CONTRACT AS ORGANISATION: AN ECONOMIC ANALYSIS OF THE JOINT CONTRACTS TRIBUNAL's STANDARD FORM OF BUILDING CONTRACT 1980

A thesis submitted to the University of Newcastle upon Tyne for the degree of Doctor of Philosophy in the Faculty of Law.

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Abstract

The objective of this thesis is to consider whether the institutionalist hypothesis that the choice of organisational form functions to limit the transaction costs of organising productive activities explains a major standard-form contract which is used in building production. I approach this task by demarcating three models of contract which represent different points along a "contracting continuum". Each of the three governance structures - classical contract, relational contracting and the firm - represents a distinct patterning of resource co-ordination and each generates its own configuration of transaction costs. Thus the contracting continuum provides a basis for comparing the cost-reducing strengths and weaknesses of governance structures that vary with respect to their characterisation of relations between economic actors, and of the form and substance of both planning and implementation of decisions.

The second part of the thesis focuses on the standard-form building contract and its location along the contracting continuum. This part of the thesis addresses the question of "transactional fit" between the building contract and the activity which it purports to regulate. The analysis proceeds by identifying sources of transaction costs in the context and in the practices of building production and examining the governance implications of the contractual responses to such costs.

In its conclusions the thesis attempts to evaluate the contribution of institutional analysis our understanding of legal conceptions of contract. By using an industry-wide standard-form contract as a focus, I hope to illustrate some of the strengths and also the limitations of this approach.

Building contracts have received little academic attention in the UK., and transaction cost analysis of governance structures is a young science which has been pursued with more enthusiasm by economists than by lawyers. As yet there has been little attempt to relate substantive aspects of the lawyer's understanding of contract to the "new institutional economics". It is hoped that this thesis will make a contribution to that exercise.

Table of Contents

VOLUME ONE

VOLUME TWO

PAGE NUMBERS CUT OFF

IN

ORIGINAL

Note: The analysis in this thesis is based on the original text of the standard form contract that was published in 1980.

VOLUME ONE

CONTRACT AS ORGANISATION: AN ECONOMIC ANALYSIS OF THE JOINT CONTRACTS TRIBUNAL's STANDARD FORM OF BUILDING CONTRACT 1980

VOLUME ONE

CHAPTERS I - V

Gail Antoinette Williams

1992

Table of Contents

VOLUME ONE

Chapter I Introduction and Literature Review

Even a brief glance at the organisation of economic activity in contemporary society reveals the centrality of contract to the processes by which capitalist societies produce and distribute wealth and power. Indeed in economies such as that of the UK, it is hard even to conceive of an economic practice, enterprise, or goal which does not at some point, in some respect, rely on the institution of contract. The pervasive character of contract and the range of purposes which it is made to serve testify to the flexibility and malleability of this legal instrument. But these same characteristics also raise questions about the analytical coherence - the tractability - of the very concept of contract. For if the social practice of contract can be all things to all men, women, and corporations how are we to talk with any specificity about its role, rationale, and purpose?

This thesis presents and develops a set of ideas which may be used to process much of our knowledge about the world of contracting. It addresses the role of the institution of contract in the organisation and management of economic activity, and the role which law plays in the making and the maintenance of that institution. At a general level, the thesis seeks to develop a framework by which to analyse the types of choices which economic actors must make whenever they engage in the practice of contracting. More specifically, I focus on the particular set of choices embedded in a major standard form contract which is used in the production of the built environment, the Joint Contracts Tribunal Standard Form of Building Contract (1980 edition). The relationship between the two levels of analysis lies in the proposition that formal characteristics and substantive provisions of contractual arrangements may be understood in terms of responses to the transaction costs of organising productive activities. I shall argue that this hypothesis explains important characteristics of the building contract, and that a focus on the transaction costs of organisation clarifies issues which may be obscured in analyses which are not sensitive to transaction costs. It will also be suggested that the "comparative institutional" theory of contract presented here has important normative implications for the adjudication of conflicts arising out of the building contract.

After a brief overview of the thesis, this chapter reviews the literature which informs the analysis to be developed in later chapters. The survey of literature has two main objectives. First, it seeks to locate comparative institutional analysis in its intellectual context of theorising about contracts, markets and economic organisation. It will be seen that contemporary theory reopens many of the questions about the relationship of contract to other social and economic institutions which were found on research agenda of economists and lawyers during the opening decades of the twentieth century.

Secondly, the review of literature serves to introduce some of the language and the conceptual structure of arguments which are developed in later chapters. "Comparative institutional analysis" of economic organisation resembles legal analysis in its reliance on a methodology of descriptive interpretation, but exponents view "contract" through a very different lens than that used by the conventional lawyer[1]. The language of the comparative institutionalist is more accessible to the neoclassical lawyer-economist. However, the lack of a sharp separation between positive and normative theory, the complexity and detail of the models, and the construction of "efficiency" as a relative concept, are quite alien to the neoclassical analyst. While a full account of the analytical tools and methods of comparative institutionalism is postponed to chapter two, this survey of literature addresses some of the similarities and differences between neoclassical and comparative institutional economic approaches to contract.

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[1] For helpful discussion of "descriptive" economic analysis of law, see Cento G. Veljanovski The New Law-and-Economics: A Research Review (Oxford: SSRC, Centre for Socio-Legal Studies, 1982); Veljanovski "The Role of Economics in the Common Law" (1985) 7 Research in Law and Economics 41; Paul Burrows & Cento G. Veljanovski, "Introduction" in The Economic Approach to Law Burrows & Veljanovski (eds.) (London: Butterworths, 1981).

A. Overview of the Thesis

The analysis developed in this thesis treats "contract", as an institution for managing resources, rather than a manifestation of "voluntary exchange". Comparative institutionalists recognise that some forms of contract are usefully conceptualised as a means of implementing "'voluntary' exchange", but insist that there are innumerable other contractual arrangements in which "exchange" is a trivial aspect of the practice under consideration[2]. These theorists are also ambivalent about the idea of using "voluntariness" as a measure of anything interesting in contractual relations[3]. On the one hand, it is argued that since all contracting practices are shaped by the legal, economic, social and political contexts in which they are located, transactions cannot usefully be analysed as if they expressed the "free" choices of pre-social individuals[4]. On

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[2] For example, transactional economic analyses of "the firm", view this form of contract as a mode of governance in which the element of exchange is subsumed within an explicitly directive relationship: see, for example, Oliver E. Williamson "The Vertical Integration of Production: Market Failure Considerations" (1971) 61 American Economic Review 112; Williamson Markets and Hierarchies:Analysis and Antitrust Implications (New York: Free Press, 1975), see, text, infra and also chapter V infra.

[3] Some theorists working in comparative institutional traditions do not explicitly address the question of voluntariness at all, although their analyses may contain implicit assumptions about economic actors "freedom" to choose within constraints, see, for example, Oliver E. Williamson, The Economic Institutions of Capitalism (New York: Free Press, 1985). Other theorists focus their analyses on the power relations inherent in all contractual processes predicated on private property rights. From this perspective, "voluntariness" is not an accurate description of the attributes of contract, nor is "freedom" or "liberty" a coherent goal of contractual practices, see, for example, Warren J. Samuels "Interrelations between Legal and Economic Processes" in Law and Economics: An Institutional Perspective Warren J. Samuels & Allan A. Schmid (eds.) (Boston: Martinus Nijhoff, 1981).

[4] Samuels ibid., see also Amartya Sen "Behaviour and the Concept of Preference" (1973) 40 Economica 241, George Akerlof "Loyalty Filters" (1983) 73 American Economic Review 54. For an overview of institutionalist and contemporary neoinstitutionalist theories of the social or cultural basis of human behaviour, see Hans E. Jensen "Theory of Human Nature" (1987) 21 Journal of Economic Issues 1029.

the other hand, to reject the unsituated self of classical liberal and neoclassical economic theory is not to abandon the idea that social actors, be they individuals, groups or societies, select between the courses of action which are open to them[5]. The comparative institutional theorist is interested in the way in which the institutional structure of a society shapes the contracting choices available to economic actors and the way in which actors' decisions shape their subsequent contractual behaviour.

Of particular concern to the analysis that we shall be using is the contractual expression of decisions about the organisation of economic activities. Comparative institutional theorists suggest that our thinking about contractual practices should be developed around the notion of "governance"[6]. This concept expresses two key ideas. First, contracts are to be thought of as frameworks for "regulating" relationships between persons by which resources are put to use. The purpose of this construction is to emphasise that "contracts" are not only packages of price, quality and quantity terms, but also institutional practices which govern the way in which price, quality and quantity terms are

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[5] Samuels describes this sense of agency as "volitional freedom" which he defines as "the opportunity or capacity to choose between alternatives". Volitional freedom is contrasted with "voluntary freedom" described as "the opportunity or capacity to determine the alternatives themselves between which one may choose" supra note 3 at 100.

[6] Oliver E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 Journal of Law and Economics 233.

"negotiated, [agreed], monitored adapted and enforced"[7]. In order to develop a fuller understanding of contract, therefore, it is necessary to devote at least as much attention to the processes for making decisions as is conventionally given to the formal expression of decisions which have already been made[8]. Second, the concept of governance denotes the idea that just as forms of contractual practices are enabled by the patterning of power and authority in the institutional context of the transaction, so also is parties' conduct of economic activity shaped by the specific organisation of restraint and permission institutionalised in the contract[9].

This thesis maintains that the structure of power, restraint and permission which is institutionalised in any specific form of contract may be seen as a response to transaction costs and as a potential source of transaction costs. Explanations of contractual governance, therefore, require contracts to be related to specific characteristics of the activity which they govern, as well as the institutional context in which they are located. Moreover, the form of organisation expressed in any particular contract is

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[7] Thomas M. Palay, "Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements" (1985) 1 Journal of Law, Economics and Organization 155, at 156.

[8] Victor P. Goldberg "Institutional Change and the Quasi-Invisible Hand" 17 Journal of Law and Economics 461; "Regulation and Administered Contracts" (1976) 7 Bell Journal of Economics 426.

[9] Williamson, The Economic Institutions of Capitalism, supra, note 3; Ronald H. Coase, "The Nature of the Firm" (1937) 4 Economica 386.

to be compared with alternative modes of governing the activity in question[10].

The specific objective of this thesis is to consider whether the hypothesis that contract is a response to the transaction costs of organising economic activity accounts for the Joint Contracts Tribunal Standard Form of Building Contract (1980 edition), (JCT80). I approach this task in two stages. The first part of the thesis presents a framework for comparative economic analysis of contractual arrangements. It is argued that forms of contracting may be viewed as distinct institutional settings for governing economic activity, and that they may be placed on a spectrum - a "contracting continuum"[11] - of relationships. Every point on the continuum represents a response to the problems of co-ordinating economic activity in an imperfect, transaction costly, world; and each response generates its own pattern of transaction costs. The second part of the thesis is an analysis of the standard form of building contract as an institutional setting for the activity of building production. The analysis uses economic models of contract, drawn from different points on a contracting continuum, as a basis for explaining the manner in which JCT80 organises building production, and evaluating

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10 See chapter II, infra for an account of the comparative institutional methodology used in this thesis; see generally, Nicholas Mercuro "Toward a Comparative Institutional Approach to the Study of Law and Economics" in Law and Economics Nicholas Mercuro (ed). (Boston: Kluwer, 1989); Neil Komesar, "In Search of a General Approach to Legal Analysis: A Comparative, Institutional Alternative" (1981) 79 Michigan Law Review 1350; Williamson, The Economic Institutions of Capitalism, supra, note 3.

11 Ian R. Macneil The New Social Contract: An Inquiry into Modern Contractual Relations (New Haven, Conn.: Yale University Press, 1980).

judicial management of conflicts arising in transactions governed by the standard form contract.

The thesis does not proceed to empirical evaluation of the use of the standard form contract. I considered this at the start of the study but eventually rejected the idea. Apart from the costs of generating relevant data in an industry which is as fragmented and idiosyncratic as construction, it became clear that an empirical study would need to be preceded by the type of analysis presented in the thesis. Not only have building contracts received little academic attention in the UK.[12], but institutional analysis of contractual governance is a young science which has been pursued with more enthusiasm by economists than lawyers. As yet there has been little attempt to relate comparative institutional theory to substantive aspects of the lawyer's understanding of contract[13]. Our analysis of the provisions of JCT80 is an example of the manner in which academic lawyers might engage with this new conjunction of law and economic thinking, and

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[12] Until recently, analysis of building contracts could be found only in treatise-style works such as Hudson's Building and Engineering Contracts Ian N. Duncan Wallace (ed.) (London: Sweet & Maxwell) and annotations to the cases reported in the Building Law Reports series. The situation has changed during the 1980's. In addition to the burgeoning loose-leaf practitioners' volumes, a number of specialist monographs have appeared, see, for example, Vincent Powell-Smith & John Sims, Building Contract Claims (London: Granada, 1983); Ray Cecil Professional Liability (London: Architectural Press, 1985). In 1985 the Architectural Press commenced publication of a law reports series featuring the judgments of Official Referees the Construction Law Reports, (edited by Michael Furmston and Vincent Powell-Smith) and Sweet & Maxwell commenced publication of the Construction Law Journal. In addition articles about building transactions are beginning to appear in general academic journals, see, for example, Richard Lewis, "Contracts between Businessmen: Reform of the Law of Firm Offers and an Empirical Study of Tendering Practices in the Building Industry (1982) 9 Journal of Law & Society 153; Andrew Grubb, "A Case for Recognising Economic Loss in Defective Building Cases" (1984) 43 Cambridge Law Journal 111; Ian Duncan Wallace "Anns Beyond Repair" (1991) 107 Law Quarterly Review 228.

[13] For an analysis which relates the economic idea of governance to legal concepts, see Anthony I. Ogus, "The Trust as a Governance Structure" (1986) 36 University of Toronto Law Journal 186.

illustrates some of the strengths, and also the limitations, of this approach.

The contracting continuum developed in the first part of the thesis highlights three forms of governance: classical, relational, and "firm-like"[14] contracting[15]. Chapter three focuses on the classical model of contractual relations, a form of governance which treats the interaction of parties' ex ante decisions with legal norms as the sole instrument for managing economic activity. Nothing in classical contractors' history, relationship or context is relevant to the governance of their transaction unless it has been expressed in a well-defined obligation. The relational model of contract, by contrast, treats history, context and relationship as central to the management of economic activity. The analysis in chapter four suggests that relational contractors rely on social and cultural norms as a means of governance and use decision-making practices which promote flexibility and change during the life of the transaction. Chapter five concentrates on "transactional" theories of the firm. It considers contractual justifications which have been advanced to explain

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[14] Demsetz uses this concept to describe the idea of the firm in theories which treat the firm as a "nexus of contracts", Harold Demsetz, "The Theory of the Firm Revisited" (1988) 4 Journal of Law, Economics and Organization 141 at 154. As I am using the term simply to avoid phrases such as "the theories of the firm which construct the firm as a contract", the reader should note that my use of the term includes other economic theories of the firm: see, text, infra and chapter V infra.

[15] Some contract theorists maintain that a spectrum bounded by the discrete exchange of classical contract and the firm too restrictive. They argue that the relational end of the spectrum should be extended to encompass "society": see, for example, Ian R. Macneil, "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law" (1978) 72 Northwestern University Law Review 854; Macneil, The New Social Contract, supra, note 11; Gideon Gottlieb, "Relationism: Legal Theory for a Relational Society" (1983) 50 University of Chicago Law Review 576.

the practices of administrative management which characterise the firm. Firm-like transactions, it will be seen, use direction and authority as a means of supplementing, or supplanting, market mechanisms for governing economic activity.

Part II opens with a discussion of the institutional context within which the building contract is situated. Chapter six outlines the structure of the construction industry and describes the development of the standard form contract. This chapter also identifies participants in a building project governed by JCT80 and outlines their transactional roles.

The substantive analysis of the building contract is organised around three dimensions of the production process: planning, administration and enforcement. Chapter seven focuses on contractual planning. It analyses the process of initial decision-making envisaged by the structure of JCT80, and the mechanisms by which planning to build is organised. The governance implications of the model of planning which is associated with JCT80 are evaluated in the light of the three economic models of contractual organisation.

Chapter eight concentrates on the issues of administration and management of building projects which are regulated by JCT80. This chapter describes the formal contractual system for governing decisions and co-ordinating activities during the process of production and analyses the transactional implications of the most significant procedures. The governance rationales and consequences of these decision-making procedures are assessed by reference to the three economic models.

Chapter nine addresses the issues of enforcement and legal sanctions. This chapter examines the formal regime for responding to critical performance failures. It analyses the contractual enforcement instruments, and explores the relationship between the general legal norms governing access to sanctions and the "private rules" of JCT80. The governance implications of the enforcement regime are developed by reference to classical, relational and "firm-like" models of contracting.

B. Literature Review

1. The Intellectual Roots of Comparative Institutional Analysis: Commons, Coase and Legal Functionalism

This review of the history and current state of development of transaction cost analysis locates the roots of contemporary comparative institutionalism in the work of American legal, economic, and organisational theorists of the early twentieth century. These scholars shared a commitment to understanding "real-world" economic practices and institutions in all their complexity. They strove for analysis which was richer and more contextual than could be achieved by the abstraction of traditional legal and economic methodologies. The same dissatisfaction with the orthodoxies of both legal scholarship and neoclassical microeconomics and the same search for nuance and relevance appears in the contemporary emergence of comparative institutionalism.

Comparative institutional analysis is influenced in important ways by the methods, the questions and the agenda of the Institutional school of economics which achieved prominence in the US between the 1880's and the 1930's[16]. Blaug summarises the intellectual thrust of institutional economics in terms of three related methodological characteristics. First, institutionalism reflected dissatisfaction with the abstract and static character of neoclassical economic analysis. Secondly, the Institutional Economists shared a commitment to viewing social problems through interdisciplinary lenses. Finally, Blaug suggests that Institutionalists were known for their belief that the development of economics as a policy science required analysts to abandon their faith in the "casual empiricism" of

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[16] Theorists associated with the Institutional school of Economics include T. Veblen, J.R. Commons, C.E. Ayres, W.C. Mitchell and J. Clark: see Anne Mayhew, "The Beginnings of Institutionalism" (1987) 21 Journal of Economic Issues 971 for a valuable analysis of early Institutionalist thought, particularly as expressed in the work of Commons and Veblen. Mayhew's discussion is particularly helpful in its linking of the growth of institutionalist thinking with the rapid urbanization and industrialisation of America at that time. See Philip A. Klein "Institutionalism as a School - A Reconsideration" (1990) 24 Journal of Economic Issues 381 for a brief, but helpful comment on the relationships between the work of Commons and Veblen. For intellectual historical analyses of the contribution of Institutionalism to the development of legal ideas about contract and property, see, Neil Duxbury "Robert Hale and the Economics of Legal Force" (1990) 53 Modern Law Review 421.

neoclassical analysis and confront the dynamic and complex realities of economic activities[17].

The orientation of institutionalism was drawn from a conception of economics as a substantive discipline in which the proper subject-matter of inquiry was the activity of material provisioning[18]. The activity of material provisioning was taken to encompass all of the formal and informal customs, processes and practices - institutions - by which collectivities, societies and individuals organised, struggled for, and secured, resources to meet their material needs. Thorstein Veblen, for example, asserted that: "[f]or the purpose of economic science the process of cumulative change that is to be accounted for is the sequence of change in the methods of doing things--the methods of dealing with the material means of life"[19].

Important institutionalist contributions to thinking about contract are to be found in the work of John R. Commons[20] and Thorstein Veblen[21]. Commons developed a

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17 Mark Blaug, The Methodology of Economics (Cambridge: Cambridge University Press, 1980).

18 Karl Polanyi, "The Economy as Instituted Process" in Trade and Market in Early Empires, Karl Polanyi, Conrad M. Arensberg & Harry W. Pearson, (eds.) (Glencoe., Ill.: the Free Press, 1957). For a contemporary version and development of the idea that economics is not per se a method, but a study of material provisioning in society, see Allan G. Gruchy, The Reconstruction of Economics: An Analysis of the Fundamentals of Institutional Economics (New York: Greenwood Press, 1987). For an alternative substantive conception of economics, see Ronald H. Coase, "Economics and Contiguous Disciplines" (1978) 7 Journal of Legal Studies 201.

19 Thorstein Veblen, "Why is Economics not an Evolutionary Science?" in Veblen, The Place of Science in Modern Civilization and Other Essays (New York: Russell & Russell, 1961) (originally published in 1919) at 56.

20 John R. Commons, Legal Foundations of Capitalism (Madison: University of Wisconsin Press 1924); "The Problem of Correlating Law, Economics, and Ethics" (1932) 8 Wisconsin Law Review 3; Institutional Economics: Its Place in Political Economy (Madison: University of Wisconsin Press, 1959).

21 Thorstein Veblen "Why is Economics not an Evolutionary Science?" supra note 19; Veblen, The Theory of the Business Enterprise (New York: Scribner, 1932) (originally published in 1904).

conceptual framework which enabled the monolithic market of traditional economic theory to be broken down and analysed in terms of specific transacting practices. From Veblen's work we can extract important criteria for evaluating particular norms of contract law and practice.

Several aspects of Commons' work are significant to the arguments presented in this thesis. First, Commons developed a basis for understanding "institutions" as means of governing economic conduct. Secondly, he argued that institutions enable the exercise of power and insisted that this aspect of institutional design and performance should be an important feature of economists' research. Third, the concept of "the transaction" was used as a fundamental construct of Commons' analytical system. Finally, the mode of analysis used by Commons was explicitly comparative. He showed, by example, how the performance of one institution might be assessed in relation to another[22], and presented a means of conceptualising and comparing the economic functions of various types of transaction[23]. These ideas are sufficiently important to the approach taken in this thesis that they bear some elaboration here.

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22 See, for example, Commons' analyses of markets, business ethics and law as alternative institutional sources of sanctions against "deviant" economic behaviour in Institutional Economics, and "The Problem of Correlating Law, Economics and Ethics", supra, note 20.

23 See, for example, Commons' analysis of managerial, rationing and bargaining transactions in Institutional Economics, supra, note 20; See also his comparative analysis of the institutional architecture of the "wage bargain", the "price bargain" and the "shelter bargain", in Legal Foundations of Capitalism, supra, note 20.

Commons defined "institutions" as "Collective Action in Control of Individual Action"[24]. "Collective Action in Control of Individual Action", he elaborated, found its expression in "working rules" emanating from "Going Concerns, such as the family, the corporation, the holding company, the trade association, the trade union, the Federal Reserve System,... the state"[25]. While "working rules" were conceived to be "continually changing in the history of an institution"[26] and to vary between institutions, their role in any specific context and at any particular moment in history was constant. Working rules existed to establish and to enforce the limits of permissible behaviour within the institutional context of the "Going Concern"[27].

Part of Commons' analytical interest in the "working rules" of an institution stemmed from his thesis that ethics, economics, and law were alternative means of sanctioning behaviour, alternative modes of enforcing the rules of conduct[28]. Where ethics dealt in the "moral sanctions of collective opinion", economics relied on the collective sanctions of economic gain or loss, and law invoked the organized sanctions of physical force[29]. As these distinct

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24 Institutional Economics, supra, note 20 at 69.

25 Ibid., at 70.

26 Ibid., at 71.

27 Legal Foundations of Capitalism, supra, note 20.

28 Institutional Economics, supra, note 20; "The Problem of Correlating Law, Economics and Ethics", supra, note 20.

29 Institutional Economics, supra, note 20 at 71.

sources of sanction might be expected to interact differently with individual action, one task for the institutional economist would be to evaluate the relative merits of modes of enforcement as they are deployed in varying institutional contexts[30].

Commons' interest in how institutions work went beyond comparative analysis of modes of enforcement, to the very nature of "working rules". He maintained that any practice of "collective action in control of individual action" is inherently contradictory in the sense that working rules which restrict the activity of some individuals and confine their choices, will free others from constraints, and expand the latters' opportunities[31]. Confronted with this unavoidable paradox, Commons argued that it was essential to avoid easy assumptions and to analyse institutional practices in their full complexity. In particular, he warned that the social policy analyst should not treat values such as "freedom", "sovereignty" and "autonomy", as innate characteristics of any particular institution, but should recognise that any institution would, at one and the same time, by the same set

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30 In effect Commons was arguing that all economic institutions are means of managing disputes. As such they may be evaluated against one another by reference to their relative ability to promote harmony, resolve conflict, and maintain co-operation, Legal Foundations of Capitalism, supra, note 20, especially, chapter 1. Not only did this insight enable the development of the explicitly comparative analytical framework which characterises transaction cost analysis, but it also pointed the way to the development of the concept of "governance" as an expression of the purposes of economic organisation. See Don Kanel, "Institutional Economics: Perspectives on Economy and Society" (1985) 19 Journal of Economic Issues 815, for a helpful discussion of this part of Commons' argument.

31 Institutional Economics, supra, note 20 at 73.

of working rules, restrain, expand, limit, and liberate individual action[32].

Commons defined the "transaction" as "the alienation and acquisition, between individuals, of the rights of future ownership of physical things, as determined by the collective working rules of society"[33] and used this concept as a means of expressing three important ideas. First, he argued that the proper subject-matter of economics was constituted by social relationships between persons rather than physical relations between individuals and nature[34]. This orientation led Commons to emphasise the "socially constructed" character of apparently natural phenomena. For example, he urged economists to explore the way in which changing conceptions of property rights - relationships between individuals defined by social institutions - shape individuals and groups access to resources, rather than taking for granted the "natural" scarcity of resources in relation to the unlimited wants of "man"[35].

Secondly, Commons argued that economically interesting relationships between persons - as expressed in the concept of "the transaction" - reflect three characteristics of human endeavour: conflicting interests, mutual interdependence and

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32 Ibid., at 73.

33 Ibid., at 58. This aspect of Commons' work is influenced by Hohfeld's analysis of legal rights, see, for example, Wesley N. Hohfeld "Some Fundamental Legal Conceptions as Applied in Judicial Reasoning" (1913) 23 Yale Law Journal 16.

34 Institutional Economics, supra, note 20.

35 Legal Foundations of Capitalism, supra, note 20.

"order", which latter concept he defined to mean security of expectations[36]. Although these characteristics seem contradictory, Commons maintained that nothing would be gained by giving analytic priority to one over others. Instead the role of the economist was to analyse the way in which different types of transactions, whether defined in terms of formal characteristics[37] or substantive objectives[38], reached different accommodations between conflicting interests, mutual interdependence and order[39].

Finally, Commons made the point that economic activities such as "exchange" or "production" are centred upon control over resources, and that within capitalist societies, control over resources is constituted by legal rights[40]. As rights are derived from the "working rules" of an institution, it followed that such activities should be conceptualised as the product of "collective action in control of individual action" rather than simply the result of individual choice. For

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36 Institutional Economics, supra, note 20.

37 As in the "bargaining", "rationing", and "managerial" transactions, analysed in Institutional Economics ibid.

38 As in the wage bargain, the shelter bargain and the price bargain analysed in Legal Institutions of Capitalism, supra, note 20.

39 Contemporary versions of these ideas can be seen in the work of transactional economists, such as Oliver E. Williamson, see, for example, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 Journal of Law and Economics 3; Victor P. Goldberg, see, for example, "Relational Exchange: Economics and Complex Contracts" (1980) 23 American Behavioural Scientist 337; Benjamin Klein, see, for example, "Transaction Cost Determinants of 'Unfair' Contractual Arrangements" (1980) 70 American Economic Review 356; and Thomas M. Palay, see, for example, "Comparative Institutional Analysis: The Governance of Rail Freight Contracting" (1984) 13 Journal of Legal Studies 265. See text, infra, and chapter IV, infra.

40 Contemporary versions of these ideas can be found in feminist theories of Contract Law and in the work of scholars associated with Critical Legal Studies, see, for example, Clare Dalton, "An Essay on the Deconstruction of Contract Doctrine" (1988) 94 Yale Law Journal; Duncan Kennedy, "Form and Substance in Private Law Adjudication" (1976) 89 Harvard Law Review 1685; Roberto M. Unger, "The Critical Legal Studies Movement" (1983) 96 Harvard Law Review 563; Hugh Collins, The Law of Contract (London: Weidenfeld & Nicolson, 1986). For further references, see, chapter IV, infra.

example, in the course of reformulating the classical economists' conception of exchange into his language of "transaction", Commons forcefully asserts that "the individual does not transfer ownership. Only the state, ... by operation of law as interpreted by the courts, transfers ownership by reading intentions into the minds of participants in a transaction"[41].

Thorstein Veblen's contribution to comparative institutional analysis of contractual governance is less direct and less frequently acknowledged by contemporary theorists working in the "transactional economics" tradition[42]. Two aspects of Veblen's work are significant for the arguments in this thesis. First, he developed a sustained critique of the classical economists' conception of "freedom" and the role of this ideology in judicial decision-making. The association

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41 Institutional Economics, supra, note 20 at 58.

42 We are confronted here with a problem of terminology. There are a number of different versions of contemporary institutional economics. One group of theorists, also known as "Evolutionary Economists" have adhered closely to the political economy tradition of Commons, Clark, and Veblen. Their work, mainly to be found in the Journal of Economic Issues, focuses on issues such as the role of economic planning, culture, power, and social conceptions of "value" in the development of contemporary economies, and relies heavily on Veblen. The methodology of these scholars tends to be historical, evolutionary and inductive. See, for example, Samuels and Schmid, supra, note 3; Mayhew, Klein, supra, note 16; and Gruchy, supra, note 18: see also Evolutionary Economics, Marc R. Tool (ed.) (Armonk: M.E. Sharpe Inc., 1988); Walter J. Waller, "Radical Institutionalism: Methodological Aspects of the Radical Tradition" (1988) 22 Journal of Economic Issues 667; Anne Mayhew, "Culture: Core Concept Under Attack (1987) 21 Journal of Economic Issues 587; William M. Dugger, "A Research Agenda for Institutional Economics" (1988) 22 Journal of Economic Issues 983. "Transactional economists", who have assumed, or been given, the label of "institutionalists", use an analytical and "positivistic" methodology which resembles that of neoclassical economics. The analysis, however, is more detailed in its focus and aims for greater richness and complexity than is commonly associated with neoclassicism. See, for example, Williamson, The Economic Institutions of Capitalism, supra, note 3, Paul L. Joskow, "Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants" (1985) 1 Journal of Law, Economics & Organization 33. This type of institutionalism, which is promoted by the editors of the Journal of Law, Economics and Organization tends not to refer to Veblen. Dugger suggests that Veblen's work is overlooked because transactional contemporary theorists are reluctant to confront directly the normative underpinnings of their work, William M. Dugger "The Transaction Cost Analysis of Oliver E. Williamson: A New Synthesis" (1983) 17 Journal of Economic Issues 95.

of "liberty" with the notion that the contractual "freedom" of one individual should be limited only by the contractual freedoms of others, Veblen insisted, was not only incoherent[43], but also obscured the extent to which the economic power to coerce is an inevitable attribute of private property[44].

Second, Veblen argued that the component institutions of an economy may be divided into two categories according to whether they served the "invidious" or the "non-invidious" economic interest[45]. Institutions serving the invidious interests reflect "predatory values", permitting greed to run rampant: they empower, enable and endorse individuals' exploitation of one another. By contrast, institutions that reflect the "non-invidious interest" promote smoother economic operations. Such "serviceability" in institutions makes for progressive and productive uses of technology, encourages co-operation in economic relationships, and contains the corrosive effects of attenuated self-interest. This dichotomy suggests a clear policy objective of encouraging institutions which promote "industrial-serviceable" values within a community and eradicating those which enable "pecuniary-

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43 Thorstein Veblen, The Theory of the Business Enterprise, supra, note 21.

44 Ibid. This argument was developed by academic lawyers such as Robert Hale, and John Dawson who maintained that contract scholars ought to confront the manner in which legal doctrines distribute economic power: see, for example, Hale, "Coercion and Distribution in a Supposedly Non-Coercive State" (1923) 38 Political Science Quarterly 47; Dawson, "Economic Duress - An Essay in Perspective" (1947) 45 Michigan Law Review 253. For an insightful discussion of the influence of Veblen, and other Institutional Economists, on the work of Robert Hale, see Duxbury, supra, note 16. The thesis that contract law distributes economic power is also an important theme in Critical Legal Studies analyses of contract law, supra, note 40. For a different analysis which makes the same point, see, Anthony T. Kronman, "Contract Law and Distributive Justice" (1980) 89 Yale Law Journal 472.

45 "The Theory of the Leisure Class & Industrial and Pecuniary Employments" in The Place of Science in Modern Civilization and Other Essays, supra, note 19.

predatory" values to flourish. A commitment to the same objective can be seen in contemporary theorists' arguments about structuring transactional governance so that economic activity benefits from smoother co-ordination and co-operation without exposing the activity to a greater risk of opportunism[46].

As in the case of Commons' work, the concept of the "transaction" and the idea that economic institutions should be conceptualised as a means of governing transactions were central to Ronald Coase's influential analysis of the firm[47]. Coase urged economists to move beyond their conception of the firm as merely a technical relationship between inputs, outputs, technology and the market, and to confront the reality of firms as socio-economic phenomena[48]. To this end he sought an analytical framework which would account for the existence of firms, identify characteristic qualities of governance within firms, and clarify the relationship between the business collectivity and the market as organisational forms.

Each of the Coasian questions has re-emerged on today's comparative institutional agenda as has his distinctive

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[46] Oliver E. Williamson, "Credible Commitments: Using Hostages to Support Exchange" (1983) 73 American Economic Review 519; Williamson, "The Economics of Governance: Framework and Implications" (1984) 140 Journal of Theoretical Economics 195; Benjamin Klein, Robert G. Crawford and Armen A. Alchian "Vertical Integration, Appropriable Rents and the Competitive Contracting Process" (1978) 21 Journal of Law and Economics 297.

[47] "The Nature of the Firm", supra, note 9.

[48] For a helpful interpretation of "The Nature of the Firm", see, Sidney G. Winter, "On Coase, Competence, and the Corporation" (1988) 4 Journal of Law Economics and Organisation 163.

theoretical perspective. Of particular significance to contemporary work are Coase's explicit recognition that it is costly to make and implement transactions, the hypothesis that the costs attached to a transaction vary with the institutional context in which it is situated; and the argument that as markets and firms are alternative institutional forms, differences in the costs of using each form to govern a particular activity may account for observed patterns of transactional governance. Contemporary theorists have also adopted Coase's conclusion that the rationale for variations in economic organisation is to be found in the relative capacity of different forms to enhance or obstruct the activities which they purport to order.

The era of the Institutional Economists also saw the development of academic interest in the economic functions of contract law and its role in the operation of the American market system[49]. Scholars such as Llewellyn[50], Cohen[51], and Fuller[52] broke with the formalist, Langdellian, tradition of treating contract law as a system of logical, timeless rules

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[49] The work of Oliver Wendell Holmes during the 1880's and 1890's is an earlier source of evolutionary and functional visions of contract law: see Holmes, The Common Law (Boston: Little, Brown & Co., 1929) (originally published in 1881); "The Path of the Law" (1897) 10 Harvard Law Review 461.

[50] Karl N. Llewellyn, "What Price Contract? - an Essay in Perspective" (1931) 40 Yale Law Journal 704 (hereafter, "What Price Contract?"; "The Modern Approach to Counseling and Advocacy, Especially in Commercial Transactions" (1946) 46 Columbia Law Review 167; "The Effect of Legal Institutions upon Economics" (1925) 15 American Economic Review 665. "Law and the Social Sciences, Especially Sociology" (1949) 62 Harvard Law Review 1266.

[51] Morris R. Cohen, "The Basis of Contract", (1933) 46 Harvard Law Review 553; Law and the Social Order (New York: Harcourt Brace, 1933).

[52] Lon L. Fuller & William R. Purdue Jr., "The Reliance Interest in Contract Damages" (1936) 46 Yale Law Journal 52-95 and 373-420; Fuller, "Consideration and Form" (1941) 41 Columbia Law Review 799.

derived from an abstract concept of promise[53]. They insisted that contract law should be conceptualised in terms of its "effect on the arrangement of economic affairs"[54].

The scholarship of this period reflected the assumptions that contract law was functional to capitalism and that explanations of its role were to be found by exploring relationships between legal rules and the activity which the rules purported to govern[55]. In the development of these ideas, contract theorists pursued three distinct lines of enquiry, each of which may be observed in contemporary economic theories of contract law.

Some scholars concentrated on rationalising existing norms of contract law[56]. These writers attempted to show how particular doctrines of contract law, however anomalous they might seem, in fact served the interests of business, commerce and the market. Their work, like that of many contemporary law and economics scholars, was driven by the belief that contract law and the market march lockstep towards a greater social

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[53] See, Robert Gordon, "Critical Legal Histories" (1984) 36 Stanford Law Review 57, for comment on the premises underlying this break with the traditions of contract scholarship".

[54] Llewellyn, "What Price Contract?" supra, note 50, at 727.

[55] It should be noted that these writers did not in fact conduct empirical studies of economic / contractual activities. Their accounts of relationships between contract law and business activity tended to rely, instead, on casual observation of social / commercial norms and "common sense" intuitions about the needs and objectives of commercial actors. See, for example, Karl N. Llewellyn, "On Law and Our Commerce" 1949 Wisconsin Law Review 625. However, the perspective which these scholars brought to analysis of appellate cases was, in many respects, quite distinctive, see, for example, John Dawson's analyses of contract decisions in Germany and the US during periods of high inflation, "Effects of Inflation on Private Contracts: Germany 1914-1924" (1934) 33 Michigan Law Review 171; Dawson & Frank E. Cooper, "The Effect of Inflation on Private Contracts: United States, 1861-1879" (1935) 33 Michigan Law Review 706.

[56] See, for example, Gerald C. Gardner, "An Enquiry into the Principles of the Law of Contract" (1932) 46 Harvard Law Review 1; Fuller and Perdue, "The Reliance Interest in Contract Damages", supra, note 52.

good. For example, Fuller and Perdue conclude their explanation of why contract law protects reliance interests by awarding expectation damages with the assertion that:

> The inference is therefore justified that the ends of the law of contracts and those of our economic system show and essential correspondence. One may explain this either on the ground that the law (mere superstructure and ideology) reflects inertly the conditions of economic life, or on the ground that economic activity has fitted itself into the rational framework of the law. Neither explanation would be true. In fact we are dealing with a situation in which law and society have interacted. The law measures damages by the expectancy <u>in part</u> because society views the expectancy as a present value; society views the expectancy as a present value <u>in part</u> because the law ... gives protection to the expectancy[57].

Other legal academics of the 1920's and 1930's agreed that contract law <u>should</u> serve the market, but argued that the legacy of formalism had driven a wedge between legal principles and commercial realities. Two distinct concerns were articulated. First, it was argued that because the process of change within the common law was slower than the rate of innovation in business practice, contract doctrine tended to lag behind the needs of business[58]. Secondly, it was thought that the seamless web of complex, confusing, and contradictory principles which constituted formalist contract law was, in fact, dysfunctional[59]. The law had become a "burden on business". This latter perception spawned an

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[57] Fuller & Perdue, "The Reliance Interest in Contract Damages", <u>supra</u>, note 52 at 63.

[58] Llewellyn, "On Law and Our Commerce", <u>supra</u>, note 55; Austin T Wright, "Opposition of the Law to Business Usages" (1926) 26 <u>Columbia Law Review</u> 916.

[59] <u>Ibid.</u>

intellectual agenda of rationalising, clarifying and simplifying the law so that it could take its rightful place as an institutional tool of the American free enterprise system[60]. The most significant achievement of these scholars was the drafting, promulgation and eventual adoption of the Uniform Commercial Code[61]. The comments of Karl Llewellyn in his brief to the New York Law Revision Commission urging adoption of the Code are a good illustration of this school of thought:

> For a free economy, for soundly developing American enterprise and competition, it is of the essence that the rules of the game should be as simple as possible and that those rules of the game should be readily known to all.... Sound, clear legal advice at a reasonable rate is good for American business and finance.... Such advice, necessary to a free-running economy, cannot be had when the law is unknown or is hard to uncover or is confused when found.... With the Code, the law of commerce and commercial finance becomes relatively quick to find, to understand and to use[62].

The third important branch of 1930's contract scholarship was less overtly normative than either of the two perspectives described above, and was again exemplified in the work of Karl

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[60] Ibid. For a thoughtful critique of the assumptions about legal methodology and market behaviour underlying this intellectual enterprise, see Richard Danzig, "A Comment on the Jurisprudence of the Uniform Commercial Code" (1975) 27 Stanford Law Review 621.

[61] This project began in the 1930's, although the first completed draft was not published until 1949. The drafters viewed the Code as a harmonious, organic form of law that would be capable of "deal[in] with all the phases which may ordinarily arise in the handling of a commercial transaction from start to finish", General Comment of the National Conference of Commissioners on Uniform State Laws and the American Law Institute 1962. The general philosophy of the Code appears in s 1-102(2)(b) which notes that one of the "underlying purposes and policies" of the UCC is "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties". For an analysis of the role of ideas promoted by Llewellyn in the development of the Uniform Commercial Code, see William L. Twining, Karl Llewellyn and The Realist Movement (London: Weidenfeld & Nicolson, 1973), chaps. 11 & 12.

[62] Statement to the Law Revision Commission by Professor Karl N. Llewellyn, Appendix E. in Karl Llewellyn and the Realist Movement, ibid., at 536-537.

Llewellyn. In What Price Contract? An Essay in Perspective[63], Llewellyn urged lawyers to re-orient the conceptual framework for thinking about contract. Of particular concern to Llewellyn was the lawyer's inability to escape "the vicious heritage of regularly viewing parties to a deal as single individuals"[64]. Individualism, Llewellyn argued, exerted such a powerful hold over thinking about contract that it was hard even to find a language in which to discuss the daily reality of contract. That reality, he maintained, was one in which individuals worked in groups: they "organised into some interlocking unity of action"[65]. In such a context, the significance of legal conceptions of contract is that they:

> ... provide a framework for well-nigh every type of group organization and for well-nigh every type of passing or permanent relationship between individuals and groups ... - a framework highly adjustable, a framework which almost never accurately indicates real working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of ultimate appeal when the relations cease in fact to work[66].

Llewellyn not only saw the importance of group or "collective" action to the functioning of capitalist markets, but he also suggested a crude typology of "groups" which might be used for analytical purposes. This classificatory scheme distinguished between the "fairly permanent group building"[67]

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63 Supra, note 50.

64 Ibid., at 734.

65 Ibid.

66 Ibid., at 736-7.

67 Ibid., at fn. 63.

of the business corporation and the "semi-antagonistic corporation for the moment"[68] of the discrete transaction and located the long-term business-customer relation somewhere between the two extremes[69]. However, Llewellyn was unable either to identify criteria for assigning economic activities to different institutional structures, or to integrate his exposition of a group perspective into his analysis of contract and property as systems of law. Contemporary comparative institutionalism has to a large extent overcome the former problem, but even today is struggling with the latter.

It is apparent that the theorists of the 1930's moved some way towards synthesising economic and legal understandings of contract. They shared a methodology of inductive reasoning, and a theoretical commitment to the analytical significance of institutional context. Taken together the work of these scholars provided cogent arguments for questioning conventional assumptions about the nature of the market, the role of contract in commercial life and the nature of economic organisation.

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68 Ibid.

69 Ibid. Llewellyn's intuitions have been developed into a formal schematic framework by scholars working in the tradition of transactional economics: see, for example, Oliver E. Williamson, "Transaction Cost Economics: The Governance of Contractual Relations", supra, note 6; see, text, infra.

2. Transitional Years

Intellectual consensus collapsed during the middle decades of the twentieth century as economic analysis of organisation took a sharply divergent path from that pursued by contract scholarship. The more innovative contract scholars of this period consolidated and developed realist, sociological and institutional perspectives, directing their energies towards restructuring the law. Some theorists continued to work on the relationship between contract law and business practices. The question on their research agenda was whether contract law could accommodate the social reality of contracting behaviour[70]. For others, the most pressing concern was the relationship of contract doctrine to social inequality and economic power[71]. Following the language of Commons' analysis, the work of these scholars may be conceptualised as interest in the way in which the working rules of market activity, as embodied in the law of contract, create, maintain, enhance, and potentially constrain economic power.

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70 Patrick Devlin, "The Relation between Commercial Law and Commercial Practice" (1951) 14 Modern Law Review 249; Franklin M. Schultz "The Firm Offer Puzzle: A Study of Business Practices in the Construction Industry" (1952) 19 University of Chicago Law Review 237; Malcolm P. Sharp, "Promises, Mistakes and Reciprocity" (1952) 19 University of Chicago Law Review 286; Friedrich Kessler, "Automobile Dealer Franchises: Vertical Integration by Contract" (1957) 66 Yale Law Journal 1135; Kessler & Robert H. Stern "Competition, Contract and Vertical Integration" (1959) 69 Yale Law Journal 1; Kessler & Edith Fine, "Culpa in Contrahendo, Bargaining in Good Faith and Freedom of Contract: A Comparative Study" (1964) 77 Harvard Law Review 401; Clyde W. Summers, "Collective Agreements and the Law of Contracts" (1969) 78 Yale Law Journal 525.

71 Hale, "Coercion and Distribution in a Supposedly Non-Coercive State" supra, note 44; Hale, "Bargaining, Duress, and Economic Liberty" (1943) 43 Columbia Law Review 603; Friedrich H. Kessler, "Contracts of Adhesion - Some Thoughts about Freedom of Contract" (1943) 43 Columbia Law Review 629; John Dawson, "Economic Duress - An Essay in Perspective" (1947) 45 Michigan Law Review 253.

Mid-twentieth century research into the economics of industrial organisation progressed with only passing reference to the Coasian insights that markets and firms are alternative institutional forms, and that the costs of conducting trades determines whether a particular transaction is integrated into a firm or carried out across the market[72]. To some extent the bypassing of Coase was a consequence of a larger movement for change within economic theory. During the 1940's and 1950's economists in the US were struggling to re-establish the "scientific" nature of their work[73]. The Institutionalists' rich explanations of the organisation of material provisioning were dismissed as "mere" descriptions of the world.

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[72] See Williamson's critiques of the economics of organization, in Markets and Hierarchies, supra, note 2, and The Economic Institutions of Capitalism, supra, note 3; see also Victor R. Fuchs (ed.) Policy Issues and Research Opportunities in Industrial Organization (New York: National Bureau of Economic Research 1972); Winter, "On Coase, Competence and the Corporation" supra, note 48; Ronald H. Coase, "The Nature of the Firm: Influence" (1988) 4 Journal of Law, Economics & Organization 33; Stephen N.S. Cheung, "The Contractual Nature of the Firm" (1983) 26 Journal of Law & Economics 1.

[73] The relationship between "science" and economics is a site of continuing conflict between economists. The late 19th century and early decades of the twentieth century saw the development of formal conceptual tools for engaging in partial and General Equilibrium analyses of markets. Partial analysis is associated with the work of Alfred Marshall. General Equilibrium analysis is associated with the work of Léon Walras: see Joseph A. Schumpeter, History of Economic Analysis (edited by E.B. Schumpeter) (New York: OUP, 1954); Blaug, The Methodology of Economics, supra, note 17. The development of a mathematical language in which to model the imputed behaviour of markets was thought, by some, dramatically to increase the power of economics as a tool of policy analysis. During the 1940's and 1950's, economists sought further refinements of modelling techniques. The "scientific" quality of economics was associated with the expression of relationships between economic variables in as "pure" and "elegant", (ie., algebraic) a form as possible. Recently, this conception of what is meant by "science" in economics has been attacked on two grounds. First, it is said that the science of economics is just another form of rhetoric, ie., a discourse intended to persuade rather than a means to discovery of "the truth": Donald N. McCloskey, If You're So Smart: The Narrative of Economic Expertise (Chicago: University of Chicago Press, 1990). Second, the science of economics is said to be an ideology, in the sense that its assumptions embed political choices about the way in which the world ought to function. Far from encapsulating objectivity, therefore, the method of scientific economics is thought to entail the suppression of "truths" which are inconsistent with the development of capitalist markets: Ezra J. Mishan "The Folklore of the Market - An Inquiry into the Economic Doctrines of the Chicago School" (1975) 9 Journal of Economic Issues 681. Finally, "scientific" economics is criticised for being insufficiently "scientific". It is argued, for example, that academic economists rely too heavily on axiomatic reasoning, have devoted too much time and energy to the refinement of models, and failed adequately to test their hypotheses against empirical evidence: see, for example, Wassily Leontief, "Theoretical Assumptions and Nonobserved Facts" (1975) 61 American Economic Review 1; and Why Economics is Not Yet a Science (London: Macmillan, 1983) Alfred E. Eichner (ed.), see in particular the essays by James A. Swanbey and Robert Premus, "Modern Empiricism and Quantum-Leap Theorizing in Economics" and John Blatt, "How Economists Misuse Mathematics".

Microeconomics, it was felt, should reclaim its heritage as a method of inquiry into human behaviour - the science of human choice[74]. To this end the proper domain of economics was reformulated. No longer would the reach of economists be confined to the operation of small and large-scale economies, their agenda would, instead, be derived from the nature of their models.

In the eyes of many economists the redefinition of their discipline in formal terms paved the way for economics to colonise all areas of human behaviour which could be characterised as involving an element of choice[75]. Others insisted that the (analytic) centrality of the "pure" untainted competitive market to "scientific" economic models reduced the relevance of these models to analysis of institutional arrangements in the "real-world"[76]. In the context of industrial organisation, it was argued that formal economists' conceptualisations of the firm as a technical production function and the market as a signalling mechanism,

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[74] A classic statement of economic formalism in the first half of the twentieth century is to be found in the work of Lionel Robbins. He defined economics as:

> the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.... [W]hen time and the means for achieving ends are limited and capable of being distinguished in order of importance, then behaviour necessarily assumes the form of choice ... it has an economic aspect.

Lionel C. Robbins, An Essay on the Nature and Significance of Economic Science (London: Macmillan, 1932) at 15.

[75] Gary S. Becker, The Economic Approach to Human Behaviour (Chicago: University of Chicago Press, 1976); Milton Friedman, "The Methodology of Positive Economics" Essays in Positive Economics (Chicago: University of Chicago Press, 1953).

[76] Vernon Smith "Economic Theory and its Discontents" (1975) 64 American Economic Review, (papers & proceedings) 320; J. Ron Stanfield "Institutional Analysis: Toward Progress in Economic Science" in Why Economics is Not Yet a Science, supra, note 73; Richard S. Markovits "A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics" 1975 Wisconsin Law Review 750.

meant that critical questions about the organisation of economic activity could not even be posed still less answered[77].

3. The Rise of Neoclassical Law-and-Economics

A second provocative essay by Coase appeared in 1960, sparking interest in economic analysis of law and legal institutions[78]. In The Problem of Social Cost Coase presented a delicate, nuanced and ambiguous argument which is at once a critique of government "intervention" in markets and a reminder of the inevitability of market failure. The overt objective of the essay is to challenge economists' conventional treatment of "social costs" as a market failure which should be corrected by taxing the producer to the point where its private costs of production are equal to the social costs of its activity. Coase argued that this "Pigovian"[79] tradition was founded on the unwarranted assumptions that regulation is a costless process, policy instruments may be

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[77] Williamson, Vertical Integration of Production: Market Failure Considerations"; and Markets and Hierarchies, supra note 2; Ronald H. Coase, "Industrial Organization: A Proposal for Research" in Fuchs (ed.) Policy Issues and Research Opportunities in Industrial Organization, supra, note 72.

[78] Ronald H. Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1. The importance of this essay was that it suggested how economic ideas might inform analysis of institutions and rules which are not overtly targeted at market behaviour. The Coase theorem complemented existing links between the two disciplines in "economic" or regulatory areas of public policy where the law was clearly informed by economic objectives, such as competition, /antitrust, utility regulation and taxation; see Veljanovski The New Law-And-Economics: A Research Review, supra, note 1. For a valuable collection of readings which illustrates both conventional and innovative syntheses of law and economics, see, Anthony I. Ogus and Cento G. Veljanovski (eds) Readings in the Economics of Law and Regulation (Oxford: Clarendon Press, 1984).

[79] Arthur C. Pigou The Economics of Welfare (London: Macmillan, 1924).

precisely targeted at the perceived problem, and social and economic policies have discrete effects.

