



# CONTRACT DESIGN AND THE GOLDILOCKS PROBLEM

By Robert E. Scott

I teach and write about contracts. I have done so for forty years. During that time, my approach has changed considerably. I used to teach contracts the traditional way: we would read cases of prior contract disputes and then, analyzing them from a litigator's perspective, help the students reconstruct the arguments. Ultimately, I would ask: What is the argument that would have given the plaintiff (or the defendant) the best chance of prevailing in court? This is a worthy exercise; it forces the students to learn the difference between good arguments and silly ones. And it is an essential skill of any good lawyer. Moreover, it is likely to be helpful to those who end up as commercial litigators. But there is one problem: data show that most practicing lawyers working in commercial and corporate law are transactional lawyers, not litigators. And so, over time, my perspective has shifted. I continue to have the students read cases, but now I spend much more of my time with the students asking a much different question: How could we have designed this contract to have prevented the dispute from arising in the first place? This is the perspective of the transactional lawyer looking at cases from the perspective of a pathologist: Why did the patient die? Sometimes, of course, the answer is that a contract dispute, like death, is inevitable. But much more often it turns out that a well-designed contract could have greatly minimized the risk of litigation. ▶▶

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A CHANGE  
IN TEACHING  
APPROACH  
TO FOCUS ON  
CONTRACT DESIGN



Nowhere is the issue of contract design more relevant today than in the current debate over contract interpretation. Contract interpretation remains the single most important source of commercial litigation and the least settled, most contentious area of contemporary contract doctrine and scholarship. Framed by the battle between the titans of contract, Samuel Williston and Arthur Corbin, and continuing to the present, two opposing positions have competed for dominance in contract interpretation. Many (indeed most) states, including Wisconsin, follow a traditional common law, “textualist” approach to interpretation. Here, when the writing is clear, courts cannot choose to consider the context surrounding the contract. In contrast, in states that follow California, and in all states where the subject matter involves the sale of goods under the Uniform Commercial Code, the courts are “contextualist.” Here, courts must consider the context regardless of the clarity of the written contract. Thus, the battle is joined: text versus context.

This battle over contract interpretation—which is better, text or context?—illustrates the deep chasm that separates scholarly debates over contract doctrine from the real world of contract design. The contract doctrine purports to address a single interpretive question, presenting itself in a variety of particular ways: What should courts do? Should a court adopt a hard or a soft parol evidence rule? Does the common law plain meaning rule still apply? Are merger clauses conclusive evidence that the writing is integrated? But the design choices lawyers make for their commercial clients are motivated by quite different considerations. Transactional lawyers who design contracts for sophisticated parties are much more concerned with managing the role of a court in resolving contract disputes than in debates over styles of interpretation. And designing a contract that successfully manages the court’s role is not an easy task.

The fundamental challenge lawyers face in designing a contract is that contractual obligations are agreed to *ex ante* (at the time the contract is formed) but are enforced *ex post* (after the transaction has broken down and parties are litigating). Because courts have the benefit of hindsight, the *ex post* world sometimes, though not always, resolves the uncertainties of *ex ante* contracting. In order to resolve those uncertainties, however, courts must be empowered to interpret contract terms. Now here is the rub: the invitation to interpret the agreement creates an opportunity for a mulligan, a “do-over,” where either party can behave strategically. The party who is disappointed by subsequent events may argue that the contract as written doesn’t fully reflect the parties’ true agreement, and, conversely, the party who was blessed by fate may argue that the contract as written is exactly what the parties intended even though it appears in hindsight to lead to unreasonable results. Anticipating this problem, the transactional lawyer faces the challenge of choosing between two very different options: either to expend costs in drafting and negotiating in order to devise innovative



Columbia’s Robert E. Scott delivers Marquette Law School’s Boden Lecture in the Eckstein Hall Appellate Courtroom.

contract terms that reduce the likelihood of future strategic behavior or to postpone those costs and delegate discretion to a later court to root out and deter this strategic behavior once litigation arises.

There are several reasons why contract doctrine does not provide any guidance on how best to respond to this challenge, but one in particular stands out. Contract law scholars have failed badly in understanding the causes and effects of contract breach. The difficulty starts with a misspecification of the problem. It is incorrect to think of contract breach as either action (or inaction) by a party who thereby fails to perform its contractual obligations satisfactorily. More properly, breach is a legal conclusion reached by a court charged with the duty of resolving these private disputes. So let's ask the question more precisely. Given the coercive power of the state to enforce contracts and award compensatory damages, why do parties ever breach?

There are three major explanations. First, many breaches are inadvertent: that is, parties breach because they are unable to provide a timely and conforming performance. For our purposes, it does not matter why—it could be failures in production or supply or any other of a host of external shocks that prevent full and complete performance. In any event, inadvertent breach does not implicate contract design (at least not directly).

What about advertent (or purposive) breaches? Here there are two candidates. One hypothesis can be traced rather directly to an article that Charles Goetz and I wrote more than 35 years ago. Developing an idea first suggested by Robert Birmingham in 1969, we coined the phrase “efficient breach.” Efficient breach theory was based on the premise that a contractual obligation is not necessarily an obligation to perform but rather an obligation to choose between performance and compensatory damages. Goetz and I explained the standard default rule of expectation damages by hypothesizing “that breach occurs where the breaching party anticipates that paying compensation and allocating his resources to alternative uses will make him better off than performing his obligation.” It was a nice try, but, in fact, it doesn't fit the data. There are very few examples of an efficient breach in which one party chooses between performance and the payment of expectation damages that are subsequently assessed by a court. In truth, efficient breach is both a null set and an oxymoron. So, while we meant well, Goetz and I are probably primarily responsible for leading a generation of scholars down the wrong garden path.

