

Determinants of the Optimal Degree of Pro-activeness in Contracting

A Law and Economics Perspective on Optimal Contracting

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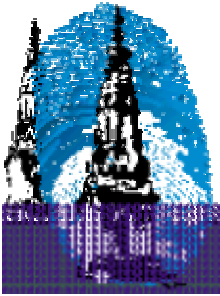
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A Law and Economics Perspective on Optimal Contracting

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1. Introduction

The so-called 'pro-active view' of the role of the lawyer is that he or she should ideally anticipate rather than resolve conflict. Applied to the contracting lawyer, the view is that lawyers should avoid conflict by making sure that the contracting parties stipulate in the contract such rights and obligations that may otherwise become the subject of dispute. The present article argues that this 'pro-activity view', while inherently sound, can be carried too far. Pro-activeness is subject to diminishing returns in the sense that some contingencies should not be addressed in contract simply because the costs of so doing is greater than the benefits. This article attempts to delineate these costs and benefits and to thereby account for the factors that enter into the determination of what may be termed the optimal degree of pro-activity in contracting.

One of the main points will be to argue that while drafting costs are certain to be incurred, the benefits are often uncertain and may be small because there are alternatives to settling conflicts through contracts *ex ante*.

When accounting for the costs and benefits, a distinction is worth drawing between the *direct* and the *indirect* benefits. The *direct* benefit is uncertain when the contingency is uncertain to occur, and it may be small simply because the contingency may not in itself involve large sums of money. And even if the probability of the contingency occurring and the stakes of it occurring are high, it may not be worthwhile drafting a specific clause covering the contingency, because it may be almost as well to leave the issue to be negotiated if the contingency should occur. A generally worded contract leaves specific contingencies to be renegotiated as they arise, and the parties may rationally choose to rely on the fairness of such renegotiation. Such reliance is particularly likely to be rational when one or both of the parties protect their reputation and when there is a wish to preserve a good contractual relationship in order to further future cooperation. Furthermore, if the parties will disagree about how to fill in a general contract in a given contingency, they may bring the issue before an arbitrator or a judge, and let him or her interpret the contract. Hence, opportunistic renegotiation may be

restrained by the possibility of court interpretation¹. For all of these reasons the benefit to writing specific clauses may seem small. However, the issue is more complex, since there are also *indirect* benefits of specifying clauses. This becomes apparent when one considers the essential functions served by contract. Contracts serve several purposes: they allocate risk and secure incentives of various kinds one of which is for the parties to undertake contract-specific investments (so-called reliance investments), and the extent to which these purposes are served by a particular contract will depend on its completeness. This provides, it will be argued, an indirect benefit of drafting specific clauses, which needs to be taken into account when deciding on the length and specificity of the contract.

The article will present this more complex trade-off between elaborate, specific clauses on one hand and simple, general contracts on the other. It will further argue that it cannot be taken for granted that contracts will become more elaborate over time; in areas of economic life where uncertainty is pervasive, one may instead see rather simple contracts supported or enforced through mechanisms that rely not so much on court enforcement as on reputation.

An example will be used throughout the article to illustrate the main concepts and ideas. The example may not be realistic in all respects; the purpose of it is to illustrate the general problem of how (much) to commit through contracting, not to analyze a specific contracting situation. The example will be introduced below, after which first the direct costs and benefits and then the indirect benefits of elaborate contracting will be analyzed. In the spirit of the theme of the conference on pro-active contracting in the information age, the article ends with some reflections on the implications of computers and the Internet for 'the optimal degree of proactiveness'.

2. *The Example*

To illustrate costs and benefits of writing specific versus general (or no) contractual terms, consider the example of e-bay offering itself as a trading mechanism to firms or individuals². Consider, furthermore, a firm that if it chooses to trade through e-bay must spend time learning about the particular rules and mechanisms of e-bay. Suppose that e-bay may at one point raise prices substantially, taking advantage of the fact that its customers have spent time learning about e-bay and cannot easily coordinate on shifting to some other trading forum (the so-called network effect). If the firm has not yet

¹ as well as by application of legal default rules.

² As alluded to above, this example will not be based on a thorough study of the contractual practices of e-bay. Rather, it is meant to illustrate the trade-offs more generally, and so some of the trade-offs mentioned may not accurately reflect the real situation for e-bay.

decided to trade through e-bay, it will be interested in a commitment from e-bay not to raise prices in the future. The question for e-bay is how specifically it should commit, if at all. Consider for concreteness three possibilities.