In the development of his critique, Coase drew on his earlier work on transaction costs to make three important claims. First, he argued that economists ought to take seriously the role of the institution of property rights as an instrument of economic policy. This argument was based on what became known as the Coase theorem, the proposition that: in a world where property rights are well-defined and transactions are costless, it is in the interests of economic actors to resolve conflicts over resource allocation by bargaining, and that the bargain that is reached will ensure that the economically preferred use of resources prevails whatever the initial allocation of rights to the resource. The logic of the Coase theorem implied that property rights might be used as a substitute for other regulatory instruments, and that in a world where transactions are costly, the content of legal rules might significantly affect the allocation of resources between conflicting uses[80].

Secondly, Coase insisted that transaction costs were an ineradicable feature of social arrangements in the "real-world". The implication of this point was that the mode of reasoning in economic policy making should change. Coase urged economists to forget about using "ideal" models as a reference point for change to existing practices, and to concentrate,

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[80] Coase, "The Problem of Social Cost", supra, note 78.

instead, on evaluating what exists in relation to feasible alternatives.

Finally, Coase maintained that the institutional context of economic activities not only influences the transaction costs of the activity, but is also a source of transaction costs. When comparing or choosing between alternative institutional frameworks for an economic process or activity, the policy maker/ analyst should, therefore, take account of the transaction cost implications of the structure itself as well as the costs of engaging in that activity within the framework.

The Coasian analysis has spawned two distinct modes of integrating law and economics[81]. The dominant approach - neoclassical law and economics - follows the Coasian exhortation to take property rights seriously. Unlike Coase, however, this school of law and economics treats the idealised model of the perfectly competitive market as a meaningful

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[81] Goetz and Scott label scholars working in these "distinct and largely unrelated analytic traditions" as "bargain model theorists" and "transaction costs theorists". They describe the two traditions as follows:

> bargain model theorists ... construct models of contract behavior under conditions of low transaction costs to examine the influence of different legal rules in environments where the parties are able to allocate all relevant risks at the time of contracting

Whereas,

> transaction cost theorists ... focus on methods of reducing transaction costs in complex contractual relationships. They assume that uncertainty and complexity often prevent parties from accurately allocating all relevant risks at the time of contracting.

Charles J. Goetz & Robert E. Scott "The Mitigation Principle: Toward a General Theory of Contractual Obligation" (1983) 69 Virginia Law Review 967 at fn.5. Although this thesis draws the same distinction as Goetz & Scott, it is thought that, in view of "bargain model theorists" constant references to transaction-costs and "transaction cost theorists" reliance on theories of bargaining behaviour, the labels are a little misleading. This thesis uses the term "neoclassical economic analysis of law" for Goetz & Scott's "bargain theorists", and classifies their "transaction cost theorists" as "transactional economists" working within the general framework of "comparative institutional analysis".

comparator against which to evaluate the performance of "real-world" institutions, and as an attainable goal of social policy. Within this paradigm, common law doctrine is assessed in terms of its impact on individuals' "willingness" to engage in voluntary exchange, and the outcomes of "law-directed" exchange are measured against those of the transaction cost-less market[82].

Following the example of Coase, neoclassical economic analysis of law began with issues which the lawyer would classify as the domain of the law of torts. However, theorists quickly moved to analysis of the rules which govern the process of voluntary exchange[83]. It was argued that contract law serves two important economic functions. First, it renders exchange over time more secure than it would be in the absence of law[84]. Secondly, law is said to supply "implied" or "default" terms which parties may use to avoid the costs of bargaining over risks that might intervene between the time of formation and discharge and affect one or other party's willingness to perform[85].

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[82] For critiques of this methodology, see Coase, The Problem of Social Cost, supra, note 78; Cento G. Veljanovski, "Wealth-Maximisation, Law and Ethics: On the Limits of Economic Efficiency" (1981) 1 International Review of Law & Economics 5; Jules Coleman "Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law" (1984) 94 Ethics 649.

[83] Some of the early literature on economic analysis of contract law is collected in Anthony T. Kronman & Richard A. Posner (eds.) Economics of Contract Law (Boston: Little Brown & Co., 1979).

[84] The editors' introduction to Economics of Contract Law, ibid.; Anthony Kronman, "Contract Law and the State of Nature" (1985) 1 Journal of Law, Economics and Organization 5.

[85] Richard A. Posner & Andrew M. Rosenfield, "Impossibility and Related Doctrines in Contract Law: An Economic Analysis" (1977) 6 Journal of Legal Studies 83. A. Mitchell Polinsky, "Risk Sharing through Breach of Contract Remedies" (1983) 12 Journal of Legal Studies 427; Anthony Kronman, "Specific Performance" (1978) 44 University of Chicago Law Review 351.

Arguments to the effect that contract law enables markets to function were not, of course, new[86]. The provocative aspect of neoclassical economic analysis lay in its stronger claim that contract law perfects the operation of the market, rendering the outcomes of "real-world" markets equivalent to those of the perfectly competitive markets of microeconomic models[87]. Some theorists working in this tradition concluded that the interaction of contract doctrine with "rational" utility or profit -maximising decisions by individuals would cause bargains situated in a transaction costly world to maximise the wealth of a society[88].

Neoclassical law and economics took off in the American legal academy[89] and quickly spread to Canada and the UK[90]. During the 1970's and early 1980's, much of the terrain of

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86 In addition to the works discussed or cited supra, see, Lawrence Friedman Contract Law in America (Madison: University of Wisconsin Press, 1965); Wolfgang Friedmann, Law in a Changing Society (New York: Columbia University Press, 1972) especially, chap.4; Willard Hurst Law and Economic Growth: The Legal History of the Lumber Industry in Wisconsin: 1836-1915 (Camb., Mass.: Harvard University Press, 1964); Patrick S. Atiyah The Rise and Fall of Freedom of Contract (Oxford: OUP, 1979).

87 Richard A. Posner, Economic Analysis of Law (Boston: Little Brown & Co., 1972); Posner, "Utilitarianism, Economics and Legal Theory" (1979) 8 Journal of Legal Studies 103.

88 Ibid., see also, Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" (1980) 8 Hofstra Law Review 487; The Economics of Justice (Cambridge: Harvard University Press, 1981) chap 2.

89 Debates ranged from the general desirability of "efficiency" as a principle animating judicial decisions to putative explanation and critique of actual rules in all areas of the law. Some idea of the variety of scholarship may be obtained from Veljanovski, The New Law-and-Economics, supra, note 1 and the essays extracted in Ogus and Veljanovski (eds.), Readings in the Economics of Law and Regulation, supra, note 78; periodicals such as the Journal of Law and Economics, the Journal of Legal Studies, the International Review of Law and Economics and "Symposium: Change in the Common Law: Legal and Economic Perspectives" (1980) 9 Journal of Legal Studies 189-366; and "Symposium: Efficiency as a Legal Concern" (1980) 8 Hofstra Law Review 485-770.

90 The development of law-and-economics in the UK is primarily associated with the Centre for Socio-Legal Studies at Wolfson College, Oxford, and the University of Newcastle upon Tyne. Five scholars who had links with one or other institution during the late 1970' and early 1980's have been particularly influential: Bill Bishop, Don Harris, Anthony Ogus, Charles Rowley and Cento Veljanovski. In addition to their own research activities, Ogus & Rowley, founded the International Review of Law and Economics and established graduate and undergraduate programmes in Law-and-Economics at the University of Newcastle upon Tyne. Don Harris, as Director of the Centre for Socio-Legal Studies, gave direction to the work of graduate students and researchers.

American common law was reworked in terms of the propensity of the rules to generate incentives for people to make "wealth-maximising" or "efficient" decisions about resource allocation[91]. In its normative guise, the goal of the enterprise was to design "efficient" liability rules[92]; as a positive exercise, economic analysis of law sought to "explain" liability rules in economic terms[93].

The excitement with which economic analysis of law was greeted in some circles was matched only by the relish with which it was attacked by others[94]. Of the many criticisms hurled at neoclassical law and economics, two are particularly germane to the development of comparative institutional analysis of contract law and practice.

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91 "Efficiency" is a sharply contested concept within economic discourse. In The New Law-And-Economics, supra, note 1, Veljanovski notes that efficiency "simply means achieving ends in the best possible way.... Thus in any model based on maximizing behaviour, the content of efficient outcomes depends crucially on the assumptions underlying the analysis" (at 37). Posner's particular formulation of efficiency in terms of "wealth-maximisation", has attracted almost as much criticism as his arguments about the role of efficiency in judicial decision-making: Veljanovski, "Wealth Maximisation, Law and Ethics: On the Limits of Economic Efficiency", (1981) 1 International Review or Law & Economics 5; A. Mitchell Polinsky "Economic Analysis as a Potentially Defective Product: A Buyers Guide to Posner's Economic Analysis of Law" (1974) 87 Harvard Law Review 1655; Warren J. Samuels, "Normative Premises in Regulatory Theory" in Law and Economics: An Institutional Perspective, supra, note 3.

92 The idea that wealth-maximisation is a value that ought to inform judicial decision-making sparked a lively controversy and was ultimately discredited: for examples of the criticisms of the normative "wealth-maximisation" thesis, see, Ronald M. Dworkin "Is Wealth a Value" (1980) 9 Journal of Legal Studies 191; Jules Coleman, " Efficiency, Utility and Wealth Maximization" (1980) 8 Hofstra Law Review 509; Cento G. Veljanovski, "Wealth Maximisation, Law and Ethics: On the Limits of Economic Efficiency" ibid.

93 Some critics of neoclassical law and economics, like many who have challenged "scientific economics", supra, note 73, argue that the attempt to draw a sharp distinction between positive and normative analysis is disingenuous because the questions, agenda, and method of positivist analyses rest on particular assumptions about how society ought to be organised and the desirability of certain forms of social relations: see, for example, Mark Kelman, A Guide to Critical Legal Studies (Camb., Mass.: Harvard University Press, 1987); Arthur Leff, "Economic Analysis of Law: Some Realism about Nominalism" (1974) 60 Virginia Law Review 451; Duncan Kennedy, "Cost-Reduction Theory as Legitimation" (1981) 90 Yale Law Journal 1275; Kennedy, "Cost-Benefit Analysis of Entitlement Problems: A Critique" (1981) 33 Stanford Law Review 387.

94 Ibid., and supra, notes 91 and 92.

One important question concerned the methodological fit between economic theory and legal analysis[95]. Neoclassical economics celebrates its dependence on the rigour and abstraction of deductive logic and the Popperian tradition of "scientific" analysis[96]. By contrast, the methodology of common law thinking is inductive, analogical, and in some respects intuitive[97]. Implicit in some of the more extravagant rhetoric of economic analysis of law, there is a contention that the problem of synthesising these dramatically divergent approaches to the production of knowledge has been solved. Needless to say, this claim has been greeted with some scepticism. Critics suggest that in order to make common law amenable to economic analysis, the analyst is forced to simplify legal doctrine almost to the point of caricature[98], and that in order to make economics relevant to the legal community the analyst must compromise scientific purity[99]. To these critics, the new law-and-economics is best

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[95] For useful overviews of differences between legal and economic reasoning, see Charles K. Rowley, "Social Science and the Law: The Relevance of Economic Theory" (1981) 1 Oxford Journal of Legal Studies 391; Cento G. Veljanovski, "The Economic Approach to Law: A Critical Introduction", (1980) 7 British Journal of Law & Society 158; Donald N. McCloskey, "The Rhetoric of Law and Economics" (1988) 86 Michigan Law Review 752. For a helpful explanation of the manner in which economic analysis of law can illuminate legal issues, see Anthony I. Ogus, "Economics, Liberty and the Common Law" (1980) Journal of The Society of Public Teachers of Law 42. Some economists have viewed the complexity and detail of the common law as both a challenge and grounds for treading cautiously. Writers such as Coase, Nutter, and Klevorick, for example, have urged neoclassical economists to understand the limits of economics as an explanatory heuristic as well as its strengths, see, for example, Ronald H. Coase, "Economics and Contiguous Disciplines" (1978) 7 Journal of Legal Studies 201; Alvin K. Klevorick, "Law and Economic Theory: An Economist's View" (1975) 65 American Economic Review (papers and proceedings) 237; Warren Nutter, "On Economism" (1979) 22 Journal of Law and Economics 263.

[96] Rowley, ibid.

[97] Rowley, ibid.; Veljanovski, "The Economic Approach to Law: A Critical Introduction" supra, note 95; Veljanovski, "The Role of Economics in the Common Law" supra, note 97.

[98] Leff, supra, note 93; Veljanovski, "The Role of Economics in the Common Law, supra, note 97.

[99] Veljanovski, ibid.

conceptualised as a new form of doctrinalism. It conforms to traditional expository approaches with the substitution of "efficiency" for "coherence", "certainty", and other conventional values of the common law[100].

Secondly, it is argued that in attempting to provide "a new analytical structure for viewing a traditional legal problem" and by "pos[ing] ... in economic terms the problem ... [that] ... the legal structure or the legal doctrine confronts"[101], the neoclassical lawyer-economist misses the point of linking economics with law. These critics make three main arguments. Legal rules, it is suggested, do not function merely as prices within a pre-existing market system, as incentives and deterrents for individuals who engage in market behaviour, but they create the very frameworks of economic activity[102]. The point of this assertion is not just that without law there is no market, but that "market" practices as constituted by law are infinitely more complex and variable than is indicated in neoclassical economic models[103]. It is argued that we should focus on the question of how law

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100 A. Mitchell Polinsky, "Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law" (1974) 87 Harvard Law Review 1655; Veljanovski, "The Role of Economics in the Common Law", ibid.; Komesar, "In Search of a General Approach to Legal Analysis: A Comparative Institutional Alternative", supra, note 10; Jules Coleman, "Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law" (1984) 94 Ethics 649; Jules Coleman, Markets, Morals and the Law (Cambridge: Cambridge University Press, 1988); Toni Williams, "Of Scientism and Storytelling: Perspectives on the Economic Analysis of Remedies for Breach of Contract" in Canadian Perspectives on Legal Theory, Richard Devlin (ed.) (Toronto: Emond Montgomery, 1991).

101 Klevorick, "Law and Economic Theory: An Economist's View", supra, note 95, at 239.

102 Bernard Barber, "The Absolutisation of the Market" in Markets and Morals G. Dworkin, G. Bermant and P.G. Brown (eds.) (New York: John Wiley & Sons, 1977); Hugh Collins, The Law of Contract (London: Weidenfeld & Nicolson, 1986); Duncan Kennedy and Frank Michelman, "Are Property and Contract Efficient?" (1980) 8 Hofstra Law Review 711.

103 Samuels, "Interrelations between Legal and Economic Processes" supra, note 3.

constitutes the operation of economies, rather than how economic language might reformulate the problems of law. Scanlon, for example, comments that:

> even if the role of social institutions in generating binding agreements is confined to that of providing a ready-made matrix for the formation of mutual expectations, the fact remains that there are many systems of rules that might fulfil this role[104].

Simple advocacy of "the market", therefore, is thought not to confront the important economic issues for legal scholars, that is, the questions pertaining to which system of rules should be chosen and why?[105].

The richness and complexity of the institutional contexts of economic activity also raise the issue of choice between different types of contractual arrangements for the delivery of goods and services to production and use. To the extent that the specific set of rights and obligations in force in any particular context affects people in their economic lives, it seems important for economists to consider why the arrangements in force take the specific shape that is observed, and to reflect upon feasible alternatives. However, the tools of neoclassical economic analysis of law do not appear to be adequate to this task. For example, one might describe the UK as a society in which housing needs are generally met by contract. But this observation must be

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104 Thomas Scanlon, "Liberty, Contract and Contribution" in Markets and Morals, supra, note 102 at 47.

105 Coleman, Markets, Morals and the Law, supra, note 100; Warren J. Samuels "Welfare Economics, Power and Property" in Law and Economics: An Institutional Perspective, supra, note 3.

refined to take account of the vast range of contracting practices which govern the terms on which households obtain access to shelter. Not only are "Owner/debtor-occupation", public housing, voluntary sector rental and "for-profit" rental housing different categories of institutional practices, each with its own implications for the production and consumption of shelter, but there may be important variations within each category. Furthermore, there have been abrupt and evolutionary changes over time in the patterning of housing tenure.

There is no question that neoclassical law and economics is capable of modelling each type of housing market[106], nor that it has the analytical equipment to address the effects of discrete changes within each market[107]; we can also point to neoclassical economic commentary on the effects of policies which change relative prices on patterns of housing tenure[108]. By contrast, few would claim any great success for the neoclassical economists' handling of legal changes in the institutional matrix of housing provision which profoundly affect peoples' lives but are not readily conceptualised as prices[109]. Nor does the primary evaluative tool of neoclassical

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106 Adela A. Nevitt Housing, Taxation and Subsidies (London: Nelson, 1966).

107 See, for example, Steven N.S. Cheung "Roofs or Stars: The Stated Intents and Actual Effects of A Rent Ordinance" (1975) 13 Economic Inquiry 1.

108 Ibid., Nevitt, Housing Taxation and Subsidies, supra, note 106.

109 For example, neoclassical economic analysis of issues such as racially restrictive covenants and broad anti-discrimination legislation is not terribly compelling: see Gary S. Becker, The Economics of Discrimination (Chicago: University of Chicago Press, 1971) (2nd ed.); see also, Posner, The Economics of Justice, supra, note 88.

analysis - the concept of pareto efficiency - enable us to make meaningful comparisons between market economies where, for example, 60% of shelter is owner/debtor occupied, 30% is governed by "for-profit" rental contracts and 10% by "non-profit" rental contracts and co-operatives; and market economies where 30% is owner/debtor occupied, 30% is in the "for-profit" rental sector and 40% governed by non-profit rental contracts[110]. Faced with the questions: why do such differences exist? what do they mean? or which state is better?, neoclassical economic analysis resorts to description of the institutional variation between these two states in terms of the proportion of "market" and "non-market" modes of allocating shelter. This dichotomy not only fails to account for the differences observed, but its rhetoric may also lead us to neglect the contractual heart of each type of arrangement, miss the point of variations in contracting form, and ignore the wider economic context of arrangements for shelter.

Finally, some critics of neoclassical economic analysis of law maintain that the most important insight to be gained from linking law with economics is that the institutional frameworks by which resources are manage typically combine authority, direction and choice[111]. To analyse contract as

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110 R.C.O. Matthews, "The Economics of Institutions and the Sources of Growth" (1986) 93 The Economic Journal 903.

111 This point is made by writers working in different branches of comparative institutional analyses. Compare, for example, A. Allan Schmid Property, Power and Public Choice: An Inquiry into Law and Economics, (New York: Praeger, 1987) with Williamson, The Economic Institutions of Capitalism,

simply an expression of "voluntary exchange", it is said, misrepresents the factors which make contracts "work" and overlooks important criteria by which to evaluate different modes of contracting[112].

4. Contemporary Sources of Comparative Institutionalism

a. The Evolution of Transactional Economics

Despite the rich legacy of early 20th century thinking about contract law and the market, the re-integration of legal and economic thinking within an institutionalist paradigm has evolved more slowly than neoclassical law and economics. Oliver Williamson attributes this relatively sluggish progress to the problem of developing viable analytical tools[113]. His point is that although the concept of the "transaction", and the idea that the content of law might affect the costs of transacting had emerged in the 1930's, it was not until the 1970's that there developed a method and a language for making systematic connections between law, the structure of economic institutions and the costs of economic activity. Since the concept of "transaction costs" has been rendered operational, transactional economic analyses of contractual governance have

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supra, note 3.

112 Ibid.

113 Williamson, The Economic Institutions of Capitalism, supra, note 3, Prologue.

developed rapidly[114]. While much of the literature is primarily concerned with refining the conceptual apparatus of the theory, there is a growing body of empirical studies of transaction governance[115].

Williamson is clearly right to stress that the "operationalising" of transaction costs, around such concepts as "bounded rationality", "opportunism", "uncertainty" and "asset specificity", was an important breakthrough. However, it would be a mistake to overlook the range of ideas that had to be challenged by the transactional economists. Even to make the point that contracting practices are shaped by the entire institutional context in which they are located, these theorists have to confront the academic lawyer's tradition of

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[114] In addition to the works by Williamson, cited above, see Williamson, "Assessing Vertical Market Restrictions" (1979) 127 University of Pennsylvania Law Review 953; "The Economics of Organization: The Transaction Cost Approach" (1981) 87 American Journal of Sociology 548; "Corporate Governance" (1984) 93 Yale Law Journal 1197; "Assessing Contract" (1985) 1 Journal of Law, Economics & Organization 177; Goldberg, "Regulation and Administered Contracts" (1976) 7 Bell Journal of Economics 426; "The Law and Economics of Vertical Restrictions: A Relational Perspective" (1979) 58 Texas Law Review 91; "Relational Exchange: Economics and Complex Contracts" (1980) 23 American Behavioural Scientist 337; "Price-Adjustments in Long-Term Contracts" 1985 Wisconsin Law Review, 527; Benjamin Klein "Vertical Integration as Organizational Ownership: The Fisher Body - General Motors Relationship Revisited" (1988) 4 Journal of Law, Economics, & Organization 199. Steven N.S. Cheung "Transaction Costs, Risk Aversion and the Choice of Contractual Arrangements" (1969) 12 Journal of Law & Economics. 23; Kirk Monteverde and David J. Teece, "Appropriable Rents and Quasi-Vertical Integration" (1982) 25 Journal of Law & Economics. 321.

[115] For an overview of the empirical literature, see, Paul L. Joskow, "Asset-Specificity and the Structure of Vertical Relationships: Empirical Evidence" (1988) 4 Journal of Law, Economics & Organization 92. For examples of specific empirical studies, see, Mark Casson "The Role of Vertical Integration in the Shipping Industry" 1986 20 Journal of Transport Economics and Policy 7; Victor P. Goldberg and John R. Erickson, "Quantity and Price Adjustment in Long-term Contracts: A Case Study of Petroleum Coke" (1987) 30 Journal of Law & Economics 369; Joskow, "Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants" (1985) 1 Journal of Law, Economics, & Organization 33; Joskow, "Contract Duration and Relation-Specific Investment: Empirical Evidence from Coal Markets" (1987) 77 American Economic Review 168; Scott Masten, "The Organization of Production: Evidence from the Aerospace Industry" (1984) 27 Journal of Law & Economics 403; Kirk Monteverde and David Teece, "Supplier Switching Costs and Vertical Integration in the Automobile Industry" (1982) 13 Bell Journal of Law & Economics 206; J. Harold Mulherin, "Complexity in Long-term Contracts: An Analysis of Natural Gas Provisions" (1986) 2 Journal of Law, Economics, & Organization 105; Thomas Palay "Comparative Institutional Economics: The Governance of Rail Freight Contracting" (1984) 13 Journal of Legal Studies 265.

legal centralism[116], and the neoclassical economists' commitment to market determinism. In order to argue that firms are conceptually related to contracts, and markets, the transactional economist must flesh out the "logical primitives" of the neoclassical analysis[117], and seek out the hidden meanings of lawyers' rich descriptions of corporate forms. It is one thing to assert that social, political and cultural influences are important determinants of contractual practice, it is quite another to show how such norms affect economic decisions on a daily basis.

The analytical tools developed by the transactional economists are explained in chapter two and applied in succeeding chapters. It will be seen that this form of economic analysis is connected to ideas derived from a variety of contemporary intellectual traditions. Empirical scholarship from the Law and Society movement is used as a basis for theorising about relationships between contract law and the operation of business transactions, and "social exchange" theories are a source of insights into the cultural practices which enable contracts to function. Economic theories of the firm, and theories of bargaining games provide additional ideas about the functions of contractual governance. It is

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[116] Legal centralism refers to the form of analysis which views judicial decision-making about contract as the primary, if not exclusive, object of enquiry. Legal centralism may be contrasted with the "private ordering" tradition which focuses on the governance of economic and social affairs "outwith" the law: see, Harry W. Arthurs, Without the Law (Toronto: University of Toronto Press, 1985), Jerrold Auerbach, Justice Without Law? (New York: Oxford University Press, 1983) and references, infra.

[117] Winter uses this term to refer to the role of the concepts of "consumer" and "firm" in neoclassical economic models, "On Coase, Competence and the Corporation", supra, note 48 at 165.

this conjunction of economic and social theorising about the process and practices of contracting which grounds the comparative institutional approach taken in this thesis.

b. The Practices of Contract and Theories of Social Exchange

The primary insight to be gleaned from the work of those who have investigated the question of how business transactions are governed is that law is seldom overtly experienced to be a driving force in the making and implementation of contracting decisions[118]. Empirical research indicates that economic actors routinely rely on factors such as general reputation, norms arising out of personal relationships, and expectations of future business as alternatives to the drafting and legal enforcement of comprehensive contracts[119]. These studies also suggest, however, that we should not be too sanguine about "non-contractual" business relations[120]. Trust may be abused,

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118 Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study" (1963) 28 American Sociological Review 55; "The Standardized Contracts of US Automobile Manufacturers" 7 International Encyclopedia of Comparative Law chap.3, 3-22 - 3.29; Law and the Balance of Power (New York: Russell Sage Foundation, 1966); Hugh Beale and Anthony Dugdale, "Contracts between Businessmen: Planning and the Use of Contract Remedies" (1975) 2 British Journal of Law and Society 45; Richard Lewis, "Contracts between Businessmen: Reform of the Law of Firm Offers and an Empirical Study of Tendering Practices in the Building Industry" (1982) 9 Journal of Law and Society 153; Terence Daintith, "The Design and Performance of Long-Term Contracts" in Contracts and Organisation: Legal Analysis in the Light of Economic and Social Theory Terence Daintith and Guenther Teubner, (eds.) (Berlin: Walter de Gruyter, 1986). For Macaulay's reflections on the insights to be gleaned from the empirical studies, see "Elegant Models, Empirical Pictures, and the Complexities of Contract" (1977) 11 Law & Society Review 507; "An Empirical View of Contract" 1985 Wisconsin Law Review 465.

119 Ibid.

120 Robert Gordon, "Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law" 1985 Wisconsin Law Review 565; Macaulay, Law and the Balance of Power, supra, note 118; Macaulay, "An Empirical View of Contract", supra, note 118.

personal relationships can break down and informal co-operation may exact a high price. Nevertheless, in view of the studies, the comparative institutionalist insists that it would be a mistake to treat apparent "failures" of informalism as a justification for greater reliance on contract / commercial law, and that it would be just as foolish to maintain that "abusive" behaviour would not occur unless it were in some way "efficient"[121]. Rather than adopt either of these positions, the comparative institutionalist argues that the problems of contractual governance in the "real-world" can be understood, and therefore addressed, only by reference to the entire institutional context of the transaction. This context would include the "informal" practices, the terms of the contract, the governing law, the particular market context, and the state defined property rights which each participant brings to a deal.

The empirical scholarship is primarily concerned with observation of private ordering practices and commentary on the implications of what is observed for lawyers traditional assumptions about relationships between contract law and business behaviour. Guidance as to how we might analyse relationships between "informal", "contractual" "legal" and "market" influences on economic behaviour can be found in the

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[121] This literature demonstrates for example, that opportunism may exist even where the opportunist is performing in accordance with the terms of the contract, see, for example, Hugh Beale, Don Harris, & Thomas Sharpe, "The Distribution of Cars: A Complex Contractual Technique", Contract Law Today: Anglo-French Comparisons, Donald Harris & Dennis Tallon (eds.) (Oxford: Clarendon Press, 1989); Stewart Macaulay, Law and the Balance of Power , supra, note 118; Robert Gordon, "Macaulay, Macneil and the Discovery of Solidarity and Power in Contract Law" 1985 Wisconsin Law Review 565.

work of sociologists, anthropologists, economists, and academic lawyers working in the relational contract tradition[122]. Comparative institutionalists draw two important insights out of this body of work. First, the idea that "market exchange behaviour ... is prescribed by values and norms, regardless of motivation, and ... depends for its possibility on a definite set of institutional arrangements"[123], grounds the premise that analysis of contracting behaviour should be situated in the context of the cultural practices of the society taken as a whole. This part of the social exchange perspective provides a dramatic contrast with the (implicit) presumptions of some neoclassical theorists that the model of market exchange reflects a "natural" or universal mode of social interaction, and that market exchange parallels non-market modes of social ordering. Those who argue that cultural institutions profoundly shape

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[122] See, for examples, George C. Homans, "Social Behavior as Exchange" (1958) American Journal of Sociology 597; Homans, Social Behavior, (New York: Harcourt, Brace & World, 1961); Alvin Gouldner "The Norm of Reciprocity" (1960) 25 American Sociological Review 161; Marcel Mauss, The Gift (Glencoe: Free Press, 1954), Clifford Geertz, Local Knowledge: Fact and Law in a Comparative Perspective (New York: Basic Books, 1983); Sally Falk Moore "Law and Social Change: the Semi-Autonomous Social Field as an Appropriate Subject of Study" (1973) 7 Law and Society Review 719; Falk Moore, Law As Process (London: Routledge & Kegan Paul, 1978); Shmuel N. Eisenstadt & Luis Roniger, Clients, Patrons and Friends: Interpersonal Relations and the Structure of Trust in Society (New York: Cambridge University Press, 1984); J. David Lewis & Andrew Weingert "Trust as a Social Reality" (1985) 63 Social Forces 967; Barbara Yngvesson, "Re-Examining Continuing Relations and the Law" 1985 Wisconsin Law Review 623; Peter Blau, Exchange and Power in Social Life (New Brunswick, USA: Transaction Books, 1986); S. Todd Lowry, "Bargain and Contract Theory in Law and Economics (1976) 10 Journal of Economic Issues 1; Y. Ben-Porath, "The F-Connection: Families, Friends, and Firms and the Organization of Exchange" (1980) 6 Population and Development Review 1; George Akerlof, "Labour Contracts as Partial Gift Exchange" (1982) 97 Quarterly Journal of Economics 543; Ian R. Macneil, "Contracts: Adjustments of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law" supra, note 15; The New Social Contract: An Inquiry into Modern Contractual Relations, supra, note 11; "Economic Analysis of Contractual Relations" in The Economic Approach to Law, supra, note 23, 61-92; "Relational Contract: What We Do and Do Not Know" 1985 Wisconsin Law Review 483; John Bell, "The Effect of Changes in Circumstances on Long-term Contracts: English Report" in Contract Law Today: Anglo-French Comparisons, supra, note 121.

[123] Barber, "The Absolutisation of the Market", Markets and Morals, supra, note 102 at 26.

market practices criticise neoclassical models for assuming away the "ethical elements ... without [which] no market could function"[124], and failing to acknowledge that "[t]rust and similar values, loyalty or truthtelling, are ... not commodities for which trade on the open market is technically possible or even meaningful"[125]. Social exchange theorists maintain that these premises, together with the commitment to methodological individualism, lead neoclassical theorists to over-emphasise the role of self-interest as a driving force in social relations, obscure the socially constructed nature of economic choices, and render invisible the values which make contracts work[126].

Secondly, the work of social exchange and relational theorists suggests that it is analytically helpful to think about contracting behaviour in terms of a spectrum of social ordering practices. The analyses diverge on the question of how the spectrum might be constructed according to the particular interests of the theorists and the level of complexity which is believed to be required[127]. For some the

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124 Kenneth Arrow Information and Economic Behaviour (Stockholm: Federation of Swedish Industries 1973) at 24.

125 Kenneth Arrow, The Limits of Organization (New York: W.W. Norton, 1974) at 23.

126 In addition to the references cited above, supra, note 122, see, Ian R. Macneil "Values in Contract: Internal and External" (1983) 78 Northwestern University Law Review 340; Macneil, "A Primer of Contract Planning" (1975) 48 Southern California Law Review 627. As is noted by Kenneth Arrow:

> There is an element of trust in every transaction.... It is not adequate to argue that there are enforcement mechanisms, such as police and the courts; there are themselves services bought and sold, and it has to be asked why they will in fact to what they have contracted to do.

Information and Economic Behaviour, supra note 124 at 24.

127 See Macneil's debate with Williamson about the desirability of "rich classificatory apparatuses"; Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" supra, note 6; Macneil, "Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a 'Rich

interesting question is the relative degrees of autonomy of "contract" from law and other state institutions[128]. Others are concerned with sources of obligations to reciprocate and social patterns by which the norm of reciprocity is maintained[129]. The theorist may choose to explore power relations embedded in different modes of exchange or they may structure their spectrum around degrees of "participation" in decisions which impact on people's economic lives[130]. Some bound their continua with values, such as the degree to which transactions depend upon trust, altruism, or good faith[131], others rely upon social forms, such as household-family-community-nation[132]. The important commonality underlying these differences is a shift from organising knowledge about economic relationships around sharp dichotomies and oppositional dualisms such as "public v. private" "market v. state" to a focus on connections and continuity in form, functions, values, or purposes[133].

Classificatory Apparatus'" (1981) 75 Northwestern University Law Review 1018.

128 Sally Falk Moore, "Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study", supra, note 122.

129 Blau, Exchange and Power in Social Life, supra, note 122; Homans "Social Behavior as Exchange" supra, note 122; Gouldner, "The Norm of Reciprocity", supra, note 122.

130 Philip A. Klein, "Power and Economic Performance: An Institutionalist View" (1987) 21 Journal of Economic Issues 1341.

131 Ian R. Macneil, "Values in Contract: Internal and External" (1983) 78 Northwestern University Law Review 340.

132 Gideon Gottlieb, "Relationism: Legal Theory in a Relational Society", supra, note 15.

133 This is a particularly important theme in critical and feminist analyses of social organisation through the instrument of contract, see, for example, Clare Dalton, "An Essay on the Deconstruction of Contract Doctrine" supra, note 40, Mary Jo Frug, "Reading Contracts: A Feminist Analysis of A Contracts Casebook" (1985) 34 American University Law Review 1065; Peter Gabel, "Intention and Structure in Contractual Relations: Outline of a Method for Critical Legal Theory" (1977) 61 Minnesota Law Review 601; Fran Olsen, "The Family and the Market: A Study of Ideology and Legal Reform" (1983) 96 Harvard Law Review 1497. See also, Edythe Miller, "Economics for What? Economic Folklore and Social Realities" (1989) 23 Journal of Economic Issues 339.

c. Economic Theories of the Firm

Scholars working in the area of economic theories of the firm seek to explain why the relationships which form the structures within which goods and services are produced assume particular institutional contours. The literature ranges from historical accounts of the evolution of corporate forms of governance[134], through models of business decision-making[135], to policy analyses of specific instruments for regulating the supply of particular products[136]. Underlying the diversity is a conception of "the firm" as an organisational framework which shapes decisions about the production and the distribution of goods and services.

Recent developments in contractual theories of the firm operate within two paradigms which are not readily subsumed within a larger explanatory framework[137]. "Property rights" theories conceptualise the firm as a conglomeration of

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[134] Alfred D. Chandler Jr. The Visible Hand: The Managerial Revolution in American Business (Camb., Mass.: Harvard University Press, 1977); Chandler & Herman Daems (eds.) Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise (Camb., Mass.: Harvard University Press, 1980), Leslie Hannah, The Rise of the Corporate Economy (London: Methuen, 1983).

[135] Herbert A Simon, The New Science of Management Decision (New York: Harper & Row, 1960) Richard M. Cyert & James G. March, A Behavioural Theory of the Firm (Englewood Cliffs, N.J.: Prentice-Hall, 1963).

[136] Industrial Organization, Antitrust and Public Policy John Craven (ed.) (Boston: Kluwer-Nijhoff, 1982); Oliver E. Williamson, "The Economics of Antitrust: Transaction Cost Considerations" (1974) 122 University of Pennsylvania Law Review 1439.

[137] Oliver D. Hart, "Incomplete Contracts and the Theory of the Firm" (1988) 4 Journal of Law, Economics and Organization 119.

ordinary market contracts[138]. As in the case of the market, the contractual arrangements which make up the firm are taken to establish the terms on which resources protected by private property rights are to be deployed in the production of goods and services[139]. Thus, the contracts which constitute the firm function simply to integrate resources into production. While these theorists reject the idea that one can draw conceptual distinctions between the contracts of the firm and the contracts of the market, they recognise variations in contracting patterns as the central puzzle for economic enquiry[140]. The theory of the firm is a search for the economic logic behind the clustering of transactions into regular patterns of interaction, in contradistinction to the disaggregated pattern of market transactions. This literature relies on neoclassical techniques of optimising analysis and its ultimate goal is to explain how patterns or systems of exchange shape productive outcomes[141]. The following comment by Harold Demsetz illustrates the type of issue that might be found on the property rights research agenda:

> The firm properly viewed is a "nexus" of contracts. Our interest might center on explaining (1) the

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138 Armen A. Alchian & Harold Demsetz "Production, Information Costs and Economic Organization" (1972) 62 American Economic Review 777; Steven N.S. Cheung "The Contractual Nature of the Firm" (1983) 26 Journal of Law & Economics 1; Fred McChesney, "Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis" (1982) 11 Journal of Legal Studies 379. Robert Hessen "A New Concept of Corporations: A Contractual and Private Property Model" (1979) 30 Hastings Law Journal 1327.

139 Oliver D. Hart, "The Market Mechanism as an Incentive Scheme" (1983) 14 Bell Journal of Economics 366.

140 Harold Demsetz, "The Theory of the Firm Revisited" supra note 14.

141 Steven N.S. Cheung "Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements" (1969) 12 Journal of Law and Economics 23.

> persistence of certain types of contracts that are found in this nexus, (2) the variation observed in other types of contracts that are "more or less" included in this nexus, and (3) the (horizontal and vertical) scope of activities covered by these contracts[142].

Transactional economists working in the area of theories of the firm follow Coase[143] in asserting that vertical integration substitutes hierarchy for the price mechanism, and authority for market incentives and deterrents. These theorists characterise the firm as a governance structure which is distinguishable from the market, and posit that the choice between these forms of governance is driven by the transaction costs of resource management[144]. This approach also treats contract as an integrative device by which resource suppliers are brought within the ambit of governance, however, "firm-like" governance is perceived to be qualitatively different from market governance[145]. In effect, the firm functions to <u>insulate</u> economic activity from market imperatives[146]. In view of their conceptualisation of the firm as analytically distinct from market transactions, the main issue on the intellectual agenda of these theorists is to

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142 "The Theory of the Firm Revisited" <u>supra</u>, note 14 at 155.

143 "The Nature of the Firm", <u>supra</u>, note 9.

144 <u>Supra</u> notes 114 and 115.

145 Scott Masten, "A Legal Basis for the Firm" (1988) 4 <u>Journal of Law Economics and Organization</u> 181.

146 Transactional economists argue that vertical integration reduces opportunism (in the form of redistributive bargaining) <u>because</u> it shelters economic activity from the "high-powered" self-interest incentives of the market, whereas property rights theorists argue that firms create a risk of opportunism (in the form of "shirking") <u>unless</u> "firm-like" transactions can be exposed to market forces. See Demsetz, "The Theory of the Firm Revisited", <u>supra</u>, note 12 at 152-153, for a helpful elaboration of this point, see also, Hart, "Incomplete Contracts and the Theory of the Firm", <u>supra</u>, note 137. For further discussion of this issue, see, chapter V, <u>infra</u>.

explain the factors which drive the choice between firm and non-firm modes of organisation. Recent work has sought to operationalise the Coasian hypothesis by developing a more sophisticated typology of governance forms, identifying the factors which cause transactions to differ, and formulating a methodology by which to match transactions to governance structures[147].

Economists working in the area of agency theory have also contributed to understanding of "the nexus of contracts that makes up the firm"[148]. These theorists are engaged in exploring the governance implications of economic relationships in which one party (the principal, "P") hires another (the agent, "A") to make decisions on her (P's) behalf and the parties are neither perfectly nor symmetrically informed. Such transactions have three important economic characteristics[149]. First, it is costly for the agent wholeheartedly to pursue the interests of the principal. Secondly, it is costly for the principal to verify whether or not the agent supplies skill and expertise of the standard agreed. Finally, P takes the benefits from A's activity net of the costs (including A's fee) of obtaining that outcome. This type of transaction

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[147] See references, supra, notes 114 and 115.

[148] Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure" (1976) 3 Journal of Financial Economics 305.

[149] A. Michael Spence and Richard J. Zeckhauser, "Insurance, Information and Individual Action" (1971) 61 American Economic Review 380; Zeckhauser & John W. Pratt (eds.) Principals and Agents: The Structure of Business (Boston: Harvard Business School Press, 1985) Stephen A. Ross, "The Economic Theory of Agency: The Principal's Problem" (1973) 62 American Economic Review 134; Jensen and Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" ibid.; Eugene F. Fama and Michael C. Jensen "Separation of Ownership and Control" (1983) 26 Journal of Law & Economics 301.

presents a risk that interests will conflict during contract execution, and that A will pursue her own interests at the expense of P[150]. The problem of governance is one of determining how best to ensure sufficient agent autonomy that the principal will benefit from the agent's skill and simultaneously to prevent the agent from taking advantage of the principal[151].

Agency theory has been used to provide a conceptual lens through which to view the relationship between management and shareholders of a firm, a relationship which is conceived as a transaction by which shareholders delegate rights to control decision-making to management[152]. Theorists seek to identify means of structuring payment and organising other incentive schemes which will constrain management discretion in situations where the pursuit of managerial self-interest would conflict with the interests of shareholders[153].

d. Theories of Bargaining

The comparative institutional conception of contract as not only the outcome of a bargained agreement, but also a site

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150 Ibid.

151 Ibid.

152 Eugene Fama "Agency Problems and the Theory of the Firm" (1980) 88 Journal of Political Economy 288; see, generally, the symposium held in honour of the fiftieth anniversary of the publication of The Modern Corporation and Private Property Adolph A. Berle & Gardiner C. Means (New York: Macmillan, 1932), in (1983) 26 Journal of Law and Economics "Corporations and Private Property".

153 Ibid., and supra, note 149; see also Steven Shavell, "Risk-Sharing and Incentives in the Principal and Agent Relationship" (1979) 10 Bell Journal of Economics 55; Eugene F. Fama & Michael C. Jensen "Agency Problems and Residual Claims" (1983) 26 Journal of Law & Economics 327.

for on-going bargaining raises the question of how contractual participants develop and maintain commitments to co-operate throughout a process - bargaining - which encourages the expression of conflicting interests. The problem for economic actors is that contractual bargaining by no means always involves "exploring for mutually profitable adjustments"[154]. The problem for the economic theorist is that even "efficiency-oriented" bargains provoke the non-trivial question of the distribution of the benefits and costs of "mutually profitable adjustments", while the issue of "distribution" is critical to our analysis of zero-sum bargains[155].

Some assistance in interpreting bargaining behaviour is to be found in the work of those developing bargaining and game theoretical accounts of economic behaviour[156]. These scholars are interested in the general question of how autonomous and imperfectly informed agents make realistic and realisable commitments to co-operate in the absence of an external enforcer[157]. They analyse the strategies and tactics

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154 Thomas C. Schelling, "An Essay on Bargaining" (1956) 46 American Economic Review 291 at 291.

155 Williamson, "Credible Commitments: Using Hostages to Support Exchange", supra, note 46.

156 Robert Axelrod, The Evolution of Co-operation, (New York: Basic Books, 1983); Masahiko Aoki, The Co-operative Game Theory of the Firm (Oxford: Oxford University Press, 1984); Thomas C. Schelling, Choice and Consequence (Camb., Mass: Harvard University Press, 1984).

157 For an early articulation of this theme in the context of contract law, see Oliver Wendell Holmes, The Common Law, supra, note 49. See also Anthony Kronman "Contract Law and the State of Nature", supra, note 84; Benjamin Klein & Keith Leffler, "The Role of Market Forces in Assuring Contractual Performance" (1981) 89 Journal of Political Economy 615; Williamson, "Credible Commitments: Using Hostages to Support Exchange" supra, note 46; Robert Sugden, The Economics of Rights, Co-operation, and Welfare (Oxford: Blackwell, 1986), especially at 104-111; Drew Fudenberg & Eric Maskin "The Folk-Theorem in Repeated Games with Discounting or with Incomplete Information" (1986) 54 Econometrica 533.

of demonstrating commitment -- the games people play to show that they will do what they have said they will do, and that they have told all that they are able to tell.

Although this literature by no means enables an observer to resolve the indeterminacy of bargaining, it does provide some guidance for our thinking about contractual governance. First, it establishes a framework for interpreting bargaining behaviour and types of commitment practices[158]. This framework enables us to clarify rationales for otherwise puzzling choices by economic actors, and classify contractual practices into analytically distinct categories. For example, most contract scholars probably believe that bargains which result in every party feeling that she or he is better off are different from those which are purely redistributional. We may or may not be concerned about the distribution of gains and losses in the former situation, but only the most paternalistic would hold that they are the same.

Secondly, bargaining and game theoretical accounts of economic activity provide a basis for distinguishing between conditions which are conducive to co-operation and those which are not[159]. Such conditions may be located in the institutional context of a transaction or in the "working rules" of governance. In either case, they are the result of decisions

158 See, in particular, Kronman, ibid., Schelling, supra, note 55; Schelling, "Enforcing Rules on Oneself" (1985) 1 Journal of Law, Economics and Organization 357; Williamson, "Credible Commitments: Using Hostages to Support Exchange", supra, note 46.

159 Ibid., see also Sugden, supra, note 157, Amartya Sen, "Goals Commitment and Identity" (1985) 1 Journal of Law, Economics and Organization 341.

which, in theory at least, are open to change. Evidence that economic actors continue to operate under apparently dysfunctional conditions may, therefore, spur investigation of problems in the institutional matrices of economic activity.

Finally, this body of work forces us to confront relationships between the law relating to contracts, contractual practices and transactional security[160]. In particular, the observation that participants in contractual arrangements frequently use non-legal commitment strategies offers a profound challenge to the legal centralist tradition[161]. Bargaining theorists remind us that we cannot simply assume that the institutional practice of common law, as administered by courts, functions to secure contractual co-operation.

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160 Kronman, "Contract Law and the State of Nature", supra, note 84; Klein & Leffler, "The Role of Market Forces in Ensuring Contractual Performance" supra, note 157; Lewis Kornhauser, "Reliance, Reputation and Breach of Contract" (1983) 26 Journal of Law and Economics 691; David Charney, "Non-Legal Sanctions in Commercial Relations" (1990) 104 Harvard Law Review 373.

161 Ibid., see also Carl Shapiro, "Premiums for High Quality Products as Returns to Reputations" (1983) 98 Quarterly Journal of Economics 659; Daniel K. Benjamin "The Use of Collateral to Enforce Debt Contracts" (1978) 16 Economic Inquiry 333.

Chapter II Methodology

Comparative institutional analysis of transactional governance combines a contractual vision of organisation with an institutional perspective on contract. It shares with the empirical literature a conception of contract as "private ordering" technique, and follows the example of social exchange theorists in locating transactional practices on a continuum of social interaction. The comparative institutionalist, like Commons and Llewellyn, is interested in the "working rules" of contractual practices, and, like Coase, uses the language of "transaction costs" to name contractual problems. As in the case of other instrumental approaches to law and the economy, a central concern of comparative institutionalism is the relationship between contract, "culture", the state, and the market.

The survey of literature in the preceding chapter indicated that the comparative institutional approach purports to offer a new fusion of legal and economic perspectives. This chapter focuses on the mechanics of achieving this synthesis. Its primary objective is to introduce the main conceptual tools of comparative institutional analysis of contractual organisation, as they are used in this thesis. Part A describes the idea of contractual governance and part B defines the primary transaction costs which are relevant to our subsequent analysis. Part C addresses the issue of power in contractual relations. Part D discusses the general idea of "contractual culture" and focuses specifically on the role of law in constituting the culture of contracting. Part E engages with the debate over the role of "efficiency" in comparative institutionalism and part F outlines the main values which shape our analysis. The concluding section draws together these issues and concepts into a framework for general analysis of contractual decision-making and our specific study of the Joint Contracts Tribunal Standard Form of Building Contract (1980 edition) (JCT80).

A Governance

The idea of governance provides an important statement of perspective on contract. The construction of "contract" as a framework for governing a "transaction" reflects a belief that decisions about contract are at least as significant as decisions whether or not to contract. Decisions about contract reflect choices between alternative decision-making institutions, each with its own structure, "culture", and context, and each with its own configuration of costs and benefits[1]. Decision-makers are viewed as mainly concerned with

[1] Neil Komesar, "In Search of A General Approach to Legal Analysis: A Comparative Institutional Alternative" (1981) 79 Michigan Law Review 1350; Oliver E. Williamson The Economic Institutions of Capitalism: Firms, Markets and Relational Contracting (New York: Free Press, 1985); A. Allan Schmid,

the extent to which different governance structures facilitate achievement of economic goals, an attribute which turns, in part, on the capacity of governance structures to enhance the quality of relationships between parties during a transaction[2]. The comparative institutionalist, therefore, is interested in the structuring of contractual decision-making after "formation"[3], as well as the ex ante patterning of incentives. Williamson describes this holistic perspective as viewing contract "in its entirety"[4].

The implications of economic actors' choice of governance structure has been likened to relationships between the parts of a complex piece of machinery[5]. This analogy makes the point that just as friction between components impedes efficient operation of physical equipment, a badly adapted form of governance results in transaction costs which interfere with the smooth running of an economic relationship[6]. Where the reward for servicing and maintaining a car lies in safer, cheaper, and more comfortable performance, the return on investment in transactional governance is to be found in the

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"Law and Economics: An Institutional Perspective" in Law and Economics Nicholas Mercuro (ed.) (Boston: Kluwer, 1989); Leonid Hurwicz, "The Design of Mechanisms for Resource Allocation" (1973) 63 American Economic Review, (papers and proceedings) 1.

[2] Williamson, The Economic Institutions of Capitalism: Firms, Markets and Relational Contracting Ibid.; Victor P. Goldberg "Relational Exchange: Economics and Complex Contracts" (1980) 23 American Behavioural Scientist 337.

[3] The idea of "formation" with its connotations of a sharp beginning to contractual relations may be an inappropriate characterisation of transactions which are not organised in the classical mode, see, Ian R. Macneil, "A Primer of Contract Planning" (1975) 48 Southern California Law Review 627.

[4] The Economic Institutions of Capitalism, supra, note 1 at 35.

[5] Ibid., at 19.

[6] Victor P. Goldberg "Price-Adjustments in Long-Term Contracts" 1985 Wisconsin Law Review 527.

relative ease with which choices are made, activities are co-ordinated, and decisions are implemented[7].

The concept of "governance" is also used as an expression of the "working rules"[8] of particular contractual practices[9]. Working rules dictate, more or less explicitly, how decisions are to be made and how things are to be done. They are constituted by legal norms, industry practices and social understandings which together comprise the "culture" of contracting[10]. For example, the competitive market of neoclassical microeconomic models might be characterised in institutional terms as "an organization of behaviour for decisions upon allocation and use of economic resources ... through private bargain and plan"[11]. While market decisions may be expressed in voluntary exchanges, driven by utility functions and directed by prices, they are governed by working rules comprised of private property rights[12], competition, and

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7 Ibid.

8 John R. Commons, Institutional Economics: Its Place in Political Economy (Madison: University of Wisconsin Press, 1959). For a helpful discussion of contemporary institutionalist perspectives on governance and "working rules" see Walter C. Neale "Institutions" (1987) 21 Journal of Economic Issues 1177.

9 Victor P. Goldberg "Toward an Expanded Economic Theory of Contract" (1976) 10 Journal of Economic Issues 45; Robert Hessen "Separation of Ownership and Control: A Reappraisal" (1983) 26 Journal of Law & Economics 280.

10 Ian R. Macneil The New Social Contract: An Inquiry into Modern Contractual Relations, (New Haven: Yale University Press, 1980); Ronald Dore, "Goodwill and the Spirit of Market Capitalism" (1983) 34 British Journal of Sociology 459.

11 J. Willard Hurst, Law and Economic Growth: The Legal History of the Lumber Industry in Wisconsin 1836-1915, (Cambridge, Mass.: Harvard University Press, 1964) 1964) at 285-6.

12 A.Allan Schmid Property, Power and Public Choice: An Inquiry into Law and Economics (New York: Praeger, 1987).

the rules, practices, and understandings which set limits to the permissible expression of self-interest[13].

