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# Introduction - Incomplete Contracts: Judicial Responses, Transactional Planning, and Litigation Strategies, symposium

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# SYMPOSIUM INCOMPLETE CONTRACTS: JUDICIAL RESPONSES, TRANSACTIONAL PLANNING, AND LITIGATION STRATEGIES

## INTRODUCTION

*Juliet P. Kostritsky*<sup>†</sup>

The three papers in this Symposium address the topic of incomplete contracts.<sup>1</sup> The recognition that parties will often fail to achieve completely contingent contracts<sup>2</sup> that provide for an optimal outcome in any future state of the world raises the important question of what role courts could or should play in such contracts.

Scholars working in the law-and-economics tradition have suggested that courts should use a hypothetical bargain approach to incompleteness, filling in terms that are optimal (efficient) and that the parties themselves would have achieved were it not for the transaction

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<sup>1</sup> Richard Craswell, *The "Incomplete Contracts" Literature and Efficient Precautions*, 56 CASE W. RES. L. REV. 151 (2005); Avery W. Katz, *Contractual Incompleteness: A Transactional Perspective*, 56 CASE W. RES. L. REV. 169 (2005); Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187 (2005). All three papers in this Symposium were inspired by the AALS Contracts Section in San Francisco, CA on January 8, 2005.

<sup>2</sup> See Karen Eggleston, Eric A. Posner & Richard Zeckhauser, *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 91 (2000) ("A more complete contract takes account of many future contingencies that would change the value of performance."); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 756 (1988); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 274 (1992) (comparing "the 'relational view' of contract adjudication to the law-and-economics view" and discussing "the causes of contractual incompleteness"); see also Kathryn E. Spier, *Incomplete Contracts and Signaling*, 23 RAND J. ECON. 432 (1992) (exploring the relationship between incomplete contracts and signaling).

costs.<sup>3</sup> While the authors in this Symposium draw on this traditional economic analysis of contracts, they explore new insights from economics and “economic contract theory”<sup>4</sup> that complicate the analysis of incompleteness in contracts. Relying on economists’ theories of incomplete contracts, the Symposium authors identify uncertainty and the cost of and limited access to information as key problems affecting parties both *ex ante* when contracts are being drafted and *ex post* when they are being enforced.<sup>5</sup> Uncertainty is a factor that makes it difficult to negotiate contracts that can simultaneously protect specific investments and also promote efficiency *ex post*.<sup>6</sup>

The Symposium authors sort out what economists and lawyers mean when they reference an “incomplete contract” and identify two key assumptions of the new economic literature. These two assumptions are (1) courts are imperfect and may be unable to verify certain facts and (2) parties can renegotiate the terms of their contracts.<sup>7</sup> Using these insights, the three authors address the implications of the verifiability problem and possibility of renegotiating contractual terms for (1) parties designing complete and contingent efficient contracts, (2) scholars designing theoretical solutions to the verifiability

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<sup>3</sup> See David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1816 (1991) (discussing complex and “unresolved” issues involved in the method and applications of the hypothetical bargain standard); Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL’Y 639, 644 (1989) (discussing hypothetical consent as basis of bargain).

<sup>4</sup> Scott & Triantis, *supra* note 1, at 187 (“[E]conomic contract theory should incorporate a more textured understanding of the process for judicial enforcement of contracts.”); see also Craswell, *supra* note 1, at 151 (“While that literature has had a good deal to say about some decisions that contracting parties must make[,] . . . it has had little or nothing to say about other decisions, including decisions about precautions that might reduce the likelihood of an accidental breach.”); Katz, *supra* note 1, at 171 (“[I]n the language of law-and-economics, scholars should pay greater attention to considerations of private transactional efficiency as opposed to larger issues of social efficiency.”).

<sup>5</sup> Scott & Triantis, *supra* note 1, at 191 (“In contract theory, incompleteness is due to the fact that information is costly and sometimes unavailable to (a) the parties at the time of contracting or (b) the parties or the enforcing court at the time of enforcement.”); see also Craswell, *supra* note 1, at 155 (focusing on the problem of setting rules with the “limitations [that] (a) courts are imperfect decision-makers and (b) parties can always renegotiate their contracts”); Katz, *supra* note 1, at 171 (stressing that “the parties have more information than the courts”).

<sup>6</sup> The authors discuss the conflict between enforcing contracts to promote the security needed to foster investment and the conflicting need to promote efficiency *ex post*. Katz, *supra* note 1, at 171-72; Scott & Triantis, *supra* note 1, at 189. Protection of the investment might call for enforcement even when circumstances have changed so that enforcement would no longer be efficient.

