

# Frameworks of Cooperation: Competing, Conflicting, and Joined Interests in Contract and Its Surroundings

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*Private law and regulation are constantly involved in the evaluation of conflicts of interest, judging some of them salutary, with others requiring adjustment. Focusing on the question of conflicts of interest allows us to clarify our vision of when such adjustment is appropriate and, more specifically, when the law should supply an infrastructure for cooperative behavior. Thus, the prism of conflicts of interest provides a lens through which to view basic legal problems that turn on whether individual actors will be deemed responsible to some joint interest or whether they will be at liberty to pursue their individual interests despite the adverse effects of such activity on others.*

*This article proposes a conflicts of interest perspective for examining contract law and its immediate surroundings. It suggests a map of conflicts of interest along three axes: the remedial axis; the axis of positive duties to avoid conflicts; and the axis of the transition from independence to loyalty. Applying the map to contract doctrine, the article examines a number of contract doctrines including: remedies for breach of contract; modification; conditions; good faith in performance; and formation. The article goes on to apply the map of conflicts to two complex fact situations: corporate acquisitions and corporate bankruptcies. The analysis underscores the fact that conflicts of interest rules do not simply protect existing interests, but*

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*also contribute to the very constitution of those interests. Recognizing the constitutive role of legal rules raises questions about our ability to determine interests ex ante and thus calls for a more nuanced approach to gauging the incentive effects of a legal regime.*

## INTRODUCTION: CONFLICTS OF INTEREST EVERYWHERE

Every time we delve deeply into a particular branch of legal doctrine, we risk missing the forest for the trees. The richness of doctrinal detail almost guarantees it. Thinking about conflicts of interest, however, may allow us to renew our perspective on a range of legal problems. By examining some familiar territory within a slightly unfamiliar framework, I hope to shed some light on doctrinal forests, that is, on broad conceptions underlying particular doctrinal problems and solutions. The analysis focuses on contract law and its immediate surroundings, showing how doctrinal solutions may be recharacterized as mediations of potential conflicts of interest. The value in this perspective is that it allows for a fresh view of the justification for legal intervention in relationships among private entities, be they human beings or corporations. The law is constantly involved in the evaluation of conflicts of interest, judging some of them salutary, with others requiring adjustment or regulation. Keeping one eye on the question of conflicts of interest should allow us to clarify our vision of when such adjustment is appropriate and, more specifically, when the law should supply an infrastructure for cooperative behavior. Thus, the category of conflicts of interest provides a lens through which to view basic legal problems: it allows us to revert to basic questions about when individuals ought to be deemed separate and when, as a society, we determine that they ought to be deemed connected.

Consider for a moment the paradigm case of prohibition of conflicts of interest: the elected government official. In the case of such officials, the law is adamant that the official's private interest be utterly disregarded. And such disregard is not contingent on any efficiency calculus. Even where allowing a public official to engage in conflicted behavior could conceivably have beneficial overall welfare effects, such behavior will be punishable under conflicts of interest standards. Something about the idea of trust in the loyalty of the public servant to the public interest is important enough for the law to disregard entirely the official's own welfare when determining her responsibility. This article is based on the insight that this situation is not *sui generis*, but rather the endpoint of a sliding scale of responsibility to common interests.

Despite the pejorative ring of the term conflict of interest, it is clear

that the law does not view every such conflict with disapproval, or even concern. Over a century ago, Oliver Wendell Holmes reminded us of the daily business of preferring the interests of one individual over those of another or at least of granting one individual a *privilege* to act in accordance with his own interests at the other's expense:

[A] man has a right to set up a shop in a small village which can support but one of the kind, although he expects and intends to ruin a deserving widow who is established there already. He has a right to build a house upon his land in such a position as to spoil the view from a far more valuable house hard by. He has a right to give honest answers to inquiries about a servant, although he intends thereby to prevent his getting a place. But the reasons for these several privileges are different. The first rests on the economic postulate that free competition is worth more to society than it costs. The next, upon the fact that a line must be drawn between the conflicting interests of adjoining owners, which necessarily will restrict the freedom of each; upon the unavoidable philistinism which prefers use to beauty when considering the most profitable way of administering the land in the jurisdiction taken as one whole... . The third, upon the proposition that the benefit of free access to information, in some cases and within some limits, outweighs the harm to an occasional unfortunate.<sup>1</sup>

In each of these situations, we could imagine the opposite outcome. The law, whether under a category of torts, or property, or unfair competition, or master and servant, can conceivably envision the parties as joined in interest and, thus, as limited regarding pursuit of their self-interests or even the interest of a third party or of society generally.<sup>2</sup> But in the instances Holmes recites, and for the reasons he mentions (among others), the law chooses to uphold the distinction between the parties, to highlight their individuality. Interestingly, Holmes conceives of the framework supporting individuality as

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1 Oliver Wendell Holmes, Jr., *Privilege, Malice, and Intent*, 8 Harv. L. Rev. 1, 3-4 (1894).

2 The case of a man who decides to "give honest answers to inquiries about a servant" is likely to be such a situation. In giving a reference, it may be that the former employer has no particular interest vis-à-vis the employee (assuming for the moment that he has no independent "interest" in truth-telling per se), and thus, honest answers express a preference for the third party who receives the information or for potential employers generally. For a detailed extrapolation of the various interests that might be balanced in a particular decision-making process, see Ariel Porat, *The Many Faces of Negligence*, 4 Theoretical Inquiries L. 105 (2003).

one that must be justified societally: an underlying policy of social welfare supplies the underpinning for the law's preferences for distinction, that is, for granting an individual the privilege to prefer her own interests over those of another individual who is negatively affected by her choice. In Holmes' framework, then, autonomy is not a justification for the choice of a legal norm, but on some level an *effect* of the legal norm. Legal rules are responsible not only for creating and protecting joint interest, but also for supplying the sense of individuality so often taken for granted as a justification for those very same legal rules.

The law's preference for distinction is, of course, not limited to the question of when a legal actor will enjoy a privilege releasing him from, say, liability in tort. The discussion of privilege seems to imply a certain level of passiveness, as if the law will sometimes deign to tolerate behavior through which one party inflicts damage on another's interests. But this would be a misperception of the law's role. In many situations, we perceive interests not as "conflicting," but as "competing." Competition often implies that one party must attempt to outdo his opponent to gain the advantage that they both seek. And when interests are envisioned as competing, the law does not simply stand idly by, but, rather, often imposes legal constraints that maintain the distinctions among legal actors. As in Holmes' examples regarding liability in tort, the law often *encourages* distinction. Such encouragement is highlighted in old common law doctrines such as that mandating the non-enforcement of covenants in restraint of trade, or in the full-fledged modern administrative apparatus of anti-trust law, or in the protection of trade secrets and patents. Thus, where competition is at stake, the law often intervenes actively to assure that interests are not joined or, in other words, to maintain a certain level of conflict of interest among legal actors whose separation is imposed, even against their will.<sup>3</sup>

On the other hand, erstwhile competitors may morph into partners or, less drastically, enter into relationships where a mutual interest might be in need of protection because of the threat of opportunism that could destroy, or at least damage, the joint interest.<sup>4</sup> When such a transition takes

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3 The obvious example here is the regulatory prohibition of certain mergers. Less obvious examples may be drawn from the way American property law generates incentives for co-owners of property not to cooperate in managing the property. See Hanoach Dagan & Michael A. Heller, *The Liberal Commons*, 110 Yale L.J. 549, 609-10 (2001).

4 Opportunism may be difficult to define precisely. For present purposes, I am referring to behavior that is, in context, judged to be insufficiently sensitive to a joint interest and to conventional expectations of honesty, normally by preferring what the opportunistic party perceives to be its self-interest. Oliver Williamson

place, the potential arises for conflicts of interest as traditionally conceived. In other words, certain kinds of interactions are viewed by the law, whether private law or regulation, as generating a protected interest, and a situation is typically viewed as entailing a conflict of interests when undercutting that joint interest draws a legal sanction. This description is intentionally vague and possibly even somewhat circular. The vague circularity highlights three axes of differentiation of the law's responses to conflicts of interest, each of which will form a prong of my analysis. I will refer to these three axes as the remedial axis, the axis of positive duty, and the axis of transition.

When faced with a conflict of interests, the law's remedial responses may vary tremendously. Granting for the moment that my characterization of various situations as conflicts of interest is tenable, we can identify a broad spectrum of remedial devices, ranging at one end from criminal sanctions and stretching at the other to mere condemnation and a seeming reliance on non-legal sanctions. In between, we may find administrative sanctions, penal damages, disgorgement of gains, damages based on harm, reduced damages, or options of rescission or discharge granted to the injured party. The remedial axis is often presented as a byproduct of the positive duty. The reason it comes first in my classification is that one goal of this article is to undermine that perspective. My hope is that addressing the remedial axis first will help to clarify our thinking about the justification for our particular mediations of conflicts of interest.

Alongside the range of remedies, the law utilizes a spectrum of characterizations of positive duty to avoid conflicts of interest, ranging from the status of the fiduciary or trustee (or perhaps the public official) on the one end, down through to the competitor on the other. It is important to note that there is no point on this spectrum at which there are no duties: even the competitor has duties, though they might be minimal, such as the duty not to cause harm through unfair competition, or the duty not to induce contract breach (i.e., a duty to avoid tortious behavior). Significantly, while it is relatively easy to sketch the spectrum of remedies and the spectrum of positive duties from the strictest to the most lax, the two axes do not overlap; in other words, common perceptions about the gravity of duties to avoid conflicts of interest do not necessarily cohere with the seriousness of the remedies imposed by law in mediating conflicts.

Finally, the third axis deals with the mode of transition from a situation of competitive interests, where the law will encourage self-regarding behavior,

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neatly encapsulates this view by calling opportunism "self-interest seeking with guile." Oliver E. Williamson, *The Economic Institutions of Capitalism* 47 (1985).

to one of a conflict of interest, where the law will require some level of loyalty to a common interest. In some cases, for instance when an individual takes public office or takes a position in management of a corporation, the transition to potential conflict is both clear-cut and voluntary. In other cases, for instance when a firm's creditors find themselves facing an insolvent or even nearly insolvent debtor, the transition may be subtle, unexpected, and involuntary. Sometimes, intriguingly, the transition can be brought on by the operation of legal rules themselves.

In what follows, I propose to utilize the framework of conflicts of interest in order to focus on how the law creates, orders, and, especially, mediates interests along these three axes. One of the keys to a conflicts of interest analysis of the type I am proposing is the recognition of the malleability of the interest that may or may not be protected. In many cases, the law's protection has a constitutive role in the creation of value.<sup>5</sup> In deciding that a particular interest has the kind of value warranting protection by a rule sanctioning conflicts of interest, the law plays a part in injecting meaning and value into the interest. For example, in a regime of contract law that never awards damages for breach beyond the injured party's out-of-pocket reliance costs, the promisee's "performance interest" will nearly cease to exist (in terms of value); it will be reduced to a "mere expectancy" rising or falling at the whim of the promisor.<sup>6</sup> Thus, even if many contracts are performed, it would be clear that there is no legally protected performance interest. This much is virtually trivial, at least for anyone raised on legal realism.

I aim to take this insight one step further. Because the interest at stake may be constituted by the legal regime, it will be difficult to gauge the value of any particular interest *ex ante*. In part, this is because some interactions are significant enough to generate fundamental shifts in preferences. But

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5 On the level of determining the value of specific assets, the argument of the law's role in the creation of value was developed in the context of the debates over rate regulation during the first half of the twentieth century. For a succinct (but cutting) version of the argument, see Robert L. Hale, *The "Fair Value" Merry-go-Round, 1898-1938: A Forty-Year Journey from Rates-Based-On-Value to Value-Based-on-Rates*, 33 Ill. L. Rev. 517 (1939). For a more general argument about law's constitutive power in determining value, see Robin Paul Malloy, *Framing the Market: Representations of Meaning and Value in Law, Markets, and Culture*, 51 Buff. L. Rev. 1, 22-25 (2003).

6 L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: I*, 46 Yale L.J. 52, 59-60 (1936); Daniel Friedmann, *The Performance Interest in Contract Damages*, 111 L.Q. Rev. 628, 633-35 (1995). In this scenario, even if social norms were to support performing promises, it is clear that the overall incentives to performance would be reduced considerably.

more importantly, the difficulty of conducting the *ex ante* analysis surfaces because the creation of a new interest is almost like the creation of a new legal subject, one that does not exist prior to the interaction among existing parties. If the interest arises, its whole may be larger than the sum of its parts had those parts been divisible and awarded to the preexisting parties. Crucially, those parts may not be divisible, or at least not easily divisible.

This idea is well-illustrated by the family unit. At the outset, two individuals undertake a cooperative venture of indefinite duration. Along the way, they change as individuals and, possibly, grow into a community (one that may include additional members). While it would be extreme to think that *ex ante* preferences should be irrelevant in designing rules to govern the possible conflicts of interest during the relationship, it seems equally extreme to view them as all-important.<sup>7</sup> The *ex ante* view simply cannot comprehend this type of uncertain future interest, especially because some of the parties to the interest do not exist *ex ante*.<sup>8</sup>

The example of the family may seem radical. The interaction that becomes a family is not quite a transaction, and the physical creation of new human beings may make the idea of the constitution of new legal subjects seem at once obvious and, at the same time, too extraordinary to be of much interest for other areas of law. But again, my suggestion is that the family is not *sui generis*, but rather one pole of a spectrum. Most interactions do not have the same potential for transforming the individual as creating a family does. Most new interests cannot claim the law's protection with anything approaching the intensity that a child can. And yet, it is not only in the family that we create things bigger than ourselves.

A good deal of social interaction works toward building mini-communities, or at least joined interests, and much of this interaction occurs in relational contracts. As the richness, complexity, and importance of the newly arising joint interest grow, it takes on independent force as a justification for legal consideration. A telegraphic way of putting this is

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7 *But see* Elizabeth S. Scott & Robert E. Scott, *Marriage as Relational Contract*, 84 Va. L. Rev. 1225 (1998).

8 One way to reincorporate this perspective into a standard economic analysis would be to see any new legal subjects or new parties to a common interest (e.g., children, in the family example) as raising the problem of externalities (whether positive or negative, as the case may be). At high levels of abstraction, this may be a plausible alternative. However, anyone wishing to adopt it will have to come to terms with the way a serious consideration of externalities threatens to undermine the power of standard economic analysis. *See* Michael J. Trebilcock, *The Limits of Freedom of Contract* 58-61 (1993).

that as the relational context thickens, the reasons for preferring *ex ante* analysis lose force.<sup>9</sup> If the conceptual claim that new interests can be born out of interaction and legal recognition is sound, we can then begin to ask the difficult questions of when such a conceptual claim will have any normative bite.