B Transaction Costs

1 The Role of Transaction Costs in Comparative Institutional Analysis

The concept of transaction costs is the central analytical tool of comparative institutionalism. At a general level, the idea of transaction costs makes the point that relations between persons are at least as important as relations between persons and things to explanations of economic activity[14]. More specifically, the concept of transaction costs is used as a description of the hazards which economic actors confront in managing their economic lives, a justification for the existence of governance structures, and a basis for comparing different modes of governance[15].

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[13] These norms may be social, moral or cultural, and encoded in a variety of institutional forms, such as law, reputation and professional or business practices. Such institutionalised limits on self-interest are examples of Veblen's "serviceable" industrial practices, promoting "non-invidious interests": "The Theory of the Leisure Class & Other Industrial and Pecuniary Employments" in Thorstein Veblen The Place of Science in Modern Civilization and Other Essays (New York: Russell & Russell, 1961), see chapter I, supra.

[14] R.C.O. Matthews, "The Economics of Institutions and the Sources of Growth" (1986) 96 Economic Journal 903.

[15] See Cento G. Veljanovski The New Law-and-Economics: A Research Review (Oxford: SSRC, Socio-Legal Centre, 1982) for a helpful discussion of normative, positive and descriptive uses of economic reasoning. Transactional economists typically combine descriptive, normative and analytical uses of the concept of transaction cost may be combined: see, for example, Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (New York: The Free Press, 1975); Charles R. Knoeber, "A Real Game of Chicken: Contracts Tournaments, and the Production of Broilers" (1989) 5 Journal of Law, Economics and Organization 271; Christopher Grandy, "Can Government be Trusted to Keep its Part

This thesis adopts the comparative institutionalist approach of combining descriptive, normative, and analytical uses of the concept of transaction costs. It is argued that the variability of contracting forms cannot be explained by reference to (material) production costs alone but is also related to the costs of organising and preserving relationships between those who control resources. It is also maintained that contractual relationships are put at risk, or made more difficult, by factors which may be described as sources of transaction costs, or "transaction hazards", and that different modes of contract reflect varying, but comparable, responses to these costs. With respect to the standard form building contract, it is argued, additionally, that the organisation of production embedded in this form of governance may be seen as a response to identifiable sources and manifestations of transaction costs.

2 Definitions and Sources of Transaction Costs

Transaction costs have been defined as "the costs of running the economic system"[16]; "the costs of running the

of a Social Contract?: New Jersey and the Railroads, 1825 - 1888" (1989) 5 Journal of Law, Economics and Organization 271.

16 This definition has been quoted by Williamson on a number of occasions, see, for example, "Transaction Cost Economics: The Governance of Contractual Relations" (1979) 22 Journal of Law and Economics 233 and The Economic Institutions of Capitalism, supra, note 1. The reference given by Williamson is to Kenneth J. Arrow, "The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Nonmarket Allocation" in The Analysis and Evaluation of Public Expenditure: The PPB System. Vol. 1. US Joint Economic Committee, 91st Congress, 1st Session. (Washington DC: US. Govt. Printing Office 1969) 59-73, at 48 (sic).

contractual relation"[17]; and "the costs of using the market"[18]. In this last sense, the notion of "transaction costs" may be understood as the resources consumed in the following processes:

> In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed...[19].

Comparative institutionalism follows the general tenor of Coase's description, but as the market is viewed as just one among many sites of transacting behaviour, any concept of transaction costs must also be capable of application to non-market forms of contracting[20]. Thus, for Wachter and Williamson, transaction costs are "the costs of planning, adapting and monitoring task completion under alternative forms of contracting"[21].

Of the many "transactional hazards" which may disrupt the

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[17] Ian R. Macneil, "Economic Analysis of Contractual Relations" in Paul Burrows & Cento G. Veljanovski (eds.) The Economic Approach to Law (London: Butterworths, 1981) at 62.

[18] Cento G. Veljanovski, The New Law-And-Economics: A Research Review (Oxford: SSRC, Socio-Legal Centre, 1982).

[19] Ronald H. Coase, "The Problem of Social Cost", (1960) 3 Journal of Law and Economics 1 at 15.

[20] Coase has been criticised for apparently assuming that the transaction costs attendant on market governance of contracts "disappear" when the same activity is governed by the firm: Sanford J. Grossman & Oliver D. Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94 Journal of Political Economy 693. However, it is clear from Coase's entire body of work in the area of transaction costs that his point is that markets and firms or markets and governments constitute different institutional settings for governing economic activity, and that each institutional setting generates transaction costs. The problem for economic enquiry, therefore, is to trace the relationships between institutional context, and transaction costly behaviour: Coase, "The Nature of the Firm" (1937) 4 Economica 386; "The Problem of Social Cost" ibid; "The Nature of the Firm: Meaning" (1988) 4 Journal of Law, Economics & Organization 19.

[21] Michael Wachter and Oliver E. Williamson, "Obligational Markets and the Mechanics of Inflation" (1978) 9 Bell Journal of Economics 549 at 551.

smooth organisation of economic activity, three stand out as particularly significant to analysis of contractual governance: "transaction-specific investment", uncertainty, and opportunism. These sources of transaction costs are not discrete, nor can their implications for contractual governance be analysed in isolation from the issue of production costs. The analysis of cost-controlling strategies, therefore, is a complex exercise. It involves explaining interrelationships between cost-reducing practices and identifying trade-offs that economic actors might make when selecting between governance techniques which reduce transaction costs in one aspect of a relationship even as they enable other transaction hazards to materialise[22].

a Transaction-Specific Investment

"Transaction-specific investment" (or "idiosyncratic investment", or "asset-specificity") exists where resources are adapted for the purposes of a particular transaction in such a manner that once the adaptation has been made the investor will reap significantly higher returns from using the resources for that purpose than in any alternative uses. The difference between the value of the resource in the specific

[22] Matthews, "The Economics of Institutions and the Sources of Growth", supra, note 14.

use and in the next best alternative is known as its "quasi-rent"[23].

The phenomenon of transaction-specific investment may be observed with respect to all factors of production. For analytical purposes it is helpful the classify the forms which specific investments may take into four basic categories[24]. "Site" or "locational" investment exists where the investing party locates itself in close physical proximity to non-investing participants[25]. The investment may be designed to minimise inventory or transportation costs, or required by the production technology which the parties are using[26]. "Physical" asset specificity arises when one or more participants in a transaction invests in plant which is designed for the purposes of a particular enterprise and has few, if any, alternative uses[27]. Transaction-specific investment in human capital may be a function of knowledge which is learned "on-the-job", or skills which are acquired for the purposes of a particular economic enterprise[28]. In

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[23] Benjamin Klein, Robert G. Crawford and Armen A. Alchian "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process" (1978) 21 Journal of Law and Economics 297.

[24] Oliver E. Williamson "Credible Commitments: Using Hostages to Support Exchange" (1983) 73 American Economic Review 519.

[25] Ibid.

[26] For examples of this type of transaction-specific investment see, J. Harold Mulherin "Complexity in Long-Term Contracts: An Analysis of Natural Gas Provisions" (1986) 2 Journal of Law, Economics & Organization 105; Paul L. Joskow "Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants" (1985) 1 Journal of Law, Economics and Organization 33; John Stuckey Vertical Integration and Joint Ventures in the Aluminum Industry (Camb., Mass: Harvard University Press, 1983).

[27] Williamson, "Credible Commitments: Using Hostages to Support Exchange" supra, note 24. For examples of "physical asset specificity" see, Stuckey, Vertical Integration and Joint Ventures in the Aluminum Industry, supra, note 26; Scott Masten, "The Organization of Production: Evidence from the Aerospace Industry" (1984) 27 Journal of Law and Economics 403.

[28] Williamson, "Credible Commitments: Using Hostages to Support Exchange", supra, note 24.

both cases the human capital (that is, brains and skills), has a significantly greater value when deployed in the specific transaction than when used for other purposes[29]. "Dedicated" investments are constituted by transaction-specific adaptations to general products which would not occur except for the prospect that they will be used in the particular transaction, and which add little or no value to general uses of the product[30].

Specific investment has implications for production costs and transaction costs. Modification of resources to suit the needs of a specific transaction is an additional cost of production for which the investor would anticipate compensation. The transaction cost dimension of specific investments lies in the impact on the relationship between economic actors of one party making its assets relatively non-redeployable. An economic actor who adapts its resources to a specific transaction isolates itself from alternative opportunities to use those resources in more general applications. If the arrangement breaks down before the anticipated returns have materialised, the investor may be

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29 For examples of this type of specific investment, see two studies which focus on the development of matketing skills and experience in sales personnel: Kirk Monteverde & David Teece, "Supplier Switching Costs and Vertical Integration in the Automobile Industry" (1982) 13 Bell Journal of Economics 206 (investment into "applications engineering effort"); Erin Anderson & David Schmittlein, "Integration of the Sales Force: An Empirical Examination" (1984) 15 Rand Journal of Economics 385 and George John & Barton A Weitz, "Forward Integration into Distribution: An Empirical Test of Transaction Cost Analysis" (1988) 4 Journal of Law, Economics & Organization 337.

30 Williamson, "Credible Commitments: Using Hostages to Support Exchange" supra, note 24; Klein, Crawford & Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process", supra, note 23. See, for example, Thomas Palay, "Comparative Institutional Economics: The Governance of Rail-Freight Contracting" (1984) 13 Journal of Legal Studies 265; Palay, "Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements" (1985) 1 Journal of Law, Economics & Organization 76.

faced with fewer, or potentially no, opportunities to realise the benefits of the investments.

By limiting an investor's alternatives to a particular transaction, this "small numbers condition" intensifies that party's reliance on its contracting partners[31]. Such a relation of dependence creates a site for non-investing participants in a transaction opportunistically to attempt to appropriate some of the quasi-rent[32]. For example, a contractor who knows that another participant will face heavy losses if the transaction breaks down may threaten to end the arrangement unless the terms are re-negotiated in its favour[33]. The potentially large discrepancy between the value of the asset in the use to which it is dedicated and the next best alternative means that the investor may well be better off accepting a redistribution of shares in the transactional surplus rather than holding-out and risking loss of the investment[34].

However, that an investor "prefers" to compromise rather than to sacrifice its entire investment does not solve the problems of contractual governance which are caused by this situation. Three specific concerns may be identified. First, it may be argued that substantive redistribution of the costs

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[31] Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (New York: The Free Press, 1975); Klein, Crawford, & Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process" supra, note 23.

[32] Ibid. See text infra, at 78 for discussion of opportunism.

[33] Ibid., see also, Williamson, "Credible Commitments: Using Hostages to Support Exchange" supra, note 24.

[34] Ibid.

and benefits of a transaction during execution is economically undesirable. Not only does redistribution cause an investor to be worse off than it had anticipated, but, by enabling opportunists to appropriate benefits without bearing all of the costs of their actions, it also reduces the economic accountability of opportunists[35]. Secondly, skirmishing over the quasi-rents generated by asset-specificity is itself a source of unnecessary transaction costs[36]. Such costs might include the impact of the conflict on performance of the contract and the relationship between the parties, in addition to the resources expended in aggressive and defensive moves[37]. Third, one might expect struggles over quasi-rent to increase the costs of using transaction-specific assets[38]. That is to say, in so far as economic actors believe themselves to be vulnerable to opportunism, they may be expected to demand a significantly greater price premium in return for the dedication of assets. In the limiting case such a response may result in economic actors forgoing use of a superior technology which requires dedication of specific assets[39].

[35] Williamson, "Credible Commitments: Using Hostages to Support Exchange" supra, note 24; Klein, Crawford & Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process" supra, note 23; Thomas C. Schelling, "An Essay on Bargaining" (1956) 46 American Economic Review 281; Anthony Kronman "Contract Law and the State of Nature" (1985) 1 Journal of Law, Economics & Organization 5.

[36] Ibid., Timothy J. Muris, "Opportunistic Behaviour and the Law of Contract" (1981) 65 Minnesota Law Review 521.

[37] Ibid.

[38] Williamson, The Economic Institutions of Capitalism, supra, note 1.

[39] Ibid.

The precise transaction cost implications of asset-specificity in any particular context varies with the governance structure within which relationships between investing and non-investing parties are located[40]. One important hypothesis which is found in the transactional economics literature asserts that the more closely a form of governance resembles market exchange, with its strong conception of economic autonomy, the greater will be the transaction costs attendant on idiosyncratic investment[41]. Conversely, it is maintained that the more "firm-like" the form of governance, the more effective will be the moulding of economic relationships to protect the quasi-rents generated by specific investment[42].

b Uncertainty

Uncertainty is a ubiquitous characteristic of economic affairs[43]. Even the simplest form of contractual governance -

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[40] Ibid. Douglas D. Heckathorn & Stephen M. Maser "Bargaining and the Sources of Transactions Costs: The Case of Government Regulation" (1987) 3 Journal of Law, Economics and Organisation 70

[41] Williamson, The Economic Institutions of Capitalism, supra, note 1; Benjamin Klein, "Vertical Integration as Organizational Ownership: The Fisher Body - General Motors Relationship Revisited" (1988) 4 Journal of Law, Economics, & Organization 199; see also, references, supra, notes 26 - 30.

[42] Ibid.

[43] The appropriate conceptualisation of "information" and its role in economic activity is a controversial issue in economic theory, see, for example, George J. Stigler, "The Economics of Information" (1961) 69 Journal of Political Economy 213; Harold Demsetz "Information and Efficiency: Another Viewpoint" (1969) 12 Journal of Law & Economics 1; Kenneth J. Arrow, Information and Economic Behaviour (Stockholm: Federation of Swedish Industries, 1973); Arrow "Informational Structure of The Firm" (1985) 75 American Economic Review 303; Vernon Smith, "Economic Theory and its Discontents" (1975) 64 American Economic Review, (papers and proceedings) 320; A. Michael Spence & Richard Zeckhauser, "Insurance, Information and Individual Action" (1971) American Economic Review 380; Joseph Stiglitz "Incentives, Risk and Information: Notes Towards a Theory of Hierarchy" (1976) 6 Bell Journal of Economics 552; Allan Schwartz & Louis L. Wilde "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis" (1979) 127 University of Pennsylvania Law Review 630;

the classical contract - may be conceived to be a response to economic actors' inability to know all that they need to know about each other, and about the world in which they live. The pervasive nature of information problems together with the range of impediments which they may place in the way of smooth co-ordination of economic activity raises the spectre that we might explain everything in terms of information costs and in fact explain nothing. Comparative institutionalist theorists have to some extent avoided this predicament by classifying information problems into three distinct types of transactional hazards - asymmetric information holdings, mutual ignorance, and excess information in a world of boundedly rational actors - and relating these hazards to specific characteristics of contractual governance.

(i) Information Asymmetry

Asymmetry exists when parties to a transaction have unequal access to information which is relevant to governance, or execution, of an economic activity. The primary consequence of asymmetry is that uninformed parties are unable to monitor and evaluate the activities of informed parties as effectively as they could were information equally accessible. Information disparity, therefore, creates scope for knowledgeable parties

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George A. Akerloff "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970) 84 Quarterly Journal of Economics 488.

to use their relative contractual power to their own advantage. Dominant parties may "cheat" on the quality of the services which they supply or manipulate open-textured contract terms to ensure that they reap a disproportionate share of the contractual benefits.

Asymmetry is a widespread condition of economic arrangements. It may be generated by differences in experience, or develop from transaction-specific investment in human capital. Perhaps the most familiar example is the situation where a buyer purchases professional expertise, as in the client-lawyer transaction. A client hires a lawyer precisely when the costs of acquiring the skills required to resolve a problem are prohibitive. The object of the transaction, from the clients perspective, is to obtain the benefits of decisions based on specialist knowledge and training, without going through the process of investing in the necessary human capital.

In one sense, the essence of such professional services transactions involves the lawyer taking advantage of the clients ignorance: if the client had equal access to the relevant information, she would not need to hire a lawyer. Within most industrialised economies, at least since the time of Adam Smith, the division of labour aspect of these transactions would be viewed as legitimate and conducive to "efficiency". Of greater concern are the illegitimate, potentially exploitative, consequences of the division of labour, which consequences may be attributed to asymmetries in information. As information disparity makes it difficult for clients (principals) to monitor the quality of the service which they receive, it creates a situation where lawyers (agents) may be able to supply a lower quality service than that for which they are paid without being held to account for the delivery of substandard advice[44]. A lawyer motivated solely by self-interest, narrowly defined, will clearly have an incentive to do so (if she can escape detection) in that the reduction in performance costs will increase her profit from the transaction[45].

The transaction costs of information asymmetry include resources expended by a principal in monitoring the performance of an agent and the costs of building protection against cheating or "implicit opportunism" into the framework for governing the relationship. Governance may be constituted by working rules derived from institutions such as professional associations or the tort system (professional negligence), together with the transaction-specific provisions of any individual relationship[46]. In addition to the costs of formulating protective terms and maintaining governing

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[44] Stephen A. Ross, "The Economic Theory of Agency: The Principal's Problem" (1973) 62 American Economic Review 134; Milton Harris & Arthur Raviv, "Optimal Incentive Contracts with Imperfect Information" (1979) 20 Journal of Economic Theory 231; Eugene F. Fama, & Michael C. Jensen, "Agency Problems and Residual Claims" (1983) 26 Journal of Law and Economics 327.

[45] Ibid.

[46] Cento G. Veljanovski & Christopher J. Whelan "Professional Negligence and the Quality of Legal Services - An Economic Perspective" (1983) 46 Modern Law Review 700; Robert Dingwall & Paul Fenn, "'A Respectable Profession'? Sociological and Economic Perspectives on the Regulation of Professional Services" (1987) 7 International Review of Law & Economics 51.

institutions, the transaction costs of asymmetry include the value of any benefits lost by reigning in the discretion of the informationally dominant party too tightly, or by means which are inaccurately targetted to the problem[47].

(ii) Mutual Ignorance

The second type of transactional hazard arising from uncertainty - mutual ignorance - exists where information which affects important contract terms is not available to the participants at a time when it is needed for decision-making. Sometimes the information is such that it could have been accessed by the parties at the beginning of the relationship but it was believed, perhaps wrongly in retrospect, that the costs of enlightenment would exceed the benefits of acting on the basis of more accurate information. Alternatively, the relevant information may relate to the future and be unknown and unknowable at the time of transacting.

Mutual ignorance undermines transactional security. Contractors face the possibility that major discrepancies between their original shared assumptions and events as they transpire will cause someone to "regret" their decision to participate in the contract, and seek to escape from the

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[47] Ross "The Economic Theory of Agency: The Principal's Problem", supra, note 44; Fama & Jensen "Agency Problems and Residual Claims", supra, note 44; Harris & Raviv "Optimal Incentive Contracts with Imperfect Information", supra, note 44; see Benjamin Klein "Contracting Costs and Residual Claims: The Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 367; Michael Jensen & William Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure" (1976) 2 Journal of Financial Economics 305.

transaction, regardless of the costs which such a decision may impose on others[48]. The transaction costs attendant on mutual ignorance include the costs of "regret" and the costs of developing and maintaining protection against premature withdrawal from the relationship[49].

Different forms of governance reflect varying strategies for managing the costs of mutual ignorance, and each strategy generates its own configuration of transaction costs[50]. For example, the working rules of classical governance transform ignorance into "risks" and provide incentives for parties to allocate risks as they are setting up the transaction[51]. Other institutional settings for transactions may encourage contractors' to adjust the terms of their relationship in the light of new information[52]. The suitability of any particular technique for the governance of a specific economic activity will depend not only on a comparison of the costs of the remedy with the costs of the problem, but also on the extent

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48 "Charles J. Goetz & Robert E. Scott, "Enforcing Promises: An Examination of the Basis of Contract" (1980) 89 Yale Law Journal 1261.

49 Anthony Kronman, "Mistake, Disclosure, Information and the Law of Contracts" (1978) 7 Journal of Legal Studies 1; A. Mitchell Polinsky "Risk Sharing through Breach of Contract Remedies" (1983) 12 Journal of Legal Studies 427.

50 Oliver E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" supra, note 16.

51 Ibid., see also, Steven Shavell "Damage Measures for Breach of Contract" (1980) Bell Journal of Economics 466; Jeffrey Perloff "The Effects of Breaches of Forward Contracts Due to Unanticipated Price Changes" (1981) 10 Journal of Legal Studies 221.

52 Ian R. Macneil, "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law" (1978) 72 Northwestern University Law Review 854; Richard E. Speidel, "Court-Imposed Price Adjustments Under Long-Term Supply Contracts" (1981) 76 Northwestern University Law Review 367; John Dawson "Judicial Revision of Frustrated Contracts: Germany" (1983) Boston University Law Review 1039.

to which the solution is compatible with other aspects of the transaction.

(iii) Excess Information and Bounded Rationality

The idea that "excess information" may constitute a transactional hazard is based on two premises. First, it is assumed that "bounded rationality" limits the capacity of contractors with respect to storing, retrieving, and processing information[53]. Second, comparative institutional models assume that information is valuable to contractors only to the extent that it can be used in contractual decision-making[54]. Contractual decision-making is characterised as a process which involves evaluating the advantages and disadvantages of available options and selecting the course of action which appears to be most beneficial given the circumstances in which decision-makers find themselves[55]. Information assists this process when it enables contractors to refine their perception of the relative advantages and disadvantages of each option. Where, however, the quantity of information available exceeds that which economic actors are able to process effectively, decision-making becomes clouded

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[53] Herbert A. Simon, Models of Man (New York: John Wiley & Sons, 1957); "Theories of Decision Making in Economics and Behavioural Science" (1959) 49 American Economic Review 253; Armen A. Alchian "Uncertainty, Evolution and Economic Theory" (1950) 58 Journal of Political Economy 211.

[54] Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" supra, note 16.

[55] Ibid.

by complexity. Boundedly rational actors, it is argued, respond to information overload by making decisions which are different from, and worse than, the decisions which they would have made had they been dealing with manageable information[56]. Some may respond by making arbitrary decisions to rely on part of the information which is available[57], others may be so overwhelmed that they react by "avoidance" or making what are in effect "non-decisions"[58].

The transaction costs of surplus information in a world of boundedly rational actors include differences between decisions which are made and those which would have been made had the decision-maker been presented with manageable data, together with the resources "wasted" in struggling to make sense of excess information. As in the case of other transactional hazards, both the extent and the effect of such costs might be expected to vary with the decision-making framework which is constituted by a structure of governance. For example, forms of governance which enable participants to make conditional or interim decisions are less taxing of scarce rationality resources than those which require once-and-for-all-commitments. Governance may, alternatively, be organised to promote a division of labour in the gathering, processing, and management of relevant information and include

[56] Ibid.

[57] Simon, "Theories of Decisionmaking in Economics and Behavioural Science", supra, note 53.

[58] Alchian, "Uncertainty, Evolution and Economic Theory", supra, note 53.

a specialised co-ordinator who is responsible for synthesising information and decision-making.

c Opportunism

Another important objective of transactional governance is limiting the scope for economic actors to engage in the "pecuniary-predatory"[59] practice of opportunism. Williamson defines opportunism as manifestations of "self-interest seeking with guile". He comments that opportunistic behaviour may be blatant or subtle and may occur as the parties are developing a framework for governance or during execution of a transaction[60]. Muris' definition of opportunism is narrower and more specific. He asserts that opportunism exists where "a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer"[61].

The intuition underlying the approaches taken by Williamson and Muris is that opportunistic behaviour involves a contractual participant attempting to take advantage of another contractor in a manner which is contrary to the spirit of co-operation which is thought to govern the transaction.

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59 Veblen, "The Theory of the Leisure Class & Industrial and Pecuniary Employments", supra, note 13.

60 Williamson, The Economic Institutions of Capitalism, supra, note 1 at 47-48.

61 Timothy J. Muris, "Opportunistic Behaviour and the Law of Contract", supra, note 36 at 521.

As noted above, the direct consequence of opportunistic behaviour is the redistribution of wealth from the "victim" to the "perpetrator". Its indirect costs may include loss of the victim's trust in the relationship and a shift from "consummate" to "perfunctory" co-operation in the execution of the transaction[62].

Some economists argue that the scope for contractors to engage in opportunistic behaviour is sometimes taken to be inversely related to the strength of market norms[63]. The essence of this argument is that economic actors who may readily access alternative buyers or sellers are less dependent on the performance of any single buyer or seller, and are therefore, not vulnerable to opportunistic exploitation[64]. The importance of this argument lies in its identification of substitutes or alternatives as one form of protection against opportunistic behaviour. However, the comparative institutionalist, who views the perfectly competitive market as an analytical fantasy, would insist that transactions governed by any kind of market which we are likely to encounter in the "real world" are at least as prone to opportunism as those governed by less "market-like" frameworks. A comparative institutional approach suggests that

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[62] Williamson Markets and Hierarchies, supra, note 31.

[63] Oliver D. Hart, "Incomplete Contracts and the Theory of the Firm" (1988) 4 Journal of Law, Economics & Organization 119; Harold Demsetz, Economic, Legal and Political Dimensions of Competition (Amsterdam: North-Holland, 1982).

[64] Ibid., see also, Richard A. Posner, "Gratuitous Promises in Economics and Law" (1977) 6 Journal of Legal Studies 411.

opportunism is enabled by relations of dependence which arise out of patterns of differential control over resources and economic decisions[65]. As the working rules of market governance, no less than other forms of governance, institutionalise patterns of differential control over decisions and resources, markets will provide the conditions under which those with relatively more power may opportunistically exploit those with relatively less power[66].

For the purposes of this thesis, opportunistic behaviour is treated as a potential hazard of economic activity under all conceivable forms of governance. The transaction costs of opportunism include resources expended in attempting to bring about, or to resist, redistribution, the costs of the reduction in trust and willingness to cooperate attendant on opportunistic behaviour, and expenditures incurred in attempting to institutionalise and to enforce protective mechanisms[67].

C Power in Contractual Relations

The importance attached to the idea of "power" varies enormously between different comparative institutionalist analyses of economies and their component institutions. Those

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65 Schmid, Property, Power, and Public Choice, supra, note 12.

66 Ibid.

67 Muris, "Opportunistic Behaviour and the Law of Contract", supra, note 36.

who are closer to the neoclassical tradition, predictably enough, are sometimes sceptical of the value of treating "power" as a significant characteristic of contractual relations and appear somewhat irritated by what is perceived to be the "undisciplined" nature of power-oriented explanations of economic institutions[68].

It should be recognised, however, that transactional economists do not reject outright the role of concepts of power in comparative analysis of economic institutions[69]. Williamson, for example, explicitly acknowledges the need to address issues of power in the analysis of certain types of transactions[70]. In addition, the idea of opportunism which is central to the governance analysis of transactional economists is readily conceptualised as a manifestation of contractual power[71].

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68 For example, in The Economic Institutions of Capitalism, supra, note 1, Williamson constructs "power" and "efficiency" explanations as competing alternatives and argues that efficiency explanations have more analytical "purchase": see, chapter 9, especially part 5. He also criticises what is perceived to be a lack of specificity in the concept of power: for example, his discussion of the organisation of work concludes with the comment:

> The main problem with power is that the concept is so poorly defined that power can be and is invoked to explain virtually anything. Such an undisciplined approach to the study of complex social science phenomena is clearly unsatisfactory. A serious effort at operationalization is greatly needed if power is to be properly evaluated.

at 237-238.

69 Victor P. Goldberg, "Bridges over Contested Terrain" (1980) 1 Journal of Economic Behaviour and Organization 249.

70 For example, Williamson concludes his discussion of the "Organization of Labour" with the comment:

> ... while the transaction cost approach to labor organization is the source of numerous refutable implications, it is not by itself adequate to deal with all the relevant issues with which the study of labor organization is legitimately concerned. For one thing, the matter of power is underdeveloped"

at 272, Economic Institutions of Capitalism, supra, note 1.

71 See, for example, Stewart Macaulay, Law and the Balance of Power, (New York: Russell Sage Foundation, 1966); Hugh Beale, Donald Harris & Thomas Sharpe, "The Distribution of Cars: A Complex Contractual Technique: English Report" Contract Law Today, Donald Harris & Dennis Tallon (Oxford: Clarendon, 1989).

Those scholars whose work fits squarely into the institutionalist tradition of Commons and Veblen are clearly more comfortable with the concept of power[72]. It is argued that the organisation of all economic activity is shaped by power relations extant in an economy and that contractual governance, so far as possible, should be structured to control economic power[73].

Despite their commitment to locating power in the operation of economic institutions, institutionalist theorists continue to find the conceptualisation of power troublesome. It has been defined in commodity-like terms as "a combination of responsibility and the capacity to coordinate and concentrate resources and foresee dangers and opportunities"[74]; and as "disproportionate control over the decision-making process"[75]. Conceived in these terms, power appears as something which is "owned" and which might potentially be measured. More overtly relational conceptions of power appear in definitions which focus explicitly on economic actors' control over, or with respect to, decisions

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[72] See, for example, A. Allan Schmid, Property, Power, and Public Choice: An Inquiry into Law and Economics, supra, note 12 and Warren J. Samuels (ed.) The Economy as a System of Power: Volume I: Corporate Power (New Brunswick: Transaction Books, 1979).

[73] Ibid., see also, Ian R. Macneil, "Power, Contract, and the Economic Model" (1980) 14 Journal of Economic Issues 909; John R. Munkirs with Janet T. Knoedler, "The Existence and Exercise of Corporate Power: An Opaque Fact" in Evolutionary Economics: Volume II Institutional Theory and Policy Marc R. Tool (ed.) (Armonk: M.E. Sharpe Inc., 1988); Rodney Stevenson "Corporate Power and the Scope of Economic Analysis" (1985) 19 Journal of Economic Issues 333; Stephen A. Woodbury, "Power in the Labour Market: Institutionalist Approaches to Labor Problems" in Evolutionary Economics: Volume II, ibid.; John R. Munkirs The Transformation of American Capitalism (Armonk: M.E, Sharpe, Inc., 1985).

[74] Don Kanel, "Property and Economic Power as Issues in Institutional Economics" (1974) 8 Journal of Economic Issues 827 at 834.

[75] Philip Klein, "Confronting Power in Economics: A Pragmatic Evaluation" (1980) 14 Journal of Economic Issues 871.

which affect the economic lives of others[76]. For example, Dugger treats power as "the ability to tell other people what to do with some certainty that they will do it"[77], while for Macneil, power is "the ability to impose one's will on others irrespective of their wishes"[78].

This thesis recognises that an entirely satisfactory concept of power as it pertains to contractual governance remains somewhat elusive[79]. But it seems preferable to acknowledge, however imperfectly, that contractual governance shapes the extent to which some economic actors may legitimately or illegitimately exercise control with respect to the decisions and behaviour of others, rather than to ignore such a critical issue. Thus, for the purposes of this thesis, power is assumed to be a significant feature of contractual governance. It is treated as a facet of relationships between economic actors, and taken to comprise control over decisions about governance, together with control over decisions within governance structures. Contractual power is assumed to be derived from the patterning of restraint and permission embedded in law and other constituents of contracting culture and manifested in the type and quantity

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[76] Schmid, Property, Power and Public Choice: An Enquiry into Law and Economics, supra, note 12.

[77] William, M. Dugger, "Power: An Institutional Framework of Analysis" (1980) 14 Journal of Economic Issues 897 at 897.

[78] Macneil, "Power, Contract, and the Economic Model", supra, note 73 at 909.

[79] One difficulty with all of the conceptions of power cited above, as in the case of the lawyer's construct of "inequality of bargaining power", is that they focus primarily on the "fact" of coercion, rather than the mechanisms and the means. With respect to the issues of contractual governance, however, it is the machinery of power which is of primary significance.

of resources which different actors command. Governance structures are taken to be shaped by power relations, and to establish their own frameworks of working rules by which some economic actors exercise control with respect to the decisions and behaviour of others[80].

D Contractual Culture

Within comparative institutionalism, the idea of "contractual culture" or "contractual context" is used to facilitate analysis of governance structures. It appears in the assumption that every transaction has a context - a background of norms, understandings, and social and economic practices - and operates as a reminder that this context shapes both the structure of contractual governance and the decisions of individual contractors[81]. In effect "culture" denotes the socially situated character of contractual organisation and behaviour[82].

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80 Warren J. Samuels, "Introduction" The Economy as a System of Power, supra, note 72.

81 For general discussion of the role of "culture" in institutional analysis, see, Anne Mayhew "Culture: Core Concept under Attack" (1987) 21 Journal of Economic Issues 587 and William T. Waller Jr. "Radical Institutionalism: Methodological Aspects of the Radical Tradition" (1988) 22 Journal of Economic Issues 667. For examples of analysis of contractual forms which is sensitive to the issues of "culture", see, Y. Ben-Porath "The F-Connection: Families, Friends, and Firms and the Organization of Exchange" (1980) 6 Population and Development Review 1; Ian R. Macneil, The New Social Contract: An Inquiry into Modern Contractual Relations 10; Shmuel Eisenstadt & Luis Roniger Clients, Patrons and Friends: Interpersonal Relations and the Structure of Trust in Society (New York: Cambridge University Press, 1984). For an important study of the role of ideas in legal elements of contracting culture, see, Patrick S. Atiyah, The Rise and Fall of Freedom of Contract (Oxford: Oxford University Press, 1979).

82 Ibid., While the idea of contractual culture is not a particularly strong theme in the work of many transactional economists, it is by no means treated as irrelevant. Williamson, for example, in describing his mode of analysis, notes that "[transaction] costs need to be located in the larger context of which they are a part. Among the relevant factors are ... The social context in which transactions are embedded - the customs, mores, habits, and so on" The Economic Institutions of

This thesis focuses largely on legal components of contractual "culture". Law is taken to shape contracting by its definition, maintenance, and enforcement of a system of property rights. Property rights systems establish rules for determining who controls which resources, and specify the implications of such control for relationships between economic actors. Furthermore, that branch of property rights systems which lawyers classify as contract law (and, to some extent, tort law) sets out the formal parameters of authority to modify the relations of property from which individuals derive control over resources. Clearly, property rights systems are not engraved in stone. They change over time, and change may be abrupt or evolutionary[83]. At any given point in time, however, the precise system of property rights institutionalised by the state, with its particular configuration of power, restraint, and permission, is important aspect of the governance of transactions[84].

This approach to "legal" aspects of contractual culture is primarily important for how we think about the role of the state in contractual governance. Neoclassical law and economics tends to treat "the market" and "the state" as separate spheres of human activity. Much attention is devoted

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Capitalism, supra, note 1 at 22.

[83] Atiyah, Rise and Fall of Freedom of Contract, supra, note 81; John R. Commons Legal Foundations of Capitalism (Madison: University of Wisconsin Press, 1924); Morton Horwitz The Transformation of American Law: 1780-1860 (Camb., Mass: Harvard University Press, 1977).

[84] I am not saying that the machinery of courts is necessarily significant to the management and enforcement of contracts. My point is that legal aspects of contractual culture may shape the range and the meaning of governance options which contractors believe to be possible.

to the general issue of the "proper" limits of "private" and "public" spheres and the more specific question of whether, and in what circumstances, the state should "intervene" in the market. By contrast, a comparative institutionalist perspective rejects the market-state dichotomy as a meaningful analytical heuristic and maintains that the notion of state "intervention" in the market is incoherent[85].

Take, for example, the Unfair Contract Terms Act 1977, (UCTA). Within a neoclassical economic paradigm, this type of innovation would be viewed as a government intervention in market behaviour. While different scholars within this tradition might take varying positions as to whether the legislation is "desirable", "regrettable but on balance necessary", or an "unacceptable infringement of individual autonomy", most would probably characterise the Act as an intervention which reduces individuals' freedom of contract, specifically, the freedom to determine their own contractual terms.

If, however, we use a framework which treats the state, in its role as custodian of property rights, as an all pervasive feature of contracting practices we would describe the UCTA somewhat differently. First, the Act appears not as

[85] Warren J. Samuels, "Interrelations between Legal and Economic Processes" in Law and Economics: An Institutional Perspective, Samuels & A. Allan Schmid (eds.) (Boston: Martin Nijhoff, 1981). Similar criticisms are to be found in contemporary feminist and Critical Legal Studies analyses of the state-market dichotomy: see, for example, Hugh Collins, The Law of Contract (London: Weidenfeld & Nicolson, 1986); Fran Olson, "The Family and the Market: A Study of Ideology and Legal Reform" (1983) 96 Harvard Law Review 1497. For early developments of this critique, see, Commons, Legal Foundations of Capitalism, supra, note 83; Morris R. Cohen, Law and the Social Order (New York: Harcourt Brace, 1933); Robert Hale "Bargaining, Duress, and Economic Liberty" (1943) 43 Columbia Law Review 603.

a state "intervention" in a pre-existing market, but as a change in the legal culture - the ground rules - which shape contracting practices. Secondly, this change would not be characterised as a restriction of contractual freedom, the desirability of which we might then debate, but as a redefinition of the property rights which parties bring to their economic relationships. Clearly, these redefined property rights are constituted by a different patterning of permission, restraint, and power between contractors than before the change. Just as obviously, we might observe that the change reduces the range of legally enforceable contractual terms available for selection by contracting parties. Viewed in isolation, however, this observation would not tell us whether there has been an increase or a decrease in contractual "freedom" taken as a whole. In order to confront this issue we would need to relate law to other aspects of contractual culture. We would need to know, for example, how relevant contractual terms were set in pre and post -UCTA era, and how law interacts with other social, economic, and cultural factors shaping parties' decisions.

Furthermore, the comparative institutionalist would insist that a change in the range of contractual terms which may be enforced cannot even be described as "greater" state intervention in the market or "more" state control over the market. The premise underlying the entire mode of analysis is that the state is just as implicated when it "permits" and then "enforces" one party's exclusion clause against the wishes of another as it is when it refuses to enforce the clause against the wishes of the "owner" of the term[86]. Viewed from a comparative institutionalist perspective, therefore, differences between the pre-UCTA world and the post-UCTA world, are not a function of the presence or absence of state intervention, or even its extent, but must be located in the specific content of the ground rules for economic relationships between buyers and sellers of goods and services.

The analysis of three models of contract in the following chapters illustrates the complexity of the relationship between contractual governance and the specific socio-economic practices of law. It will be seen that law may function as a source of transaction costs and as a solution to transaction costs; it may open up or diminish opportunities for strategic behaviour; it permits restraint and coercion even as it liberates and enables. These characteristics of the legal constitution of contractual governance suggest a couple of important points about the role of law in contractual relations. First, it appears that the economic functions of the law relating to contracts might be more coherently treated as defining and regulating control discretion over decision-making - contractual "power" - than as a means of fulfilling parties intentions or a determinant of (efficient) resource

[86] Ibid.

allocation. Secondly, it would seem that judgments about the implications of contract law need to be grounded in specific, institutional analysis of particular contractual forms. The analysis of the building contract in the second half of this thesis illustrates how we might engage in such analysis and the way in which law is implicated in the organisation and ordering of discretion within a specific form of contractual governance.

E Efficiency

One important difference between neoclassical economic analysis of law and comparative institutionalism lies in the role of efficiency within the two theoretical frameworks. Efficiency is central to both normative and positive neoclassical economic analysis of common law. It is used as an evaluative criterion, an organising concept, and a testable hypothesis[87]. Unfortunately, it is not possible to describe institutionalist perspectives on efficiency quite so succinctly. While all self-described institutionalists would probably agree with Ronald Coase's view that optimising analysis has had a "pernicious" influence on policy debate[88],

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87 Richard A. Posner "Utilitarianism, Economics and Legal Theory" (1979) 8 Journal of Legal Studies 103; Posner, The Economics of Justice (Cambridge: Harvard University Press, 1981). "Efficiency" is a contested concept even within neoclassical economic analysis of law: see, Cento G. Veljanovski, "Wealth-Maximisation, Law and Ethics: On the Limits of Economic Efficiency" (1981) 1 International Review of Law and Economics 5.

88 Ronald H. Coase, "The Regulated Industries: Discussion" (1964) 54 American Economic Review 194 at 195.

theorists take significantly different positions on the question of what role, if any, efficiency should play in their analyses.

Some institutionalists point to Commons' lengthy discussion of "efficiency"[89] as a justification for retaining the concept, albeit in somewhat altered form[90]. To others, the idea of efficiency is so "tainted" by its association with the perfectly competitive market that it is thought not to have a place in the analysis of "real-world" economic arrangements. Two arguments are made. First "efficiency" is said to have been equated with "promote voluntary exchange of private property rights until gains from trade are exhausted". However, this criterion of welfare has no operational content, in that the particular allocation of resources which marks the point at which gains from trade are exhausted, is specific to the structure of rights in place[91]. If property rights were differently distributed, the point at which resources were allocated efficiently would also be different[92]. As efficiency is a function of rights, it does not provide a normative basis

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89 John R. Commons Institutional Economics: Its Place in Political Economy (Madison: University of Wisconsin Press, 1959) at 251-389.

90 See, for example, William D. Dugger, "Property Rights, Law, and John R. Commons, (1980) 38 Review of Social Economy 41.

91 Veljanovski, "Wealth-Maximisation, Law and Ethics: On the Limits of Economic Efficiency", supra, note 87; Jules Coleman "Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law" (1984) 94 Ethics 649; Victor P. Goldberg "Relational Exchange: Economics and Complex Contracts" (1980) 23 American Behavioural Scientist 337; A. Mitchell Polinsky "Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law" (1974) 87 Harvard Law Review 1655; Warren J. Samuels, "Normative Premises in Regulatory Theory" in Samuels & Schmid (eds.) Law and Economics: An Institutional Perspective, supra, note 85.

92 Ibid.

for determining policy issues which typically entail choices between alternative distributions of rights[93].

Secondly, it is argued that because the highly specific, complex and contextual markets which comprise our economies have little connection with the abstract model of perfect competition, policies which are drawn from this model are misdirected. There is no reason to believe, critics charge, that policies which are designed for one particular context will be effective, or even workable, when transported to another institutional setting[94].

By contrast, the work of some transactional economists relies heavily on an efficiency construct. Oliver Williamson, for example, describes institutions of contracting as "hav[ing] the main purpose and effect of economising on transaction costs"[95]; and argues that in order to make an "accurate assessment" of capitalist institutions "greater respect for organizational features and for <u>efficiency</u> purposes is needed"[96].

The transactional economists' interest in explaining "real-world" economic arrangements, however, causes their conceptual frameworks to differ from the neoclassical model of efficiency. In particular, transactional economists use a considerably more detailed - more microanalytical -

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93 <u>Ibid</u>.

94 Goldberg, "Relational Exchange: Economics and Complex Contracts", <u>supra</u>, note 91.

95 Williamson <u>The Economic Institutions of Capitalism</u>, <u>supra</u>, note 1 at 1.

96 <u>Ibid</u>., at 17.

theoretical lens[97]. They focus on the particularities of transaction types and the minutiae of the processes by which contractors co-ordinate economic activities.

Furthermore, the transactional economists reject the "nirvana" orientation of neoclassicism[98]. Within the transactional paradigm it is assumed that economic actors are always faced with choices between governance structures which are in some sense inadequate for realising all of their goals[99]. The role of the analyst, therefore, is to "attempt to assess which alternative real institutional arrangement seems best able to cope with the economic problems"[100], rather than to "seek ... discrepancies between the ideal and the real and if discrepancies are found ... deduce that the real is inefficient"[101]. In at least one respect, however, the work of many transactional economists fits squarely into the neoclassical tradition[102]. Efficiency, albeit in this modified form, is used in much of this literature, as a value, perhaps,

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97 Arrow characterises this interest in the small details of economic institutions as a "nanoeconomic" reasoning. Kenneth J. Arrow, "Reflections on the Essays", in G. Feiwel (ed.) Arrow and the Foundations of the Theory of Economic Policy. (New York: New York University Press 1987).

98 See, for example, Oliver E. Williamson, "The Economics of Antitrust: Transaction Cost Considerations" (1974) 122 University of Pennsylvania Law Review 1439; Williamson, The Economic Institutions of Capitalism, supra, note 1; Thomas Palay "Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements" (1985) 1 Journal of Law, Economics and Organization 155; Heckathorn & Maser, "Bargaining and the Sources of Transactions Costs: The Case of Government Regulation", supra, note 40.

99 Ibid.

100 Harold Demsetz, "Information and Efficiency: Another Viewpoint" (1969) 12 Journal of Law & Economics. 1 at 1.

101 Ibid.

102 William M. Dugger "The Transaction Cost Analysis of Oliver E. Williamson: A New Synthesis?" (1983) 17 Journal of Economic Issues 95.

the value[103], against which to measure the outcomes generated by contractual practices[104].

The "realism" of the transactional economic approach generates a rich account of the efficiency implications of governance choice. Moreover, because theorists working within this tradition engage with contractual governance "in its entirety", their version of efficiency analysis confronts some important interactions between technology, individual decisions, transaction hazards and contractual outcomes. However, the retention of an outcome-oriented conception of efficiency hinders analysis of the institutional determinants, specifically, the legal-cultural, determinants of decisions about contractual governance.

Outcome-oriented uses of efficiency take the institutional context of governance for granted[105]. That is to say the important analytical question is constructed to be "given an institutional context and set of technological

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103 There is some ambiguity about the extent to which efficiency is to be treated as a value in the work of Williamson. In Markets and Hierarchies, supra, note 31, he describes his analytical approach, despite its constant references to the "efficiency" of economic organisation, as "relatively value free--it is biased neither for nor against unfettered market modes of organization" at 453. In The Economic Institutions of Capitalism, supra, note 1, however, Williamson talks about efficiency as a valued goal of economic organisation which might rationally be sacrificed, at a cost, in furtherance of other valued purposes, at 408. For a critique of the purported "neutrality" of Markets and Hierarchies, see William M. Dugger, "The Transaction Cost Analysis of Oliver E. Williamson: A New Synthesis" (1983) 17 Journal of Economic Issues 95.

104 That is, transactional economists' conclusions to the effect that a particular structure of governance is an adaptation to identifiable transaction costs typically embody a normative judgment that the adaptation is "efficient, given the circumstances of the transaction": see, for example, J. Harold Mulherin, "Complexity in Long-Term Contracts: An Analysis of Natural Gas Contractual Provisions" (1986) 2 Journal of Law, Economics and Organization 105; Scott Masten & Keith J. Crocker "Efficient Adaptation in Long-Term Contracts: Take-or-Pay Provisions for Natural Gas" (1985) 75 American Economic Review 1083; Williamson, The Economic Institutions of Capitalism, supra, note 1. For a development of this point, see Dugger, "The Transaction Cost Analysis of Oliver E. Williamson: A New Synthesis?" supra, note 103.

105 Supra, note 91.

options which involve factors A, B, & D, which of the governance forms X, Y & Z will best enhance the productivity of economic activity S?". But if the factors which are taken to determine contractual governance - the A's, B's, & D's - are themselves contingent on a changeable institutional context, we need a mode of analysis that will enable the issue of choice of governance to be addressed at two levels. Not only should our analytical constructs relate particular outcomes to modes of governance <u>within</u> specific institutional contexts, but they must also provide a means for addressing choices between different sets of contractual ground rules. We need, in short, a form of analysis by which to compare governance choices where, for example, the operative factors are A, B, D and rule C, with those where the institutional context generates A, B, D and rule G. Outcome-efficiency may shed light on the separate relationships between A, B, D & C, and governance structures X, Y, Z, and between A, B, D, & G and governance structures V, X, & Y. Such an efficiency criterion may, for example, lead one to conclude that given A, B, D, and rule C, governance structure X leads to the best outcomes for activity S, but that in the context of A, B, D, & rule G, the parties should co-ordinate activity S by using governance form V. However, precisely because efficiency is contextual, it cannot provide an evaluative criterion for addressing a crucial issue which arises from the relationship between institutional context and contractual governance -

- the comparison between A, B, D & rule C, and A, B, D & rule G.

Neil Komesar's approach to comparative institutional analysis of law provides a helpful reconstruction of the role of a "modified efficiency hypothesis"[106]. He argues that for the purposes of comparative institutional analysis of law, efficiency may usefully be employed as an analytical device rather than a basis for evaluating the performance of economic institutions. Used in this way, "efficiency" appears as an imputed goal to be held constant so that the analyst may address the determinants of choices between alternative decision-making institutions. The theorist taking Komesar's approach treats efficiency as analytical given and searches for variations in the institutional context of a transaction which would explain governance decisions.

While this thesis is considerably more microanalytical in focus than Komesar's work, it follows the general contours of his perspective on efficiency. The concept is used primarily to link observed contractual practices to their institutional context. To label a practice as "efficient" means only that it may be related to its institutional context in a regular and systematic fashion. Efficiency does not serve as a judgment that outcomes, practice, or context are ideal or even "the best that could be attained given the circumstances".

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[106] Komesar, "In Search of a General Approach to Legal Analysis" supra, note 1.

The point of using efficiency in this way is to aid identification of the determinants of economic activity, specifically, the determinants of decisions about contractual governance. For example, to describe "classical contract", "relational contract" and "the firm" as models of "efficient" adaptations to transactions and production costs derived from particular institutional contexts does not entail the conclusion each generates desirable outcomes in all circumstances. Rather, it begs the institutional questions of what factors, what patterning of restraint, coercion, power and opportunities would lead economic actors to use one or other of these structures to govern their economic activities? and how might changes in the patterning of restraint, coercion, power and opportunity affect participants' decisions about governance? Within this form of analysis, neither critique, nor policy advocacy can rest on the efficiency of outcomes generated by a particular structure of governance. Efficiency appears here not as a value but as an analytical presumption that institutionally defined means are related to socially constructed ends in a regular and systematic fashion[107].

[107] Goldberg, "Relational Exchange: Economics and Complex Contracts" supra, note 91.

F Values

Although this thesis does not treat "efficiency" as a social value, it does recognise the centrality of values to any theoretical activity. Values, in the sense of assumptions and beliefs about what is good or bad, important or trivial, pervade analytical practice. They shape the framing of questions, the selection of relevant facts, the drawing of conclusions and the presentation of advice. As argued by Gunnar Myrdal:

> Facts do not organize themselves into concepts and theories just by being looked at.... There is an inescapable a priori in all scientific work. Questions must be asked before answers can be given. The questions are an expression of our interest in the world, they are at bottom valuations. Valuations are thus necessarily involved already at the stage when we observe facts and carry on theoretical analysis, and not only at the stage when we draw political inferences from facts and valuations[108].

To reject the possibility of "value-free" analytic practice is not to deny that we can have meaningful "scientific" debates about social and economic phenomena[109]. It simply requires us to engage with the value premises underlying the interpretive frameworks of our "sciences"; and understand the extent to which the persuasiveness of all

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108 Gunnar Myrdal, The Political Element in the Development of Economic Theory (London: Routledge & Paul, 1965) at vii.

109 Samuels "Normative Premises in Regulatory Theory" supra, note, 91; Peter Wiles "Ideology, Methodology and Neoclassical Economics" in Why Economics is Not Yet a Science Alfred S. Eichner (ed.) (London: Macmillan, 1983).

"scientific" knowledge rests on shared beliefs about how we (ought to) make sense of the world.

Values in economic reasoning may be more or less pragmatic or ideal and articulated with greater or lesser degrees of generality, according to the level of analysis at which the theorist is working. For example, one may believe that the organisation of an economy should foster democratic participation and control[110], or it might be thought that economic relationships involve an inevitable trade-off between "liberty" and "equality"[111]. A more narrowly defined, more specific, mode of analysis might involve the assumption that economic policy should be directed at replicating the outcomes of a perfectly competitive market[112]; or it might be assumed that the market, as an "enabling myth" which passively reflects pre-existing power relations cannot be a cause of changes in social welfare[113].

The explicitly microanalytical focus of this thesis embodies the following values, beliefs and assumptions. At a methodological level, it is assumed that contractual governance is instrumental, in the sense that contractors decisions with respect to governance are intended as a means to particular economic goals. It is also assumed that analysis

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110 Munkirs, The Transformation of American Capitalism, supra, note 73.

111 Richard A. Posner The Economics of Justice, supra, note 87.

112 Richard A. Posner, Economic Analysis of Law (Boston: Little Brown & Co., 1977).

113 William M. Dugger, "A Research Agenda for Institutional Economics" (1988) 22 Journal of Economic Issues 983.

of governance choices generates useful knowledge of the constraints and transaction costs which shape contractors' decisions.