<sup>7</sup> Craswell, *supra* note 1, at 152, 155 (distinguishing the “newer ‘incomplete contracts’ literature” from the traditional law-and-economics analysis of contracts); Katz, *supra* note 1 at 173-74 (discussing the theory of “strategic renegotiation design” and the problem of “unverifiable information, or unverifiability”); Scott & Triantis, *supra* note 1, at 188, 192 (stating that “[a]n important concern of contract theory is the renegotiation of agreements”).

problem,<sup>8</sup> (3) courts searching for rules that will best promote optimal investment beforehand and ex post efficiency once the future has resolved the prior uncertainty, and (4) contracts scholars attempting to decide what issues should be further explored.<sup>9</sup>

Professors Scott and Triantis illuminate what they view as an unrealistic view of verifiability.<sup>10</sup> That view assumes that matters are either verifiable or not in a static way and that when matters affecting contract enforcement can be classified as nonverifiable, enforcement costs will necessarily be high.<sup>11</sup> Scott and Triantis reject this “stylized” view of verifiability as unrealistic.<sup>12</sup> Rather than accepting unverifiability as an unalterable and insuperable obstacle for parties and courts, they argue that verifiability is a dynamic and nuanced concept. Scott and Triantis view the process as a dynamic one in which parties themselves can affect costs either by investing in litigation strategies in ways that reduce enforcement costs or by trading off between enforcement (what Scott and Triantis call “back-end costs”) and drafting costs (what Scott and Triantis call “front-end costs”).<sup>13</sup>

Professor Avery Katz also identifies verifiability as a key issue in the literature of incomplete contracts,<sup>14</sup> but he urges a reorientation in contracts scholarship.<sup>15</sup> He urges a “different perspective” that offers advice not only to legal decision-makers but to parties and their lawyers.<sup>16</sup> Katz offers party-based “transactional strategies for managing contractual incompleteness”<sup>17</sup> problems in ways that will “increase transactional value.”<sup>18</sup>

<sup>8</sup> Scott & Triantis, *supra* note 1, at 191 (classifying these scholarly solutions as part of the mechanism design literature).

<sup>9</sup> Craswell, *supra* note 1, at 167 (outlining the search for contracting parties as one avenue for incomplete contracting literature to pursue); Scott & Triantis, *supra* note 1, at 198-200 (urging scholars to investigate different choices that parties might make in the process of litigation (whether to arbitrate or settle) and how the anticipation of such choices might affect earlier choices that parties make both in crafting their initial contracts and in acting efficiently during performance of the contract).

<sup>10</sup> Scott & Triantis, *supra* note 1, at 195-96.

<sup>11</sup> *Id.* In addition to high costs, there may be problems of judicial errors.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 196. For example, one can reduce the ex ante drafting costs by leaving certain matters for courts to decide later on, adding to back-end enforcement costs. *Id.* at 196-97. The overall costs may be lower under such a strategy since at the actual time of enforcement, “information may yet be superior to (less costly than) that of the parties *at the time they contract.*” *Id.* at 197.

<sup>14</sup> Katz, *supra* note 1, at 174-75.

<sup>15</sup> *Id.* at 171.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 176. Professor Katz offers several reasons for this reorientation, both “pedagogical” and “substantive.” *Id.* at 171. Students will be better at negotiating agreements if they are trained in how efficiency might affect the parties’ choice of strategies given the fact of contractual incompleteness. In addition, devising strategies for parties will avoid the problems that courts and public lawmakers will inevitably lack information that is more readily available to

Professor Craswell helps us understand what the economics of incomplete contracts scholarship is and is not about. As Craswell explains, the issue is not about whether a particular contract is or is not complete in the sense that it contains a gap.<sup>19</sup> Rather, what matters in designing optimally complete contracts and deciding on legal strategies to deal with complete and incomplete contracts are the assumptions that certain matters may be unverifiable to a third party and that parties can renegotiate contracts.<sup>20</sup> He uses those assumptions to offer new insights into legal issues that previously had been addressed by the older law-and-economics literature, including how to provide incentives for parties to invest efficiently *ex ante* and make efficient decisions about breach *ex post*.<sup>21</sup> Craswell also explores a topic that previously had been addressed by the older literature, but which has not yet been addressed by the “incomplete contracts” literature: whether the law can encourage parties to take efficient precautions that will actually avoid the necessity of breach.<sup>22</sup>

All three authors are concerned with how to improve welfare for the parties<sup>23</sup> given the dual assumptions concerning verifiability<sup>24</sup> and renegotiation. Thus, efficiency and incentives remain central to the authors’ scholarship on incomplete contracting. However, the papers take different approaches to the issue of achieving optimal outcomes. Craswell accepts the problem of verifiability as a real problem and examines how to design legal rules that will best achieve particular types of efficiencies.<sup>25</sup> In contrast, Katz focuses on guiding parties to design contracts that can overcome or mitigate incompleteness.<sup>26</sup>

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the parties. *Id.* In fact, maximizing value will require access to much “local” information that “is much more likely to be accessible to them [the contracting parties] in the context of planning than to a court in the context of adjudicating a dispute . . .” *Id.* at 172.

<sup>18</sup> *Id.* at 185.

<sup>19</sup> Craswell, *supra* note 1, at 153.

<sup>20</sup> *Id.* at 152-53.