The article proceeds as follows. In Part I, I sketch the contours of a map of conflict of interest situations, along the three axes outlined above: remedies, positive duties, and transitions. Part II is an abstract application of the mapping exercise of Part I. It uses the map of conflicts to refresh our view of a number of traditional contract doctrines. Viewing contract doctrine through the prism of conflicts of interest should allow us to reconsider some of the justifications for familiar legal rules. Part III is a different application of the map, beginning instead with concrete fact situations rather than doctrinal categories. It utilizes the insights gleaned through the framework of conflicts of interest to consider two practical examples: merger agreements and corporate bankruptcy.

## I. MAPPING CONFLICTS OF INTEREST

In this part of the article, I present a three-dimensional map of conflicts of interest. The first dimension is remedies; the second, positive duties; the third, the transition to loyalty. After sketching these three spectra, I propose several parameters that may explain some of our intuitions about their internal ordering and the possible relationships among them. None of the analysis in this mapping exercise is new. Instead, the goal is to use a

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<sup>9</sup> It is worth distinguishing, even at this preliminary stage, between two different kinds of arguments that question the value of *ex ante* analyses. One strand of argumentation, often discussed under the heading of behavioral law and economics, rests on a critique of the assumptions of the rationality of the actors. Systematic distortions of rationality (such as the endowment effect, risk aversion, over-optimism, improper weighting of risks because of salience, etc.) weaken the power of *ex ante* arguments aimed at perfectly rational actors. For a recent critique along these lines suggesting that welfare economics should rely more than it usually does on *ex post* analysis, see Barbara H. Fried, *Ex Ante/Ex Post*, 13 J. Contemp. Legal Issues 123 (2003). For a general survey of behavioral considerations, see Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stan. L. Rev. 1471 (1998). While I find this line of critique persuasive, it is not my concern in this article. Instead, I offer another line of argument, based on the claim that certain interests are systematically excluded from consideration *ex ante* and thus must be considered *ex post* if they are not to be ignored altogether.



unified perspective revolving around the idea of conflicts of interest to take a bird's eye view of a wide range of legal ordering from a unified perspective of conflicts of interest.

### A. Remedies

Behavior that ought to be characterized as stemming from a conflict of interest comes in various shapes and sizes. For the purposes of this section, I will not foray into a detailed description of the behavior itself, but, rather, will concentrate primarily on the law's response to such behavior. My goal is to show that the form of legal intervention is as varied with respect to the remedy as is the behavior regulated by legal rules. Rather than responding with a unitary legal implement, the law is sensitive to the differences among various forms of conflicted behavior and employs a rich arsenal of remedial devices.

The most extreme remedial response to a conflict of interest is the criminal sanction, presenting perhaps the most straightforward complement to outright prohibition. A paradigmatic instance is the federal statute governing bribery and other conflicts of interest of government officials.<sup>10</sup> According to the statute, a public official guilty of taking a bribe may be imprisoned for up to fifteen years and fined three times the monetary equivalent of "the thing of value" taken, in addition to other sanctions. The statute goes on to detail lesser punishments (i.e., shorter sentences and lesser fines) for milder forms of conflicts of interest, but penal sanctions including imprisonment are, at least on the books, the most traditional response to this type of conflict of interest. Outside government service, it will be rare (though not impossible) to find criminal sanctions including imprisonment as a response to a conflict of interest.<sup>11</sup>

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<sup>10</sup> 18 U.S.C.A. § 201 (2000).

<sup>11</sup> For purposes of this article, I do not include fraud in the realm of conflicts of interest (therefore the criminal sanctions of legislation like the Sarbanes-Oxley Act are not relevant here). While analytically difficult to draw the line (say, between the impropriety of fraud and that of accepting bribes), the analysis presented here deals primarily with behavior that, on its own, could be considered legitimate but for its effect on a recognized common interest. The word "bribe" may have a harsh ring, but the objective actions involved are part of legitimate commercial routines. Regarding the difficulty of distinguishing between illegitimate bribes and legitimate inducements to business in the context of commercial bribery, see *Foremost Sales Promotions, Inc. v. Bureau of Alcohol, Tobacco & Firearms*, 860 F.2d 229 (7th Cir. 1988). The economic analysis of law routinely treats certain "bribes" as just another name for (completely legitimate) renegotiation of contractual entitlements. See Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient*

Closely related to criminal sanctions are administrative sanctions, many of which compete in intensity even with short prison sentences. Government officials guilty of conflicts of interest may lose their positions; attorneys guilty of conflicts may be sanctioned or, in extreme cases, even disbarred. Ethics codes in a range of professions set standards for avoiding conflicts of interest, and the results of violations can be career-ending and, indeed, life-altering.

Descending the ladder of severity, the next remedy to consider is punitive damages. The typical case in which this remedy is applied is the insurer who, in bad faith, delays or denies coverage of a claim or refuses a reasonable settlement of a claim. Any insurer presented with a claim faces the possibility of a conflict of interest. Tactics that delay and possibly avoid payment generate an immediate payoff but undermine the expectations of the insured regarding coverage. Such behavior is easily grasped as a betrayal of the common interest that the insurance relationship entails.<sup>12</sup> Over the last quarter century, findings of bad faith in such behavior by insurers have been accompanied by significant (some would say exorbitant) punitive damage awards. While such awards are not a standard part of the collection of contract remedies, there are arguments suggesting that opportunistic contract breach should be met by punitive damages.<sup>13</sup>

The next remedy down is disgorgement of gains from the conflicted action. There are two analytically distinct areas where disgorgement comes into play. In one scenario, the common interest is created by a traditional fiduciary relationship, for instance, a trusteeship. A trustee guilty of betraying the trust by self-dealing may be required to disgorge any benefit received handing over any profit from the transaction to the trust. The potential for conflict of interest in the context of this type of self-dealing is clear, and a pure deterrent attitude might favor disgorgement, even if a particular transaction was on balance beneficial.<sup>14</sup> In the second scenario, a common interest is created by a regulatory regime that protects a competitive environment. Violators of the

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*Breach*, 61 S. Cal. L. Rev. 629 (1988); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L.J. 1807, 1842-43 (1998). For the foundational analysis of certain incentives as bribes (conducted in the context of torts rather than contracts), see Guido Calabresi, *The Costs of Accidents* 150 (1970).

12 The relationship begins, on some level, with a contract, but the legal response to its betrayal is divided between contract and tort.

13 William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 Duke L.J. 629 (1999).

14 See Hanoch Dagan, *The Law and Ethics of Restitution* 234-40 (2004); Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decision Making — Some Theoretical Perspectives*, 80 Nw. U. L. Rev. 1, 42-43 (1985).

rules of competition wreak general and specific harms: in general, they erode the competitive framework whose ground rules have been set, and are thus considered fair (or efficient, or protective of the environment, or whatever policy is being advanced by the rules), and weaken the will of others to play by the rules; specifically, they take advantage of the cooperation of others in order to reap gains that might have been open to the other competitors. Disgorgement in this setting has a dual purpose: on the one hand, the possibility of being caught and forced to give up the profits is a deterrent; on the other hand, the possibility of gaining the disgorged benefit gives the most directly injured parties (and those who are likely to have easy access to the information necessary for catching the perpetrators) a strong incentive to play the role of private attorneys-general.<sup>15</sup>

Following disgorgement, we find harm-based, or market damages. Such damages are limited to those injuries that were foreseeable at the time of the injurious action (or, in the contractual setting, foreseeable at the time of contract formation) and to those damages that can be proven with reasonable certainty. Many torts can be conceived within this paradigm, where the tortious behavior is seen as the injurer's improper balancing between his own interests and those of the injured party.<sup>16</sup> Possibly more pertinent for this setting, many contract breaches should be viewed in this light. A party to a contract may be presented with an opportunity for action that would undermine her ability to perform the contract, but would be more profitable than the contract. In most cases, such a party will be required to pay the victim of the breach only the victim's actual (and provable) damages resulting from the exploitation of the more profitable opportunity — in other words, expectation or performance damages.<sup>17</sup>

Contracts cases also occasionally provide examples of reduced damages measures that do not reach the level of expectation damages. Whether such damages are based on reliance expenditures or on restitution of benefits

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15 Ofer Grosskopf, *Protection of Competition Rules Via the Law of Restitution*, 79 Tex. L. Rev. 1981, 2006-08 (2001).

16 Again, within the framework I present here, this should apply primarily to tortious behavior that could, under certain circumstances, be perceived as legitimate. The classic case of the factory whose pollution causes damages to the laundry downstream would be a good example. For an analysis of negligence law characterizing negligence as improper balancing of conflicting interests (but taking into account a wider range of interests than a binary choice between those of the injurer and the victim), see Porat, *supra* note 2.

17 In fact, a range of behavior within contractual relationships (not just the breach or perform decision in the face of a valuable opportunity) may be vulnerable to conflicts of interest, and I will examine a few points within that range in Part II.

actually provided to the breaching party by the victim, they represent, at least analytically, a distinct remedial device. The legal event that brings about the application of the device may be a breach of contract or even the breach of a pre-contractual duty of good faith quite similar to those mentioned in the expectation damages setting. In other words, the setting for assessing reduced damages may be the exploitation of an alternative opportunity instead of performing the contract. Contracts scholars have debated the justifications for granting such damages, with some suggesting that there may be good reasons to broaden the scope of the remedy's application.<sup>18</sup>

Finally, the lowest rung on the remedies ladder is the legal power to rescind or void the transaction tainted with a conflict of interest. Such a remedy usually does not stand alone, but, rather, entails restitution as well. However, if the tainted transaction remains executory, rescission or voiding may be employed independently. Of course, there are also situations where the law will not intervene to prevent or redress a conflict of interest, and yet other situations where the law will intervene to prevent consensual mediation of the conflict. But when the law does seek to redress conflicts, these remedies, or combinations of them, seem to be its primary tools.<sup>19</sup>

## B. Positive Duties

The spectrum of positive duties to avoid conflicts of interest is, for my purposes here, easier to sketch. Roughly, we can draw a normative spectrum extending from those relationships where we expect the highest intensity

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18 George M. Cohen, *The Fault Lines in Contract Damages*, 80 Va. L. Rev. 1225, (1994); Richard Craswell, *Against Fuller and Perdue*, 67 U. Chi. L. Rev. 99 (2000); Robert Cooter & Ariel Porat, *Should Courts Deduct Nonlegal Sanctions from Damages?*, 30 J. Legal Stud. 401 (2001); Robert Cooter & Ariel Porat, *Decreasing Liability Contracts*, 33 J. Legal Stud. 157 (2004).

19 From criminal sanctions down to disgorgement, we are in the realm of property rules; from harm-based damages on down, liability rules. The seeming exception is the power of rescission, which seems to act generally as a property rule, but, in fact, only does so when combined with a restitutionary remedy. If rescission is accompanied only by discharge, it works as a rule of truncated liability. The original application of the property/liability rule distinction to contract remedies is Anthony T. Kronman, *Specific Performance*, 45 U. Chi. L. Rev. 351 (1978). For an extension of the property/liability rule distinction to the context of group rights in the control of corporate self-dealing, see Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393 (2003).

of loyalty to the protected interest down to those where a minimal level of loyalty seems to be required.

The paradigmatic duty to avoid conflicts of interest resides in public officials. If pressed to hierarchize, we might say that elected public officials, at least by intuition, ought to be held to an even higher standard of loyalty than appointees or civil servants. Regardless, for all public officials, the position entails a public trust, the protection of which is the foundation of our intuitions about the very term conflict of interest. Next in line after public officials in terms of common expectations of duties of loyalty we would probably find a range of professional fiduciaries or trustees, people whose professions put them in one-on-one relationships of trust. For attorneys, accountants, doctors, and the like, the ethos of the profession and its authority are bound up with the idea of trust. The direct relationship with the beneficiary, the fact that the beneficiaries are heavily dependent on the expertise offered, and the self-image of the professionals as repositories of trust combine to intensify the sense that the duty to avoid conflicts of interest in these relationships is strict indeed. When fiduciaries remain professional but owe their duties to large indefinite groups, the level of duty would seem to relax, at least slightly. This would be the case for corporate managers, for example, and possibly for insurers. A further relaxation of duty might be in order for incidental fiduciaries: people who do not seek out the fiduciary position, but, rather, have it thrust upon them by circumstance, for instance, guardians of people judged incompetent.

Until this point on the spectrum of loyalty, the actors entrusted with a duty of loyalty are readily recognizable as fiduciaries. But even beyond this point, there are still duties that are usefully considered duties to avoid conflicts of interest. Thus, under certain circumstances, parties to a contract owe each other a duty to avoid conflicts of interest. Obviously, such a duty arises when the purpose of the contract is to enter the status of a fiduciary, for instance, the contract between the corporation and its CEO, between attorney and client, and, in many cases, between insurer and insured. But these are only the extreme cases, and not the most interesting ones. The more interesting cases arise in the context of the performance of contracts, where opportunities conflicting with performance as expected at formation arise for one or both of the parties. And the world of contracts is far from monolithic, but, rather, encompasses a spectrum of required levels of loyalty. Here, Ian Macneil's description of a spectrum of contracts from the transactional to the relational is helpful: we should expect that contracts closest to the transactional pole will raise the fewest problems of conflicts

of interest, while every incremental approach to the relational pole will raise both the possibility and the stakes of such conflicts.<sup>20</sup>

The possibility for a conflict of interest that the law will address by imposing positive duties of loyalty extends to situations where the parties do not even enter into a contract among them. A salient example is that of joint creditors. Each creditor enters into a contractual relationship with a single debtor and, at the outset, has no relationship whatever with the other creditors. If, however, the debtor reaches or even approaches insolvency, the actions of any of the creditors may have drastic effects on the chances of any of the others to secure payment of the debt. One option for legal response is to impose a duty on the creditors not to undertake certain actions that prejudice their common interest, even before a bankruptcy proceeding is initiated.<sup>21</sup>

Finally, positive duties to refrain from certain conflicts of interest are imposed even among competitors, whose loyalty to a common interest is generally considered minimal. Examples include the duty to refrain from unfair competition, obligations arising from antitrust laws, the duty to respect patents and trade secrets, the duty to refrain from tortious inducement to contract breach, and others.