Secondly, contractual governance structures are treated as means of managing actual and potential conflicts between economic actors whose situations are shaped by the institutional context within which they are situated. It is assumed that there are better and worse ways of managing conflicts between contractors and that it is generally better for contractual governance to manage conflict by promoting "participation" in decisions about or within transactions, and "accountability" for choices which have been made. By supporting participation in contractual decision-making of those whose economic lives are affected by a transaction, structures of governance may further dignitary values[114], restrain contractual power[115], and limit the potential for "demoralisation costs"[116]. The goal of "contractual accountability" resembles the neoclassical economist's objective of eliminating "externalities". The norm of accountability, however, is primarily concerned with the distributional implications, within transactions, of enabling contractors to shift costs to other participants. Contractual

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[114] Oliver E. Williamson, "The Economics of Governance: Framework and Implications", in Economics as Process: Essays in the New Institutional Economics Richard N. Langlois (ed.) (Cambridge: Cambridge University Press, 1986).

[115] Munkirs with Knoedler, " The Existence and Exercise of Corporate Power: An Opaque Fact" supra, note 73; Marc R. Tool, The Discretionary Economy (Santa Monica: Goodyear, 1979).

[116] Frank Michelman, "Property, Utility and Fairness Comments on the Ethical Foundations of 'Just Compensation' Law" (1967) 80 Harvard Law Review 1165.

accountability, therefore, is a means of limiting the scope for opportunistic transfers of shares in the benefits of a transaction.

Third, decisions about governance are taken to be inspired by a range of motives apart from self-interest, narrowly defined. Economic actors may, for example, care about "dignity" or "honour", value the experience of trusting and being trusted, treasure working relationships which are informed by "friendship", or enjoy the degree of autonomy afforded by one particular type of governance relative to others[117]. Such motives, like self-interest itself, are assumed to be derived from the culture of a contract and to reflect the socially situated character of individuals and their behaviour. The significance of such motives to contractual governance lies in the extent to which they are institutionalised in the working rules of governance as "serviceable", that is, economically useful, practices and norms[118].

It is also assumed throughout this thesis that self-seeking behaviour is not necessarily a "serviceable" aspect of contractual relations, but may be a manifestation of

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117 Ian R. Macneil, "Values in Contract: Internal and External" (1983) 78 Northwestern University Law Review 340; Dore, "Goodwill and the Spirit of Market Capitalism", supra, note 10; George A. Akerlof "Loyalty Filters" (1983) 73 American Economic Review 54; Hans E. Jensen, "Theory of Human Nature" (1987) 21 Journal of Economic Issues 1029; J. David Lewis & Andrew Wingert "Trust as a Social Reality" (1985) 63 Social Forces 967.

118 Veblen, "The Theory of the Leisure Class and Industrial and Pecuniary Employments", supra, note 13; Victor P. Goldberg, "Toward an Expanded Economic Theory of Contract" (1976) 10 Journal of Economic Issues 45; S. Todd Lowry, "Bargain and Contract Theory in Law and Economics" (1976) 10 Journal of Economic Issues 1.

"pecuniary-predatory" practices[119]. It is argued that contractual governance ought to institutionalise protection against pecuniary-predatory manifestations of self-interest to the fullest extent possible.

Finally, the analysis in this thesis is based on the premise that the allocation to some economic actors of unbridled and disproportionate discretion over decisions about, or within, economic relationships with others is an undesirable characteristic of contractual arrangements. It is maintained that the onus is on those who assert that such patterns of power are "serviceable" to demonstrate the rationale for their incorporation into structures of contractual governance.

G Towards Synthesis: The Governance of Transactions

The mode of analysis used in this thesis is closer to the inductive tradition of legal (common law) scholarship than the deductive, "Popperian" logic of neoclassical economics[120]. The argument proceeds by moving from the interpretation of "facts"

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119 Ibid.

120 For a succinct description of Popperian methodology as it is used in positive economics and a helpful comparison of legal and positive economic methodologies, see Charles K. Rowley "Social Sciences and the Law: The Relevance of Economic Theories" (1981) 1 Oxford Journal of Legal Studies 391. For a general debunking of popperian methodology in law and economics, see Donald N. McCloskey, "The Rhetoric of Law and Economics" (1988) 86 Michigan Law Review 752. For a thoughtful and provocative analysis of the methodology of purportedly positivistic law and economics, see Christopher J. Bruce "A Positive Analysis of Methodology in the Law and Economics Literature" (1989) 12 Hamline Law Review 197; see also, Cento G. Veljanovski, "The Role of Economics in the Common Law" (1985) 7 Research in Law and Economics 41.

which are "observed"[121] to general theories, rather than deducing hypotheses from abstract first principles and comparing what is observed with what was predicted. This approach leads us to ask "what explains what we observe?" rather than "does what we observe fail to falsify our explanation?"[122].

Our response to the former question is complicated by the premise that there exists an interactive relationship between institutional context, governance and economic behaviour. Not only is the institutional context of a contract assumed to shape choices about the working rules of contractual governance and influence the behaviour of contractors[123], but the behaviour of contractors is also seen, in part, to constitute the institutional culture and the framework of governance[124]. Contractors' decisions about governance are obviously taken to shape their behaviour within transactions,

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121 Supra, text at note 108; see also, William M. Dugger, "Property Rights, Law and John R. Commons" (1980) 38 Review of Social Economy 41.

122 Rowley, "Social Sciences and the Law: The Relevance of Economic Theories", supra, note 120. For the classic exposition of the importance of "falsifiability" to positivist economics, see, Milton Friedman, "The Methodology of Positive Economics" in Essays in Positive Economics (Chicago: University of Chicago Press, 1953).

123 For example, the institutionalisation of "good faith" as a ground rule of contractual relations is thought to produce a different organisation of governance and different expectations of participants' behaviour than would occur if "antagonism" were the operating norm.

124 For example, "friendship" or notions of "honour" between the executive directors of two corporations which form part of the culture/context of their decisions about governance may be translated into "working rules" of contractual governance. For an interesting examples of the manner in which such "informal" norms may outweigh the regulatory power of contradictory legal norms, see Robert B. Ferguson "Commercial Expectations and the Guarantee of the Law: Sales Transactions in Mid-Nineteenth Century England" in Law, Economy & Society: Essays in the History of English Law 1750-1914 David Sugarman & Gerry R. Rubin (eds.) (Abingdon: Professional Books, 1984).

and may also feed back into the contractual culture of the transaction[125].

The interactive nature of relationships between context / culture, governance and behaviour creates something of an analytical dilemma. On the one hand, if everything is related to everything else and all factors are constantly and dynamically interacting, it is difficult to imagine how we might develop meaningful analysis. On the other hand, we should be wary of reducing the complex socio-economic reality of contracting to a set of simple, uni-directional relationships[126]. The analysis in this thesis attempts to mediate between over-elaboration and over-simplification through its use of relatively complex concepts (transactional hazards, culture and governance) as the cornerstones of a relatively simple hypothesis - that contractual governance is fruitfully viewed as a choice between imperfect, decision-making frameworks for managing transaction costs.

Classical, relational and "firm-like" models of contractual governance differ in their patterning of responses to transaction costs, in their organisation of contractual decision-making, and in the relative weight accorded to

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125 For example, industry practices and norms may be incorporated into legal principles for regulating particular classes of transactions.

126 Some simplification of complex reality is clearly entailed by any analytical practice. The issue which is raised concerns both the level of abstraction - how simple? - and selection of the representative characteristics of the phenomenon to be analysed - what is the essence of the problem?. My point is that comparative institutional analysis of contractual governance should not simplify contract to the point where context and culture disappear from view, and that the interactive relationship between context, governance and contractual decisions is an integral aspect of the phenomenon to be explained.

sanctions derived from different facets of the culture within which a contract is situated. They offer different combinations of transaction-specific provisions, and reliance on norms and constraints drawn from the institutional culture of the contract. The analysis of these models of contract in the following chapters is organised around the transaction cost implications of the sources, scope, and extent of discretionary decision-making authority available to economic actors within each form of governance. This approach is used in order to highlight relationships between transaction costs, institutional setting and contractual power. Our discussion of the building contract in later chapters develops these themes in the specific context of building production. The analysis explores the particular relationships between institutional setting, contractual authority and transaction costs, which are embodied in planning, management and enforcement of transactions governed by JCT80.

Chapter III The Classical Model of Contract

The classical model of contractual relations constructs transactions as discrete, voluntary, bilateral agreements in the present to perform promises at a future date. It portrays contractors as autonomous, equal and well-informed individuals, whose decisions are driven by each party's perception of self-interest and constrained by the resources which they separately command. Perhaps the most striking characteristic of the classical model is the premise that contractors' rights against each other and obligations toward one another, are limited by the terms of their bargain. A classical contract is said to be a relationship:

> in which no duties exist between the parties prior to the contract formation and in which the duties of the parties are determined at the formation stage....[A]t the time they enter into their agreement, in a single joint exercise of their choice, [parties] determine their respective duties to each other for the duration of the agreement; completion of the promised performance terminates that party's obligations[1].

This conception of contractual relations has proven to be remarkably durable. Critics have argued that classical contract is more a state of mind than a statement of law or a representation of business practices. Classical contract has been charged with irrelevance[2], and on more than one occasion,

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1 Victor P. Goldberg "Toward an Expanded Economic Theory of Contract" (1976) 10 Journal of Economic Issues 45 at 46.

2 Addison Mueller, "Contract Remedies: Business Fact and Legal Fantasy" 1967 Wisconsin Law Review

declared dead[3]. It continues, however, to exert a powerful influence over the way in which judges decide, academics debate, and law students learn, throughout the common law world.

Consistent with the themes of this thesis, our interest in the classical model of contract lies in its vision of how economic activity ought to be managed. This concern leads us to focus on the governance of contractual decisions within the classical model. The two issues of particular interest are the organisation of contractual planning, and the implications of the enforcement regime for contractors' decisions about contractual performance. The decision-making focus lends itself to analysis of both the pattern of responses to transactional hazards which is embedded in classical governance, and the transactions costs which may be generated by classical governance.

This chapter is divided into five sections. Part A is an overview of the institutional structure of classical governance. I briefly describe the particular relationships between law, private ordering and market context which constitutes the classical model of contract, and introduce the idea of classical contract law as a set of ground rules for making "private" decisions about contracting. The next three sections are devoted to explanations of the decision-making

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[3] Grant Gilmore, The Death of Contract (Columbus: Ohio State University Press, 1974); Patrick S. Atiyah, The Rise and Fall of Freedom of Contract (Oxford: Oxford University Press, 1979).

structure of classical contract as exemplified in particular areas of doctrine. Part B focuses on planning rules governing the communication of information during bargaining for a contract. Part C addresses the organisation of "private" contingency planning within the classical model, and part D concentrates on the enforcement rules of classical contract. Each of these doctrinal sections relies on insights drawn from neoclassical economic analyses of contract law. For the purposes of our discussion, however, the important question is not whether this or that doctrine is efficient, but, "what does this doctrine reveal about the ground rules of classical contractual relations"? Part E reviews the transaction cost dimensions of classical governance taken as a whole. It highlights the assumptions about impediments to economic activity which are embedded in the institutional structure of classical contract, and outlines the transaction cost implications of the manner in which the model responds to transactional hazards.

A. The Institutional Structure of Classical Governance

1. Law, Markets, and Private Ordering

The classical model constructs contracts as a set of private rules of a bargain drawn up "in the shadow of"[4] "public" rules of law[5] and situated in the context of a competitive market. The market context of trading activity by numerous buyers and sellers operates to standardise goods and identities. It enables classical governance to be:

> ... blind to details of subject matter and person. It does not ask who buys and who sells, and what is bought and sold.... it does not matter whether the subject of the contract is a goat, a horse, a carload of lumber, a stock-certificate or a share.... it does not matter if either party is a woman, a man, ... a corporation, the government, or a church[6].

The "private rules" of classical governance (terms) function as transaction-specific regulation of the activity for which the contractual relationship was created. These

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[4] As used by Mnookin in his work on the settlement of conflicts over the breakdown of marriage contracts this phrase connotes an idea of private ordering in which law functions to empower individuals to create their own commitments and solutions to problems, rather than impose order from above, Robert H. Mnookin, "Bargaining in the Shadow of the Law: The Case of Divorce" (1979) 32 Current Legal Problems 65.

[5] The use of the term "public" to refer to contract law expresses Morris Cohen's idea that:

> ... the law of contract may be viewed as a subsidiary branch of public law, as a body of rules according to which the sovereign power of the state will be exercised in accordance to the rules agreed upon by the parties to a more or less voluntary transaction

Law and the Social Order (New York: Harcourt Brace, 1933) at 69. Karl Llewellyn's concept of "iron rules" of contract law seems to express the same idea: Llewellyn "What Price Contract? - an Essay in Perspective" (1931) 40 Yale Law Journal 704. It should be noted, however, that within legal studies the coherence of public / private dichotomies is increasingly under attack: see, for example, Fran Olsen, "The Family and the Market: A Study of Ideology and Legal Reform" (1983) 96 Harvard Law Review 1497.

[6] Lawrence Friedman, Contract Law in America (Madison: University of Wisconsin Press, 1965) at 20.

rules define what is to be done, by whom, how, when, where, and for what price, and, in theory, at least, stipulate what is to happen if contractors' initial assumptions about the conditions under which the transaction will be executed are mistaken.

Public rules of classical governance serve a range of purposes. These norms may constitute the market in which the contractors are operating, provide a framework for the creation of private rules, and supply "off-the-peg" contingency provisions which contractors may use in lieu of transaction-specific rules[7]. Public rules have another, more subtle, effect in that their particular conception of economic relations operates to exclude from view much of the specificity and cultural context of contracts[8]. The assumption of formal equality, for example, renders invisible disparities of wealth, experience and market power[9]. The premise that contracts are discrete insulates agreements to exchange from social, cultural and professional norms and codes, drastically limits the significance of previous dealings between the

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[7] Richard A. Posner & Andrew M. Rosenfield "Impossibility and Related Doctrines in Contract Law: An Economic Analysis" (1977) 6 Journal of Legal Studies 83; Charles J. Goetz & Robert E. Scott "The Mitigation Principle: Toward a General Theory of Contractual Obligation" (1983) 69 Virginia Law Review 967.

[8] Friedman Contract Law in America, supra, note 6; Hugh Collins The Law of Contract (London: Weidenfeld & Nicolson, 1986); Roberto M. Unger "The Critical Legal Studies Movement" (1983) 96 Harvard Law Review 563; Mary Jo Frug "Reading Contracts: A Feminist Analysis of A Contracts Casebook" (1985) 34 American University Law Review 1065.

[9] Ibid.

parties, and makes expectations of future dealings irrelevant[10].

2. The Ground Rules of Classical Contract

a. Market Enabling Norms

Market enabling rules are perhaps the most fundamental and the least visible norms of classical governance[11]. These rules shape the ordering of power, restraint and permission within existing markets and create opportunities for new forms of market activity[12]. As Willard Hurst observed in his account of the development of the lumber industry in Wisconsin:

> [t]he market took on legal definition mainly in the law of contract... it was the law of contract which supplied the assurances and the procedures and tools necessary for the immediate operation and steadily expanding energy of the institution[13].

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10 Ian R. Macneil, "Restatement (Second) of Contracts and Presentiation" (1974) 60 Virginia Law Review 589; Edwin Patterson, "The Apportionment of Business Risks" (1924) 24 Columbia Law Review 335.

11 The invisibility of market enabling norms in many of the discourses of contract is partly attributable to the role which the ideology of "freedom of contract" has played in shaping our understanding of classical governance. The rhetorical claims that economic actors are free from obligations towards one another except in so far as they choose otherwise, free to enter into obligations on whatever terms they choose, and that the terms chosen are sacred, have tended to obscure the ways in which the economic practice of classical contract involves the state in distinguishing between economic practices which will be endorsed, and those from which support will be withheld: Collins The Law of Contract 8; Duncan Kennedy & Frank Michelman, "Are Property and Contract Efficient?" (1980) 8 Hofstra Law Review 711; Robert B. Seidman, "Contract Law, the Free Market and State Intervention: A Jurisprudential Perspective" (1973) 7 Journal of Economic Issues 553; Patrick S. Atiyah, The Rise and Fall of Freedom of Contract, supra, note 3.

12 Llewellyn, "What Price Contract?" supra, note 5; Wolfgang Friedmann, Law in a Changing Society (New York: Columbia University Press, 1972), chap.4. John R. Commons, The Legal Institutions of Capitalism, (Madison: University of Wisconsin Press, 1924).

13 J. Willard Hurst, Law and Economic Growth: The Legal History of the Lumber Industry in Wisconsin 1836-1915 (Cambridge, Mass.: Harvard University Press, 1964) at 285.

The primary function of market enabling rules is to establish the parameters of what may and may not be done in pursuit of individual self-interest. Governing norms may be expressed in permissive or restrictive terms. They operate to sanction opportunism and promote whatever level of "institutionalised honesty" is believed to be necessary for the functioning of markets[14].

Market enabling norms appear in rules governing non-performance of a contract[15], and the conditions under which an agreement to exchange will be viewed as "voluntary", and hence capable of generating classical contractual rights and obligations[16]. A good illustration of the manner in which these norms empower at the same time as they constrain is the "restraint of trade" doctrine[17]. As between employer and worker, a norm which restricts the use of contracts in restraint of trade obviously limits employers' power to use contract to protect their businesses from competition, and at the same time opens up market opportunities for departing

[14] Bernard Barber, "The Absolutization of the Market" in Markets and Morals Gerald Dworkin, G. Bermant, & P.G. Brown (eds.) (New York: John Wiley & Sons Inc., 1977); Joseph A. Schumpeter Capitalism, Socialism and Democracy (New York: Harper & Row, 1942).

[15] Oliver Wendell Holmes The Common Law (Boston: Little, Brown & Co., 1929) (originally published in 1881); Anthony Kronman "Contract Law and the State of Nature" (1985) 1 Journal of Law, Economics and Organization 5.

[16] For arguments with respect to whether these norms are, or should be informed by values such as "efficiency", "paternalism" or visions of "distributive justice", see, Michael J. Trebilcock, "An Economic Approach to the Doctrine of Unconscionability" in Barry J. Reiter & John S. Swan (eds.) Studies in Contract Law (Toronto: Butterworth, 1980); Duncan Kennedy "Distributive and Paternalist Motives in Contract and Tort Law, With Specific Reference to Compulsory Terms and Unequal Bargaining Power" (1982) 41 Maryland Law Review 563; Anthony Kronman "Contract Law and Distributive Justice" (1980) 89 Yale Law Journal 472; Kronman, "Paternalism and the Law of Contracts" (1983) 92 Yale Law Journal 763.

[17] For an important study of the development of this doctrine and economic analysis of its implications, see Michael J. Trebilcock, The Common Law of Restraint of Trade: A Legal and Economic Analysis (Toronto: Carswell, 1986).

employees[18]. Although the law would still be enabling in function, the structuring of opportunities - and the market - would clearly be different if contracts in restraint of trade were permitted subject only to the classical requirement of "voluntariness".

b. Qualifying Norms

The second function of public rules of classical governance is to provie a framework within which economic actors may create their own private rules of contract. The existence of this framework is also a somewhat hidden dimension of the classical model. Judicial comments to the effect that "courts will not make contracts for parties" and "courts merely enforce the agreements that parties have made" convey a sense that classical governance is comprised solely of the arrangements which contractors make for themselves.

The commitment to substantive laisser-faire within classical contract, however, is located in a context of formal rules governing what will and will not count as contractual planning sufficient to ground classical obligations. That is to say, the contractual character of parties' private definitions and rules turns on these terms having met classical criteria for determining whether particular economic

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[18] Herbert Morris v. Saxelby [1916] 1 AC 688; M. & S. Drapers (A Firm) v. Reynolds [1956] 3 All ER 814.

decisions qualify as contracts[19]. By prescribing the conditions under which transactions will be recognised as contractual, the planning rules of classical law constitute a non-negotiable structure of governance. Transactions which do not conform to the requirements of this framework may ground some types of legal liability but do not create contractual obligations[20].

The qualifying norms of contract law govern the process of reaching a contractual bargain, and provide criteria for interpreting the outcome of that process. However, their impact may be felt throughout the life of a transaction. Such rules promote communication and interaction during negotiations for a contract, encouraging parties to invest in detailed private planning of those parts of the transaction which are within their control. The resulting package of private rules functions to "commodify" the exchange[21], and clarify what each party should expect from execution of the transaction, so long as all other conditions remain as they were at formation.

Planning rules also generate information for the enforcement process should disputes arise. In this context

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19 Lon L. Fuller, "Consideration and Form" (1941) 41 Columbia Law Review 799.

20 Jack Beatson "Benefit Reliance and the Structure of Unjust Enrichments" (1987) 40 Current Legal Problems 71. For criticism of the classical division of common law liability into "contractual", "tortious" and "restitutionary" principles, see, Patrick S. Atiyah, "Contracts, Promises and the Law of Obligations" (1978) 94 Law Quarterly Review 193; for an attempt to justify the conventional classification, see, Andrew S. Burrows "Contract, Tort and Restitution - A Satisfactory Division or Not?" (1983) 99 Law Quarterly Review 217.

21 Arthur A. Leff, "Contract as Thing" (1970) 19 American University Law Review 131.

they function as "rules of recognition"[22] by which to identify the private rules of the contract. As such, planning rules enable external agencies, such as courts, to determine the extent of parties' commitments to one another as a preliminary step in the adjudication of the issue of breach[23].

c. Contingency Norms

The contingency norms of classical contract interact with parties' decisions and are essentially facilitative in function. These rules serve as a backdrop set of provisions available to contractors who do not want to incur the costs of negotiating transaction-specific private rules for managing risks[24]. Although these rules are invoked after disruptive events have materialised, economic analyses of classical governance suggest that they should be viewed as implied terms which are read back into the contractors' arrangement[25].

In order to clarify the way in which contingency rules are thought to assist in the governance of risk, it is helpful briefly to describe the assumptions about risk and its

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[22] Gideon Gottlieb, "Relationism: Legal Theory for a Relational Society" (1983) 50 University of Chicago Law Review 576 at 604, citing to Herbert L.A. Hart, The Concept of Law (Oxford: Oxford University Press, Clarendon Series, 1961).

[23] Fuller "Consideration and Form", *supra*, note 19.

[24] Posner & Rosenfield "Impossibility and Related Doctrines in Contract Law", *supra*, note 7; Goetz & Scott "The Mitigation Principle, *supra*, note 7; see also, Goetz & Scott, "The Limits of Expanded Choice: an Analysis of the Interaction of Express and Implied Contract Terms" (1985) 72 Southern California Law Review 261; Ian Ayres and Robert Gertner "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 Yale Law Journal 87.

[25] *Ibid*.

management which are embedded in the classical model of contract[26]. Classical contract treats risk as a change in the environment of a contract which causes the costs and benefits of the transaction to differ from parties' original assumptions[27]. This type of change is contractually significant where it means that a decisions which was originally perceived to be beneficial is no longer the best course of action available to one of the parties. While classical contractors are presumed unable to control the economic context in which they are situated, they are assumed capable of managing the impact on the transaction of changes in that context. In theory, the ideal method of classical risk-management entails economic actors using the process of contract formation to plan transaction-specific responses to disruptive events[28]. Ex ante planning is thought to enable contractors to structure transactions so that the probable effects of changes which are likely to alter one party's costs of performing are taken into account in prices and other relevant terms[29]. "Completely contingent contracts"[30] integrate risks into the entire package of contract terms and ensure that the costs of managing risks are incurred when parties are

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26 Jack Dowie, "The Risks of Contract Law" (1982) 2 International Review of Law and Economics 193.

27 Ibid., see also, Patterson "The Apportionment of Business Risks", supra, note 10; A. Mitchell Polinsky "Risk Sharing through Breach of Contract Remedies" (1983) 12 Journal of Legal Studies 427; Jeffrey Perloff "The Effects of Breaches of Forward Contracts Due to Unanticipated Price Changes" (1981) 10 Journal of Legal Studies 221.

28 Ibid., see also Steven Shavell "Damage Measures for Breach of Contract" (1980) Bell Journal of Economics 466.

29 Lester G. Telser, "A Theory of Self-Enforcing Agreements" (1980) 50 Journal of Business 27.

30 Shavell, "Damage Measures for Breach of Contract", supra, note 28.

looking forward to co-operation rather than at a point, during execution, when the parties' interests are implacably opposed.

The "real-world" of classical contract, however, is one in which time, energy and negotiation resources are scarce, and events which have not been anticipated routinely occur. The classical model's response to this reality can be seen in "public" rules of governance which, in effect, substitute for private *ex ante* planning. Rules relating to discharge of obligations and remedies, for example, appear as standard form risk allocation provisions which may be read back into a contract where a disruptive event occurs during execution and the contract is silent as to the effect of such an event.

B. The Governance of Contractual Bargaining

1. Consideration and Information Interchange

One of the most important characteristics of classical governance is that transactions must be structured as bargains[31]. This requirement, associated with the doctrine of consideration, has a long and controversial history in Anglo-

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[31] While doctrinal models of contract law often link classical ideology to a conception of contract as an agreement to trade, economic models of contract law tend to treat the enforceable bargain as the central characteristic of classical contract: see, for example Richard A Posner, *Economic Analysis of Law* (Boston: Little Brown & Co. 2nd ed., 1977); Posner "Gratuitous Promises in Economics and Law" (1977) 6 *Journal of Legal Studies* 411; Charles J. Goetz & Robert E. Scott, "Enforcing Promises: An Examination of the Basis of Contract" (1980) 89 *Yale Law Journal* 1261; Melvin A. Eisenberg, "Donative Promises" (1979) 47 *University of Chicago Law Review* 1; Eisenberg, "The Principles of Consideration" (1982) 67 *Cornell Law Review* 640; Eisenberg "The Bargain Principle and its Limits" (1982) 95 *Harvard Law Review* 741.

American law[32]. Just as contentious are the economic justifications for distinguishing between bargain and non-bargain transactions[33].

Posner's analyses of consideration treats the doctrine as a way of "presentiating"[34] promissory exchange so that current decisions to trade in the future are functionally identical to the instantaneous and simultaneous voluntary exchange of the market[35]. He both explains and justifies specific rules of promissory liability in terms of their propensity to facilitate voluntary exchange as a means to the end of wealth-maximisation[36].

In an important essay, Enforcing Promises: An Examination of the Basis of Contract[37], Goetz and Scott suggest that justifications for consideration are to be found in the economic functions of promise rather than the logic of voluntary exchange. A promise, they argue, is a signal that resources will be transferred from promisor to promisee. This

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32 See, for example, Lord Mansfield's "crusade" against the doctrine of consideration: Pillans v. Van Mierop (1756) 3 Burr. 1663; Hawkes v. Saunders (1782) 1 Cowp 289 and the response of Lord Denman in Eastwood v. Kenyon (1840) 11 Ad. & El. 438. For academic commentary on the relationship between the idea of bargain, the concept of promise and the doctrine of consideration, see, Atiyah, Rise and Fall of Freedom of Contract, supra, note 3; Atiyah, Consideration in Contracts: A Fundamental Restatement (Canberra: Australian National University Press, 1971); Charles J. Hamson, "The Reform of Consideration (1938) 54 Law Quarterly Review 233; A.G. Chloros, "The Doctrine of Consideration and the Reform of the Law of Contract" (1968) 17 International and Comparative Law Quarterluy 137; Roscoe Pound "Promise or Bargain" (1958-59) 33 Tulane Law Review 455.

33 Supra, note 31.

34 Macneil, "Restatement (Second) of Contracts and Presentiation" supra, note 10.

35 Posner, Economic Analysis of Law, supra, note 31; "Introduction" to Anthony Kronman and Posner (eds.), The Economics of Contract Law (Boston: Little Brown & Co., 1979).

36 Posner's original argument was that gratuitous promises should not be enforced because they are simple wealth transfers and not wealth-maximising: Posner, Economic Analysis of Law, supra, note 31). Posner's later rationalisations of consideration focus on the administrative costs of enforcing promises: "Gratuitous Promises in Economics and Law", supra, note 31; and the costs of opportunism avoidance: Economic Analysis of Law (1986, 3rd ed.).

37 Supra, note 31.

signal serves the valuable economic function of encouraging promisees to adapt current behaviour in the light of the anticipated transfer. Adjustments in reliance on expectation of future resources, it is argued, enable promisees to obtain maximum benefit from their total resource holdings over present and future time periods. However, the same preparatory decisions which produce "beneficial reliance" if the transfer of resources materialises, will be detrimental if intervening events cause a promisor to "regret" a prior decision to transfer resources and decide not to complete the transfer. The detrimental aspect of the promisees reliance can be seen in two classes of costs. First, preparatory expenditures which were based on the prospective transfer may be wasted. Secondly, by relying on the signal of one promisor, the promisee will have forgone opportunities to deal with others[38].

Goetz & Scott assert that rules of promissory liability ought to promote the benefits of promises and minimise the costs. This objective, they argue, is best accomplished by encouraging prospective contractors to communicate with one another. Promisors might then inform promisees of the possibility that a transfer which has been signalled might not be forthcoming, and promisees could notify promisors about the

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[38] This type of cost is the opportunity cost of the decision to rely. Opportunity cost may be defined as "the benefit forgone by not using the resources in their most highly valued alternative use" Anthony J. Culyer, Economics (Oxford: Basil Blackwell 1985) at 147.

likely extent of their reliance. This type of communication, it is argued, may be achieved at relatively low cost within a bargaining framework, and encouraged by attaching liability to promises which emerge from such a framework. The rationale for promissory liability in the case of bargained promises, then, is that it promotes beneficial reliance by inducing economic actors to produce and communicate reliable information.

Goetz & Scott's analysis suggests that planning doctrines of classical governance may be analysed as a system for promoting information interchange between prospective contractors. Viewed from this perspective, public rules governing contractual bargaining can be seen to have three main functions. Rules denying contractual status to transactions where the subject-matter is not fully specified denote the type of interaction which qualifies for classical governance. These norms operate to deter reliance on transactions before the negotiations have generated sufficient information to justify that reliance. Doctrines relating to the quality of representations made during bargaining are directed at policing inaccurate information. By prescribing sanctions against the proffering of false or misleading information, the courts limit the scope for opportunism - and the need to engage in defensive strategies - during information interchange[39]. Finally, by holding economic actors to bargains based on false assumptions which the other party neither caused nor contributed to[40], classical contract may encourage prospective contractors to clarify possible misunderstandings before relying on a transaction[41].

2. Inadequate Bargaining and the Problem of Certainty

Inadequate specification of the subject-matter of a contract may take a number of forms, and any of the definitional terms - commodity, price, timing, quantity, and method of payment and delivery - may be implicated. Sometimes the lack of definition is apparent from the terms of the arrangement. For example, there were two plausible interpretations of the transaction in Raffles v. Wichelhaus[42]: sale of cotton on board the ship called "Peerless" which had sailed in October or sale of cotton on board the December "Peerless". The court's decision not to enforce the transaction can be interpreted to mean that the bargain did not qualify as a contract and so would not attract enforcement

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39 Timothy J. Muris, "Opportunistic Behaviour and the Law of Contract" (1981) 65 Minnesota Law Review 521.

40 The extent to which classical contract promotes individual responsibility in this context is vividly illustrated by the landmark decision of Smith v. Hughes (1871) LR 6 QB 597. In this case, the plaintiff's failure to disabuse the defendant of his assumption that the oats were in fact old oats, led the defendant to buy what was to him a useless commodity. During the course of his judgment, Cockburn CJ. posed the question: "whether the passive acquiescence of the seller in the self-deception of the buyer will entitle the latter to avoid the contract?" and answered in the negative: at 603.

41 Anthony T. Kronman, "Mistake, Disclosure, Information and the Law of Contracts" (1979) 7 Journal of Legal Studies 1.

42 (1864) 2 H & C 906.

within the classical regime[43]. In effect, by failing clearly to identify the commodity neither party established a sufficient basis for relying on the transfer occurring[44].

Alternatively, inadequate information interchange during negotiations may result in the parties leaving gaps in the private rules of the transaction. Again, the courts tend to deny contractual status to transactions which fail clearly to designate their subject-matter. For example, in May & Butcher Ltd. v. R.[45], the sales transaction identified the commodity and quantities with some specificity, but the parties had made only vague provision for price and timing of payment[46]. When the plaintiff sued for non-delivery, the House of Lords was asked, in effect, to determine whether the plaintiff's beneficial reliance on information that a transfer would be forthcoming was justified given the decisions which had and had not been made during negotiations.

The House of Lords denied that a contract existed on the explicit grounds that the parties had neither agreed a price nor had they created a workable mechanism for defining the price. By virtue of this result, the court reserved the classical governance structure for those situations where the terms of a prospective transfer are sufficiently well-defined

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43 For an alternative interpretation of this decision, see Grant Gilmore, The Death of Contract supra, note 3 at 34-44; and compare A.W. Brian Simpson "Innovation in Nineteenth Century Contract Law" (1975) 91 Law Quarterly Review 247 at 268 n.99.

44 See also Scriven Bros. & Co. v. Hindley & Co. [1913] 3 KB 564.

45 [1934] 2 KB 17n.

46 The provision for each of these matters was that "[it] shall be agreed upon from time to time ... as the quantities ... become available", ibid., at 17.

that there can be no dispute over critical private rules such as price. The parties' failure to finalise crucial terms effectively meant that their bargain did not meet the criteria of contract, defined by Vs. Dunedin as "a concluded bargain ... which settles everything that is necessary to be settled and leaves nothing to be settled by agreement between the parties"[47].

3. Inaccurate Bargaining: The Problems of Truth and Disclosure

In addition to encouraging parties to disclose information about their wants and preferences so that a contract is well-defined, "public" rules of classical governance regulate the communication of material "local knowledge" during negotiations[48]. This type of knowledge includes information about the characteristics of the contractual commodity, beliefs with respect to its value or potential uses, and assumptions pertaining to economic context of a transaction. Regulation of the production and distribution of "local knowledge" poses a dilemma for classical governance. That asymmetrical information-holding creates scope for fraud and other manifestations of opportunism suggests that law ought to promote disclosure and

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[47] Ibid., at 21. See also Scammell & Nephew Ltd. v. Ouston [1941] AC 251. For a contemporary illustration of a similar approach, see the judgment of Robert Goff J. in British Steel Corporation v. Cleveland Bridge Engineering Co. [1984] 1 All ER 504.

[48] Kronman "Mistake, Disclosure, Information and the Law of Contracts" supra, note 41.

sanction attempts to preserve unilateral control over relevant knowledge. On the other hand, the belief that exploitation of privately held information is a corner-stone of enterprise and initiative in market societies may be used to justify protection of an individual contractor's superior knowledge[49].

Classical contract mediates between the contradictory implications of information dispersal by means of working rules governing the general question of disclosure and the specific issue of the accuracy of information which is divulged[50]. These norms embody two critical assumptions[51]. First, knowledge is viewed as a source of economic power within transactions. Secondly, it is assumed that abuse of such power may pose a threat to the system of market relations.

Analysis of classical conceptions of abuse of power derived from knowledge is complicated by the range of relevant doctrines and by the fact-oriented nature of the reasoning in these cases. However, a number of basic scenarios may be identified. In the first case A lies to B and as a result B is induced to contract with A. As between A & B alone, this

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[49] Friedrich A. Hayek, "The Use of Knowledge in Society" (1945) 35 American Economic Review 519; Kronman, "Mistake, Disclosure, Information and the Law of Contracts" supra, note 41. This argument is used, by some economists, to promote protection of "intellectual property rights", see, for example, Ward S. Bowman, Patent and Antitrust Law: A Legal and Economic Appraisal (Chicago: University of Chicago Press, 1973).

[50] Janet Kiholm Smith & Roger L. Smith, "Contract Law, Mutual Mistake and Incentives to Produce and Disclose Information" (1990) 19 Journal of Legal Studies 467.

[51] The distinction between ommission and commission is not very satisfactory. As can be seen from the decision in Smith v. Hughes, supra, note 40, it may be just as misleading for an information-holder to refrain from correcting the other's mistaken assumption as for the person to make an inaccurate statement.

situation presents classical contract with the simplest possible problem[52]. Lying is not conducive to well-functioning markets, and is censured by withholding from A the power to enforce the contract, enabling B to rescind the contract[53] and affording B power to sue for damages.

Unintentionally inaccurate representations may attract less moral censure, but classical contract treats such statements as scarcely less of a threat to the functioning of contractual markets. Contracts which result from the communication of inaccurate material information may be set aside at the behest of the person who relied on the information[54], or the information giver may be required to compensate its co-contractor[55].

Recission attempts to replicate the pre-contractual position and is available only so long as it is deemed possible to approximate the opportunities which were open to

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52 What makes this situation contentious in classical contract is A's subsequent actions in using property fraudulently obtained from B in a contract with C and then disappearing. For for a comparative analysis of the manner in which different legal regimes handle the problem of allocating losses between B and C, see, Saul Levmore, "Variety and Uniformity in the Treatment of the Good-Faith Purchaser" (1987) 16 Journal of Legal Studies 43; for a review of the problems and possibilities of using efficiency criteria to determine the distribution of property rights between the "innocent" original seller and the "innocent" ultimate buyer, see, Harold Weinberg "Sales Law, Economics, and the Negotiability of Goods" 9 Journal of Legal Studies 569.

53 Redgrave v. Hurd (1881) 20 ChD 1.

54 Redgrave v. Hurd, ibid.; Abram SS Co. v. Westville Shipping Co. Ltd. [1923] AC 773. The remedy of recission was given a statutory basis in the Misrepresentation Act 1967.

55 In theory, classical doctrine did not provide for an award of damages to compensate those who were induced to contract by a non-fraudulent misrepresentation, Le Lievre v. Gould [1893] 1 QB 491. However, even before the decision in Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd. [1964] AC 465, courts routinely awarded financial compensation to promisees by constructing the representation as a term of the contract. Thus, those who relied on a misrepresentation were able to recover for their losses in an ordinary action for breach of contract: Dick Bentley Productions Ltd. v. Harold Smith (Motors) Ltd. [1965] 1 WLR 623; see also the opinion of Lord Denning MR in Esso Petroleum Ltd. v. Mardon [1976] QB 801 for discussion of the rationale of the collateral warranty theory.

the parties at that time[56]. As a result, those who have relied on inaccurate information are encouraged to act quickly and avoid actions which might suggest that the transaction fits their private plans[57]. The damages remedy attaches financial costs to inaccurate statements and is readily analysed as a market enabling norm which sanctions opportunism by the statement-maker. That is to say, by holding representors accountable for the information contained in a statement, classical governance not only enables someone who has been misled to recover wealth which has been transferred, but also reduces the prospects of gains from trading on the basis of false information.

The general issue of disclosure poses greater difficulties for classical governance[58]. Take, for example, a situation where A is in possession of information which B does

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[56] See, for example, Leaf v. International Galleries [1950] 2 KB 86, where a plaintiff who had bought a painting after a misrepresentation that the painting was by Constable did not bring an action until five years after execution of the contract and the court withheld the rescission remedy. See also, Clarke v. Dickson (1858) E.B.& B. 148, where a plaintiff who had been induced by misrepresentation to take shares in a partnership subsequently assented to the registration of the partnership as a limited liability company. The Court withheld the recission remedy on the grounds that the transformation from partnership to a corporation had changed the subject-matter of the transaction. As the plaintiff was unable to return his purchase in its original form, it was thought to be impossible to restore the parties to their pre-contractual position.

[57] The decision in Leaf v. International Galleries, ibid., is a good illustration of this incentive function of the remedy in that the plaintiff brought the action as soon as he discovered that the painting was not a Constable. The court's decision that the five year delay barred the plaintiff from his preferred remedy suggests that the representee has some responsibility to verify information about the subject matter of a contract which was communicated during negotiations. In addition the judgment seems to imply that it is inappropriate to undo transactions after the point at which it is reasonable for representors to assume that their contracting partners are satisfied with the commodity.

[58] For contrasting, economic interpretations and analyses, see, Kronman "Mistake, Disclosure, Information and the Law of Contracts" supra, note 41; Kiholm Smith & Smith, "Contract Law, Mutual Mistake and Incentives to Produce and Disclose Information", supra, note 50; Jules Coleman, Douglas D. Heckathorn & Steven Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law' (1989) 12 Harvard Journal of Public Law and Public Policy 639. For an insightful and provocative treatment of the manner in which classical contract handles secrecy and disclosure and a powerful critique of neoclassical economic analysis of disclosure in contract law, see Kim Lane Scheppele, Legal Secrets: Equality and Efficiency in the Common Law (Chicago: University of Chicago Press, 1988).

not have (and could not obtain at low cost) and the fact that the knowledge is privately held makes the contract more beneficial to A than if the information were shared. According to Scrutton LJ., in Moody v. Cox & Hatt[59], classical governance should maintain a ruggedly individualistic approach towards the transaction between A & B. He insists that it is the responsibility of a contractor to bargain for the information which she needs even if the co-contractor knows that the other is relying on a false assumption about the product, or the economic context of the transaction.

> Generally, when you have made a legal contract ... and it has not been obtained by any misstatement of fact, innocent or fraudulent, the contract stands, and the fact that one party or the other knows facts about which he says nothing, which make the contract an unprofitable one to the other party, is of no legal importance[60].

The analysis developed by Cooter & Ulen advocates a different approach to protection of privately held information. They argue that the issue of disclosure may be

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[59] [1917] 2 Ch. 71.

[60] Ibid., Classical case law sometimes recognises that economic actors may rely on non-verbal forms of communication. Compare: Curtis v. Chemical Cleaning and Dyeing Co. [1951] 1 KB 805, where it was held that silence which distorts a positive representation should be treated as a false statement; With v. O'Flanagan [1936] Ch. 575; where it was held that a party who makes a false statement believing it to be true is required to disclose the truth once she has discovered her mistake; and Davies v. London and Provincial Marine Insurance Co. (1878) 8 Ch.D 469 where it was held that: statement makers are responsible for disclosing that a statement which was once true no longer holds. In addition, courts may sanction failure to disclose the whole truth by fine-tuning remedies for breach of contract. For example, in Walters v. Morgan (1861) 3 DeGF & J. 718, Lord Campbell, after noting that contracts of sale do not attract a general duty of disclosure, Lord Campbell commented:

> Simple reticence does not amount to legal fraud, however it may be viewed by the moralists. But a single word, or (I may add) a nod or a wink, or a shake of the head, or a smile from the purchaser intended to induce the vendor to believe the existence of a non-existing fact, which might influence the price of the subject to be sold, wuld be sufficient ground for a Court of Equity to refuse a decree for specific performance of the agreement.

at 723-4.

analysed by distinguishing between "productive facts" and "redistributive facts"[61]. A "productive fact" is an item of information which opens up new opportunities for economic activity[62]. Such facts are thought to create the possibility of increasing wealth. Using the same basic theory which grounds economic justifications for patents[63], Cooter and Ulen argue that the asymmetric holdings of "productive facts" ought to be protected by a rule of non-disclosure in order to preserve incentives to seek out and use such information.

By contrast, "redistributive facts" create only bargaining disparities between economic actors. Possession of redistributive facts may enable information-holders to obtain greater wealth from transactions. However, the gains are secured entirely at the expense of their contracting partners.

Cooter & Ulen use this dichotomy as the basis for developing three normative principles of contractual governance. First, transactions which are based on private knowledge of purely productive facts ought to be enforceable as negotiated and an "owner" of productive facts ought not to be required to share the information. Secondly, this protection of unilaterally held information should be extended to transactions where one party has exclusive knowledge of

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61 Robert Cooter & Thomas S. Ulen, Law and Economics (US: Harper Collins, 1988), chap.7.

62 Compare Kronman's "deliberately acquired knowledge", Kronman, "Mistake, Disclosure, Information and the Law of Contracts", supra, note 41.

63 See Bowman Patent and Antitrust Law, supra, note 49.

"mixed" productive and redistributive facts[64]. Third, purely redistributive facts are thought not to warrant protection. The failure of an information holder to disclose such facts during negotiations, therefore, ought to be a basis for the other party legitimately to refuse to complete the transaction if she so chooses.

C. Private Contingency Planning

Private contingency planning raises the general issue of the management of disruptive events which occur during execution of the transaction. As noted above, the classical model envisages economic actors responding to their inability to control the environment in which they are located by ex ante allocation of the risks of specific contingencies. The classical model's support for this practice of private ex ante planning appears in the "shorthand" provisions for securing remedies such as termination and withholding of performance[65] and in the courts' reluctance to engage in substantive review of exclusion and limitation clauses[66].

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64 The rationale for protection of the information owner lies in the importance of encouraging investment into discovery of productive facts, and the costs of distinguishing between benefits obtained from redistributive and productive information when the two forms are intertwined: Cooter & Ulen Law and Economics, supra, note 61 at 260.

65 See Hugh Beale, Remedies for Breach of Contract (London: Sweet & Maxwell, 1980) for a helpful analysis of doctrines such as "substantial performance" and the conditions / warranties distinction as "self-help" remedial provisions.

66 Parker v. South Eastern Railway (1877) 2 CPD 416; Photo Production Ltd v. Securicor Transport Ltd. [1980] 1 All ER 556.

Illustrations of the extent to which classical governance promotes the institution of private ex ante contingency planning are to be found in doctrines which deal with modification of contract terms. Classical law consistently opposed simple adjustment of a transaction in the light of events which occur after planning has been concluded. This position is reflected in rules denying enforceability to uncompensated changes in contract terms[67], restrictive definitions of the circumstances in which courts will supplement or clarify the private rules of a transaction[68], and the limited range of circumstances which will excuse performance[69].

Explanations for these areas of doctrine may be found in the particular conception of contractual decision-making which is embedded in classical governance. The model assumes that economic actors have the cognitive capacity to understand the risks which disruptive events may pose and treats the bargaining process as an opportunity for intending contractors to trade information about the probability and likely effects of contingencies[70]. As parties are thought to be capable of

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67 Foakes v. Beer (1884) 9 App. Cas. 605.

68 The Moorcock (1889) 14 P.D. 64.

69 Davis Contractors Ltd. v. Fareham Urban District Council [1956] AC 696.

70 Dowie, "The Risks of Contract Law" supra, note 26; Goetz & Scott, "Enforcing Promises: An Examination of the Basis of Contract", supra, note 31; for a helpful classification of classical assumptions with respect to the cognitive capacitities of contracting parties, see Clayton P. Gillette "Commercial Rationality and the Duty to Adjust" (1985) 69 Minnesota Law Review 521; for an insightful critique of the classical premises with respect to private contingency planning, see, Richard E. Speidel, "Excusable Non-Performance in Sales Contracts: Some Thoughts about Risk-Management" (1980) 32 Southern California Law Review 241.

using bargaining to decide how risks might best be allocated, adjustments after formation are perceived to be quite anomalous[71]. Indeed, given the premises of the model, unilateral bids to modify terms during execution of a transaction appear to be opportunistic. Contractors who seek such changes are assumed to be attempting to divest themselves of the actual costs of events for which they had undertaken to bear the expected costs. By withholding support from simple modifications after formation, the working rules of classical governance endorse the institution of <u>ex ante</u> planning both as a means of managing risks and as a protection against redistribution of the transactional surplus[72].

1. Material Modification

The requirement that an alteration to the terms of a contract be supported by consideration[73], together with the doctrines that a promise to perform an existing contractual duty cannot be good consideration[74], and past consideration will not support a later promise[75], limit the scope for renegotiation of risk allocation during contract execution.

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71 <u>Ibid</u>., see also Posner, "Gratuitous Promises in Economics and Law" <u>supra</u>, note 31.

72 Posner, "Gratuitous Promises in Economics and Law" <u>supra</u>, note 31; Muris, "Opportunistic Behaviour and the Law of Contract" <u>supra</u>, note 39; Varouj A. Aivazian, Michael J. Trebilcock & Michael Penny, "The Law of Contract Modifications: The Uncertain Quest for a Bench Mark of Enforceability" (1984) 22 <u>Osgoode Hall Law Journal</u> 173.

73 <u>Vanbergen</u> v. <u>St Edmund's Properties</u> [1933] 2 KB 233.

74 <u>Stilk</u> v. <u>Myrick</u> (1809) 2 Camp 317.

75 <u>Eastwood</u> v. <u>Kenyon</u> (1840) 11 Ad. & El. 438.

This restriction is particularly significant in circumstances where it is difficult, that is, costly, for an outsider to verify a contractor's claim that a disruptive event has been more costly than the parties had anticipated. Classical contract's refusal to endorse uncompensated changes in a contract specification, therefore, provides an alternative to ex post adjudication of conflicting claims about the allocation of risk[76].

Working rules which compel a contractor who seeks adjustment during execution to negotiate and pay for changes in the private rules of a bargain have implications for the initial planning process and parties' decisions about reliance on transactions. Although opportunistic behaviour occurs after a contract has been formed, the success of such behaviour depends in part on the victim's "failure" to invest in adequate precautions during contractual planning[77]. Defensive measures such as extensive pre-contractual search and protracted negotiations, together with restricting beneficial reliance on the contract for fear of opportunism, generate transaction costs. By requiring a material modification to be supported by consideration, the ground rules of classical governance provide a relatively low cost form of protection against opportunism. The doctrinal position of not recognising opportunistic wealth transfers eliminates the payoff from such

[76] Posner, "Gratuitous Promises in Economics and Law", supra, note 31.

[77] Muris, "Opportunistic Behaviour and the Law of Contract" supra, note 39.

behaviour and thus enables economic actors to reduce _ex ante_ resource expenditures on precaution[78].

At first sight it might appear that the ground rules of classical governance are over-inclusive because they do not differentiate between attempts to redistribute shares in the transactional surplus and modifications where a contractor's performance costs have, in fact, risen[79]. For the purposes of classical governance, however, these two situations are indistinguishable. As classical contract assumes that parties were able fully to allocate the risk of changes in performance costs during the bargaining process, it holds that _any_ uncompensated change in contract terms is presumptively opportunistic[80]. Consideration rebuts this presumption because it is taken to indicate two important "facts" about re-negotiation during execution. First, that the party seeking modification pays the other is thought to suggest that the latter consented to the change despite its redistributional consequences. Second, consideration provides evidence that any adjustment in the terms of a transaction is founded on sufficient information interchange to enable the parties to adapt their reliance on the contract in the light of the contingency.

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78 _Ibid_.

79 Aivazian, Trebilcock & Penny "The Law of Contract Modifications", _supra_, note 72.

80 Posner, _Economic Analysis of Law_, _supra_, note 31; compare, Aivazian, Trebilcock and Penny,"The Law of Contract Modifications", _supra_, note 72.

2. Immaterial Modifications: The Doctrine of Implied Terms

Respect for private planning, coupled with awareness of the potential for the law to be used strategically, is also apparent in judicial reluctance to augment "properly constituted" bargains[81]. This issue arises where a contingency which occurs during execution of the contract reveals an ommission in the parties' private rules of the transaction.

Classical governance treats contractual gaps as ambiguous[82]. They might signify that the parties anticipated the event but allocated the risk to the party on whom the losses would fall according to the ordinary working rules of classical governance. In this context a contractor's plea for a different term to be implied may evidence an opportunistic attempt to modify the original distribution of the contractual surplus[83]. Alternatively, contractual gaps might be a reflection of the costs of translating transactional understandings into private rules. Parties may, in fact, have planned for the event but expressed their decision in language

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81 Shirlaw v. Southern Foundries Ltd. [1939] 2 KB 206.

82 Gillette "Commercial Rationality and the Duty to Adjust", supra, note 70; see also, Gillette, "Commercial Relationships and the Selection of Default Rules for Remote Risks" (1990) 19 Journal of Legal Studies 535; Ayres & Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", supra, note 24; Coleman, Heckathorn & Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law, supra, note 58; Kilholm Smith & Smith, "Contract Law, Mutual Mistakes and Incentives to Produce and Disclose Information", supra, note 50; Goetz & Scott, "The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms", supra, note 24.

83 Gillette, "Commercial Rationality and the Duty to Adjust" supra, note 70; Ayres & Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", supra, note 24; Coleman, Heckathorn & Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules", supra, note 58.

which is unclear or otherwise inadequate. In this scenario, the "implication" of a term is thought not to change the bargain, but make it conform to parties decisions at the time of formation[84] and it is resistance to the court's "intervention" which may indicate opportunistic behaviour[85]. Finally, the "gap" may indicate that the parties overlooked the issue during negotiations[86]. The dilemma for classical contract is whether a working rule which permits implication of a term in this context would undermine the model's commitment to bargaining as the primary instrument of governance[87].