<sup>21</sup> *Id.* at 157-61.

<sup>22</sup> *Id.* at 151, 163-67.

<sup>23</sup> For example, Scott and Triantis seem to share the assumption of the economic literature “that the private goal of contracting parties is to maximize the shared value created by a contract (the ‘surplus’).” Scott & Triantis, *supra* note 1, at 188.

<sup>24</sup> In the case of Scott and Triantis, the concept of verifiability is one that assumes that parties will weigh these costs when they actually design contracts to take account of such costs. *Id.* at 197-98. Rather than automatically assuming that unverifiable matters will not be included in a contract *ex ante* because the enforcement costs will be so high, Scott and Triantis argue that the process of trading off costs is a more complex one than originally perceived. In a state of the world that remains uncertain at the time of contracting, parties can either try to reduce that uncertainty by investigating matters up front and incurring drafting costs to take into account future contingencies, or alternatively, they can decide to leave a matter unresolved until litigation, with its expected costs, forces a resolution. Even litigation costs however, are not fixed since they can be affected by the parties’ litigation strategies. *Id.*

<sup>25</sup> Craswell, *supra* note 1, at 153-54.

<sup>26</sup> Katz, *supra* note 1, at 177-85.

Scott and Triantis are also concerned with how to design optimal contracts, but they suggest that to arrive at an answer to that question, economic contract theory must account not only for the possibilities of performance, breach, and renegotiation, but also for litigation or enforcement costs.<sup>27</sup> They stress that scholars who take account of enforcement costs should also conduct a “backward induction” process.<sup>28</sup> In particular, the process would follow a similar pattern to that employed in looking backward at the effects of ex post renegotiation on a variety of matters, including the effects on ex ante efficient investment and ex post efficient breach, to determine the effect of ex post litigation costs would have on contract design.<sup>29</sup> In addition, Scott and Triantis explore strategies that parties use in litigation and contract design to demonstrate how the transactors can mitigate verifiability problems themselves.<sup>30</sup>

The idea that contracts are inevitably incomplete is not new to economists or lawyers.<sup>31</sup> What is new is the insight that all contracts are incomplete and that lawyers and economists might approach the idea in different ways.<sup>32</sup> Lawyers emphasize that a contract is incomplete when it contains a gap.<sup>33</sup> Absent a gap, the contract would be considered “obligationally complete.”<sup>34</sup> Economists, however, use a different approach to determine if a contract is incomplete. They argue that even if a contract contains complete terms, “[a] contract is incomplete if it fails to provide for the *efficient* set of obligations in

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<sup>27</sup> Scott & Triantis, *supra* note 1, at 201.

<sup>28</sup> *Id.* at 198.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 199-200.

<sup>31</sup> In a perfect world, contracts would be complete. Parties would be able to anticipate all future contingencies that might affect payoffs from the contract and provide for them. These contracts would be self-enforcing because no party would have any incentive to deviate from the terms. There would be no need for contract law at all and no role for courts. “A fully specified contract is also an equilibrium, that is, it is self-enforcing in the sense that no party has an incentive unilaterally to defect from its terms.” Coleman, *supra* note 3, at 640.

<sup>32</sup> Craswell, *supra* note 1, at 152-53.

<sup>33</sup> Scott & Triantis, *supra* note 1, at 190. Professor Craswell recognizes that the presence of gaps and “the distinction between complete and incomplete contracts might well be useful for other purposes—for example, in evaluating rules of contract interpretation—that do not concern” him in understanding the economic literature since that literature takes incompleteness as a given. Craswell, *supra* note 1, at 152.

<sup>34</sup> Scott & Triantis, *supra* note 1, at 190-91. However, whether or not a “gap” exists in most contracts will depend on the rules used by courts to interpret the agreement. The example used by Craswell to illustrate the role of judicial interpretation in determining incompleteness is a contract stating that a seller will “deliver 100 widgets on July 1.” If courts interpret this contract to mean that the widgets must be delivered in all states of the world, there is no gap. Craswell, *supra* note 1, at 154-55. Should the court interpret the contract as not specifying a result in the event of an extraordinary circumstance (the example used by Craswell is the closure of the Suez Canal), then the contract is said to contain a “gap.” *Id.*

each possible state of the world.”<sup>35</sup> A contract does not need to provide an outcome for every state that might materialize. If an optimal contract would differentiate for a particular contingency, then a contract that fails to do so would be incomplete. A judgment has to be made as to whether a contract that looks incomplete is in fact incomplete when measured against an optimal contract.<sup>36</sup>

Traditional approaches to incomplete contracts focused on finding out if and why a contract was incomplete or contained gaps.<sup>37</sup> Some scholars emphasized that incompleteness was often a result of the transaction costs of negotiating for complete contracts given the constraints on the parties’ ability to anticipate future states or information.<sup>38</sup> Others argued that incompleteness stemmed from strategic withholding of information and suggested tailored legal strategies tied to the cause of incompleteness.<sup>39</sup> The transaction cost theorists suggested that gaps should be filled to achieve the results that parties would have achieved absent transaction costs using either a hypothetical bargain approach<sup>40</sup> or one that would maximize joint gains for the parties absent such costs.<sup>41</sup> Theorists emphasizing strategic withholding suggested a penalty default rule approach to gap-filling in an attempt to force the disclosure of information ex ante.<sup>42</sup>

