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Claire A. Hill

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A COMMENT ON LANGUAGE AND NORMS IN COMPLEX BUSINESS CONTRACTING

CLAIRE A. HILL*

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* Associate Professor of Law, Chicago-Kent College of Law. I wish to acknowledge helpful conversations with Lisa Bernstein, Bernie Black, Jacob Corré, Tyler Cowen, Dick Craswell, Daniel Garber, Bruce Johnsen, Stewart Macaulay, Mark Lemley, Larry Solan, Jonathan Yovel, and participants at workshops at the University of Maryland School of Law and Chicago-Kent College of Law, and the Law & Society Conference in May of 1997, the Latin American Law and Economics Association Conference in June of 1997, and the International Association of Forensic Linguists Biannual Conference in September of 1997. This Article is dedicated to my late colleague Richard S. Murphy.

INTRODUCTION

Sometimes, saying it's so makes it so. The utterance of certain words in certain contexts creates a state of the world; before the utterance, the world was different. In philosophy of language, such an utterance is called a "performative utterance."[1] Classic examples are the words "I now pronounce you husband and wife" uttered during a wedding ceremony, or the words "I warn you." Performative utterances cannot, in some profound sense, be true or false.

Laws are exemplars of performative utterances, as are many of the creatures the law creates, such as rulings, judgments, licenses, patents, permits, and contracts. In the paradigm cases of performative utterances considered in philosophy, the act performed by the words is clear, as in the examples above. The (rough) corollary for law is specification and imposition of consequences for certain events or behaviors. Other acts also are performed; an obvious example is attachment of a stigma to certain behaviors (and people engaging in them).[2] But the express act—of, say, making certain conduct illegal—is, if not a law's raison d'être, certainly, among the most important acts the law performs.

Complex business contracts,[3] too, expressly summon up the law's force for all the promises they contain. Indeed, complex contracts are filled with performative-sounding grammar, such as "I hereby promise to pay." Such contracts clearly function like performative utterances. A party "enters into" a contract and thereby becomes "bound," agreeing that the contract is enforceable against it. Enforceability means enforceability in a court of law: entry into the contract has created a state of the world that previously did not exist, namely the attachment of certain legal consequences to certain acts (or failures to act). Yet, the correspondence between the express words of the contract and the actual relationship between the parties

1. The classic texts are J.L. AUSTIN, HOW TO DO THINGS WITH WORDS (1962) and JOHN R. SEARLE, SPEECH ACTS: AN ESSAY IN THE PHILOSOPHY OF LANGUAGE (1969). A recent article by Searle on the subject is John R. Searle, *How Performatives Work*, 58 TENN. L. REV. 371 (1991).

2. Discouraging people from engaging in prohibited conduct because they fear the law's sanction is clearly part of a law's intent; reasonable people could, I believe, differ as to whether that is one of the (speech) acts the law performs.

3. By complex business contracts, I mean elaborately negotiated and tailored contracts governing major transactions between two commercially sophisticated parties. The examples I will discuss are acquisition agreements and loan agreements, two of the most common agreements of this type.

is sometimes quite attenuated. The parties have performed an act—in this case, entered into an enforceable contract—but what act have they performed?

In the paradigm cases of performative utterances discussed by scholars in philosophy, the answer is obvious. When a couple is pronounced husband and wife, they are therefore husband and wife, with all the attendant consequences. In some examples, there is ambiguity—but the ambiguity is resolved at the same time as the speech act is labeled as such, having served its function of establishing that context is an integral part of meaning. One example: "Stay off the grass" means one thing when uttered by a groundskeeper, and another when uttered by a drug counselor.[4]

In the cases considered by law and language scholars, the matter is more complex: we know that "All vehicles are prohibited from the park" is intended to attach particular legal consequences to some set of activities, but there may be ambiguity or disagreement as to what is included in the set.[5] In complex business contracts, there is an additional layer of complexity. Legal consequences attach upon entry into a "binding, enforceable" contract: an act is being performed. But the act is not, I will argue, the attachment of legal consequences to each and every promise in the contract. This contrasts with the vehicles example above, in which the act *is* the attachment of legal consequences (to each instance of the conduct described); once the set of "vehicles" is identified, the act's content is known.

It is, at second blush, unsurprising that the speech act performed by complex contracts is itself complex. After all, unlike the simple prohibition, the contract is many pages long, and very complicated and detailed. (Indeed, the interpretive difficulty of the simple prohibition stems largely *from* its brevity and simplicity). The act of entry into the complex contract is more complex; naturally, the content of the act is more opaque. And the attenuation is qualitative as well: the contract, while expressly summoning up legal consequences, owes quite a bit of its power and content to forces and mechanisms other than the law.[6] Moreover, as carefully and ardu-

4. *See generally Northwestern University/Washington University Law and Linguistics Conference*, 73 WASH. U. L.Q. 769 (1995) [hereinafter *Conference*].

5. *See id.*

6. Many scholars find this claim uncontroversial. *See* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1787–89 (1996) [hereinafter Bernstein, *Merchant*], and sources cited therein. To such scholars, my contribution is to provide an illustration of the interplay between legal and

ously crafted as the contract is, as hard-fought as each provision is, the contract often serves more to set the stage: accommodation is more the rule than the exception. The contract establishes, and constrains, the relationship, even though the constraints may be hard to articulate. There may be no better way to specify a complex, custom-tailored relationship among parties who are part of a large, loose web of relationships.

I explore the "speech act" performed by entry into a contract, using a methodology from economics. Following standard scholarship in the field, I posit that contracting parties have as an "end" increasing the size of the contracting pie; I set forth a taxonomy of canonical "means" by which parties might seek to achieve that end. These means include some "speech acts" as well as other types of acts. I argue that the contract is most plausibly seen as using specified "means" to achieve the posited end. I illustrate how law interacts with reputational and other forces to establish and define the parties' relationship. I also show the circuitous linguistic route through which some of these forces are summoned up. Indeed, in my account, economics picks up where language leaves off, and vice versa: the words "mean" something (determinate) other than what they "literally" say. The language perspective dissolves the stark opposition between "literal" meaning and contextual meaning; the economics perspective translates from one meaning to the other. The two disciplines are describing the same phenomena, but from two different vantage points.

This Article has three aims. First, it seeks to describe the contracting endeavor as a speech act, whose content economics methodology is well situated to elucidate. Second, it seeks to argue that contract-as-stage-setting is optimal given limits of both knowledge

other forces in particular types of contracts entered into in particular institutional settings, and consider how the institutional setting permits relational contracts.

With some notable exceptions, such as Macaulay's seminal work, Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963), the institutional settings considered in such work differ in some important respects from that involved in complex contracts. Some settings involve a formal substitute for the legal process, such as trade associations; most settings involve close-knit communities, homogeneous in certain important respects. *Id*; *see also* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (discussing how neighbors settle disputes where the disputes concern "wayward cattle"); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Diamonds*]. In both industries Bernstein studied, there were formal substitutes for law. Among the cattle men Ellickson studied, there were not. Certainly, a formal substitute might very well supplant much of law's force. Moreover, reputational sanctions will likely be particularly effective in close-knit, homogeneous communities.

and language. Third, it seeks to present a model of meaning[7] sufficiently constrained by context—where "you know it [only] when you see it,"[8] but "you" includes the relevant community.

My approach differs from much other scholarship in law and language.[9] Much of the scholarship asks how linguistics and philosophy of language can elucidate what laws mean, or what courts should do: language is examined to see how it can help the law. My focus is almost the opposite: a creature of the law, complex contracts, is examined to see what it might say about language. I am overstating the case somewhat, of course: exploring the relationship created by a complex contract, and the law's role in creating and maintaining that relationship, is in the province of law as well. Yet, my analysis has, I think, as much to say about language as about law.