Classical contract manages contractual gaps by reference to two doctrinal criteria. First, a transaction will qualify for an implied term only if it is necessary "to give such business efficacy to the transaction as must have been intended by both parties"[88]. Second, the content of the private rule which is to be implied must be "... something so obvious that it goes without saying"[89].

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84 The Moorcock, supra, note 68; Errington v. Errington [1952] 1 KB 290.

85 The Moorcock, ibid.

86 For example, Stubbs v. Trower, The Times May 5, 1987, a firm of solicitors had made an unconditional offer of articles to a law student without drawing his attention to their standard terms to the effect that the offer was subject to the student having passed the Solicitor's Final Examination. In holding that it was not appropriate to imply a term that the offer was predicated on passing the examination, the court, in effect, sanctioned the Law Firm for its carelessness in failing to spell out its underlying assumptions.

87 Coleman, Heckathorn & Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law", supra, note 58; Ayres & Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", supra, note 24.

88 Bowen LJ in The Moorcock, supra, note 68.

89 MacKinnon LJ. in Shirlaw v. Southern Founderies (1926) Ltd., supra, note 81 at 227; see also, the judgment of Lord Wilberforce in Liverpool City Council v. Irwin [1977] AC 239 and note the contrast with the opinion of Lord Denning MR sitting in the Court of Appeal in the same case, where Lord Denning reiterated the views that he had expressed in Greaves & Co. (Contractors) Ltd. v. Baynham Meikle &

3. The Doctrine of Frustration

The limited scope given to the doctrine of frustration provides a further example of the manner in which classical governance reinforces forward planning by treating claims for an ex post alteration in contract terms with considerable scepticism. The issue of frustration arises where a disruptive event which occurs during execution of the contract impacts on the economic activity in such a manner that one party's obligations become substantially more onerous than had been anticipated[90], and the contract terms do not provide for the event. While it is true that ever since Taylor v. Caldwell[91] "frustration" claims have been recognised as potential grounds for relief from contractual obligations[92], it is clear that classical theory has been reluctant to accommodate the idea of frustration, and that in practice, judges have been suspicious of "impossibility" arguments[93].

Partners [1975] 3 All ER 99 to the effect that courts could imply terms into contracts when it would be "just and reasonable" to do so and that the content of such terms should be based on what would be "just and reasonable" in the circumstances of the transaction.

[90] But nb. F.A.Tamplin SS Co. Ltd. v. Anglo-Mexican Petroleum Products Co. Ltd. [1916] 2 AC 397 where the allegedly frustrating event (requisitioning of a ship) made the contract much more profitable to the charterer (who received compensation) and the owner argued frustration in the hope of capturing a share of the compensation.

[91] (1863) 3 B. & S. 826.

[92] For example, in Krell v. Henry [1903] 2 KB 740 a contract to rent a suite of rooms during the days that were planned for the coronation procession of Edward VII was frustrated when the procession was cancelled.

[93] Thus, the closure of the Suez Canal did not frustrate an international sales contract despite the fact that the terms of the transaction were predicated on a shared assumption that the goods would be shipped through the canal: Tsakiroglou & Co. Ltd. v. Noblee Thorl G.m.b.H. [1962] AC 93; and the outbreak of a war which prevented the seller from importing timber did not frustrate a contract to sell Finnish birch timber: Blackburn Bobbin Co. Ltd. v. T.W. Allen & Sons Ltd. [1918] 2 KB 467.

Frustration raises the same general problems as other questions relating to modification of contracts after the conclusion of planning[94]. That is to say, there is the danger that readily to permit discharge in the light of supervening events would undermine ex ante planning and create scope for opportunistic actors to redistribute shares in the contractual surplus during execution. However, classical governance does recognise that there may be circumstances in which contractors should be released from their remaining obligations toward one another[95].

Posner and Rosenfield argue that courts' decisions to discharge contractual obligations may be rationalised as implicit allocations of losses to the superior risk-bearer[96]. The superior risk-bearer, they suggest, is the party who is able to prevent the loss at lower cost. In the event that neither contractor has power to influence the contingency - perhaps the typical case which is governed by the doctrine of frustration - the superior risk-bearer, they argue, should

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94 Aivazian, Trebilcock, & Penny, "The Law of Contract Modifications: The Uncertain Quest for a Benchmark of Enforceability", supra, note 72; Michelle White, "Contract Breach and Contract Discharge due to Impossibility: A Unified Theory" (1988) 17 Journal of Legal Studies 353; Allan Schwartz, "Sales Law and Inflations" (1976) 50 Southern California Law Review 1.

95 Jackson v. Union Marine Insurance Co. (1874) LR 10 CP 125; Poussard v. Spiers (1876) 1 QBD 183 (compare Bettini v. Gye (1876) 1 QBD 351; Morgan v. Manser [1848] 1 KB 184; Krell v. Henry [1903] 2 KB 740 (compare Herne Bay Steam Boat Company v. Hutton [1903] 2 KB 683.

96 Posner & Rosenfield, "Impossibility and Related Doctrines in Contract Law: An Economic Analysis", supra, note 7.

be defined in terms of the party who is the lower cost insurer against the risk[97].

As Michael Trebilcock has demonstrated, the problems of identifying the criteria by which to select the "better insurer" means that superior risk bearer arguments do not provide particularly compelling justifications for decisions in frustration cases[98]. Alan Sykes' economic analysis of the "commercial impracticability" provisions of article 2-615 of the Uniform Commercial Code raises doubts about whether an efficiency norm can either explain, or provide guidance for, judicial dispositions of conflicts over contractual discharge[99]. The rich and detailed model developed by Sykes suggests that it is:

> [e]xceptionally difficult to formulate a default rule of common law that limits discharge to circumstances in which it is efficient - to administer such a rule, courts will typically require more information than is reasonably available to them[100].

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97 Ibid. Bruce argues that the analysis of Posner & Rosenfield abandons the idea of precaution and prevention too quickly. He points out that contractors who are unable to control the context of a transaction, from which is derived an unanticipated contingency, may yet be in a position to influence the impact of the contingency on the transaction. Bruce, therefore, suggests that contract law should maintain incentives to mitigate the effect of unanticipated contingencies, by holding contractors accountable for losses which might have been reduced by cost-justified precautions: Christopher J. Bruce, "An Economic Analysis of the Impossibility Doctrine" (1982) 11 Journal of Legal Studies 311.

98 Michael J. Trebilcock, "The Role of Insurance Considerations in the Choice of Efficient Liability Rules"(1988) 4 Journal of Law Economics and Organization 257; see, also, Speidel, "Excusable Non-Performance in Sales Contracts: Some Thoughts About Risk-Management", supra, note 70.

99 Alan O. Sykes "The Doctrine of Commercial Impracticability in a Second-Best World" (1990) 19 Journal of Legal Studies 43. As Sykes notes, the "commercial impracticability" doctrine of art. 2-615 is distinct from the common law doctrines of mistake and frustration. However, there is sufficent similarity between the intuitions underlying the working rules of both classes of working rules, to suggest that any difficulties in making the UCC provision conform to the norm of efficiency will be at least as profound in the context of the common law norms.

100 Ibid., at 93. Contrast White, "Contract Breach and Contract Discharge due to Impossibility: A Unified Theory", supra, note 94.

To reject Posner & Rosenfield's conclusions with respect to the efficiency of the doctrine is not to deny the intuition that frustration may usefully be viewed as an implied contingency term derived from public rules of governance rather than an implied private rule of governance[101]. Viewed from this latter perspective, the critical issue raised by frustration relates to its implications for contractual bargaining.

The working rules of frustration doctrine, along with other classical norms governing modification during execution, constitute a framework within which intending contractors formulate their private rules of a transaction[102]. This framework is part of the complex set of social relation which define the strength of economic actors' bargaining positions. Norms which prohibit unilateral changes during execution institutionalise a different set of initial bargaining positions than would norms which promote adjustment in the

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[101] Note that the "implied [private] term" rationalisation of frustration, (which treats discharge as an expression of the intention of the parties) was rejected by the House of Lords in Davis Contractors v. Fareham UDC, supra, note 69, see, in particular, the opinion of Lord Radcliffe; see also the view of Lord Denning in Ocean Tramp Steamers v. V.O. Sovracht, The Eugenia [1964] 1 All ER 161. Justifications for discharge which are based on implied "public" norm of governance need not bear any relationship to what the parties might have intended at the time of bargaining. The discharge norm, is viewed, instead, as a ground rule governing contingencies: see, Ayres & Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", supra, note 24; Coleman, Heckathorn & Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law", supra, note 58. Notice that these theorists expressly reject the traditional neoclassical economic methodology of justifying a ground rule or default norm of law by reference to the parties imputed intentions: compare Goetz & Scott, "The Limits of Exapanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms", supra, note 24, where the intention-justification approach to efficency arguments, is used.

[102] Coleman, Heckathorn & Maser, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law", supra, note 58.

light of contingencies which have occurred. The restrictive conditions for the operation of discharge and adjustment within classical governance means that contractors who might wish to change the private rules of a transaction during execution are in a relatively weaker position than if changes were less transaction costly. Rather than permitting on-going adjustment, classical governance requires such contractors to articulate their perception of risks, disclose the costs which they anticipate and bargain for protection during initial negotiations.

That classical governance permits discharge if a contingency is held to constitute a "frustrating" event may relieve some of the pressures on contractors to address remote risks at formation. However, to the extent that courts retain substantial control over definition of the circumstances in which contractual obligations are discharged, the operation of the doctrine would seem to reinforce the model's support for "private" ex ante planning. Contractors who cannot depend upon the courts to discharge contracts in the event of a remote contingency are compelled to confront the possibility of such risks during bargaining and decide whether or not they should be addressed in the private rules of the transaction[103].

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[103] Gillette, "Commercial Relationships and the Selection of Default Rules for Remote Risks", supra, note 82.

D. Enforcement

The remedial structure of classical governance is comprised of ground rules which reflect market enabling norms and contingency norms of governance. In this context, market enabling norms supply the transactional "glue"[104] which renders the "long run, long range, impersonal bargain"[105] of classical contract a reliable basis for action. The instrument of legal enforceability, in effect, transforms private decisions to trade into commitments which "the state will enforce by placing its coercive powers at the disposal of either party if the other fails to perform"[106]. The implications of legal enforceability, however, extend beyond the boundaries of particular arrangements. By providing an assurance that reliance on another's promise will not be betrayed by the bad faith of that other party, enforceability enables "the confidence necessary for social intercourse and enterprise"[107] to develop as a systemic characteristic of market relations over time[108].

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[104] Stewart Macaulay, "An Empirical View of Contract" 1985 Wisconsin Law Review 465.

[105] Llewellyn "What Price Contract? - An Essay in Perspective", supra, note 5 at 720.

[106] Kronman, "Contract Law and the State of Nature", supra, note 15 at 5; see, also, Oliver Wendell Holmes, The Common Law, supra, note 15.

[107] Morris R. Cohen, "The Basis of Contract" (1932) 46 Harvard Law Review 553.

[108] Ibid., see also, the Editors' introduction to Kronman & Posner, The Economics of Contract Law, supra, note 35 where it is suggested that:

> the nonsimultaneous character of [contractual] exchange offers one of the parties a strategic advantage which he can use to obtain a transfer payment that utterly vitiates the advantages of the contract to the other party. Clearly if such conduct were permitted, people would be reluctant to enter into contracts and the process of economic exchange would be retarded.

at 4 (emphasis added).

In their role as contingency norms, the remedies of classical contract function to facilitate "private" decision-making. The remedies embody implicit allocations of the risk that market conditions will change between planning and execution, causing one or other party to "regret" their contractual commitments[109]. These general provisions for risk allocation are available for economic actors to use as an alternative to negotiating transaction specific terms. Where such incorporation occurs, the "standard form" risk allocations function in concert with parties own definitional rules to move the transaction towards the completely contingent ideal[110].

Viewed from a comparative institutional perspective the significance of these two aspects of legal enforcement lies in their influence on contractual decision-making. As market enabling norms, contractual remedies may be seen to limit the scope for unilateral decisions to withhold performance as a means of altering the contractual distribution of benefits, but at the same time they may permit more subtle forms of opportunistic behaviour to thrive. In their role as contingency norms, the remedies may shape contractors' decisions about performance or breach and reliance.

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109 Goetz & Scott, "Enforcing Promises: An Examination of the Basis of Contract", supra, note 31; White, "Contract Breach and Contract Discharge due to Impossibility: A Unified Theory", supra, note 94; Polinsky, "Risk Sharing through Breach of Contract Remedies", supra, note 27; Polinsky, "Fixed Price v. Spot Price Contracts" (1987) 3 Journal of Law, Economics, & Organization 27; Perloff, "The Effects of Breaches of Forward Contracts Due to Unanticipated Price Changes", supra, note 27.

110 Ibid., see discussion, supra, see also, Shavell, "Damage Measures for Breach of Contract", supra, note 28.

1. Opportunism and the Problem of Absolute Enforcement

The market enabling dimension of legal enforceability is embedded in every form of remedy for breach of contract. Whether our interest lies in the discretionary sanctions of literal enforcement, the action for compensatory damages, or "public" governance of "private" remedial techniques such as agreed damages and termination, the practice of enforcement may be understood to increase transactional security[111]. All of the remedies of classical contract may, therefore, be analysed as means of reducing the scope for blatant bad faith in circumstance where contractual performances cannot readily be organised to ensure that cost and benefit streams remain synchronised. It would be wrong to conclude, however, that sanctions against breach of contract completely eradicate opportunism. Not only may legal enforcement leave open the possibility of bad faith appropriation of part of a promisee's expected surplus from a transaction[112], but the remedies themselves may also become a site for opportunistic skirmishing[113].

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[111] For analyses of particular contract remedies which demonstrate sensitivity to opportunism issues, see Thomas S. Ulen, "The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies" (1984) 83 Michigan Law Review, 341; Don Harris, Anthony I. Ogus & Jennifer Phillips, "Contract Remedies and the Consumer Surplus" (1979) 95 Law Quarterly Review 581; Kenneth W. Clarkson, Roger L. Miller, Timothy J. Muris, "Liquidated Damages v. Penalties: Sense or Nonsense" 1978 Wisconsin Law Review 351.

[112] Harris, Ogus, & Phillips, "Contract Remedies and the Consumer Surplus" ibid.

[113] Clarkson, Miller & Muris, "Liquidated Damages v. Penalties: Sense or Nonsense?" supra, note 111.

As an example of the former problem take the action for damages. The often stated working rules of common law damages award is: "that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed"[114]. The combined effect of rules which limit promisors' responsibility for the consequences of their breach, and the difficulty of measuring promisees' true valuations of contracts, however, is that in reality, damages awards may not fully compensate promisees for the loss of their expected contractual surpluses[115]. To the extent that promisors are contractually responsible for delivering goods or services which generate a particular surplus value, the undercompensatory nature of the damages award may, therefore, enable promisors to appropriate part of promisees share of the contractual surplus.

An example of the manner in which contractual remedies may become a site for opportunistic skirmishing may be found in the "public" governance of agreed damages clauses[116]. For example, rules which authorise judicial review of agreed damages clauses create scope for economic actors

[114] Baron Parke, Robinson v. Harman (1848) 1 Exch. 850 at 855.

[115] See Daniel A. Farber, "Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract" (1980) 66 Virginia Law Review 1443; Allan Schwartz, "The Case for Specific Performance" (1979) 89 Yale Law Journal 271; William F. Fritz, "'Underliquidated' Damages as a Limitation of Liability" (1954) 33 Texas Law Review 196; Thomas Ulen, "The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies", supra, note 111; Harris, Ogus & Phillips, "Contract Remedies and the Consumer Surplus", supra, note 111.

[116] Clarkson, Miller and Muris, "Liquidated Damages v. Penalties: Sense or Nonsense", supra, note 111, especially at 368-372.

opportunistically to assent _ex ante_ to a heavy penalty for breach in the knowledge that they can always appeal to the courts for relief against the application of the sanction. On the other hand, a rule which treats agreed damages clauses like any other "private" rule of the bargain opens up the possibility that potential beneficiaries of punitive clauses might opportunistically try to induce breach in order to force payment[117].

Although opportunistic behaviour is a cost of transacting which has no social value, a number of factors mitigate against using the instrument of legal enforceability to ensure absolute transactional security[118]. First, there are the resource costs of maintaining a system for processing claims for relief against the consequences of opportunism, and enforcing penalties that are imposed. Even if the state has the machinery to coerce behaviour always in place, activating its powers will consume resources that might be used for other purposes.

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117 _Ibid_.

118 The extent to which legal enforcement deters opportunism depends on the credibility of the threat that an opportunist will pay for his or her behaviour. Credibility depends on the availability of sanctions, and the severity of the penalty, relative to the expected gain to an opportunist from engaging in strategic behaviour. Availability is a function of the costs to the promisee of invoking the legal remedy, and the conditions under which the promisee qualifies for redress. From the promisor's perspective these two factors determine the probability that opportunistic behaviour will be sanctioned and operate to discount the severity of the penalty. Legal enforcement will provide absolute transactional security only where the penalty discounted by the probability that it will be applied is greater than the net gain which the opportunist can expect from opportunistic behaviour. For analysis of the dynamics by which threats are made credible, see Thomas C. Schelling, "An Essay on Bargaining" (1956) 46 _American Economic Review_ 281, especially at 292-299; Williamson has extended Schelling's analysis in the context of transactional governance, see, for example, "Credible Commitments: Using Hostages to Support Exchange" (1983) 73 _American Economic Review_ 519, and chs. 7 and 8 of _The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting_ (New York: The Free Press, 1985).

Secondly, a regime of absolute enforcement carries its own moral, transactional and political costs. Such a system would require either an enforcement process with the institutional competence to detect every violation (in which event the penalty could be made equivalent to the offence) or a sanction which is sufficiently costly to deter potential opportunist even if the sanction were not applied in every case[119]. A comprehensive, error-free enforcement process would be costly to administer and would entail a degree of overt "public" intervention in private transacting which is inconsistent with the ideology of delegated decision-making promoted by classical contract[120]. The alternative route to absolute enforcement - making the sanction sufficiently punitive to deter any form of strategic behaviour - is also problematic. First, it may entail granting to disappointed promisees enormous power over their contracting partners[121]. Secondly, as in the case of penalty clauses, a heavy sanction may create the potential for reverse opportunism[122].

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119 Ibid., see also, Farber, "Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract", supra, note 115.

120 Duncan Kennedy, "Form and Substance in Private Law Adjudication" (1976) 89 Harvard Law Review 1685.

121 The conventional rationales for the non-availability of specific performance in the event of breach of contracts for personal services seem to reflect a concern with limiting the power of one contractor over another. For example, it is argued that if specific performance were the generally available remedy for breach of contract, it would be more difficult for contractors to depersonalise relationships and that in the context of contracts for personal services the promisor's inability to distance the other party would have a demoralising and demeaning effect. These arguments are discussed in Guido Calabresi & A. Douglas Melamed, "Property Rules, Liability Rules and Inalienability: One View of the Cathedral" (1972) 85 Harvard Law Review 1089; Anthony T. Kronman, "Paternalism and the Law of Contracts", (1983) 92 Yale Law Journal 763; Kronman, "Contract Law and the State of Nature", supra, note 15. See also, Collins, The Law of Contract, supra, note 8.

122 Clarkson, Miller & Muris "Liquidated Damages v. Penalties: Sense or Nonsense", supra, note 111.

The final argument against using absolute enforcement to deter opportunism is centred on the difficulty of identifying opportunistic behaviour, and in particular the costs of distinguishing between "pure" bad-faith failure to perform and non-performance due to the occurrence of a contingency between the decision to trade and delivery. The problem lies in the classical model's ambivalence towards the issue of breach of contract. On the one hand, classical contract treats breach as a possible manifestation of opportunism. On the other hand, the contingency-management function of contractual remedies is based on the assumption that breach may be legitimate where market conditions have changed since the time of planning[123]. It may be argued, therefore, that where it is difficult to infer the reason for non-performance from the fact that it occurs, implementation of a sanction which will deter strategic behaviour may also deter "legitimate" or "efficient" breach[124].

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[123] Holmes, The Common Law, supra, note 15.

[124] John H. Barton, "The Economic Basis of Damages for Breach of Contract", (1972) 1 Journal of Legal Studies, 277; Posner, Economic Analysis of Law, supra, note 31. It should be recognised that "efficient" breaches might also be redistributional, but that classical governance implicitly takes the position that the allocative benefits of such breaches outweigh the redistributional costs.

2. Contingency Norms

The standard enforcement instrument of classical contract is the action for damages[125]. Subject to two important qualifications, the action for damages requires breaching promisors to compensate promisees for the loss of their net expectation from the transaction as measured by the market value of that which promisees expected to gain. Promisees will not, however, receive compensation for "unusual" losses, unless the probability that such losses would occur had been disclosed to the other party during bargaining[126]; nor for costs which might have been avoided by "prudent" action after the breach[127].

As has been argued by contract scholars at least since the 1920's, the idea that remedies compensate plaintiffs for losses caused by defendants' breaches of contract is not, by itself, terribly enlightening. Writing in 1936, Fuller and

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125 As the analysis in this section takes the action for damages to be the paradigm sanction of the classical model of contract, the "working rules" governing specific performance are not addressed here. For an overview of the literature concerning the choice between damages and specific performance as remedies for breach of contract, see Anthony Ogus "Remedies: English Report", in Contract Law Today Don Harris & Denis Tallon (eds.) (Oxford: Clarendon Press, 1989).

126 Hadley v. Baxendale (1854) 9 Exch. 341. For an economic analysis of the remoteness of damage doctrine in terms which are consistent with the idea that contract law functions to promote information interchange, see William D. Bishop "The Contract-Tort Boundary and the Economics of Insurance" (1983) 12 Journal of Legal Studies 241.

127 Payzu v. Saunders [1919] 2 KB 581. For a comprehensive analysis of the mitigation principle, see Goetz & Scott "The Mitigation Principle: Toward A General Theory of Contractual Obligation", supra, note 7; see also, Paul Fenn "Mitigation and the Correct Measure of Damages" (1981) 1 International Review of Law and Economics 223. For contrasting economic analysis of the issue of mitigation and "lost volume" sales (compare, for example, Charter v. Sullivan [1957] 2 QB 117 with Thompson (WL) Ltd. v. R. Robinson (Gunmakers) Ltd. [1955] Ch. 177), see, Charles J. Goetz & Robert E. Scott, "Measuring Seller's Damages: The Lost Profits Puzzle" (1979) 31 Stanford Law Review 323 and Victor P. Goldberg "An Economic Analysis of the Lost Volume Retail Seller" (1984) 57 Southern California Law Review 283.

Purdue, for example, pointed out that in breach of contract actions:

> ... the loss which the plaintiff suffers ... is not a datum of nature but the reflection of a normative order. It appears as a loss only by reference to an unstated ought. Consequently, when the law gauges damages ... it is not merely measuring a quantum, but it is seeking an end, however vaguely conceived this end may be[128]

Contemporary economic analysis of law suggests that the end which should be conceived by the remedy of compensatory damages is accountability for costs resulting from promisors' decisions about breach or performance and promisees' decisions about reliance[129]. It is also argued that in so far as the remedy of compensatory damages induces contractors to internalise the costs which their decisions may impose on contracting partners, the law facilitates management of events which intervene between planning and execution to make performance less profitable than breach[130].

Economic analysis of the manner in which damages awards may shape contractual decision-making address two main issues[131]. Remedies are thought capable of influencing

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[128] Lon L. Fuller and William R. Perdue Jr. "The Reliance Interest in Contract Damages:1" (1936) 46 Yale Law Journal 52 at 53. For a comprehensive treatment of the goals of working rules of contract damages which makes use of English cases, see Anthony I. Ogus, The Law of Damages, (London: Butterworths, 1973).

[129] Barton, "The Economic Basis of Damages for Breach of Contract", supra, note 124; Shavell, "Damage Measures for Breach of Contract", supra, note 28; Posner, Economic Analysis of Law, supra, note 31.

[130] Ibid., see also, Polinsky, "Risk Sharing through Breach of Contract Remedies", supra, note 27; Perloff, "The Effects of Breaches of Forward Contracts Due to Unanticipated Price Changes", supra, note 27; White, "Contract Breach and Contract Discharge due to Impossibility: A Unified Theory" supra, note 94.

[131] For a comprehensive review of economic models of compensatory damages, see, Cooter & Ulen, Law and Economics, supra, note 61.

promisors' decisions about breach or performance in contexts where they receive a better offer from a third party during the time between planning and performance of the original contract. Second, the action for damages is said to have implications for promisees' decisions to rely on the signal, contained in the promise, that resources will be transferred.

With respect to promisors' breach or performance decision, economic models suggest that expectation damages discourage breach except where the new offer is so much better than the price of the first transaction that promisors are able to compensate promisees for the market value of the latters' losses from breach and still be better off[132]. As this remedy requires promisors actually to pay the market value of promisees expectations, it ensures that promisors who are contemplating breach take full account of promisees' beneficial reliance on a contract[133].

Neither of the two alternative measures of compensation - reliance damages or restitution damages - provides the same incentives for promisors to internalise the costs of their decisions to breach. In the case of the reliance measure of damages the objective of restoring promisees to their pre-contractual position means that promisees recover what they have spent in preparation for the exchange, but are not

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[132] Barton, "The Economic Basis of Damages for Breach of Contract", supra, note 124; Shavell, "Damage Measures for Breach of Contract", supra, note 28; Posner, Economic Analysis of Law, supra, note 31.

[133] Ibid.

compensated for the opportunity costs of their reliance[134]. With respect to the restitution measure of damages, not only are the loss of contractual surplus and the loss of an opportunity to make a different contract excluded, but promisors may not even be required to compensate to the full extent of promisees' reliance[135]. Each of these measures, in effect, apportions between the two parties the costs of an event which prompts the promisor to consider breach[136]. As a result, they enable promisors to make their decisions without fully accounting for the costs of their choices.

When applied to promisees' decisions about how far to rely on a contract, economic analysis suggests that a compensation principle will encourage promisees to internalise the costs of this decision only if they are compelled to take account of the possibility that the contract will not be performed[137]. Remedies should, therefore, provide incentives for promisees to limit the extent of their reliance to the point where the cost of the final increment of reliance is equal to the increment of additional value which that reliance adds to the transaction, <u>in the light of</u> the possibility that the promisor may receive a better offer and choose to breach.

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[134] <u>Ibid</u>., see also, Polinsky, "Risk Sharing through Breach of Contract Remedies", <u>supra</u>, note 27; Cooter & Ulen, <u>Law and Economics</u>, <u>supra</u>, note 61 chap. 7.

[135] <u>Ibid</u>.

[136] This point is articulated most clearly in Polinsky, "Risk Sharing through Breach of Contract Remedies", <u>supra</u>, note 27.

[137] <u>Ibid</u>., see also, Shavell, "Damage Measures for Breach of Contract", <u>supra</u>, note 28.

Full protection of the expectation interest does not provide the appropriate incentives to internalise the costs of reliance decisions[138]. Promisees who know that they will receive their contractual expectations in one form or another are fully insured against their private reliance costs being wasted. As they have no reason to discount the benefit of additional reliance by the probability that the resources might be valued more highly by someone else, promisees who anticipate receiving expectation damages have an incentive to invest in reliance as if performance were a certainty[139].

The reliance measure of damages also fails to encourage promisees to make reliance decisions in the light of the possibility of non-performance. Although promisees are not compensated for the opportunity cost component of their reliance, restoration to the pre-contractual position enables recovery of preparatory and incidental reliance costs. As a result, reliance based damages also encourage promisees to view contracts as insurance rather than an investment with an uncertain payoff[140].

By contrast, the restitution measure does encourage promisees to take account of the full costs of their reliance decisions. The limitation of recovery to the value of benefits conferred on promisors means that it is promisees who bear the

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138 Ibid.

139 Ibid.

140 Ibid.

risk of nonperformance. Promisees, therefore, have every incentive to limit their beneficial reliance on a contract to a level which appears justified given their estimate of the probability of breach.

This brief account of the implications of different measures of damages reveals the difficulty of using a single instrument - the remedy for breach of contract - to shape the subsequent decisions of two autonomous decision-makers. The paradoxical nature of compensation within such a two party context means that none of the possible contingency provisions, in their pure form, forces promisors and promisees to bear the full costs of their separate decisions pertaining to a transaction[141].

However, to accept that these basic conceptions of potential contingency terms do not encourage perfect internalisation of contracting decisions is not to deny the possibility that public remedies of classical contract facilitate private risk management. Some law and economics theorists, for example, point to the fact that classical contract law restricts the expectation measure of damages by reference to the doctrine of remoteness of damage, and malleable principles governing causation and mitigation[142]. It

[141] The paradox of compensation is developed in Robert Cooter "Unity in Tort, Contract, and Property: The Model of Precaution" (1985) 73 California Law Review 1.

[142] Ibid., see also, Ogus, "Remedies: The English Report", supra, note 125; Jeffrey Perloff, "Breach of Contract and the Foreseeability Doctrine of Hadley v. Baxendale" (1981) 10 Journal of Legal Studies 39; Goetz & Scott, "The Mitigation Principle: Toward A General Theory of Contractual Obligation", supra, note 7.

is argued that these refinements enhance the accountability of promisees for reliance decisions. Remoteness of damage, for example, is said to compel promisees either to bear the costs of reliance which was not "reasonably foreseeable" themselves, or disclose information about their prospective reliance during contract planning[143]. Once disclosed, the information about reliance may be processed into limitation or exclusion clauses or bargained into the contract price and provisions for remedies. However the information is dealt with during planning, the very fact that it is disclosed means that promisees are more likely to be forced to internalise the costs of their decisions[144].

It should also be recognised that the claim that contingency norms of classical governance facilitate risk management does not depend on the remedies generating "perfect" outcomes[145]. The argument, rather, is that classical contract remedies purely by their existence provide a

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[143] Bishop "The Contract-Tort Boundary and the Economics of Insurance", supra, note 126.

[144] Ibid. Bishop argues that where a plaintiff has exclusive information about its reliance on the transaction; the information might cause the defendant to change its behaviour making breach less likely; and it would not be costly for the plaintiff to convey the information to the defendant, a rule denying recovery will encourage information interchange during bargaining.

[145] See, chapter II, supra, for discussion of the problems with using "outcome-oriented" efficiency criteria. See Jules Coleman, Markets, Morals and the Law (Cambridge: Cambridge University Press, 1988) for a comprehensive critique of "market mimicking" theories of contract law; see also, Coleman, Heckathorn & Maser "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law", supra, note 58. One of the issues which arises in the context of the damages remedies is the range of decisions which might be affected by a contingency norm. It seems unlikely that even a refined working rule governing remedies can generate "efficient" outcomes with respect to issues such as: (i) incentives to search for trading partners; (ii) negotiations (iii) explicitness of contract terms; (iv) performance or breach; (v) precautions against events causing breach (include contributory negligence); (vi) reliance on promises; (vii) reducing loss caused by broken promises; and (viii) resolving the disputes caused by broken promises (Cooter & Ulen, Law and Economics, supra, note 61, n.40 at 304). Note that Cooter & Ulen describe this list as a partial list of behaviours which might be affected by the working rules of contract remedies.

baseline, a ground rule, which at a minimum creates a place for parties negotiations to start and a reference point against which contractors may assess their own efforts[146]. Furthermore, to the extent that parties cannot, at reasonable cost, develop a private rule which effects a more complete internalisation of the costs of relevant decisions, the contingency norms of classical governance, however imperfect, may be better than available alternatives. Upon observing such a choice, our comparative institutionalist question would then be: what is it about the parties' context or economic activity which leads them to use the norm of classical governance rather than one of their other options?

E. The Transaction Cost Implications of the Classical Model of Contractual Governance.

The classical model of contract, taken as a whole, represents one response to the transaction costs of organising economic activity. It embodies a specific conception of the factors which might impede smooth co-ordination of economic activity and it promotes a particular set of strategies for managing these costs. The strategies themselves have transaction cost implications which will vary in severity

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[146] Ayres & Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules", supra, note 24; Coleman, Markets, Morals and the Law, supra, note 145.

according to the nature of the activity which they are supposed to govern.

As I have shown the most striking institutional characteristic of classical governance is its emphatic support for the practice of ex ante planning. The working rules of this model provide direct and indirect incentives to bargain before performance begins and withhold recognition from unilateral changes to the initial decisions during execution of the transaction. Parties to a classical contract are, therefore, encouraged to incur bargaining and negotiation costs at an early stage in their relationship on the implicit assumption that the greater the investment in ex ante planning, the less scope there will be for the development of unproductive conflicts.

Ex ante planning of the subject-matter of a contract is treated as a matter for contractors to decide for themselves, and their decisions are expected to be detailed and precise. Classical contract eschews judicial participation in the definition of "who-does-what-where-when-how-and-for-what-price" and it withholds support from arrangements which are inadequately specified. On the other hand, contractors' failure specifically to plan for contingencies is not necessarily fatal. Contract law may be used to plug a planning gap so long as the implied contingency term of the law is consistent with the parties private decisions.

The idea that contingency norms of law are read into bargains only when they do not contradict contractors' private rules further supports the integrity of <u>ex ante</u> planning as the primary decision making practice of classical contract. Law appears as an instrument which economic actors may use to avoid the transaction costs of negotiating and spelling out each and every rule which is to govern their relationship. The contingency norms of classical governance facilitate the organisation of economic activity without <u>mandating</u> a particular ordering of transactions.

Law is directly implicated in the ordering of economic activity, however, in so far as it supplies market enabling norms[147]. In this guise law draws the line between legitimate and illegitimate forms of advantage-taking within classical contract. The meaning which law attributes to parties' decisions through the norm of enforceability, for example, delimits the extent to which contractors are responsible for their undertakings. By providing a standard (as well as machinery), for enforcement, contract law enables parties to avoid the costs of negotiating a minimum level of reliability and creates a foundation from which economic actors may bargain over greater degrees of responsibility. Market enabling norms also create a framework for bargaining. This framework permits contractors to bargain as if they have no responsibility towards one another apart from the obligation

[147] Collins, <u>The Law of Contract</u>, <u>supra</u>, note 8.

to negotiate in conformity with the classical conception of institutionalised honesty[148].

The front-loading of decision-making costs together with the patterning of restraint and permission embedded in classical governance, suggests that the primary transactional hazards within this model are the uncertainty, and the scope for opportunism created by the intervention of time between decisions to engage in a transaction and its execution. One of the implications of time is that parties to a classical contract are unlikely to be able to perform simultaneously. The resulting divergence in cost-benefit streams creates the risk that at any point where one party has already received a larger part of his share of the benefits and the other has incurred a high proportion of her contractual costs, the former will opportunistically attempt to evade his remaining obligations. To the extent that the interaction of detailed planning with the norm of enforceability aids identification and punishment of opportunism, classical contract enables contractors to avoid the costs of using private techniques to restrict the scope of such bad-faith failures to perform[149].

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148 Ibid., see also, Coleman, Markets, Morals and the Law, supra, note 145; Barber, "The Absolutisation of the Market", supra, note 14.

149 For economically informed analyses of the role of non-legal instruments in promoting transactional security, see, Kronman, "Contract Law and the State of Nature", supra, note 15; Telser, "A Theory of Self-Enforcing Agreements", supra, note 29; Lewis A. Kornhauser "Reliance, Reputation and Breach of Contract" (1983) 26 Journal of Law and Economics 691; Charles Knoebber, "An Alternative Mechanism to Assure Contractual Reliability" (1983) 12 Journal of Legal Studies 333; David Charney, "Non-Legal Sanctions in Commercial Relations" (1990) 104 harvard Law Review 373. See, also, chap. IV infra.

Time also introduces the element of contingency into economic activity. It means that economic actors cannot be certain that decisions taken in the light of existing economic conditions will still seem to make sense when performance is due. With respect to this potential impediment to co-ordination both the structuring of incentives to plan and the supply of standard form risk-allocations within classical contract may be seen as instruments for managing mutual ignorance about the future. Although reliance on these instruments entails transaction costs the costs of using classical contingency planning for the simple economic activity which is sharply defined and sharply executed, may well be lower than alternative forms of risk management.

The institutional structure of classical contract suggests that it may facilitate co-ordination of economic activities located in a fairly competitive market context between relatively equal and honest individuals who are sufficiently well informed about the present to make educated guesses about the future. Classical contract supports reasonable beneficial reliance on this type of transaction by enabling parties to avoid some of the direct costs of egregious bad faith and planning for risks.

Nothing in the classical model suggests, however, that it is an effective means of governing economic activities which involve asset-specificity or non-trivial information asymmetries. In such cases the inequalities between participants in the activity creates the possibility that subtle forms of opportunistic behaviour may occur despite apparent compliance with the private rules of a classical style bargain. Classical contract renders subtle opportunism quite literally invisible, with the result that potentially vulnerable contractors must either incur precautionary costs or risk losing part of their expected gains from the contract.

Nor if we accept the premise of bounded rationality does the particularised ex ante decision making of classical contract serve the needs of those engaged in complex economic activities. Classical contract presents participants in such transactions with a choice between two equally unsatisfactory alternatives. Contractors who attempt to engage in detailed ex ante planning in order to make use of the classical model face the risk that their initial decisions are completely inappropriate in the light of their evolving understanding of the activity. On the other hand, those who try to maintain flexibility by avoiding precise specification may find that their transaction does not qualify for protection within the institutional structure of classical contract.

Chapter IV The Relational Model of Contract

Academic interest in relational contracting has flourished in recent years[1]. The relational contract is said to represent a new model of commercial law[2], illustrate the organic complexity of exchange relations[3], and reveal the power and durability of private ordering in contractual practice[4]. Some relational contract theorists take issue with economists' hostility or indifference to business arrangements which do not fit the conventional market/firm dichotomy[5], others challenge the idea that contract law reflects only images of "autonomy", "discreteness" and "the individual" and does not also contain visions of "connection", "dependence" and "society"[6].

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[1] The symposium on Law, Private Governance and Continuing Relations held to commemorate the 21st anniversary of the publication of Stewart Macaulay's important study of contracting practices: "Non-Contractual Relations in Business" (1963) 28 American Sociological Review 55 provides a good sampling of the range of literature, see 1985 Wisconsin Law Review 461-757.

[2] Robert E. Scott, "A Relational Theory of Secured Financing" (1986) 86 Columbia Law Review 901; John White, "Contract Law in Modern Commercial Transactions: An Artifact of Twentieth Century Business Life" (1982/83) 22 Washburn Law Journal 1. The work of scholars working to develop relational commercial law is reminiscent of Karl Llewellyn's campaign for the promulgation and adoption of the Uniform Commercial Code in the USA, see, for example, Llewellyn "On Law and Our Commerce" 1949 Wisconsin Law Review 625, see, chap 1, supra.

[3] Ian R. Macneil The New Social Contract: An Inquiry into Modern Contractual Relations (New Haven: Yale University Press, 1980); Gideon Gottlieb, "Relationism: Legal Theory for a Relational Society" (1983) 50 University of Chicago Law Review 576. Much of this literature is reminiscent of the work of Emil Durkheim, see, for example, The Division of Labour in Society (London: Macmillan, 1984).

[4] Stewart Macaulay, "Elegant Models, Empirical Pictures, and the Complexities of Contract" (1977) 11 Law and Society Review 507.

[5] Lester F. Saft and Benjamin Klein, "The Law and Economics of Franchise Tying Contracts" (1985) 28 Journal of Law and Economics 345; Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (New York: The Free Press 1985); Victor P. Goldberg, "The Law and Economics of Vertical Restrictions: A Relational Perspective" (1979) 58 Texas Law Review 91.

[6] Supra note 3; see also, Clare Dalton "An Essay on the Deconstruction of Contract Doctrine" (1985) 94 Yale Law Journal 997; Peter Gabel "Intention and Structure in Contractual Relations: Outline of a Method for Critical Legal Theory" (1977) 61 Minnesota Law Review 601; Duncan Kennedy "Form and Substance in Private Law Adjudication" (1976) 89 Harvard Law Review 1685; Hugh Collins The Law of Contract (London: Weidenfeld and Nicolson, 1986).

All theories of relational contracting contest the idea that the classical model of contract should play a central role in our understanding of how economic activity is managed. However, the varying analyses explore two distinct themes. For some theorists the problem with classical contract is that it is an inadequate account of the law pertaining to contractual relations[7]. This area of law, it is argued, does not merely provide a framework for voluntary exchange and endorse privately defined undertakings, but also constructs a network of social responsibilities and obligations which attach to roles, relationship and status[8]. In order to understand the social nature of contract norms, it is necessary, therefore, to discard the classical model and completely restructure the way in which we conceptualise contract law[9].

Other scholars assert that the problem with the classical model is not so much the substance of its norms but its vision

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[7] Ibid., see also, Patrick S. Atiyah, The Rise and Fall of Freedom of Contract (Oxford: Clarendon, 1979) Atiyah, Essays on the Law of Contract (Oxford: Clarendon Press, 1986); Grant Gilmore The Death of Contract (Columbus: Ohio State University Press, 1974); Macneil, The New Social Contract, supra, note 3. It should be recognised that there are differences between the nature of the restructuring of contract law which is proposed by theorists who remain within a legal centralist tradition. Atiyah and Gilmore, for example, have focused on reforming or removing "articifical" boundaries between contractual, tortious and restitutionary obligations. The work of the Critical Legal Scholars, cited above, makes many of the same points, but situates the analysis in a more overtly political and "realist" framework. Classical contract is seen as an "ideology" and its norms are viewed as "contingent". Much of this type of critique is devoted to showing that contract law could be more communitarian, than it is generally perceived to be. Macneil's work addresses some of these themes, but is devoted to expanding our conceptions of contractual relations, and draws its proposals for contract law from this expanded vision.

[8] Ibid., see also Charles Knapp, "Judgment Call: Theoretical Approaches to Contract Decisions-making" (1988) Annual Survey of American Law 307.

[9] Ibid.

of law as fundamental to contractual relations[10]. Economic actors, it is argued, do not treat law as essential, nor even particularly relevant to their contractual arrangements. The idea that legal rules, whatever their content, routinely govern or facilitate economic activities is, therefore, quite simply wrong. The implication of this approach is that we cannot know whether law needs restructuring without a theory of the actual relationship between private and public ordering of economic activity[11].

Consistent with the general themes of the thesis, this chapter is largely concerned with the interaction of private and public ordering embodied in relational forms of governance. A relational contract is viewed as an economic instrument for connecting parties to a long term transaction, and a framework within which participants make decisions about complex economic activities. Relational governance is taken to confront particular impediments to co-ordination and provide distinctive responses to these sources of transaction costs.

This chapter is divided into three main sections. Part A is an overview of relational models of governance. It draws on three schools of relational contract theory to create a picture of the institutional practices by which relational

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[10] Macaulay, "Elegant Models, Empirical Pictures, and the Complexities of Contract", _supra_, note 4; Stewart Macaulay, "An Empirical View of Contract" 1985 _Wiconsin Law Review_ 465; Addison Mueller, "Contract Remedies: Business Fact and Legal Fantasy" 1967 _Wisconsin Law Review_ 833.

[11] _Ibid_.

contracts organise and support economic activity. Part B focuses on the planning of relational contracts. It describes several planning techniques which contractors may use to provide a flexible but reliable framework for making decisions about economic activity. Part C addresses the issue of relational enforcement. It discusses the particular forms of "failure" which might befall relational contracts and describes possible responses to these problems.

A The Institutional Structure of Relational Contracting.

Relational theories of contract are concerned with the management of decisions about complex economic activities situated in an uncertain world. Relational contracts are usually long-term and they may be multipartite. The contract governs the terms on which economic actors participate in economic activity and the processes by which tasks are organised, co-operation is secured and co-ordination is maintained.

It would be a mistake to think that the "working rules" of relational contracts are necessarily to be found in the explicit provisions of agreements between participants[12]. Relational transactions may be constituted as much by cultural

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[12] Macaulay, "Non-Contractual Relations in Busines" supra, note 1, Hugh Beale and Anthony Dugdale, "Contracts Between Businessmen: Planning and the Use of Contractual Remedies" (1974) 2 British Journal of Law and Society 45; Thomas Palay, "A contract does not A Contract Make" 1985 Wisconsin Law Review 561.

understandings and business practices as documented promises. These understandings and practices may be part of the structure of governance whether or not they are formally expressed as such. A transaction which is formulated in the classical form, for example, may in fact be relational because parties behave "as if" governed by norms other than those expressed on the face of a document and implied by contract law[13].

The amorphous character of relational governance means that it is difficult to find comprehensive but succinct definitions of these transactions or even a set of clear identification criteria[14]. In view of this limitation, our discussion of relational governance is perhaps best developed by exploring different perspectives on relational contract and drawing out some common themes. The three models of relational contract reviewed here - empirical studies of contract in action, social exchange theories, and transactional economic analysis - are concerned with the management of complex long-term transactions[15]. The disparate analyses seek to identify

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13 Ibid.

14 Ian Macneil comments to the effect that although "we" may all know what relational contract is, but the number of different "wees" in the community of relational contract scholars leads one to wonder how many conversations are taking place. "Relational Contract: What We Do and Do Not Know" 1985 Wisconsin Law Review 483.

15 Articles which use neoclassical economic arguments to advocate relational norms of contract law are cited where relevant. However, they are not thought to be sufficiently distinctive in method or approach to warrant separate treatment here. This body of work draws on empirical studies, social exchange theory and transactional economics to argue that relational contract law should supply "default" terms which relational contractors could use in lieu of making their own arrangements. It is generally oriented to a "what parties would want" standard and is vulnerable to the same criticisms as "market-mimicing" theories of classical contract law, see, Jules Coleman, Douglas Heckathorn & Steven Maser, "A Bargain Theory Approach to Default Provisions and Disclosure Rules in Contract Law" (1989) 12 Harvard Journal of Law and Public Policy 639; Ian Ayres & Robert Gertner "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 Yale Law Journal 87. For examples

the factors which constrain decisions and to understand the processes by which parties to relational contracts formulate objectives, adjust expectations, perform tasks, and secure compliance with decisions. Each implicitly takes as its starting point Llewellyn's perceptive portrayal of contractual governance:

> [i]n the self-government of sub-groups contract provides an original framework, a constitution, a source of ultimate sanction in dispute or breakdown.... But for the running of affairs [contract terms] say but little. The play of personality, the unrecorded adjustment from day to day, further factual agreement from time to time, informed by usage and by initiative and acquiescence which do not even call for conscious agreeing - these are what fill the contractual framework with a living content; these are what often so stretch and overlay it as to make the initial contract a wholly misleading guide to what occurs[16].

1 Empirical Studies of "Contract in Action"[17]

The "contract in action" branch of relational contract analysis focuses on the extent to which law appears as a

of neoclassical arguments for relational contract norms, see, Charles E. Goetz & Robert E. Scott "Principles of Relational Contracting" (1981) 67 Virginia Law Review 1089; Scott, "A Relational Theory of Default Rules in Commercial Contracts" (1990) 19 Journal of Legal Studies 597; Scott "Conflict and Cooperation in Long-Term Contracts" (1987) 75 California Law Review 2005; Clayton P. Gillette "Commercial Relationships and the Selection of Default Rules for Remote Risks" (1990) 19 Journal of Legal Studies 535; Leon Trakman, "Winner Takes Some: Loss-Sharing and Commercial Impracticability" (1985) 69 Minnesota Law Review 471.

16 Karl N. Llewellyn "What Price Contract? - An Essay in Perspective" (1931) 40 Yale Law Journal 704 at 730.

17 Two points of clarification are in order. First, this section draws on empirical studies in the "Law and Society" tradition and does not deal with empirical testing of the hypotheses of transactional economics. See, infra for citations to the latter studies. Second, this section focuses on empirical studies of "commercial" relationships only. For interesting empirical studies of transactions between businesses and consumers, see, William C. Whitford & Harold Laufer, "The Impact of Denying Self-Help Repossession of Automobiles: A Case Study of the Wisconsin Consumer Act" 1975 Wisconsin Law Review 607; Stewart Macaulay, "Private Legislation and the Duty to Read - Business Run by IBM Machine, the Law of Contracts and Credit Cards" (1966) 19 Vanderbilt Law Review 1051.

significant variable in contractual decision-making[18]. This issue is addressed by examining how far commercial actors "make use of" norms of contract and commercial law when planning, administering and enforcing transactions. In line with the tenets of the classical model, "contract" is characterised as a method of planning and enforcing trading arrangements by reference to structural and contingency rules of law. The studies then compare the practices of business decision-making with the assumptions of the classical model of governance. The (in)significance of contract law to business practice is evaluated by the (lack of) conformity between commercial "reality" and classical contract theory.

Not surprisingly, the empirical studies reveal a wide range of primary planning techniques. But these consistently confound the textbook ideal of complete ex ante definition of performance. Parties may exchange conflicting standard form contracts[19]; sometimes the agreement consists of little more than price and quantity terms, or it may fail to define quantity[20]. Even where there are indications of detailed

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[18] For earlier empirical studies which were much more explicitly directed at law reform or critique of contract law see, Franklin M., Schultz "The Firm Offer Puzzle: A Study of Business Practices in the Construction Industry" (1952) 19 University of Chicago Law Review 237; Friedrich H. Kessler "Automobile Dealer Franchises: Vertical Integration by Contract" (1957) 66 Yale Law Journal 1135.

[19] Macaulay, "Non-Contractual Relations in Business", supra, note 1; Beale & Dugdale, "Contracts between Businessmen: Planning and the Use of Contractual Remedies", supra, note 12.

[20] White, "Contract Law in Modern Commercial Transactions: An Artifact of Twentieth Century Business Life", supra note, 2; Stewart Macaulay, "The Standardized Contracts of US Automobile Manufacturers" 7 International Encyclopedia of Comparative Law ((The Hague: Tubingen, 1974) chap.3, 3-22 - 3-29.

planning, omissions may be as significant as stipulations[21]. Some studies describe a deliberate "non-use" of contract[22], others found that common legal techniques were used in surprising ways[23].

It might be thought that incomplete planning would prompt disputes which parties would then attempt to "resolve" according to the remedial provisions of contract law[24]. On this point the studies consistently suggest that in the event of a conflict the last thing on the minds of parties to a transaction which is a "going concern" is their formal contractual position[25]. Time after time, the empirical studies indicate that the enforcement regime of classical contract is

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[21] Daintith, for example, found that parties to long-term contracts for the supply or iron ore found that while provisions for price adjustments had been planned into contracts, quantities were stated to be fixed. In practice, however, quantities were routinely negotiated according to unstated norms, see Terence Daintith, "The Design and Performance of Long-Term Contracts" in Contract and Organisation: Legal Analysis in the Light of Economic and Social Theory Terence Daintith and Gunther Teubner (eds.) (Berlin: Walter de Gruyter, 1986).

[22] For example, in a study of requirements transactions between automobile manufacturers and their suppliers, Macaulay found that the transactions were structured so that manufacturers avoided any obligation to order components, and were only liable to pay the contract price of finished components and cost of producing partially finished components "excluding profit or losses" which they had ordered but did not need. The framework arrangements, including the expectation that suppliers would supply to order were, however, experienced as binding by suppliers, and reliable by manufacturers. "The Standardized Contracts of US Automobile Manufacturers", supra, note 20.

[23] Beale & Dugdale, for example, found that neither buyers nor supplies showed much enthusiasm for agreed damages clauses, and that if the terms had been planned into a transaction, they were seldom used as a remedy. Parties, instead, negotiated a settlement with little reference to the clause Beale & Dugdale, "Contracts between Businessmen: Planning and the Use of Contract Remedies" supra, note 12 at 55.

[24] The availability of classical contractual remedies as a means of enforcement would of course depend upon the parties having drawn up their transaction so that it qualified as a contract, although transactions which did not meet the standards of contract might still attract reliance or restitutionary obligations and remedies. The studies, however, found little use of the apparatus of law to regulate problems of performance.

[25] For example, Macaulay uses the following comment by a purchasing agent to illustrate "a common business attitude":

> if something comes up, you get the other man on the telephone and deal with the problem. You don't read legalistic contract clauses at each other if you ever want to do business again. One doesn't run to lawyers if he wants to stay in business because one must behave decently.

"Non-Contractual Relations in Business" supra, note 1.

of little relevance to problem-solving in everyday economic activity. Contractors routinely use bargained settlements which may or may not be correlated with legal rights: they draw on obligations of goodwill and rely on sanctions of shame/guilt.

