CONTRACT AND INNOVATION: THE LIMITED ROLE OF GENERALIST COURTS IN THE EVOLUTION OF NOVEL CONTRACTUAL FORMS

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In developing a contractual response to changes in the economic environment, parties choose the method by which their innovation will be adapted to the particulars of their context. These choices are driven centrally by the thickness of the relevant market—the number of actors who see themselves as facing similar circumstances—and the uncertainty related to that market. In turn, the parties' choice of method will shape how generalist courts can best support the parties' innovation and the novel regimes they envision. In this Article, we argue that contractual innovation does not come to courts incrementally, but instead reaches courts later in the innovation's evolution and more fully developed than the standard picture contemplates. Highly stylized, the trajectory of innovation in contract we find is this: Private actors respond to exogenous shocks in their economic environments by changing existing structures or procedures to make them efficient under the new circumstances. The innovating parties stabilize their newly emergent practices through a variety of regimes—both bilateral and multilateral—with the goal of establishing the context through which the innovation is implemented. It is only at this point, and when a dispute is presented to them, that courts step in. If contract innovation does indeed reach generalist courts through the mediating institution of these contextualizing regimes, then our argument follows directly: Because a central goal of contract adjudication is to enforce the agreement in the context the parties intended, the courts' willingness to defer to the context provided by the parties will put the law more directly in the service of innovation.

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INTRODUCTION

Contract is broadly regarded as a cohesive body of law precise enough to facilitate transactions across very different domains, yet open and flexible enough to accommodate and eventually discipline substantial variations and changes in commercial practice without sacrificing its cohesion. There is disagreement as to whether contract achieves these ends best when judges most fully respect the autonomy of the parties and decide disputes principally by reference to the formal agreements that the parties enter, or when judges are instead free to go beyond the terms of the contract and inquire into the context of the parties' dealings, and decide disputes with reference to the parties' practices and informal understandings.[1] But there is little

[1] Beginning with the battle between the titans of contract—Samuel Williston and Arthur Corbin—and continuing to the present, two polar positions have competed for dominance in the interpretation of formal agreements between sophisticated parties. The primary battleground has taken place in generalist courts that are committed to polar interpretive styles: In a textualist regime, and absent ambiguity, generalist courts cannot choose to consider context; in a contextualist regime, these courts must consider it. Textualist interpretation—as embodied in the parol evidence and plain meaning rules and

disagreement that contract law, as developed by generalist judges, approximates the ideal image of the common law as a highly decentralized and sensitive institution for responding incrementally to incipient changes in the parties' relations. Thus, common law courts are generally believed to be fully capable of extending the reach of existing legal principles to emergent forms of agreement without undermining the security of actors who continue to rely on traditional doctrine.

In our view, this familiar picture mischaracterizes the ways in which generalist courts do, and do not, effectively support innovation in contract law. The goal of this Article is to replace this common but erroneous picture with a more accurate one. We argue first and most fundamentally that contractual innovation does not come to courts incrementally—as where innovation is shaped gradually through iterative exchanges between contracting parties and the courts—but instead reaches the courts later in the innovation's evolution and more fully developed than the standard picture contemplates. Highly stylized, the trajectory of innovation in contract we find is this: Private actors respond to exogenous shocks in their economic environments by changing existing structures or procedures to make them efficient under the new circumstances. The innovating parties stabilize their newly emergent practices through a variety of regimes, both bilateral and multilateral, with the goal of establishing the context through which the innovation is implemented. It is only at this point, and when a dispute is presented to them, that courts step in.