### C. Transitions to Loyalty

The final dimension on the map of conflicts of interest is the mode of transition into positions requiring loyalty, or, in other words, to a duty to avoid conflicts. Outside of legal incapacity, there is no position of complete immunity from certain duties to refrain from conflicts of interest. However, as the remedial and positive duty axes demonstrate, the statement that one should avoid a conflict of interest might have a wide range of meanings, so it is worthwhile considering how one finds oneself on any particular point of the spectrum. The transition from a position of minimal duty to one of heightened duty may be clear-cut or subtle, voluntary or accidental, or simply an outcome of the background conditions. Elected officials, the

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20 See Ian R. Macneil, *The Many Futures of Contracts*, 47 S. Cal. L. Rev. 691, 735-44 (1974); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 Nw. U. L. Rev. 854, 856-59, 886-99, 902-05 (1978) [hereinafter Macneil, *Contracts: Adjustment of Long-Term Economic Relations*]. I examine some of these situations in more detail in *infra* Part II.

21 See Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 Emory L.J. 1317, 1320-21 (2002).

paragons of public trust and maximal duties to avoid conflicts of interest, typically work hard to reach such a position of trust. They lobby the public, often putting their character on display, and (hopefully) see the duty implied in public trust as a reward in itself. Nobody becomes President by accident.<sup>22</sup> The same is true for professional fiduciaries of all sorts. Managers of firms compete for their positions, seeking out the responsibility to the corporation, just as attorneys compete for clients. Professional fiduciaries enter into their duties, for the most part, in relatively well-defined events that determine the outset of the relationship. As opposed to these active seekers of positive duties of loyalty, incidental fiduciaries (guardians) may be able to point in retrospect to events that generated their status, but the legal implications were often unclear at the time.

Parties to a contract may face complex transitions into duties to avoid conflicts of interest. Upon formation of a contract, duties to avoid conflicts of interest may be quite minimal and also well-defined. However, to the extent that the contract is incomplete and unexpected contingencies arise, the duties to avoid conflicts may grow in scope and significance.<sup>23</sup> Thus, contracting parties are typically well aware that they are entering into relationships that require some aspect of loyalty, but the intensity of their duties to avoid conflicts of interest may change significantly from the moment of formation through long periods of contractual performance. In this sense, the initial transition to some joint responsibility is both visible and voluntary, but the change in the level of duty (typically the increase in that level) may be subtle, uncertain, gradual, and unrelated to voluntary action. Joint creditors or others who see themselves primarily as competitors might never engage in a voluntary assumption of a duty to avoid conflicts of interest and yet find themselves bound by such duties.

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22 Of course, this is not always true. In hereditary regimes, leadership is not sought, but thrust upon the leader by virtue of birth (and death of the current ruler). And the possibility exists even in democratic regimes: When Missouri Governor Mel Carnahan was killed in an accident during his successful campaign for election to the Senate, his wife took up the position as senator. I take it as uncontroversial, however, that this is the exception that proves the rule.

23 In economic terms, as asset specificity, uncertainty, and frequency rise, the possibility for opportunism will rise as well and the parties will need mechanisms of efficient contract governance. An observable duty to maximize the joint interest (or to avoid conflicts of interest) would solve the problem, if there were a way to implement such a duty. See Williamson, *supra* note 4, at 68-80. Part II, *infra*, attempts to gauge contract doctrine's attempts at approximating such a duty.

#### **D. Navigating the Axes — A Provisional Key to the Map of Conflicts**

It might be analytically convenient if the spectrum of remedies and the spectrum of positive duties were to overlap neatly and receive positive reinforcement from the dimension of the transition to loyalty. Unfortunately for analytical neatness, no such strict overlap exists in any recognizable legal regime. In fact, while criminal sanctions are, indeed, most closely associated with violations of loyalty by public officials, below this level any attempt to line up remedies with characterizations of positive duty results in a loose correlation at best, perhaps precisely because of the multiplicity of legal responses to violations of loyalty.<sup>24</sup> At any rate, rather than harping over the question of whether there is enough regularity to declare a pattern or whether the exceptions swallow up the rules, I would like to point out a few parameters that could be relevant from a normative perspective, when trying to align specific remedies with specific levels of duty.

I begin where most people, or at least most economists, would end: with culture. We all have moral intuitions about which violations of loyalty are more or less blameworthy. Indeed, my hierarchy of positive duty characterizations is based on little more than such an intuition, and while there is certainly room for argument, I would venture a guess that many people (or at least many lawyers) would find it plausible. Having such ideas about relative blameworthiness, many people would expect that the law, in terms of the remedies it offers to correct violations of loyalty, should accord with those intuitions and give them authoritative expression by meting out the severest "punishments" to the most guilty. We expect law to accord with our moral intuitions, and those intuitions are, in turn, fed (particularly for lawyers) by the law's traditional responses, and so on *ad infinitum*. Thus, even where other considerations (such as deterrence or administrative convenience) might point to the use of a weak remedy, independent cultural

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24 One way to bring more coherence to the relationship between the remedial and positive duty dimensions would be to assume that once a high-level remedy (with criminal sanctions being the highest level) is available, every remedy below that level will be available as well. While I have not played out all the permutations of this scenario, it is conceivable that this is a decent rule of thumb, to which there would be some exceptions. For instance, the fact that competitors might sometimes be able to seek disgorgement when a fellow competitor breaks an antitrust rule, or, say, a rule prescribing legitimate areas for fishing would be seen as a peculiarity of competition law that upsets some general intuitions about how far parties are allowed to pursue their self-interest.



attitudes regarding the type of violation at stake might mandate a strong remedy.<sup>25</sup>

A second parameter affecting the relationship among remedies and levels of duty is the ability of the parties to a potential conflict of interest to design their relationship. Several kinds of factors regarding relationship design will have an impact on the legal response to conflicts. One crucial element is the parties' own choice of levels of loyalty. Some parties desire convergence of interests to a great extent (e.g., two individuals who form a general partnership; two firms that decide either to merge or engage in a joint venture through a third firm of their creation), while others desire a relationship based on predetermined allocations of risk with easy separation. Where such a choice is manifest, there may be good justifications for respecting it and trying to align the remedies to the expected levels of loyalty. But the other side of the coin has normative implications as well: when parties could not bargain in advance (because of transactions costs), there are good reasons for imposing mandatory duties;<sup>26</sup> conversely, when parties could have bargained but did not, there may be good reasons for limiting the extent to which the law should recognize a joint interest, usually by denying liability.<sup>27</sup> Another important element in relationship design is the alignment of incentives. In some cases, the parties can generate mechanisms whose goal is to obviate conflicts of interest. Performance-based compensation for corporate executives is a key example of the idea, despite the difficulties in implementation.<sup>28</sup> If the parties are, indeed, successful in aligning their incentives, the conflict of interest problem shrinks considerably and needs to

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25 For an account of the relationship between legal norms, their possible consequences, and the expression of appropriate attitudes regarding their subject matter, see Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. Pa. L. Rev. 1503, 1508-20 (2000).

26 Consider the elected official and the public or the dispersed creditors of a single debtor: the coordination problem presented here is the basis of the creditor's bargain view of bankruptcy. See *infra* text accompanying notes 96-102.

27 This is one explanation for the rule denying liability for restitution of unrequested benefits. See, e.g., Restatement (Third) of Restitution & Unjust Enrichment § 23 (Tentative Draft No. 2, 2002).

28 For extended analysis of the difficulties in implementing an incentive structure based on a true correlation between performance and compensation, see Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751 (2002); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. Econ. Persp. 71 (2003).

be addressed by law only in those cases of opportunism that slip through the mechanism designed by the parties.

The third parameter that merits consideration is deterrence of behavior motivated by conflicts of interest, and it comprises two elements. The first is the magnitude of the temptations to breach duties of loyalty; the second, the probability of detection. The second element is dependent on a range of factors, some of which are included in the design of the relationship by the parties or by third parties. Included amongst the questions that arise regarding detection are the transparency of the actions involved; the observability and verifiability of the relationship between the duty and required performances; and the availability of other oversight mechanisms (especially those that are not relationship specific). The obvious intuition would be that as the magnitude of temptations and the difficulty of detection increase, so should the available remedy — to the extent that deterrence is the goal.

Applying these parameters to specific legal problems should help us align the relationship amongst remedies and duties. Such alignment, in the best case, advances clarity in our justification of legal rules, and such clarity in turn provides an implement for critiquing existing legal arrangements.

## II. CONTRACT DOCTRINE AND CONFLICTS OF INTEREST

In this part of the article, I offer a conflicts of interest perspective on a range of contract doctrines. The treatment of each is necessarily far from exhaustive, but does aim to be deep enough to lead us incrementally toward three objectives. The first goal is to show how the conflicts of interest analysis supplies a relatively unified perspective on a wide assortment of issues. It allows us to ask similar questions about disparate doctrines, possibly allowing us to refine our legal reasoning by comparing its applications across problems. The second goal is to improve our descriptions and understandings of positive contract law and its justifications. In other words, viewing certain legal rules as responses to possible conflicts of interest should clarify the connection between the rule and the goals it ought to achieve. Third, the conflicts of interest analysis should provide insight into a few existing normative debates over contract rules and, in certain cases, support for particular positions in those debates. The discussion includes five doctrinal areas: remedies; modification; conditions; good faith in performance; and issues of formation.

## A. Remedies for Breach of Contract

### 1. Determining a Remedial Regime

In accordance with the initial mapping of conflicts of interest in Part I, this Part will begin by analyzing remedies. This is partly inspired by the legal realist analysis of private law that demonstrated the weakness of reasoning that begins with broad statements of positive rights rather than with an analysis of their definition and delimitation through remedies.<sup>29</sup> Taken as a whole, the conflicts of interest analysis of contract remedies shows that when a legal regime determines the remedies available for breach, it does more than choose a method of compensation for a wrong or a set of incentives for performance. It also contributes importantly to the definition (perhaps even the self-definition) of the parties and the interests at stake.

The common law tradition crowns expectation damages as the primary remedy for the breach of contract. In order to understand expectation damages from a conflicts of interest perspective, we need to go through a few rather obvious steps. First, two parties to a contract have agreed on some plan of action together. Next, before performance is complete on both sides, at least one party, call her *B*, is faced with a choice: perform according to the plan, or carry out some other action (breach) that seems more beneficial (to *B*), but deprives *A* of his expectation of the plan being carried out.<sup>30</sup> This choice presents a conflict of interest: *B*'s perceived interest in the alternative, versus an interest (yet to be defined) encapsulated in the contract.

Assuming that *B* chooses her alternative and breaches the agreement, a regime of contract law is then faced with a choice of remedies. The law could decide that *B* is responsible to compensate *A* only for actual harm inflicted, for instance, out-of-pocket expenses incurred in reliance on the agreement.<sup>31</sup> This would be tantamount to declaring that the parties are still as

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<sup>29</sup> See, e.g., Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 Yale L.J. 28 (1913); Walter Wheeler Cook, *The Alienability of Choses in Action*, 29 Harv. L. Rev. 816 (1916); Arthur L. Corbin, *Assignment of Contract Rights*, 74 U. Pa. L. Rev. 207 (1926); Fuller & Perdue, *supra* note 6.

<sup>30</sup> Analytically, it makes no difference if the breach is carried out in order to pursue a positive alternative opportunity (say, selling the product for a higher price to a third party) or in order to avoid losses (say, not producing the product because production costs are unexpectedly high). In what follows, I will usually refer to the former example.

<sup>31</sup> I ignore the possibility of no remedy, since this would not be a regime of contract law, but a regime of no contract law. Even in such a regime, it is likely that tort principles would be invoked at least to require compensation of actual harm in the sense of out-of-pocket reliance expenses. Indeed, this was probably not far from

distinct as competitors: they have a duty only to refrain from inducing reliance resulting in loss. The contract itself, on this view, raises only a minimal nexus, one that is closely comparable to a duty of care: it has no inherent value worth protecting, except in that the parties to the contract are responsible for the harm they cause one another.<sup>32</sup> The conflict of interest envisioned here is between the benefit from the breach and the concrete harm (in the shape of actual expenses) to the aggrieved party. Of course, this regime of out-of-pocket reliance compensation is not the regime we are familiar with.

The more familiar alternative would be a regime of expectation damages. In this regime, *B* is responsible to "compensate" *A* by placing him in the economic position he would have enjoyed had the contract been performed. One may view expectation damages as based on harm caused to the aggrieved party, but the conception of *harm* has shifted critically from the tort-based or out-of-pocket reliance regime. In the expectation regime, the law recognizes the expected value of the contract as an interest that could be harmed and, indeed, as a joint interest of the parties. The parties themselves are joined, becoming in a sense co-owners of a contractual interest. A breach then represents disloyalty, not simply in the sense of harming a second party, but also in the sense of harming the other party's commitment to the joint contractual interest. Expectation damages respond

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the situation in fifteenth-century England (if not much later as well) for agreements not under seal. I emphasize out-of-pocket reliance expenses in order to make clear the distinction between such a regime and one that includes opportunity costs. Such a regime might closely approximate an expectation regime, especially to the extent that transactions are carried out in a well-developed market.

32 Charles Fried's arguments for expectation damages notwithstanding, this regime of out-of-pocket reliance compensation would be the ultimate libertarian ordering of contract. It would assume that the state intervenes only to protect a party from wrongful inducement to harm, completely analogous to tort, and that the "good" of promise-keeping is a strictly private matter. In this sense, the state would not be in the business of "enforcing" a vision of the good, just as it would not be in the business of creating an incentive for efficiency-enhancing behavior. A "right" to performance or its equivalent (expectation damages) must take the additional step of favoring one particular version of the "good" of being able to alienate entitlements in the future. See Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 Mich. L. Rev. 489 (1989). There is in the literature at least one full-fledged attempt to circumvent this necessary step by claiming that the very formation of a contract entails the present transfer of a *proprietary* right in the thing promised. See Peter Benson, *The Unity of Contract, in The Theory of Contract Law: New Essays* 118, 134-37 (Peter Benson ed., 2001). This is not the place to take issue with Benson's theory in detail, but this particular aspect is at odds with all common understandings of contract and, as far as I am able to judge, unsurpassable.

to *this* conflict of interest minimally, by quantifying the value of the joined interest and limiting damages to those that guarantee the aggrieved party his expected economic value from the agreement. An explanation of what I mean by minimal protection might be in order. Once the parties' plan for the future is recognized as an interest worth protecting, the law could go to all kinds of lengths to ensure performance.<sup>33</sup> But expectation damages do not mandate performance or, in some circumstances, even encourage it. As Holmes famously said,

The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses.<sup>34</sup>

Holmes here put his finger on the way that, in an ideal abstracted world, the expectation regime defines the *minimal liberal* union. The law recognizes a common interest and protects it, but only by guaranteeing its economic value: it recognizes each party's power to exit the union, at the price set by an objective valuation of the aggrieved party's expectation.<sup>35</sup>

Before considering additional remedies or the possible drawbacks of those already mentioned, it is important to note the difference between reliance damages and expectation damages that the conflicts of interest perspective offered here identifies. The choice between these damage measures is not simply a choice of how to protect a given interest. Instead, it is a determination that shapes the protected interest itself and, in so doing, shapes the parties, their degree of (in)dependence, their approach to fusion.