Does this mean that the data show there is no such thing as an advertent breach, in the sense of a conscious breaking of a promise to perform? Not at all. There are literally hundreds of cases where parties have been found by a court to have consciously breached their obligations under the contract. The interesting thing about these cases, however, is that “breach” is not the result of a rational choice between the alternatives of undertaking a performance that costs more than it is worth or paying equally costly compensatory damages. Rather, it is a conclusion reached by a court following a trial in which both parties insisted that their behavior was entirely proper under the contract. So what is going on here?

A possibility is that one of the parties—let's call him “the doofus”—is simply miscalculating what kind of performance the contract requires. If that is so, then the breach is merely inadvertent, the product of a mistaken judgment and thus no different from any other error that prevents a party from performing as promised. A second—much more likely—possibility is that one of the parties is welching on the deal. We might well be tempted to label this latter behavior as opportunism. Indeed, several scholars have recently argued that the risk of opportunistic breach is sufficiently acute that courts should zealously police against opportunism by deploying their traditional equity powers to punish an opportunistic party even in the face of a fully integrated and unambiguous written contract. They contend that this heightened risk of opportunism undermines any argument that sophisticated parties are better equipped to deal ▶▶

## THE FAILURE OF CONTRACT SCHOLARS TRULY TO UNDERSTAND BREACH

## AN APOLOGY FOR EFFICIENT-BREACH THEORY



with the risk of opportunism in advance through rational contract design. Contrary to the views of these scholars, I am going to defend the view that reliance on contract design is, in fact, the better approach. My claim is that what the proponents of a return to traditional equity believe can be done as a matter of theory, generalist courts, in fact, cannot do (at least not reliably).

Let's begin with the concept of opportunism. Oliver Williamson famously defined opportunism as "self-interest with guile." But that characterization isn't quite right here: as it appears initially to the court, both of the contracting parties are guileless. Thus, we need to sort the behavior of the honest but mistaken breacher (who is not an opportunist to be sanctioned by a court using its equity powers) from behavior that is, in fact, self-interested but appears completely guileless. So let's call the latter behavior that I am describing "shading," as in "shading the truth." My hypothesis is that both the parties and the courts face a fundamental dilemma: First, shading behavior is ubiquitous, and, second, it is nearly impossible for a court to sort out who is the doofus and who is the shader. Let me take a moment to defend both of these propositions.

## REACTION FROM **GEORGE TRIANTIS**

### PRODUCT DESIGN IN CONTRACT DRAFTING

I am honored to be writing these comments on Bob Scott's essay. During the past four decades, contracts scholarship has evolved through several phases focusing on a distinct set of issues: in particular, remedies in the 1970s, default rules in the 1980s and early 1990s, the interplay between legal and nonlegal enforcement since the 1990s, and, currently, the challenge of contract design. Bob Scott is unique among contracts scholars in having been the leading voice through each of these phases; in so doing, he has inspired generations of legal scholars. I was particularly privileged to have had Bob as my teacher, colleague, and dean at the University of Virginia School of Law, my co-teacher in a contracts seminar we offered during several academic years, and a coauthor of several articles and a book. Much of what I know about the analysis of contracts, I learned at his elbow. Yet this would not be an interesting commentary if I did not discuss some respect, however slight, in which our viewpoints diverged. I shall try to be efficient enough, relying through the notes on some of my past work.

For the past 15 years or so,<sup>1</sup> I have been more sanguine than Bob about contextual interpretation in the resolution of contract disputes, whether by arbitration or court. In fact, commercial parties themselves invite reference to industry standards or course of dealings in the vague language they adopt in their agreements (such as "good faith," "best efforts," "commercial reasonableness"). A decade ago, Bob and I combined to publish "Anticipating Litigation in Contract Design,"<sup>2</sup> in which we presented a framework by which parties decide whether to describe their obligations in rule- or standard-like language. In doing so, the parties trade off the ex ante costs of contract design (involved in specifying rules) against the ex post costs of litigation (in applying standards to the particular circumstances). By evaluating this trade-off, the parties can choose, on a provision-by-provision basis, between a textual or contextual interpretation. Merger clauses can exclude precontractual communications and the like, but industry standards and courses of dealing are invoked by the use of standard-type language.

The parties have other tools at their disposal in the design process. As Bob and I noted in that article, they have significant discretion to opt out of the default procedural and evidentiary laws. In this way, the parties

<sup>1</sup> See George G. Triantis, "The Efficiency of Vague Contract Terms: A Response to the Schwartz-Scott Theory of U.C.C. Article 2," 62 La. L. Rev. 1065 (2002).

<sup>2</sup> Robert E. Scott & George G. Triantis, "Anticipating Litigation in Contract Design," 115 Yale L. J. 814 (2006).



To begin: Why is shading pervasive? There are several reasons, but most important is the fundamental fact that all contracts—even those carefully drafted in every detail—must be interpreted. Even if the interpretation is by a formalist court relying on the parol evidence rule to limit its inquiry to the text of the agreement and its plain language, the court is still required to harmonize and make coherent a contract with more than 100 individual provisions, each of which may be unambiguous when viewed in isolation but subject to interpretation when taken together. This means that all contracts depend on courts to implement correctly the ex ante instructions that the parties have embedded in their agreement. Those instructions can be framed either as “hard” terms (precise, bright-line rules) or as “soft” terms (broad standards) or, more often, as combinations of the two. But whether hard or soft, one party or the other will obtain a significant ex post advantage whenever there is a substantial exogenous shock between the time of contracting and the time of performance. Thus, if the contract terms are hard, the party with the apparent benefit of a bright-line rule can extort rents by refusing to adjust its behavior in ways that would reduce the ex post losses of the counterparty (let’s call this Type I shading). In light ▶▶

can tailor these provisions to the circumstances in which they expect their disputes to arise. By making the procedure more efficient, they increase the attractiveness of standards and contextual interpretation, and save on front-end transaction costs.

