

19. The Enforcement of Contracts and Private Ordering

VICTOR P. GOLDBERG

The primary purpose of contract law is, most would concede, to facilitate private ordering. The parties are the best judges of their interests and the law should, as much as possible, stay out of the way. There are exceptions—there might turn out to be good reasons to discourage, or prohibit, certain classes of promises (for example, disclaimers or promises to commit illegal acts) or to be suspicious of the manner in which agreements have been reached (for example, the battle of the forms or duress). Still, the facilitation of voluntary exchange remains the primary goal of contract law. Voluntary exchange is not a zero-sum game; it allows parties to achieve gains from trade. The parties enter into their agreement because they each expect to be better off. They might, of course, turn out to be wrong. It might have seemed a good idea at the time, but conditions might have changed so that one party now regretted having entered into the agreement. Or, one party might simply have misperceived the possible outcome. Had it known more (or been a more intelligent processor of available information), it would not have entered into the deal. Regardless, the basic presumption that there are gains from trade is the economic foundation for a facilitative law of contract.

Even if all agree on the economic virtues of private ordering, it does not follow that economic analysis would be of use in designing, evaluating, or operating the system of contract law. In a recent paper Eric Posner [2003] asked whether, after three decades, the economic analysis of contract law had been a success or failure. His answer, somewhat qualified, was the latter. About the best that he could say is that it seems to have failed less than other approaches. He is probably right in claiming that economic scholarship has had little impact on American courts (and presumably on courts throughout the world as well). Economic concepts like efficiency or the Coase Theorem virtually never make their way into contract opinions. Indeed, it could be argued that since the birth of the economic analysis of contract law, the doctrinal evolution has been away from economics.

Posner's assessment, however well it characterizes the present situation, is too pessimistic. Lawyers are transactional engineers, designing structures to cope with problems such as information asymmetry, moral hazard, costly enforcement and the like. I perceive a significant disjunction between the intellectual frameworks of the transactional lawyers structuring deals and the litigators and

judges interpreting those transactional structures after problems had arisen. The theoretical framework of the transaction-cost engineer, I will argue, is appropriate for analyzing contract disputes and for developing contract doctrine—at least for business to business transactions. The central questions of a transactionally sensitive contract law are: Why might reasonable, profit-seeking actors structure their relationship in a particular way? How does the answer to that question affect the interpretation of a contract or suggest the appropriate contract law rule?

Application of this approach has led me to be much more optimistic than Posner. It works. Rather than present a superficial overview, I will illustrate by concentrating on a few examples. First, I want to consider a basic puzzle of contract law: why enforce a contract even when there has been no reliance? The answer to that question, developed in Part II, suggests how, ideally, the contract should be enforced. The breacher should pay the market-contract price differential. In practice, that might be too difficult to administer, but it should remain the guiding principal. I illustrate how the rule might be applied by discussing a few American cases in which ascertaining the contract-market differential becomes progressively more difficult.

The argument for this damage rule is derived from the economics of imperfect information. The other two illustrations also revolve around imperfect information. First, there is a standard “lemons” problem when a deal involves sale of an asset of uncertain value. How can the seller convince the buyer that he is not buying a lemon? I illustrate this by analyzing *Bloor v. Falstaff*, discussed in Part III. This case is the standard casebook illustration of the judicial interpretation of a “best efforts” clause. Remarkably, despite the fact that the essence of the transaction was a sale of most of a corporation’s assets, the court (and the litigators) ignored the fact entirely. Instead, they attempted to interpret the “best efforts” clause without any analytical framework and, not surprisingly, botched it. Once the problem is properly framed, the role of the “best efforts” clause is clear: it was ancillary to that sale and was meant to cope with the lemons problem. So framed, the outcome should have been straightforward. The court asked the wrong question and gave the wrong answer. The only problem with *Bloor* as an illustration of the power of the analysis is that the case doesn’t generalize. It is a one-shot clean kill.

The other theme concerns the sequential nature of decision-making and the allocation of discretion. The particular focus is long-term contracts with variable quantity (requirements or full output contracts) giving one party the discretion to determine the quantity. Parties enter into such arrangements in order to facilitate adaptation to changing circumstances, particularly adapting to new information as it comes in. The contracts typically provide rather nuanced boundaries on the discretion to protect the reliance of the party without the discretion. The Uniform Commercial Code, provides a blunter instrument: “good faith” and courts will in some instances override the balancing chosen by the parties. In Part IV, I will analyze two cases, *Feld v. Levy*, the leading New York decision, and *Amerada Hess v. Orange & Rockland Utilities, Inc.*, in which the court used good faith to trump a perfectly sensible balancing by the parties.