The way remedies shape protected interests becomes even more salient if we compare expectation damages to a common rival for primacy, namely, specific performance.<sup>36</sup> The real difference between a regime of expectation

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33 For instance, the law could provide remedies such as punitive damages or even imprisonment for breach of contract. For cases in the not-too-distant past where imprisonment was a contract remedy, see Robert J. Steinfeld, *Coercion, Contract, and Free Labor in the Nineteenth Century* 41-53 (2001).

34 Oliver Wendell Holmes, Jr., *The Common Law* 236 (Mark DeWolfe Howe ed., 1968) (1881).

35 On the connection between the value of *exit* and liberal values, see Dagan & Heller, *supra* note 3, at 567-70; Carolyn J. Frantz & Hanoach Dagan, *Properties of Marriage*, 104 *Colum. L. Rev.* 75 (2004). For an account of expectation damages as expressive of the collaboration inherent in the concept of contract, see Daniel Markovits, *Contract and Collaboration*, 113 *Yale L.J.* 1417, 1504-07 (2004).

36 See generally Kronman, *supra* note 19. For arguments that specific performance

damages and one of specific performance does not reside on the level of incentives for the breach-or-perform decision.<sup>37</sup> Instead, the difference lies in the extent to which the remedy recognizes and thus engenders a joint interest or, in other words, the extent to which it joins the parties. Specific performance entails a greater degree of joinder, in the sense that unexpected gains must be shared. Rather than freezing the joint interest at the expected value of the performance at the time of formation, specific performance lets the joint interest expand into the actual present, allowing the combined forces of the contract to capture not only objectively-established foreseeable gains, but also concrete and unexpected gains.<sup>38</sup> In this shift from a liability rule to a property rule, the crucial question is not that of transactions costs, but rather the normative question of what kind of interest is at stake. Should we prefer a regime that enhances liberal individuality with its emphasis on distinction and the right of exit or, instead, a regime that holds parties in a tighter bond of sharing, the bond of joint contractual interest?

## 2. Mitigations: Aligning Performance Incentives beyond Breach

The duty of aggrieved parties to mitigate the damages from breach is one

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may be a better default remedy than expectation damages, see Alan Schwartz, *The Case for Specific Performance*, 89 Yale L.J. 271 (1979); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 Mich. L. Rev. 341 (1984).

37 To see why, consider the following illustration. Assuming we still occupy a nether world of varied valuations and no transactions costs, let us consider a seller [S] and a first buyer [B], who contract for the sale of a machine at 100, and a second buyer [J], who offers the seller a price (say, 150) higher than the first buyer's subjective valuation of the machine (say, 120). In a regime of expectation damages, S sells to J, compensates B by paying expectation damages of 20, and pockets the additional gain of 30, beyond her expected profits from the contract with B. In a regime of specific performance, S does not, as some would assume, perform the contract with B. Instead, she renegotiates with B, dividing the surplus from the sale to J instead of keeping it to herself. Either way, the efficient result is reached, and J, the highest valuer, attains the machine. The only reason to conclude that breach with expectation damages might be preferable from an efficiency perspective in this scenario is the assumption that transactions costs between S and B are high enough to thwart the deal with J. For an extended discussion of the role of transactions costs in the model of efficient breach, see Ian R. Macneil, *Efficient Breach: Circles in the Sky*, 68 Va. L. Rev. 947 (1982).

38 Significantly, it does so even though the aggrieved party, B in our example in *supra* note 37, never bargained for extra benefits or contributed to their realization. While it is possible to plug the possibility of a specific performance regime into the pricing mechanism, the new opportunity is often truly unexpected, and in that sense, B's payment would be negligible if at all existent.

of the easiest contract doctrines to conceptualize within the framework of conflicts of interest.<sup>39</sup> When one party has breached the contract, the aggrieved party is not free to engage in behavior that would increase its damages and, in a sense, not even free to sit idly by while the injury grows.<sup>40</sup> The underlying meaning of such a doctrine is clear: parties to a contract may owe each other a duty to undertake unexpected actions, including expenses, in order to minimize the costs of unexpected contingencies such as breach. In other words, the law recognizes a joint contractual interest, one that does not translate straightforwardly into the expected value of performance of the contract. Instead, the joint interest is a fluctuating and flexible entity, to which the parties owe some type of loyalty. Refusal to act to minimize the costs of a contingency in the anticipation that the breaching party will make full compensation is behavior that exhibits a conflict of interest, a disloyalty to the joint contractual interest. As in the determination of the regime of remedies, fixing the level of activity required by the aggrieved party entails a normative choice regarding how closely bonded the parties to the contract will be.<sup>41</sup>

The more interesting aspect of mitigation from the conflicts of interest perspective is the way the principle may be generalized, adding nuance both to any remedial regime and to the elaboration of duties of contractual performance.<sup>42</sup> I offer one brief illustration here, though the examples could be multiplied. Let us consider the remedial regime characterized by expectation damages. Scholars have pointed out that while expectation damages may offer adequate incentives for the breach-or-perform decision by the promisor, they

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39 Of course, analytically, the aggrieved party is under no *duty* to mitigate damages. There is only the rule that damages that could have been mitigated by the exertion of reasonable efforts are not compensable. From the perspective of incentives, there is no difference between the two, and thus no normative significance attaches to the question of whether the rule on mitigation is independent or actually derives from a view of causation that holds that if the aggrieved party could have mitigated or avoided a given loss, that part of the injury was not *caused* by the breach.

40 Restatement (Second) of Contracts § 350 (1981).

41 For instance, will the aggrieved party be under a duty to undertake expenses disproportionate to its investment in the contract in order to mitigate damages? Will the duty extend to taking small losses in order to save the breaching party extremely large losses? The scope of the doctrine in the courts is far from certain, despite the fact that the principle itself is well-established.

42 The foundational analysis of the applicability of the principle of mitigation to performance duties generally is Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 Va. L. Rev. 967 (1983). Their joint cost minimization model of adjustment to contingencies, including attempts to overcome strategic behavior, is in essence a model of contract law based on a conflicts of interest perspective.

may actually distort incentives of the promisee and induce over-reliance.<sup>43</sup> Over-reliance is best understood as a conflict of interest problem. Knowing that his damages in case of breach will be pegged to actual expectation, the promisee plans his reliance expenditures as if contract performance were a certainty, rather than discounting for the probability of breach. One response might be to say that a promisee *should* be allowed to treat his contract partner as an insurer of performance, precisely because the parties to a contract remain in a completely adversarial mode throughout performance. If, however, the contract itself is seen as creating a joint interest, maximizing that joint interest requires the promisee to consider the possibility of breach when making his reliance (and precaution) investments. The difficulty for contract law is how to generate an incentive for such accounting, in the face of conflicts of interest. One possibility would be through an expansive interpretation of the rule regarding mitigation of damages: a level of damages beyond what would have resulted from efficient reliance expenditures could be restricted.<sup>44</sup> An analogous set of problems arises in the context of choosing a mode of readjustment when a contingency makes breach likely. If the potentially aggrieved party is assured full expectation damages, he may be unwilling to cooperate to adjust to the contingency in a manner that minimizes the joint costs of responding to it.<sup>45</sup>

### 3. Summary

The extended analysis of contract remedies should allow us to proceed more quickly through other areas of contract doctrine. Before going on to those other issues, however, it seems worthwhile to recapitulate the advances offered by the analysis of remedies. The upshot of the conflicts of interest analysis of remedies is that a normative inquiry into remedies is

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43 Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 Cal. L. Rev. 1, 11-18 (1985); Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 Cal. L. Rev. 1432, 1464-68 (1985). For a technical elaboration of the problem, see Robert Cooter & Thomas Ulen, *Law and Economics* 248-58 (3d ed. 2000). For the argument that the problem of over-reliance is not generally significant, see Melvin A. Eisenberg & Brett McDonnell, *Expectation Damages and the Theory of Overreliance*, 54 Hastings L.J. 1335 (2003).

44 Traditionally, the rule on mitigation has been applied only to action subsequent to the breach, whereas this interpretation would require application to actions prior to the breach. And, while it is unlikely that courts will delve deeply into the promisee's investment calculus prior to breach, they might see extreme levels of reliance as unreasonable, especially in unusual cases where the probability of breach is significant. See Goetz & Scott, *supra* note 42, at 975, 989-90.

45 See *id.* at 979-81.



in essence two-pronged. One stage involves a normative choice regarding the scope and meaning of the common interest through which parties to a contract are joined. This choice is straightforwardly political. We may have all sorts of reasons to espouse or reject regimes where parties quickly or gradually meld into one another, where joint interest and solidarity encroach upon and perhaps eventually replace individual, discrete interests. Similarly, we may have reasons to espouse or reject a regime that disintegrates the organic ties that bond communities of interest, breaking them down into smaller, atomistic particles that resemble the abstracted individuals of classical political economy.<sup>46</sup> In either case, the law is not the only factor in constituting individuality or any other element of social life — but at the same time, it is not simply a technique that acts on a preexisting and stable world. It is one factor in shaping the entities that will be recognized (and will recognize themselves) as communities, individuals, or other units, and not simply a reflection of a known, existing world. The second stage involves some of the same considerations, but is concerned primarily with the fine-tuning required to assure the alignment between the type of interest we want to pursue in the framework of the contractual relationship and the tools for achieving it. This stage must take into account institutional concerns, for example, the relative competence of legal actors, the ease of administering particular rules, the possibility of unintended consequences, just to name a few. It is important not to slip into thinking that the first phase is simply required by a vision of efficiency; that vision of efficiency needs a baseline that rests on a political decision regarding what kinds of units or interests are at stake.<sup>47</sup>

## B. Modification

A basic puzzle of first-year contracts classes revolves around the question of which modifications of existing contracts should be enforceable.<sup>48</sup> The traditional common law discussion centered around the doctrine of

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46 For the argument that such choices are argued and reargued, made and remade, in almost all significant private law adjudication, see Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 Harv. L. Rev. 1685 (1976).

47 See Duncan Kennedy & Frank Michelman, *Are Property and Contract Efficient?*, 8 Hofstra L. Rev. 711 (1980).

48 The thing that makes the modification problem such a gem for first-year classes is that it begins as a pure doctrinal problem, with a series of complications that often yields surprising and possibly maddening results; it then blossoms into a discussion of policy (regarding duress or extortion) that seems like it will save the day, putting order into the chaos. But the policy discussion turns out to be very partial and ends up raising many of the same questions posed by doctrine in a new form, without

consideration and, in particular, around the preexisting duty rule.<sup>49</sup> Better understanding of the issue was advanced by the legal realists who taught that the underlying issue is akin to duress or to extortion of a favorable modification by one party.<sup>50</sup> Economic analysis and relational contracts scholarship have undertaken a maneuver closely related to the one I pursue here: while not using the terminology of conflicts of interest, they have analyzed the desirability of modifications and their enforcement on the basis of an investigation into opportunism.<sup>51</sup> Rather than inquiring into the doctrinal niceties of whether a particular modification offers the promisor something, however minimal, as consideration or on the question of whether there was a voluntary rescission of the initial contract alongside its replacement by a new one, a conflicts of interest analysis asks primarily whether the joint contractual interest is enhanced by the modification. While such an inquiry will not always yield easy answers, it does recast the questions in a way that avoids blurring the policy objectives the law might try to achieve.

An example should clarify the difference among the various approaches and the advantages of the conflicts of interest analysis. In *Rexite Casting Co. v. Midwest Mower Corp.*,<sup>52</sup> Rexite agreed to supply lawnmower frames to Mower. A year into performance of the contract and after filling about one-fifth of the order, Rexite demanded a price increase of approximately 50% per frame due to increased metal costs that it had not foreseen when negotiating the contract. Mower had outstanding orders for lawnmowers to fill and its immediate search for someone to replace Rexite turned up producers who would need months to produce the frames that Mower needed. Faced with the prospect of having to shut down production, Mower continued to order through Rexite, but when the season ended and there was time for new production, it terminated the contract and refused to pay the additional price agreed to in the modification. The court limited itself to an analysis of contract doctrine narrowly construed, searching for any change in Rexite's preexisting duty under the contract as opposed to under the modification. Finding none, it

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necessarily offering clear answers. The economic analysis then becomes another stripe in this policy discussion.

49 See *Foakes v. Beer*, 9 App. Cas. 605 (1884).

50 See Restatement (Second) of Contracts §§ 73, 89 (1981); 1A Arthur L. Corbin, *Corbin on Contracts* § 171 (1963).

51 See Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 Minn. L. Rev. 521, 532-52 (1981); Varouj A. Aivazian, Michael J. Trebilcock & Michael Penny, *The Law of Contract Modification: The Uncertain Quest for a Bench Mark of Enforceability*, 22 Osgoode Hall L.J. 173 (1984); Macneil, *Contracts: Adjustment of Long-Term Economic Relations*, *supra* note 20, at 873-76.