Although the studies by no means speak with one voice on all matters, they issue a clear challenge to the premises of legal and economic analyses of classical contract. Existing studies indicate that commercial arrangements are frequently neither bilateral nor discrete, performance is often ambiguously specified, and breach is seldom countered by invoking legal sanctions. The surveys further suggest that commercial persons when they know, do not care, that daily arrangements to secure supplies and sales are legally ineffective[26]. There is nothing in these studies to support the legal centralist assumption that contract law is a significant "resource allocation facilitator"[27], and there is much to suggest that classical contract may be dysfunctional[28].

Reactions to these findings have varied. Writing in 1977, Stewart Macaulay commented that "many who write about contract law or who advocate social reforms using that body of law

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[26] Macaulay, "Non-Contractual Relations in Business" supra, note 1; Beale & Dugdale, supra note 12.

[27] Sally Falk Moore "Law and Social Change: the Semi-Autonomous Social Field as an Appropriate Object of Study" (1973) 7 Law and Society Review 719.

[28] Robert Gordon, "Macaulay, Macneil and the Discovery of Solidarity and Power in Contract Law" 1985 Wisconsin Law Review 565. Macaulay, Law and the Balance of Power, (New York: Russell Sage Foundation, 1966); Macaulay, "An Empirical View of Contract" supra note 10, see discussion, infra.

argue as if they were unaware of what these studies show"[29]. Despite the steady growth of citations to Macaulay's Non-Contractual Relations during the 1980's, the empirical studies remain largely marginal to contract teaching and scholarship[30].

Among those who do engage with this literature, two competing interpretations dominate. Some treat the empirical work as a diagnostic tool for exposing "gaps" and wrinkles in the legal ordering of business relations. The "non-use" of contract is interpreted as evidence that contract / commercial law is not serving the needs of business and this failure is believed to make economic life difficult for business actors[31]. The studies are taken to establish the need for changes in the law and the direction of reform[32]. Moreover, it is implicitly assumed that upon the plugging of "gaps" and the smoothing of wrinkles, contract / commercial law will be restored to its rightful role as the central "resource

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[29] Macaulay "Elegant Models, Empirical Pictures, and the Complexities of Contract" supra, note 4 at 508; see also Mueller "Contract Remedies: Business Fact and Legal Fantasy", supra, note 10.

[30] The two dominant intellectual movements in contract scholarship over the last two decades - neoclassical economic analysis and critical legal studies - focus almost exclusively on contract law as it appears in cases and textbooks; for recent comments on the invisibility of the empirical literature in contract research and teaching, see Macaulay, "An Empirical View of Contract", supra, note 10 and Gordon, "Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law", supra note 28. Teachers of contract law working in the UK, however, are able to draw on Beale, Bishop & Furmston's excellent casebook, Hugh G. Beale, William D. Bishop & Michael P. Furmston, Contract Cases and Materials (London: Butterworth, 1985) as well as John Tillotson's helpful text, Contract Law in Perspective (London: Butterworth, 1986) (2nd ed.).

[31] White "Contract Law in Modern Commercial Transactions: An Artifact of Twentieth Century Business Life" supra, note 2; Schultz "The Firm Offer Puzzle: A Study of Business Practices in the Construction Industry", supra, note 18; John Swan & Barry J. Reiter Contracts: Cases, Notes and Materials (Toronto: Emond Montgomery, 1991).

[32] White, for example, concludes his investigation of the chemical industry's non-use of article 2-615 of the Uniform Commercial Code by urging "lawmakers" to be "more willing to make the law conform to the sensible practices of business and to accept the fact that the law is incapable of changing these practices except at great cost". White, ibid., at 19.

allocation facilitator" of business activity[33].

An alternative interpretation of the empirical literature suggests that to argue for law reform based on what the studies reveal about the "non-use" of contract is to miss the point[34]. The studies, it is argued, do not indicate that business persons find it difficult to make commercial arrangements which they experience as binding. Rather, they demonstrate that in making, performing, and enforcing contracts, business actors respond to norms which are derived neither from complete ex ante planning nor from the public rules of classical governance[35]. The evidence, therefore, does not so much prove the inadequacy of particular legal rules, as raise serious doubts about the direct relevance of any legal norms and sanctions, whatever their content. Viewed from this perspective, the "contract in action" literature is not about the failure of legal norms but about the "limitations on legal control and the tendency for non-legal norms to compliment legal ones"[36]. The resulting challenge for contract scholars is to develop an understanding of when and why legal norms matter to contractual relations[37]. Commenting on

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[33] Ibid.

[34] Macaulay, "An Empirical View of Contract" , supra, note 10; Douglas G. Baird, "Self-Interest and Cooperation in Long-Term Contracts" (1990) 19 Journal of Legal Studies 583; Richard Lewis "Contracts between Businessmen: Reform of the Law of Firm Offers and an Empirical Study of Tendering Practices in the Building Industry" (1982) 9 Journal of Law and Society 153.

[35] Ibid.

[36] Edwin Schur, Law & Society; a Sociological View, (New York: Random House, 1967) at 131.

[37] There are different interpretations of what this limited "reach" of law might signify. Macaulay, for example proposes that we should explore the way in which contract law might "operate at the margins of ... systems of private government through institutionalised social structures and less formal social fields", Macaulay, "An Empirical View of Contract" , supra, note 10 at 477. Others suggest that the relational behaviour in commercial transactions may indicate that traditional contract

arguments for the incorporation into law of a "default" norm which mandates co-operative adjustments to relational contracts in the event that circumstances change during execution, Douglas Baird remarked:

> To say that parties want re-negotiation when conditions change is not to say that parties want a legally enforceable obligation to re-negotiate when conditions change ... Parties may rationally decide that a promise should not be legally enforceable. They may rationally refuse to embrace a legally enforceable norm of re-negotiation even if they believe such negotiations to be both desirable and inevitable[38].

A third, and as yet relatively undeveloped, interpretation of the "contract in action" literature accepts that law is significant to business relations, but points to "a radical discontinuity between official ways of thinking about law, and the expectations of the inhabitants of the 'semi-autonomous social fields' that the law is supposed to affect"[39]. Contract law, it is argued, always has an effect on relational transactions because by institutionalising property rights, it necessarily distributes entitlements and hence

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law is, in fact, functional, but not as a system of incentives. Contractors, it is said, may be able to behave in a flexible and cooperative manner precisely because the law promotes inflexibility. The essence of this argument is that the requirements of clarity and certainty in conventional legal norms enable contractors to prove their commitment to acting in an "honourable" manner by making concessions and eschewing reliance on formal rights. To enforce a legal obligation to behave relationally, therefore, far from creating incentives to cooperate, would eliminate an important means of demonstrating good faith in commercial relations: see, for example, Baird, "Self-Interest and Cooperation in Long-Term Contracts", supra, note 34; Goldberg suggests that we should not worry about the normative legal implications of relational contracts until we have a clearer understanding of business practices: Victor P. Goldberg "Price-Adjustments in Long-Term Contracts" 1985 Wisconsin Law Review 527.

38 Baird "Self-Interest and Co-operation in Long-Term Contracts" supra, note 34, at 595-6.

39 Gordon, "Solidarity and Power in Contract Law", supra, note 28 at 573.

contractual power and bargaining power between economic actors[40]. There is no reason to assume, however, that the effect of contract law is benign. Indeed the evidence from the studies indicates that when participants in relational contracts use law they do so strategically. Law is wielded to reinforce a tough negotiating position, to be vindictive, or to coerce compliance. It appears "in a completely alienated form as a set of games, strategies and hurdles"[41] and is used as a weapon, an exercise of power, a means of gaining leverage for oneself, or tripping up the other side[42].

2 Social Exchange Theories of Relational Contract[43]

This branch of relational contract theory seeks to reconstruct contractual relations as forms of social exchange.

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[40] Lewis, "Contracts Between Businessmen: Reform of the Law of Firm Offers and an Empirical Study of Tendering Practices in the Building Industry", supra, note 34; Macaulay, Law and the Balance of Power, supra, note 28; Kessler, "Automobile Dealer Franchises: Vertical Integration by Contract", supra, note 18. For a purely theoretical treatment of contract law and the distribution of power, see Anthony Kronman "Contract Law and Distributive Justice" (1980) 89 Yale Law Journal 472.

[41] Gordon, "Solidarity and Power in Contract Law", supra, note 28, at 572.

[42] Ibid; see also, Baird, "Self-Interest and Cooperation in Long-Term Contracts" supra, note 34.

[43] This terminology is awkward. However, the label used by many working within this tradition - relational contract theory - would be confusing. By social exchange theorists, I mean scholars whose ideas inform our understanding of relational contracting, but whose work is neither based on empirical studies of contract in action, nor transactional economic analysis. This body of literature is primarily, though not exclusively, directed at law, and is associated with the work of Ian Macneil. Other contributions to social exchange theories of relational contract, however, are to be found in the deconstruction of "liberal legalism" promoted by the Critical Legal Studies Movement, see references supra, at note 6, and in economic, sociological and anthropological analyses of exchange relationships, see, for example, Cyril Belshaw Traditional Exchange and Modern Markets (1965); Clifford Geertz, "The Bazaar Economy: Information and Search in Peasant Marketing" (1978) 68 American Economic Review (papers and proceedings) 28; Karl Polanyi, The Great Transformation (Boston: Beacon Press, 1957); George A. Akerlof, "Loyalty Filters" (1983) 73 American Economic Review 54; Janet Landa "A Theory of the Ethnically Homogenous Middleman Group: An Institutional Alternative to Contract Law" (1981) 10 Journal of Legal Studies 349; Peter M. Blau, Exchange and Power in Social Life (New Brunswick, USA: Transaction Books, 1986); Richard Lempert "NormMaking in Social Exchange: A Contract Law Model" 1972 Law and Society Review 1.

Its underlying premise is that all forms of exchange, including purely economic exchange, are located within a context of social norms, community bonds, power relations, and experiences of trust, from which their meaning is derived[44]. Contract is viewed as a collective, or community practice. As such, it is said to require an analytical lens capable of encompassing all of the institutions, norms and structures which regulate "the relations among parties to the process of projecting exchange into the future"[45].

Social exchange theorists challenge the individualistic premises of classical contract[46]. They emphasise that contractual relations are shaped by "other-regarding" values like "altruism"[47], "goodwill"[48], and friendship[49], and governed by norms such as participation in decision making[50],

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[44] Anne Mayhew "Culture: Core Concept Under Attack (1987) 21 Journal of Economic Issues 587; Warren J. Samuels "Interrelations between Legal and Economic Processes" in Samuels & A. Allan Schmid (eds.) Law and Economics: An Institutional Perspective (Boston: Martin Nijhoff, 1981).

[45] Macneil, The New Social Contract, supra, note 3 at 4; In "Values in Contract: Internal and External" (1983) 78 Northwestern University Law Reveiw 340, Macneil slightly amends his definition by substituting "persons" for "parties"; more recently he has "clarified" this definition to emphasise that he is including apparently "instantaneous" exchanges (nb. Macneil believes that even instantaneous exchanges involve some projection into the future) in his definition of "the contract dimension" of social relations. The revised definition now reads "the realm of contract encompasses all relations among people in the course of exchanging and projecting exchange into the future", Macneil "Relational Contract: What We Do and Do Not Know", supra, note 14 at 523 and fn. 185.

[46] S. Todd Lowry, "Bargain & Contract Theory in Law & Economics" (1976) 10 Journal of Economic Issues 1; Victor P. Goldberg, "Toward An Expanded Economic Theory of Contract" (1976) 10 Journal of Economic Issues 45.

[47] Kennedy "Form and Substance in Private Law Adjudication" supra, note 6.

[48] Ronald Dore, "Goodwill and the Spirit of Market Capitalism" (1983) 34 British Journal of Sociology 459.

[49] Sally Falk Moore "Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study", supra, note 27; Y. Ben-Porath, "The F-Connection: Families, Friends, and Firms and the Organization of Exchange" (1980) 6 Population and Development Review 1; Shmuel Eisenstadt & Luis Roniger Clients, Patrons and Friends: Interpersonal Relations and the Structure of Trust in Society (New York: Cambridge University Press, 1984).

[50] Ian R. Macneil "Values in Contract: Internal and External, supra, note 45; William Whitford, "Ian MacNeil's Contribution to Contracts Scholarship" 1985 Wisconsin Law Review 545; William M. Dugger, "The Transaction Cost Analysis of Oliver E. Williamson: A New Synthesis" (1983) 17 Journal of Economic Issues 95.

fairness[51], solidarity, and reciprocity[52]. The argument is not merely that economic actors care about things other than the wealth which is expected from an exchange[53], but that without such social and cultural practices, contract could not exist[54]. In effect, these theorists maintain that we cannot comprehend contract without reference to moral norms and social codes governing how things are done[55], and economic actors' commitments to preservation of personal relationships and status.

The immediate priority of social exchange theorists is to develop a model of exchange relations which situates

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51 George A. Akerlof "A Theory of Social Custom, of Which Unemployment May be One Consequence" (1980) 94 Quarterly Journal of Economics 749; Daniel Kahneman, Jack L. Knetsch & Richard Thaler, "Fairness as a Constraint on Profit Seeking: Entitlements in the Market" (1986) 76 American Economic Review 728.

52 Macneil The New Social Contract, supra, note 3; George C. Homans "Social Behaviour as Exchange" (1958) American Journal of Sociology 597; Alvin Gouldner, "The Norm of Reciprocity" (1960) American Sociological Review 161.

53 This claim is readily accommodated within neoclassical economic theorising. It may be argued, for example, that as individuals may derive utility from altruism, self-interested utility maximisation entails the pursuit of generosity along with other preferences in the utility function: see, William M. Landes & Richard A Posner, "Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism" (1978) 7 Journal of Legal Studies 83. Alternatively, it may be argued that for the purposes of relational contracting, it is self-interestedly rational for contractors to seek to co-operation, see, for example, Scott, "A Relational Theory of Default Rules in Commercial Contracts", supra, note 15; Scott, "Conflict and Co-operation in Long-Term Contracts", supra, note 15.

54 Todd Lowry, supra, note 46 ; Kenneth Arrow, Information and Economic Behaviour, (1974) Stockholm); Arrow, The Limits of Organisation, (New York: W.W. Norton & Co., 1974); Ian R. Macneil, "Economic Analysis of Contractual Relations: Its Shortfalls and the need for a 'Rich Classificatory Apparatus'" (1981) 75 Northwestern University Law Review 1018: Amartya Sen, "Rational Fools: A Critique of the Behavioural Foundations of Economic Theory" (1977) 6 Philosophy and Public Affairs 317; Sen, "Goals, Commitment, and Identity" (1985) 1 Journal of Law, Economics and Organization 341.

55 Robert Ferguson provides a dramatic example of the power of professional-cultural norms in his discussion of the prevalence of illegal stock exchange transactions during the nineteenth century, and the inviolability of these transactions as between members of the Stock Exchange. For example, he quotes from the testimony of the Chair of the Committee of the Stock Exchange in front of the Foreign Loans Committee 1895, the following description of sanctions imposed on those who transgressed the rules of Exchange by complying with the legislation in force:

> There is not a gentleman on the Stock Exchange who could stand on the boards one day who refused to carry out the contracts he had made, even in spite of Sir John Barnard's Act ... he would be obliged to walk out; he would be expelled, simply because it would be dishonourable.

"Commercial Expectations and the Guarantee of the Law: Sales Transactions in Mid-Nineteenth Century England" in Law, Economy and Society: Essays in the History of English Law 1750-1914 Gerry R. Rubin and David Sugarman (eds.) (Abingdon: Professional Books, 1984) at 196.

practices of contractual exchange in the context of the cultural arrangements by which these practices are made meaningful. Like the empirical scholars, social exchange theorists treat conventional norms of classical contract as, at best, marginal to the world of transacting. Their concern is not, however, the use of contract law, but the constitution of contractual relations. It is argued that analysis of even the most "relatively discrete" transactions must integrate factors which are filtered out by a tunnel-visioned focus on utilitarian markets[56]. The social construction of needs and tastes, language, and institutions of stability are viewed as significant determinants of all contractual relations[57]. Classical contract, therefore, becomes just one idiosyncratic form of contractual relations, distinguished from others by the fact that decision-makers act "as if" they experience freedom to choose between alternatives, and choose "as if" they are aware of the future[58].

The ultimate objective of social exchange theorists is a general theory of contract relations which integrates "the exclusions, the exceptions and the repressions"[59] from the

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[56] Goldberg, "Toward an Expanded Economic Theory of Contract" supra note 46; Goldberg, "Relational Exchange: Economics and Complex Contracts" (1980) 23 American Behavioural Scientist 337; Dore, "Goodwill and the Spirit of Market Capitalism", supra, note, 48. This theme runs throughout Macneil's work, see, for example, "The Many Futures of Contract" (1974) 47 Southern California Law Review 691.

[57] Macneil, The New Social Contract, supra, note, 3; Don Kanel "The Human Predicament: Society, Institutions, and Individuals" (1988) 22 Journal of Economic Issues 427.

[58] Ibid.

[59] Roberto M. Unger, "The Critical Legal Studies Movement" (1983) 96 Harvard Law Review 561 at 617. Unger's point is that classical conceptions of contract remain ideologically dominant despite the ever-decreasing content and scope of "pure" contract law; see, also, Lawrence M. Friedman Contract Law in America (Madison: University of Wisconsin Press, 1965).

domain of contract with forms of interaction that have remained within. As suggested by Ian Macneil, the project is daunting:

> [t]o have even a glimmer of hope of understanding relational contract we must overcome the impact hundreds of years of history have had on our minds.... By now, we are so brainwashed as to be almost unable to conceive of exchange except in terms of markets and discrete transactions[60].

The relational vision of contracting not only requires that we liberate ourselves from the "false consciousness" of the discrete transactions mentality, but also demands an alternative matrix for managing knowledge of contractual behaviour. Such a theory must provide a single analytical framework for interpreting and understanding corporate and labour law, regulation of housing markets and consumer transactions, as well as such "informal" phenomena as trade association codes, and industry practice. The analytical lens suggested by Macneil is a continuum of integrated contractual relations ranging from the "relatively" discrete exchange[61] to an entire "society"[62]. Contractual relations are to be evaluated by reference to their location along the continuum, and that location is determined by reference to a complex

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[60] Macneil, "Relational Contract: What We Do and Do not Know", supra, note 14 at 483.

[61] Recall that Macneil believes that exchange is never absolutely discrete, supra, note 45.

[62] Macneil, "Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law" (1978) 72 Northwestern University Law Review 854; Gottlieb "Relationism: Legal Theory for a Relational Society" supra, note 6.

combination of relational characteristics[63]. These characteristics include prosaic factors like "time frame", "the extent to which entry and exit are clearly defined," and "number of participants"; complex variables such as "nature of the interaction" and "potential for transformations during the relationship"; and relational values as exemplified by "role integrity", "solidarity", "balancing power in an appropriate fashion", "propriety of means", and "harmonization of the relations with the external social matrix in which they are located"[64].

The development of social exchange theories of contractual relations is currently pursued largely through advocacy of reforms in the law pertaining to contracts[65]. Theorists maintain that legal conceptions of contract should be based on relational characteristics, and that doctrines

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[63] Macneil has developed various schematic forms of classification, see, for examples, "A Primer of Contract Planning" (1975) 48 Southern California Law Review 627; "Values in Contract: Internal and External" supra note 45; "Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law", supra, note 62. Although the emphasis varies according to the particular aspect of contractual relations which is at issue in each piece of work, it is clear that the overarching framework consists of a synthesis of the different criteria. The examples of relevant criteria given here are accordingly drawn from different essays. The intention is merely to illustrate the analysis and not to attempt a synthesis.

[64] In "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 Journal of Law and Economics 233, Oliver Williamson argues that the "rich classificatory apparatus" used by Macneil poses "serious problems of recognition and application" (at 236). Macneil's response to the charge was to insist that the "rich classificatory apparatus" was essential to his point that contract is never merely a "transaction" divorced from social relations, see Macneil "Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a 'Rich Classificatory Apparatus'", supra, note 54 see also, Whitford, "Ian Macneil's Contribution to Contracts Scholarship" supra, note 50.

[65] It is at this point that the work of "social exchange theorists" appears to merge with that of economic theorists of law who use neoclassical arguments to advocate relational contract law. Note, however, that the latter justify the norms which are suggested by reference to the wants and preferences of individual contractors, supra, note 15, and references cited therein.

should embody relational values[66]. Obligations to act in good faith[67] are promoted, as are duties to adjust in the light of changing circumstances[68], recognition of "pre-contractual" reliance[69], and broad judicial discretion with respect to the disposition of contractual disputes[70].

3 Transactional Economic Analysis of Relational Contracting

Transactional economics treats the relational contract as one of a number of decision-making structures for governing economic activity[71]. Relational transactions are distinguished

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[66] Barry J. Reiter, "The Control of Contract Power" (1981) 1 Oxford Journal of Legal Studies 347; Charles Knapp, "Enforcing the Contract to Bargain" (1969) 44 New York University Law Review 673; Duncan Kennedy, "Distributive and Paternalist Motives in Contract and Tort Law, With Specific Reference to Compulsory Terms and Unequal Bargaining Power" (1982) 41 Maryland Law Review 563; Mary Jo Frug "Reading Contracts: A Feminist Analysis of A Contracts Casebook" (1985) 34 American University Law Review 1065.

[67] Robert Summers, "The General Duty of Good Faith - Its Recognition and Conceptualization" (1984) 67 Cornell Law Review 810; Barry Reiter, "Good Faith in Contracts" (1983) 17 Valparaiso University Law Review 705.

[68] Macneil, "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law", supra, note 62; Robert A. Hillman, "Policing Contractual Modification Under the Uniform Commercial Code: Good Faith and the Doctrine of Economic Duress" (1979) 64 Iowa Law Review 849; Richard E. Speidel, "Court-Imposed Price Adjustments Under Long-Term Supply Contracts" (1981) 76 Northwestern University Law Review 369.

[69] Note that within a relational paradigm, the relevant acts in reliance are not, of course, "pre"-contractual: Jay Feinman, "The Meaning of Reliance: A Historical Perspective", "The Meaning of Reliance: A Historical Perspective" 1984 Wisconsin Law Review 1373; Patrick S. Atiyah, "Contracts, Promises and the Law of Obligations" (1978) 94 Law Quarterly Review 193.

[70] Whether or not it is articulated as an explicit goal, greater judicial discretion seems to be an inevitable result of most arguments for more flexible contract law. For an explict treatment of this theme, see Macneil's use of Abram Chayes' essay, "The Role of the Judge in Public Law Litigation" (1976) 89 Harvard Law Review 1281 in "Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law" supra, note 62.

[71] Williamson, The Economic Institutions of Capitalism, supra, note 5; Benjamin Klein, Robert G. Crawford, & Armen A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process" (1979) 21 Journal of Law and Economics 356 Victor P. Goldberg & John R. Erikson, "Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke" (1987) 30 Journal of Law and Economics 369; Kirk Monteverde & David J. Teece, "Appropriable Rents and Quasi-Vertical Integration" (1982) 25 Journal of Law and Economics 321; Paul L. Joskow "Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants" (1985) 1 Journal of Law, Economics & Organization 33; Ronald H. Coase "The Nature of the Firm: Influence" (1988) Journal of Law, Economics & Organization 33; Thomas Palay, "Comparative Institutional Economics: The Governance of Rail Freight Contracting" (1984) 13 Journal of Legal Studies 265; for a brief summary of the main ideas in this body of literature, see, Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 Journal of Law and Economics 233.

from "firm-like" contracts by the parties' relative autonomy, and from classical contract by the parties' comparative interdependence. Contractors' choice of a relational framework is taken to be driven by the transaction costs of managing economic activity under different forms of governance[72].

This type of analysis suggests that relational governance is designed to encourage and to protect the "strong" forms of reliance which arise in transactions where there is no readily available market substitute for performance by the original participants[73]. This "small numbers" condition differentiates the economic context of relational governance from that of the classical transaction and exists whenever the particular identity of contracting parties is significant to the management of a transaction[74]. Relational contractors are assumed consciously to develop a small numbers environment for their activity. They may do so in order to draw on bonds arising from "familiarity", "friendship" or "goodwill", or to make use of transaction-specific investment[75]. Whatever the precise reason for a small numbers condition, it may be viewed as a means of securing a larger transactional surplus than would be obtained if the parties felt that the transaction could easily be replaced.

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[72] Ibid.

[73] Oliver E. Williamson Markes & Hierarchies: Analysis and Antitrust Implications(New York: The Free Press, 1975); Klein, Crawford & Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process", supra, note 71; see, chap. II, supra.

[74] Ibid.

[75] Ibid.

One negative consequence of the small numbers condition is that the distribution of the transactional surplus may become a site for opportunistic behaviour[76]. By sheltering their transaction from market substitutes, relational contractors increase their dependence on one another[77], creating what are in effect "reciprocal monopolies"[78]. However, the mutual dependence which characterises reciprocal monopolies is not necessarily equal. Whether the lack of equivalence is caused by transaction-specific investment, information asymmetry, or the parties' prior failure to specify the contract terms in any detail, the inequality means that there will be stages during the relationship when one party is more dependent than others on the completion of this particular transaction[79]. Such differences in degrees of reliance opens up opportunities for relatively less dependent actors strategically to threaten to withhold co-operation unless shares in a transactional surplus are redistributed in their favour[80].

Not only is the relational transaction situated in a small numbers context, but its environment is also assumed to

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[76] Ibid.

[77] Daintith quotes a source in the iron-ore industry who described the market context of their transactions as "intimate", Daintith, "The Design and Performance of Long-Term Contracts", supra, note 21 at 168.

[78] Chap. II, supra.

[79] Williamson, The Economic Institutions of Capitalism, supra, note 5; Klein, Crawford & Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process", supra, note 71; see chap. II, supra.

[80] Ibid.

be highly uncertain[81] and its participants are taken to be boundedly rational as well as potentially opportunistic. Each of these factors creates additional problems for the governance of economic activity. The bounded character of rationality, for example, means that economic actors may not be able to process all of the information which is relevant to a project[82]; while substantial uncertainty may make it difficult for contractors even to anticipate even the probability of disruptive events still less the impact of such events on their activity[83].

The combined effect of these constraints, together with inequalities arising from information asymmetry, transaction specific investment, or complexity, is to complicate the process of making decisions about economic activity. The environmental and technological characteristics of complex transactions mean that the complete <u>ex ante</u> decision-making practices of classical contract are prone to high error costs[84]. Furthermore, the remedial provisions of classical governance are unlikely adequately to protect agreed shares

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81 This is usually attributed to the lengthy duration of the transaction, and may also arise because of complexity.

82 Herbert A. Simon "Theories of Decision Making in Economics and Behavioural Science" (1959) 49 <u>American Economic Review</u> 253; Armen A. Alchian "Uncertainty, Evolution and Economic Theory" (1950) 58 <u>Journal of Political Economy</u> 211; see chap. II, <u>supra</u>, for an expanded discussion of the idea of "bounded rationality".

83 Williamson <u>Markets and Hierarchies</u>, <u>supra</u>, note 71; Daintith, "The Design and Performance of Long-Term Contracts" <u>supra</u>, note 21; Paul L. Joskow "Commercial Impossibility, the Uranium Market, and the Westinghouse Case" (1977) 6 <u>Journal of Legal Studies</u> 119; Victor P. Goldberg "Relational Exchange: Economics and Complex Contracts", <u>supra</u>, note 56.

84 Williamson, <u>Economic Institutions of Capitalism</u> , supra, note 5; Williamson "Assessing Contract" (1985) 1 <u>Journal of Law, Economics & Organization</u> 177; Goetz & Scott, "Principles of Relational Contracting", <u>supra</u>, note 15.

in the transactional surplus from opportunistic attempts at redistribution[85]. On the other hand an unregulated process of adapting to issues as they arise creates its own problems. First, there is a danger that negotiations for each decision will assume the dimensions of full-scale contractual bargaining[86]. Secondly, the absence of a governing framework raises the spectre of opportunism every time the parties are at the bargaining table[87].

Transactional economists maintain that contractors who are unable to engrave in stone the entire sequence of activity required by a project, or unwilling to specify in advance responses even to conceivable contingencies are neither forced to resort to ad hockery nor contractually powerless. Economic actors, it is argued, may obtain many of the advantages of flexibility and avoid some of its potential costs by constructing a transaction-specific framework of governance[88]. Such a framework may incorporate reassurance techniques to bolster trust and precautionary strategies to restrict the scope for opportunistic behaviour[89]. It may also include procedures for making decisions during the transaction as information improves or becomes more manageable. Taken as a

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[85] Infra, part C.

[86] Williamson, The Economic Institutions of Capitalism, supra, note 5.

[87] Ibid., see also, Goldberg, "The Law & Economics of Vertical Restrictions: A Relational Perspective", supra, note 5.

[88] Supra, note 71.

[89] Carl Shapiro "Premiums for High Quality Products as Returns to Reputations" (1983) 98 Quarterly Journal of Economics 659; Tracy R. Lewis "Reputation and Contract Performance in Long-Term Projects" (1986) 17 Rand Journal of Economics 141; Benjamin Klein & Keith Leffler, "The Role of Market Forces in Assuring Contractual Performance" (1981) 89 Journal of Political Economy 615.

whole, this type of relational governance enables and maintains collaboration between economically autonomous actors who may be uncertain about the future, and unable to grasp information relevant to the present.

4 Toward Synthesis

The three conceptions of relational contracting are driven by opposition to the particular vision of economic relations embedded in classical contract law and neoclassical microeconomic theory. The analyses are sufficiently distinct, however, as to raise doubts about whether they may be assimilated into any metatheoretical framework of analysis[90]. Not only does each school of theorists direct its attack at different aspects of the classical model of exchange relations, but each also pursues its own distinctive agenda. The intellectual commitment of many social exchange theorists to the reconstruction of law in relational form, for example, is based on the premise that law is central to contractual relations. Empirical scholars, by contrast, largely focus on commercial practice "without" the law in order to develop theories of the actual relationship between contract /commercial law and business activity. While the primary

[90] As is evident from the work of scholars such as Goldberg, Palay, Gordon, Lowry, supra, it is possible to make insightful connections between these distinct traditions. A unified framework of analysis, however, may be harder to achieve. One approach to analytical convergence can be seen in Harry N. Butler & Barry D. Baysinger, "Vertical Restraints of Trade as Contractual Integration: A Synthesis of Relational Contracting Theory, Transaction-Cost Economics and Organization Theory" (1983) 32 Emory Law Journal 1009.

objective of many transactional economists is to challenge conventional neoclassical models of economic organisation as a precursor to the development of alternative policies for economic regulation[91].

Without denying the significance of these differences, it is possible to draw out of the disparate analyses some common ideas about the institutional structure of relational governance. First, all three approaches emphasise the importance of "context" or "contractual culture" to relational governance of economic activity. These dimensions of context include participants' (lack of) history of previous dealings and their hopes for future collaboration, together with understandings which arise from "reputation" or "friendship", industry practices and local customs, and trade association or professional codes. Contractual culture operates as part of the normative framework of relational transactions. It grounds expectations and secures reliance. Deliberate transgression of a norm derived from contractual culture is at least as serious within the relational paradigm as is breach of contract to the classical lawyer.

Secondly, the relational contract appears in each branch of theory as a framework for managing economic relationships. This "constitutional" dimension of relational governance is

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[91] See, for example, Klein & Saft, "The Law and Economics of Franchise Tying Contracts", supra, note 5; Goldberg, "The Law and Economics of Vertical Restrictions", supra, note 5; Goldberg, "Institutional Change and the Quasi-Invisible Hand" (1974) 17 Journal of Law and Economics 461; Williamson, "Assessing Vertical Market Restrictions" (1979) University of Pennsylvania Law Review 953.

comprised of decision-making processes which participants experience as binding. These procedures serve two main functions. They designate which issues are to be decided by whom, when and how, thereby creating a structure for adding specificity to general arrangements and adapting to contingencies. In addition, to the extent that the procedures embody norms and values for governing the transaction, the decision-making framework provides a context of commitment to the economic enterprise.

The different theories also share the premise that the institutional structure of transactions creates and shapes relations of power between participants[92]. That is to say, the relational contract is not only a reflection of power relations, but also a source of contractual power. Relational governance is taken to generate opportunities for one or more parties to exercise discretion over decisions which affect the economic lives of other contractors. As this dimension of power is built into the structure of long-term complex transactions it is, in a sense, ineradicable. Relational contract theorists maintain, however, that the organisation of governance shapes the extent to which individual contractors are liable to exploit internal inequalities. The institutionalisation of "other-regarding" values, for example, may reduce the likelihood that a participant would abuse his

[92] As noted in chap. II, supra, some transactional economists appear to be ambivalent about the idea of "power" in economic relations. However, phenomena which are labelled as sources of "transaction costs" may also be described as manifestations of power relations.

or her contractual dominance, as might the incorporation of norms derived from professional socialisation into a structure of governance. Similarly, the coupling of the reputation of a contractually dominant participant to public demonstrations of honesty and fair-dealing may also inhibit exploitation of contractual dominance.

Finally, each of the models of relational contracting treats the law / competitive market nexus of classical contract as, at best, a trivial source of commitment to transactions. Relational contracts are held together by a variety of transactional "glues". Contractors may draw on "cultural" norms such as local custom and industry practice, and construct transaction-specific provisions which are deisgned to secure co-operation "outwith" classical contract law. Such provisions may take the form of direct incentives, deterrents, monitoring procedures and sanctions, or be expressed in transaction-specific conceptions of contractual "morality".

B Relational Planning

It has been seen that theories of relational contracting maintain that boundedly rational actors situated in an uncertain world who are "incapable of reducing important terms of the arrangement to well-defined obligations"[93] are still

[93] Goetz & Scott, "Principles of Relational Contracts", supra, note 15 at 1091.

competent to plan and execute complex, long-term transactions. Relational contractors may use discretion rather than definition, trading certainty for flexibility.

The execution of economic activity demands, however, that at some point, some person or persons select the courses of action which are to be followed. The relational alternative to complete ex ante specification involves supplementing partial initial planning with decision-making machinery for filling in gaps during execution of a transaction[94]. Relational planning techniques may draw on commitments made during the process by which contractors were sought and selected, or understandings derived from participants' history of shared projects. These planning mechanisms differ in the extent to which issues are left open for subsequent determination, the type of process for creating precision which is envisaged, and the degree to which they are currently supported, or even recognised, by law. Underlying these very real differences, however, there is the common premise that whatever decisions are made at an early stage of a relationship, some issues will require further consideration during execution of the transaction.

Relational decision-making techniques may be grouped into

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[94] Ibid., for other comprehensive discussions of discretionary planning techniques, see, Macneil, "A Primer of Contract Planning", supra, note 63; "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law", supra, note 62; Victor P. Goldberg "Regulation and Administered Contracts" (1976) 7 Bell Journal of Economics 426; Goldberg & Erikson, "Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke", supra, note 71; John Bell, "The Effect of Changes in Circumstances on Long-Term Contracts: English Report", in Don Harris & Denis Tallon, Contract Law Today: Anglo-French Comparisons (Oxford: Clarendon Press, 1989).

three basic categories according to whether they make use of "evolutionary planning by participants", "aspirational norms", or "specialist decision-makers". Evolutionary party planning strategies and aspirational norms are forms of "internal" planning which are used to channel the transactional decisions of one or more parties in the direction of their mutual objectives. Reliance on specialist decision-makers, by contrast, involves the use of "external" actors to guide and direct some aspects of the parties' activity. The organisation of tasks and decisions within any actual relational contract may, of course, combine techniques drawn from different categories. For ease of exposition, however, the different strategies will be considered separately.

1 Evolutionary Planning by Participants

This group of relational planning practices is comprised of procedures which enable participants in a transaction to make decisions about specific issues as information becomes available. The governing procedures are usually developed at an early stage in the relationship and are both normative and formal in character. That is to say, the framework of governance not only sets out when decisions are to be made, by whom and within what parameters, but may also incorporate values which the parties have adopted to regulate the transaction. An evolutionary planning practice may, for example, grant one party unilateral discretion over a particular decision but require that contractor to give reasonable or fair notice of decisions before they take effect. Failure to provide the appropriate notice would then result in a decision having less transactional force than if the procedure had been followed.

The category of evolutionary participant planning encompasses an enormous variety of relational decision-making practices. Some techniques delegate decision-making to one contractor[95], in other instances responsibility is shared between two or more parties[96]. The transaction may be organised so that only one or two matters are left for subsequent determination[97], or parties may be involved in on-going decision-making over a range of issues[98]. A decision-making process may be triggered by particular incidents[99], or

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[95] Parties to a requirements contract, for example, agree on price, duration, quality, timing of delivery but leave the quantity term unspecified or make only the general provisions that the buyer will purchase the amount of goods that it needs. More specific decisions are left almost entirely to the buyer's discretion and are to be made as information about its needs emerges. See, for example, Macaulay, "The Standardized Contracts of US Automobile Manufacturers" supra, note 20; see also, Daintith, ""The Design and Performance of Long-Term Contracts", supra, note 21; J. Harold Mulherin, "Complexity in Long-Term Contracts: An Analysis of Natural Gas Contractual Provisions" (1986) 2 Journal of Law, Economics and Organization 105.

[96] For example, relational contracts may be structured as "recurrent sequential transactions". This type of contract involves partial re-negotiation at regular intervals. Unlike the classical model, however, the re-negotiations are shaped by an expectation of continuing interaction: Goetz & Scott, "Principles of Relational Contracts", supra, note 15; Macneil, "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law", supra, note 62.

[97] Scott E. Masten & Keith J. Crocker "Efficient Adaptation in Long-Term Contracts: Take-or-Pay Provisions for Natural Gas" (1985) 75 American Economic Review 1083; Goldberg & Erickson, "Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke", supra, note 71.

[98] See, for example, Acheson's account of negotiations between dealers, co-operative managers, wholesalers and fisherman in Maine: James M. Acheson "The Maine Lobster Market: Between Market and Hierarchy" (1985) 1 Journal of Law, Economics and Organisation 385; see also, chap. VII, infra.

[99] Revision to the price term of a relational contract, for example, may be activated by a particular level of inflation in input costs: Goldberg & Erickson, "Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke", supra, note 71. An example of a different type of triggering event is to be found in Richard Lewis' study of tendering practices in the construction industry. He shows that while general contractors may rely on bids by sub-contractors when preparing

the contract may be structured so that certain types of decisions are made at regular intervals[100].

Daintith's study of supply contracts between iron-ore mines and steel manufacturers provides a good illustration of the use of evolutionary party planning techniques[101]. Contemporary practice within the industry shows that quantity terms are largely determined unilaterally by the buyer on the basis of an annual estimate of its needs for the next year. Although these terms are open to revision during the year, buyers and sellers have a clear understanding that alterations should not be arbitrary, nor should buyers whose needs change unreasonably discriminate between their various suppliers[102]. The determination of price, by contrast, is usually made within bilateral decision-making framework. Daintith gives an example of a model price clause which sets out in considerable detail the procedure for an annual negotiation process and articulates a general governing norm of good faith

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tenders for a building contract, decisions with respect to the terms of a transaction between the general contractor and sub-contractor are activated by the progress of the general contractor on the project: Lewis "Contracts between Businessmen: Reform of the Law of Firm Offers and an Empirical Study of Tendering Practices in the Building Industry", supra, note 34.

100 For example, relational contracts may be structured to accommodate periodic review and, where necessary, revision of decisions with respect to issues such as timing or payments see, for example, chap. VII, infra, or to facilitate evaluation of the quality of performance: see, for example, Oliver E. Williamson "Franchise Bidding for Natural Monopolies - In General and with Regard to CATV" (1976) 7 Bell Journal of Economics 73.

101 "The Design and Performance of Long-Term Contracts" supra, note 21. This study is particularly interesting for its account of the evolution of flexible governance to in response to dramatic shocks in the industry during the 1970's. The iron-ore industry was rocked by devaluation of the US$ - the currency of the contract - the rise of new steel manufacturing states and a drop in demand. Daintith discusses the manner in which fixed classical style transactions are now managed as relational contracts. He notes, for example, that even those contemporary contracts which are still formulated in the "fixed term, fixed quantity, fixed price" mode of the late 1960's are currently governed as if every crucial term were open for revision.

102 Ibid.

bargaining[103].

As is the case with other forms of relational planning, evolutionary decision-making enables contractors to avoid some of the potential error costs of defining specific tasks and responsibilities on the basis of incomplete or inadequate information. By formalising a transaction-specific procedure, relational contractors limit the time span of each decision, and control the range of potentially relevant variables. The premise underlying this type of planning is that contractors will be in a position to formulate well-defined classical style "private rules" at some stage during the transaction. The purpose of situating rule formulation in a relational context is to ensure that the parameters within which terms are defined protect the economic value of the reliance inherent in relational trading arrangements.

The centrality of economic reliance to the relational contract raises the question of whether reliance principles in contract law might function to enhance or protect some forms of evolutionary decision-making[104]. While relational analysis of contractual behaviour suggests that flexible decision-making practices are not dependent on the content of

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[103] Ibid.

[104] For normative arguments to the effect that contract law ought to promote evolutionary decision-making, see, Scott "Conflict and Co-operation in Long-Term Contracts", supra, note 15; Scott, "A Relational Theory of Default Rules in Commercial Contracts" supra, note 15; Knapp, "Enforcing the Contract to Bargain" supra, note 66; Speidel, "Court-Imposed Price Adjustments Under Long-Term Supply Contracts", supra, note 68; Clayton P. Gillette, "Commercial Relationships and the Selection of Default Rules for Remote Risks" (1990) 19 Journal of Legal Studies 535.

law[105], it is possible to identify areas of doctrine which contractors might draw upon to support evolutionary planning. The doctrine of promissory estoppel, for example, gives limited support to adjustments in contract terms when the beneficiary of the change does not compensate the other party[106]. The retroactive extension of contractual liability to decisions made and tasks performed before the parties reach final agreement on every contract term may also be viewed as recognition of non-classical forms of contractual planning[107]. Advocates of relational contract law might also point to the provisions in the Sale of Goods Act for fixing prices in the absence of an explicit contract term. S.8 of the Act not only grants contractual status to sales arrangements where prices are "left to be fixed in a manner agreed by the contract, or ... determined by the course of dealing between the parties"[108], but also supplies a relational style "default" norm for transactions where the parties have not made other arrangements[109].

With respect to other evolutionary planning techniques, however, contract law remains indifferent, ambivalent or even hostile. Even predictable reliance on tenders, for example,

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105 Supra.

106 Central London Property Trust v. High Trees House Ltd. [1947] KB 130.

107 Trollope and Colls v. Atomic Power Construction [1962] 3 All ER. 1035; compare the judgment of Robert Goff J. in British Steel Corporation v. Cleveland Bridge & Engineering Co. Ltd. [1984] 1 All ER. 504.

108 Section 8(1).

109 Sections 8(2) & (3) state: "Where the price is not determined as mentioned in subsection (1) above the buyer must pay a reasonable price. (3) What is a reasonable price is a question of fact dependent on the circumstances of each particular case".

as part of a process of gathering information about the likely costs of a transaction, does not ground contractual responsibility[110]. Nor have English courts embraced the type of framework arrangements to make decisions as are to be found in requirements transactions[111] and "agreements to negotiate" or "agreements to agree" upon, the private rules of a contract[112]. Finally, English courts have tended to be dismissive of general norms of "co-operation" and "good faith" except to the extent that it is "reasonably necessary" to impose such obligations on one party in order to enable the other to perform its contractual undertakings[113]. For example, in Mona Oil Equipment Co v. Rhodesia Railways[114], Devlin J. commented that:

> It is no doubt, true that every business contract depends for its smooth working on co-operation, but

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110 Dickinson v. Dodds (1876) 2 Ch. D. 463; "Reform of the Law of Firm Offers" Law Commission Working Paper no. 60 (London: HMSO, 1975). See also Lewis, "Contracts between Businessmen: Reform of the Law of Firm Offers and an Empirical Study of Tendering Practices in the Building Industry", supra, note 34. Compare the decision of the Supreme Court of California in Drennan v. Star Paving Company (1958) 51 Cal. 2d. 409.

111 The idea that English law does not recognise the "framework" agreement of requirements contracts as a source of obligations is associated with the decision in Great Northern Railway v. Witham (1873) L.R. 9 C.P. 16, see in particular the discussion at 19. However, in a careful study of the relevant case law, John Adams demonstrates that English courts have sometimes supported this type of planning technique: "Consideration for Requirements Contracts" (1978) 94 Law Quarterly Review 73; see also R. v. Demers [1900] AC 103 (PC); Miller v. Sadd [1981] 3 All ER 265. For an illuminating analysis of US theories with respect to these transactions, see, Harold C. Havighurst & Sidney M. Berman "Requirement and Output Contracts" (1932) 27 Illinois Law Review 1.

112 Courtney & Fairbairn v. Tolaini Bros. (Hotels) Ltd. [1975] 1 All ER. 716. Although note that the courts may give some recognition to this planning strategy, once the parties have embarked on execution of the transaction: see, for example, F & G. Sykes (Wessex) Ltd. v. Fine Fare ltd. [1967] 1 Lloyd's Rep. 53.

113 The general principle is to be found in the judgment of Lord Blackburn in Mackay v. Dick [1881] 6 AC 251. Lord Blackburn states:

> Where in a written contract it appears that both parties have agreed that something should be done which cannot effectively be done unless both concur in doing it, the construction of the contract is that each agrees to do all that is necessary to be done on his part for the carrying out of that thing

at 267.

114 [1949] 2 All ER 1014.

> in the ordinary business contract ... the law can enforce co-operation only in a limited degree - to the extent that it is necessary to make the contract workable. For any higher degree of co-operation the parties must rely on the desire that both of them usually have that the business should get done[115].

2 Aspirational Planning Norms

Aspirational planning involves economic actors describing contractual performance in terms of norms such as "good faith", "best efforts", "reasonable care" and "fair dealing"[116]. The operative norms will usually be planned into the transaction at an early stage in the relationship, and they may be linked to standards drawn from the culture of the contract. Relational contractors may, for example, rely on trade association or professional ethical codes as a means of giving specific content to an aspirational norm such as "reasonable care".

This form of planning is typically used to govern those dimensions of a contract which cannot readily be described (or evaluated) as a series of measurable tasks. Aspirational norms may appear in a variety of relational contexts and regulate aspects of a transaction which involve any number of the participants. For example, parties to a long-term contract may, commit themselves to "good-faith" negotiations as a means

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[115] Ibid., at 1018; see, also, Baird, "Self-Interest and Co-operation in Long-Term Contracts", supra, note 34.

[116] Goetz & Scott "Principles of Relational Contracts" supra, note 15; Macneil, "A Primer of Contract Planning", supra, note 63.

of revising crucial terms. An example of aspirational norms governing "unilateral discretion" may be seen in White's study of allocation practices in the chemical industry. He found that there was an operating norm that suppliers' whose production was disrupted by unanticipated contingencies so that they were unable to fulfil outstanding orders would deal "fairly" with their various customers[117].

Perhaps the most significant use of aspirational planning norms is in contracts for services between specialist suppliers of advice and clients. Such transactions are marked by substantial information asymmetries between clients and advisers and are frequently structured to permit advisers to exercise considerable unilateral discretion over the delivery of services to meet the contractual objectives[118]. Planning by reference to outcome alone may adequately channel advisers' discretion in the direction of contractual objectives where the objective is straightforward and the context in which the

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117 White "Contract Law in Modern Commercial Transactions: An Artifact of Twentieth Century Business Life" supra, note 2; see also Daintith, "The Design and Performance of Long-Term Contracts" supra, note 21; Falk Moore, "Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study", supra, note 27. Compare what appears to have happened in Sky Petroleum Ltd. v. V.I.P. Petroleum Ltd. [1974] 1 WLR 576.

118 This type of relational contract fits into the economic model of the principal-agent relationship, although it may not fall within the legal definition of an agency relationship. The economic model of the agency transaction is defined in chap. I, supra; some of the problems which stem from the informationally asymmetrical nature of these contracts are adressed below and in chapter II supra; see, also chapter V, infra. See, generally, Stephen Ross, "The Economic Theory of Agency: The Principal's Problem" (1973) 62 American Economic Review 134; and Steven Shavell, "Risk-Sharing and Incentives in the Principal and Agent Relationship" (1979) 10 Bell Journal of Economics 55. The primary difference in scope between legal and economic models of agency transactions is that professional relationships which are exclusively concerned with the sale of "advice" are typically not viewed as agency transactions within the legal model, see, for example, the judgment of Mackinnon LJ. in Leicestershire C.C. v. Michael Faraday and Partners [1941] 2 KB 205. While such transactions are by no means the paradigm example of the economic conception of the agency relationship, they are sufficiently close in essential characteristics - information asymmetry, the structuring of shares in the transactional surplus, and the costs to the client of monitoring or observing the adviser's performance - that they may fruitfully be analysed in terms of the principal-agent model.

contract is situated is not expected to have a significant impact on the outcome[119]. However, where the problem of information asymmetry is compounded by complexity and uncertainty, the parties may find that it is almost impossible to formulate a contractual outcome with sufficient precision that it provides a useful guide to what the adviser is supposed to do[120]. In this context the inclusion of aspirational norms within a contract - particularly where the norms in effect express a whole code of performance criteria - provides a framework for governing advisers' exercise of unilateral discretion[121].

Doctrinal support for the use of aspirational norms in the governance of relational planning varies with the particular norm and the legal characterisation of the relationship between contractors[122]. The basic norm of "reasonable care", for example, may be treated as an ordinary contractual term and is also recognised as a general rule for governing advisory transactions[123]. It should also be noted that contract law has historically used "fiduciary" obligations as a means of constraining, and hence potentially

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119 Ross, "The Economic Theory of Agency: The Principal's Problem", supra, note 118.

120 Ibid.

121 Veljanovski and Whelan make this point, although their analysis is primarily concerned with monitoring /regulating quality rather than planning: Cento G. Veljanovski & Christopher J. Whelan "Professional Negligence and the Quality of Legal Services - An Economic Perspective" (1983) 46 Modern Law Review 700.

122 I am not suggesting that aspirational planning norms require the support of contract law any more than evolutionary planning processes. However, in view of the debates over relational contract law, it is interesting to note how far relational planning practices are recognised in contract law.

123 Anthony M. Dugdale Professional Negligence (London: Butterworth, 1989) (2nd ed.); Veljanovski & Whelan, "Professional Negligence and the Quality of Legal Services - An Economic Perspective", supra, note 121

guiding, unilateral discretion in transactions which fit the legal definition of agency contracts or for other reasons are viewed as relations of confidence[124]. By contrast, norms such as "best efforts" and "fair treatment" have met with lukewarm judicial support[125].

3 Planning by Reference to a Specialist Decision-maker.

Parties to a relational contract may decide to "contract out" responsibility for particular aspects of planning to a specialist decison-maker who is not otherwise involved in the project. The governance of this type of planning strategy requires participants to make a number of critical choices during the process of developing general arrangements for the transaction. First, contractors must decide which issues will be delegated to the specialist, and agree upon the procedures which are to govern the specialists' decision-making. Secondly, the parties will need to reach agreement on the identity of the specialist, or set up a process for selecting the decision-maker. Finally, the effectiveness of this form of planning as a means of managing relational contracts depends on the participants committing themselves to accept

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[124] Lamb v. Evans [1893] 1 Ch. 218; T. Mahesan S/O thambia v. Malaysian Government Officers' Housing Society [1979] AC 374; see also, the discussion of "relations of confidence" and the obligations which may arise within such relationships, in National Westminster Bank plc v. Morgan [1983] 1 All ER 821.

[125] See, for example, A. Schroeder Music Publishing Co. Ltd v. Macaulay [1974] 3 All ER 616, see in particular, the opinion of Lord Reid where he dismisses the idea that norms such as "good faith" or "best endeavours" might have been a source of legally significant obligations owed to the songwriters by the publishers.

the specialist's decisions.

Specialist decision-makers are frequently used to manage actual or potential conflicts between participants during the transaction. For example, relational contractors may agree to submit particular questions to arbitration on the understanding that their continuing relationship will be based on the arbitrator's determination of the issue[126]. As noted by Macneil this type of "interest-arbitration" over contractual gaps is "inherently more open-ended" than "rights-arbitration"[127]. The parameters within which the decision-maker operates are not derived from legal concepts of rights and obligations but must be sought in the parties' "situation" and needs for continuity and commitment to the transaction[128]. Resolution of any serious conflicts or actual disputes between contractors is less concerned with the vindication of one participant at the expense of others than with persuading contractors that their interest lies in maintaining co-operation and finding common ground[129].