The newer economic literature redefines completeness in terms of whether a contract can provide an efficient outcome in all states of the world calling for a distinct outcome.<sup>43</sup> Under this economic definition, it is expected that virtually every contract will be incomplete.<sup>44</sup> Because this incompleteness is accepted as an integral part of contracting, the newer literature focuses on developing a set of rules that will provide optimal incentives for both parties either to perform or breach a contract and to rely efficiently.<sup>45</sup>

<sup>35</sup> Scott & Triantis, *supra* note 1, at 190.

<sup>36</sup> *Id.* at 190-91.

<sup>37</sup> Identification of the cause of the incompleteness was the first step in formulating judicial responses. Katz, *supra* note 1, at 172.

<sup>38</sup> See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 45-46 (1985) (discussing role of bounded rationality in contributing to incompleteness in contracts).

<sup>39</sup> Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 94 (1989).

<sup>40</sup> Frank H. Easterbrook & Daniel R. Fischel, *Close Corporation and Agency Costs*, 38 *STAN. L. REV.* 271, 298 (1986) (discussing how a hypothetical bargain approach should be used to determine what corporate law should govern close corporations).

<sup>41</sup> Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 *J. LEGAL STUD.* 597, 602-06 (1990) (discussing the positive effects of utilizing a strategy that maximizes joint gains for the parties).

<sup>42</sup> Ayres & Gertner, *supra* note 39, at 94.

<sup>43</sup> Scott & Triantis, *supra* note 1, at 190-91.

<sup>44</sup> Craswell, *supra* note 1, at 153-55.

<sup>45</sup> *Id.* at 153-54.

The newer literature attempts to develop these rules while recognizing that certain factors make designing such rules very difficult.<sup>46</sup> One is the assumption that courts have limited competence and may be “unable to evaluate key factual claims.”<sup>47</sup> The verifiability concept explains why economic theorists think that parties will agree to incomplete contracts even if the parties have complete information.<sup>48</sup> It has also provided a rationale for these theorists to advocate limits on judicial relief under such circumstances.<sup>49</sup>

Scott and Triantis demonstrate that verifiability has a more complex meaning distinct from an all or nothing “binary” concept<sup>50</sup> and is a component that affects litigation costs. These authors convey the idea that parties can interactively invest in litigation strategies in ways affecting the cost of litigation.<sup>51</sup> Therefore, it may be premature to assume that when matters are “nonverifiable,” they will always be so, and that the litigation costs associated with such unverifiable matters will necessarily “outweigh[] the incentive benefits to the parties”<sup>52</sup> from having such terms.<sup>53</sup>

The second assumption of the economic literature on incomplete contracts is the recognition that parties can renegotiate contracts *ex post*. The Symposium authors use insights and assumptions from economics to explore different facets of the design and enforcement of complete and incomplete contracts.

Using insights from the economic literature, Professor Craswell explores how the law can provide efficient incentives to the parties<sup>54</sup> in the different stages of a contract. He explains just how easy it would be to advise legal decision-makers on how to “design a legal regime that optimized every incentive”<sup>55</sup> if courts could perfectly ascertain when actions were efficient. The recognition that courts are imperfect and may be unable to discern or verify certain matters (in-

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<sup>46</sup> *Id.* at 155-58; see also Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992) (tying judicial restraint in supplying terms in incomplete, relational contracts to perceived limits on courts’ abilities); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003) (arguing for new, but fewer, state-supplied default rules when asymmetric information causes incompleteness).

<sup>47</sup> Craswell, *supra* note 1, at 152.

<sup>48</sup> Scott & Triantis, *supra* note 1, at 195.

<sup>49</sup> Schwartz & Scott, *supra* note 46, at 606-08.

<sup>50</sup> Scott & Triantis, *supra* note 1, at 196.

<sup>51</sup> *Id.* at 198-99.

<sup>52</sup> *Id.* at 195.

<sup>53</sup> *Id.* One such assumption is that parties will design contracts to avoid drafting terms that require courts to deal with matters that are unverifiable. *Id.*

<sup>54</sup> Craswell, *supra* note 1, at 157.