52 267 S.W.2d 327 (Mo. App. 1954).

held the modification invalid for a lack of consideration.<sup>53</sup> An analysis inspired by duress might have come to the same conclusion: Mower had agreed to fulfill outside orders based on Rexite's promise to perform, and the frames were not easily replaceable. Thus, Mower was, as the court put it, "over a barrel" and under extreme pressure to agree to the modification.<sup>54</sup>

The conflicts of interest perspective throws a different light on the issue. The question from this perspective is whether the modification enhanced the joint interest or whether it was simply an opportunistic maneuver to redistribute the contractual surplus. In order to see that even a simple price increase might have enhanced the contractual interest, all we need to do is assume that Rexite's "threat" to stop production if the increase was not forthcoming was credible. If, for example, continued production at the original contract price would have caused Rexite losses significant enough to drive it into bankruptcy, Mower's acquiescence would make good business sense: it would not only avoid costly breach of its own supply contracts, but it would also avoid having a nearly worthless claim against Rexite in bankruptcy.<sup>55</sup> The fact that there is a net benefit resulting from the modification is not enough to decide its enforceability. There is still an important distributive question that needs to be answered, and that question, in turn, entails a reevaluation of the shared contractual interest. Should the contractual interest be conceived of as a commitment to share broadly in the economic contingencies that affect the actors, bringing them close to a partnership model, or should the interest be conceived of as a pure allocation of risks between two separate entities who remain completely distinct? Imagine two scenarios. In the first, two firms who have no prior dealings and expect no future dealings contract for the sale of lawnmower frames. In the second, two firms have extensive long-term relations of which the lawnmower frames are a significant but partial manifestation. In the first scenario, the modification seems unlikely, and a broad interpretation of the contractual interest seems like an externally forced imposition; in the second, the modification seems almost routine and the broad interpretation rings true to expectations from economic allies who expect to help each other through hard times. But which scenario

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53 *Id.* at 330-31.

54 *Id.* at 329.

55 If we further assume that Rexite is experiencing financial rather than economic problems (i.e., problems supporting its debt, even though its production can still be profitable), then a bailout by a creditor — or, in this case, a buyer of products — makes economic sense for all the parties. However, since what is at stake is a change in contract price rather than interim financing, there is an open distributive question that still needs to be addressed.

is the right one for the case at hand? Deciding the matter may be difficult, but the very willingness to accept the modification may be an indication.<sup>56</sup> The conflicts of interest analysis allows us to keep sight of the most significant implication of the decision, which is to what extent contracting parties are joined in responsibility for one another.

### C. Conditions

The crucial issue in the law of conditions is the distinction between a condition and a duty or a promise. Analytically, a condition is "some operative fact subsequent to acceptance and prior to discharge ... upon which the rights and duties of the parties depend."<sup>57</sup> In other words, a condition is a fact that must exist before the promisor's duties come into being. The distinction between condition and duty is crucial because the aggrieved party's remedies in either case will be fundamentally different. A condition that does not come into being will discharge performance obligations, but will not yield any right to damages for breach. For example, in *Sturges v. System Parking*, a real estate broker (Sturges) agreed on a commission of a percentage of the management fees paid to the property owner (System) according to a contract with a management company (Hyco) secured by the broker. Actual payment by the management company was delayed indefinitely due to a subsequent agreement with System. The question for the court was whether payment by the management company was a condition of System's liability or whether System undertook a duty to pay the percentage of its entitlements

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56 Note the difference implied here between a conflicts of interest analysis and the previous analyses based on opportunism. By claiming that modifications are acceptable when the conditions of frustration or impracticability apply, the latter analyses collapse two distinct inquiries. See Aivazian, Trebilcock & Penny, *supra* note 51 (calling enforceable modification a substitute for the doctrine of frustration). The conflicts of interest analysis here is more nuanced: even where the conditions would not amount to frustration, the acceptance of a modification may be an indication that the relationship between the parties was significant enough to warrant the modification. In fact, the position here is that in cases where the relationship has such significance, the *ex post* benefit is a more important consideration than the possibility that the availability of modifications may decrease the parties' welfare *ex ante*. For analyses of how modification rules affect the parties' incentives, see Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. Legal Stud. 203 (1997); Jason Scott Johnston, *Default Rules/Mandatory Principles: A Game Theoretic Analysis of Good Faith and the Contract Modification Problem*, 3 S. Cal. Interdisc. L.J. 335 (1993).

57 Arthur L. Corbin, *Conditions in the Law of Contract*, 28 Yale L.J. 739, 743 (1919) (emphasis omitted).

from the contract. In deciding in favor of the broker and holding that System had a duty to pay, the court relied in part on the traditional rule that "[i]n construing a contract, forfeiture by finding a condition precedent is to be avoided when another reasonable reading of the contract is possible." Interestingly, the court expands on the rationale:

In the instant case, System and Hyco [the management company] modified the management agreement to indefinitely postpone the management fee. In doing this, System is basically spreading the risk of non-payment to Sturges who was not party to the management agreement. The risk of non-payment should rest with System who contracted with Hyco, rather than on Sturges who has no privity of contract with Hyco.<sup>58</sup>

While the court seemingly complicated its doctrinal analysis (for instance, by pointing to issues of privity), this justification for its holding is actually a gesture toward an underlying idea of a conflict of interests: there is one contractual joint interest between Sturges and System. By trying to shift the costs of its relationship with Hyco onto Sturges, System is acting opportunistically and betraying its duty of loyalty to the initial brokerage contract. And this rationale can be generalized to explain the disparate preferences of courts regarding interpretation of conditions and promises. The preference for duty, the preference against forfeiture, the ease with which behavior is often (but not necessarily predictably) interpreted as a waiver of a condition, and the "presumption that the performing party would not have wanted to put himself at the mercy of the paying party's whim"<sup>59</sup> are all instances of an attempt to regulate the potential conflict of interest. Indeed, if it were clearly acknowledged that this was a primary goal of distinguishing between conditions and promises (or duties), a sense of clarity might be brought to bear in an area rife with seeming arbitrariness.

#### **D. Good Faith in Performance**

The Uniform Commercial Code and the Restatement (Second) of Contracts establish good faith in the performance of contracts as a central pillar of American contract law.<sup>60</sup> While the meaning and proper scope of

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58 834 S.W.2d 472, 474 (Tex. App. 1992).

59 *Morin Bldg. Prods. Co. v. Baystone Constr.*, 717 F.2d 413, 415 (7th Cir. 1983). For a discussion of the preferences in interpreting conditions and duties, see E. Allan Farnsworth, *Contracts* 530-40 (3d ed. 1999).

60 U.C.C. § 1-203 (2000); Restatement (Second) of Contracts § 205 (1981).

the obligation to perform contracts in good faith are contested, the basic framework for the operation of the doctrine seems widely agreed upon. That framework views good faith as a mechanism for interpretation and supplementation of incomplete agreements. When contract language is unavailable or unclear, the obligation of good faith may be used to hold parties to the spirit of the deal, to prevent sharp dealing or chiseling, to prevent overreaching interpretation, or to prevent attempts to use technicalities to avoid contractual obligation.<sup>61</sup> In contrast with the doctrine of unconscionability, good faith is not a doctrine designed to police the market by shielding the weak from the excessive bargaining power of the strong. Instead, good faith is designed to police the behavior of the parties within the contractual relation, limiting the discretion of one party vis-à-vis the other.<sup>62</sup>

In order to better understand the content of the obligation of good faith, scholars and judges have turned to an analysis based on opportunism. Judge Posner characterized the obligation thus: "The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule."<sup>63</sup> And one of the most popular scholarly treatments of good faith claimed that the role of the obligation is to prevent the use of contractual discretion "to recapture opportunities forgone upon contracting."<sup>64</sup>

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61 See generally Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195 (1968).

62 A treatise devoted to good faith in contracts sets out the distinction clearly:  
 The good faith performance doctrine thus may be used to protect a "weaker" party from a "stronger" party. Unlike the unconscionability doctrine, however, weakness and strength in this context do not refer to the substantive fairness of the bargain or to the relative "bargaining power" of the parties. Unconscionability gives the courts latitude to refuse to enforce all or part of an agreement that is not a product of meaningful choice by both parties or that is so one-sided in its terms as to favor one party unreasonably at its inception. It is a limitation on freedom of contract that allows the courts to police the bargaining relationship and to override the agreement of the parties in the interests of justice and public policy. It is a mistake to think that, because unconscionability and good faith emerged in this century and are stated in vague terms, one is a post-formation counterpart to the other. Good faith performance cases typically involve arm's-length transactions, often between sophisticated business persons. The relative strength of the party exercising discretion typically arises from an agreement of the parties to confer control of a contract term on that party. And ... good faith generally is used not to override the parties' agreement, but rather to implement it.

Steven J. Burton & Eric G. Andersen, *Contractual Good Faith* 50-51 (1995).

63 *Market St. Assoc. v. Frey*, 941 F.2d. 588, 595 (7th Cir. 1991).

64 Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369, 373 (1980). See also *Muris*, *supra* note 51, at

Indeed, as should be clear from the analysis up to this point, the examination of good faith or any other doctrine from the perspective of opportunism has much in common with the perspective of conflicts of interest. But there is a crucial difference. According to the popular analysis based on opportunism, the doctrine of good faith is "a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties."<sup>65</sup> The standard analyses based on opportunism rely heavily on fixing the parties' obligations at the time of formation. Accordingly, they look to the contract language for guidance, and when such guidance runs out, they revert to a hypothetical analysis of the parties' intentions. In general, such analyses rule out the possibility that opportunism will be judged, not according to the parties' preferences at the time of contract formation, but rather at the time of the action (possibly breach) in question.

The conflicts of interest analysis advanced here opens the door to expanding the consideration of opportunism, because it at least asks the question of what the contractual interest actually is: because the contractual interest may be different at formation and during performance, especially in contracts with significant relational elements, there may be good reasons to prefer protecting an interest that simply was not present at formation but arose during performance, even if similarly situated parties would prefer a different contract *ex ante*.<sup>66</sup> One reason is that protection of the interest *ex post* may be more valuable than the anticipated *ex ante* distortion of

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552-56 (arguing that the deterrence of opportunism provides a more rigorous basis for identifying bad faith behavior than other theoretical approaches).

65 Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) (emphasis added).

66 This discussion may be read as an oblique reference to the dispute over the incorporation of relational norms into contract disputes. Arguments against incorporation rely primarily on the idea that incorporation may not be efficient, and if so, parties would not prefer it if given the choice *ex ante*. See Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. Rev. 847 (2000); Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. Chi. L. Rev. 710 (1999); Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. Chi. L. Rev. 781 (1999). This position, however, places undue emphasis on one function of judicial decision in contracts disputes, namely, laying down rules for future contracts and thus providing incentives for future contractors. The position accords little or no weight to two other functions of judicial dispute resolution: fairness as between the parties in deciding the dispute and the expressive function of judicial pronouncements. My claim here is that when efficiency tradeoffs are not excessive, there will be good reasons to prefer results that do better along these two additional dimensions. For the argument that interpretation should consider elements of the agreement that arise

incentives. This is particularly so when the *ex post* determination is based on facts unlikely to replay themselves in new relationships. To the extent that a judicial decision is fact-specific (i.e., based on special facts), its incentive effects on distant parties will be minimal. Therefore, the benefit to the actual parties before the court may outweigh the incentive effects of the decision.

### E. Formation, Negotiation, and Reliance

Contractual negotiations are a site of transition at which parties legitimately concerned with their individual interests may create a nexus or joint interest requiring some form of legal protection. There are (at least) two phases worth distinguishing in the development of such negotiations. At the earliest stages of negotiation, parties to a potential contract conduct negotiations whose main goal is information gathering. During this phase, the parties bear the duties typically accorded to competitors, for instance, to avoid direct fraud or other tortious behavior. At some point during the process, however, the nature of the negotiations begins to shift and enters into a second phase, as parties begin making investments in reliance on the expected contract. The dynamics of negotiations are often such that the point at which the parties become bound to one another is unclear. A number of contract doctrines, ranging from promissory estoppel through the rules on what constitutes an offer, what constitutes an acceptance, when the power of acceptance terminates, the status of counteroffers, and others, are implicated in the decision as to whether such reliance is protected or not. Economic analysis has shown that such investments have the potential to increase the value of the relationship, such that both parties may have an economic interest in the protection of such reliance.<sup>67</sup> In contrast, entitlements theorists have vigorously opposed contractual liability based on reliance, especially reliance that precedes explicit consent to be bound.<sup>68</sup>

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after formation, see Dennis M. Patterson, *Good Faith and Lender Liability* 145-55, 189-98 (1990).

67 Articles devoted to this issue include Avery Wiener Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 *Yale L.J.* 1249 (1996); Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 *Stan. L. Rev.* 481 (1996); Lucian Arye Bebchuck & Omri Ben-Shahar, *Precontractual Reliance*, 30 *J. Legal Stud.* 423 (2001); Jason Scott Johnston, *Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation*, 85 *Va. L. Rev.* 385 (1999). Earlier work that pointed to the joint interest in pre-contractual reliance includes Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 *Yale L.J.* 1261 (1980).

68 Benson, *supra* note 32, at 177; Randy E. Barnett, *Foreword: Is Reliance Still Dead?*,



At first sight it may be a bit puzzling what entitlements theorists and economists are really arguing about. The confusion arises in part because entitlements theorists seem to be concerned with doctrinal categories (if there is liability, should it be in tort rather than contract?), while economists seem deaf to such considerations. But the question of categorization is really a side show. The conflicts of interest perspective reveals that the underlying quarrel is over the question of whether to recognize a joint interest between the parties. Entitlements theorists want to use the rules regarding formation of such a joint interest as shields for autonomy.<sup>69</sup> Economists, for their part, are willing to see the law governing contract formation as a framework for cooperation, where imposing responsibility toward the joint interest may be justified by the fact that such imposition generates new value. A conflicts of interest analysis foregrounds the malleability of the joint interest: in some cases, it is significant, while in others it is not. Such an analysis seems to call for a case-by-case examination of the facts, avoiding a bright-line, one-size-fits-all rule of liability or no-liability.<sup>70</sup> The conflicts of interest analysis puts more emphasis on the question of whether a joint interest worth preserving has arisen between the parties and somewhat less emphasis on the question of how distant parties will respond to a particular, fact-sensitive judicial decision.

## F. Summary

The foregoing discussion of varied contract doctrines contains a unifying theme that brings together a conceptual and a normative claim. The conflicts

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38 San Diego L. Rev. 1 (2001); Randy E. Barnett, *The Death of Reliance*, 46 J. Legal Educ. 518 (1996).

69 In this setting, their main difficulty becomes one of defending the autonomy of the non-relying party while not invading the autonomy of the relying party, assuming her reliance was reasonable. For an indication of the difference of opinion on this score within the entitlements theory camp, compare Charles Fried, *Contract as Promise* (1981), with Randy E. Barnett, *A Consent Theory of Contract*, 86 Colum. L. Rev. 259 (1986).