Even with imperfect and costly courts, parties might still opt for contextual interpretation of some provisions because it is superior to the alternative choice of textual interpretation of imperfect rules. Indeed, by manipulating the cost of litigation and the liquidated damages for breach to adjust for judicial error, the parties can design a contract under which a party would have the incentive to bring an action for breach only when the other party has in fact failed to meet its obligations.<sup>3</sup> In his essay here, Bob refers to the moral hazard problem of a party’s exploiting the court’s error to reallocate the division of losses that had been agreed to in the contract. Yet consider whether such a plaintiff would incur the litigation cost of, say, \$40,000, for even a 30 percent chance of fooling the court into awarding liquidated damages of \$100,000. This illustrates a more general point about design: it is an opportunity to think of damages more creatively as serving a purpose beyond simple compensation. In fact, even casual observation will reveal that liquidated damages often deviate in practice from the purely compensatory level.

The notions that contracts are products and that products can benefit from design thinking are not new. How to encourage innovation and improve contract quality remains a challenge.<sup>4</sup> At Stanford, our law students have the opportunity to learn from Stanford’s Institute of Design (the “d-school”) about techniques that can unleash their creativity to create more value through negotiation and contract design. This is an especially productive path in educating the next generation of transaction lawyers.

<sup>3</sup> Albert Choi & George Triantis, “Completing Contracts in the Shadow of Costly Verification: The Case of Corporate Acquisitions,” 37 J. Legal Stud. 503 (2008); Albert Choi & George Triantis, “Strategic Vagueness in Contract Design,” 119 Yale L. J. 848 (2010).

<sup>4</sup> George G. Triantis, “Improving Contract Quality,” 18 Stan. J. Law, Bus. & Fin. 177 (2013).



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## SHADING—THE DIFFICULTY OF ITS DETECTION

of the problem that hard terms can work an injustice to the party who has been disadvantaged by fate, many scholars have argued that courts should imply broad standards of reasonableness or good-faith adjustment to moderate the effects of the bright-line obligation that subsequently proves so vexing. But this strategy merely shifts the advantage to the counterparty. Substituting a soft standard—such as good-faith adjustment—for the hard rule merely creates a moral hazard risk on the other side, inviting a losing party to exploit the court's discretion by persuading it to reallocate losses that were in fact allocated to the losing party by the contract (call this Type II shading).

Shading is not only pervasive but also difficult to detect. Often the shader is entirely sincere in her belief that she has complied with the contract and that it is the counterparty who is the breacher. There are two related but distinct phenomena here. The first is the “noisy prisoner's dilemma” problem: it is very difficult for parties engaged in iterative acts of performance to interpret correctly the behaviors of their counterparty. A cooperative action can often be misinterpreted as a defection and vice versa. This can lead to sincere but mistaken retaliation against a perceived breach of trust. Second, there is a phenomenon that every good commercial lawyer understands: the behavioral reality is that agreeing before the fact to bear a low-probability, long-tail risk is quite a different matter from being willing to absorb the entire cost once the risk materializes. The prospect of suffering large ex post losses can produce a form of cognitive amnesia in which both parties are convinced that their behavior is perfectly consistent with their contractual obligations. To be sure, a party's claim of compliance may be purely strategic, in which case the court will be confronted with a self-conscious opportunist in shader's clothing. But in any event, there is no “breach” in any meaningful sense of the word unless and until a court—acting as a referee—assesses the evidence and makes a call.

One might be tempted at this juncture to turn to relational contract theory and ask whether norms of trust, reciprocity, and the desire to preserve one's reputation will deter shading on the margin and avoid the problem altogether. But relationships built on trust alone are little help in this situation. Contract disputes of this sort present an end game—bet the ranch—situation in which the relationship will come to an end one way or the other, so the shader has little to lose. Moreover, even if contracting parties are willing to punish selfish or unfair actions by their counterparty, as the behavioral research suggests, this won't deter shading either. As I have suggested, both parties see themselves as behaving fairly under the circumstances and therefore feel that their actions are fully justified.

So what is a court supposed to do? As I mentioned earlier, several scholars have recently argued for a return to traditional equity—on this view, courts would make a Solomonic determination of who likely is the opportunistic party, and they would impose sanctions independently of what the contract appears to require. But before we endorse that approach, we must first answer a key empirical question: Can generalist courts find the shaders among the doofuses?

To begin to answer that question, I have assembled a data set of 75 randomly selected contract disputes presenting this issue to the court: who breached the contract? I tested two hypotheses. First, that disputes in which a party could plausibly be guilty of either Type I or Type II shading are common. Second, that courts in such cases would not (or could not) reliably identify behavior as opportunistic. The hypothesis that shading disputes are frequent is a function of the fact that disputes of this sort often require a third party to resolve. The second hypothesis rests on the claim that shading behavior requires a court to understand the underlying context of the transaction with sufficient depth to be able to identify subtle forms of aberrant behavior. Conceding that there is a considerable amount of judgment involved in my coding of the cases, I can report that the tentative findings are consistent with both hypotheses.

## CAN A GENERALIST COURT FIND THE SHADERS?



Of the 75 selected cases, 46 involved claims where the counterparty's behavior could plausibly have constituted either Type I or Type II shading. In 19 of the 46 cases, at least one party alleged, in either pleadings or briefs, that its counterparty's claims were opportunistic. Yet, in none of the 19 cases alleging opportunism did the court either explicitly or by inference identify the behavior as opportunistic. To be sure, these results are only suggestive. These courts could be resolving the doofus/shader decision sub rosa but declining to identify it explicitly. But at best, the judicial silence gives us a very noisy signal.