<sup>55</sup> *Id.* at 156.



cluding the efficiency of behaviors<sup>56</sup>) helps to rationalize traditional rules on efficient breach. This recognition also explains the tendency of courts to adopt legal tests that do not rely on a court's direct assessment of the efficiency of certain actions (such as the efficiency of a breach), but that will still provide correct incentives to the parties without putting too many measurement burdens on a court.<sup>57</sup>

Craswell then explores the implications of the second assumption of this newer economic literature—the possibility that contracts can be renegotiated—to explore how that factor might complicate the effort to design legal rules encouraging various efficiencies, including efficient breach and efficient reliance.<sup>58</sup> He concludes that the legal rule may not matter all that much once renegotiation as a possibility is recognized when it comes to encouraging efficient breach.<sup>59</sup> However, Craswell explains why designing optimal incentives to rely may be difficult when the renegotiation possibility exists.<sup>60</sup>

Craswell's paper highlights the implications of renegotiation to investigate an incentive that has not been thoroughly explored: the incentive of a party with a performance obligation to take efficient pre-

<sup>56</sup> A classic example focuses on the efficiency of reliance investments made by a party.

<sup>57</sup> Craswell, *supra* note 1, at 156-57. Thus, the courts adopt a damage measure that forces a breaching party to internalize the costs of its breach. As Craswell notes, this damage rule is efficient in the same way that strict liability rules in torts can be efficient: parties can estimate for themselves when it is efficient to breach. Because the breacher will take into account the damage that a court would assess and compare that amount to the benefits from breaching, the party can be trusted to make efficient decisions without requiring the courts to verify whether these decisions are efficient using a cost/benefit analysis. *Id.* at 157.

<sup>58</sup> Craswell, *supra* note 1, at 158-60.

<sup>59</sup> *Id.* at 159-60. Craswell assumes that an efficient outcome will be attainable. For example, if the damage rule imposes a steep penalty for breaching and a party finds itself in a position where it is no longer efficient to perform, the party can simply renegotiate and "buy" its way out of the contract for an amount greater than that party's cost of performance but less than the value the other party expected to receive from the contract. *Id.* at 159.

<sup>60</sup> *Id.* at 161-62. If parties are able to renegotiate, a buyer has little incentive to rely efficiently on the seller's performance. No matter the amount of resources the buyer expends in reliance on the contract, if renegotiation is possible, the buyer can shift part of the burden of this reliance to the seller by demanding a higher "buyout price" in the event of the seller's breach, while at the same time capturing all of the benefits of reliance in the event the seller performs. Thus, some of the risk is shifted to the seller, and all of the benefits redound to the buyer, leaving the buyer with little incentive to restrain itself. Absent the ability to renegotiate the contract, the buyer would have an incentive to rely efficiently. *Id.* at 162-63. If the damage measure remained insensitive to increases in the buyer's reliance, the buyer would be bearing both the costs and benefits from any "additional reliance expenditures," leading to optimal decisions. *Id.* at 161.

Of course, this problem of over reliance would only be true under some measures of damages. If, as Craswell assumes, "the remedy for breach is such that the seller has to renegotiate and pay so that he will not have to perform, the buyer will be led to rely too much." STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 365 (2004). Of course, if the remedy for breach were zero, the buyer would rely too little. "[W]hen the buyer has to renegotiate and bargain for performance, some of the value of reliance to him is extracted in the process, and anticipating this, he will tend to rely too little." *Id.* In that situation, the possibility that contracts can be renegotiated would have the opposite effect of inducing too little reliance.

cautions that “reduce[] the probability of an event that would make it harder to perform under a contract” from occurring.<sup>61</sup> This incentive has been neglected because scholars have focused on events that made breaching more likely to occur, but were beyond the parties’ control. As a result, the older economic models focused on the decisions parties would make after such an event occurred, ignoring the idea of efficient precautions.

Craswell recognizes there are events that promisors control that may be able to reduce the likelihood of a breach.<sup>62</sup> However, the possibility of renegotiation may dilute a seller’s incentive to take efficient precautions, especially when the precautionary steps are of a particular type involving “cooperative” investments whose benefit redounds largely to the noninvesting party.<sup>63</sup> Although not offering a solution, Craswell uses the insights from the economics of incomplete contracting to open up a window onto the hitherto neglected problem of how to design legal rules that will optimize the precautions parties take.<sup>64</sup>

Scott and Triantis also recognize that the perceived problems of verifiability “have driven a large body of the theorists’ models.”<sup>65</sup> These authors document the accepted theory that parties will be constrained in how they can contract because they will not want their contracts to be conditioned on states that are not verifiable to third parties.<sup>66</sup> That theory also postulates that those constraints on contracting will have negative efficiency effects both *ex post* and *ex ante*.<sup>67</sup> Verifiability concerns have also led contract theorists to suggest that courts should take a limited role in intervening in incomplete contracts and to argue that literalist interpretation is the preferred strategy for courts.<sup>68</sup>

Without directly challenging the implications that non-verifiability, in unmitigated form, would pose for both contracting and efficient incentives for parties, Scott and Triantis set out to chal-

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<sup>61</sup> Craswell, *supra* note 1, at 163. This decision on what precautions to take to avoid having to breach is also explored in another article by the same author. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988).

<sup>62</sup> Craswell, *supra* note 1, at 163 (discussing precaution taking in the context of *Jacob & Youngs v. Kent*, 129 N.E. 889 (N.Y. 1921)).