70 This picture becomes more complicated when we consider the details. While such an analysis is antithetical to a strict bright-line rule that disregards significant reliance, it is open to two different alternatives. According to one, judges should examine reliance decisions *ex post*, finding liability where they deem such decisions justified (whether on the basis of conventional understandings of inducement of reliance or on the basis of efficiency). This is the solution advocated by Craswell, *supra* note 67. According to the other alternative, judges should assign the costs of pre-contractual reliance to the party with greater *ex post* bargaining power. This solution is advocated by Katz, *supra* note 67.

of interest analysis takes its starting point from the existence, or at least the potential existence, of a relationship-specific joint interest between the contracting parties. Legal recognition and protection may be part of what brings this interest into existence, and they play a major role in instilling value into the interest. Such a relationship-specific interest typically arises in relational contracts, but the joint interest is double-edged. On the one hand, preservation and nurturing of the interest itself serve the parties, thus aligning their reasons for action. On the other hand, the existence of the joint interest provides a temptation to attempt to exploit the larger share of the interest, either by contributing less to its preservation and growth or by extracting more of the surplus. A recurrent argument in this part of the article has been that as the joint interest grows and almost takes on a life of its own, it should become a principal focus in deciding disputes between the parties. In other words, as the relational context thickens, the reasons for advertent to *ex ante* analysis of incentives become less compelling. The joint interest is fact-specific (making a judicial decision easy to distinguish on the facts); the parties themselves have much to lose if the outcome is unjust between them (by definition, they have a significant joint interest); and they are likely to be in dispute precisely about the elements of their relationship that they could not plan successfully in advance.

This view of the joint interest that may arise in the relational contract setting highlights the role of contract law as supplying a framework for cooperation. By underscoring the existence and possibly the independence of the joint interest, the analysis points to one of the effects of contractual solidarity, which is to assist in the creation of value that the parties could not achieve on their own. Part of that value could be the knowledge that they live in a society where people rely on one another safely; but the value I have concentrated on is more localized, residing in the joint interest created by the relationship. That interest may be difficult to measure or divide and yet may be palpable to the parties or their surroundings.<sup>71</sup> A decade ago, a leading law and economics scholar expressed frustration with the work of relational contracts scholars, explaining that they avoided grappling with the questions he was interested in, questions revolving around the effects that contracts rules would have on the behavior of contracting parties.<sup>72</sup> This part has been

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71 In the bankruptcy context, something like this difficult-to-measure-or-divide joint interest is routinely discussed and termed the "going concern value." Why such an interest has received less attention in contract is something of a mystery.

72 Richard Craswell, *The Relational Move: Some Questions from Law and Economics*, 3 S. Cal. Interdisc. L.J. 91, 91, 98-99 (1993).

an attempt to engage in such a grappling, exploring the limits of economic thinking on contract without forgetting the importance of incentives.

### **III. COMING TOGETHER, COMING APART: AN ANALYSIS OF CORPORATE ACQUISITIONS AND CORPORATE BANKRUPTCY**

This part of the article discusses the ways that conflicts of interest are implicated in two fact situations: corporate acquisitions and corporate bankruptcies. Whereas the focus of Part II was an analysis of doctrine, this Part analyzes the convergence of a number of doctrines in particular contexts. Again, the reason for an analysis of this sort rests on arguments developed by legal realists, who showed that the abstraction inherent in reasoning from doctrine can generate blind spots for legal analysis generally.<sup>73</sup> I begin with corporate acquisitions, which offer an almost obvious case for analysis from the perspective of conflicts of interest. A dominant feature of the market for corporate control is that it highlights the potential conflict of interest between management and shareholders. However, as the analysis will show, the conflicts of interest perspective illuminates more than just this dominant feature.

#### **A. Acquisitions, Lockups, and Remedy Rules**

Corporate acquisitions are complex transactions with high stakes and many opportunities for breakdown. The players in the market for corporate control are well aware that an agreement of sale is only the first step toward consummation of the deal. In order to mitigate the possibility of a conflict of interest between the target's management and its shareholders, management has to bring the proposal before the shareholders for approval. This primary conflict of interest arises because management may have engaged in the transaction because the acquirer promised post-transaction benefits (e.g., retaining current management or replacing it on favorable terms). In many cases, the transaction also requires approval by regulatory agencies. Moreover, while the various forms of review of the transaction are taking place, there is a significant likelihood that competing offers will be tendered. Any of these eventualities may contribute to the breakdown of the initial transaction. Thus, the acquirer's costs in identifying the target

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73 For a developed version of the realist argument, see Karl Llewellyn, *Our Case-Law of Offer and Acceptance*, II, 48 Yale L.J. 779, 779-83 (1939).

company and its legal, accounting, and financing expenses are in jeopardy, often for significant amounts of time.

In order to protect its investments, the acquirer typically bargains for and obtains deal-protective measures in merger agreements. These protective measures come in many forms, ranging from no-shop provisions (whereby target management agrees not to solicit competitive bids), to stock or asset lockups, to simple termination fees or combinations of these and other measures.<sup>74</sup> The various measures are designed to raise the likelihood of consummating the deal and, as a second best option, to ensure that the acquirer receives compensation if the deal falls through.<sup>75</sup> Because of the importance of such provisions for shareholders, their potential to distort the market for corporate control, and the potential for managerial self-interest, courts have applied enhanced scrutiny in passing on the validity of such provisions.<sup>76</sup>

Originally, evaluation of deal-protective measures in the case law concentrated on corporate law, focusing primarily on whether management of a target corporation had violated its fiduciary duties to shareholders by agreeing to asset or stock lockups. Early scholarly treatment of the issue followed suit, but expanded the inquiry by asking whether stock lockups are an obstacle to the functioning of a market for corporate control.<sup>77</sup> Recently, scholars have begun to focus on the interplay between contract and corporate law in evaluating deal-protective measures.<sup>78</sup> The meeting of corporate law and contract law in this setting is especially interesting from a conflicts of interest perspective, because rules that are designed to combat conflicts on

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74 For a detailed description of available protective provisions, see John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 *Stan. L. Rev.* 307 (2000).

75 Deal-protective measures always impose a cost on the target if it does not carry out the original transaction. Since the target (or its successful late bidder) must absorb this cost, the protective measure can make the target that much less attractive to other would-be bidders.

76 See, e.g., *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

77 See, e.g., Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions*, 90 *Colum. L. Rev.* 682 (1990).

78 See, e.g., Celia R. Taylor, *When Good Mergers Go Bad: Controlling Corporate Managers Who Suffer a Change of Heart*, 37 *U. Rich. L. Rev.* 577 (2003); Judd F. Sneirson, *Merger Agreement, Termination Fees, and the Contract-Corporate Tension*, 2002 *Colum. Bus. L. Rev.* 573; Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups*, 21 *Cardozo L. Rev.* 1 (1999); Celia R. Taylor, *A Delicate Interplay: Resolving the Contract and Corporate Law Tension in Mergers*, 74 *Tul. L. Rev.* 561 (1999).

one plane may exacerbate conflicts on another. The traditional concerns of corporate law — in particular, safeguarding shareholders' interests in the face of managerial discretion — are in tension with equally traditional goals of contract law — i.e., protecting party expectations. A closer look at the stages of the transaction and the conflicts it engenders should clarify.

As already mentioned, the initial acquisition agreement raises the specter of a conflict of interests between the target's management and its shareholders. This could be because the acquisition agreement may be based on promises to existing management that it will not be replaced. In return for such a promise, management may be willing to accept a bid for the company that does not reflect the corporation's true value. This conflict of interests is ostensibly neutralized by the provision that any acquisition agreement must be approved by the shareholders. However, shareholder approval may be an ineffective mode of policing managerial discretion, especially if management can deter competitive bids by agreeing to deal-protective measures such as asset or stock lockups. Thus, the courts' initial suspicion of deal-protective measures is based on the awareness that such measures may allow management to circumvent its fiduciary duties to the shareholders by agreeing to an acquisition that does not maximize shareholder profit.<sup>79</sup>

However, the basic conflicts problem attended to by managers' fiduciary duties is not the whole picture, for it focuses only on the relationship between the managers and the shareholders of the target. A more complete story must offer, in addition, some account of the relationship between the acquirer and the target. That relationship is contractual, and as recent scholarship has highlighted, the standard deal-protective measures involved are akin to complex liquidated damage provisions.<sup>80</sup> The contractual spotlight offers courts a new vehicle with which to evaluate a deal-protective provision, as it instructs them to gauge whether the provision corresponds to a reasonable estimate of actual damages in case of breach, in which event the provision should be upheld. But in order to make such an estimate, we need to revisit the method for calculating damages in the merger context. This is where the conflicts of interest perspective will be useful as an explanatory device with discrete normative implications.

The question of appropriate damages for the breach of an acquisition agreement may be approached from either *ex post* or *ex ante* angles of inquiry.

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79 See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

80 See *Sneirson*, *supra* note 78; *Regan*, *supra* note 78.

*Ex post*, we are concerned with balancing the interests of shareholders of the target, on the one hand, and the expectations of the acquirer, on the other. Granting full expectation damages would inflict the same injury on the shareholders that a preclusive lockup would have. If the managers' fiduciary duties are not to be circumvented, the obvious starting point for the inquiry is that some reduction of damages is necessary, if damages are to be assessed at all. The more difficult question is how to compensate the acquirer for her investments in the transaction if the deal falls through. The problem is especially salient from a fairness perspective, because the acquirer has often created a market for the target.<sup>81</sup> Recent scholarship has begun to converge around reliance as the best compensatory measure in the merger context.<sup>82</sup> The conflicts of interest perspective helps to explain why. The merger agreement is in essence a preliminary agreement. Technically, it is a contract conditioned upon the approval of shareholders (and possibly regulators). Substantively, the possibility of better offers also limits the likelihood of consummation. When the parties to a contract realize in advance the preliminary and tentative nature of the agreement, only reimbursement of the costs of entering the agreement represents a fair result.<sup>83</sup> Reliance is the best standard from the compensation perspective because "it better approximates the real consequences of breach to an initial bidder than an expectation measure would."<sup>84</sup> The reason is that the expectation interest in this context is "too flimsy to count as a full-fledged

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81 It is on the basis of one acquisition offer, with its background in research, that the potential for an auction situation is created. When management is actually interested in becoming a target for acquisition, it may even lure a potential acquirer as a stalking horse in order to generate the highest bids possible.

82 See, e.g., David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 Nw. U. L. Rev. 564 (1996); Regan, *supra* note 78, at 117-19; Sneider, *supra* note 78, at 624-26.

83 When faced with a breach of an agreement to negotiate in good faith, or "an agreement to agree," the appropriate remedy is reliance damages. See E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum. L. Rev. 217, 267 (1987) ("But the appropriate remedy [for a breach of an agreement to negotiate] is not damages for the injured party's lost expectation under the prospective ultimate agreement but damages caused by the injured party's reliance on the agreement to negotiate."). See also *Venture Assocs. Corp. v. Zenith Data Sys. Corp.*, 96 F.3d 275 (7th Cir. 1996). For the argument about why this might be the appropriate rule even from the perspective of the party held liable when it did not agree to a binding agreement, see Craswell, *supra* note 67.

84 Skeel, *supra* note 82, at 596. For an extensive, detailed analysis of the fairness of lockups and breakup fees, including an endorsement of reliance damages as the proper tool of analysis when balancing shareholder interests and acquirers' contractual interests, see Regan, *supra* note 78. Regan's treatment of the analogy

entitlement the violation of which should be treated as analogous to the violation of a property right."<sup>85</sup> An agreement that is in itself conditional on approval of shareholders simply does not create a sufficient communal interest between the parties to the negotiation to warrant full expectation-based compensation. And the lack of a strong common interest is exacerbated by the fact that full expectation-based compensation would undermine the prior relationship, itself based on loyalty, between two distinct elements (management and shareholders) that comprise one of the contracting parties. The reduced damages measure thus serves to highlight a partially existing perception and, more importantly, to define the common interest as a limited one: leaders cannot always make communities.

The *ex ante* angle of inquiry leads us to similar results. Analysis of the incentives provided by rules governing damages for breach of contracts has led to a widespread acceptance of two propositions: first, the rule of expectation damages will normally give promisors optimal incentives in deciding whether to breach; and second, reliance damages are better suited to inducing the optimal level of reliance expenditures by the promisee.<sup>86</sup> A decision regarding whether to adopt the expectation or reliance measure is then sometimes framed as a question about which incentives are most important to the kind of transaction in question: incentives regarding the breach/perform decision or incentives regarding the precaution/reliance expenditure decision. While incentives for these two decisions are often considered to be in tension, in the case of merger agreements both sides of the equation point to the efficiency of reliance damages. The promisee (the acquirer) must make

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to fairness arguments in related contexts of excuse, particularly when dealing with agents and trustees, is especially illuminating.

85 Leo Katz, *What to Compensate? Some Surprisingly Unappreciated Reasons Why the Problem Is So Hard*, 40 San Diego L. Rev. 1345 (2003). In this context, I do not mean simply to rely on preexisting moral intuitions about whether the interest is "flimsy." Instead, my claim is that the law ought to take a stand and define this particular interest as unfit for protection typically accorded to full-fledged property rights. At least in situations where moral intuitions are not very well-developed, the legal position is likely to play a defining role.

86 Technically, optimal incentives for reliance expenditures require a damage measure that is invariant with regard to actual reliance. A reliance measure that aspires to efficient incentives to rely would then have to place a limit on reliance, precisely at the optimal level. Cooter, *supra* note 43, at 14-16. In fact, "reliance" here functions as a proxy for damages lower than expectation damages. For a classification of remedies more accurate from the economic perspective, see Craswell, *supra* note 18, at 157-61. According to that classification, everything I have to say about "reliance" in the merger context actually refers to "remedies below expectation."

significant investments in identifying the target and in legal, accounting, and financial fees, all in the context of an agreement that holds a significant likelihood of falling through before consummation. Guaranteeing his profits as if the probability of consummation is one hundred percent will give him an incentive to over-rely and a disincentive to continue to search out better opportunities.<sup>87</sup> Moreover, if expectation damages are assessed according to the value of a foreclosing lockup, they will actually have the effect of precluding a more efficient transaction.<sup>88</sup> The promisor's breach-or-perform decision is also best addressed by reliance damages. Generally, damages set below expectation are thought to allow for inefficient breach, because the promisor may elect to breach by engaging in an alternative contract when the promisee's valuation is higher than the price of the alternative. In the merger context, however, such a decision is always the opening parry to an auction situation, in which the original acquirer can change his offer, all the way up to his actual valuation. Thus, the "breach" will only take place if it is efficient, in the sense that the highest value user will win the auction.<sup>89</sup>

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87 On the other hand, eliminating all possibility of compensation for reliance losses will discourage the acquirer from undertaking any expenses and thus foreclose the possibility of efficient transactions.