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in the effect of an integration clause—looks to a contract's formal language and disregards claims, unless anchored in the text, that the parties intended to assign contract terms a special meaning that is revealed by the course of dealings or some other feature of the context of their relation, or that the parties otherwise intended to supplement the formal contract by unwritten understandings and undertakings. Contextualist courts, on the other hand, reject the notion that words in a contract can have a plain or unambiguous—contextfree—meaning at all. By the same logic, they favor a soft parol evidence rule. Thus, the court may admit extrinsic evidence notwithstanding an unambiguous merger clause declaring the contract to be an integrated writing, or, absent such a clause, notwithstanding the fact that the writing appears final and complete on its face. Robert E. Scott, *Text Versus Context: The Failure of the Unitary Law of Contract Interpretation*, *in* THE AMERICAN ILLNESS: ESSAYS ON THE RULE OF LAW (F. H. Buckley ed., forthcoming May 2013) (manuscript at 6) (on file with the *New York University Law Review*). For a discussion of the competing interpretive regimes, see Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023, 1057–62 (2009); Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 926, 957–63 (2010) [hereinafter Schwartz & Scott, *Contract Interpretation*]; Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 568–91 (2003) [hereinafter Schwartz & Scott, *Contract Theory*].

As we develop here, the nature of these "contextualizing regimes,"[2] and hence the courts' function and the allocation of responsibility between courts and alternative interpretive institutions, depends on two characteristics of the economic market in which the innovating parties participate: the thickness or scale of that market, as measured by the number of actors who understand themselves to be transacting under similar circumstances,[3] and the uncertainty associated with that market.[4] Across the four principal regions of space defined by these two dimensions—low and high levels both of scale

[2] We extend to purely private contractual relationships the conception of "contextualizing regimes" that was first used to describe public-private collaborations in Charles F. Sabel & William H. Simon, *Contextualizing Regimes: Institutionalization as a Response to the Limits of Interpretation and Policy Engineering*, 110 MICH. L. REV. 1265, 1266 (2012).

[3] The thickness or scale of the relevant market facing contracting parties is one of the central variables that explains how contractual innovation evolves. A thick market is one in which many commercial actors are exchanging goods or services by using the same or similar contracting behaviors and strategies. Hence the contracting is multilateral. In this respect, similarity should be understood as a continuum. As we will see, broadly similar transactions may still have significant idiosyncrasies, which will influence how a multilateral contextualizing regime addresses markets that are thick at a general level and thinner with respect to particular transactions. *See infra* text accompanying notes 97–113 (discussing fast-track construction rules and the Delaware Court of Chancery). The polar opposite—a thin market—exists when each contracting party must negotiate a bespoke agreement with its counterparty. Here contracting is bilateral.

[4] As is commonplace, we follow Frank Knight in distinguishing between risk (the likelihood of an event that can be estimated probabilistically) and uncertainty (the likelihood of an event whose occurrence, or even whether it could happen at all, is unknown). *See* FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 197–232 (1921). For a discussion of Knight's concept of uncertainty, see Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 433 & n.2 (2009). For a helpful discussion of how the incomplete foresight associated with Knightian uncertainty is central to institutional (contractual) design, see Rudolph Richter, Efficiency of Institutions: From the Perspective of New Institutional Economics with Emphasis on Knightian Uncertainty 16–20 (July 13, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2105604. Exogenous uncertainty—say, technological change that overtakes current knowledge—can produce a feedback effect on the contracting process itself. Gilson, Sabel & Scott, *supra*, at 448–49. Thus, in high-uncertainty environments, where future contingencies cannot be estimated and parties must adapt collaboratively, the contracting process itself reflects continuous uncertainty. *Id.* at 455–56. In that sense, uncertainty is endogenous to the contract. As with market thickness and the similarity of transactions, *see supra* note 3, risk and uncertainty are also a continuum, where any particular transaction will present elements of both risk and uncertainty but in different proportions. For expositional purposes, we will treat the term "low-uncertainty" as covering situations in which probabilistic assessments can be made in important respects, and we will use the term "high-uncertainty" for circumstances where probabilistic assessments are of little consequence. Thus, a high level of uncertainty exists when exogenous events that may affect the parties' obligations to perform are unknown or cannot be estimated probabilistically. Conditions of high uncertainty—generally the product of an exogenous shock—can occur in either bilateral or multilateral markets. Similarly, under conditions of low uncertainty, both bespoke and multilateral contractors can identify relevant risks that may impede future performance, estimate their occurrence probabilistically, and allocate those risks in the resulting agreement.