There are other data that support the hypothesis that generalist courts are poor candidates for using their equity powers to reduce the incidence of opportunism. One line of analysis shows the difficulty of measuring allegedly opportunistic behavior against the norms and customs of the relevant trading community. Recent research on the medieval law merchant by Emily Kadens and on twentieth-century trade associations by Lisa Bernstein has shown that ongoing, "traditional" dealings never crystalize into well-defined, customary usages of trade at all. This evidence suggests that many courts, when asked to identify a trade usage, rely exclusively on interested-party testimony rather than on a careful evaluation of complex evidentiary submissions. Just to posit one example, the plaintiff's warehouse manager may testify that shipments usually arrive within three days. In short, there is virtually no evidence that courts undertake the empirical investigations needed to find a relevant custom and then use it to identify opportunistic behavior—and even less reason to imagine they could succeed if they did. Long-term, reciprocal relations always reflect the idiosyncrasies of the histories of each party with the others; and these idiosyncrasies prevent the community's practice from settling into a determinate custom or practice. Thus, even if generalist courts were better equipped for empirical investigation than they normally are, there will typically be no custom-based, context-embedded usage or practice for them to discover and use in evaluating a litigating party's actions.

Here then is the dilemma: Enforcing contracts requires interpretation, which means that courts are asked to police shading behavior, but doing so often leads to errors, because the courts are asked to do more than they are able to do. Let's call this "the Goldilocks problem." Left to their own devices, courts will intervene either too much or too little. ▶▶

## THE GOLDILOCKS PROBLEM





## CONTRACTS AND THE EXIGENCIES OF BUSINESS

Let me offer some observations, perhaps more on the general topic of Professor Robert E. Scott's Boden Lecture than on his specific thesis, but touching on both. My fundamental point is this: Whether and to what extent lawyers can effectively draft a contract for the express purpose of shaping the scope of a court's eventual interpretation of that contract seems to me to be primarily an economic question. It is really a matter of how much certainty my client wants to buy and how much "lawyering" my client will expect or at any rate tolerate. This is a function of circumstance.

In a lawyer's perfect world, we would always have the time and resources needed to craft a contract that consciously and deliberately takes into account all of the possibilities of a court's involvement in a dispute over that particular transaction. But this world would require two things we rarely have: the unlimited patience and the unlimited checkbook of a client.

In mergers and acquisitions, securities, commercial real estate, or other high-value work, where boilerplate has been tested, retested, and adjusted over time, this or something approximating it can happen. But what about closing an emerging technology license agreement that no one has ever quite done—before 10 p.m. on the last day of the quarter? The former can be readily and predictably drafted; the latter not so much.

It seems to me, then, that one of the primary drivers of contract-design innovation, with respect to managing a court's role in contract interpretation, is the reality of day-to-day commercial practice. There the luxury of theoretical reflection is usually trumped by necessity—necessity driven foremost by practical business considerations and limitations on time and money. These resource limitations save the lawyers involved from the indulgences of thinking "too much" and spending too much, increasing the efficiency of the result and perhaps even reducing the likelihood of a dispute: Practical contracts that work tend not to produce disputes that require a court's involvement to resolve.

Consider the situation in 1970, when the team of NASA engineers supporting the mission of Apollo 13 had to design a carbon scrubber for the crew in space, using only items on hand in the space module. They had some tubes, some duct tape, some cardboard, and other odds and ends. Under extreme time and resource pressure, this team of engineers came up with a solution that worked and saved the mission. How would that situation have turned out if that team of engineers had been hired on a consultant basis and told that it could take as much time as it needed, using any item from a vast catalogue of parts and supplies? To understate the answer: Not well for the astronauts.

To be sure, the observation is contextual—as I acknowledged at the beginning of this short essay. But I see the same dynamic every day as an in-house lawyer, where the contracting parties generally also have unique knowledge of the businesses and industries they serve and have no choice but to take more cooperative and relational postures in the contracting process. This makes the question of the ultimate scope of contract interpretation by a court less relevant from the outset.

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So what is the alternative? How do we get just the right amount of judicial policing of contracts? My argument is that sophisticated contracting parties and their lawyers can, in fact, design their contracts in ways that invite a court to perform this policing function but only when the court is likely to get the question right.

But before we look at the ways transactional lawyers can accomplish this task, we should remember that the problem was not always this severe. At early common law, the Goldilocks problem was contained by virtue of the historic division of roles between law and equity. Historically, the English common law applied two different sets of doctrines to interpret a disputed contract. The first consisted of rules—such as the parol evidence and plain meaning rules—that were cast in objective terms, minimizing the need for subjective judgment in their application. They were administered strictly, without exceptions for cases in which the application of a rule appeared to defeat its purpose. These doctrines originated in the first seven centuries of adjudication in King’s Bench and Common Pleas, the English courts that produced the corpus of the common law from the twelfth to the nineteenth century. The second set of doctrines consisted largely of equitable principles originating in the English Court of Chancery, which, by the end of the fourteenth century, began to exercise overlapping jurisdiction with the common law courts to hear cases that, in J. H. Baker’s characterization, “in the ordinary course of law failed to provide justice.” These doctrines were framed as broad principles administered loosely and were designed to provide exceptions to the common law interpretive rules. They were generally cast in subjective terms and therefore required judges to exercise judgment by evaluating the fairness or the “equities” of the particular transaction.

The Chancery’s willingness to provide an independent and alternative forum stemmed from the perception that the common law courts were incapable of policing opportunism because of the strict, rule-bound inclination of common law judges to apply the common law rigorously, without reference to the context of the case at hand. The Chancery’s sole focus, in contrast, was with the equities of the case at bar. Indeed, for many years the Chancery’s decrees had no formal precedential effect, which initially freed the Chancery from any concern that its context-specific rulings could undermine the consistency and predictability of contracting. And, important for our purposes, there was one key additional factor: in preindustrial England, the Chancery was more intimately familiar with the contextual environment of typical party disputes and could fairly sort relevant from irrelevant facts. Thus, even though the Chancery reversed or avoided outcomes dictated by the interpretive rules, these actions could be seen as necessary in order to vindicate, rather than undermine, the common law.

