost always have tails stretching indefinitely in the future. A buyer might sue the seller for a defect in goods discovered months or years after delivery, a suit that requires the court to determine whether any intervening contingencies are relevant for the determination of obligations.

Second, courts have trouble understanding the simplest of business relationships. This is not surprising. Judges must be generalists but usually they have narrow backgrounds in a particular field of the law, and they often owe their positions to political connections, not to merit. Their frequent failure to understand transactions is well-documented. One survey of cases involving consumer credit, for example, showed that the judges did not even understand the concept of present value.[21] The judges struck down contracts because the credit price was higher than the cash price, not

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[20] See Schwartz, Incomplete Contracts, supra note __.

[21] Jeffrey E. Allen and Robert J. Staaf., The Nexus Between Usury, 'Time Price,' and Unconscionability in Installment Sales, 14 U.C.C. Law Journal 219 (1982).

taking account of risk and of the time value of money. The authors showed that the implicit interest rates were reasonable. Even when judges do not misunderstand basic ideas, we must take their interpretation of facts on faith. Judges' reasoning can be evaluated only against the canned facts described in the opinion, which themselves are the result of a fact-finding process that does not inspire confidence. Parties can reasonably believe that given the varying sophistication of trial judges, lawyers, and juries, the accidents of discovery, the varying credibility of witnesses, the vagueness of the law, and so on, that the chance of winning a breach of contract suit is pretty much random. Skepticism about the quality of judicial decision-making is reflected in many legal doctrines, including the business judgment rule in corporate law, which restrains courts from second-guessing managers and directors, and the many contract doctrines that restrain courts from second-guessing parties to contracts.

These observations suggest the following possibility. Courts are not very good at deterring opportunistic behavior in contractual relationships, but parties are. This is why so much contractual behavior depends on reputation, ethnic and family connections, and other elements of nonlegal regulation, and not on carefully written and detailed contracts enforced by disinterested courts. The next section analyzes this hypothesis more formally, and suggests an answer to the question why, if they cannot rely on courts to enforce contracts properly, people so frequently take pains to ensure that their contracts are legally enforceable.

II. The Model

The claim behind the model is that even if courts cannot determine who breached a contract, or whether a contract has been breached, they can deter opportunistic behavior. This claim might sound implausible, but the key to it is that parties choose when they want to use courts and when they do not, so even an uncomprehending court can serve useful purposes as long as it allows itself to be manipulated by the parties. Parties use the courts as a *commitment* device, which allows them to make credible promises to perform an action and allows them to rely on the promises of the

other.[22]

The argument has two steps. First, I claim that nonlegal sanctions deter breaches when the payoff to the breaching party from breaching is not too high. The standard repeat prisoner's dilemma explains such run-of-the-mill commercial cooperation, which is no doubt the most common kind of cooperation. The law is needed only for ensuring cooperation when the payoff from breach is relatively high. Second, I show that when the payoff from breaching is high, parties can protect themselves ex ante by entering a legally enforceable contract. But the protection does not result from the ability of courts to punish the party that breaches. It is assumed that courts are not able to acquire the information that they would need in order to determine liability and harm. The protection results because the victim of the breach, if he cares about his reputation, can credibly threaten to inflict mutual harm by bringing a negative-sum lawsuit.

A. Some Preliminaries: How People Cooperate

The model relies on the assumption that people are able to cooperate in diverse settings. To understand this assumption, imagine that contractual relationships take the form of prisoner's dilemmas. Seller offers a customized widget of a certain quality, and Buyer offers to pay on delivery. Seller fears that Buyer will breach by refusing to accept delivery and holding out for a lower price; Buyer fears that Seller will breach by selling the widget to a third party who offers to pay more. If the parties cannot provide assurance that they will not breach, they might not enter the contract in the first place. The neoclassical or traditional law and economics view is that contract law provides this needed assurance. If one party breaches, the other party will have a remedy. So a party will not breach, or if he does, the victim will not be injured. With 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.

But this description of contract law is highly idealized, and we will not rely on it. We will assume to the contrary that courts are radically incompetent, so they cannot enforce promises in an

[22] The term, and the basic insight, come from Thomas C. Schelling, The Strategy of Conflict 24-28 (1960).

accurate way. But we also assume that run-of-the-mill cooperation is possible in the absence of the courts and the law.

There are many explanations for how people are able to cooperate in the absence of legal sanctions, and this is not the place to survey them or to go into much depth. One common explanation is that when people have repeated interactions with each other, they have an incentive not to breach or "cheat" in one interaction, because then people will not trust them in later interactions. In the simplest case, Seller does not break her promise to deliver the customized widget, because Buyer is a valued customer, and she does not want to lose him. Seller expects that Buyer will place periodic orders for additional widgets in the future, but only if Seller has not breached in the past. Buyer similarly does not break his promise to accept delivery, because he expects to place additional orders in the future, and anticipates that Seller will refuse to deliver if Buyer has breached in the past. Because each party invests in the relationship—Seller, by customizing to the Buyer's needs, and Buyer, by modifying his factory in anticipation of the Seller's products—each party prefers performance by the other to whatever substitute may be available on the market. As long as both parties value future payoffs to a sufficient degree and as long as the value of breach is never too high, it is possible (as a matter of theory) and likely (as a matter of common sense) that they will not breach in any round.