This Article proceeds as follows. Part I describes the contracting endeavor, using a standard economics model. Part II then describes the structure and terms of complex contracts, and develops a grammar of contract language. Part III then considers how contracts achieve their purposes, examining the roles of both law and language.

7. I seek to sidestep arguments as to what meaning "is," (admittedly very important) distinctions like intension versus extension, and more generally, whether a satisfactory account of meaning is possible. My approach is, instead, more functional. I consider the relationships the use of certain words in a certain context establish: what the parties are doing with these words. I hope, and believe, that nothing in my analysis turns on these distinctions.

8. The famous phrase, "I know it when I see it," from Potter Stewart's concurrence in *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964), a case about pornography, has, in my view, been unduly maligned as an abandonment of "rationality," even by scholars who have come to its (and Justice Stewart's) defense. *See, e.g.*, Paul Gewirtz, *On "I Know It When I See It,"* 105 YALE. L.J. 1023 (1996) ("'I know it when I see it' invites us to reappraise the role of nonrational elements in judicial decisionmaking, which I think deserve both more attention and more acceptance than they typically enjoy."). We "know" many things only when we "see them"—our ability to know things far outstrips our ability to articulate, ex ante, necessary and sufficient conditions for a thing to be a thing of its "type." (If this weren't the case, many more philosophers and other academics would be out of work.) In realms such as law, where we need to at least *appear* to know it before we see it, we get around the problem by designating a methodology we agree to be bound by (the arbitrator's decision), or standards that sound far more determinate than they are ("reasonable," or what a reasonable person would think). That any of these designations are qualitatively different than "you know it when you see it" seems to me quite naive. What makes law sufficiently determinate (when it is so) is that enough of us "see it" the same way. A new book on the application of cognitive science to law makes precisely this point. STEVEN L. WINTER, A CLEARING IN THE FOREST: LAW, LIFE, AND MIND (2001). And, I am arguing, the existence of a community that sees things enough the same way makes the use of contracts-as-stage-setting possible, and indeed, optimal, given the parties' need for flexibility and the limits of language and imagination.

9. *See, e.g.*, *Conference*, *supra* note 4.

I. THE COMPLEX CONTRACTING ENDEAVOR

A. *Complex Contracts*

This Article deals with what I call "complex business contracts"—heavily negotiated contracts between two businesses, establishing the terms of a short, moderate, or long-term commercial relationship, such as buying a business (an "acquisition agreement"), or loaning money (a "loan agreement").[10] The parties to these contracts are part of a larger, loose-knit community. The community consists of parties bound together in a large, elaborate web of relationships, somewhat akin to Japan's keiretsus.[11] The same group of companies, financial institutions, lawyers, investment banks, accounting firms, and other principals and professionals interact with each other again and again, but the couplings are different: law firm A represents client company B in a transaction in which financial institution C and investment bank D are involved; another transaction involves law firm A and client company B, but also company E and its law firm, F. Company E is involved in another transaction, in which investment bank D is involved, and so on.[12]

While the contracts are custom tailored, all transactions of a particular type will have the same general structure and the same general types of provisions. (The coverage of the provisions will, of course, be very different.) The provisions set forth: (i) the operative terms of

10. My analysis in this Article generally is not applicable to contracts that are heavily regulated by statutory schemes, such as securities offerings, transactions that are heavily tax driven, or those that involve heavily regulated entities such as public utilities or investment companies. Much of the transaction documentation is dictated by law; even where it is not, standard legal considerations govern the lawyer's role and the document she produces far more than is the case for the types of transactions I discuss.

11. In keiretsus, Japanese companies become intertwined through cross ownership often where suppliers and customers have ownership interests in each other and thereby create an interlocking web of firms. Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 Yale L.J. 871, 872, 882 (1993).

12. The web is not "formal," but instead, consists of more-than-occasional participation in transactions and dealings with others in the community. It exists "naturally" as a function of, among other things, the efficient size and scope for the conduct of many of the businesses involved. Law firms, investment banks, and financial institutions all need money and venerability in varying but significant degrees. And companies that engage in large transactions—transactions for which it makes sense to hire experienced law firms and investment banks—usually need a lot of money as well. The community's membership is not static; however, changes are slow and infrequent, with many moves occurring between the center and the periphery. Indeed, membership is, in a sense, a matter of degree: for many purposes, a member at the most peripheral part is indistinguishable from a nonmember.

the transaction; (ii) information about, among other things, the subject matter of the transaction and the parties ("representations and warranties"); (iii) promises by one or both parties as to matters occurring during the transaction term ("covenants and agreements"); (iv) often, events of default and associated remedies; (v) often, express allocations of liabilities as between the parties ("indemnification"), and procedures a party must follow to trigger the other party's indemnification obligation; (vi) for transactions in which parties bind themselves to carry out the transaction before they actually do so, the conditions under which they are obligated to carry out the transaction ("closing conditions"). I will discuss many of these provisions in greater detail in Part II, *infra*. For present purposes, it suffices to delineate these categories, and thereby conjure up the length and complexity of the contracts and the precedent negotiations.

B. An Economic Model

A branch of economics, variously named transaction cost economics,[13] information cost economics, and new institutional economics, offers an approach: a world view as to the parties' likely end in entering into a contract, and a taxonomy of means by which the parties might be achieving that end.[14] I sketch out the approach only briefly, referring interested readers to the voluminous literature on the subject.[15]

The "end" is increasing the size of the transactional pie,[16] in a world where (1) each party has the incentive, and may have the

13. *See generally* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979).

14. My discussion draws heavily on Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984). Gilson's article is an elegant characterization of lawyers as transaction cost engineers, creating value by helping parties price a transaction as if they were in the "perfect" frictionless world of financial models. He focuses mainly on the role of lawyers; however, he also touches on the functions of the various transaction provisions and the roles of other third parties. His account expressly discusses only acquisition agreements, but his arguments are also to some extent applicable to other types of complex contracts, including loan agreements.

15. *See generally* RICHARD CRASWELL & ALAN SCHWARTZ, FOUNDATIONS OF CONTRACT LAW (1997); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 65–100 (4th ed. 1992); Williamson, *supra* note 13; READINGS IN THE ECONOMICS OF CONTRACT LAW (Victor Goldberg ed., 1989) [hereinafter READINGS IN ECONOMICS].

16. In the types of contracts I am considering, parties are sufficiently well matched that they are better rewarded seeking to get a smaller or same-sized piece of a larger pie than they would be seeking a larger slice of the same-sized pie; I make no claim that parties in other types of transactions would also be better rewarded for pie-increasing than for share-increasing

ability, to increase its portion of the pie regardless of the effect on the whole pie,[17] (2) information production, logistical, coordination, and other costs associated with entering into and carrying out the agreement are amenable to reduction, and (3) some residual risks will be outside of the parties' control and knowledge.

What means do the parties have available? They can align incentives with an appropriate scheme of carrots and sticks, and assign duties, coordinate tasks and allocate risks with cost reduction in mind. As I will discuss below, *a crucial "stick" is costliness: parties will be deterred from doing something if they will have to pay more than it is worth to them to do it. Law—its sanctions, and the various consequences it can impose—is, in this perspective, simply one of many types of costs.* Another very important cost is "relational" or "reputational."[18] Parties not in an end game benefit from good relations with their contracting partners, and good relations and reputations in the overall business community. Most appreciable contract breaches will carry reputational costs as well as legal costs: failure to abide by any appreciable contracted-for duty will likely be deemed undesirable in a contracting partner, whether or not legal recourse is sought or obtained. Thus, parties who do not fear legal sanctions may nevertheless refrain from breaching a contract to avoid reputational costs.[19]

The specter of reputational costs may, in many cases, be a more effective deterrent than the specter of legal consequences (costs).[20] There are significant uncertainties and costs associated with the legal system. There may be greater certainty in the reputational sphere, if,

activities. Furthermore, even assuming, as seems likely, that in particular complex contracts, one party sometimes benefits more by self-serving behavior than pie-increasing behavior, my analysis is unaffected: I look at "forms" which have been developed in the course of many "battles"; the effects of many parties prevailing in their self-serving agendas should, in the moderate term, cancel each other out.

17. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

18. "Reputational" (cost, sanction, or consequence) is one imposed or potentially imposed by or within the relevant business community. "Relational" here refers only to a subset of reputational—the direct parties to the transaction. One interesting feature, suggesting that reputational forces are more at issue than relational forces, is the extent to which acquisition agreements seem to rely on extralegal forces, even though they are not infrequently short-term agreements.

19. There is a significant, but not complete, overlap between events triggering reputational and legal sanctions: some things, whether prohibited in a contract or not, are simply "not done." And some matters contracts prohibit or address can be sufficiently unimportant that no reputational sanction would attach to a breach involving such a matter.

20. Indeed, the efficacy of reputational bonds makes the business of acquiring reputations-for-hire worthwhile. In many professions, a significant part of the services offered are reputations-for-hire. Examples include lawyers, accountants, and rating agencies.

as may very well be the case, there is a greater consensus among the relevant reputational community as to which matters warrant sanction.[21] Undoubtedly, the costs are lower: indeed, imposition of reputational costs typically requires no "enforcement" beyond publicity.[22]

Contracting parties' incentives will always be to some extent misaligned: behavior that benefits one party sometimes harms another. Indeed, misaligned incentives can cause problems throughout a contractual relationship. A party entering into a transaction may have an incentive to make its attributes and prospective performance seem better than they are. A borrower will have an incentive, for instance, to make its financial condition appear rosier than it is in order to borrow on better terms. In the course of an ongoing contractual relationship, one party may have an incentive to behave in ways that increase its own share of the transactional pie at the expense of the aggregate pie. Thus, each party's attributes and behavior are a potential source of peril for the other party. Each party will rationally presume, unless the presumption is rebutted, that the other party may have undesirable attributes and be apt to behave opportunistically.

Each party's presumption of undesirable attributes about the other party, pessimism about the other's prospects, and optimism about its own prospects, will contribute to parties' different valuations

21. The relevant (reputational) community may be large and diffuse, but it is likely smaller than the community for which judges are deciding cases. Moreover, it has more flexibility to "make determinations" based on "smell." Both factors suggest greater certainty in the imposition of reputational, rather than legal, consequences. But I do not want to overstate the case for reputational sanctions' superiority in the realm of complex contracting; the size and diffuseness of the relevant community may make reputational sanctions far less effective than they would be in a more close-knit community such as the diamond industry. *See* Bernstein, *Diamonds*, *supra* note 6, at 138–43; *see also supra* note 19. Some subcommunities within the larger complex contracting community are quite close-knit. One such subcommunity consists of parties who participate in "swaps" (a complex financial transaction often involving hundreds of millions of dollars); in the subcommunity, the reputational bonds are so strong that writings memorializing the transaction are finalized only long after the transaction occurs.

22. In some cases, the parties and proximate third parties can observe the breach or other bad behavior in a manner sufficient to satisfy the relevant reputational community's standards for imposition of a sanction, but not in a manner sufficient to satisfy the standards of the legal system. This phenomena, where it is common, adds to the advantages of reputational forces over legal ones. *See* Bernstein, *Merchant*, *supra* note 6, at 791–92. But there may be some advantages to the legal sanction imposition process: it is clear who is supposed to impose the sanction, and what the sanction is. A complete comparison of legal and reputational sanctions would take such matters into account. But in most situations involving complex contracting, reputational sanctions still should offer more enforcement "bang for the buck" than legal sanctions; legal sanctions are almost certainly better when the parties are in an end game. *See* Bernstein, *Merchant*, *supra* note 6.

of their respective contributions to the transaction. That a borrower could be insolvent at the time a loan was made, and its lender not know, is an adverse selection (or "lemons") problem.[23] That a borrower could spend all its money on excessive salaries and perks and hence become insolvent is an opportunistic behavior problem.[24] That the borrower might make these expenditures because it expected that the lender might not discover how it spent the money is a moral hazard problem.[25] That the lender might not discover that the borrower was insolvent or spending money recklessly, whether or not the borrower was affirmatively concealing it, is an asymmetric information problem. Each party will offer contractual terms that reflect its expectation and valuation of what the other party is bringing to the transaction, and what the future holds. Each party's valuation will discount for the possibility that the other party has undesirable attributes and will behave opportunistically, as well as its views about what third parties and nature have done and will do.

Each party will want its contribution to the transaction to be as highly valued by the other party as possible. To that end, each party will attempt to convince the other party that it will not behave opportunistically (that is, attempt to increase its share of the pie at the expense of the other party), that its optimistic self-appraisals of its prospects are accurate, and that the other side's (rational) presumption that it has undesirable attributes is unwarranted. Each party also will be willing to accept duties and liabilities if it thinks the other party's discount for its failure to do so would be excessive.

The process of contracting will necessarily involve reconciliation of parties' different valuations of present and likely future states of affairs. Obvious examples include parties' negotiations over the purchase price of a business or the interest rate for a loan. In each case, one party (the seller or borrower) values what it is contributing to the transaction more highly than the other party (the buyer or lender), and the negotiations consist of the party with the higher valuation trying to convince the other party to raise its valuation (raise the purchase price, lower the interest rate). Where the parties seek to reconcile valuations as to matters they cannot influence (such as many "acts of God"), they can only affect the payoff for good or

23. The seminal exposition of the "lemons" problem is Akerlof, *supra* note 17.

24. Defined as self-interested behavior unconstrained by morality. *See* PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 601 (1992).

25. Mark V. Pauly, *The Economics of Moral Hazard: Comment*, *in* READINGS IN ECONOMICS, *supra* note 15.

bad outcomes; they cannot affect the likelihood of a particular outcome. Where parties seek to reconcile valuations as to matters they *can* influence, they can affect both the payoff amounts and likelihood of particular outcomes.

Indeed, contracting behavior can largely be understood as a means for parties to reconcile their expectations, future actions, and consequent valuations to increase the size of the aggregate pie.[26] The aggregate pie is a function of each party's individual pie. For each party, its payoff from engaging in a transaction is a function of its payoffs under various possible outcomes and the likelihood of those payoffs ("expected value");[27] if a contractual provision increases one party's expected value more than it decreases the other's, the provision is pie-increasing. For example, allocating risk of a particular loss to the party more cheaply able to take precautions against it should be pie-increasing; the aggregate amount spent on precautions should decline, and the savings should be available for both parties to share.

I discuss in Parts II.A and B, *infra*, a variety of contractual mechanisms to solve the problems identified above, and thereby increase the size of the aggregate pie. These mechanisms assign tasks and duties to the best-situated parties, align incentives by designing a scheme of carrots and sticks, establish information and compliance-eliciting mechanisms that might work when carrots and sticks do not, establish early warning devices triggered when parties are particularly likely to act against each others' interests, and so on.

One mechanism, signaling by posting a bond, warrants prior explanation. This mechanism can help a party rebut the presumption that its disclosures about itself are self-serving. The party agrees, by making representations and warranties in a contract, that legal (and other) consequences can attach if its disclosures in the contract prove false.[28] The specter of bad consequences constitutes a "bond" the

26. Pie-increasing can involve aligning previously misaligned incentives, or making various nonadversarial cost reductions, or both. I focus more on the problems associated with misaligned incentives. Where cost reductions are not adversarial and merely need to be discerned and coordinated, the analysis is complete: the "problem" is solved once the necessary steps are identified. The foregoing is, to some extent, an oversimplification: one party might "strategically" refrain from taking an action that would benefit it, where the detriment to the other party was greater than the forsaken benefit, but the issues raised by these "mixed" cases are the same as those in the misaligned incentive cases I do discuss.