Fundamentally, however, the institutions of the common law and the Chancery were at cross-purposes. The result was two competing systems, often with incompatible procedural and substantive doctrines, yet overlapping in jurisdiction. The ultimate result of the merger of law and equity meant that the institutional framework of the state could no longer, by itself, solve the Goldilocks problem. In consequence, commercial parties today are likely to be poorly served if they choose to rely on subjective, equitable review by contemporary courts. Lacking the requisite specialization, courts today are relatively ineffective at uncovering the underlying context that is essential if they are to police opportunism effectively. In contrast to early courts of equity, when the courts were close to the actors in a largely homogenous economy, generalist courts today are removed from the enormously varied commercial-contracting context in modern economies and therefore are critically impaired in their ability to divine how and when parties might seek to exploit the uncertainties of ex post interpretation. ▶▶

## A LOOK BACK AT THE COMMON LAW AND CHANCERY COURTS



## THE ROLE OF CONTRACT DESIGN

So let's abandon the question the commercial litigator might ask: What contract doctrines best help courts determine when to intervene to deter opportunism? Rather, let's ask the question from the transactional perspective: How can we design a contract that appropriately limits the risk of opportunism and thus properly confines the court's role in supervising the contracting process?

We return (finally) to the question with which we began: How do skilled transactional lawyers—the contract designers of this world—address the Goldilocks problem? Is it possible to design a contract in which the court plays a superintending role that is sensitive to the context the parties have created? Unfortunately, we have only preliminary data to answer this question because contract design remains something of a mystery, largely neglected by both legal and economic scholars. Indeed, a large and growing literature demonstrates the resistance of contracts to change even in the face of a significant exogenous shock. We know that boilerplate terms in corporate indentures, sovereign bonds, and other standard-form contracts resist improvements that would appear to enhance contractual efficiency. Even when customized, bespoke contracting emerges from law-firm precedents that are tightly protected and resistant to amendment. Yet despite these impediments, contracts do change in many different ways, and the changes appear to be the product of intelligent design, perhaps aided by a quasi-Darwinian evolutionary process of trial and error. Studies of contemporary commercial practices that my colleagues, Ron Gilson and Chuck Sabel, and I have undertaken over the past four years show that sophisticated parties choose several different means of anticipating and deterring shading behavior in the design of their contractual regimes.

## CUSTOMIZED CONTRACTS

To understand how contracts have evolved to address the Goldilocks problem (even as exogenous shocks alter the business environment in unpredictable ways), we should first begin by distinguishing two fundamental design categories. The first and most common is customization or “tailoring” of familiar contractual formulations. This involves changes in the terms within a particular instrument to better address particular uncertainties with future states. Thus, for example, in the past 50 years, parties have increasingly inserted vague terms such as “best efforts,” “reasonable best efforts,” or “commercially reasonable efforts” as modifiers that are combined with specific or precise performance obligations under the contract. Another example of customization occurs in thick contractual markets where trade associations or other collective bodies use an updating mechanism external to the parties to propose changes in particular terms that will ultimately be adopted by most if not all members of the collective body.

## ENHANCED UNCERTAINTY AND THE INFORMATION REVOLUTION

A quite different category of contractual design has occurred, however, as a product of the enhanced uncertainty triggered by the “information revolution.” These design changes are innovative in a much more fundamental way: they involve mutations in the very form of a contractual agreement. In this latter category, we see radically incomplete contracts being used to manage, *inter alia*, supply chains, complex platform production relationships, and pharmaceutical alliances. Parties in this environment of enhanced uncertainty are doing something different—and, we might surmise, what they are doing is an effort to solve the Goldilocks problem in novel ways.

To understand what is going on, let us begin by focusing on two critical characteristics of the particular contracting environment. The first is the level of uncertainty—are commercial practices stable and predictable, or are they disrupted by unforeseeable changes in technical possibilities and market conditions? All else equal, the higher the level of uncertainty, the more difficult it is for parties to write, and courts to interpret, completely specified and fully integrated contracts. Rather, when the level of uncertainty is high, sophisticated parties develop agreements grounded

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in the commitment to a regular exchange of private information but with no commitment as to the product that this agreement will produce. The second characteristic is the scope or thickness of the market—whether there are many traders or only a few engaged in a particular class of transaction that are using similar contracting strategies. All else equal, the greater the number of traders engaged in a transaction, the more likely that the contract terms and the rules for their interpretation—as well as a mechanism for adjusting terms as needs change—will be provided by a collective entity, such as a trade association, that can then provide a court the necessary context for interpretation. The interplay of these two forces—uncertainty and scale—points to the new forms of contracting among sophisticated parties and, at the same time, helps clarify the (often overwhelming) institutional demands that are placed on generalist courts.

Let me briefly illustrate the way that uncertainty and scale together determine whether and how the contract in question deals successfully with the Goldilocks problem. Begin with the case of thin markets, where the key variable is the level of uncertainty: For example, think about the battle for evolving technology in the market for electronics. Here the principal actors are few and scattered. Thus, unlike, say, the grain industry, these parties cannot rely on a trade association to institutionalize their design solutions because the market is too thin. In these circumstances, contract design occurs primarily in bilateral relationships, and here the level of uncertainty will determine how the parties respond to the problem of shading.