<sup>63</sup> *Id.* at 166-67 (discussing an example in which investments that the seller could make to improve quality actually benefit the buyer, not the seller, and exploring distinction between cooperative and self-investments).

<sup>64</sup> *Id.* He also explores possible structural solutions to the efficient reliance problem that take account of renegotiation. *Id.* at 160-62.

<sup>65</sup> Scott & Triantis, *supra* note 1, at 191.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 189-90.

<sup>68</sup> *E.g.*, Schwartz & Scott, *supra* note 46.

lunge the conventional wisdom on verifiability in a number of ways and argue for “a more textured understanding of the process for judicial enforcement of contracts.”<sup>69</sup> Initially, they create this understanding by assessing the “strengths and weaknesses” of recent economic contract theory and then illuminating these insights for legal scholars.<sup>70</sup> They introduce a new element of the adversarial process as a topic worthy of further research. Contracting parties must account for it when they design their contracts and when they assess strategic choices in litigation.

Next, Scott and Triantis identify the key problem for contract: when contracts are negotiated under conditions of uncertainty, conditions may change that later make it unprofitable for a party to go forward with its contract obligations.<sup>71</sup> There are two conflicting goals that contract law would like to achieve. First, it would like to provide enough security through enforcement to encourage parties to invest ex ante in efficient ways. Second, contract law also wishes to promote ex post efficiency by allowing parties to abandon unprofitable exchanges. If you afford parties the discretion to abandon exchanges, the parties may fail to invest ex ante in these contracts.<sup>72</sup>

Scott and Triantis posit that the traditional solution, which could achieve both types of efficiencies, was for the parties to negotiate a completely contingent contract.<sup>73</sup> They then posit that both transaction costs and verifiability problems will prevent these contracts from being negotiated. They argue that the possible solutions to the verifiability problems suggested by mechanism design theorists<sup>74</sup> are not likely to provide a solution because the solutions themselves are “unrealistic”<sup>75</sup> and the solutions are not general enough to deal with a wide range of “information problems.”<sup>76</sup>

Scott and Triantis identify the contribution of recent economic contract theory in arguing that scholars had to look beyond the decisions as to performance and breach<sup>77</sup> and examine renegotiation. Renegotiation could affect whether parties would invest efficiently ex ante since parties subject to having part of their specific investments shared with the other party would be reluctant to invest ex ante. At

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<sup>69</sup> Scott & Triantis, *supra* note 1, at 187.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 189.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 191 (discussing Eric Maskin’s solutions to the problem).

<sup>75</sup> *Id.* at 192.

<sup>76</sup> *Id.* (explaining that “[o]ption contracts and other similar implementation mechanisms . . . are parameter-specific”).

<sup>77</sup> *Id.* at 194-95.

the same time, renegotiation posed a problem for the solutions to the verifiability problem that had been suggested by mechanism design theorists.<sup>78</sup>

Scott and Triantis trace how economic theory has analyzed renegotiation and its likely effect both on incentives and contract design. They suggest that a similar framework of “backward induction” should be applied to litigation, another arena in which parties are likely to act in a strategic manner.<sup>79</sup> Applying their framework, Scott and Triantis assess how the litigation strategy game will affect the parties’ design of optimal contracts.<sup>80</sup>

Prior to Scott and Triantis, contract theorists had thought parties were limited to two fairly negative choices (a Hobbesian dilemma): either they could leave gaps in their contract (leading to inefficiencies) or they could complete their contracts, but with terms a court could not verify (subjecting them to another risk of court error). Neither option was palatable, nor were the devices proposed by mechanism design theorists a good way around the problem of unverifiable information.

These authors argue that this picture of verifiability is distorted for several reasons, weakening contract theory in two distinct ways. The distorted view is that matters are really either verifiable or nonverifiable. We know that in cases where the information is nonverifiable, it will not make sense to include such terms. Consequently, scholars have argued that there is a whole “category of contract terms [that] assum[es] a priori” that the beneficial effects such terms might have on incentives will not be worth the costs.<sup>81</sup>

Scott and Triantis challenge this view by pointing to the reality of parties’ actual contractual practices. If conventional theory were correct, then parties would not include nonverifiable terms, but as Scott and Triantis note, the parties do so anyway.<sup>82</sup> The authors explain that the strange “gap between theory and practice”<sup>83</sup> derives from the failure of economic contract theory to recognize either that front-end and back-end costs should both be considered in assessing the cost of en-

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<sup>78</sup> *Id.* at 193. Parties who negotiated an option contract as a means of getting the parties to reveal information would find one party simply abandoning the option and renegotiating in a way that will “unravel mechanisms designed to elicit information ex post.” *Id.*

<sup>79</sup> *Id.* at 194.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* at 195.

<sup>82</sup> *Id.* at 196. (pointing to the presence of best efforts clauses in commercial contracts to demonstrate that parties do use nonverifiable contract terms).