and uncertainty—courts must follow the instructions of the contracting parties as to how their contract is to be adapted to its particular context. In each case, the role of generalist courts—the nonspecialized workhorses of formal dispute resolution—is more restricted than in the standard account, as much of the interpretation of context will already have been established by other institutions including by the parties themselves. Thus, in responding to contract innovation driven by changes in the contracting parties' business environment, courts must practice the passive virtues: The parties, not the courts, drive innovation. Nonetheless, a court's approach to an innovative contract can support or undermine the innovation—the court can be either a friction or a facilitator.

In practice, the respect for party autonomy that we urge is under threat from two directions. First, courts can—through inertia or jurisprudential conviction—apply what they take to be standard default rules of the common law of contract in disregard of the parties' explicit understanding to the contrary (often elaborated jointly with trade associations and regulators).[5] Second, contemporary courts can reinterpret or disregard the parties' agreement in favor of the judges' understanding of the context of their dealings. Common law courts were traditionally reluctant to incorporate informal understandings and practices in the course of resolving commercial disputes, relying instead on the maxim that "the courts do not make a contract for the parties."[6] However, the adoption of the Uniform Commercial Code presaged the triumph in many areas of contract law of a new activist approach.[7] The Code's incorporation doctrine is the standard bearer for the activist judicial role in the development of new forms of agreement; it explicitly commits the courts to aid in the continued expansion of commercial practices so that the law can be developed "by the

[5] *See infra* Part II.C.1. As an example of this tendency, from roughly the 1960s through the end of the 1980s, courts, in concord with the insurance industry and its regulators, protected consumer interests by extending the scope of reasonable expectations of coverage, explicit language in the agreement notwithstanding. Courts also elaborated a strong variant of contra proferentem, so that a court, encountering an ambiguity in an agreement, would immediately decide for the policy holder, rather than undertaking usual efforts to determine the parties' meaning. Later courts played an important role in undermining this insurance law regime by reaffirming the general, orthodox understanding of contra proferentem as a last, not a first resort in the resolution of ambiguity, and the priority of text over expectations. For discussion, see Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 109–11 (2007) (describing trends in judicial treatment of contracts).

[6] *See, e.g.*, Agnew v. Lacey Co-Ply, 654 P.2d 712, 715 (Wash. Ct. App. 1982) ("A court may not create a contract for the parties which they did not make themselves.").

[7] The Second Restatement of Contracts has adopted the activist incorporation approach first advanced by the Uniform Commercial Code. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 204 (1979) (Supplying an Omitted Essential Term); *id.* § 221 (Usage Supplementing an Agreement); *id.* § 222 (Usages of Trade).

courts in the light of . . . new circumstances and practices."[8] This commitment to the incorporation of inchoate contractual understandings through the agency of generalist courts is deeply embedded in contemporary contract law and forms the foundation for the standard account of the role of courts in the development of contract.

Our argument, in contrast, is that sophisticated parties better understand the subtleties of their context and better grasp the implications of the applicability vel non of the standard rules of contract law to the support of their dealings than do even the most acute generalist courts.[9] Courts facilitate innovation in contract most directly by recognizing these limits and giving effect to the regimes that the parties have created to take account of their context and its interaction with the law of contract.