27. For a definition, see RONALD J. GILSON & BERNARD S. BLACK, ESSENTIALS OF FINANCE AND INVESTMENT 85–88 (1993).

28. On the effects of legal enforceability on parties' incentives to tell the truth, see generally Richard Craswell, *Performance, Reliance and One-Sided Information*, 18 J. LEGAL

party posts;[29] the representations and warranties thus serve as a "signal" that the disclosure is accurate.[30] But the mechanism by which the signal works is circuitous. The party to whom the representation is directed, party B, much prefers the good outcome (that the representation and warranty is true) and its associated payoff to the bad outcome payoff for breach of contract.[31] But because of party A's potential liability should the representations be false, party B knows that party A much prefers the good outcome as well.[32] Party B therefore thinks that party A would not make the representation if it were false; party A's making of the representation signals to party B that the representation is likely true. In other words, the signal primarily serves to increase the likelihood of the good outcome; only secondarily does it increase the payoff to the bad outcome.

STUD. 365 (1989).

29. What counts as a "bad consequence" to one party may or may not count as a bad consequence to another. For instance, a party with a bad reputation ex ante pays little for being caught in a subsequent lie. Thus, the strength of a signal turns on how bad the party to whom the representation is made believes the consequence of a false representation is to the other party. The complex contracting community requires, and in my view, largely achieves, a correct assessment in these matters: consequences are as bad as they appear.

30. *See* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); AVINASH DIXIT & BARRY NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE 142–67 (1991). Signals can serve different functions; one is, as discussed in the text, to convey credibility to self-serving or otherwise "incredible" communications. In my account in the text, I treat credibility-enhancing signals as involving bonds posted by someone, often the signaling party, which will be forfeited if the signal is not accurate.

Another use of signaling is as "shorthand," to communicate something more quickly than might otherwise be possible, whether or not credibility is not at issue. An example might be wearing a religious symbol. A third use is to articulate something that defies formulaic articulation, such as confidence, or "fit" or desire for a particular job. Further exploration of the taxonomy of signaling is beyond the scope of this Article.

31. And this is true more generally: parties do not value bad outcome payoffs (say, insurance proceeds) as much as performance (the good outcome); if they did, they would have contracted for that payoff instead of the performance. Indeed, the pure cases of mechanisms that increase the bad outcome payoff but not the likelihood of a good outcome are rare. Even insurance against "acts of God" may for some reason make, not the act, but damage from the act, smaller, if the insurance company has some expertise in, say, damage- or weatherproofing a facility. Certainly, title insurance functions mostly to increase the likelihood of a good outcome, and only secondarily to increase the bad outcome payoff. Title insurance is used in real property conveyances, and insures against a defect in the title being conveyed. The same company does the title search and provides the insurance. Title insurance is mainly intended to make the bad outcome (a defective title) less likely by motivating the title insurance company to conduct a diligent search.

32. A will make representations that cost her less to make than B is willing to pay her to make them. A will therefore make all of the representations she knows to be true: her cost is nearly zero, and B's benefit is positive. A also may make representations she assesses as more likely to be true than B does, since, again, her cost in doing so may be lower than B's benefit (and payment therefor). All else equal, the more symmetric A and B's information is, the less likely that a representation made by one to the other will be positive-sum.

The specter of bad consequences (the bond) may, but need not, be something the party to whom the signal is directed (party B in the preceding paragraph) values,[33] such as money damages for breach. Indeed, reputational bonds help send some of the most effective signals—and a person's reputation is of considerable value to him, but typically of no independent value to anyone else.

The concept of signaling thus has wide applicability in the realm of contracting. The specter of bad consequences can serve as a signal even if the precise consequences are quite indefinite (as with loss of reputation), or the bad consequences can be borne by someone not a party to the contract, renting its reputation to the contracting party—say, a lawyer, accountant, or appraiser. So long as someone is posting a bond, the signal can serve its intended purpose.[34]

In contracting, signaling and many other mechanisms typically work through incentive alignment: a party (or its agent) is rewarded, or avoids a punishment, by acting in the other party's interest. Such mechanisms leave a gap, insofar as they rely on a party's ability and will to act in the desired fashion. A party might, for instance, inadvertently make a false representation or fail to abide by its promises, notwithstanding having taken care to avoid doing so. Or a party might deliberately make a false representation or fail to abide

33. The same distinction is made in the related concepts of "collateral" and "hostages." Both are means of increasing transactional security. By using one, or both, parties assure one another that their prospective performance will be as valuable as promised. "Collateral" provides security because the promisee (the party to whom performance has been promised) values it: the promisee's "insecurity" extends only to the difference between the collateral's value to the promisee and the value the promisee placed on the promised performance. "Hostages" provide security because the promisor (the party providing the hostage) values them and will abide by its promise rather than risk losing them. Something that serves as one of these sometimes, but not always, serves as the other. *See* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5 (1985); *see also* Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

34. In all these cases, the "signal" relies on the signaling party's fear that it might have to bear some bad consequence. This, in turn, is predicated on an ability to discover whether the conditions on which the bad consequence is conditioned have occurred. Thus, the contract will contain many such provisions, not intended to provide direct recourse to law, but enabling parties to detect bad behavior. The provisions will cover more than just behavior that can be prohibited; if one party falls on bad circumstances *for any reason*, the other party will want to know quickly. For reasons economics helps us understand, there may be extra perils to party B if party A were to have financial difficulties. There may be no prohibition that's possible or plausible—how can you prohibit someone from suffering financial reverses—but being put on notice, as the contract provisions require, is sensible. What if party A fails to provide the required notice? Whatever party B has negotiated in the way of remedies, it is unlikely that legal recourse will be of much help. This matter is discussed *infra* Section II.C.

by its promises if it were in an end game and hence indifferent to legal and reputational sanctions.[35]

Contracting employs an additional information-and-compliance-eliciting mechanism to help fill this gap. The process of negotiating and memorializing the parties' agreement, and monitoring compliance, serves to make forgetfulness, lying, or noncompliance more costly, independent of the effect of rewards and punishments: asking a party the same, or similar, questions, repeatedly, as occurs in the process of negotiation of representations, makes forgetting or lying more costly—forgetting or lying many times is more difficult than doing so once. Similarly, where an agreement provides for a party to certify its own compliance with its promises, every scheduled certification is an occasion for care and truthfulness—again, the difficulty of forgetting or lying repeatedly is greater than the difficulty of doing so once. Thus, regardless of the efficacy of contracting mechanisms invoking rewards and punishments, this mechanism should make the "good" (pie-increasing) outcome more likely.

II. CONTRACTUAL SOLUTIONS

A. *Contractual Provisions Generally*

Contractual provisions, typically representations and warranties, serve to credibly communicate information, chiefly to rebut the presumption of undesirable attributes which divergent interests inspire and information asymmetry makes possible. They provide a means for one party to signal to the other the absence of undesirable attributes and presence of desirable attributes. They also often allocate the information-producing duty to the cheapest-cost provider.