The argument can be extended. Buyer might not anticipate purchasing additional widgets from Seller, but does expect to purchase additional goods from other sellers, and these sellers are likely to hear about Buyer's past interaction with Seller. Buyer does not breach his contract with Seller because he fears that if he does, these other sellers will refuse to deal with him, cutting him off from important sources of supply in the future.

The model has two important implications, both of which have been mentioned. The first is that cooperation is more likely when parties have low discount rates. I will say a little more about this point below, but it has little to do with the main argument of this paper. The second implication is more important. The threat to retaliate can deter opportunism in the repeat prisoner's dilemma only if the payoff from opportunism is not too high. Suppose the contract price for the widget is $10 in the example above; Buyer anticipated

that he would value it at $12 when it is delivered, and thus would obtain a profit of $2. In fact, because Buyer's own customers reduce their orders for the product for which the widget is an input, Buyer's valuation of the widget falls to $9 and thus his profit is -$1. Buyer would like to breach but understands that under the contract he bore the risk of fluctuation of demand for his product. He knows that if he breaches in order to save $1, he can expect Seller to refuse to deal with him in the future, and this will cost him, say, $5 in future profits, in present value terms. Buyer absorbs the loss and declines to breach, because future payoffs worth $5 exceed the current savings of $1.

Suppose alternatively that Buyer's valuation plummets to $0, perhaps because his employees strike. Now the Seller's threat of retaliation will not deter Buyer from breaching the contract. If Buyer breaches, he saves $10, which is higher than the $5 he would lose as a result of Seller's retaliation. This is an example of what I will call *high-value opportunism*, which is defined as opportunism that cannot be deterred by the threat of (nonlegal) retaliation. The earlier case is an example of *low-value opportunism*, which will not ordinarily occur because of nonlegal sanctions.[23]

There are additional complexities that need not detain us for long. I will just mention that I have argued elsewhere that much of the odd and interesting behavior associated with contracting is explained by the importance of signaling that one is a "good cooperator," or, in terms of the model, that one has a low discount rate. In the model, everyone has private information about his own discount rate.[24] Those with low discount rates want to persuade others that they have low discount rates, because that makes them attractive contractual partners—the kind who is unlikely to cheat in the repeated prisoner's dilemmas. Those with high discount rates want to persuade others that they also have low discount rates, because if it is revealed that their discount rates are high, no one else will want to enter relationships with them. These assumptions produce a phenomenon known as "signaling," in which the good

[23] See Posner, Groups, supra note __, at 155-61.

[24] See Eric A. Posner, Symbols, Signals, and Social Norms in Politics and the Law, 27 Journal of Legal Studies 765 (1998); Eric A. Posner, Law and Social Norms ch. 2 (Harvard, forthcoming 2000).

types take costly, nonproductive actions in order to distinguish themselves from the bad types, on the assumption that the bad types lose more from imitating these actions than they gain by entering relationships and cheating other people.

The various behaviors I described above—dinners, lunches, parties, clubs, gift-giving, charitable activity, and so on—are consistent with the signaling theory. They are expensive, and although people may enjoy these activities, there is little reason to believe that they engage in them just because they enjoy them. Most people would rather go to dinner with their (real) friends than with their business associates; most people taken out to dinner by their business associates would prefer the money value of the meal. But cash gifts cannot serve as a signal because of their fungibility. If X gives cash to Y, then X cannot know whether Y is attracted to X for X's business or for X's money. In bilateral signaling, both sides must waste time, effort, and money. These wasteful actions constitute what might be called commercial culture, the idiosyncratic activities that accompany all commercial behavior despite not directly generating value and in fact having the opposite effect.

The signaling theory has little to do with the model I discuss in this paper, but I mention it because it suggests why the traditional model of contract law is inadequate. If it were true, we would not observe the commercial behavior that we see in the real world. Parties would not try to become friends, exchange gifts, mix commercial and social activities, form clubs and associations, and so on, if they could rely on the courts to deter opportunism in contractual relationships. They would not be offended by breaches but be indifferent between breaches and remedies. They would not shun people who have proven unreliable in past contracts because they could rely on courts to deter unreliable behavior in future contracts. Indeed, the standard conception cannot explain why reputation is the central element of commercial transactions, why so much of commercial success is tied up with the creation and maintenance of reputation for fair play.

B. The Role of Contract Law

So far I have explained how nonlegal sanctions deter low-value opportunism. What then, is the role of contract law? The answer is that contract law serves to deter certain kinds of high-value

opportunism, even under the assumption that courts are radically incompetent.