This Article proceeds as follows. Part I frames the taxonomy of contract innovation: the multi-dimensional space on which we build our account of the relationship between generalist courts, contextualizing regimes, and contract innovation. Part II develops the general argument of the relation between contractual innovation and contextualizing regimes with regard to bilateral contracts and the role of uncertainty. We stress two exemplars: first, the emergence of collaborative contracting in global supply chains, platform production, and project development that has figured prominently in recent years, and second, the use of preliminary agreements as a means to investigate whether to pursue a business opportunity with a partner. Part III discusses multilateral contextualizing regimes involving institutions beyond the particular contracting parties, ranging from trade

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[8] U.C.C. § 1-103(a)(2) cmt. 1 (2011). The Code explicitly invites courts to incorporate incipient commercial context into novel forms of agreement through its definitions of "agreement" and "contract." Agreement is defined as the "bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade . . . ." *Id.* § 1-201(3). Contract, in turn, is defined as "the total legal obligation that results from the parties' agreement . . . ." *Id.* § 1-201(12).

[9] In this Article, we examine the role of generalist courts in the emergence of innovations in commercial contracting between sophisticated parties. We argue elsewhere that any theory of optimal contract design and interpretation requires a separation of the question of consumer protection—whether a particular contract is exploitive and, in turn, what terms would be reasonable—from the design and interpretation of commercial contracts. Consumer protection is an important goal of public policy, but placing the responsibility for advancing this goal in the hands of generalist courts charged with the task of contract enforcement and interpretation of commercial contracts is a category error. *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, Text and Context: An Integrated Theory of Contractual Interpretation 48–58 (Mar. 15, 2012) (unpublished manuscript) (on file with the *New York University Law Review*) (arguing that courts should not uniformly apply standard common law rules of interpretation designed for commercial parties to consumer contracts and exploring alternative approaches).

associations in the cotton industry to the Delaware Court of Chancery in complex corporate disputes. We situate these regimes by mapping them against the combination of the two central characteristics of the environment in which each arises: the level of uncertainty concerning the activities that are covered, and the thickness of the market for those activities—whether there are many or few participants facing similar circumstances.

We conclude by summarizing the relation between the character of the contextualizing regime and the uncertainty and scale associated with the relevant market. In the end, the message is straightforward: To facilitate innovation, courts must pay increased attention to the role the contracting parties have given them through the formation of contextualizing regimes. That role will only infrequently reflect the traditional assumption that courts appropriately respond to innovation by extending the reach of existing contract doctrine to emergent forms of agreement. Nonetheless, even in respecting these limits, generalist courts will retain an important, albeit less central, role than that accorded by the standard account. Common law contract doctrine and generalist courts are still needed to deter opportunistic efforts by contracting parties to exploit their counterparties. In this way, generalist courts will retain their historic role in policing efforts to game the system.

I
The Taxonomy of Contract Innovation and the Role of Generalist Courts

In developing a contractual response to changes in the economic environment, parties will choose the mechanism by which their innovation will be best adapted to the particulars of their context. These choices are driven centrally by the thickness of the relevant market and the uncertainty related to that market. In turn, the parties' choice of method will shape how generalist courts can best support the parties' innovation and the contextualizing regimes they envision. In Part I.A we frame the taxonomy of innovation in terms of the four regions created by the intersection of high and low uncertainty and thin and thick markets. Part I.B then addresses how that analysis informs the role of generalist courts in interpreting the resulting contextualizing regimes.

A. The Taxonomy of Contract Innovation

When markets are thick—in the sense that many actors face similar changes in their dealings and stand to benefit from concerted responses to them—the affected parties often will institutionalize their

innovative contract forms and terms through collective action. Put differently, there are economies of scale in contracting. Depending on the precise character of the collective action problems parties face, the resulting structure for adapting their contracts to the particulars of the context—what we will call a multilateral contextualizing regime—may be entirely private (with contract terms developed by industry associations and disputes resolved by private arbitration), largely public (with terms developed by an administrative agency in consultation with trade associations and disputes resolved by an administrative tribunal), or a combination of these (where courts enforce the collectively determined contract forms). The nature of the regime, moreover, will vary according to the level of uncertainty[10] faced by the actors. When uncertainty is low (where insiders to the activity know what to do but judges are ignorant of the relevant details and likely to remain so), attention will be focused on elaborating specialized terms and industry codes. When uncertainty is high (where neither insiders nor outsiders can reliably predict on their own what should be done), attention will focus on the creation of a joint framework for exploring and defining new opportunities and mitigating hazards in their realization.