When uncertainty is low—say, for example, a one-year license of patented electronic software—sophisticated parties can turn to customized, completely specified contracting. By incorporating any context thought to be relevant as part of the “terms” of a complete, formal agreement, they can specify precisely the evidentiary base that will be made available to a court, while still preserving the court’s historic role in policing opportunism. For example, the contract can provide clear directions to a court of the context within which the specified uses of the licensed intellectual property are to be interpreted. This might include (a) a “whereas” or “purpose” clause that describes the parties’ business plans; (b) a series of definition clauses ascribing to words and terms particular meanings that may vary from their plain or ordinary meaning; and (c) appendices that provide illustrations or examples of the permissible uses of the licensed intellectual property as well as any memoranda the parties want an interpreting court to consider in interpreting the contract’s text. Alternatively, the parties can specify in the agreement that the meaning of terms should be interpreted according to the customs and norms of a particular industry or commercial community. ▶▶

## UNCERTAINTY AND SCALE

## LOW UNCERTAINTY



## MODERATE UNCERTAINTY

The point here is simply that low uncertainty permits parties to design a contract that dramatically reduces (if not eliminates) the need for courts to inquire into any evidence extrinsic to the written agreement. By reducing the burden on a court to have to characterize ex post shading behavior accurately, this contract also reduces the likelihood of a court's making a mistake in interpreting the contract. Correspondingly, it reduces the incentive for the party disfavored by subsequent events (who, after all, is the likely shader) to engage in opportunistic litigation in the first place. With a completely specified contract in the low-uncertainty setting, therefore, courts are less mistake-prone, and parties less likely to encourage mistakes, resulting in less risk of judicial error.

Now suppose that the contracting parties confront moderate levels of uncertainty, in the sense that they can identify what should happen in some but not every future state of the world. One clear example is the decision to hire a sales representative to market the firm's electronic products following their manufacture. The parties can specify what they want the agent to accomplish as matters stand at the time of drafting the contract: they can identify the potential customer base, or geographic region, and they can specify sales goals. But they can't detail how the agent will try to market the products, how the agent will allocate her time across different products, or what adjustments the agent should make if market conditions change or competitors alter their strategies. Similarly, what if the product is a new drug, and the contract contemplates a license between the owner of the intellectual property and an agent who agrees to secure regulatory approval and commercialize the product? Contracts such as these will typically charge the agent/licensee with using "commercially reasonable" or "best" efforts to accomplish the specified tasks, reflecting the fact that the appropriate strategy is dependent on the outcome of uncertain events, such as the market demand and competitive conditions for the product in the first case and the results of clinical tests and the course of the regulatory process in the second example. The reason to use standards is clear: Courts assess performance with respect to standards only after the relevant future events have occurred. In this way, parties can obtain the advantage of hindsight: at the time for dispute resolution, the court has information that at the time of drafting the contract the parties lacked.

Both of these examples illustrate the design challenge of granting the agent some—but not too much—discretion in choosing the strategies that best meet the parties' ex ante expectations for performance. In this intermediate range of uncertainty, sophisticated parties use design strategies to constrain the discretion of a court later asked to assess the agent's behavior under the applicable standard. What we see is that parties (or more accurately their transactional lawyers) combine precise or specific obligations with the broad contractual standards. The specific obligations are directions about the context through which the standard should be applied. By combining specific terms with generalized obligations, the parties can add context evidence that is revealed over the course of contract performance to the original text of the agreement. The more effectively this context evidence can be harnessed so as to limit the court's discretion in applying the relevant standard, the more attractive is the use of standards that take advantage of the court's hindsight advantage. In this way, the parties design a contract to answer two key questions: when the court will look to context and who decides what context matters.

When and the extent to which parties design a regime deploying these broad standards thus depends on how effectively context can be specified in ways that reduce the risk a court can be persuaded by a shader to misunderstand or misapply the standard. To reduce this risk, parties can describe in the contract the context that will be relevant—what ▶▶



## OPPORTUNISM AND THE TRANSACTIONAL LAWYER

In his essay, Professor Bob Scott notes that a transactional lawyer faces a choice in fashioning an agreement—either drafting to reduce the likelihood of opportunistic behavior by the counterparty or leaving it to a court to root out strategic behavior. Yet sometimes a transactional lawyer wants to preserve the potential for opportunism for his own client. To do this, the lawyer typically either omits any reference to the potential future opportunity in the contract or uses a vague or ambiguous standard with respect to the activity. That contractual silence or lack of specificity, in turn, enables the client to argue its interpretation in any subsequent litigation.

In this situation, the transactional lawyer, through planning, is enabling the client's opportunism. Often the counterparty is not even aware of this potential for opportunism, for it is not aware of the probable, or even possible, future opportunities that the client anticipates in its business. In this way, even the contractual counterparty (much as with a court) is ignorant as to the real purpose behind either a contract's silence or its vague or ambiguous standard on a particular topic.

Let us briefly consider the role of the transactional lawyer in this situation. Specifically, is it ethical for the transactional lawyer to draft a contract in a way that enables client opportunism?

On the one hand, it is arguably dishonest for a lawyer intentionally to draft contractual language in a way that allows the client to pursue future opportunities of which the counterparty is not aware. After all, it is misconduct for a lawyer knowingly to assist a client in misleading the counterparty as to the content of a writing that documents a contract, such as by failing to disclose a provision added to a contract where the counterparty would reasonably expect such disclosure—so teaches *Hennig v. Ahearn*, 601 N.W.2d 14 (Wis. Ct. App. 1999). It is only one step away from this type of drafting omission to fail to disclose information to the counterparty as to the client's opportunistic purpose for using a general contractual standard.

On the other hand, if, as Bob argues, courts cannot tell when a contractual party is pressing for an opportunistic interpretation of contractual language, then there is no way to determine where a transactional lawyer knowingly facilitated that opportunism. Thus, even if unethical, this type of conduct is impossible to police. Moreover, if a lawyer is supposed to diligently and competently represent her clients, then she must generally have the freedom to advance the clients' interests, especially when planning their business affairs in light of the uncertain future. The argument is therefore strong that the transactional lawyer is justified, if not required, to facilitate her clients' opportunism.