1. e-bay freely sets the price of its services over time, constrained only by its reputation
2. e-bay promises not to raise prices in a way that is not justified by increased costs
3. e-bay's prices follows some price index

These contracts differ in terms of their specificity and in terms of drafting costs. Which contract is optimal depends on the direct and the indirect benefits and costs of specific clauses, that will now be analysed in turn.

3. The direct benefits of specific clauses

In deciding between the three contracts, the following factors play a role, apart from the cost of defining the price index and writing it into the contract³:

1. the probability that it will become advantageous for e-bay to increase the price (substantially)
2. the way in which the legal system will interpret the contract which forbids price increases that are not justified by cost considerations
3. the extent to which parties can negotiate about the interpretation of a generally worded clause (as that of the second contract) and in this way fill in the contract as time passes
4. the extent to which e-bay will be kept from increasing price by concern for its reputation

In abstract terms, whether parties to a contract should write a contingency into a contract depends on the probability that it will ill occur and whether it will be cheaper for them to renegotiate the contract if the if the contingency should occur. That (re-) negotiation is likely to be influenced by the way in which a court will interpret the general contract in the contingency, and by the parties' concern for their reputation.

³ For a more extensive and formal analysis, see Steve Shavell: 'On the Writing and the Interpretation of Contracts', [Harvard Law and Economics Discussion Paper No. 445](#). See also R. Posner: The Law and Economics of Contract Interpretation, [U Chicago Law & Economics, Olin Working Paper No. 229](#).

Ad 1. If the probability of a price hike is small, it may not be worthwhile incurring the certain cost of writing a cost-plus contract (the second contract). Quite simply, many contingencies are not worth addressing specifically because they occur with a low probability.

Ad 2. If e-bay stipulates that it will not raise prices unless its costs increase, the question becomes how a court will interpret such a clause. Clearly, if e-bay significantly raises its price and cannot document any change of costs, the price increase may be found to be a breach of contract. But what if the cost increase is due to a higher quality of service? Clearly, an elaborate or complete contract would allow e-bay to raise prices somewhat in response to a higher level of quality that may e.g. follow from a technical innovation. If the court can be trusted to interpret the contract in such a way that *the interpreted contract* becomes akin to that which the parties would ideally wish to write if it were costless to write elaborate contracts, the parties can - in theory at least - fall back on court interpretation and thereby save the costs of writing elaborate contracts. However, the court cannot realistically be assumed to always come near to what the parties intended, they lack information concerning the parties' true desires and may find it hard to know whether a given innovation justifies a cost increase of a given magnitude, even with expert assistance. Furthermore, the court may not always understand its role as that of coming as close as possible to what the parties would have written into a complete contract, i.e. as coming as close as possible to what the parties 'truly intended'. Note that if courts do have this understanding it may be easier and less costly for parties to contract, for they can trust courts to fill out incomplete contracts in ways that come close to what they would have written into a more complete contract⁴. If courts can be relied on to fill in incomplete contracts and to interpret them in a reasonable way, this may at the same time deter e-bay from initiating an unreasonable price increase and allow e-bay some necessary flexibility. In this case there will hence be less reason for the parties to incur the cost of linking prices to a price-index or to constrain e-bay through other specific clauses. But naturally court interpretation of a contract is costly⁵, and so this way of saving drafting costs works better if the parties can anticipate how the court will interpret a general clause. If so, the parties can settle the issue

⁴ If this principle is accepted, it follows that damages should, as a general rule, be considered the better remedy compared with specific performance. Specific performance is the rule that contracts should be enforced as written, while damages allow parties to escape from obligations by paying compensation to the other party under some contingencies. Often, the latter is what the parties would have agreed to in a more complete contract if the cost of writing such a contract were less significant.

⁵ And therefore courts may interpret contracts literally to force the parties to spend resources on writing contracts.

through negotiation, knowing how the court will settle the issue in the event they cannot agree⁶.

In this context, it may also be noted that default rules serve the same function as contract interpretation. Default rules should ideally come close to what the parties would have included in an elaborate contract. The example of damage measures illustrates the important role default rules may play in this regard: Consider a seller and the buyer of some good to be produced in the future, who wish to condition production and sale on future production costs for the seller and future needs of the buyer. However, stipulating such future contingencies may be costly, and so the parties may wish to fall back on being able to breach the contract if costs become too high or needs turn out to diminish. The default rule is (in reality, for production contracts) expectation damages, and the point is that this default rule leads (under idealized assumptions) to the same outcome as would result from a completely specified contract (this is the so-called 'efficient breach of contract' result). Hence, well-designed default rules can substitute for elaborate contracts as can contract interpretation by a tribunal (arbitrator or judge).