When markets are thin and the actors few and scattered, parties facing similar problems cannot rely on collective action to institutionalize contractual innovation because the necessary scale is not present. In these circumstances, innovation occurs initially in bilateral relationships. Here, too, the level of uncertainty will determine how the parties respond to changes in the business environment. When uncertainty is low, parties in bilateral relationships can turn to bespoke contracting, relying on contract design itself as the means of integrating the relevant context into a novel formal agreement. But where uncertainty is high, even sophisticated parties cannot respond adequately to exogenous shocks by simply relying on forms of state-contingent contracting. Rather, in the process of collaboration, the parties develop governance mechanisms based on rich and regular exchange of information on a project's progress that allows each to ascertain the other's capacity to jointly proceed to define and produce a product. This same exchange of information creates enough mutual transparency so that opportunism can generally be detected before it has ruinous consequences for the more vulnerable party. These collaborative arrangements—commonly found in supply chains, joint efforts to develop new technologies, and preliminary agreements—differ from traditional contracts in that they typically obligate the parties to

[10] *See supra* note 4 (discussing uncertainty).

jointly explore possibilities without committing them to execute any specific project.[11] Nevertheless, the purpose of these bilateral contextualizing regimes—as of the institutionalized multilateral regimes that come with scale—is to harmonize contractual relation and context. This process of contracting for innovation is a governance framework designed to create a context in which the parties can ascertain whether extended collaboration is possible and desirable.

In sum, the level of uncertainty will identify the vehicles for contractual innovation that respond to substantive change in the business environment. Depending on the thickness of the market, the parties' contractual responses to these changes may take the form of bilateral agreements between the participating firms; complex, multilateral efforts through industry groups; or public-private "regulatory" structures.

B. Implications for the Role of Generalist Courts

It is only when such contextualizing responses take form (or are well on the way to formation) that generalist common law courts systematically begin to encounter significant innovations in contract. Prior to that point, disputes that lead to litigation are unlikely. The choice then posed for the generalist judge who first confronts the contractual innovation is not merely (as the standard picture suggests) how to weave a partial and incipient innovation into the fabric of contract doctrine. Rather, the fundamental choice is (1) whether to accept the output of the innovative contractual or institutionalized structure even when it deviates (for reasons particular to the context) from outcomes the court would reach in applying its normal rules of contract enforcement and interpretation, and (2) when the court does generally defer to the judgments and instructions that emerge from the innovative contractual structure, whether and when to superintend its operation so that parties do not exploit their counterparties.

If contract innovation does indeed reach generalist courts through the mediating institution of the contextualizing regime, then our argument follows directly: The role of the generalist court is more limited, and different, from the one commonly depicted. And the court's role is more limited because, as innovations accumulate and contextualizing regimes multiply, the proportion of cases properly decided under the general rules of contract declines in relation to the proportion resolved in accord with the principles and rules of the various regimes. The court's role is also different because the problem

[11] *See infra* notes 47–48 and accompanying text (discussing collaborative arrangements).

of how best to manage relations in contextualizing regimes requires courts to determine when to defer to the regimes, and when superintending correction—policing opportunism—is necessary. That the role of the generalist judge is more limited and different from that normally portrayed does not make judges and courts unimportant to the development of contract law. Contextualizing regimes are vulnerable to disruption in many ways, and a proper balance between judicial deference to such a regime's independence and judicial intervention to protect the integrity of its operation is a necessary, though not sufficient, condition for its survival.[12]

II
The Impact of Uncertainty: Bilateral Contracting as Innovation in Contract Design