Yet it is not altogether clear. In these circumstances, most strikingly for me, the uncertainty of the propriety of the lawyer's conduct in this situation demonstrates the failure of current rules of professional conduct adequately to contemplate the role of the transactional lawyer. Without such guidance, transactional lawyers must often help their clients plan their business affairs in light of not only the uncertain future but also—for the lawyers—the uncertain present.

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## THE GOLDILOCKS PROBLEM IN CONTEXTS WITH EVEN-GREATER UNCERTAINTY

industry, what kind of products, and, when possible, the evidence the court should use to measure performance under the standard. In this way, the contractually specified standard directs the court to make use of context in addition to text, but limits the court's inquiry to only that context evidence that is relevant to the particular obligation embedded in the standard. Thus, even where the level of uncertainty calls for the use of standards, it is the parties and not the courts choosing the balance between text and context that best suits the level and kind of uncertainty the transaction protects.

A central design question, however, is this: Can parties still solve the Goldilocks problem when even-greater uncertainties challenge the skills of contract designers? As the level of uncertainty rises even higher, commercial parties (and their lawyers) can no longer rely on the traditional forms of contracting. Over the past 15 years, the challenges of the information revolution have led to increasing levels of uncertainty and motivated parties in affected industries (and their lawyers) to innovate by designing entirely new and radical forms of contracting. Electronics is a good example of an affected industry. Electronics firms compete with each other to anticipate and design the next breakthrough in technology—for example, the smartphone platform displaces the PC, only to find itself displaced by whatever comes next. This high-uncertainty environment, where an entirely new technology can disrupt the status quo, has triggered a revolution in the basic form of the contract. As I suggested earlier, lawyers for these parties have innovated by designing novel collaborative agreements that only obligate the parties to explore possibilities together without committing them to execute any specific project. In other words, even though there is a formal and very detailed contract of many terms and pages, the contract regulates only the commitment to collaborate, and not the course or the outcome of the collaboration, which is left entirely unspecified. This means that any effort to enforce this agreement in court is limited to protecting each party's promised investment in the collaborative process rather than directing a division of any surplus that might result if the collaboration were to succeed.

This limited legal commitment means that there is a significant constraint on the potential role of a court charged with policing shading. Any resulting agreement to produce a specified product or to purchase a key input to production (the usual stuff of contracts) is not part of the formal contract at all. Rather, the substantive outputs of the collaboration develop only from the informal relationship of mutual trust that is the result of the collaboration process itself. It follows that a reviewing court's primary focus will be limited to questions of character rather than capability: Has one party cheated, say by using information gained during the collaboration for its own private purposes? Because any judicial sanction applies only to the commitment to collaborate, it is limited to the vulnerable party's verifiable reliance costs and does not extend to the award of profits that might have been earned had the project gone forward.

Let's turn now and see how scale—the thickness of the market—changes the landscape of contract design. Consider for example the market for key commodities—grain, cotton, and the like. Here we encounter a thick market where many parties engage in the same or similar forms of contracting. When markets are thick, the costs of design can be spread, in the sense that many actors face similar risks and stand to benefit from concerted responses to them. In this environment, the affected parties often institutionalize their contract design through the collective action of industry associations. Once again, the design challenge will vary according to the level of uncertainty faced by the actors, but scaling the contractual product permits novel solutions to the Goldilocks problem.

## TURNING FROM UNCERTAINTY TO SCALE

Notice how scale changes the parties' design responses even in low-uncertainty settings. Let's assume that commercial practices in the particular industry are stable and well understood by a substantial community of traders. Nevertheless, a generalist judge can't be expected to have knowledge of such embedded trade practices or be able to conveniently obtain the information needed to make an accurate determination of which party is the shader. So the trade association has to cope with the adverse consequences of judicial ignorance while, at the same time, creating a framework to reduce the risk of shading. This challenge motivates the trade association to engage in innovative design. What is the result? These trade groups have chosen to rely on expert arbitrators to strictly enforce industry-approved, standardized contract terms. They regularly update the terms to keep them current with practice as it evolves. In this way, the trade group enlists a third party with a limited charge: just monitor the shading risk by holding parties to the strict terms of the contract. But what about context—the party-to-party adjustments that are always necessary as changed conditions affect performance? That is left entirely to relational norms of reciprocity (tit for tat) and the discipline of repeated dealings. As a consequence, the risk of a party's making strategic argument about the "true agreement" is eliminated. This is a solution that cabins the court's enforcement role much more successfully than in the parallel case of the bilateral standardized agreement—the paradigmatic exchange of purchase order and acknowledgment forms—that is governed by the context-friendly Uniform Commercial Code.

Finally, then, what happens in thick markets when uncertainty increases and, as in the case of bilateral contracting, the parties need to rely on standards in order to harness the hindsight advantage of a court? Under certain conditions parties use their scale to invest a particular court with expertise in discovering the relevant context. For example, intimate familiarity with evolving commercial practice permits an expert court, such as the Delaware Court of Chancery, to reliably recover the always-evolving contextual facts needed to resolve fiduciary-duty disputes between shareholders and corporate managers. Courts in these areas of geographic concentration of similar contracting parties can develop, over time, both judicial expertise in the subject matter and a body of precedents that can parallel the private interpretive regimes created by trade associations. In effect, in instances such as the Delaware Court of Chancery and perhaps the Santa Clara County Superior Court with respect to the Silicon Valley industrial district, we see a contracting regime that reflects both the constraints imposed by the problems of uncertainty and scale and the potential that generalist courts may become specialist courts through repeated exposure to the particular industry. Under these circumstances, a generalist court can serve a geographic concentration of similar contracting parties by engaging in contextualist interpretation in careful and skillful ways that police shading effectively and thus help parties in their quest to solve the Goldilocks problem. ▶▶

*Here then is the dilemma: Enforcing contracts requires interpretation, which means that courts are asked to police shading behavior, but doing so often leads to errors, because the courts are asked to do more than they are able to do. Let's call this "the Goldilocks problem." Left to their own devices, courts will intervene either too much or too little.*



The preceding examples are only illustrative of the many variations in contract design where transactional lawyers have relied on experience and intuition to innovate. Contract scholars can aid this process by undertaking further empirical investigations: the central idea is that the level of uncertainty and the thickness of the relevant market will determine the range of design strategies found in contemporary commercial transactions. In each of these cases, my analysis suggests that the key is to design a contract that meshes with the relational or informal enforcement provided by the context and that thereby serves to cabin the role of the decision maker tasked with policing difficult-to-verify shading behavior.