Ad 3. As just mentioned, the parties may reach agreement or compromise about the meaning of a general clause⁷. They will do so in the light of how a court is likely to interpret the clause, but may also be concerned about what is fair and reasonable. If the agreement is likely to come close to what the parties would have agreed upon ex ante, there is little reason for them to write a specific clause since doing so incurs a certain cost while the cost of (re-) negotiation will only be incurred if the contingency arises.

Ad 4. In reality, e-bay is pre-occupied with its reputation. For example, it enters into a public dialogue with some of its core users concerning its mechanisms and policies. When such a dialogue is made public on the internet, it may constrain e-bay in its pricing policies more effectively than commitment through specific contractual clauses. Note that a specific clause cannot specify how e-bay should price new services; which services will be invented is essentially not knowable ex ante, and hence cannot be the object of contracting. The pricing of such new services is hence better constrained by reputation than by explicit contracting.

⁶ Note, however, that for court interpretation to have a significant effect on the outcome of re-negotiation, it must be credible that one of the parties will bring the issue before the court.

⁷ As will be further mentioned below, e-bay has in fact established a group of users whose views of e-bay policy are communicated to a wider audience and hence carries weight. Conceivably, e-bay could negotiate with a representative of this group.

To this account of direct costs and benefits of specific clauses must be added the cost of not coming close to the complete contract, of not establishing the kind or level of commitment desirable. To analyse this indirect cost, the fundamental rationales of contracting must be addressed.

5. The indirect benefits of specific clauses

At the most general level one can inquire why people enter into contracts at all. Prevailing theory stresses four motives each of which will first be described generally and then related to the example of e-bay.

Contracts:

1. avoid future disputes by anticipating issues and by aligning the parties' expectations
2. allocate risk between the parties in a way that corresponds to the parties' risk preferences and in a way that establish incentives for the parties to act cooperatively
3. allow the parties to commit to future acts, rendering it optimal for one or both parties to invest in their cooperative project
4. enable the parties to plan future activities

As for the first purpose, when people cooperate on some venture, they often hold some implicit and possibly conflicting views of what the cooperation entails. It is important that such differences are addressed, otherwise they may later lead to conflict when disagreement arises. This rationale of contract is sometimes stressed by practitioners as the more important, but it may be noted that it is not so much a rationale for creating binding commitments (which is what contracts do in a legal sense), as it is a rationale for the parties to communicate their expectations to each other before embarking on a joint effort.

For e-bay it may be worth stipulating the circumstances in which it will raise prices in the future. Raising prices without prior announcement may surprise customers and lead some to view e-bay with suspicion. If price increases have been announced from the start, e-bay may lose less trust with customers.

Risk allocation is an important part of many contracts, most clearly for insurance contracts the purpose of which is simply to trade risk. For such contracts, the rationale of specifying contingencies is straightforward: when one party wishes to carry some risk in one future contingency but not in

another where the cost of carrying the risk may be lower for the other party, this result may be obtained through contingent contracting. Through a sufficiently contingent contract the parties may be able to share risk in a way that corresponds to the relative cost of risk to them in a particular contingency.

This principle of optimal risk sharing through contingent contracting is rather straightforward for financial or insurance instruments, but applies also to other kinds of contracts, e.g. those involving the sale of goods. One example is that of a seller offering a warranty-contract to a buyer, putting the risk of a dysfunctional good on the seller for a specified period of time. To the extent that the seller carries risk more easily than the buyer (the opposite may well be true) the warranty induces a better risk allocation the broader it is in scope (the more contingencies it covers). But of course incentives come into the picture; a warranty increases the incentive for the seller of delivering a non-defective good and decreases the incentive for the buyer to take care of the good, and hence from the perspective of incentives, it may be optimal to condition the seller's obligations in some way, i.e. to distinguish future contingencies in the warranty contract. Hence, it is clear that a greater degree of completeness may well enhance efficiency. Thus, it is evident that the (sometimes conflicting) purposes of risk allocation and incentives, provide an important rationale for writing elaborate contracts; distinguishing between future contingencies allows a more efficient combination of risk sharing and incentives.

Applied to the example of e-bay, the issue of risk allocation is clearly pertinent to the choice between the contract permitting e-bay to increase prices when justified by increased costs and the contract stipulating some price index. It is a well-known problem with price indexes that the input costs of the supplier may not follow any general index. If some services become difficult for e-bay to deliver unless it hires highly skilled and hence expensive computer experts, it may have to increase prices for this reason; the contract with the price index hence puts the risk of this occurrence on e-bay rather than on its customers. From a pure risk allocation viewpoint it may be better to spread the risk among the many customers but this would lower the incentive for e-bay to avoid such a situation. Thus, the trade-off between optimal risk-allocation and optimal incentives mentioned above, arises also in the example of e-bay.