In this Part we address uncertainty—one of the two central features of our account of the determinants of innovation in contract. We develop this theme in the context of bilateral relationships where changes in the level of uncertainty can stimulate dramatic changes in contract design. Thus, for example, a dramatic increase in the uncertainty associated with product design has required radical innovations in the contract forms to support businesses' efforts to operate under the now prevailing conditions. We argue that this innovation in contract design is stimulated by three factors that operate along different dimensions but are highly interactive. Exogenous shocks produce dramatic changes in the structure of efficient business arrangements, whether because of changes in the firm, its industry's economic environment, or the relevant regulatory environment. In turn, the change in efficient business arrangements evoked by the shock induces innovation in the contractual forms that institutionalize the new business arrangements. These new contractual arrangements are highly sensitive to the regulatory power of the state. That power is exercised through the adjudicatory process. In other words, generalist courts have to get the scope of enforcement right, respecting the autonomy of these bilateral contextualizing regimes while at the same time intervening to protect their integrity. This interactive process is neither simple nor monotonic, and in each instance the nature and extent of the innovation is a product of differing levels of uncertainty. Part II.A

[12] An important question, one that we reserve for future work, is how generalist courts can appropriately determine when to intervene so as to deter opportunism and when to defer to the contextualizing regime created by the parties themselves. A failure to make the right decision can undermine the emerging regime. *See infra* note 54 (discussing various forms of judicial error in interpreting innovative contracts).

introduces the pattern by which bilateral innovation—substantive and contractual—evolves in both low- and high-uncertainty environments. Part II.B then illustrates the high-uncertainty pattern through two examples of contract innovation: collaborative agreements and preliminary agreements. Part II.C addresses how these contract innovations have fared in generalist courts.

A. The Evolution of Innovation in Contracting

In previous work, we identified what is loosely called "the information revolution" as the exogenous shock that marked the emergence of collaborative contracting in global supply chains, platform production, and project development.[13] During this period, innovations cascaded, often leading to improvement cycles that became self-perpetuating, devaluing or disrupting existing—and apparently robust—solutions as these innovations progressed.[14] The resulting high levels of uncertainty rendered prior contracting forms obsolete. Existing transactional structures, including contingent contracting through modular exchange, relational contracting, and vertical integration, offered no solution to the contracting problem the parties confronted: how to share capabilities in devising a product that no single party could define on its own.[15] Rather, in diverse settings—including contract manufacturing of advanced electronics, contracts between suppliers of sophisticated components and their manufacturers, and collaborations between biotech firms with innovative technologies and large pharmaceutical companies with expertise in the regulatory and commercial complexities of bringing new drugs to market—these changes led to an increase in interfirm relations in which *both* parties with necessary skills expected to innovate jointly.[16]

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[13] Gilson, Sabel & Scott, *supra* note 4, at 441–42.

[14] This increasing unpredictability manifests as the pervasive fear of what Clayton Christensen calls "disruptive" technologies. *Id.* at 442; *see* CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL xviii–xix (1997).

[15] *See* Susan Helper, John Paul MacDuffie & Charles Sabel, *Pragmatic Collaborations: Advancing Knowledge While Controlling Opportunism*, 9 INDUS. & CORP. CHANGE 443, 443–47 (2000) (arguing that firms have increasingly adopted a model of "pragmatic collaborations" to address these challenges); Charles F. Sabel, *A Real-Time Revolution in Routines*, *in* THE FIRM AS A COLLABORATIVE COMMUNITY: RECONSTRUCTING TRUST IN THE KNOWLEDGE ECONOMY 106, 108 (Charles Heckscher & Paul S. Adler eds., 2006) ("Network organizations manifestly outperform hierarchies in volatile environments.").