88 "[I]f a termination fee is excessively high, it could artificially increase the price of breaching a merger agreement such that a target is no longer able to efficiently breach a merger agreement with one acquirer to pursue a better opportunity with another." Sneirson, *supra* note 78, at 580-81.

89 David Skeel has argued that reliance is the better measure of damages in the context of lockups, both from the perspective of compensation and from the perspective of incentives. Regarding incentives, his analysis is worth quotation at length:

The principal advantage of a reliance measure, as compared to expectation, is its effect on promisee (bidder, in the lockup context) incentives. Because it assures a bidder the benefit of the agreement at hand, expectation gives the bidder inadequate incentives to mitigate the consequences of breach by continuing to look for other opportunities. ...

...

[T]here is little reason to be concerned about "excessive" promisor breach in the lockup context. The agreement between an initial bidder and a target is preliminary by its very nature. If a higher valuing bidder emerges, the parties arguably contemplate — and efficient breach theory would encourage — the target's sale to the higher bidder. While a reliance-based measure might appear to give target managers an incentive to shift to another bidder even in circumstances where the new bidder does not value the target more highly, this possibility is far less problematic with respect to corporate control contests than elsewhere. In contrast to other promisees, the lockup bidder does not simply disappear if another bidder emerges. The lockup bidder still can attempt to outbid the new bidder, and it is likely to succeed unless the new bidder places a higher value on the target — precisely the context where "breach" would be appropriate.



The conflicts of interest perspective helps explain the efficiency analysis in two ways. First, the attempt by an acquirer to exploit expectation from an acquisition agreement entails the possibility of a conflict of interest between the acquirer and the shareholders of the target.<sup>90</sup> Limiting the acquirer's damages to its reliance expenditures mitigates (or eliminates entirely) this particular conflict of interest. Second, the acquirer may also be involved in a conflict of interest in the sense that exploiting his expectation interest from the agreement is a form of rent-seeking on the public interest. This is because a well-functioning market for corporate control entails a positive externality in the form of disciplining corporate management generally. By watering down the threat represented by a takeover, the acquirer and target management team up to dilute the effectivity of that discipline, undermining the public interest. Limiting damages to reliance expenditures minimizes this type of rent-seeking and ensures that shareholders and the public enjoy the benefits of the market for control.

The context of corporate acquisition yields visible results for the conflicts of interest analysis. The conflicts perspective has explanatory and normative power in supporting reliance damages for the breach or termination of merger agreements, and the explanation and arguments it offers reveal a certain coherence between *ex ante* and *ex post* angles of analysis.<sup>91</sup> The

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Focusing on a bidder's reliance damages thus can be seen as providing appropriate incentives to both the bidder and the target in the lockup context. Not only does the reliance measure give the bidder an incentive to anticipate and mitigate any losses should the deal with the target fall through, but the incentive that reliance gives a target to shift to another, higher valuing bidder, should one emerge, arguably can also be seen as desirable rather than problematic.

Keel, *supra* note 82, at 596-98 (citations omitted).

90 See Regan, *supra* note 78, at 57-61 (arguing that only wholly innocent acquirers, that is, acquirers who are not knowingly party to a breach of target management's fiduciary duties, should be able to recoup even reliance expenditures).

91 The argument here has been that the conflicts of interest analysis largely tracks the efficiency analysis. However, this is not an uncontroversial statement in itself. To be accurate, it requires that we accept an efficiency analysis sensitive to this particular context, and one that overcomes the standard economic analysis supporting the efficiency of liquidated damage clauses, even when the common law would treat those clauses as penalties. For an argument supporting enforcement of lockups from an efficiency perspective, see Stephen Fraidin & Jon Hanson, *Toward Unlocking Lockups*, 103 Yale L.J. 1739 (1994). On the efficiency of liquidated damage clauses despite the common law rule on penalties, see Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 Yale L.J. 369 (1990); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554 (1977).

following section on corporate bankruptcy shows that such coherence is not necessary, but rather fortuitous.

## **B. Bankruptcy**

Corporate bankruptcy is a scenario rife with conflicts of interest, very few of which I will analyze here. The conflicts range from those between shareholders and managers, to those between the firm and its creditors, and on to those among the creditors themselves. Various conflicts are present even while the firm is in good financial health: the potential conflict between managers and shareholders is at least formally answered by the fiduciary duties of the former to the latter; the potential conflicts between the firm and its creditors are mediated by the contracting arrangements between them and by substantive corporate law doctrines.<sup>92</sup> Creditors of a healthy firm are competitors, responsible primarily to respect the framework of competition. However, as the firm approaches insolvency, these conflicts transform themselves, expanding in intensity and shifting potential alliances.

The most drastic shift concerns the duties of management. When the firm is healthy, managers owe a fiduciary duty to the firm and its shareholders, one usually envisioned as a duty to maximize shareholder value. As the firm approaches insolvency, attempts to maximize shareholder value may prejudice the creditors, in the sense that such attempts "could lead managers to take actions that reduce the value of debt more than they increase the value of equity and therefore reduce total value."<sup>93</sup> Taking this shift into account, courts and commentators have argued that managers of an insolvent firm, and possibly even of a firm approaching insolvency, should owe fiduciary duties to creditors as well.<sup>94</sup> By shifting fiduciary duties, corporate law recognizes that certain fact situations heighten the potential for conflicts of interest among contracting parties. Creditors, who as an initial matter were considered competent to protect their interests primarily through contract, morph from simple contract partners to holders of an interest that

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92 Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 *Cardozo L. Rev.* 647 (1996).

93 Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 *Vand. L. Rev.* 1813, 1815 (2002). This formulation is general, but the temptation for such action is significantly greater when approaching insolvency, because at that point the downside risk for management shrinks.

94 *Id.*; Schwarcz, *supra* note 92, at 667-73.

looks much like equity, and thus they need and receive the protection from conflicted management that fiduciary duties offer.

An even more radical transformation affects the creditors' relationship among themselves. During the firm's financial health, the creditors do not, in any meaningful sense, comprise a group. They are, directly or indirectly, competitors, but they typically have little or no knowledge of one another,<sup>95</sup> and any direct contact among them is probably a matter of mere chance, unrelated to their common status as creditors of the same debtor. Their duties to one another are minimal, and to the extent that they exist, they are generally filtered through duties owed to the debtor, with whom each creditor has a direct, private law (usually contractual) relationship. All this changes if the firm approaches insolvency. At that point, the self-interested actions of any of the creditors may have a significant (possibly devastating) impact on the interests of the others. Each of the creditors is interested in recovering its claim, but a run on the debtor means both that only the swiftest of the creditors will have their efforts rewarded (the so-called "race of diligence") and that liquidation will ensue, destroying the going concern value of the firm, which otherwise could have been divided among the creditors. In other words, the creditors have a collective action problem: left to their own competitive devices, the creditors are likely to deplete the value of the firm, as well as suffer from strategic costs in reaping any value at all.<sup>96</sup>

Before delving into the way the conflicts of interest perspective intervenes in the academic debate over corporate bankruptcy, it is worth emphasizing the unusual context of corporate insolvency for such a perspective. The key feature here is the subtle transition into a position that entails conflicts of interest. Creditors did not contract with one another to become a common pool. They did not choose their partners in this pool, but, rather, chose a common partner in contractual relationships or happened into the pool unwittingly (as in the case of the victims of the firm's torts). It is no

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95 This is especially true if they are dispersed bondholders (though the price of publicly traded bonds should reflect knowledge of the firm's credit structure). Employees also have little knowledge of other creditors; tort victims presumably have none. Trade creditors may know of banks and, to a certain extent, know of the existence of other trade creditors, but this knowledge is typically very limited, to say nothing of creating a direct relationship. Only banks are likely to study the makeup of the firm's creditors and, even then, without entering into a direct relationship with any of them.

96 See Douglas G. Baird, *A World Without Bankruptcy*, 50 *Law & Contemp. Probs.* 173 (1987); Thomas H. Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors' Bargain*, 91 *Yale L.J.* 857 (1982).

simple task to determine a magic moment when duties to abstain from conflicts of interest took hold. Instead, these barely related parties inch toward a relationship they never sought. And yet, despite critiques of the very existence of Chapter 11, almost all commentators agree that some mode of collective action entailing collective duties must be in place.<sup>97</sup> The transition is subtle, but its effects are firm, and firmly established.<sup>98</sup>

Over the past two decades, bankruptcy scholarship has been characterized by a split into two major schools of thought, labeled by Douglas Baird proceduralists and traditionalists. Proceduralists, largely academic lawyers pursuing economic analysis, are primarily concerned with the incentive effects of bankruptcy rules or with the *ex ante* angle of analysis, and in keeping with such a perspective, they do not view the preservation of firms as an independent good in itself. Traditionalists believe that preserving firms, especially when many jobs are at stake, is a principal goal of the regime of corporate bankruptcy, and they are more concerned with sorting out the disputes among the parties before a bankruptcy court than with the *ex ante* effects of bankruptcy rules.<sup>99</sup> The conflicts of interest perspective advanced here points to a possible mediation between these two schools of thought.

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97 Bankruptcy law is the dominant collective action mechanism within any municipal legal system. But collective action is also seen as necessary where no bankruptcy system applies, for instance, in the context of defaults on sovereign bonds. See Buchheit & Gulati, *supra* note 21; William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of the Creditors*, 57 Vand. L. Rev. 1 (2004).

98 For indications that the wave of critiques of the very existence of a corporate bankruptcy regime is a thing of the past, see David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003); Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 Bankr. Dev. J. 287 (2003). Quite recently, two very prominent scholars argued that large scale reorganizations were a thing of the past, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751 (2002). Almost at the same instant that their piece was published, companies like Enron, WorldCom, Adelphia, and Global Crossing were entering Chapter 11. Even if it turns out to be true that these Chapter 11 cases are primarily liquidation-oriented rather than reorganizations of the entire business, the collective action procedures of bankruptcy are clearly crucial in dealing with insolvency of large corporations.

99 Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 Yale L.J. 573, 576-80 (1998). According to Baird, proceduralists and traditionalists also split over the role of the judge, but that conflict is less crucial to my argument here. For fuller accounts of the issues at stake and the positions involved, see Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775 (1987); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815 (1987).

The key fault-line between proceduralists and traditionalists is the division over whose interests should be considered in designing bankruptcy rules. Proceduralists would draw narrow limits on those interests, adopting exclusively rules aimed at solving "only the creditors' coordination problem."<sup>100</sup> This is what drives the proceduralist heuristic of the creditors' bargain and its implication that the only interest that ought to be protected in bankruptcy is the interest of those who have non-bankruptcy property rights in the assets of the distressed firm.<sup>101</sup> Traditionalists, in contrast, are likely to draw the boundaries of the protected interest expansively to include employees of the distressed firm and additional elements of the surrounding community that would be injured by its immediate liquidation.<sup>102</sup>

The weakness of the proceduralist position lies in its extremism, and this is precisely the point at which a conflicts of interest perspective may be able to ameliorate the problem. I will attempt to show how by expanding on a concrete example of proceduralist analysis drawn from Alan Schwartz's *Contract Theory Approach to Business Bankruptcy*.<sup>103</sup> Schwartz's argument in the essay is that while a mandatory structural framework of bankruptcy is necessary to solve the creditors' coordination problem (thus supporting the mandatory automatic stay rule), much of bankruptcy law need not consist of mandatory rules, but ought rather to consist of default rules that the parties could contract around. His central example is Section 365 of the Bankruptcy Code, a mandatory rule nullifying *ipso facto* clauses, clauses that allow the solvent contracting partner to exit from her contractual obligations in the case of the other party's insolvency.<sup>104</sup> I briefly rehearse Schwartz's argument

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100 Schwartz, *supra* note 11, at 1810. Schwartz admits a troubling gap in his analytic model, regarding those creditors who do not bargain with the firm: "Tort and environmental victims of the firm's activities do not bargain with the firm *ex ante*, but do have current bankruptcy claims against it. These claims should be protected in bankruptcy, but just how is beyond the Essay's scope." *Id.* n.15.

101 Douglas C. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 103 (1984).

102 See Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* 206-14 (1997); Warren, *supra* note 99.

103 Schwartz, *supra* note 11.

104 11 U.S.C. § 365(e) (2001). Section 365(f) makes contractual prohibitions of assignment unenforceable, and Schwartz's analysis of the Section largely tracks his discussion of *ipso facto* clauses. While I do not analyze that argument in detail here, my critique would be largely analogous to the one I advance regarding *ipso facto* clauses. Schwartz made substantively the same claims in a more technical paper. Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. Econ. & Org. 441 (1999).

and then move onto critiques that show the relevance of a conflicts of interest perspective.

Schwartz's analysis begins with the claim that mandatory rules are not relevant to *ex post* efficiency because they do not directly determine the decision whether to continue performance of the contract or to breach. If performance is efficient, the parties will perform irrespective of the initial location of the right to performance: the rule (or conversely, the *ipso facto* clause in the agreement) will only affect the distribution of the contractual surplus through renegotiation of the price, or what Schwartz terms a "bribe."<sup>105</sup> Schwartz admits that the bankrupt firm enjoys an *ex post* benefit from the banning of *ipso facto* clauses, but argues that the benefits come at a price:

When the estate holds the property right over contract performance, the seller must bribe it in order to exit. As a consequence, the seller will raise the product price to the firm. When the seller has the property right, creditors will charge the firm a higher interest rate than they would charge if the insolvent estate had the property right (because when the seller has the property right, the estate will be smaller). Thus, any increase in the *ex post* value of the estate is offset by the shrinkage in the estate caused by worsened terms of trade that the disadvantaged parties exact. This argument can be generalized to any rule that creates no new social wealth but only shifts *ex post* surplus from one set of bankruptcy claimants to another.<sup>106</sup>

Further, Schwartz argues that in light of judicial error in assessing damages, allowing *ipso facto* clauses will create more efficient investment incentives. The banning of *ipso facto* clauses allows the insolvent party to use the threat of high damages to compel the seller to perform at a loss or to buy the right to exit. The threat of high damages in combination with the mandatory rule banning *ipso facto* clauses will lower the expected harm from bankruptcy,

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105 Schwartz, *supra* note 11, at 1842-44. I reproduce Schwartz's numerical illustration: [I]f the seller would lose \$100 from continued performance while the estate would gain \$200, the trustee has an incentive to pay the seller some sum between \$100 and \$200 to continue.