Contractual provisions, typically covenants and agreements (which I will call "promises"), address the problem of opportunism by aligning parties' incentives—by establishing rewards and punishments which make opportunism less worthwhile and cooperative (pie-increasing) behavior more worthwhile. Promises also address opportunism by permitting monitoring. Monitoring makes the

35. Having outside parties such as law firms, accountants, or perhaps insurers, involved in a transaction minimizes the size of the gap. It is rather unlikely that all such parties are in an end game, and a contracting party needs only one party (with sufficient resources or expertise) on the other side, either its contracting partner or an outside party, who is not in an end game.

application of the established rewards and punishments more likely, and hence makes establishing them more effective. Promises also may serve to credibly communicate information: a saleswoman's willingness to accept commission-based compensation generally communicates that she thinks she will make many sales.

Legal and extralegal consequences underlie much of the force of both representations and warranties and promises; the good outcome, that the representations and warranties are true and that the parties will abide by their promises, is made more likely by the specter of the consequence. Moreover, the good outcome is also made more likely by the process by which representations and warranties and promises are negotiated, and the manner in which they function in the contract.

Legal consequences also serve as compensation mechanisms, yielding a bad outcome payoff if the bad outcome occurs (and the party contracting for the bad outcome payoff prevails in court). In some cases, too, the specter of reputational consequences, or, relatedly, the desire to establish a good reputation, may also yield a bad outcome payoff—there have been cases where a party, under no legal obligation to compensate its contracting partner, has nevertheless done so.

Contractual provisions will tend to assign duties and risks to those best situated to bear them. If the party best situated is the party on whom the duty or risk falls if the contract is silent, the contract will be silent. "Best situatedness" is relatively simple in some cases, but quickly becomes more complicated. Who is best situated to maintain an asset leased under a long-term lease? The answer may be different at different stages of the lease term. At the beginning, the lessee may be the appropriate party; later on, the lessee's stake may diminish to the point where the lessor would be better advised to hire an outsider. One function of risk reallocation is as a compensation mechanism: the party to whom the risk has been reallocated pays the other party the bad outcome payoff (contractual damages, for instance) if the specified event occurs.

In the succeeding subsections, I will discuss three types of important contract provisions: representations and warranties, covenants and agreements, and closing conditions. Representations and warranties and covenants and agreements are important types of contractual provisions; virtually every complex contract has them.[36]

36. The importance of a type of provision depends on the type of contract involved. In loan agreements, the primary time period at issue is the future and, secondarily, the present.

And closing conditions are used in all agreements that contemplate both a "signing" and a subsequent "closing" in which the transaction is consummated; such agreements are the norm in acquisitions, and also are common in other types of transactions.

B. *Acquisition Agreements*

1. Representations and Warranties

Representations and warranties about the company being sold are likely the most important provisions in acquisition agreements. They are certainly the longest, and often the most hard fought,[37] contributing much of the agreement's "weight and density."[38] Standard representations and warranties as to the seller cover, among other things: (a) various organizational and "corporate housekeeping" matters, including the seller's authority to enter into the acquisition agreement; (b) the seller's compliance with applicable law and regulations; (c) that the financial statements it provided to the buyer are true and complete; (d) that there are no undisclosed liabilities or pending or threatened litigation; (e) that the company has paid all its taxes and is not being audited, except as it has disclosed to the buyer; (f) that it has provided the buyer with lists of its major assets and contracts; and (g) that it is not in default under any of its major contracts. Some of these provisions will include "knowledge" and/or "materiality" qualifiers—that is, the seller

Thus, covenants—that is, promises, which are necessarily fulfilled (or not) in the future—will be quite important, and representations, which deal with the present, may be less important. In acquisition agreements, the opposite often is true. Thus, representations take on primary importance, with covenants relegated to a lesser role.

37. One prominent acquisitions lawyer thinks that lawyers exaggerate the importance of representations and warranties. JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 229 (1975) ("I don't mean to denigrate the important role which representations play in any acquisition, but there is a definite tendency on the part of lawyers and their clients to overreact in this area—at least partially as a result of their failure to analyze what is actually at stake."). One possible intimation of Freund's statement, and the tone of the remainder of the passage from which the quote is taken, is that there may be an agency problem between lawyers and their clients—that lawyers sometimes may do things purportedly on behalf of their clients, but actually more for themselves. To use colloquial language, the lawyers get carried away. I have seen many examples of this in my practice experience; I was likely guilty of it at times myself. The client seems far removed from the process when the lawyers are negotiating the smaller points among themselves, and one gets caught up in the craft of precision as an end in itself. I gloss over this and other agency problems in my analysis, not because I think there are no such problems, but because the gloss does not affect the overall conclusions I reach.

38. *Id.* The "weight and density" phrase is from Gilson, *supra* note 14, at 272.

represents "to the best of its knowledge," or only as to matters that are "material." For instance, the seller might represent that to the best of its knowledge there is no threatened litigation. Or the seller might represent that it has listed all its "material" contracts or is not in "material" default on these contracts.[39] The parties sometimes define materiality in the agreement; sometimes, however, they leave the term undefined, relying instead on general understandings as to the term's meaning.[40]

The "weight and density" of these provisions is not surprising. Representations and warranties are an important way the buyer finds out what she would be getting for her money (and the seller convinces her to part with more of it). As discussed in Section I.B, *supra*, the seller provides information, the credibility of which is bolstered by its agreement to bear certain costs if the information proves to be false. Her willingness to make representations or promises on pain of legal (and other) consequences is "signaling" her honesty or intent to abide by its promises. For most of these provisions, the contractual remedy—the bad outcome payoff—is a distant secondary benefit. The bad outcome payoff (and the associated reputational and

39. I am glossing over and combining "materiality" and other "objective" measures of size. Whether a standard-like term, like "materiality" or "best efforts," or a more rule-like "objective" term will be used depends on the subject matter involved, the parties' relationship, and other factors. One such factor will be the reputational "penumbra" that attaches to the provision. For instance, sometimes the desired coverage is obtained with a rule-like "objective" provision that imports a reputational penumbra increasing its express scope.

40. The provisions are worded descriptively rather than performatively: "The company represents and warrants that there are no lawsuits pending or threatened against the company or any of its subsidiaries." However, as every lawyer will tell her client, the representation is equivalent to the following: "If there are lawsuits pending or threatened against the company or its subsidiaries, the company is liable to the buyer." One small, interesting caveat: Clients sometimes resist making a representation even when they would accept liability if the representation were false. (The liability at issue is the residual liability remaining after all reasonable inquiries have been made; someone has to take the residual risk as to matters *no one* knew about. This in no way detracts from the general story that representing parties signal that they feel quite confident that the representation is true, to a reasonable level of certainty arrived at after due inquiry.) These clients (a minority, but not a negligible one) feel that they "should not" represent something they do not know to some high degree of certainty to be true. Their lawyers argue with them, saying that the legal effect of the representation is only to allocate liability, so that if the client is willing to accept the liability, it should have no objection to making the representation. The economists' perspective on representations-as-signals might warrant some rethinking of the lawyers' arguments. In this regard, characterizing as information-eliciting the negotiations starting from strong, unqualified representations and ending at nuanced and qualified representations suggests qualitative distinctions between representations and indemnity provisions assigning liability for breaches of representations. I discuss this matter in CLAIRE A. HILL, WHAT WE DON'T (AND DO) COMPLETE IN INCOMPLETE CONTRACTS (working paper, 1998) (on file with author).

relational sanction) is, more importantly, the means to give credibility to the information conveyed.

Additional information is revealed via the negotiating process. The buyer's lawyer, using "forms" that reflect the wisdom (or at least the experience) of scads of lawyers, prepares the first draft of the acquisition agreement. The process by which the parties come to agree on terms reveals a great deal about the business and its managers and employees. The first draft might ask for all the representations without qualifiers ("Schedule A lists all your contracts"); the seller responds, selecting the qualifiers it wants, and justifying why. The seller provides lists of assets or contracts, and makes some representation about these constituting all, or all the material, assets or contracts, as the case may be. A seller who tried to qualify lists of material assets with "knowledge"—who was only willing to tell the buyer about all the material assets it "knew about"—would be saying, or more precisely, signaling,[41] a great deal about itself.[42] Moreover, during the negotiation period, the buyer is investigating the seller, guided in part by what the negotiations reveal—what the seller identifies, expressly or implicitly, as an area of concern or dispute and the manner in which the revelations are made (confidently? grudgingly? hesitantly?). Even if the seller is forgetful or apt to conceal, the negotiating process makes being so more difficult, as different representatives of the seller are asked the same or similar questions repeatedly.