<sup>83</sup> *Id.*

forcement or that litigation costs can be affected by what the parties themselves do in crafting litigation strategies.<sup>84</sup>

These defects in theory lead the economic contract authors astray. The failure to recognize that parties may decide to contract for terms that are unverifiable and save front-end transacting costs (even if they cause back-end enforcement costs), shows that scholars may have myopically focused on the back-end costs. In doing so, these scholars have neglected the principle that front- and back-end costs must both be weighed in deciding whether aggregate costs (including the possible reduction in transaction costs from postponing decisions that may depend on unverifiable information<sup>85</sup>) justify the beneficial effects on incentives.<sup>86</sup>

Beyond presenting a more nuanced picture of verifiability and a cost/benefit framework that includes both transaction and enforcement costs, Scott and Triantis significantly contribute to the literature by suggesting that parties themselves control litigation costs through their litigation strategies in dealing with the verifiability problem.<sup>87</sup> If courts make errors because they cannot verify events, then parties' incentives for efficiency may be affected because of the uncertainty that the court will reach the correct result.<sup>88</sup> However, Scott and Triantis seek to demonstrate that verifiability concerns with litigation may be mitigated. Even if one accepts that verifiability might pose a problem if all disputes reached a court, parties themselves can take actions that lower those costs. They can settle cases and minimize or eliminate verification costs.<sup>89</sup>

Similarly, renegotiation of contracts would avoid the need for verification. Once the parties had the relevant information, they could simply reach new terms and a court would not be involved. Scott and Triantis link the ways in which other litigation strategies, including "the interacting strategies of the parties to initiate, defend, and present evidence at trial," can contribute to lower litigation costs.<sup>90</sup>

Finally, Scott and Triantis also help persuade the reader that enforcement costs associated with nonverifiable factors may be more

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<sup>84</sup> *Id.* at 198. It is for this reason that Scott and Triantis refer to litigation costs as "endogenous" rather than exogenous.

<sup>85</sup> *Id.* at 197.

<sup>86</sup> *Id.* at 196 (explaining that the goal is of course to "align [the parties'] incentives closer to the efficient optimum"). Scott and Triantis further explain that the "objective of contracting parties is to maximize the incentive bang for their contracting-cost buck." *Id.*

<sup>87</sup> *Id.* at 198-99.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 201. Parties will exercise "discretion to decide how much to invest in the production of evidence in court. Their investments may well depart from the level that is efficient from the parties' ex ante perspective." *Id.* at 199.

<sup>90</sup> *Id.* at 199.

“relative,” and thus present less of a risk once one recognizes that litigation is not about a “finding of an objective truth” with absolute “certainty.”<sup>91</sup> While courts will make some mistakes, the mistakes will be subject to some “risk of error”<sup>92</sup> even though this “risk” is not 100 percent merely because one calls a matter “nonverifiable.” This more subtle calculation of risk and associated costs may affect how parties design contracts. By adding litigation strategy to the mix of a promisor’s options, Scott and Triantis let us see that the risks of non-verifiability are not as absolute as was once thought and that parties have many options for overcoming verifiability.

The third Symposium author, Avery Katz, shares the view of the other authors that “maximizing contractual value” and “transactional efficiency” should be the central concern in determining how courts and parties should deal with the incompleteness problem in contracts.<sup>93</sup> Like Craswell and Scott and Triantis, Professor Katz stresses that the problem of determining what to do about incompleteness in contracts is a complex problem.<sup>94</sup> Determining whether a judicial response is warranted first requires an understanding of reasons why the contract remains incomplete.

Professor Katz explores both of the problems causing incompleteness in the “ex ante negotiation” of contracts: bounded rationality and strategic nondisclosure.<sup>95</sup> He also highlights “additional and novel explanations”<sup>96</sup> that explain why parties leave contracts incomplete. These explanations emphasize that incompleteness may occur because parties anticipate that the initial contract can be supplemented in subsequent rounds of negotiation. Alternatively, parties may leave a contract incomplete because informational asymmetries between courts and parties will hinder competent judicial decisions interpreting contractual meaning “at a reasonable cost.”<sup>97</sup> The ex post enforcement costs of the verifiability problem make it futile to invest efforts in achieving a complete contract since the courts will not be able to ascertain what the parties agreed to.<sup>98</sup>

Katz argues that all of these explanations for incompleteness mean that the decisions on legal intervention must first confront these

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<sup>91</sup> *Id.* at 198.

<sup>92</sup> *Id.*

<sup>93</sup> Katz, *supra* note 1, at 171.

<sup>94</sup> *Id.* The complexity may require “drawing a proper balance among various decisional margins, and trading off reduced efficiency along one margin in order to achieve enhanced efficiency along another.” *Id.*

<sup>95</sup> *Id.* at 173.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at 174.