We start by defining what is meant by radical incompetence. Assume that a legal system exists but that courts are unable to determine whether a party to a contract has broken a promise. To be more precise, assume that a person can ask a court to give him a remedy for breach of contract, but that the court is so prone to error that its decisions are random as to liability, with damages being represented by an unbiased distribution around the amount at stake. Suppose, for example, that X cheats Y, with the result that 50 is transferred to X at a cost of 100 to Y. Y sues for 100. The court holds with 50% probability in favor of X and 50% probability in favor of Y. If the court holds for Y, damages will be normally distributed around 100. If the court holds for X, damages will be normally distributed around 0 (with negative damages interpreted to mean that the court holds in favor of X on a counterclaim for a positive amount). The assumption can be understood as one of judicial incompetence or error-proneness but it is equivalent to the assumption that whatever the intelligence and sophistication of judges, parties cannot anticipate and contract about any contingencies in a sufficiently fine-grained way to provide guidance to such judges.[25]

I also assume that even though a court cannot determine whether a promise has been performed or breached, it can determine whether the parties intended to enter a contract. I will defend this assumption below.

Imagine that two parties, Seller and Buyer, enter a contract whose ex ante value to each exceeds the value of the next best opportunity. The contractual relationship has the form of a repeat prisoner's dilemma, so that the ex ante value of the contract is realized only if each party can overcome its incentive to defect. A party always observes a defection (that is, a breach or instance of "cheating"), and can retaliate by refusing to cooperate in later rounds.

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[25] Existing work on judicial error does not make such an extreme assumption. See, e.g., Richard Craswell and John E. Calfee, Deterrence and Uncertain Legal Standards, 2 Journal of Law, Economics, and Organization 279 (1986); Gillian Hadfield, Judicial Competence and the Interpretation of Incomplete Contracts, 23 Journal of Legal Studies 159 (1994).

A court cannot observe a defection. In the standard vocabulary, defections are observable but not verifiable.

Figure 1 depicts a simplified version of the relationship, one in which only Buyer has the chance to engage in opportunism (but this is not essential to the argument). Seller moves first by signing a contract to sell a widget, or not. If she refuses to sign, payoffs are assumed to be 0 for each party. Next, Buyer chooses between cooperating (that is, paying for deliver) or cheating (that is, rejecting delivery). If he cooperates, payoffs are P for each party. If Buyer cheats payoffs are D for Buyer and S for Seller: D>P>0>S. For now, assume that the game ends at that point, and there are no further rounds.

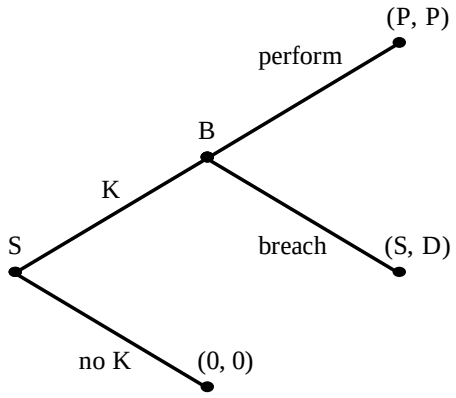

Figure 1: Payoffs for (S, B)

The game so far is a simple one-sided prisoner's dilemma. Buyer gains more by cheating than by cooperating in round 2, so Seller must expect that Buyer will cheat in round 2. Because Seller prefers 0 to the sucker payoff S, Seller will not enter the contract in the first place. The result is that the potential gain, 2P, is not realized.

As an aside, note that the solution to this problem under the traditional approach is to direct the court to award damages to Seller if Buyer breaches, damages equal to P-S. This ensures that Buyer will either perform (when D+S<2P) or breach but fully compensate Seller for his loss (so-called “efficient breach,” when D+S>2P), in

which case S will have the proper incentive to enter the value-maximizing contract in round 1.[26] But this solution is available only if courts can determine whether Buyer breaches, and award the right level of damages, conditions that violate the assumption of radical judicial incompetence. Under the latter assumption, cooperation is not possible, and the bad outcome, where Seller does not enter the contract in the first place, is unavoidable—at least if the game ends at round 2.

But suppose there is a round 3, and in this round Seller has the option to sue Buyer or not. Figure 2 depicts the game with this third round. If Seller does not sue Buyer, the round 3 payoffs are the same as the round 2 payoffs, namely (S, D) for Seller and Buyer respectively. If Seller sues, then both sides incur a litigation cost C. The reason is that litigation is a negative sum game: one party must pay the other party damages or neither pays the other damages, but in either case both parties must invest a great deal of time and money in lawyers and litigation. Because of judicial incompetence, we assume that expected damages are the same for both parties, but this assumption is not essential.