In sum, these representations and warranties mostly serve to help produce and deliver credible information about the seller. Collecting the bad outcome payoff—the contractual damages—sometimes not only does not help much, it doesn't help at all. What if the seller were not properly formed or organized, or the signatories were not authorized to sign the agreement, what good would a legal remedy do? Similarly, what if the seller had granted liens on its properties? What if there were major lawsuits pending against the seller? In many cases, a claim against the seller scarcely provides much comfort; the representations' value is elsewhere. Indeed, for transactions in

41. Here, the signal simply provides information, in ways that would be costly and pointless to fake; this use of signaling is different from the other use principally discussed in this paper, that of signaling to impart credibility. *See supra,* note 30.

42. Note that this signal, like all the credibility-imparting signals I discuss in this paper, could be false. If someone is willing to pay the price, or, if they have nothing to lose, they can say things that are not true and make promises they do not intend to keep. That is one reason why reputational communities arise; they magnify the payoffs to being reliable and the costs to being unreliable.

which the seller is publicly held, representations typically "die"—that is, cease to give rights—after the transaction closes.[43]

2. Closing Conditions

Another important type of provision in acquisition agreements is closing conditions. Parties typically agree on the acquisition before consummating it; the period between agreement and consummation of the purchase and sale gives the buyer a chance to "kick the tires" under the terms and conditions of the contract. The closing conditions set forth the conditions under which the parties are obligated to consummate the acquisition. For instance, a buyer may not be obligated to enter into a transaction if, at the time of the closing, (a) the seller's representations and warranties are not accurate, (b) the seller has not performed its obligations under the agreement, such as obtaining all necessary consents from regulatory and other authorities, or (c) the seller is subject to pending or threatened litigation. Other typical closing conditions include the delivery of certificates and expert opinions (including legal opinions), and corporate documents establishing the parties' existence and authority to enter into the transaction such as corporate charters, bylaws, and minutes reflecting the directors' approval of the transaction.

Closing conditions work more often to set the stage for mutual accommodation than to expressly govern the terms of the parties' relationship.[44] The agreement permits a party not to consummate the transaction if the closing conditions are not met. There is not infrequently a "technical" failure to meet the conditions; a party would have a reasonable legal argument that his obligation to close never arose. But the party entitled not to close will often close, perhaps after obtaining some concession. The subject matter of concessions is not typically considered when closing conditions are being negotiated: typically, the contract simply sets forth the closing conditions as conditions to the respective parties' obligation to close, and makes no mention of the form any such accommodations would take.[45] The community standard in this area is sufficiently well

43. More generally, I am assuming here that the "seller" is someone from whom money (for damages for breach, say) can be recovered postclosing. As noted in the text, in purchases of public companies this is not the case; there, the analysis would be different, in part because the signaling mechanism would only operate as mediated through a principal-agent gloss.

44. *See generally* FREUND, *supra* note 37, at 532–39.

45. Indeed, in some circumstances, parties might suffer reputational sanctions if they did not close a transaction in which the closing conditions were not met, but only in some

established that James Freund, a leading acquisitions lawyer, can have written the following dialogue in a "play" meant to illustrate a "typical" acquisition transaction: "[M]y feeling [said the lawyer for the seller] is that, as a practical matter, they [the buyer] would never utilize the Strikesuiter contract to walk away from the deal unless they wanted to terminate for other reasons."[46] And indeed, in Freund's "play," the parties make a few minor accommodations, and the transaction closes.[47]

C. *Loan Agreements: Covenants*

The borrower's covenants are among the most important, if not the most important, provisions in loan agreements. Typical covenants would include the borrower's promise: (a) to timely provide complete and accurate financial statements to the lender; (b) to inform the lender promptly of any litigation; (c) to continue the business without fundamental changes; (d) to incur no more than the agreed amount and type of additional debt; (e) to keep its financial condition within certain "financial ratios"; (f) to not pay more than the agreed amount of dividends, in the circumstances permitted under the agreement; (g) to limit its transactions with affiliates; and (h) to limit its capital expenditures. The economics account of why these types of provisions are needed is compelling: the provisions cover precisely the set of activities from which the borrower could benefit at the expense of the lender, or provide the information the lender needs to exercise contractual remedies. An arithmetic demonstration is straightforward: in many cases in which the expected value of the borrower's stock would increase after taking these actions, the expected value of the lender's loan would commensurately decrease.

Legal remedies for breaches of these provisions are worth the least in the cases where they are needed most. To take an egregious example, what would the lender do if the borrower, in violation of many covenants, had sold its most valuable assets in "fire sales," and loaned the sales proceeds to its retired CEO, who used the funds to purchase, and move to, an estate in the Cayman Islands (which has no extradition treaty to the United States)? Legal recourse would be of little help, since a borrower who breached so egregiously would

immaterial respect. A party also might suffer some legal sanction if the refusal to close were deemed to be in bad faith.

46. FREUND, *supra* note 37, at 534.

47. *Id.* at 539–40.

presumably be in an end game, with little left to lose. A less egregious example might involve innocent third parties, who are not easily divested of their rights to, say, crucial income-producing assets they had bought from the borrower. The lender therefore *cannot* be using these provisions to "mean" what they "say"; the lender does not have the power to successfully stop the buyer from selling assets. All he can do is punish the buyer for violating a prohibition. Rather, these provisions are part of a scheme whereby the lender checks whether the borrower is apt not to mean (and do) what the borrower says. Thus, the lender monitors the borrower's financial position carefully, especially when its financial position would suggest it would prefer lender-harming long shots to more cautious investments.[48]

Some legal remedies for breach are worthless for other reasons. Consider the borrower's obligation to periodically supply to the lender financial information and a certification that it is complying with its obligations under the agreement. Almost certainly, a willful failure to supply the information or certification will be accompanied by other, more substantive breaches. The lawsuit for the more substantive breaches is unlikely to award significant damages for the failure to supply information or the certification. Moreover, what will the lender do if it receives disastrous financial information? Unless the information indicates that the borrower is in breach of its financial covenants, the lender can only monitor more closely; its monitoring activities may be completely outside of the contract's stated auspices.

More likely, then, the provisions serve to remind the borrower, who may use the agreement as a checklist. Each time a certification is due, the borrower is "reminded" to check its compliance with the agreement, and hence should catch any inadvertent noncompliance. Deliberate noncompliance should be deterred as well: the borrower presumably only has a limited supply of officers willing to make false certifications. Thus, noncompliance, whether or not inadvertent, becomes more difficult and costly with contractual provisions requiring periodic disclosures and certifications. The provisions also help the lender monitor the borrower: if the borrower is "forgetting" to send some required information or certification, what else might it

48. Indeed, some insurers agree to give a secured lender notice that the borrower is not paying its premiums on the insurance the borrower carries on the lender's collateral and give the lenders the opportunity to pay the premiums instead.

be forgetting? Indeed, the provisions serve these functions with only minimal assistance from law.