<sup>98</sup> *Id.* (“[T]he promise in question [in such cases] is effectively unenforceable and . . . not worthwhile to the parties to spell out.”).

causes affecting both how parties negotiate contracts *ex ante* and how or if courts should respond.<sup>99</sup> The complexities in why contracts remain incomplete mean that it is not possible to identify one legal intervention that will enhance efficiency in “all contractual settings.”<sup>100</sup> In some instances, courts should be hesitant about intervening with terms if the parties have deliberately failed to cover a contingency deemed of low probability or left a gap in anticipation of the fact that later bargaining could resolve the matter.<sup>101</sup> In other instances, legal intervention may be beneficial in curbing opportunistic behavior by agents.<sup>102</sup> “[T]he nature of the substantive issue,” is a second factor that should determine whether collective legal intervention is warranted or not.<sup>103</sup>

After addressing the complexity of normative decisions about legal responses to incompleteness in contracts, Katz urges the legal academy to reorient its inquiry away from a comparative institutional assessment limited to hypothetical decision-makers, such as courts and legislatures.<sup>104</sup> Katz stresses that increased intellectual effort should be devoted to the parties themselves who must make difficult decisions about what kind of interpretative regime should apply to their transaction.<sup>105</sup>

Katz suggests several private strategies that the parties themselves can use when they negotiate and draft contracts to “manage” the incompleteness problem in contracts.<sup>106</sup> Some involve investing additional resources to make the *ex post* contractual gap filling less costly.<sup>107</sup> Others involve delegating authority to one party who can make decisions after the contracting date when uncertainties that led to the initial incompleteness have been resolved by the passage of time.<sup>108</sup>

<sup>99</sup> *Id.* at 175 (indicating “the appropriate response to incomplete contracts depends on which of these determinants are at work”).

<sup>100</sup> *Id.*

<sup>101</sup> *See id.* at 173 (describing “*strategic renegotiation design*”). In fact, leaving gaps in such cases may be considered a rational strategy. *Id.*

<sup>102</sup> *See id.* at 176 (explaining that *ex post* gap filling by the courts might be beneficial “if contracts are left open because of shirking by subordinate agents”).

<sup>103</sup> *Id.* If the nature of the substantive problem is a recurring one, Katz suggests that “it may be worth bearing the costs of litigation in the public courts. It may even be worth state subsidy if that is the only way to take advantage of the scale economies.” *Id.*

<sup>104</sup> *Id.* at 185. The hypothetical bargaining approach to incomplete contracts suffers from this myopic focus on public decision-makers. This myopia ignores the fact that many disputes never end up in court and so the need for a decision over the appropriate legal intervention never arises. *Id.* at 170.

<sup>105</sup> *See id.* at 171 (urging scholars to “pay greater attention to considerations of private transactional efficiency as opposed to larger issues of social efficiency”).

<sup>106</sup> *Id.* at 176.

<sup>107</sup> *Id.* at 177.

<sup>108</sup> *Id.* at 180-81. Katz recognizes that *ex post* gap filling delegation by one party presents a

Other devices are entered into *ex ante* but actually operate to discourage *ex post* filling in of contracts by nonparty actors (parol evidence, liquidated damages clauses, etc.).<sup>109</sup> These devices are a signal to the courts of the parties' preference for literalist and formalistic interpretation rather than a contextualized approach to contract interpretation and gap filling.<sup>110</sup> The assumption is that such devices will lower the costs associated with filling gaps since formalistic regimes will arguably be less costly.<sup>111</sup> The final strategy for dealing with incompleteness is premised on institutional arrangements that promote cooperation between the parties and allow them to complete the contracts *ex post*, obviating the need for judicial intervention.<sup>112</sup>

Katz concludes by arguing that the relative usefulness of private strategies for dealing with contractual incompleteness depends on a myriad of local factors that can be more easily accessed by private decision-makers than public tribunals.<sup>113</sup> Ultimately, Katz argues that the private decision-makers should be the primary focus of legal scholarship in contracts.

#### SUMMARY

All four authors in the three Symposium papers have chosen to explore the challenges that incomplete contracts pose for courts, scholars, and contracting parties. They have educated the reader about just what we mean when we say that a contract is "incomplete." They have situated incomplete contracts within the economics literature and alerted us to just how complicated it is to design contracts and provide efficient incentives after accounting for the verifiability problem and renegotiation possibility. They have undermined the idea that verifiability is an unalterable and fixed problem and shown how parties themselves may mitigate verifiability problems by designing and managing litigation in certain ways. They have also reinvigorated the economic analysis of contract law by using the assumptions of the newer economic literature to revisit how contract rules can be designed to provide efficient incentives for parties both *ex ante* and *ex post*.

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potential for opportunism. *Id.* at 182.

<sup>109</sup> *Id.* at 178-79.

<sup>110</sup> *See id.* The same preference can be achieved by designating particular forums for the dispute.

<sup>111</sup> *See id.* (describing methods to reduce the scope of the court's inquiry by supplying formal standards of interpretation).

<sup>112</sup> *See id.* at 183-85 (describing institutional arrangements that impede or facilitate exit from a relationship).

<sup>113</sup> *Id.* at 184-85.