This type of specialist decision-making is likely to be found in transactions where the antagonistic nature of the

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126 Lon L. Fuller "Collective Bargaining and the Arbitrator" 1963 Wisconsin Law Review 3; Linda Dickens "The Advisory Conciliation and Arbitration Service: Regulation and Voluntarism in Industrial Relations" in Robert Baldwin & Christopher McCrudden (eds.) Regulation and Public Law (London: Weidenfeld & Nicolson, 1987); Soia Mentschikoff, "Commercial Arbitration" (1961) 61 Columbia Law Review 846; Rick Brown "Contract Remedies in a Planned Economy: Labour Arbitration Leads the Way" in Barry J. Reiter & John Swan (eds.) Studies in Contract Law (Toronto: Butterworth, 1980).

127 Macneil, "Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law" supra, note 62.

128 Ibid.

129 Dickens, "The Advisory Conciliation and Arbitration Service: Regulation and Voluntarism in Industrial Relations", supra, note 126; Fuller, "Collective Bargaining and the Arbitrator", supra, note 126.

parties' interests with respect to particular issues poses a threat to the general framework of collaboration[130]. Participant planning of such issues brings the opposition of interests to the forefront of the transaction. The resulting focus on conflict rather than co-operation may undermine or even destroy the parties' commitment to the relationship. It is argued that in such a context relational contractors who delegate responsibility for deciding contentious issues to a specialist who is trusted by all parties may, in effect, distance themselves and the relationship from the conflict[131]. Resort to specialist decision-making in such circumstances, therefore, is not only a process for making difficult planning choices, but also a means of preserving co-operation.

Legal recognition of the use of specialist decision-makers to deal with particular issues in contract planning can be seen in doctrinal support for agreements to submit such issues for determination by a third party[132]. Not only do English courts view arbitration and external valuation clause as generally valid, but they may also sanction contractors who attempt to circumvent such provisions[133].

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[130] Macneil, "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law", _supra_, note 62; see, for example, Dickens, "The Advisory Conciliation and Arbitration Service: Regulation and Voluntarism in Industrial Relations", _supra_, note 126.

[131] _Ibid_., see also, George Marcus & Paula Marcus "Fact-Based Mediation for the Construction Industry" (1987) 42 _Arbitration Journal_ 6.

[132] _Arcos Ltd_ v. _Aronson_ (1930) 36 Ll L. R. 108; _Sudbrooke Trading Estate_ v. _Eggleton_ [1982] 3 All ER 1.

[133] _Doleman & Sons_ v. _Osset Corporation_ [1912] 3 KB 257 & 267. Note also, that under the Arbitration Act 1950, the court may stay proceedings in the event that a contractor seeks to use the courts before resorting to arbitration: s.4(1).

C Transactional Security in Relational Contracts

1 The Problem of Enforcement in a Relational Context

The institutions and instruments of relational enforcement are shaped by the specific forms of transactional insecurity to which these contracts are exposed. The flexibility of relational planning means that there is relatively little need for remedies to perform the contingency management function ascribed to them by classical contract theory[134]. However, the strong nature of contractors' reliance on relational transactions, the potential for reciprocal monopolies and the fact that the value of a relational contract is substantially higher than available alternatives create conditions in which opportunism can flourish[135].

Opportunism in relational contracts is essentially a function of power relations which are built into the structure of the transaction. That is to say, it is the organisation of the contract which enables one party to exercise sufficient control over matters affecting the economic lives of other participants that she or he is in a position to effect a

[134] Goldberg "Price Adjustments in Long-Term Contracts" , supra, note 37.

[135] Williamson, The Economic Institutions of Capitalism, supra, note 5; Klein, Crawford & Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process" supra, note 71; Beth V. Yarbrough & Robert M. Yarbrough "Institutions for the Governance of Opportunism in International Trade" (1987) 3 Journal of Law, Economics & Organization 129.

redistribution of shares in the transactional surplus[136]. Whether such a redistribution is sought, and if attempted successful, however, is also shaped by the contract[137]. Opportunism, it is argued, may be made less likely by the development of social norms and cultural bonds within the parties' relationship, deterred by the incorporation of "reputation" into the contract, and pre-empted by well-designed sanctions[138].

The efficacy of different responses to the danger of opportunism hinges in part on the nature and the extent of inequality between participants. Of particular relevance are two sources of relational dependence: transaction-specific investment and significant information asymmetries.

As we have seen contracts in which transaction-specific investment links otherwise autonomous actors have two important characteristics[139]. First, there exists a substantial gap between the value of the transaction specific assets when deployed for the purposes of the contract and their value in alternative uses[140]. Second, transaction-specific investment

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136 Ibid.

137 Williamson, "Credible Commitments: Using Hostages to Support Exchange" (1983) 73 American Economic Review 519; David Charney, "Nonlegal Sanctions in Commercial Relationships" (1990) 104 Harvard Law Review 373.

138 Ibid., see also, Tracy R. Lewis, "Reputation and Contract Performance in Long-Term Contracts" supra, note 89; Shapiro, "Premiums for High Quality Products as Returns to Reputations" supra, note 89; Lewis Kornhauser, "Reliance, Reputation and Breach of Contract" (1983) 26 Journal of Law & Economics 691; Daniel K. Benjamin, "The Use of Collateral to Enforce Debt Contracts" (1978) 16 Economic Inquiry 333.

139 Supra, chap. II.

140 Williamson, The Economic Institutions of Capitalism, supra, note 5 at 52-56; Klein, Crawford, Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process" supra, note 71.

causes inequality in the rate at which investing parties and non-investing parties incur contractual costs and receive their shares of the transactional surplus[141]. Taken together these traits create reciprocal but unequal monopolies between investing and non-investing contractors. That is to say, while investors and non-investors rely upon the particular transaction to achieve their economic goals, and both may be in such a position that completion of the particular transaction is more valuable than any available alternative, investors typically have more to lose from breakdown of the transaction than non-investors[142].

The unequal dependence of parties to a relational contract involving transaction-specific investment, together with the high value of the transactional surplus, opens of the possibility of opportunistic attempts to resdistribute shares in the surplus. At the most basic level non-investors may simply threaten to withhold co-operation unless the investor gives up part of her share in the surplus. Agreement to such a change would clearly leave an investor worse off than under the original contractual provisions for distribution of the transactional surplus. The power of this type of strategic behaviour, however, is that the threat erases the original contractual provisions from the range of options available to investors. Investing parties are, instead, faced with a choice

141 Ibid.

142 Ibid.

between accepting a smaller share of the surplus and losing everything that they had expected to gain from non-investors continued co-operation.

As is apparent from the economic model of the principal-agent relationship, transactions based on information asymmetry open up the possibility of another form of opportunism[143]. The power relations of these contracts arise from parties' differential expertise or access to relevant knowledge in an uncertain world, either of which conditions results in principals relying on agents' to achieve their economic objectives[144]. One consequence of this inequality is that less expert, less informed principals do not have the resources to observe and evaluate all dimensions of performance by agents. To the extent, therefore, that the value of the transaction to the principal depends on aspects of the agents performance which the principal is unable to monitor, the agent may, by delivering a substandard service, redistribute shares in the transactional surplus[145]. Such cheating may be described as <u>implicit</u> opportunism in that the agent is able to bring about the redistribution without directly confronting the principal[146].

It is apparent that these two forms of redistributive

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[143] Ross "The Economic Theory of Agency: The Principal's Problem", <u>supra</u>, note 118; see also, chap. II, <u>supra</u>.

[144] <u>Ibid</u>.

[145] <u>Ibid</u>., see also, Eugene F. Fama & Michael C. Jensen "Agency Problems and Residual Claims" (1983) 26 <u>Journal of Law and Economics</u> 327; Benjamin Klein "Contracting Costs and Residual Claims: The Separation of Ownership and Control" (1983) 26 <u>Journal of Law and Economics</u> 367.

[146] <u>Ibid</u>.

behaviour may be traced to inequalities in contractual relations, and it might plausibly be argued that both types of opportunism are to some extent be curtailed by the incorporation of "other-regarding" values and social norms into relational transactions[147]. With respect to more direct preventative strategies, however, the design of protective instruments is tied to the specific form of inequality which underlies different manifestations of opportunism. Security against the explicit opportunism of redistributive bargaining is associated with "commitment" and "reassurance" strategies which make it more difficult for non-investors credibly to threaten to withhold co-operation[148]. Protection from implicit opportunism is more commonly linked to contractual practices which promote "fusion" of parties interests[149], or monitoring strategies which create measurable proxies for non-observable aspects of performance[150].

2 Explicit Opportunism and Commitment Strategies

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147 Charney, "Non-Legal Sanctions in Commercial Relations", supra, note 137; Macneil, "Values in Contract: Internal and External" supra, note 45; Robert Dingwall & Paul Fenn, "'A Respectable Profession'? Sociological and Economic Perspectives on the Regulation of Professional Services" (1987) 7 International Review of Law & Economics 51; Williamson, "The Logic of Economic Organization" (1988) 4 Journal of Law, Economics, & Organization 65.

148 Williamson "Credible Commitments: Using Hostages to Support Exchange", supra, note 137; Anthony Kronman "Contract Law and the State of Nature" (1985) 1 Journal of Law, Economics and Organization 5; Thomas C. Schelling, Choice & Consequence (Camb., Mass: Harvard University Press, 1984); Tracy R. Lewis, "Reputation and Contract Performance in Long-Term Contracts" supra, note 89; Shapiro, "Premiums for High Quality Products as Returns to Reputations" supra, note 89; Lewis Kornhauser, "Reliance, Reputation and Breach of Contract", supra, note 138.

149 Kronman "Contract Law and the State of Nature", supra, note 148; Leonid Hurwicz, "The Design of Mechanisms for Resource Allocation" (1973) 63 American Economic Review (papers and proceedings) 1.

150 Fama & Jensen "Agency Problems and Residual Claims", supra, note 145.

The primary relational response to the reciprocal but unequal monopolies of contracts based on idiosyncratic investment involves structuring the contract so that the rate at which contractors incur costs and receive benefits is more closely aligned. In theory, at least, realignment may be achieved by organising the contract so that non-investing parties commit themselves to incurring certain costs in the event that they opportunistically attempt to redistribute shares in the transactional surplus[151]. By exposing themselves to losses in this way, non-investing parties, in effect, reduce the credibility of strategic threats to withhold co-operation[152].

The efficacy of this type of commitment strategy in any particular relational contract depends on whether the prospect of loss is in fact an adequate deterrent to redistributive bargaining. This issue in turn hinges on three related factors: the size of the loss which an opportunist will incur relative to the potential gain from redistribution, the likelihood that an investor will correctly identify opportunistic behaviour, and the probability that the sanction will be invoked. The institutional structure of real-world relational contracting means than none of these factors can be taken for granted. Some insight into the potential role of commitment strategies may be gained, however, by exploring

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151 Williamson, "Credible Commitments: Using Hostages to Support Exchange", supra, note 137;
152 Ibid.

two aspects of relational governance: the extent to which the legal regime of contract enforcement obstructs or facilitates reliance on commitment strategies and the type of contractual practices which relational contractors may use to secure commitment.

As noted above the issue of whether contract law actively facilitates the creation, management or performance of relational contracts is highly debateable[153]. Much less contentious is the claim that law is at some level implicated in strategic behaviour. Some contract theorists argue that relational legal norms may prevent opportunism[154]. Others are sceptical[155]. Most agree, however that contract law shapes relations of power within relational transactions. Therefore, to the extent that relational contractors have access to law, its content is likely to be relevant to struggles over the distribution of transactional surpluses[156].

Legal remedies which provide any sanction against non-performance clearly promote some degree of commitment to contracts. Relational transactions involving idiosyncratic

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[153] Supra, see also, Lester G. Telser, "A Theory of Self-Enforcing Agreements" (1980) 50 Journal of Business 27.

[154] Goetz & Scott "Principles of Relational Contracts", supra, note 15; Scott, "Conflict and Cooperation in Long-Term Contracts", supra, note 15; Gillette, "Commercial Relationships and the Selection of Default Rules for Remote Risks", supra, note 104.

[155] Macaulay, An Empirical View of Contract, supra, note 10; Gordon, "Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law", supra, note 28; Baird, "Self-Interest and Co-operation in Long-Term Contracts", supra, note 34.

[156] One important implication of this perspective is that parties to transactions regulated by flexible or "soft" norms of law may be just as vulnerable to opportunistic skirmishing as if the contract were governed by more rigid norms. However, the manner in which opportunism is expressed is likely to be shaped by the legal culture of the transaction: see, Baird, "Self-Interest and Co-operation in Long-Term Contracts", supra, note 34.

investment, however, raise further issues. Not only is it necessary to examine whether legal sanctions adequately protect transaction-specific investments, but it is also important to consider the extent to which law supports "private" commitment strategies which the parties might devise. Moreover, in view of the reciprocal monopolies which attach to this type of relational contract, the implications of the law for redistributive bargaining should also be addressed.

The standard enforcement instrument of contract law - compensatory damages, measured by the market value of what the promisee expected to gain from performance, and limited by remoteness and mitigation doctrines - is unlikely fully to protect transaction-specific investment in relational contracts. At a structural level, the requirement that there be an identifiable breach does not sit easily with the flexible planning and governance of relational transactions. Some relational arrangements do not satisfy legal criteria for contractual relations[157]. Others meet the qualifying standards but their norms of co-operation are not expressed in a form which lends itself to evaluation of behaviour according to a crude breach / no breach dichotomy.

Even if structural limitations are overcome, a relational contractor who is vulnerable to opportunism faces the problem that legal principles governing compensation are not geared

[157] See chap. III, supra, for discussion of the "qualifying" norms of contract law.

to protection of strong forms of reliance on contracting partners[158]. Not only is the process of determining damages costly and prone to error, particularly in a "small numbers" context, but compensation is limited to losses which were foreseeable by the breaching party <u>at the start of the relationship</u>. Thus, even if damages were certain to be awarded, they are unlikely to cover the full extent of an investing party's loss from breach.

Finally, it should be remembered that relational contractors who have made transaction-specific investments typically seek continuity of transactions. As is apparent from the empirical studies of contract, the process of invoking legal sanctions in most relational contexts, is hardly conducive to this goal[159].

Turning now to the implications of compensatory damages for redistributive bargaining, the inability of the legal remedy fully to protect reliance on relational transactions creates further problems for transaction-specific investors. First, the undercompensatory nature of the legal sanction, together with the costs of obtaining damages and the investor's reliance on the survival of a contract, mean that investors cannot credibly respond to redistributive threats as if they were indifferent between co-operation and non-co-

158 *Supra*, Chap. III.

159 *Supra*.

operation[160]. Secondly, liability for compensatory damages may not be sufficiently feared by non-investors to enable investors to issue a plausible threat that opportunism will result in costs which are equivalent to the wealth which is appropriable[161]. This legal sanction, therefore, affords transaction-specific investors relatively little bargaining power with which to defend themselves against opportunistic attempts to redistribute shares in the transactional surplus[162].

The literal enforcement remedies of contract law, it may be argued, are more likely to protect transaction-specific investors from redistributive bargaining. This enhanced protection arises not so much because literal enforcement sanctions inevitably result in performance of contracts, but is derived from the distinct economic character of these sanctions. Drawing upon the analysis developed by Calabresi & Melamed[163], economic theorists have argued that specific performance and injunction remedies protect interests in contracts by means of a "property rule", rather than the

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160 Kronman, "Contract Law and the State of Nature" supra, note 148; Williamson, "Credible Commitments: Using Hostages to Support Exchange", supra, note 137.

161 Ibid.

162 Harris, Ogus & Phillips' analysis of courts' choices between "cost of completion" and "market value" measures may, perhaps, be used to address the problem of transaction-specific investment, Don Harris, Anthony I. Ogus & Jennifer Phillips, "Contract Remedies and the Consumer Surplus" (1979) 95 Law Quarterly Review 581; compare, Timothy J. Muris, "Cost of Completion or Dimunition in Market Value: The Relevance of Subjective Value" (1983) 12 Journal of Legal Studies 379.

163 Guido Calabresi & A. Douglas Melamed "Property Rules, Liability Rules and Inalienability: One View of the Cathedral" (1972) 85 Harvard Law Review 1089.

"liability rule" of compensatory damages[164]. The primary consequence of property rule protection is that potential breachers are compelled to negotiate "exit" from a contract directly with the other party and without the protective price ceiling set by compensatory damages[165].

Of the many implications of property rule protection of interests in contracts, two are particularly relevant to redistributive bargaining in relational contracts. First, the lack of a price ceiling reduces the relative bargaining power of potential breachers during negotiations over exit. In the event of complete breakdown of the transaction, therefore, an investor is in a stronger position to secure compensation for the remaining value of the investment, than when negotiations are conducted "in the shadow of" the damages remedy. Second, literal enforcement remedies also bolster investors' defences against strategic maneuvering designed to redistribute shares in the transactional surplus. That is to say, because these sanctions ultimately enable non-breachers to call upon the state to coerce actual performance, they provide investors with a means to issue a credible rejoinder in response to opportunistic threats to withhold co-operation[166].

It should be noted, however, that it is precisely the

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[164] Anthony Kronman "Specific Performance" (1978) 44 University of Chicago Law Review 351; Allan Schwartz, "The Case for Specific Performance" (1979) 89 Yale Law Journal 271; Thomas S. Ulen "The Efficiency of Specific Performance: Towards A Unified Theory of Contract Remedies" (1984) 83 Michigan Law Review 341; William D. Bishop "The Choice of Remedy for Breach of Contract" (1985) 14 Journal of Legal Studies 299.

[165] Ibid.

[166] Kronman, "Contract Law and the State of Nature" supra, note 148.

ability to make a credible threat to coerce performance which underlies opposition to the use of specific performance as a standard sanction against breach of contract in many analyses of contract law. Specific performance, it is feared, grants non-breachers "too much" power over co-contractors, so that its availability should be confined to a limited set of transactions[167]. An economic version of the argument against specific performance, for example, maintains that not only may specific performance turn non-breachers into opportunists, but also that in wielding their "excessive" power to extract wealth from potential breachers, non-breachers may prevent efficient breach[168].

One response to this concern is to point out that it overlooks the contextual nature of efficiency[169]. The meaning of efficient breach, it may be argued, is determined by the institutional framework in which contracts are located. One important aspect of that institutional framework is, of course, the remedy for breach. Comparison of the outcomes of damages regimes with those of specific performance regimes, therefore, may not reveal very much about the relative efficiency of the two sanctions. Literal enforcement remedies, it may be argued, constitute a particular set of incentives and deterrents to make breach or performance decisions, and

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[167] Ibid.

[168] Richard A. Posner, Economic Analysis of Law (Boston: Little Brown & Co., 1977).

[169] Goldberg, "Relational Exchange: Economics and Complex Contracts", supra, note 56; Goldberg, "Institutional Change and the Quasi-Invisible Hand", supra, note 91; see chap. II, supra.

the compensatory damages sanction contains a different set of inducements and constraints. While the terms on which each remedy promotes breach may or may not be efficient given that regime, the difference in institutional context of transactions, created by the remedy, renders the two packages of breach / performance incentives non-comparable.

Of more significance to relational transactions than the efficient breach arguments about damages and specific performance, is the contention that both remedies distribute contractual power. That literal enforcement remedies grant relatively more bargaining power to non-breachers and damages relatively more power to breachers seems, perhaps, to justify a preference for literal enforcement in contexts where non-breaching investors face struggles over redistribution of quasi-rents[170]. However, the reciprocally monopolistic nature of many relational contracts suggests the exercise of caution in advocacy of general legal principles to govern such transactions. Legal sanctions, like legal duties are "double-edged swords"[171]. It is not difficult to imagine circumstances in which the power to call upon the state to coerce performance may be wielded aggressively by an investing party[172].

Before moving to the question of how far contract law

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170 It should just be noted that as inequalities of contract power are of course not a function of available remedies alone, they are unlikely to be solved by the content of legal sanctions.

171 Baird "Self-Interest and Co-operation in Long-Term Contracts", supra, note 34.

172 See, for example, Law and the Balance of Power, supra, note 28; Warner Brothers Pictures Inc. v. Nelson [1937] 1 KB 209.

supports the use of private commitment strategies, it may be helpful briefly to consider the way in which such strategies function to increase transactional security in a relational context. Private commitment strategies may be viewed as a direct attempt to equalise the dependence of parties to relational contracts[173]. Their basic form, as described in bargaining theory, involves contractors who are relatively less dependent on the transaction transferring to those who are more dependent some degree of power to impose costs on opportunistic withholding of co-operation[174]. These strategies, it is argued, operate both _ex post_ and _ex ante_. That is to say, not only does such a transfer of power reduce non-investors' ability credibly to threaten to withdraw their support from a contract during execution, but an early indication of willingness to make such commitments is said also to serve as a signal of reliability[175].

This basic idea of commitment (or bonding) devices has been used to account for a range of observed contractual practices. Vertical restraints, reciprocal trading arrangements, linkages of future business to current contracts, and the incorporation into contracts of sanctions which impact on reputation have all been analysed as means of

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[173] Williamson, "Credible Commitments: Using Hostages to Support Exchange" _supra_, note 137; Kronman, "Contract Law and the State of Nature", _supra_, note 148; Lewis, "Reputation and Contract Performance in Long-Term Projects", _supra_, note 89; Klein & Leffler, "The Role of Market Forces in Assuring Contractual Performance", _supra_, note 89.

[174] _Ibid_., see also, Thomas C. Schelling, "An Essay on Bargaining" (1956) 46 _American Economic Review_ 281; Charney, "Non-Legal Sanctions in Commercial Relations", _supra_, note 137.

[175] _Ibid_.

pre-empting, or protecting against, redistributive bargaining[176]. Commitment practices, it is maintained may be subtle or overt, incorporate participants' contractual history, and make use of economic practices developed for other purposes[177].

The variety of strategies which economic actors may call upon in moving towards equal dependence within reciprocal monopolies means that it is difficult unequivocally to assert that contract law does or does not facilitate relational bonding. The contradictory principles governing privately agreed financial penalties for breach, however, illustrates some ambivalence towards one simple form of constructed commitment to relational contracts.

Privately agreed financial penalties may be viewed as a form of "collateral bonding"[178]. As described in the bargaining literature, this type of security instrument operates by giving non-breaching investors control over something which both breachers and non-breachers value in the event that co-operation is withheld in breach of contract. All such financial penalties take the form of an agreement that the monetary sanction attached to breach is greater than the compensation for which the breacher would be liable under

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176 Williamson, The Economic Institutions of Capitalism, at 183-189; Klein & Saft "The Law and Economics of Franchise Tying Contracts", supra, note 56; Shapiro, "Premiums for High Quality Products as Returns to Reputations", supra, note 89; Klein & Leffler, "The Role of Market Forces in Assuring Contractual Performance", supra, note 89; Lewis "Reputation and Contract Performance in Long-Term Projects", supra, note 89; Kornhauser, "Reliance, Reputation and Breach of Contract, supra, note 138.

177 Ibid.

178 Charney, "Non-Legal Sanctions in Commercial Relations", supra, note 137.

orthodox compensatory principles. The doctrines of contract law, however, distinguish between financial bonding strategies where money which is paid ex ante is forfeitable on breach and those where breach is supposed to trigger an obligation to pay the penalty[179]. The forfeitable deposit is viewed as "a guarantee that the contract shall be performed"[180] and the penalty clause as "a payment of money stipulated as in terrorem of the offending party"[181]. While forfeiture clauses are typically enforced because they encourage contractors to perform rather than breach[182], it is exactly this consequence which courts seek to avoid by holding penalty clauses unenforceable.

The legal principles governing ex ante and ex post financial bonding obviously have diametrically opposed implications for redistributive bargaining over quasi-rents in relational transactions involving specific investment. Investors who have secured a forfeitable deposit from non-investing contracting partners are relatively well-placed to counter opportunistic threats to withhold co-operation with a credible threat that a failure to co-operate which amounts to breach of contract will be costly to the opportunist. By contrast, courts' jurisdiction to relieve against penalty

179 Jack Beatson "Discharge for Breach: The Position of Installments, Deposits and other Payments Due Before Completion" (1981) 97 Law Quarterly Review 389.

180 Howe v. Smith (1884) 27 Ch D. 89 at 95.

181 Dunlop Pneumatic Tyre Co. Ltd. v. New Garage Motor Co. Ltd. [1915] AC 79 at 86.

182 The equitable principle providing for relief against forfeiture is used primarily as a means of extending the time for performance, Re Dagenham (Thames) Dock Co. (1873) LR 8 Ch. App. 1022; Starside Properties v. Mustapha [1974] 1 WLR 816.

clauses, in effect, reinforces the relative bargaining power in redistributive negotiations of the non-investing party.

As in the case of specific performance, conventional legal justifications for refusing to grant non-breachers power to enforce penalty clauses have been given economic interpretations[183]. Clarkson, Miller & Muris, for example, argue that penalty clauses are inefficient and should not be enforced when non-breachers are likely to gain such a benefit from breach that they may be tempted opportunistically to induce non-performance[184]. As in the case of literal enforcement remedies, however, a relational perspective would seem to suggest that the issue of enforcing financial bonding arrangements does not so much to entail a choice between granting and withholding power to be opportunistic, but shapes the distribution of bargaining power between contractors[185].

3 Implicit Opportunism and Relational Monitoring

As noted above, implicit opportunism is a potential hazard in transactions whenever uncertainty in the environment of the transaction is combined with substantial differences

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183 Charles J. Goetz & Robert E. Scott "Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach" (1977) 77 Columbia Law Review 554; Paul H. Rubin "Unenforceable Contracts: Penalty Clauses and Specific Performance" (1981) 10 Journal of Legal Studies 237; Sam Rea jr. "Efficency Implications of Penalties and Liquidated Damages" (1984) 13 Journal of Legal Studies 147.

184 Kenneth W. Clarkson, Roger Leroy Miller & Timothy J. Muris, "Liquidated Damages v. Penalties: Sense or Nonsense" 1978 Wisconsin Law Review 351.

185 Supra, see generally A.Allan Schmid Property, Power and Public Choice: An Inquiry into Law and Economics (New York: Praeger, 1987); Kronman, "Contract Law and Distributive Justice", supra, note 40.

in expertise or access to knowledge between contractors. The value of such contracts to less expert parties (principals) depends on both the quality of their contracting partners' (agents') performances and uncontrollable contextual factors. The differential expertise of the parties means that a principal is unable adequately to evaluate an agent's activities, while variability in the context of transactions may cause results to be an unreliable measure of the agent's performance[186]. As some qualitative aspects of the agent's execution of a transaction can neither be directly observed nor inferred from outcomes, opportunistic agents, it is argued, are able to cheat on their contracts by delivering lower quality performances than those for which they are paid[187].

The risk of implicit redistribution of shares in transactional surpluses poses a conundrum for contractual governance. On the one hand, perhaps the simplest means to the contractual goal of enabling a principal to gain access to expertise and skills which she does not possess is to organise the contracts so that the agent has considerable scope for the exercise of discretion. The greater an agent's discretion, however, the less likely it is that the principal will be able

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186 Ross "The Economic Theory of Agency: The Principal's Problem", supra, note 118; Fama & Jensen, "Agency Problems and Residual Claims", supra, note 145; Shavell "Risk-Sharing and Incentives in the Principal and Agent Relationship", supra, note 118; Michael Jensen & William Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure" (1976) 2 Journal of Financial Economics 305.

187 Ibid.

to detect cheating. If, on the other hand, principals' attempt to reduce opportunities to cheat by reigning in agents' discretion, they may lose some of the benefits of the agents' expertise[188].

The extent of a principal's vulnerability to cheating is clearly influenced by a range of factors which shape the relative contractual power of principals and agents. Corporate executives who are repeat purchasers of legal advice in the area of commercial law, for example, typically have more knowledge and experience of markets for legal services than a consumer who hires a lawyer because of a single failed transaction. While the corporate contractor's experience does not provide absolute security against cheating, such experience is a resource which the executive can draw upon in assessing the quality of the services received. Furthermore, the relative ease with which experienced contractors is able to search for legal services may reduce the chance that she will contract with and opportunist. Finally, as a repeat-purchaser of legal services, the corporate executive is in a position to hold out the possibility of future business as an inducement to good performance. Taken together, the resources of the experienced principal may afford reasonable protection against opportunism even if the contract grants broad unilateral discretion. By contrast, the consumer with his one-off legal problem is generally not well-placed to search. He

188 Ibid.

is unlikely to have the experience necessary to evaluate performance or to hold out the prospect of lucrative future business. Within this type of transaction extensive unilateral discretion, without any other protection, may well function as a charter to cheat.

Contractual safeguards against implicit opportunism may be divided into two categories. "Fusion" strategies entail organisation of the transaction so that an agent's incentives with respect to performance are aligned with the principal's goals[189]. That these strategies are founded on ex ante incentives renders them effectively self-enforcing[190]. By contrast, monitoring strategies require the construction of observable and measurable proxies for hidden dimensions of agents' performance and are generally backed by external agencies.

Although fusion is primarily associated with the transactions which constitute the firm[191], practices which attempt to align agents' incentives with the objectives of principals may also be seen in relational contracts between otherwise autonomous contractors. Such a contract may, for example, be structured so that an agent's prospect of future business depends on the extent to which the principal is

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[189] Kronman, "Contract Law and the State of Nature", supra, note 148.

[190] Ibid., see also, Ross "The Economic Theory of Agency: The Principal's Problem", supra, note 118; Fama & Jensen, "Agency Problems and Residual Claims", supra, note 145; Shavell "Risk-Sharing and Incentives in the Principal and Agent Relationship", supra, note 118; Oliver D. Hart, "The Market Mechanism as an Incentive Scheme" (1983) 14 Bell Journal of Economics 366.

[191] Ibid., see also, Richard J. Zeckhauser & John W. Pratt, Principals and Agents: The Structure of Business (Boston: Harvard Business School Press, 1985).

satisfied with the outcome of the current contract. Similarly, relational transactions may use commission payments in which the agent's fee is an agreed percentage of the principal's profits, or payment arrangements which supplement a basic fee with variable bonuses.

In theory at least, the primary strength of fusion lies in the inevitability of its sanction against implicit opportunism[192]. That it is to say, the effect of incentive alignment is that agents who cheat necessarily incur costs which they might have avoided had there not been a connection between agents performance and principals goals. As a result of this linkage principals are able to obtain some security against implicit opportunism without directly involving themselves in agents' activities[193].

The extent to which fusion in fact protects principals against implicit opportunism in any particular context depends on how far the contractual incentives are able to bring about true merger of the parties interests[194]. Merger of interests may be incomplete because some dimensions of the agent's performance are not (and perhaps cannot be) captured by the incentives which the parties are able to devise[195].

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192 Kronman, "Contract Law and the State of Nature", supra, note 148; Hurwicz, "The Design of Mechanisms for Resource Allocation", supra, note 149.

193 Ibid., see also, Hart "The Market Mechanism as an Incentive Scheme", supra, note 190.

194 Kronman, "Contract Law and the State of Nature" supra, note 148; Hurwicz "The Design of Mechanisms for Resource Allocation", supra, note 149.

195 An interesting example of this problem is to be found in transactions where the agent is subject to, or experiences, duties which may be contradict the principal's objectives. The professional socialisation of lawyers, for example, entails serving the interests of the administration of justice, which may, at times, conflict with the specific interests of the principal in the particular

Alternatively, the satisfaction which an agent derives from undetected cheating may outweigh the loss of the benefits which would follow from wholehearted pursuit of the principal's interests. In addition, because fusion strategies are implicitly based on the assumption that result is a good measure of an agent's performance, they may not be well-suited to transactions where the complexity or uncertainty is such that outcome remains an ambiguous signal of the quality of performance.

Monitoring strategies provide a more direct means of protecting principals against implicit opportunism[196]. These strategies require the creation of observable contractual proxies for hidden dimensions of an agent's activity, and a process by which agent's performance can be measured and sanctions applied[197]. While the practice of assessment and, where necessary, sanctioning, is based on review of what the agent has already done, economic theories of monitoring maintain that these strategies also have an ex ante deterrent role[198]. Cheating or other self-serving exercises of discretion, it is argued, becomes a pointless exercise when agents know that their actions will be detected and punished.

Economic analysis of the principal-agent transaction

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transaction. See, Dingwall & Fenn, "'A Respectable Profession'? Sociological and Economic Perspectives on the Regulation of Professional Services", supra, note 147.

196 Goetz & Scott "Principles of Relational Contracts", supra, note 15; Veljanovski & Whelan, "Professional Negligence and the Quality of Legal Services - An Economic Perspective", supra, note 121; Fama & Jensen, "Agency Problems and Residual Claims", supra, note 145.

197 Ibid.

198 Ibid.

suggests that the extent to which monitoring is likely to deter implicit opportunism depends on whether agents anticipate that the costs attached to cheating exceed the benefits. The ability of principals to confront agents with the prospect of bearing the costs of cheating is in turn shaped by the weight of the sanction and the probability that it will be applied. While principals who use monitoring strategies may have a wide range of cultural and contextual sources from which to derive sanctions, their ability to invoke penalties cannot be taken for granted.

At the most basic level, parties to transactions based on information asymmetry face the problem of formulating a measurable proxy for unseen dimensions of the agents performance. General aspirational norms such as "best efforts" commitments may be a good approximation of what the principal demands of an agent, but performance against such norms may be difficult to assess. On the other hand, easily measurable units such as time may have only the most tenuous connection with important attributes of performance. In terms of deterrence arguments, the primary implication of inadequate definition of a proxy is that principals will find it more difficult, that is, costly, to establish breach. Cheating agents, therefore, face a lower risk of incurring a sanction than if performance were well-defined[199].

Some economic theorists point to the <u>institutionalisation</u>

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199 <u>Ibid</u>.

of aspirational standards in normative social fora such as legal doctrine and the codes of licensing agencies, as a partial solution to the problem of creating measurable proxies[200]. Once adopted by regulating agencies, norms such as "in the best interests of the client" or "best efforts" are subjected to a regular process of interpretation and application. This process is thought to transform vague standards into workable and measurable constraints on agents' discretion[201]. Therefore while the verbal formula of a "purely" private undertaking may be identical to that of an institutionalised standard, the difference in context, it is argued, attributes distinct meanings to the types of norm.

A second problem with monitoring strategies is that however workable the proxy, the strategy requires cheating to be detected and sanctions to be applied. Not only is the process of detection costly in itself, but in the context of transactions based on information asymmetry that process may also be highly error-prone. Monitoring errors may result in under or over detection of cheating, and while the consequences differ, neither is conducive to a well-functioning transaction. Under-detection is perhaps the more predictable error in transactions based on parties' differential access to knowledge or expertise and may, in

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200 Veljanovski & Whelan "Professional Negligence and the Quality of Legal Services" supra, note 121; Dingwall & Fenn "'A Respectable Profession'? Sociological and Economic Perspectives on the Regulation of Professional Services" , supra, note 147; Macneil, "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law", supra, note 62.

201 Ibid.

effect, enlarge the scope for agents to cheat. Its primary implication, for the purposes of deterrence arguments is that agents who want to cheat perceive the probability of incurring a penalty to be lower than it would be with a more accurate monitoring process.

Mistaken over-detection of cheating exacerbates the antagonism which underlies all monitoring processes and may precipitate the very event - hostile or indifferent performance - which the principal is trying to avoid. The essence of this problem is that while both parties know that principals monitor and check agents' performance because they fear opportunism or incompetence, successful completion of contracts requires parties to overlay this core of suspicion with a veneer of trust[202]. Aggressive monitoring which leads to mistaken allegations of cheating may destroy the fragile surface of trust and provide the impetus to cheat in a manner which the principal is unable to detect.

Summary

This chapter has shown that relational transactions challenge conventional legal and economic conceptions of contractual governance. Relational contracts are neither primarily guided by contract law, nor are they driven by the

[202] Eisenstadt & Roniger, Clients, Patrons and Friends: Interpersonal Relations and the Structure of Trust in Society, supra, note 49.

forces of the competitive market. These transactions may have a longer and more stable life than many firms, and the parties' relationship may exhibit much of the interaction and dependence which is found in "firm-like" transactions. Relational contracts are not, however, firms. Parties retain separate profit streams, and relational transactions may be highly dependent on the identity of the parties.

The relational contract is a means of governing complex economic activities situated in an uncertain contractual context. The problems of managing such activities lead contractors to develop flexible planning instruments by which decision-making may be postponed until relevant information is available. While flexible planning may facilitate co-ordination of complex activities, and limit the strain on boundedly rational contractors, this type of decision-making procedure may be costly to implement. Moreover, flexible planning may also have the effect that important issues are not addressed until contractual relations of dependence are well-established.

The internal inequalities of relational contracts open up the risk of opportunistic exploitation. The second important characteristic of relational governance, therefore, is the development of transaction-specific strategies to protect vulnerable contractors against predatory contracting partners. Such governing instruments vary in degrees of formality. They may make use of norms drawn from the context of the specific transaction or from a broader contractual culture and rely on implicit understandings or overt contractual bonding. Taken as whole these strategies serve to maintain co-operation and reinforce decision-making "outwith" classical contract law and the market.

Chapter V Contractual Theories of the Firm

Recent developments in contractual theories of the firm mark a sharp break with the traditions of neoclassical microeconomics[1]. Contemporary theorists insist that the firm should not be viewed simply as a technical relationship between inputs, outputs, technology and market forces[2], nor assumed to be just another market player whose behaviour is shaped by the price system. Far from being mere "logical primitives of a theoretical system"[3], firms are complex contractual forms for organising economic activity. Both creature of contract and creator of contract, the firm is the central economic institution in market-capitalist societies.

Although still at an early stage of development, contractual theories of the firm have generated provocative insights into the nature and structure of economic organisation in contemporary society[4]. They have been used,

1 Contemporary analysis has reopened many of the issues placed on economists' intellectual agenda by scholars of the 1930's. Berle and Means' influential study of the dispersion of share ownership in large american corporations, for example, raised questions about the neoclassical assumption that the behaviour of business firms could be analysed as a single-minded pursuit of profits: Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (New York: Macmillan, 1932). The empirical study by Hall & Hitch, published in 1939, focused on the process of managerial decision-making, and found that far from making decisions in accordance with the tenets of economic rationality, managers seemed rather to decide important issues on the basis of "rules of thumb" designed to ease the task of coping with uncertainty: R.L. Hall & C.J. Hitch, "Price Theory and Business Behaviour" (1939) 2 Oxford Economic Papers 12. Finally, the 1930's also saw the publication of Ronald Coase's influential analysis of the firm: "The Nature of the Firm" (1937) 4 Economica 386.

2 Sidney G. Winter, "On Coase, Competence, and the Corporation" (1988) 4 Journal of Law, Economics & Organisation 163.

3 Ibid., at 165.

4 Transactional economic models of the firm are still under construction. Explanations tend to consist of a series of tentative hypotheses around a set of loosely linked issues rather than well defined paradigm. For a good sampling of the literature and the intellectual directions of this analysis, see the set of essays published to celebrate the fiftieth anniversary of the "Nature of the Firm" (1988) 4 Juornal of Law, Economics & Organization 3-180.

for example, to question the premises underlying contemporary competition law, justify minimal regulation of financial markets, and rationalise the emergence and organisation of massive conglomerate enterprises[5]. For the purposes of this thesis, however, our interest lies not so much in what contractual theory implies about the organisation of the firms, but in the implications of the firm for our understanding of the institution of contract. "Firm-like" transactions illustrate, for example, how contracts may be organised to survive the departure of individuals actively engaged in pursuit of contractual goals, and that a contractual culture of loyalty and trust is consistent with the idea that individuals are dispensable[6]. They also reveal that contractual governance accommodates explicit relations of hierarchy and control, and demonstrate that complex transactions are viable in the absence of a strong correlation

[5] See, for examples, Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (New York: Free Press, 1975); Paul L. Joskow & Alvin K. Klevorick "A Framework for Analyzing Predatory Pricing Policy" (1979) 89 Yale Law Journal 89; Michael Jensen & William Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure" (1976) 2 Journal of Financial Economics 305; Michael Ryngaert & Jeffry Netter "Shareholder Wealth Effects of the Ohio Antitakeover Law" (1988) 4 Journal of Law, Economics & Organization 373; Frank Easterbrook & Daniel Fischel "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harvard Law Revies 1161; Sanford J. Grossman & Oliver D. Hart "The Allocational Role of Takeover Bids in Situations of Asymmetric Information" (1981) 36 Journal of Finance 253; Alfred A. Chandler jr. The Visible Hand: The Managerial Revolution in American Business (Cambridge, Mass.: Harvard University Press, 1977); John M. Stopford & Lewis T. Wells jr. Managing the Multinatinational Enterprise (New York: Basic Books, 1972).

[6] These comments refer primarily to the Euro-American model of capitalist organisation. Note the contrast with the fabled mode of organisation within and between Japanese firms. Time and again scholars working within the Euro-American tradition have commented on the importance of "reciprocal loyalty" to the internal relationships of firms in Japan and to relations between firms: see, for example, Ronald Dore "Goodwill and the Spirit of Market Capitalism" (1983) 34 British Journal of Sociology 459; Dore British Factory -- Japanese Factory (Berkeley: University of California Press, 1973); Rodney Clark The Japanese Company (New Haven: Yale University Press, 1979); Frank Gibney Miracle By Design (New York: Times Books, 1982); see also, Williamson's analysis of sub-contracting practices in the auto-manufacturing industry in Japan, in Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (New York: Free Press, 1985) at 120-123; see also, Will Hutton, "The Student Becomes the Master", The Guardian, November 25, 1991.

between shares in the transactional surplus and effort or quality of performance.

As in the case of the analyses of classical and relational models of contracting, this discussion of "firm-like" governance focuses on the organisation of economic activity. The firm is viewed as a standing contractual institution for managing resources supplied by different classes of economic actors. This idea of management denotes two types of contractual arrangements: the framework or "constitutional" provisions for governance, and the administrative procedures for co-ordinating activity on a daily basis. Framework terms govern the distribution of costs, risks and surpluses between suppliers of capital, and the powers of those who control the use of capital assets owned by others. Administrative provisions are directed at the execution of economic activity. The implicit terms of these arrangements regulate the processes by which decisions are made, activity is co-ordinated, and conflict controlled.

The discussion in this chapter is organised around these two facets of management. Part A focuses on the framework provisions of two legal models of the firm: the partnership and the company. This section is not intended to be a comprehensive discussion of the law pertaining to these forms of business enterprise. Its aim, rather, is to delineate the institutional structure of each of these transactional forms and describe the relationships which they entail. Part B concentrates on economic theories of management within "firm-like" contracts. The section opens with a discussion of Coase's analysis of the nature of the firm, an essay which, while speculative in tone and exploratory in approach, is the foundation of modern theories. It then moves on to describe two dominant paradigms in contemporary analysis: the first constructs the firm as a cluster or "nexus" of contracts; and the second as a contract of hierarchy. Both models view the institution of administrative management as central to "firm-like" contracts, and both treat management as a way of dealing with problems of opportunism. Underlying these similarities, however, there are important differences in assumptions about the nature of administrative management and its relationship with other institutions for governing economic activity.

A. The Institutional Structure of Legal Models of the Firm

In the course of a recent essay Steven Cheung asserted that "we do not exactly know what the firm is - nor is it vital to know"[7]. This comment speaks to the apparent impossibility of defining the essential characteristics of a class of institutions which includes the local grocer and the transnational conglomerate. The legal forms, the constitutive structures and the objectives of the firms which we observe

[7] Steven N.S. Cheung, "The Contractual Nature of the Firm" (1983) 26 Journal of Law and Economics 1 at 3. Note also, Buckley J.'s comment on the concept of the company: "the word company has no strict legal meaning" in Re Stanley [1906] 1 Ch.131 at 134.

are so highly differentiated that in some respects it seems quite bizarre to use the concept of the firm as if it were analytically coherent.

On the other hand, beneath the diversity of shapes, forms and sizes in which contemporary firms appear, there are certain regular patterns of economic relationships. Firms, at their core, are simply institutional structures for governing relations of property between those who supply resources to collective processes of production. Of particular significance to understanding of formal structures of governance are those resource holders who furnish financial capital. Conventional legal models construct the business enterprise as an arrangement for furthering the interests of capital and take the appropriate structure of governance to be determined by the manner in which the supply of financial capital is organised[8].

"Standard" legal forms for managing capital so as to facilitate its accumulation include the common law trust[9], the cooperative[10], the partnership and a variety of companies. Within each of these frameworks legal norms appear in both mandatory and facilitative guises. These norms establish

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[8] Erich Schanze, "Potential and Limits of Economic Analysis: The Constitution of the Firm" in Contract and Organization Terence Daintith and Gunther Teubner (eds.) (Berlin: Walter de Gruyter, 1986).

[9] For an insightful analysis of the trust as a means of managing economic activity, see Anthony I. Ogus, "The Trust as a Governance Structure" (1986) 36 University of Toronto Law Journal 186.

[10] See Avner Ben-Ner "Producer Cooperatives: Why do They Exist in Capitalist Economies" in Walter Powell (ed.) The Non-profit Sector: A Research Handbook (New Haven: Yale University Press, 1987); Henry Hansmann "The Role of Nonprofit Enterprise" (1980) 89 Yale Law Journal 835.

qualifying criteria for using the particular structure of governance, create an institutional context for economic association between capital suppliers, and provide ground rules to govern relations between suppliers of capital and other economic actors.

1. Partnership

Partnership is a contractual form which attaches to relations between two or more persons who combine capital to trade for profit, except where the parties have adopted a different form of governance[11]. While the status of partnership, therefore, is a necessary incident of particular types of business relationship, parties are empowered to define some provisions of their transaction within parameters set out by law.

The agreement of individual participants in a partnership may be expressed in a formal deed that regulates the rights and liabilities of the partners _inter se_. Whatever the precise terms of the partnership deed, however, all partners own both assets and profits in common, and are collectively reaponsible

[11] Section 1 of the Partnership Act 1890 defines partnership as "the relation which subsists between persons carrying on a business in common with a view to profit". Many of these principles, originally formulated in the courts were codified in the Partnership Act 1890, others are now to be found in the Companies Act 1989. The common law and equitable sources remain significant, however, for interpretation, innovation, default norms and "gap-filling". Note that despite the broad definition of partnership given in section 1, not every participation in profits will be held to establish a partnership interest: see, for example, _Cox_ v. _Hickman_ (1860) 8 HLC 268 where creditors were given an interest in profits, but not thereby held to be partners. On the issue of "salaried" partners, see _Stekel_ v. _Ellice_ [1973] 1 WLR 191.

for business decisions whether these decisions were made by an individual or a group of partners. Moreover, pure partnerships are not corporate entities, so that, in formal terms, at least, there is no separation between the firm, and the owners of capital[12].

The legal regime governing partnership has three main functions. First, definitional rules specify the conditions under which a relationship qualifies as a partnership and establish the character of the partnership arrangement. The relationships entailed by a partnership to carry out illegal acts, for example, would be not be protected by law. Second, the law supplies a set of default terms for the distribution of risks, profits and costs between partners who have not formulated transaction-specific terms. For example, the Partnership Act provides that in the absence of specific agreement to the contrary, partners take equal shares in both costs and benefits[13]. Finally, the partnership regime mandates minimum non-disclaimable provisions in partnership transactions. These terms govern the obligations of partners

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[12] The substantive reality is a little more complex. Note, for example, that the Companies Act now requires partnerships with more than 20 members to incorporate and register as companies, unless they fall into one of the exempted categories: Companies Act 1989. (The exempted categories, as defined by regulations inclued professionals whose trade association rules prevent incorporation eg. solicitors, accountants, stockbrokers, and other service suppliers who have obtained exemption eg. Architects, chartered engineers, estate agents etc.). Secondly the legislation requires partnership to be kept separate from the property of individual partners, and creditors look to partnership assets first. Third the tax regime treats partnership accounts separately from tax assessments of members. Finally, partnerships, like companies may convey an image of an existence distinct from the members by adopting and registering a business name under the Business Names Act 1916. Once such a name is registered, the partnership can sue and be sued under the name.

[13] Note the contrast with the rules developed during the nineteenth century to govern "classical" forms of contractual relationships, supra, chapter III.

towards one another and to the firm[14], and their business relationships with "external" economic actors[15].

An important defining characteristic of the partnership transaction is its intensely personal and individualistic conception of participation. The extent of law's commitment to individual autonomy in this context may be seen in the general principles governing voluntary departure from a partnership[16]. The departure of an individual, for any reason, automatically determines the partnership relationship as a whole and triggers apportionment of assets and liabilities in accordance with the terms of the contract[17]. Despite the potentially serious consequences of exit for others in the relationship, the Act permits individual partners unilaterally to withdraw at any point in time and for any reason, without

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[14] Fiduciary obligations.

[15] Eg. individual partners are responsible for business obligations assumed by the firm or by one of the partners on behalf of the firm and the Act requires partnership property to be kept separate from that of individual partners despite the fact that the firm may not have an independent legal personality.

[16] Another example of the personal nature of the transaction is the right to exercise choice with respect to other members delictus personarum. This right gives each partner power of individual veto against a new member.

[17] See also Harrison v. Tennant (1856) 21 Beav. 482. In this case the Court dissolved a partnership primarily because the parties could no longer get on with each other. Romilly J., justified his decision on the grounds that:

> the circumstances under which the parties entered into the partnership have, by matters over which they have no control, materially altered, [and] these altered circumstances have, combined with the conduct of the parties themselves, produced a mistrust which the Court cannot say is unreasonable; ... taking all these things together, it is impossible that the partnership can be conducted on the footing on which it was originally contemplated without injury to all these persons concerned.

at 496-7.
This case also presents an interesting contrast to the classical model of contract in that the court's jurisdiction to dissolve the partnerships was not derived from the express terms of the agreement. Romilly J. noted that judges have the power to dissolve a partnership where it would be just and equitable to do so.

consultation[18].

The default rules of the partnership regime function in the same way as the contingency management provisions of classical contract. That is to say, these norms operate as terms to be implied where the parties have not made a transaction-specific arrangement. Unlike the classical model of contract, however, the default rules of the partnership transaction cover issues which lie at the heart of the relationship. For example, whereas classical contract treats the distribution of costs and benefits through the mechanism of price and other definitional terms as a matter for contracting parties alone[19], the partnership regime is indifferent between participants' development of their own rules to govern these issues or reliance on the standard terms.

Mandatory, non-disclaimable rules of the partnership regime may be divided into two categories according to whether they are primarily directed at partners' relationships with the firm (that is, one another), or with other business

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18 ss.26-27. Note that the Act does require reasonable notice. An intriguing dimension of this norm is that it seems to open up scope for strategic behaviour directed at redistribution of shares in the transactional surplus. An opportunistic partner who occupies a key role in the firm may, for example, threaten to exit from the relationship unless the terms governing liabilities and profits are renegotiated in her favour. Such opportunistic behaviour may not only disrupt and demoralise the particular partnership transaction within which it is expressed, but the threat which it poses may also undermine the stability of partnership forms of governance. It should be noted, however, that even if the general legal regime affords little protection against opportunism once a threat of departure has been made, partnerships are not wholly defenceless. Partners who are unable to contract out of the individualistic conception of participation may yet use the institution of ex ante planning to mitigate some of its effects. The duration clauses which are found in many partnership deeds, for example, subject untimely exit to liability for breach of contract. While the danger of losing assets and capital investment may not be adequate to deter an opportunist, by increasing the costs of departure such transaction-specific norms may reduce the credibility of strategic threats to withdraw.

19 Supra, chapter III.

actors. The former category is comprised of fiduciary obligations to resolve conflicts between personal and partnership interests in favour of the firm. These norms are derived from equitable doctrines which regulate the holding of property by way of the trust instrument and are applied to all legal frameworks governing combinations of capital[20]. In the context of partnership transactions, fiduciary duties require, for example, personal profits made in the course of a firm's business to be apportioned in accordance with the partnership deed or the Act, and prohibit collusion between groups of partners to the exclusion of others[21].