Lenders often have rights under the loan agreement to participate in management (or take certain other actions) if the borrower's financial condition is poor, but they are often loath to exercise their rights for fear of incurring "lender liability" under various statutes, most notoriously the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), an environmental statute. That lenders typically negotiate for rights they are loath to exercise adds to the force of my argument: if they aren't negotiating for these rights in order to exercise them, they must want the rights for some *other* reason, e.g., to define parameters for the relationship, and set the stage for any needed accommodations.[49]

The loan agreement gives the lender broad discretion in a variety of areas, including those most critical to the transaction: to make or not make the loan, or to declare the loan in default. The lender can in some cases condition making the loan on the borrower's provision of "such documents, or legal opinions covering such matters, as lender reasonably requests." If contract words had their literal meaning, the lender's discretion would be limitless: conventional wisdom is that at all times, every borrower under every loan agreement is in "technical" default. If the lender wished, he could accelerate the loan. But lenders are apparently sufficiently constrained to act "reasonably" *from the borrower's perspective* that borrowers are willing to agree to provisions giving lenders broad discretion. The economist's explanation of such provisions might be that the borrower bonds herself by giving the lender this discretion. The borrower is saying: "Lender, I have your money, *but you have rights against me (almost) anytime you want.*" The words establish the parties' relationship to their mutual satisfaction, even though the words "literally" should put the borrower in constant peril. *The language establishes the lender's rights, but also the (implicit) constraints on its exercise of those rights.* The contract evens the score:

49. Other factors contributing to the inclusion of provisions not intended to be used are path dependence, agency costs, and various internal firm dynamics. As I discuss in Claire A. Hill, *Why Contracts Are Written in Legalese*, 77 CHI.-KENT L. REV. 59 (2001), loan and other complex agreements tend to cumulate the thoughts and experiences of every lawyer and principal associated with the transaction or a prior transaction involving the same parties or institutions. No lawyer wants to explain to his client, and no junior banker wants to explain to his senior, why some provision typically included in a loan agreement was not included in the loan agreement at issue, given that the issue will most likely arise when the provision's noninclusion adversely affects the client or bank.

the lender may have rights against the borrower, but the borrower has the lender's money.

The lender is given broad discretion in another, related way. There are many provisions with potentially draconian consequences, such as "hair trigger" defaults. Borrowers agree to such provisions trusting that their lenders will not exercise them. In my experience, their trust is rarely misplaced. Lenders who could exercise their rights under such provisions rarely do so to the extent allowed under the contract. Rather, they begin discussions and, perhaps, arguments, with the other party, seeking an accommodation. The words serve as a point of departure for the parties' conversations, metaphorically speaking (indeed, the communication often starts with a reiteration and preservation of the contractual rights); however, the journey away from literal meaning may be long, and is virtually inevitable.

One interesting provision common in Japan, and occasionally seen in the United States, is an "obligation to consult" or, perhaps, an "obligation to consult in good faith" before making major decisions, or in developing a business plan, or something of the sort. Is this a "real" obligation? If "real" means enforceable in any predictable way in a court of law, probably not. What would the parties be obligated to? Again, this is a case where law is playing a role, but only a minor one, consisting mostly of the fear, on the part of the party obligated to consult, that the other party will use the provision "strategically" to impose costs in a legal proceeding. (Indeed, except in a very close-knit community such as Japan, such a provision would not seem to raise the specter of reputational consequences. In the United States, the provision is sufficiently uncommon that there would not be sufficient consensus as to what constituted a breach.) But the existence and occasional use of such a provision (and the arguments against it by the party obligated to consult, on grounds that it could be used "strategically" in a court of law) is another example of the dynamic I have been hypothesizing: an obligation parties value, which helps shape their relationship, but in somewhat ephemeral ways.

III. LAW, ECONOMICS, AND PHILOSOPHY

A. The (Limited) Role of Law

Where is law in this picture? Once parties have agreed on the contract provisions, they perform a legal ritual: they enter into a

"valid, binding, and enforceable" contract.[50] The specter of legal consequences has thereby attached to false representations, promises not kept, and breaches of the other provisions. But the specter of other consequences also has attached, including reputational consequences: the consequences of being known throughout the relevant community as unreliable, or untruthful, or someone capable of breach.[51] And, as discussed in Section I.B, *supra*, the specter of reputational consequences can sometimes be more powerful than the specter of legal consequences.

Furthermore, the costs and uncertainties of the legal system assure that parties will typically not seek recourse for minor breaches.[52] Thus, provisions will be crafted to accommodate minor deviations. Agreeing to maintain a particular ratio may mean, in practice, maintaining a ratio no more than a certain (implicitly agreed upon or accepted) percentage above the prescribed ratio.[53] And, as I discussed in Section II.A, *infra*, many provisions function mostly as stage setting. I argued above that forces alongside, and sometimes trumping, law play a large role in shaping the parties' "contractual" relationship.[54] Bolstering the argument, as I discussed in Section II.A, *infra*, for quite a large number of provisions in complex contracts, summoning up law's force would seem of little help; the provisions

50. The negotiating process itself also can be thought of as a legal ritual, in some respects as stylized as the ritual of "becoming bound."

51. On the other hand, there are businesses where it pays to be considered untruthful, irrational, or downright "crazy." *See* DIXIT & NALEBUFF, *supra* note 30.

52. The characterization in the text is, I would argue, true for the vast bulk of firms in the complex transacting community. But there are also firms that would not allow themselves even minor deviations, and those that would strategically object to such deviations by others. These two extremes—"squeaky-clean" transacting parties and "outlaw" transacting partners—may be in the vast minority in the US, but may be a larger proportion of the transacting community in parts of the world where legal enforcement is weaker and more uncertain. Indeed, I am told that Venezuela has significant numbers of all three types of parties. The squeaky-clean parties are those who do not bribe the judges. The midcaliber parties bribe the judges, but only within certain determinate levels. The outlaw parties kill the judges. In the US, of course, the definitions would differ, as would something else of significance: in the US, squeaky-clean parties are willing to do business with midcaliber parties, counting on the existence and force of law. In Venezuela, the squeaky-clean parties do business only with each other.

53. This can be characterized as a reputational penumbra. Moreover, as Lisa Bernstein points out, the amount of acceptable latitude may vary depending on whether parties are in the midst of a mutually beneficial contractual relationship, or, rather, in an "end game." *See* Bernstein, *Merchant*, *supra* note 6, at 1796–98.

54. Indeed, those for whom this proposition is not controversial might rephrase my argument on this point as "Relational contracts are relational." For those for whom the proposition is controversial, I offer as support my own anecdotal evidence, based on my experience as a corporate lawyer, and extensive discussions on this issue with many lawyers and business people, as well as scholarly work documenting this effect. *See, e.g.*, *supra* sources cited in note 6.

are better suited for some other purpose. For instance, the contract requires notice that a party is in default.[55] A claim of breach will never be brought unless the default actually occurs. If the default does occur, the additional claim for the breach of the notice provision adds nothing. Or the contract requires insurance on the company's major asset; if the company's major asset is destroyed, how much is a claim for breach against the company worth? Or the company promises (in this case, represents) that the agreement is binding and enforceable against it; if the representation is false, what good is legal recourse against the company?

In sum, relegating law to a smaller, different role is consistent with sensible views about the workings of law. Enforcement is always costly, and often uncertain. Moreover, features of complex contracts compound these effects. In particular, directly applicable precedent, which would reduce costs and increase certainty, is less likely to exist in the case of complex business contracts, owing to the complex, custom-tailored, and nonrecurrent nature of the transactions at issue.[56]

And the limits of language, too, constrain parties' ability to specify exactly what they want and how they want the law to treat them in various circumstances. Economists couch the problem as though it were purely quantitative: some contingencies cost more to anticipate than the benefits of doing so warrant. But for the types of contracts my paper addresses, the difficulty may be not only quantitatively greater, but also qualitatively different. Parties sometimes want

55. Notice provisions alert lenders that the borrower may be in an end game, skimping on loss and damage prevention to pay operating expenses (or perks or ill-advised investments). The lender can hence increase its monitoring activities. Moreover, contracts will typically require the borrower to regularly certify nondefault; thus, the lender should be alerted of possible difficulties, either because he has received a notice of default or because he has not received the required notice of nondefault. Note, that the provision's value is in helping the lender identify situations where early intervention might limit or prevent losses rather than in giving the lender a right of action against the borrower.