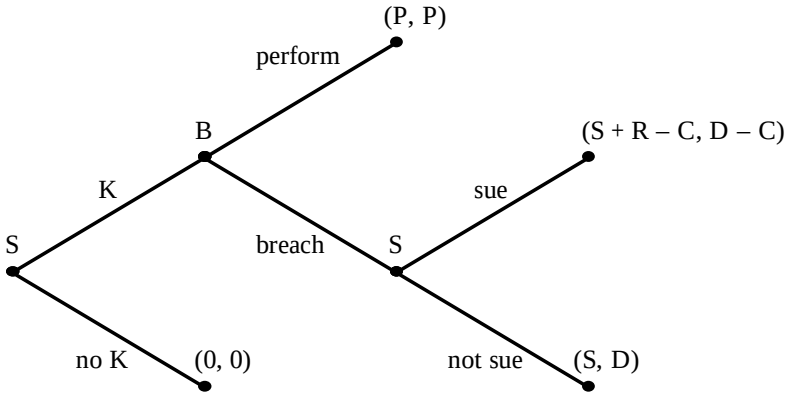

Figure 2: Payoffs for (S, B)

[26] I assume away a number of complications that are well-rehearsed in the literature. The most lucid discussion remains Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach, 61 Southern California Law Review 630 (1988).

If these assumptions are plausible, and Seller can make a credible threat to sue Buyer, then Buyer might refrain from cheating. Buyer's expected payoff if Seller sues is D-C. That is, whether or not Buyer ends up winning the lawsuit, he must expect that on average he will lose C, and this must be subtracted from the payoff from cheating. When Buyer decides whether to cheat in round 2, he compares the payoff from cheating and then being sued (D-C), with the payoff from cooperating (P). If P>D-C, then Buyer will cooperate. We will discuss in a moment whether C is likely to be high enough to produce this outcome; for now, note that the fear of a lawsuit will deter Buyer from cheating if C is high enough, that is, if C>D-P.

But would Buyer have this fear? Buyer would fear a lawsuit only if Seller can credibly threaten to sue if Buyer cheats her. But one might doubt whether Seller's threat is credible in a world of incompetent courts. Suppose that Buyer decides to cheat Seller. If Seller does not sue, her payoff is S. If Seller does sue, her payoff is S-C. Because S-C<S, Seller will not sue. But if Seller will not sue, then Buyer has nothing to fear and might as well cheat, in which case the incompetent courts do not serve to deter opportunism.

To avoid this outcome, one must make another assumption. Seller (and Buyer) cares about having a reputation among third parties for being tough: if anyone cheats her, then she will retaliate by suing. Seller wants this reputation, because if other buyers in the future believe it, they will not (usually) cheat her. This reputation is credible, as long as Seller actually sues anyone who cheats her. But now it pays Seller to sue anyone who cheats her, as long as the short-term loss, C, is offset by the long-term gain resulting from the future contracts, in which Buyer or other buyers do not cheat Seller. This long-term gain, R, is the value of having a reputation for suing people who cheat you.[27]

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[27] One might make different assumptions about how much information the third parties have. In the simplest case, the third parties know who cheated. By hypothesis, this knowledge does not deter Buyer from cheating because Buyer has a high-value opportunity. But it is enough to give Seller an incentive to sue, and the suit is what deters Buyer. (Imagine that Seller deals with these third parties more than Buyer does; or Buyer's gain from cheating is high compared to Seller's loss.) In the other extreme, third parties do not know whether Buyer cheated. If that is the case, in the current model Seller may have no incentive to sue, because

Although C must be high enough to deter Buyer from cheating, C cannot be higher than R, Seller's gain from having a good reputation. If C is too high, then Seller would not sue Buyer after Buyer cheats, and knowing this, Buyer would cheat. Because C must exceed the difference between D and P, it follows that if D is very high relative to P, Seller cannot credibly deter Buyer from cheating. Buyer knows that Seller must impose a very high cost on him, but because an expensive lawsuit would hurt Seller too much, Seller would prefer taking the reputational hit. The availability of incompetent courts, then, enables more cooperation than would exist in their absence, but clearly—and intuitively—does not make full cooperation inevitable. Put otherwise, incompetent courts will deter some of the high-value opportunism that cannot be deterred by nonlegal sanctions; but they cannot guarantee that the very highest-value opportunism will not occur.[28]

An important question is how C is determined. Notice that C is not the same as, say, expectation damages. When Seller sues, she can spend as much on litigation as she wants to. How much will she spend? She will not settle with Buyer, because then she will not obtain a reputation for toughness. She must spend enough that observers see that she is willing to impose enough costs on Buyer so that Buyer gains nothing from cheating. If we make the plausible assumption that one's chances of winning a lawsuit increase with the amount of money one spends on litigation, then Seller can force Buyer to incur litigation costs simply by incurring litigation costs herself. To prevent Seller from winning, Buyer will try to match

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third parties do not know whether Seller is suing because Buyer cheated her or is suing in order to persuade them that she is tough. But real cases no doubt fall between the two extremes. In such cases, third parties have more information about Buyer's actions than courts do but less than Buyer and Seller do. The consequence of such partial information is to blunt the reputation effect on which the model relies but not to eliminate it.