With respect to transactions between partners and other business actors, the mandatory rules maintain a regime of joint and several liability. This pattern of responsibilities means that each partner is personally liable to external actors for all obligations undertaken by any partner (or employee) of the firm which have been expressly authorised or which are undertaken "in the usual course of business"[22]. As for transactions which are neither explicitly nor implicitly authorised, courts have been willing to limit liability to the individual partner involved where the external actor knew or ought to have known that the partner was not empowered to

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[20] Ogus, "The Trust as a Governance Structure", supra, note 9.

[21] Featherstonhaugh v. Fenwick (1810) 17 Ves. Jun. 298.

[22] S.5. Partnership Act. Note that the distribution of costs within the firm is based on the terms of the deed or the Act.

commit the firm[23].

Although the legal regime governing transactions between partnerships and external actors makes use of "coercive" non-disclaimable rules, its role is said to be facilitative[24]. These norms, it is argued, allow partnerships to obtain credit, secure supplies and market their products on the basis of a set of public commitments and understandings about responsibilities. Partnership firms are thereby enabled to avoid some of the costs of negotiating with prospective contractors. The legal regime is also thought to reassure co-contractors that the costs of management failure, incompetence, lack of communication, or whatever other factors might put external transactions at risk, will be internalised within the partnership[25].

2. Companies

The company is the form of business collectivity most closely identified with developed capitalist economies. Its most distinctive characteristic is the formal independence of the organisation from the human actors who have a direct

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[23] See Kendal v. Wood (1871) L.R. 6 Exch. 243, especially the reasons of Blackburn J.

[24] See generally, Henry Hansmann "Ownership of the Firm" (1988) 4 Journal of Law, Economics & Organization 267. The logic of this analysis is similar to those economic theories of insolvency which rely on the creditors' bargain construct: see, for example, Thomas Jackson "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain" (1982) 91 Yale Law Journal 859; Douglas G. Baird & Jackson, "Corporate Re-organisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy" (1984) 51 University of Chicago Law Review 97.

[25] Ibid.

economic interest in its activities. This attribute of legal personality empowers companies to own and trade property, use courts, and survive the departure from the enterprise of real persons. Perhaps the most important consequence of incorporation is that it enables those who supply capital and other financial resources to avoid responsibility for the obligations of the firm[26], and to limit their personal liability if the company fails[27].

The company has proven to be an enormously flexible institution for the management of resources[28]. It is used by non-profit organisations to extend the powers available under the trust instrument[29] and by small private businesses in order to pursue profits without incurring personal liabilities to the extent entailed by partnership[30]. In the context of the large business enterprise, the company form enables investors to pool resources as a means of enlarging the range of profitable uses and deploy capital productively without

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[26] See, for example, the opinion of Lord Halsbury in Salomen v. A. Salomen & Co., Ltd. [1897] AC 22. In describing the consequences of incorporation, he asserts:

> once the company [is] legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and ... the motives of those who took part in the promotion of the company [are] absolutely irrelevant in discussing ... those rights and liabilities.

at 30.

[27] For an interesting economic exploration of the issue of limited liability, see Paul Halpern, Michael J. Trebilcock & Stuart Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 University of Toronto Law Review 117.

[28] See generally, L.C.B Gower, J.B. Cronin, A.J. Easson, Lord Wedderburn of Charlton, Gower's Principles of Modern Company Law (London: Stevens & Sons, 1979) (4th ed.); Tom Hadden Company Law and Capitalism (London: Weidenfeld & Nicolson, 1977) (2nd ed.)

[29] For economic analysis of the powers available under the trust instrument, see Ogus "The Trust as a Governance Structure", supra, note 9; on the use of the company form to govern non-profit enterprises, see generally, Gower, Gower's Principles of Company Law, supra, note 28 chapter 1; Henry Hansmann "The Role of Non-Profit Enterprises" (1980) 89 Yale Law Journal 835.

[30] But note the convergence between the two forms which occurs where financial (loan) institutions demand personal guarantees from shareholders of small private companies.

becoming actively involved in its management[31].

Companies are subject to an elaborate legal regime. As in the case of the partnership form, law defines the institutional structure of the company and establishes the rights, obligations and powers of those who supply capital to the enterprise[32]. In addition legal norms constitute a regulatory framework for governing relationships between suppliers and managers of capital assets[33].

The process by which a company is formed requires the registration of a Memorandum of Association and Articles of Association with the Registrar of Companies[34]. The Memorandum is an outward-looking document, primarily concerned with relationships between the company and other economic actors. It specifies the objects, purposes and powers of the corporation, and in effect, defines its capacity to do business[35]. The Articles of Association regulate the internal administration and management of the company. They deal with

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[31] As noted by Berle & Means, the benefits to shareholders of avoiding personal management responsibilities are associated with the costs of decreased control and a reduced ability to monitor management: The Modern Corporation and Private Property, supra, note 1.

[32] The Companies Acts have traditionally addressed issues such as voting powers, distinctions between different classes of shares, decision-making authority, risks, dividends, sale of rights to dividends etc. The law relating to companies is overwhelmingly concerned with transactions by or on behalf of suppliers of capital. The concept of corporate personality and the associated practice of limiting liability, together with the doctrine of ultra vires, however, have important implications for other constituencies with interests in companies, particularly labour and unsecured creditors.

[33] These norms are primarily to be found in the fiduciary obligations imposed on managers. Their main objective appears to be promoting the accountability of management to shareholders.

[34] In the case of the public company, the Companies Act demands the further step of obtaining a certificate to do business and exercise borrowing powers. The Companies Act supplies a default set of articles of association which may be used for companies limited by shares but not in the case of companies limited by guarantee or unlimited companies. The primary rationale for registration appears to be information and disclosure: see, generally John H. Farrar, Company Law, (London: Butterworths, 1985).

[35] Ibid.

issues such as procedures for the appointment of company officers, the extent to which corporate officers may exercise discretion without direct reference to shareholders, and the distribution of profits and voting rights between different classes of shareholders[36].

Taken together the Memorandum and Articles of Association make up the constitution of the firm. The relationship between the two documents is complicated, however, by the fact that they represent different conceptions of the corporation[37]. The Memorandum embodies the historical image of the business enterprise as a company of merchants empowered to exercise trading powers and privileges delegated by the state[38]. This essentially governmental vision of the company is embedded in the traditional practice of policing of compliance with the Memorandum through the doctrine of ultra vires[39].

The Articles, by contrast, portray the company as an institution that "results from negotiation of concrete

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36 Ibid.

37 See, for example, the contemporary debate over the role of "status" and "contract" in corporate law. The vision of the corporation as essentially a "creature of the state" underlies arguments that the basic governing framework within which corporations operate is comprised of public and non-disclaimable rules. Others insist that the corporation is essentially a "purely" contractual relation between individuals. The latter perspective is taken to mean that corporation law should be faciliative only. While the state may legitimately provide default norms to assist those who wish to engage in the corporation transaction, it ought not to mandate specific terms of such transactions. For a useful collection of essays on this issue, see the recent symposium in the Columbia Law Review on "The Debate on Contractual Freedom in Corporate Law" (1989) 89 Columbia Law Review 1395-1860. For a general overview, see in particular, Lucien A. Bebchuk, "Foreword" 1395; for powerful advocacy of a minimum content of non-disclaimable norms, see, Jeffrey Gordon "The Mandatory Structure of Corporate Law" 1549; for a contractarian view, see, Frank Easterbrook & Daniel Fischel "The Corporate Contract" 1416. For a general critiques of the use of economic models of the firm as a justification for disclaimable rules, see, Victor Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract" (1985) 85 Columbia Law Review; William J. Bratton "The New Economic Theory of the Firm: Critical Perspectives from History" (1989) 41 Stanford Law Review 1471.

38 For a helpful overview of this history, see Hadden, Company Law and Capitalism, supra, note 28.

39 See, generally, Farrar Company Law, supra, note 34.

organizational rules in the market place.... [I]t is up to the (potential) entrepreneurs, the employees, and the financiers ... to agree on the legal form for the reciprocal relationships according to their respective needs"[40]. This contractual idea of the company undergirds the enforcement of terms governing relationships between shareholders, and between the company and its shareholders[41].

In terms of the relationship between Articles and Memorandum, traditional doctrines of company law not only maintain that the provisions of the former are to be read subject to the latter, but also preclude reliance on the Articles to supply statutory terms which are missing from the Memorandum[42].

Regulation of the rights, obligations and powers of capital suppliers is based on the legal incidents attributed to financial instruments such as shares and debentures, as well as the working rules contrained in the Articles of Association. Share capital affords the holder an interest in the company which is presumptively transferable, although

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40 Friedrich Kubler, "Juridification of Corporate Structures" in Gunther Teubner (ed.) Juridification of Social Spheres: A Comparative Analysis in the Areas of Labor, Corporate, Antitrust and Social Welfare Law (Berlin: Walter de Gruyter, 1987) at 220.

41 Note that although the Articles create rights and obligations between "members", they usually have to enforce through the institution of the company and cannot normally enforce directly, (the rule in Foss v. Harbottle (1843) 2 Hare 641).

42 Guinness v. Land Corporation of Ireland (1822) 22 Ch. D. 349. Note that it is legitimate to refer to the Articles where conflict centres on a matter which is not required to be in the Memorandum. Note laso that courts have resorted to the Articles to resolve ambiguity in the Memorandum or to supplement non-statutory terms, Angostura Bitters (Dr JGB Siegert & Sons) Ltd. v. Kerr [1933] AC 550. Hadden argues that the jurisprudence renders it impossible to maintain a clear hierarchy: Hadden, Company Law and Capitalism, supra, note 28. The practical reality, therefore, would seem to be that Memorandum and Articles together constitute an integrated structure of governance.

within private companies transfer is implicitly restricted by the lack of a market, and may be explicitly curtailed by provisions in the Articles[43].

In general terms, the economic interests attached to shareholding include rights to take a portion of both the transactional surplus generated by the firms' activities and the residual assets upon winding up. Moreover, in theory at least, shareholders have the right to participate in governance of the company by voting at general meetings. The precise implications of share ownership for governance or control, however, depend upon the distribution of the share capital. As was argued by Berle & Means, shareholding is by no means synonymous with the idea of control[44]. Not only may widely dispersed ownership of shares in large public companies mean that control is in reality the exclusive domain of professional managers[45], but highly concentrated patterns of shareholding may also exclude some shareholders from meaningful participation in governance[46]. In addition to substantive variations in the power of shareholders arising

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[43] The primary contractual instruments for restricting transfer are: compulsory purchase, pre-emption, and directors' powers to refuse registration into the Articles of Association: see, Farrar, Company Law, supra, note 34.

[44] The Modern Corporation and Private Property, supra, note 1; for challenges to the Berle & Means hypothesis which are based on neoclassical economic analysis of the power of market forces, see, generally the essays published as part of a symposium held to celebrate the fiftieth anniversary of this book (1983) 26 Journal of Law and Economics, see, in particular, Eugene F. Fama & Michael C. Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 301.

[45] This issue was of particular concern to Berle and Means. They identified 5 different forms of control: control through almost complete ownership, majority control, control through legal instruments apart from majority control, management control and minority control: The Modern Corporation and Private Property, supra, note 1.

[46] It should be recognised that concentrated shareholding may engender problems in both large public corporations and small-scale private companies.

from the distribution of capital, formal distinctions between the rights of different classes of shareholders may be specified in the Articles of Association[47].

Contractual forms for managing loan capital vary in duration and in the extent to which they are secured against the assets of the company. All such capital, however, creates an interest against the company and is repayable during the life of the company[48]. In the event that the loan remains outstanding at a point when the company becomes insolvent, legal norms dictate that creditors whose loans are secured on the assets of the company are to be repaid before unsecured creditors, who in turn have priority over suppliers of share capital[49].

The formal relationship between capital suppliers and managers of a company is governed by the interaction of mandatory legal norms with the constitutional provisions of the firm[50]. In theory, at least, companies are managed by Boards of Directors who are appointed, and may be removed, by a general meeting of shareholders. The relationship between

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47 "Preference shares", for example, typically provide for a fixed dividend which has priority over the distribution of surplus to ordinary shareholders; but may restrict voting rights to issues which involve only the distribution of preferential dividends.

48 Contrast share capital which is repayable only on winding up of the company or an authorised reduction in share capital: Farrar, Company Law, supra, note 34.

49 The interaction of share capital and loan capital is not particularly troublesome while the company transaction is on-going. However, the power of secured creditors to trigger insolvency, together with the potentially far-reaching nature of their charges over the assets of a company, means that the balance between share capital and secured loan capital has profound implications for the position of unsecured creditors whose loans are outstanding at the time of insolvency. The problem for unsecured creditors is that their claims against an insolvent company rank ahead of shareholders, but behind secured creditors.

50 In practice the two functions are often combined in small firms. However, in legal terms, they remain conceptually distinct.

the board and the general meeting is a contract based on the management term in the Articles of Association, or if none is stated, a default term implied by law. In practice, however, many companies are managed either by individuals who combine the roles of shareholder and director[51], or an executive class of specialists to whom the Board delegates its management authority. In the latter situation, the Board is at best a supervisory body, and at worst, simply ratifies the decisions of management[52].

Whatever the particular practice of management, the exercise of management powers is subject to general legal rules. These norms govern managers' authority to commit the firm to transactions with other economic actors; specify the conditions under which tortious or criminal acts by directors are attributed to the company; and constitute a range of fiduciary obligations which are owed to the company[53].

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51 Henry Manne "Our Two Corporation Systems" (1967) 53 Virginia Law Review 259 for discussion of this aspect of the management of companies.

52 This observation was the basis of Berle & Means' hypothesis in The Modern Corporation and Private Property, supra, note 1.

53 Enforcement of these duties may be complicated by the fact that they are wwed to the company rather than to shareholders. The category of fiduciary obligations includes duties to: to make decisions in the best interests of the company and not for improper purposes, to exercise reasonable care and skill, to avoid conflicts between personal and corporate interests, and account for personal profits derived from exercising management functions: see, generally, Farrar, Company Law, supra, note 34, chapter 24.

3. Summary

The institutional frameworks of partnership and company forms of governance address the problem of managing financial capital supplied by different actors whose assets are combined in a single profit-seeking economic venture. Whereas partnership relies on the instrument of co-ownership to regulate apportionment of costs and risks, and distribution of surpluses, companies use shareholding, legal personality and limitations on liability.

The most striking characteristics of these contractual forms of governance is their exclusive focus on a single class of resource suppliers. Although the process of engaging in profit-seeking activity requires financial capital to be combined with other resources, legal models of the firm treat the integration of labour (and to some extent physical capital that is not "owned" by the firm) as a peripheral issue. It is simply assumed that "external" markets will ensure an adequate supply of whatever additional resources are needed and that once integrated, these resources will be deployed in the interests of financial capital. Missing from the legal models, of the firm is any explicit provision for governing potential conflicts over the distribution of surpluses between different classes of resource suppliers. The economic theories of the firm, to which we now turn, focus on the question of how the firm contract manages the interaction of labour and capital resources to maintain smooth co-ordination of activity and contain conflict over shares in the transactional surplus.

B. Economic Theories of the Firm

1. The Coasian Analysis[54]

Coase sought to develop a theory of relationships between firms and markets in capitalist economies. Such a theory, he argued, ought to address two critical issues. First, it should account for the existence of these "islands of conscious power"[55] in the disaggregated and decentralised world of individuals trading in markets. Secondly, it was important to explain why firms appear in a range of institutional shapes and sizes[56].

The Coasian analysis begins with the proposition that the firm is functionally equivalent to the market, in the sense that both are institutions which co-ordinate and constrain decisions about resource use. Rationales for the existence of firms, Coase maintained, are therefore to be found by comparative analysis of the manner in which the two institutions govern economic activity.

Coase's comparison of firms and markets was based on

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54 "The Nature of the Firm", supra, note 1.

55 D.H. Robertson, Control of Industry at 85, quoted by Coase in "The Nature of the Firm", supra, note 1 at 388.

56 Although both issues were on the original Coasian agenda, the primary emphasis of "The Nature of the Firm" was on the former question: why do firms exist?

their distinct instruments of control and co-ordination. The firm relies on the "visible hand" of entrepreneurial decision-making to regulate activity, while market behaviour is driven by price. This difference in mode of governance, Coase argued, has its corollary in the manner by which operations are organised. Within a firm, entrepreneurial direction of production is accompanied by administrative organisation of economic activity (management); whereas economic activity propelled by the price mechanism is co-ordinated by exchange transactions.

After clarifying these differences between firm and market organisation of economic activity, Coase turned to the factors by which they might be compared. Organisation of economic activity, he argued, is not a costless process. Economic actors expend resources in deciding what to do with whom, when, where, and how, and in ensuring compliance with decisions. An important basis for comparison of markets and firms, therefore, is the relative cost of using each institution to make, monitor and enforce decisions about economic activity[57].

According to Coase, there are two main classes of costs associated with using the market to co-ordinate productive

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[57] Coase's original counterposition of market exchange and administrative management suggested that he did not view the firm as a "nexus of contracts", but as an entirely different form of governance. In a recent reflection on the original essay, Coase recognised that his treatment of the employment relation as the defining characteristic of the firm may have been misleading in that it gave insufficient emphasis to the number and variety of contracts that are implicated in the transactional form of the firm: see Ronald H. Coase "The Nature of the Firm: Influence" (1988) 4 Journal of Law, Economics & Organization 33.

activity. Producers who attempted to rely on the market alone would need to expend resources in discovering prices for each input, and in negotiating, monitoring and enforcing fully specified, consistent and interactive contracts with every input supplier. In addition, market co-ordination of exchange may result in economic actors foregoing the benefits of long-term planning. The primary problem, as identified by Coase, being that the flexibility inherent in such planning is incompatible with the type of detailed arrangements between large numbers of separate resource suppliers which are necessary when complex transactions are governed by the market[58].

The firm substitutes a single set of transactions between each individual resource supplier and a central agent - the employer - for the multiple, interrelated contracts of the market. Furthermore, because employers purchase both the services of the resource and the power to direct the way in which resources are used, the contracts of the firm may be more flexible and open-textured than those of market exchange[59]. The firm, therefore, requires fewer and less complex transactions to achieve a given production goal, and

[58] In the "Nature of the Firm", supra, note 1 Coase did not spell out which aspects of long-term planning are facilitated by reliance on the firm rather than the market. However, subsequent commentators have interpreted the Coasian analysis to mean that the firm emphasises "quantity mode" planning while market-governed planning is geared to price: see, for example, Oliver D. Hart "Incomplete Contracts and the Theory of the Firm" (1988) 4 Journal of Law Economics and Organisation 119.

[59] Note that Coase associates the greater flexibility of planning within the firm, as compared to the market, with the relationship of authority between employer and employee: Coase, "The Nature of the Firm", supra, note 1.

enables flexible planning of economic activity.

Coase was not arguing, however, that the firm is inherently a less costly institution than the market. His point, rather, was that the firm provides an institutional setting for economic activity which under some circumstances would generate lower transaction costs than market-governed exchange. In order to clarify the conditions under which the firm provides a lower cost institutional setting for economic activity, it is necessary, therefore, also to identify the transaction cost implications of its structure of governance.

Firms, Coase argued, not only require resource expenditure on internal co-ordination and management, but their governing instrument - entrepreneurial decision-making - is also more prone to error than market-governed decisions driven primarily by price. Thus, while firms enable economic actors to avoid the costs of discovering prices and negotiating interactive contracts, they entail the costs of an agent who acts as a specialist decision-maker, and involve a higher risk that decisions will be "wrong". The significance of both types of costs, as a proportion of total production costs, Coase maintained, is likely to increase with the size of the firm.

Explanations for why a particular economic venture is governed by the market or located within a firm are to be found, therefore, in comparison of the relative costs of using centralised administration and multiple contracting to organise the activity in question. In short, the central propositions of The Nature of the Firm were that:

> [a] firm had a role to play in the economic system if it were possible for transactions to be organized within the firm at less cost than would be incurred if the same transactions were carried out through the market[60].

and:

> [t]he limit to the size of the firm would be set when the scope of its operations had expanded to the point at which the costs of organizing additional transactions within the firm exceeded the costs of carrying out the same transactions through the market or in another firm[61]

Three aspects of the Coasian analysis stand out as critically important to subsequent developments in contractual theories of the firm. First, the construction of firms and markets as alternative contractual means of governing economic activity provided a general conceptual framework for thinking about the economic function of firms. Secondly, Coase's explicitly comparative use of the concept of transaction costs created a methodological alternative to conventional optimising analysis[62]. Finally, Coase's hypothesis that

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[60] Ronald H. Coase, "The Nature of the Firm: Meaning" (1988) 4 Journal of Law, Economics & Organization 19 at 19.

[61] Ibid.

[62] The distinctive aspect of the Coasian approach to transaction costs is its rejection of the "perfectly competitive market" as a reference point for analysis: see also "The Regulated Industries: A Discussion" (1964) 54 American Economic Review 194; Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1, especially at 14-18. Thus in the context of the firm, the Coasian analysis does not ask "what would be the perfect institutional form if transactions were costless" and then attempt to replicate that outcome by refining existing organisational arrangements; but takes as its starting point the assumption that transactions are always costly, whatever their context. The analytical goal is to understand how different classes of transaction costs are shaped by their institutional settings, and to expose the limits of different institutional settings relative to one another. For an expanded discussion of these methodological issues, see chapter II, supra.

transactions are organised in markets or firms according to the relative costs of using central direction and multiple contracting as co-ordinating mechanisms provided a workable foundation on which later theories could build.

Coase's specific conception of the firm as comprised of long-term open-textured contracts in which the price mechanism is superseded by employers' power to direct employees is endorsed by those who view the firm as a contract of hierarchy and implicitly rejected by many working in the "transactional clustering" or "nexus of contracts" tradition[63]. However, both groups of contemporary theorists have tended to focus their explanations of the firm on the transaction costs of monitoring and enforcing contracts rather than follow the Coasian emphasis on the costs of discovering prices and planning.

2. Transactional Clustering Theories of the Firm

a. The Theory of "Team" Production

The basic theory of the business enterprise as a "cluster of contracts" constructs the firm as a means of managing and enforcing claims to transactional surpluses in circumstances

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[63] This term was coined by Jensen & Meckling: "Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure", supra, note 5.

where economic actors have "chosen" to engage in team production[64]. Theorists working within this tradition treat the contracts which constitute the firm as conceptually the same as the contracts of the market. Differences between the two institutions, therefore, lie not in the inherently more directive nature of "firm-like" contracts[65], nor even in the fact that they are necessarily longer term, but are to be found in their disparate patterns of contracting. That is to say, while "pure" market transactions are disaggregated and discrete, the contracts which constitute the firm are clustered into distinctive formations. Moreover, "firm-like" contracts include within the nexus of transactions a "centralised contractual agent"[66] who has a specific set of rights and responsibilities.

The questions raised by this conception of the firm include: Why do transactions cluster at all? and why is team production typically organised so that most contracts are based on an agreed price for the resources supplied, with one contract (or class of contracts) grounded on rights to take

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[64] This branch of the theory of the firm is associated with the work of economists such as Demsetz, Cheung, Grossman and Hart. See, for example, Armen A. Alchian, & Harold Demsetz, "Production, Information Costs and Economic Organisation" (1972) 62 American Economic Review 777; Demsetz "The Structure of Ownership and the Theory of the Firm" (1983) 26 Journal of Law and Economics 375; Demsetz & Lehn "The Structure of Corporate Ownership: Causes and Consequences" (1985) 93 Journal of Political Economy 1155; Steven N.S. Cheung "Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements" (1969) 12 Journal of Law and Economics 23; Sanford J. Grossman and Oliver D. Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94 Journal of Political Economy 691; Oliver D. Hart "Incomplete Contracts and the Theory of the Firm" (1988) 4 Journal of Law, Economics & Organization 119; Bengt Holmstrom "Moral Hazard in Teams" (1982) 13 Bell Journal of Economics 324; Robert Hessen "A New Concept of Corporations: A Contractual and Private Property Model" (1979) 30 Hastings Law Journal 1327.

[65] This phrase was coined by Harold Demsetz: "The Theory of the Firm Revisited" (1988) 4 Journal of Law, Economics & Organization 141.

[66] Alchian & Demsetz "Production, Information Costs and Economic Organisation", supra, note 64.

the transactional surplus?

The rationale given for transactional clustering into firm-like organisations is its potential productivity. It is argued that team production enables economic actors to pool resources in situations where the combined used of their "comparative advantages" creates a larger total product than if assets were not combined[67].

The transformative effect of clustering raises the question of how shares in the enhanced transactional "pie" are to be distributed between resource suppliers when the increased output cannot be unambiguously attributed to any individual actor[68]. Two characteristics of team production are seen to militate against using the conventional market instrument of enforceable ex ante agreements as the basis of distribution. First, the number of participants and the variety of the resources which they supply increases the complexity of negotiations and the costs of securing agreement over the appropriate distribution of the surplus[69].

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[67] Cheung, "Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements", supra, note 64; Alchian & Demsetz "Production, Information Costs and Economic Organization", supra, note 64.

[68] In "Production, Information Costs and Economic Organization", supra, note 64, Alchian & Demsetz argue that if it is impossible for team participants directly to observe each person's exact contribution to the total value of profits, then rewards cannot readily be assigned according to conventional performance criteria, nor according to the initial property rights. On the other side of the equation, team production also means that costs may not be fully internalised by the relevant actor. In particular, the absence of a precise relationship between the input contracted for and the total output means that individual suppliers do not bear the full effects of their own "shirking". As such behaviour results in a lower total output (than would have resulted if the actor had supplied in accordance with its contract) the costs of shirking are shared between all to whom output is distributed. Alchian and Demsetz argued that in this context joint ownership of the team's output may result in excessive shirking. Because each person can shift some of the costs of their "on the job" consumption to their co-workers, each has an incentive to increase the benefit for which they do not bear the entire cost. Ultimately the entire system of team production would be threatened. See also Holmstrom "Moral Hazard in Teams", supra, note 64.

[69] Note the similarity with the Coasian analysis, supra.

Secondly, because potential output is so much greater than the sum of individual inputs, team production is thought to open up opportunities for shirking[70]. Non-separability, it is argued, makes it difficult to attribute shortfalls in output to any individual contractor's failure to deliver as expected. Such contractors, therefore, are neither sanctioned within the contract, nor does information about their inadequate performance reach the market where it could affect the price that might be commanded on future participation in team production[71].

In effect, although team production is potentially "efficient", the organisation of the transaction obscures the contribution of each individual to the larger transactional surplus. As a result, market contracting mechanisms may not have enough information on which to base their normal measurement and reward system of compensation according to marginal product of each input[72].

It is further argued that in the absence of a good correlation between performance and reward, the system of team production is unstable. Not only may those who supply high quality input be demoralised by the lack of recognition of their efforts, but the failure to price performance accurately

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70 Alchian & Demsetz, "Production, Information Costs and Economic Organization", supra, note 64; Holmstrom, "Moral Hazard in Teams", supra, note 64; Grossman & Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", supra, note 64.

71 Ibid.

72 See, generally, Bengt Holmstrom "Moral Hazard and Observability" (1979) 10 Bell Journal of Economics 74; Sherwin Rosen "Transactions Costs and Internal Labor Markets" (1988) 4 Journal of Law, Economics & Organization 49.

also creates openings for individual team members to shirk without bearing the full costs of their behaviour[73].

Transactional clustering theorists suggest that difficulties in monitoring team production might be solved by incorporating an ownership-management contract into the pool of transactions[74]. Such a contract would assign two formal rights to a single contractor or small class of contractors: the right to control the deployment of resources in production; and the right to appropriate the transactional surplus once all other contractors had been paid[75].

The management right replaces the practice of detailed ex ante planning of each transaction and of relationships between the transactions which comprise the firm[76]. The substitution of a single decision-maker for multiple bargaining processes reduces the complexity of bargaining. No longer does each input supplier need to plan its interaction with every other participant. Instead, co-ordination is

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[73] Alchian & Demsetz, "Production, Information Costs and Economic Organization", supra, note 64; Holmstrom, "Moral Hazard in Teams", supra, note 64; Cheung, "The Contractual Nature of the Firm", supra, note 7.

[74] Ibid., see also, Grossman & Hart, "The Costs & Benefits of Ownership: A Theory of Vertical and Lateral Integration", supra, note 64; Hansmann, "Ownership of the Firm", supra, note 24.

[75] Ibid. Note that while every exchange expressly or implicitly reflects a particular configuration of these two rights, the significance of ownership as a distinct concept varies between different patterns of transacting. For example, within a transaction such as sale of a consumer commodity where each party controls the decision to trade her / his assets (freedom of contract) and each takes that share of the total transactional surplus which she/he can extract from the other by bargaining, the concept of ownership adds nothing very interesting to the (economic) analysis of exchange (note that the passing of "title" may be a highly significant legal issue). Conventional economic analysis of such transactions simply assumes that individuals' rights to control assets are derived from the initial assignment of property rights and the allocation of shares in the transaction surplus is a product of the bargaining process. By contrast, analysis of firm-like transactions is characterised by the explicit attention that is paid to "ownership" of residual earnings.

[76] Alchian & Demsetz, "Production, Information Costs and Economic Organization", supra, note 64; Grossman & Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Horizontal Integration", supra, note 64; Hansmann, "Ownership of the Firm", supra, note 24.

achieved through the agency of the central decision-maker. In addition, the existence of a central decision-maker with powers to adjust relationships and reassign tasks in the light of emerging circumstances avoids the need to plan in advance for each and every contingency which might occur over the course of transaction.

The right to take residual earnings is thought to ensure that the specialist decision-maker faces incentives to make economically justifiable decisions about the use of resources[77], and provide incentives for the decision-maker to monitor the activities of all input suppliers[78]. In this latter role, the decision-maker functions as an information-gathering resource and a source of sanctions[79]. As such the decision-maker serves to amplify the relatively weak market signals which would otherwise govern team production[80].

Transactional clustering theories of the business enterprise therefore justify the management structure of the firm as a means of organising team production in a manner which ensures that there is enough information for market governance of transactions. Central decision-makers are

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77 Ibid.

78 In this role, the decision-maker might be expected to measure output, apportion rewards between team members, and observe input behaviour in order to estimate the marginal productivity of each team member. Theorists working within this tradition also insist that it is necessary for the central decision-maker / monitor to have the power to terminate the team membership of shirking individuals: see, for example Alchian & Demsetz, "Production, Information Costs and Economic Organization", supra, note 64.

79 Ibid.

80 The right to take positive residual claims is also sometimes justified in terms of compensation for compensation for bearing the risk that the net cash-flows will be negative: Hansmann, "Ownership of the Firm", supra, note 24.

thought to use market information in creating or renegotiating contracts with other input suppliers, and their decisions to continue or terminate the participation of other resource suppliers feed information back into the markets for those resources. The argument also suggests that input suppliers, who know that evaluation of their performance will influence renegotiations of existing contracts and reach the market for their services, will realise that it is more difficult for opportunistic behaviour to escape detection and "punishment". While the costs of the central agent are recognised to be potentially substantial, theorists maintain that these costs are likely to be outweighed by the improved performance of team when market rewards are better correlated with performance[81].

Taken together, these ideas about the role of combined ownership and management rights in firms, provide a rationalisation of the classical entrepreneur, and small partnership and private company forms of the business enterprise. They do not, however, answer all of the questions raised by observed patterns of "firm-like" governance. The argument that a well-defined class of input suppliers should own the transactional surplus of team production does not explain why ownership is usually associated with suppliers of

[81] Grossman & Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", <u>supra</u>, note 64; Hart, "Incomplete Contracts and the Theory of the Firm", <u>supra</u>, note 64.

a particular form of finance capital[82]. The theory would seem to be just as plausible if capital were integrated into clusters by way of agreed price contracts - as is the case with loan capital - and the transactional surplus were shared between suppliers of labour resources[83].

Nor does the basic theory of transactional clustering account for the structure of the dominant institution of modern capitalist economies, the large public corporation. Within these organisations, the right to take the transactional surplus is separated from on-going control over the deployment of assets and the rights in the surplus are dispersed between many individuals[84]. The resulting free-rider problem would seem to indicate that ownership is unlikely to serve the monitoring function suggested in the rudimentary theory of transactional clustering.

b. Agency Theory

Perhaps the most influential attempts to refine the basic team production theory to accommodate the large public corporation are to be found in the rapidly developing

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[82] Note that owners of share capital are a sub-class of those who finance production within a firm. Loan institutions, trade creditors, and workers paid in arrears are also involved in financing of production.

[83] Of course, within small firms, suppliers of share capital - the owners - are frequently also suppliers of labour resources.

[84] Berle & Means, The Modern Corporation and Private Property, supra, note 1; Eugene F. Fama & Michael C. Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 301.

literature of agency theory[85]. Agency theorists construct the relationship between professional managers and shareholders in the large public corporation as a transaction which has four main characteristics[86]. First, shareholders, (principals) hire management (agents) to make decisions about resource use in the expectation that managers will use their expertise to maximise the profits of the firm. Secondly, shareholders are unable to observe all dimensions of managements' performance of the contract. Third, the benefits of the contract are distributed so that shareholders take the transactional surplus after the costs of performance, including managers' fees, have been paid. Finally, the extent to which the shareholders objective of maximum profits is met depends on economic conditions over which neither party has direct control, as well as the skill and effort of management.

This combination of characteristics would open up substantial scope for management to deliver less than the contracted quality of expertise and effort, were it not for an array of supervisory and incentive-alignment or "fusion" practices which may be used to regulate the transaction[87]. The

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[85] See generally, Steven A. Ross "The Economic Theory of Agency: The Principal's Problem" (1973) 62 American Economic Review 380; Eugene F. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 Journal of Political Economy 288; Fama & Jensen, "Agency Problems and Residual Claims" (1983) 26 Journal of Law and Economics 327; Jensen & Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Capital Structure", supra, note 5; Richard J. Zeckhauser & John W. Pratt (eds.) Principals and Agents: The Structure of Business (Boston: Harvard Business School Press, 1985).

[86] Ibid.

[87] Milton Harris & Arthur Raviv, "Optimal Incentive Contracts with Imperfect Information" (1979) 20 Journal of Economic Theory 231; Oliver D. Hart, "The Market Mechanism as an Incentive Scheme" (1983) 14 Bell Journal of Economics 366; Stephen Shavell "Risk-Sharing and Incentives in the Principal-Agent Relationship" (1979) 10 Bell Journal of Economics 55.

contract between principal and agent, for example, may be constituted so that the initiation and implementation of decisions (management) within the firm is always separated from ratification and monitoring of decisions (control)[88]. Such a patterning of responsibility limits the decision-making autonomy of any one manager, and facilitates the development of a ladder of authority in which ultimate control may be vested in an agency representing the shareholders.

With respect to governing instruments based on incentives, agency theorists, consistently with the basic tenets of the contractual clustering perspective, focus on practices which intensify the disciplinary mechanisms of the competitive market[89]. For example, it is argued that a general practice of hiring management on renewable contracts from the external labour market encourages incumbents to deliver high quality performances[90]. This incentive effect is said to be based not only on managers' fear of non-renewal, but also on a material interest in enhancing the market's valuation of human capital for the time when they choose to seek a new job[91].

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88 Fama & Jensen "Separation of Ownership and Control", supra, note 84.

89 Hart, "The Market Mechanism as an Incentive Scheme", supra, note 87.

90 The claim that managerial labour markets deter opportunism rests on a view of agency cost as a problem of valuing the human capital that managers rent to their existing employers. A manager who contemplates shirking is thus forced to compare the present value of doing so with the future devaluation of her/his skills by the labour market. Unless the manager does not anticipate long-term participation in the labour market her/ his incentives to shirk will be reduced simply because such behaviour will have an effect on their future marketability.

91 Eugene F. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 Journal of Political Economy 288.

Regular recourse to the external labour market is also thought capable of inhibiting what is perceived to be a particularly threatening form of opportunism: managerial collusion against the interests of shareholders. The essence of this argument is that internal "lock-step" promotions of employees in management positions facilitate the development of social and professional bonds between managers[92]. These relationships may enhance profitability in so far as they reduce the costs of communication and co-operation. The negative dimension to such alliances, viewed from the perspective of shareholders, however, is that they may encourage managers to protect one another in the pursuit of their own interests rather than those of the principals. Reliance on the external labour market for recruitment of at least some members of management teams, therefore, may, function both to break up existing collusive arrangements and curb the formation of others[93].

On the other hand, creation of strong internal labour markets for promotion and other rewards may be used to strengthen supervisory practices such as peer review or mutual monitoring[94]. This argument maintains that managers who know that they are located in a restricted competition for better

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92 Roger L. Faith, Richard S. Higgins & Robert D. Tollison, "Managerial Rents and Outside Recruitment in the Coasian Firm" (1984) 74 American Economic Review 660.

93 Ibid.

94 On the dynamics of internal labour markets within firms, see, Rosen, "Transactions Costs and Internal Labor Markets", supra, note 72; Edward P. Lazear & Sherwin Rosen, "Rank Order Tournaments as Optimum Labor Contracts" (1981) 89 Journal of Political Economy 841; Rosen, "Prizes and Incentives in Elimination Tournaments" (1986) 76 American Economic Review 701.

jobs not only face incentives to work hard in order to improve their own chances of promotion but are also encouraged to report on the performance of their colleagues[95].

Incentives may also be combined with supervision in the form of differential reward structures[96]. As deployed in institutions such as law firms, this practice entails compensating workers at lower levels of the organisation by means of an ex ante agreed wage, and those at higher levels in a manner where payment is correlated more closely with marginal productivity[97]. This structure of payments creates pecuniary incentives for workers to move up through the organisation until they reach levels where they will be compensated according to actual productivity rather than on the basis of a proxy for their input[98]. Incentives are maintained once an employee reaches that rung by the knowledge that their reward is closely correlated with effort and human capital.

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95 Mutual monitoring procedures have relatively low direct costs in that they make use of information which economic actors acquire about one another by working together. As the relevant information emerges "naturally" within the cluster of contracts, the use of monitoring as a means of supervision requires only the creation of incentives for agents to reveal information about the skill and efforts of co-workers with whom they interact. The problems or costs associated with peer review include: lack of co-operation between workers. (Note that this may be beneficial to owners in so far as it prevents the development of a strong and effective collective organisation - workers do not perceive common interests against the owners but only the individual competition between themselves). Secondly, the existence of incentives to inform does not guarantee that experience rating will be effective: one might for example question whether the internal labour market will be able to filter out vindictive, false, and misleading information, or information procured by duress and encourage the production of only fair and accurate assessments of the performances of a co-worker.

96 Rosen, "Prizes and Incentives in Elimination Tournaments", supra, note 94.

97 Ibid., for an insightful analysis of reward structures within law firms, see Ronald J. Gilson and Robert H. Mnookin "Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits" (1985) 37 Stanford Law Review 313; see also, Fred McChesney, "Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis" (1982) 11 Journal of Legal Studies 379.

98 Rosen, "Prizes and Incentives in Elimination Tournaments", supra, note 94.

Nor are labour markets the only source of market discipline against errant managers. It has been argued, for example, that the "takeover", far from presenting a threat of economic domination by large conglomerate organisations is primarily a mechanism by which capital markets detect and punish "shirking" managers[99]. The essence of this argument is that experienced capital market players are able to detect firms that do not live up to their potential, and will generally attribute under-performance to managerial shirking[100]. The gap between performance an potential provides financial incentives for stock-market players to gain control by purchasing shares and to improve profitability by instituting a new regime under which managerial performance will be scrutinised more closely. As takeover is likely to be unattractive to incumbent managers, the constant threat that it might occur creates incentives for agents to ensure that deviation remains below the level which would precipitate takeover.

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[99] Grossman & Hart "The Allocational Role of Takeover Bids in Situations of Asymmetric Information", supra, note 5; Ryngaert & Netter "Shareholder Wealth Effects of the Ohio Antitakeover Law", supra, note 5; Easterbrook & Fischel "The Proper Role of a Target's Management in Responding to a Tender Offer", supra, note 5.

[100] Ibid.

3. Transactional Economic Analysis of the Firm as A Contract of Hierarchy

Theorists working in the transactional economics tradition construct the firm as a hierarchical transaction[101]. Like Coase, these scholars argue that the firm is a vertically integrated transaction characterised by the substitution of explicit relations of direction, authority and control for the price mechanism. The firm, to be sure, is a contract, but it is a form of contract that bears little resemblence to the transactions of a competitive market.

Transactional economists not only maintain that the conceptual form of the vertically integrated contract is distinct from the market contract, but also assert that the firm is consciously used to insulate economic activity from market forces[102]. The interaction of market incentives with specific characteristics of some economic activities is taken to create an institutional setting in which self-interest may readily flourish into opportunistic behaviour[103]. The firm

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[101] Williamson, Markets and Hierarchies: Analysis and Antitrust Implications, supra, note 5; Williamson, The Economic Institutions of Capitalism (New York: The Free Press, 1985); Benjamin Klein "Vertical Integration as Organizational Ownership: The Fisher Body - General Motors Relationship Revisited" (1988) 4 Journal of Law, Economics, & Organization 199; Kirk Monteverde & David Teece "Supplier Switching Costs and Vertical Integration in the Automobile Industry" (1982) 13 Bell Journal of Economics 206: see, generally, Paul L. Joskow "Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence" (1988) 4 Journal of Law, Economics, & Organization 95.

[102] Oliver E. Williamson, "The Vertical Integration of Production: Market Failure Considerations" (1971) 61 American Economic Review 112; Williamson, The Economic Institutions of Capitalism, supra, note 101.

[103] Ibid., see also, Benjamin Klein, Richard G. Crawford, & Armen A. Alchian "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process" (1978) 21 Journal of Law and Economics 297.

constitutes a different institutional setting for the activity. While vertical integration does not destroy the propensity for individuals to act opportunistically, the transformed context is thought to eliminate certain avenues for the expression of opportunism and contain residual opportunism in more manageable form[104].

The basic tenets of the transactional economists' analysis are by now familiar to the reader of this thesis, but perhaps should be briefly reiterated here. Vertical integration is taken to be one among many structures for governing economic activity. Governance structures are consciously fashioned out of institutions and cultural practices which give order to economic interaction. They vary in complexity and may be ranged along a continuum bounded by the discrete exchange of the spot market and the internal economy of the multinational corporation. Each form of governance constitutes a distinct type of context for economic ventures and each generates its own configuration of governance costs.

Within this theory, economic activities are also viewed as highly variable. Of particular significance to the analysis are differences pertaining to: degrees of uncertainty in the environment of the activity, complexity, and the extent to which the activity makes use of specific investment into assets which have a substantially lower value when deployed

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104 Ibid.

in other uses. The transaction costs of organising activities are taken to be further exacerbated by the bounded nature of human rationality and the propensity of self-interest to degenerate into opportunistic attempts to redistribute shares in the transactional surplus. Observed forms of economic organisation are interpreted as the outcomes of individuals' attempts to match structures of governance to activities in a manner which contains the combined transaction costs of governance and co-ordination.

Viewed from this perspective, the theory of the firm is a tool for determining when economic activities will be governed by vertical integration rather than market exchange or relational contracts. At present the literature is primarily devoted to refining and testing the hypothesis that the hierarchy contract is found where activities entail substantial specific investment and recurrent interaction in an uncertain environment, and participants find it difficult to sustain the transaction-specific commitments necessary to support relational contracting[105].

However, the idea that firms and markets are distinct institutional settings for economic activity has also

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105 See, for example, Williamson, The Economic Institutions of Capitalism (New York: The Free Press, 1985); Benjamin Klein "Vertical Integration as Organizational Ownership: The Fisher Body - General Motors Relationship Revisited", supra, note 101; Monteverde & Teece "Supplier Switching Costs and Vertical Integration in the Automobile Industry", supra, note 101; Scott E. Masten "The Organization of Production: Evidence from the Aerospace Industry" (1984) 27 Journal of Law and Economics 403: see generally, Joskow's review of the empirical literature in "Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence", supra, note 101. Note that while the empirical studies broadly corroborate the idea that specific investment, uncertainty and frequency of interaction are related to closer ties between individuals than is typical of classical contracting, it is less clear on the precise point at which transactional choice shifts from relational contracting to vertical integration.

generated interest in the internal management of vertically integrated enterprises. For the transactional economists are clearly not arguing that "integration transforms a hostile supplier into a docile employee"[106], but that particular problems of opportunism are more easily dealt with within the firm than by using an alternative contractual form. It is necessary to consider, therefore, how the organisation of the firm might influence the possibility and the potential costs of opportunism.

A shift from relational contracting to vertical integration entails a fusion of separate but interdependent profit streams into one. This change in institutional setting transforms power relations. It opens up access to a more powerful range of weapons by which to pre-empt or counteract what are perceived to be opportunistic attempts to redistribute wealth and creates new problems of exploitation. For example, a firm is in a better position to organise the work of an internal department so that employees' skills are developed in a manner which is specific not just to the task, but also to the firm[107]. Employees whose skills are highly "firm-specific" are in a relatively weak position to threaten to withhold co-operation as a means of securing an individual

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[106] This comment was part of Grossman & Hart's critique of the thrust of Coase's argument: see, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", supra, note 64, at fn.1. For Coase's response to the criticism, see Coase, "The Nature of the Firm: Meaning", supra, note 60.

[107] See, for example, Anderson & Schmittlein's study of the integration of marketing: Erin Anderson & David Schmittlein, "Integration of the Sales Force: An Empirical Examination" (1984) 15 Rand Journal of Economics 385.

advantage.

Vertically integrated enterprises are also able to institute more pervasive systems of command and control over employees than would be observed in interdependent relational transactions. Finally, employees whose economic lives depend on a single job are typically more vulnerable to sanctions which may be imposed by an employer than an independent contractor who has several contracts at any one time.

Williamson recognises that the firm may expose workers to opportunism, but argues that such exploitation is not in the transactional interests of employers. Drawing on his earlier work with Wachter and Harris, he also suggests that abuse may be curtailed by collective organisations of workers. Unions, he states, "can be made to serve ... the mutual interests between workers and firms in protecting the employment relation against exploitation by the other"[108].

Four characteristics of unions are viewed as particularly important to safeguarding the employment relation[109]. First, unions facilitate communication between workers and employers, providing a direct channel for the articulation of workers' needs and wishes, and a resource to assist worker evaluation of management initiatives. In this respect, the union functions primarily as a co-ordination and information mechanism.

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108 Williamson, The Economic Institutions of Capitalism, supra, note 101 at 255.
109 Ibid.

Secondly, unions, acting as the sole bargaining agent of workers, inhibit the emergence of individual and "small-team" bargaining. This function of enhancing solidarity between workers also serves the interests of management in reducing the scope for sub-groups of workers to combine and exploit any internal monopolies[110].

Collective organisation also provides a channel for the expression of individual grievances and a means of managing abuses of authority. This aspect of the role of unions not only contains conflicts over the employment relationship, but also serves the interests of senior management in that grievance procedures may encourage workers at lower levels of the hierarchy to report on their immediate supervisors[111].

Finally, unions, as collective organisations enable workers who make specific investments to combine forces for greater protection against attempts by management to degrade the value of their investments. The transactional function of the union, in this context, is to provide a means by which workers may credibly threaten to impose costs on firms which attempt opportunistically to change the terms of the employment relation[112].

Transactional economists, like agency theorists, have confronted the possibility of management shirking within the

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110 Ibid.

111 Ibid.

112 Ibid., see, generally, Williamson "Credible Commitments: Using Hostages to Support Exchange" (1983) 73 American Economic Review 519.

vertically integrated enterprise as a potential problem. However, the orientation of the analysis differs from that of the principal-agent literature in two respects. First, the transactional economists argue that the relevant comparison for evaluating the problem and potential responses is not the discrete transaction of the competitive market model, but the type of relational contract that might otherwise have been used to govern a transaction based on specific investment[113]. Masten, for example, has compared American legal doctrines regulating directors' duties with some of the norms of commercial law which govern transactions between independent contractors[114]. He shows that "owners" of firms may draw on a range of norms to protect themselves against management shirking which are not available in commercial contracts. The point of the essay is not so much to demonstrate the significance of law as a means of intensifying the signals of the market, but to reveal that different legal norms are implicated in different institutional settings[115].

Second, consistently with the general argument that the firm is a means of sheltering transactions from markets, transactional economists argue that managerial "shirking" is more effectively governed by the internal pattern of authority

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[113] Williamson, The Economic Institutions of Capitalism, supra, note 101; Paul L. Joskow "Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants" (1985) 1 Journal of Law, Economics & Organization 33.

[114] Scott E. Masten "A Legal Basis for the Firm", (1988) 4 Journal of Law, Economics & Organization 181.

[115] Ibid.

relations within a firm than by the "high-powered" incentives of the market[116]. The primary mechanism of governance identified in the literature is a hierarchical structure of command and control culminating in the Board of Directors.

Williamson argues that the role of the Board of Directors as a governing mechanism devoted entirely to the protection of one class of resource suppliers can be rationalised in terms of distinctive characteristics of shareholders' interest in firms. The diffuse nature of shareholders' investments, their lack of physical control over productive assets, and the absence of a mechanism for adjusting shareholders' relationships with the firm in the light of emerging information, are thought to inhibit the power of contract to safeguard shareholders' interests. That shareholders' assets are so obviously vulnerable to appropriation, exacerbates the risk that opportunistic managers may take advantage of their relative transactional power[117]. This risk, Williamson suggests, may be countered by an agency, accountable to shareholders alone, which is empowered to participate in policy formation, gain access to internal performance measures, authorise auditing, review and ratify management decision-making, and ultimately replace management[118].

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116 Williamson uses this phrase: The Economic Institutions of Capitalism, supra, note 101.

117 Williamson notes that the nature of their investment exposes finance suppliers to two forms of opportunism: management may embezzle funds allocated to general purchasing power; and quasi-rents derived from firm specific investments may be appropriated: The Economic Institutions of Capitalism, supra, note 101.

118 Williamson, The Economic Institutions of Capitalism, supra, note 101.

Summary of Themes

This chapter has shown how contemporary theorists have attempted to enrich conventional economic conceptions of "the firm". Within this disparate literature, the firm appears as an institution of governance: a means of organising productive activity. For the purposes of this thesis, the main insights to be gained from the emerging research relate to the role of specialised decision-makers in complex transactions.

Contractual theories of the firm demonstrate that the inclusion of a permanent management function which stands apart from the central economic activity of production may serve important transactional goals. Specialised management may open up the possibility of new planning strategies, facilitate co-ordination during execution of economic activities, and provide a powerful mechanism for monitoring the performance of other input suppliers. Taken together, these attributes of specialised decision-making enable participants in "firm-like" transactions to avoid some of the organisational costs that arise in other institutional settings.

However, inclusion of an on-going management function within a complex transaction is far from costless. Firm-like transactions entail interactive relationships between a number of diverse resource suppliers. Managerial planning and co-ordination involve judgments that may have widespread repercussions for participants in firm-like transactions. Adjustments to interactive relationships is likely to be considerably more costly than simple changes within bilateral transactions.

Perhaps the most substantial costs associated with the deployment of specialised management arise where ownership of the transactional surplus is separated from day-to-day control over operations. In this context, management introduces a new site for opportunistic behaviour. By cheating on their contractual obligations with respect to competent planning, efficient co-ordination and effective supervision, managers may, in effect, increase the net value of their wage. However, such strategic behaviour has a negative impact on other participants. To the extent that managerial opportunism shifts costs to the owners of the transactional surplus, its effect is to reduce the return on owners' investments. Managerial opportunism may also have implications for labour and other resources that are subject to the direction of managers in that the discretionary powers afforded specialised decision-makers may enable managers subtly to shift costs to workers, thereby degrading the net value of the workers' wages.

In general terms, the transaction costs of managerial decision-making are shaped by distinctive relationships between the price mechanism and productive activity within firms. While scholars working within the theory of the firm tradition take divergent positions as to whether market forces are an obstacle or a solution to co-ordination problems, all would agree that the price mechanism has different implications for firm-like transactions than for exchange governed by the market alone.

Specifically, management functions as a filter for "pure" price signals. Managerial discretion entails the translation of price signals into formal direction of economic activity. This process may intensify, reflect or distort the messages contained in price. It would be wrong to conclude, however, that because the management decisions which govern production within a firm differ from production choices driven solely by a perfectly competitive market, such decisions are necessarily "wrong" or inferior. The real-world of complex economic activity is one in which a specialised management function is adopted primarily because such an institutional setting generates different outcomes from those of the actual markets in which economic actors are situated.