The seller would also continue if bankruptcy law eliminated its right to exit. To see why this statement is not trivial, assume now that the seller would lose \$200 from continued performance while the estate would gain only \$100. Then the seller would exit even under 365: There is some sum between \$100 and \$200 that the seller could pay to the buyer or its trustee for permission to exit.

106 *Id.* at 1844.

as well as lower the firm's incentives to exert effort to avoid insolvency.<sup>107</sup> Thus, there are two parts to Schwartz's argument. First, any *ex post* benefit to the insolvent party will be balanced (precisely) by *ex ante* price adjustments, and forcing parties into an agreement they do not desire has an efficiency cost. Second, the ability to threaten excessive damages will distort the potentially insolvent firm's incentives to avoid bankruptcy.

Schwartz's thesis is thrice flawed. The first flaw is that Schwartz assumes that the *ex post* gains to the estate from the banning of *ipso facto* clauses are precisely nullified by *ex ante* pricing, leaving only "worsened terms of trade" between the parties. But consider what such pricing would entail for parties interested only in efficiency. The party hoping to impose an *ipso facto* clause would first have to gauge the probability that the other party would file for bankruptcy during the life of the contract.<sup>108</sup> Next, the same party would have to multiply the probability of insolvency by the probability that the contract turned out, *ex post*, to be a losing one from its perspective.<sup>109</sup> This multiplication is likely to yield a figure too small to have any effect on the price, especially if it is not negotiated, but made part of the background rules by the bankruptcy code.<sup>110</sup> In any case, to the extent that such an effect

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107 *Id.* at 1845-47. Schwartz's description of high expected values in damages is important to his argument:

This representation of damages implies that the expected damages the seller faces exceed true damages. If  $z$  is positive, the court overestimates the buyer's damages and the seller pays the erroneously high sum. If  $z$  is negative, the court underestimates the buyer's damages. These damages, however, are bounded from below by zero. Thus, a breaching seller expects to bear the full cost of judicial error on the high side, but expects not to profit fully from judicial errors on the low side. This biases the expectation damages upwards.

*Id.* at 1845 n.97.

108 Business bankruptcy filings over the past five years have held fairly steady, ranging from 8 to 10 thousand per quarter. See [http://www.abiworld.org/Template.cfm?Section=Business\\_Bankruptcy\\_Filings1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=5238](http://www.abiworld.org/Template.cfm?Section=Business_Bankruptcy_Filings1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=5238) (Quarterly Business Filings 1999-2004, May 24, 2004) (last visited Dec. 6, 2004). If bankruptcies were randomly distributed among contracting corporations, the initial probability would have to be quite small.

109 In line with Schwartz's assumptions, a losing contract will be the most important trigger to the solvent party's desire to exit the transaction. The solvent party may also try to renegotiate if the contract is a big winner for the insolvent party. The larger the gap in valuations, the greater the chance that renegotiation will ensue.

110 For a discussion of how background rules seep into the parties' preferences, even when those rules are default rules, see Russel Korobkin, *The Status-Quo Bias and Contract Default Rules*, 83 Cornell L. Rev. 608 (1998).

exists, the firm's other creditors will make up for the loss by improving the terms of credit. It is not just that the *ex post* benefit, real enough in itself, is bought for nothing, but rather that the claim that there are "worsened terms of trade" evaporates when so little is at stake *ex ante*. That is, from an efficiency perspective as between the parties themselves, nearly nothing rides on the *ipso facto* clause except a long-shot distributive gamble. This conclusion raises a question as to why parties would ever contract for *ipso facto* clauses, and the answer to that question leads us to the second flaw in Schwartz's argument.

Schwartz conducts his investigation as if the parties to a contract are interested only in efficiency until bankruptcy law comes along and imposes a mandatory rule banning *ipso facto* clauses. A closer look reveals that the parties negotiating an *ipso facto* clause are actually engaged in a predominantly distributive adventure, and one in which they are working together against the firm's other creditors. The party negotiating for the clause knows that if the other party enters bankruptcy, it can both turn a losing contract into a winning contract and turn a winning contract into an even more profitable transaction. Because it will have a credible threat to cease performance, it will be able to renegotiate a better price for continuing. That is, the other party's bankruptcy may be the occasion for a small windfall. The potentially insolvent firm faces a classic conflict of interest because it has nothing to lose by granting such a concession: as long as it is solvent and bears the risks and rewards of the contract, nothing will upset the distributional balance that the contract created. However, if it enters bankruptcy, the firm itself (i.e., equity holders and management) will not be adversely affected by the clause, since only the firm's other creditors will see any of the proceeds of the estate. Thus, the real aim of the *ipso facto* clause is to extract *ex post* gains, even if at a low probability, from the firm's other creditors. Because the likelihood of using the clause is remote, both parties to the contract believe it will not significantly change the terms of credit that the potentially insolvent party faces even from its sophisticated voluntary creditors like banks; it goes without saying that trade creditors, employees, and most of all tort or environmental victims have no influence on such a clause *ex ante*, but suffer its effects *ex post*.<sup>111</sup> *Ipsso facto* clauses could be seen primarily as attempts at rent-seeking from remote third parties.

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111 There is one fact situation where an *ipso facto* clause may be more salient, which is a "bet-the-company" contract. But precisely in those cases where the *ipso facto* clause is significant *ex ante*, its attendant distortions of incentives become most serious.



As such, they create externalities that should concern economic analysis, at least when such analysis is not unduly narrow.

The third flaw in Schwartz's argument lies in his claim that *ipso facto* clauses improve investment decisions. This claim turns on the idea that firms in bankruptcy may be able to pressure their contract partners into performing losing contracts by threatening to sue for excessive damages, thus lessening the impact of insolvency and distorting the firms' incentives to avoid it. This claim in itself entails three difficulties. First, it treats the banning of the clause as a facilitator of the insolvent party's strategic behavior, without accounting for reciprocal strategic behavior by the solvent party in the event that the clause were valid. Second, it relies on the analytically possible but practically implausible claim that contract damages are overcompensatory. The strategic behavior that Schwartz envisions builds on the threat of suit for excessive damages; such a threat, however, is not credible. Technically, Schwartz bases his analysis on the idea that since damages are bounded below their real level by zero but unbounded above their real value, the mean value of damages is excessive. But this ignores the fact that the probability of winning the suit is always less than one and that various limitations of contract law (including foreseeability, certainty, and the duty of mitigation) make contract damages undercompensatory as a matter of course. Indeed, Schwartz has argued as much himself and bases his support for specific performance on this well accepted wisdom.<sup>112</sup> Thus, the possibility of relying on the fact that the firm could threaten excessive damages and thus gain leverage in a renegotiation might exist analytically, but is meaningless functionally. This fault is exemplary of the tendency of economic analysis to overestimate the effects of *ex ante* distortions on the basis of the theoretical (sometimes merely theoretical) possibility of their existence. Third, for the reasons stated above, performance incentives (to the extent they can be affected) are actually distorted more by the existence of the *ipso facto* clause than by its disappearance. The *ipso facto* clause has the potential of effecting a transfer from the insolvent firm's creditors to the solvent party. Because the insolvent firm itself (in its transactional incarnation, i.e., managers and equity holders) will not bear the *ex post* cost

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112 Schwartz, *supra* note 36. See also Craswell, *supra* note 11; Cohen, *supra* note 18, at 1229 ("Expectation theorists struggle to explain why, if protecting the expectation interest is the goal, contract damages so often undercompensate the expectation interest. Doctrines such as mitigation, foreseeability, and uncertainty, as well as the inability of the victim of the breach to recover attorney's fees or prejudgment interest at market rates, make contract damages undercompensatory from the perspective of the expectation interest.").

(in terms of the reduction of the value of the estate), its investment decisions will not respond to that cost optimally.

None of my critiques undermines the general proposition that Schwartz advances in his essay, which is that parties could conceivably contract for an optimal insolvency regime.<sup>113</sup> Instead, they show that the details of Schwartz's plan offer only weak support for his general claim that bankruptcy ought to be privatized.<sup>114</sup> In banning *ipso facto* clauses, the Code pursues the creation of a framework of cooperation that extends beyond the contracting parties. Such clauses attempt to exploit the framework by extracting rents from distant parties who cannot bargain over such terms, a result that the cooperative framework rightfully prevents. The flaws in Schwartz's argument share a characteristic that is endemic, perhaps even necessary, to much economic analysis of bankruptcy: they all flow from an unduly narrow vision of the interests at stake in the discussion. By reducing the considerations at stake to the rules' *ex ante* incentive effects on contracting parties, Schwartz misses the opportunity to see bankruptcy law generally as an important part of a framework for cooperation, one whose effects stretch far beyond the parties to any given contract.<sup>115</sup> The conflicts of interest perspective, with its emphasis on the malleability of protected interests and thus the necessity

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113 For such a critique, see Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 Yale L.J. 317 (1999). For a reply to the reply, see Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 Yale L.J. 343 (1999).

114 The provocative slogan is taken from Schwartz's concluding sentence: "This Essay's central claim is captured in a variation on a trendy slogan: Privatize bankruptcy." Schwartz, *supra* note 11, at 1851. It is difficult to reconcile this slogan with Schwartz's support for the mandatory automatic stay (especially in light of the fact that waivers of stay clauses are a crucial element in the freedom of contract-bankruptcy debate), but a discussion of sloganeering would take us too far afield.

115 I have already mentioned traditionalist bankruptcy scholarship that emphasizes the interests of the community. Offering another angle on the wider interests that should be considered in bankruptcy, David Skeel has argued that large scale Chapter 11 cases hold out an "antitrust benefit." In industries that are relatively concentrated, the failure of one company can undermine the competitive structure of the industry as a whole.

In the airline industry, for instance, if United, U.S. Air and perhaps one or two of the other troubled airlines were liquidated or absorbed into their healthier peers, the industry could become increasingly monopolistic. By providing a way for existing companies to reorganize in stand alone form, Chapter 11 supplies a benefit that has received surprisingly little attention from bankruptcy commentators.

Skeel, *supra* note 98, at 27.

of normative choice in defining them, highlights this fault and perhaps helps to ameliorate it. In doing so, it points to the limits of economic analysis as traditionally conceived, even though it may be swallowed up by economic analysis in the very next breath. Ted Janger recently articulated this point in an article that engages economic analysis while pointing to its limits:

The approach advocated in this Article draws on both the economic and traditionalist accounts [of bankruptcy] but follows neither precisely. Like the proceduralist, I assume that the goal of a business bankruptcy case is to achieve a socially efficient result. Unlike the proceduralist, I don't assume that such an efficient result can be achieved by parties bargaining *ex ante*, because I don't assume that all interested parties are at the table when an entity incorporates, or even when an entity borrows. Limited liability and the institution of secured credit render it axiomatic that there will be negative externalities associated with the operation of a business that fails. Collective action problems inherent in any complex business organization will also mean that important creditor interests will not be effectively represented in the bankruptcy bargaining process. Thus, bankruptcy law has a role in correcting inherent imperfections in the market.<sup>116</sup>

Professor Janger puts his finger on the crucial issue facing not only bankruptcy scholarship, but private law theory generally. The focus on coordination problems in bankruptcy advanced the discussion of this species of economic regulation. But the narrowness of this focus, while giving proceduralist scholarship its impetus, also turns into its major weakness. The creditors' coordination problem is one window through which we gain a clear view into how bankruptcy law must function to create a framework for cooperation. What proceduralists like Schwartz have missed is that the framework requires the cooperation of actors beyond the voluntary creditors pool. Traditionalist bankruptcy scholars, including some economically oriented allies, have successfully pointed out that the benefits of cooperation extend well beyond creditors who could protect themselves by *ex ante* bargains. Indeed, over the past two decades, bankruptcy has learned something from contract. But maybe the time has come to turn the tables: today, contract may have much to learn from bankruptcy.

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<sup>116</sup> Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 Ariz. L. Rev. 559, 574 n.60 (2001).

### C. Summary

The detailed examination of complex fact situations highlights some of the advantages of conflicts of interest analysis. Such an endeavor takes economic analysis seriously, while not succumbing to certain recurrent faults that plague much of the genre. The analysis of corporate acquisitions showed how legal rules may sometimes exacerbate conflicts of interest, even where the overarching normative aims of policymakers would be geared toward mediating or eliminating such conflicts. On this score, the eye on conflicts probably coheres, in terms of normative suggestions, with economic analysis. The analysis of bankruptcy showed that sometimes those areas highlighted by the conflicts of interest perspective will be precisely those areas that traditional economic analysis has difficulty comprehending.

### CONCLUSION

The conflicts of interest perspective has explanatory and normative power. It underscores the fact that the array of rules on conflicts of interest may in fact be critical in creating the protected interest itself. In other words, the law may have a constitutive role in creating interests. This insight has wide-ranging implications. The most important builds on the understanding that some interests arise only in the course of relationships among legal actors. The newly created and protected interest is sometimes akin to a new legal subject. In order to take responsibility for creating this interest, the law must be willing to acknowledge its creative role. When the interest arises in the course of the relationship, it may be impossible or otherwise undesirable to conduct a normative investigation solely on the basis of the effects of a legal rule *ex ante*, because such rules will not be able to account for an interest that may not exist at that time and that may not be divisible by the original parties later on. Some interests simply have no representative *ex ante*.

One goal of this article has been to offer a normative framework that engages with the limits of economic thinking about the law. When those limits are made explicit, economic analysis generally manages to translate and reincorporate whatever is initially perceived as outside those limits. *Externality* is the key concept, in both its technical and spatial senses. But sometimes, at least, attempts to incorporate elements from "outside" an analytical framework threaten to cripple it. This may be the case when outside elements are difficult to translate into accepted units of measurement, or dollars and cents. The ostensible solution to this problem has too often

been to rely on an assumption that whatever is outside the framework is not very important. That is a crucial mistake. The conflicts of interest perspective I have proposed here challenges economic thinking to compare things whose comparison is difficult, with tools that do not promise precision. At the same time, it attempts to expand the set of tools to make such comparisons. The conflicts of interest perspective may run aground trying to account instrumentally for things whose value lies beyond instrumentality, but one may hope that the failure would be enlightening.