56. And if the parties are disagreeing in good faith as to the meaning of the provision, there are likely hard issues involved. Hard issues likely mean high litigation costs and uncertain outcomes. And if the disagreement is not in good faith—if one party, in an end game with nothing to lose, is simply acting strategically and espousing meritless positions to impose costs, that party will likely succeed in its objective: the legal system allows extensive delays and costly discovery, and the use of other cost-imposing tactics. In other words, the more meritorious claims are costly and uncertain because they are meritorious; the less meritorious claims may be less uncertain, but they are not less costly. Indeed, quite the contrary, since a party with nothing to lose is able and apt to use unfair and unseemly tactics. I have seen a significant number of claims brought by parties who knew their positions were quite shaky but were simply trying to impose costs on the other party; their success in this strategy was one factor in my decision to leave law practice for academia.

something that they will only "know when they see"—flexibility of a degree and kind that seems appropriate, say, when unanticipated contingencies arise. More precise specification at contract inception may be impossible.[57]

Even if parties could specify all contingencies, they might not want to. Making contracts clearer and more comprehensive for a court may have a very low, or even negative, expected value. If the probability that the contract is going to be adjudicated in court is low, many increments of increased clarity and comprehensiveness may not be worth the associated costs. Indeed, making contracts easier for courts to interpret might even make them less effective at fulfilling the various extralegal functions discussed in this Article, particularly information revelation.

Where are the lawyers in this picture? Besides structuring, drafting, and negotiating the agreement,[58] they also give (lend?) an imprimatur of respectability and venerability; this is part of the service they provide, together with their expertise. And invoking the law adds ritual and gravity; it compounds the effect of the "act" itself—the act of entering into a contract, and thereby becoming "bound."

B. *Philosophy of Language Meets Economics*

I have described the same phenomenon from two different perspectives at once: how contracts "do things with words." I have considered, first, what those things are—the economics perspective. I have also considered how contracts—that is, the words that comprise

57. *See generally* Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 755–56 (1988); *see also* Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 983 (1983). Lisa Bernstein argues that in effect, one contract creates two contractual relationships. The "enforceable" contract, to be used when parties are sufficiently estranged as to invoke legal proceedings (an "end game"), consists of the provisions as written. The contract that governs the parties' relationship during harmonious periods includes various implicit terms allowing for flexibility and accommodation. *See* Bernstein, *Merchant*, *supra* note 6, at 1796. For the institutional settings involved in complex contracting, I am not sure I would postulate two qualitatively different regimes. And, for the reasons I discuss in the text, including that some of the provisions do not lend themselves to "enforceability," I do not think there is a regime in which all the provisions of a contract are intended to have their "literal" meanings.

58. In my experience, many transaction provisions need not be drafted by lawyers at all; indeed, I have seen business people do as good a job drafting such provisions as lawyers, if not better. The transactional provisions involved are those going more to the business deal than the legal structure. That being said, there are likely economies of scope in having the lawyer who has been involved in structuring the transaction draft the documents, even the parts which are less "legal."

the contracts—do those things: the philosophy of language perspective. Each perspective enriches the other. Economists understand, perhaps better than philosophers of language, some of the mechanisms by which words create a state of the world—mechanisms which sometimes scarcely acknowledge the words' "literal meaning." But philosophers of language understand more the role of linguistic communities in establishing meaning. In this paper, I have used economics to paint a picture philosophy "commissioned"—the state of the world created by a contract. Later work might profitably use philosophical insights to help economists seeking to understand contracts and contracting behavior. One area in which the perspective might be particularly useful is the increasing number of cross-border, and often, cross-cultural transactions. In my practice, I represented many Japanese, and some German, clients; much of what I did was "translate," not the words, but how the words were "meant."[59] The clients' knowledge of the words' "literal meanings" was extensive, and, for many purposes, would have sufficed; their understanding of what the words actually did in this context—the contractual relationship that had been created—was not.

CONCLUSION

Complex contracts are performative utterances. They create a state of the world—parties entering into a contract thereby become "bound." The contract expressly summons up legal consequences for every promise it contains. But, I have argued, the relationship between the promises and the law's force is more attenuated. Very often, contract provisions set the stage rather than providing the script: accommodation is more the rule than the exception. And the attenuation goes much further: many provisions can be understood better as serving some other function, such as ferreting out information (representations and warranties in acquisitions) or reminding people to check certain things (various notification and certification requirements in loan agreements). The shadow of the law is ever present, but quite pale. For most contracting parties, the law's specter is one of many reasons to do what they promised to do, and often, not the most important reason.

59. Indeed, such clients often were inclined to take "literally" the rights and duties set forth in the contract, and imagined, for instance, that their borrowers' violation of financial covenants would, in practice, give them rights as though the recourse to law were costless and certain.

Law's role is intricate and circuitous, as is the role of language. Three ways contracts use words are of particular interest. One is the use of words to "signal" belief—*the words are being used not to communicate their content, but that the speaker (whose belief is authoritative) believes their content.* In the cases I discuss in the paper, the words' "literal meaning" is the same as what they signal. But this need not be the case. For instance, a seller of a company that offers to its future buyer access to the company premises without notice, when the industry norm is to offer access upon one day's notice, is probably signaling that he is eager to do the transaction and has nothing to hide. The signal's strength depends on the perceived sincerity and genuineness of his offer. (Otherwise the offer would be, as economists would say, "cheap talk." Signals must be "expensive talk.") The actual words, and the rights they give, matter much less in the buyer's valuation of the provision. The dynamic is no different than when people burn money, literally or metaphorically, to signal that they are rich.[60] Another familiar example, returning to the sphere of law, is the paradigmatic lawyer's and banker's office furniture—it is expensive and solid *looking*, and intended to signal venerability, and a commitment to staying in business in the long term.

Another interesting use of words is as information and compliance-eliciting mechanisms in the "ritual" of contracting. Contracting accomplishes part of its purpose not just with the words agreed upon and given legal effect, but also with the words discussed and ultimately rejected.

A third interesting use of words I discussed was contract-as-stage-setting. Contracts use words to set parameters and points of departure for accommodation and negotiation; the relationship thus crafted is constrained, but allows for flexibility. The existence of a complex contracting community, albeit a loose one, makes this possible. The people involved, the parties as well as the professionals, form a loose web of relationships; the contracts are "relational," as that term is understood in the literature.

How contracts do things with words is, in the end, not so different from how people generally do things with words. In both cases,

60. Burning money can only demonstrate being rich via a signaling mechanism. Whatever amount you burn, you do not have; while we may think that you would be unlikely to burn *any* amount of money if you did not have lots more you *were not* burning, you *might* do so. The more money you burn, the less you have; yet, the signal works precisely the other way.

the meaning of words is established in part by ex post community consensus—in short, we "knew it when we saw it." I have long believed that necessary and sufficient conditions are a bit like Godot; in many, if not most cases, they are not forthcoming, even in the law, where they are ostensibly crucial. So long as there is enough consensus among the community (the "you's"), "you know it when you see it" can be sufficiently determinate. Philosophy teaches that there are infinite numbers of possible worlds, and thus, infinite possible futures; philosophers spend time thinking about what each of these futures might hold. Contracts can create relationships that constrain, consistent with allowing needed flexibility; lawyers are saved from having to become philosophers.