[28] Seller will enter the contract, and Buyer will not cheat, when $R>C$, $P>D-C$, and $P>0$. It follows that contracts will occur when $D<P+R$. When $D>P+R$, Seller does not enter the contract in round 0 because she knows that the threat to sue will not deter Buyer from cheating in round 2. To sum up, there are three possibilities. (1) $D<P$: contracting is possible because Buyer either gains little from defecting or because nonlegal sanctions are effective ("low-value opportunism); (2) $P<D<P+R$: contracting is possible because of incompetent courts; and (3) $D>P+R$: contracts are not possible.

Seller, thus keeping the odds of prevailing as even as possible. So Seller will choose C, such that C>D-P. But because Seller will not spend more on litigation than she could gain from an enhanced reputation, she will choose C, such that C<R. In sum, Seller will choose C in the range (D-P, R).

Note that Seller's expenditure on C is, as game theorists say, "off the equilibrium path." Under the model's assumptions, it will not happen. If D<P+R, then Buyer will not cheat, because Seller's threat to sue, and thus to impose litigation costs as great as Buyer's gains from cheating, is credible. If D>P+R, then Seller will not enter the contract in the first place, because she knows that she will not be able to deter Buyer from cheating. Of course, in the real world Seller does not have perfect information, will sometimes enter contracts despite the fact that D>P+R, and sometimes sue even though the net present value of the suit is less than zero. Then litigation will occur unless the parties settle; but sometimes the parties will not settle because of the same imperfect information that causes Seller to enter the contract in the first place. But as long as parties do not err too often, they can rely even on radically incompetent courts to deter certain forms of high-value opportunism.

Now return to the assumption that the parties can choose whether or not their relationship will be subject to legal intervention. This assumption is necessary to the argument. If a party could involuntarily be subject to contractual liability, or if parties could not choose to be contractually liable, then people would have an incentive to make fraudulent claims that strangers have entered contracts with them, as a way of extracting value from the strangers. In addition, a party always has an interest in binding the other party but not himself. Seller might be willing to enter a legally binding contract with Buyer; but Seller would prefer a legal relationship in which she (the Seller) is not bound and Buyer is. So if Buyer cheats, Seller can credibly threaten to sue Buyer. But if Seller spots a good opportunity to cheat, she can cheat without fearing a lawsuit from the Buyer. To prevent these results, it must be the case that our incompetent court is not *too* incompetent: it must be able to distinguish a legally binding promise from a non-binding promise. Courts are too incompetent to fill gaps in contracts, but not too incompetent to determine whether the parties intended to make

legal remedies available to each other.

Is this a plausible claim? The answer turns on an important difference between the desire to subject oneself to legal enforcement, which is a binary yes/no issue, and the desire to accomplish some cooperative goal, which involves constantly shifting and always idiosyncratic positions. Courts can, in advance, state that certain signals will be interpreted as a desire to subject oneself to legal enforcement, and they can pick those signals that they find easiest to interpret. If courts announce that a seal is a signal of a desire for legal enforcement, the parties can unambiguously signal their desire for legal enforcement by attaching a seal to their written contract. If courts say that a writing alone is necessary, the parties can use a writing. By contrast, courts can only with difficulty state that certain promises will be interpreted in one way, and other promises will be interpreted in another way, because there are too many kinds of promises that parties might find valuable in a particular business context.[29]

A crisp example of this phenomenon—confidence in courts' ability to evaluate the use of form but not to determine obligations and evaluate performance of them—comes from family law. Most people believe that courts have little ability to evaluate an ongoing marital relationship. The evolving obligations are too complex for an outsider to understand. Although courts and other agencies intervene more in family relationships than they did in the past, it remains true that families enjoy a great deal of autonomy. If dissolution of marriages is easier than before, courts no longer try to determine who was at fault. But—now, as in the past—parties are required to commit themselves or not to legal enforcement by either getting married or not getting married. It is thus assumed that courts *can* determine whether two people are married. We see here the sharp distinction between the assumption that courts can understand the use of form to signal an intention to enter a legal relationship and the assumption that they cannot understand the obligations that arise within that relationship.

[29] The contrast is a bit overstated. Courts do state that certain promises will be interpreted in certain ways. For example, they often say that if an employment contract does not provide expressly for tenure or termination for cause, it will be interpreted as employment at will.

C. Summary

Radically incompetent courts can deter high-value opportunism that ordinary nonlegal sanctions cannot deter, but only under the following conditions. First, the promisor (the party facing the decision whether to engage in high-value opportunism) receives a higher payoff from performing than by breaching and incurring litigation cost C. Second, the promisee gains more by maintaining a reputation for toughness (in the form of future business) than by avoiding the cost of litigation. Third, the third parties would have at least partial information about who engaged in opportunism if such opportunism occurred. Fourth, the court can determine whether the parties intended to be legally bound with greater than zero accuracy.