This context-specific relationship among uncertainty, scale, and the form of the contract illustrates vividly the problem confronting generalist courts in assessing how to cope with

## REACTION FROM STEWART MACAULAY AND WILLIAM C. WHITFORD

### DO COURTS USUALLY GET IT WRONG?

Professor Robert E. Scott—Bob, to us—has been an admired friend for a long time. His thinking, as presented in this essay version of his Boden Lecture, shows why. Bob draws on his own insights, a wide range of scholarship, and his original and excellent empirical research about practices in drafting complex contracts, to show us some cutting-edge drafting approaches and the reasons for them.

Bob focuses on how sophisticated transactional lawyers draft terms directed at possible litigation of disputes concerning complex business contracts. He argues that courts should later respect these drafting efforts. When contracts are written with great forethought between sophisticated parties who are paying attention to what they are doing, we agree.

Yet, as Bob discusses at much greater length elsewhere, many contracts between sophisticated parties are not carefully planned.<sup>1</sup> Professor Claire Hill has written a series of articles about the contract-drafting processes that are common in our largest law firms when they are preparing contracts between sophisticated parties.<sup>2</sup> Often partners expect associates to produce a written document quickly to keep down costs. Often associates copy terms from other contracts prepared for other clients. Sometimes the resulting document contains language that is inappropriate or inapplicable to the contract at hand, or even directly conflicting terms, none of which is discovered or appreciated at the time the contract is signed.

As Bob recognizes, these practices thrive because in almost all business transactions, what guarantees performance is trust, concern about reputation, and hope that a long-standing business relationship will continue. Litigation is rare. Even when trouble is encountered, lawyers are seldom brought in when businesspeople still have a valued ongoing relationship. A fortiori, businesspeople do not want to invest resources at the negotiation stage to provide clearly in the written document what the courts should do if certain contingencies arise—or, sometimes, even to memorialize understandings or assumptions shared when they formed the deal.

Bob expresses concern about a court's trying to resolve disputes by going beyond the words of a written contract and looking at the context of the parties' relationship. He recognizes that the written contract may not record what the parties were thinking when they negotiated and signed it, but Bob (and he is not

<sup>1</sup> Bob and his coauthor, Mitu Gulati, titled a book about such contracts: *The Three and a Half Minute Transaction—Boilerplate and the Limits of Contract Design* (2013).

<sup>2</sup> E.g., Claire A. Hill, "What Mistakes Do Lawyers Make in Complex Business Contracts, and What Can and Should be Done About Them? Some Preliminary Thoughts," in *Revisiting the Contracts Scholarship of Stewart Macaulay* (Jean Braucher, John Kidwell & William C. Whitford eds., 2013).



the risk of opportunistic behavior. The role of generalist courts will differ across the various dimensions I have outlined, but in all events it will be more restricted than the standard account under which the court is supposed to fit innovative forms of contracting into the traditional categories of common law contract. If a central goal of contract adjudication is to enforce the contract in the context that the parties have provided, then the courts need to defer to the context the parties have given them. To do that, both judges and contract theorists will have to attend to the unique characteristics of the novel contracts currently being designed by transactional lawyers. Thus, as I suggested earlier, in this environment, courts must practice the passive virtues. For it is the parties, not the courts, that drive the innovations in contract design. ■

alone) sees enforcing such accidental contracts as the price we must pay to avoid even-worse problems. He is convinced that judges usually get it wrong when they turn to context to seek what parties probably intended to happen in the unlikely event of litigation—or would have intended had they thought about it. Judges, after all, are rarely immersed in the practices and expectations in a particular business area. And inquiries into context can dramatically lengthen both discovery and trial.

Do courts often get it wrong when they go beyond a literal reading of the words of a contract document? This is an empirical question, albeit one that is very difficult to answer. We think that although written opinions often are easy to criticize, in many cases courts stumble but find a “rough justice”—that is, a result that is in the vicinity of what careful study would suggest to be appropriate. Space does not allow us to provide multiple examples,<sup>3</sup> but we note that belief in “rough justice” has a long history. Karl Llewellyn, perhaps the greatest contracts scholar in the twentieth century, wrote frequently of his faith in judges’ “situation sense” when it came to resolving disputes brought to them. Even judges who did not reason well in an opinion often come to fair results.

Moreover, with respect to what lawyers expect judges to do, we should consider its likely impact on settlement of disputes, both before and during the course of litigation. Often if parties are pushed to find an acceptable if not ideal solution, they will do better than what is possible in the formal legal process. If there is a risk that judges will seek a fair result, in some situations at least, this may provoke more effort to find a solution that both sides can live with.

Contracts not drafted with mutual care are inevitable, but none of this detracts from the importance of studying how parties who want a carefully drafted contract can best insure that courts will respect their mutual understandings. This is Bob’s primary focus in this essay. We want to thank Marquette Law School for presenting Bob’s paper as its annual Robert F. Boden Lecture and for asking us to comment on it. His work is both excellent in quality and important.

<sup>3</sup> Our study of the famous contracts case, *Hoffman v. Red Owl Stores, Inc.*, 13 N.W.2d 267 (Wis. 1965), is one example. See William C. Whitford & Stewart Macaulay, “Hoffman v. Red Owl Stores: The Rest of the Story,” 61 *Hastings L.J.* 801 (2010).

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