Commitments by one party to a contract to do or not to do something in the future may affect the other party's incentive to do something in the present. This is particularly clear in the case of a simple loan contract where (in the absence of altruism) person A will not lend to person B, if B cannot commit in

some way to repay the loan. Among friends or relatives, a promise may be sufficient commitment, but among strangers a formal commitment that can be enforced by a third party (such as the State), i.e. a contract, is necessary for the establishment of a credible commitment. Clearly, if B cannot commit, as may be the case in the absence of contract enforcement, both A and B will be worse off, since a voluntary contract would have enhanced the expected welfare of both parties (as they see it), otherwise it would not be voluntary or they would not enter into it. This essential role of commitment applies whenever one party has to undertake acts before the other party does, and hence the ability to commit through contracts is essential for economic efficiency.

Applied to the example of e-bay, recall that the essential problem was stated as the risk that e-bay may take advantage of a future increased bargaining power due to customers being to some degree locked into trading through e-bay. The reason for e-bay to commit itself not to raise prices is that in the absence of such commitment its potential customers may be dissuaded from trading through e-bay in the first place. In other words, relationship specific investments (learning how to trade through e-bay) may not be undertaken in the absence of commitment from e-bay. Again, a trade-off arises: the third contract, which links prices to an index, provides the most commitment and hence may attract more customers, but puts perhaps too much risk on e-bay⁸.

Ad 4. Contracts establish commitments that allow people to plan their activities. This rationale is related to the protection of reliance investments, and will not be described further here.

The main point can be restated as follows: whether or not to include a contingency or specific clause in a contract depends on three factors:

- whether the contingency is sufficiently likely and important for it to be worthwhile to spend time on drafting a clause concerning it
- whether something approaching the clause may come about as the result of renegotiation of the contract under the shadow of default rules and contract interpretation by the court (including the possibility of invalidation of unfair contract terms) as well as under the parties concern for reputation
- how important any deviation from the optimal contract is in terms of the essential functions served by the contract, including securing efficient risk-allocation, incentives, and reliance investments.

⁸ and may stifle innovation to the extent new services cannot be priced according to the demand for them.

6. Concluding remarks

In the modern computerized economy, two factors seem of particular importance in determining the optimal level of completeness of contract⁹.

First, uncertainty concerning the future is pervasive; in the example, e-bay cannot predict what its trading mechanisms will be three years from now, and any specific commitments concerning price will tend to be outdated when new hitherto unknown or even unimagined services come to exist. Second, reputation seems to have become a factor of growing importance through the sharing of information on the internet. Hence, as already noted, the way in which e-bay has in fact solved the commitment problem is through the reputation mechanism: On its home-page, e-bay writes that it

‘also encourages open and honest communication between the community and the company. Frequently, members of the community give their feedback to improve the environment in which they work and play’.

To some extent, this may work as a reputation mechanism which restrains e-bay from changing its prices unreasonably, and may well provide a better combination of commitment and flexibility than any specific price-clause. Note also that e-bay has organized a forum for sellers and buyers to give each other positive or negative feedback, made public by e-bay¹⁰. For the buyers and sellers interacting through e-bay this possibility may lower the need for elaborate contracting, although it should be recalled that the cost of elaborate contracting is lowered through standard contracts. The main development may in fact be to render standard contracting terms more efficient: when reputation becomes a factor of greater importance, standard terms will become more generally known and will become part of the quality of the product sold. This provides an incentive for sellers of products to deliver contract terms that are reasonable and do not give rise to ‘negative feedback’ on the internet.

Hence, the main point of this article has not been to argue that reputation will overtake lengthy contracting in the information society. How contracting will

⁹ Contracts in civil law countries have increased considerably in length in recent years. It used to be said that contracts in civil law countries were shorter than in common law countries due to the less literal interpretation of contracts in civil law countries. However, this traditional wisdom no longer holds up, as contracts tend to become longer without any corresponding change in the way civil courts interpret contracts. On the general issue, see Hill and King: ‘*How do German Contracts do as Much with Fewer Words?*’ 79 CHL.-KENT L. REV. 889 (2004).

¹⁰ This mechanism which may lower the need for lengthy contracts has, however, led to the problem of ‘feed-back extortion’.

evolve is a complex issue that requires closer study. Rather, the purpose of this article was to present some main determinants of the optimal length and specificity of contracts.