The model of contract law that I have described does not put great demands on the courts. It is as though two parties to a relationship agreed that if they had a dispute, both parties would have a finger chopped off by a government agent. Neither party cheats, because he believes that the other would retaliate by invoking his right to have the mutual sanction imposed. The cheated party will credibly retaliate with a lawsuit, because otherwise he risks obtaining a reputation as a softy, in which case he will be unable to avoid being cheated the next time he plays this game. The government agent's role is just to chop off fingers if one person complains. The government is like a parent, who punishes both children who are fighting rather than only the child who started the dispute. Even if you do not know which child is at fault, you can discourage future misbehavior, for each child knows that he will be punished if he engages in such misbehavior. Like the parent, the government does not have to determine who is right and who is wrong. The purpose of contract law is to enable parties to have the government penalize both if they have a dispute; and contract doctrines merely give parties a reliable way to indicate ex ante their desire for such government involvement, and to limit the size and the variance of the penalty to something close to what should be sufficient: a finger rather than a head.

This theory answers the question why, if nonlegal sanctions are so powerful, people take care to ensure that their contracts comply with the formalities of contract law. The answer is that although nonlegal sanctions are powerful, they cannot deter defections when

the benefit from defection is high enough. When this occurs, the injured party benefits from the contract even incompetently enforced. And both parties, not knowing in advance whether they will be injured by the price change or benefited by it, agree to the contract in order to protect themselves from defection.

If this view of contract law seems improbable and perverse, consider the similarities between the role it assigns to the courts and the historical role of related institutions. An early remedy for legal wrongs was the trial by battle, which entitled the complainant to face the defendant in a tournament. And an extremely important non- or semilegal institution for dispute resolution—in every major country and in every period of history before the twentieth century—has been the duel. Both forms of dispute resolution present the following puzzle. If the outcome of the dispute depends on skill with arms, and not on the reliable discovery of fault, then the tournament and the duel do not deter opportunism but give skillful people a license to do whatever they want, a license that, ironically, they would not want, since then no one would trust them to keep their contracts. The history of dueling reveals many practices that took away this advantage, including the practices of giving the challenged person the choice of weapons and, in the case of pistols, forcing the parties to use highly inaccurate pistols at a great distance.[30] In the Icelandic holmgang dueling parties wore so much armor that death was rare.[31] By analogy, efforts over time to make courts harder or easier to use, the liability rules more or less expansive, the damages more or less generous—all of this is like increasing or reducing the distance between duelists, modifying the weapons they use, adding or subtracting the armor they wear, and so on. These practices made the outcome of the duel a matter of luck, much as the outcome of a dispute before a radically incompetent court is a matter of luck.

Aleatory dispute resolution mechanisms may well be functional. They persist over time because they serve social purposes. They succeed for two reasons. People do not cheat because they fear being subject to enormous losses; they do not settle because they fear being

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[30] Warren F. Schwartz, et al., The Duel: Can These Gentlemen Be Acting Efficiently?, 13 Journal of Legal Studies 321 (1984).

[31] William Ian Miller, Bloodtaking and Peacemaking: Feud, Law, and Society in Saga Iceland (Chicago: University of Chicago Press 1990).

thought to be cowards.

III. Legal Implications

A. Form

The value of a legally enforceable promise as a commitment device depends on the freedom of parties to opt into or out of legal liability. The ability to impose legal liability on a stranger without ex ante consent would give people the ability to use courts strategically to extract wealth from each other. This was a problem with the duel: a highly skillful person or a risk-preferring person can threaten to challenge people to duels if they do not do what he wants them to do, and his skill or boldness enables him to overcome the element of randomness. In England, great nobles feared such challenges from lesser nobles, and so had to isolate themselves or surround themselves with bodyguards in order to deprive the lesser nobles of the opportunity to challenge them to a duel.[32] Similarly, if X and three friends can persuasively but fraudulently say before a jury that Y had agreed to buy some stock at time 0 but had since breached his promise because prices had fallen at time 1, then any con artist can use the court system in order to effect wealth-decreasing transfers from hapless victims to himself. To prevent such behavior, contract law must distinguish between obligations that have been voluntarily incurred and those that are fraudulently asserted.[33]

The mechanism for making this distinction is form. Courts and legislatures establish certain forms, like the seal or the writing, as a way of indicating a desire for legal enforcement; by violating these forms one can indicate one's desire to avoid legal enforcement.

Form, then, takes center stage in the commitment model, whereas in the standard one-shot model it had been elbowed into the wings. Under the standard model it was understood that form is a way for parties to signal their desire to opt into or out of legal enforcement. It was recognized that the cost of forms is that sophisticated people can use them to bind others who believe

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[32] V.G. Kiernan, The Duel in European History: Honor and the Reign of Aristocracy (Oxford: Oxford University Press 1988).

[33] See generally Melvin A. Eisenberg, The Bargain Principle and Its Limits, 95 Harv. L. Rev. 741 (1982).

themselves not legally bound and to avoid binding themselves when others believe them legally bound. The benefit of forms is that they enable people to avoid legal liability.[34] These points remain relevant. But because there was no theory explaining why parties would want to opt out of legal enforcement, there was no explanation for why form mattered. Indeed, the standard theory assumed that courts should determine optimal terms in order to fill in gaps, and as long as courts are assumed to be doing that, there is no reason why parties would want to opt out of legal enforcement.

This is why modern writers on contracts have such trouble with people like Holmes and Hand, who believed that parties' intentions are irrelevant as long as their contracts satisfy formalities.[35] The formalist approach seems perverse: why should it matter if parties adhere to a form or not, when we really care about their intentions? If a party fails to dot an i, we shouldn't let that tiny omission prevent us from enforcing the contract. But this modern view assumes away the problem that form is intended to meet—the problem whether we know the parties' intentions. It assumes that courts can determine the parties' intentions from context and common sense. If this assumption is correct, then courts should ignore form. But Holmes' and Hand's view make sense under the assumption of judicial incompetence. Courts cannot read parties' intentions from context,

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[34] See, e.g., Ayres and Gertner, Filling Gaps, supra note __; Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke Law Journal 557 (1992).

[35] See Oliver Wendell Holmes, The Common Law (M. Howe, ed. Cambridge, Mass.: The Belknap Press of Harvard University Press 1963); Hand's most famous remark on this subject can be found in Hotchkiss v. National City Bank of New York, 200 F. 287, 293 (S.D.N.Y. 1911):

> A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort. Of course, if it appear by other words, or acts, of the parties, that they attribute a peculiar meaning to such words as they use in the contract, that meaning will prevail, but only by virtue of the other words, and not because of their unexpressed intent.

so they must rely on the forms that the parties choose. There is no evidence for the modern conviction that judges can reliably determine intentions. And although courts are no longer as formalistic as they used to be, there is no reason to believe that this trend is desirable, that judges are more competent than they used to be, or that contracts are more complex, or that the old attitude was wrong. The modern view is based on an empirical hunch, and no more, and on this basis contract law has slowly shed some of its formal requirements.[36]

The formalist approach requires that courts or legislatures choose the form that parties must satisfy in order to convey their desire that a court intervene if a dispute arises. A historical example is the seal. In order to obtain a legal remedy for breach of certain kinds of promises, the promisee had to produce a document that bore the promisor's stamp in hardened wax. No doubt one could forge seals, but it must have been difficult to do so. Because the promisor would not have placed his seal on the document unless he wanted to make himself vulnerable to legal enforcement, the seal could serve the purpose of form.

The problem with the seal was that it was expensive and cumbersome. Over the years, various substitutes emerged. For certain contracts, a writing and a signature would serve the purpose. Again, one can forge a signature, but doing so is difficult, and laws against forgery increased the risk. For relatively low-value, short-term contracts, the requirements of form are now quite minimal, but they remain significant. The contract must be based on a quid pro quo; there must be evidence of something like an offer and acceptance; the terms of the original contract must be sufficiently clear and definite; and so on.

It is clear, then, that the formal requirements of a contract, or of a kind of contract, can vary across a range, from minimal to maximal. Costly form protects people who do not enter contracts: they are less likely to be held obliged to keep a promise they did not make. But costly form also increases the cost of business for those who want to obligate themselves. Cheap form reduces the cost of entering

[36] See Eric A. Posner, The Decline of Formality in Contract Law, in The Fall and Rise of Freedom of Contract (Frank Buckley, ed., Duke University Press, forthcoming 1999).

contracts, but increases the risk of being held liable through fraud or by accident. The proper tradeoff will depend on circumstances, will never be obvious, and will change as the underlying incentives change.[37]

The formal requirements of a contract differ from the rules of contract interpretation in a significant way: the former are self-correcting, the latter are not. To see why, observe that when courts change a form, or even purport to abandon form in favor of loose standards, parties in subsequent contracts can always respond by mimicking approved contracts as closely as possible. Even if a court says that it applies a standard, cautious lawyers will draft the next contract with an eye toward the contract that the court approved, because in case of legal dispute the lawyers can plausibly argue that since the last contract was enforced, and the current contract is similar to it, the standard that approved the last contract would approve the current contract as well. When this happens, the earlier contract sets a pattern and effectively becomes a new form to which parties adhere. And when parties want to avoid liability in the wake of expansive standards, like that of Hoffman v. Red Owl,[38] they protect themselves by requiring potential contractual partners to issue waivers up until a contract is signed. By contrast, when courts misinterpret contracts, there is little that parties can do except try to make their contracts more explicit, which is a costly and uncertain process.

B. Damages, Excuses

Suppose that Seller and Buyer enter a contract in which the payoff from mutual cooperation is (100, 100), the payoff when Seller defects and Buyer cooperates is (110, 50) and vice versa, and the payoff when both defect is (70, 70). If the court had perfect information, it might award damages equal to 50 against the person who defects when the other cooperates, as this would compensate the loser while deterring future cheaters.

Suppose that Buyer sues for failure to deliver, and claims damages of $X. Seller countersues, claiming that Buyer breached by failing to provide specifications, and claims damages of $X. Suppose

[37] This is the point of the literature on this, cited above.
[38] 133 N.W.2d 267 (WI 1965).

further that Seller and Buyer believe that the court, far from being perfect, will randomly choose an amount in this range, that is from -$X to $X; and that each can improve his chance of winning $1 by spending $1 on litigation. Then Seller and Buyer will each spend $2X in litigation in order to avoid a loss of $2X. If, for example, Seller sues for $50, and Buyer countersues for $50, they would each spend $100 in litigation costs.

Observe that the $100 expected cost for each party, C, serves the purpose of commitment. If each party can credibly impose a $100 litigation cost on the other if cheating occurs, the ex ante payoff from defection is $10 (if S or B defects) or -$30 (if both defect), which is lower than the ex ante payoff from cooperation when the other person cooperates, which remains $100. Ex post, the parties face a strong incentive to settle for an award of $0, rather than spend $100 each for an expected gain of $0, but they resist this incentive in order to maintain a reputation for toughness.

Although this result is good, it is not optimal. Commitment would be possible if the parties could agree not to spend more than $11 to litigate, since this amount exceeds the $10 payoff from defection. When parties are unable to settle, they will spend $200 when they should spend no more (or less) than $20, and ex ante an agreement that required a joint payment of $20 in case of any dispute would provide adequate deterrence without risking mutual annihilation should a dispute nonetheless occur. But the parties could not make such an agreement ex ante; and ex post any agreement to settle might be taken by observers to indicate that the parties are not tough, and can be exploited in the future. This would be like two duelists agreeing that they will fire at each other with cap guns.[39]

Several features of contract law mitigate this problem. Contract doctrines strictly limit the size of damage awards.[40] Examples of such doctrines include the Hadley rule and the penalty doctrine, and rules that prohibit awards for emotional or speculative losses. Thus, the

[39] As noted above, technically this behavior is off the equilibrium path, but would occur in a model in which the parties (more realistically) have imperfect information and make mistakes.

[40] Alan Schwartz, The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures, 100 Yale Law Journal 369 (1990).

parties would not expect the court to award them between -$50 and $50, but to award them an amount in a narrower range. Thus, they would not spend $100 each on litigation, but say $90, $80 or less.

In addition, the excuse doctrines limit contract liability, and these doctrines serve this desirable purpose even if, consistent with my assumption of judicial incompetence (and, many would say, with the case law), they are applied randomly. The reason is that if the range is, say, -$80 to $80, the excuse doctrine means that occasionally courts will award $0 rather than -$80 or $80. Thus, the average award declines, and so will C.[41]

All of this might seem like awfully rough justice, but that may be the best we can do in an imperfect world. Dueling was also rough justice. The rules of dueling, including the use of seconds to intervene, the insertion of elements of chance to even out differences in skill, and the reliance on weapons that reduce the risk and amount of harm, are elements that, like contract doctrine, preserve the deterrent effect of the institution while ensuring that harm does not exceed by too much the amount necessary for this deterrent effect. Contract law is best understood as a modern version of dueling, indeed an improvement insofar as it eliminates the need for violence and physical harm, reduces the variance of the outcome, and minimizes the possibility of opportunism.

C. Interpreting Contracts

If courts are radically incompetent, they should not bother trying to interpret contracts or providing reasons for their decisions, but should instead flip a coin. They clearly do not do this. They may decide randomly, but if they do, one must explain why they bother to invent an elaborate justification for the outcome. Why not render a judgment without providing reasons?

To answer this question, one must first recognize that because we do not claim that courts decide matters of form randomly, the use of reasons to explain such matters does not present a puzzle. If we assume that courts can adequately decide whether a contract satisfies

[41] The argument assumes that Seller obtains R simply if she sues Buyer after Buyer cheats. One might alternatively assume that R is an increasing function of C, because future parties are more likely to be impressed by Seller's toughness when Seller spends a lot on litigation rather than a little.

formalities, then they should give their reasons in order to provide guidance to parties in the future.

The puzzle concerns the judicial practice of explaining why the promisor's performance either satisfies or violates the contract. It is interesting to note that in the old days, courts did not perform this function, leaving it instead to the jury; and even today, that often remains the case. But courts cannot avoid performing this function when the contract must be interpreted, and when parties attempt to overturn a jury's decision or prevent the jury from making a decision. The jury, of course, can be considered a randomizer *par excellence*.

In any event, the answer is clear as long as judges are not perfectly incompetent but occasionally right. Even if they are right only rarely, they can deter bad behavior by exerting effort to discover whether the promisor breached or not. A slightly more subtle answer is that courts like to moralize, either as a self-indulgence or as a way of providing a general sort of guidance about what they think is good business practice.[42] But the general lesson of the model is that even if we are skeptical when courts claim that a contract means X, because the contract must have meant blah-blah for if it had not, the parties would have said Y, etc.,—and what lawyer has not occasionally felt the force of this skepticism?—we can still conclude that contract law, and judicial enforcement of contracts, serve the important social purpose of enabling parties to engage in value-generating exchanges.

[42] See Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009 (1997).

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