[16] For a discussion of the rise of collaborative contracting in these diverse industries, see Gilson, Sabel & Scott, *supra* note 4, at 438–44. The development of the Boeing 787 aircraft is a good example of the demand for collaboration. Innovation in the design and manufacture of the wing, the province of one supplier (or group of suppliers), is dependent on the design and manufacture of the fuselage, the province of a different supplier (or group of suppliers), and vice versa. Innovation in one structure must mesh with innovation

In precisely that setting, when standard theory predicts vertical integration as the response to combining different capabilities in the face of uncertainty,[17] parties chose contract—not common ownership—as the structure of their collaboration.[18]

Note that initial uncertainty does not inevitably lead to this outcome. In some of these settings the parties anticipate that joint exploration, if successful, will resolve the uncertainty at the outset of their dealings and give rise to familiar contractual problems.[19] In the case of the pharmaceutical collaborations, for example, as uncertainty is reduced, reliance on the contextualizing regime gives way to reliance on more familiar instruments, either traditional statements of obligation and remedy with a mix of rules and standards[20] or, when the

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in the other in order for either to be successful. The wing must not only be compatible with the fuselage; the two must fit. "Innovation is thus a collaborative and iterative process rather than a discrete product supplied by a party upstream in the supply chain according to specifications set by a downstream customer." *Id.* at 450. As difficulties in managing the complex 787 supply chain have shown, the problems associated with extreme uncertainty are not easily solved even by innovation. *See id.*

[17] *See* Francine Lafontaine & Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 45 J. ECON. LIT. 629, 649–50 (2007) (noting that the hold-up problem "clearly pose[s] problems for long-term contracting, and those problems are exacerbated in volatile environments," and that "when the problems that are associated with transaction costs are important, [transaction costs] models suggest that firms will choose governance structures—including vertical integration or separation—to reduce the likelihood and cost of haggling and exploitation").

[18] *See, e.g.*, JOHN DEERE & CO. & STANADYNE CORP., LONG TERM AGREEMENT (Dec. 14, 2001) [hereinafter JOHN DEERE/STANADYNE AGREEMENT] (on file with the *New York University Law Review*) (five-year supply contract for the purchase of fuel filtration systems, injection nozzles, and related products by Deere from Stanadyne); WARNER-LAMBERT CO. & LIGAND PHARM. INC., RESEARCH, DEVELOPMENT, AND LICENSE AGREEMENT (Sept. 1, 1999) [hereinafter WARNER-LAMBERT/LIGAND AGREEMENT], *available at* http://contracts.onecle.com/ligand/warner.rd.1999.09.01.shtml (pharmaceutical research and development collaboration between "big pharma" and "little pharma"); PHARMACOPEIA, INC. & BRISTOL-MYERS SQUIBB CO., COLLABORATION AND LICENSE AGREEMENT (Nov. 26, 1997) [hereinafter PHARMACOPEIA/BMS AGREEMENT], *available at* http://contracts.onecle.com/accelrys/bristol-myers.collab.1997.11.26.shtml (same); APPLE COMPUTER, INC. & SCI SYSTEMS, INC., FOUNTAIN MANUFACTURING AGREEMENT (May 31, 1996) [hereinafter APPLE/SCI SYSTEMS AGREEMENT], *available at* http://contracts.onecle.com/apple/scis.mfg.1996.05.31.shtml (a contract manufacturing agreement for SCI to produce designated products at the plant in Fountain, Colorado). For an in-depth analysis of these contractual responses to continuous uncertainty, see Gilson, Sabel & Scott, *supra* note 4, at 458–71.

[19] For an example of how a high-uncertainty collaborative agreement can evolve into a low-uncertainty contingent contract, see PHARMACOPEIA/BMS AGREEMENT, *supra* note 18. For detailed discussion of this contract, see Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1405–10 (2010).

[20] *See, e.g.*, WARNER-LAMBERT/LIGAND AGREEMENT, *supra* note 18, art. 4.2 (granting Warner-Lambert an option to proceed to develop or market product subject to its obligation to "use diligent efforts to pursue" commercialization); Gilson, Sabel & Scott, *supra* note 4, at 467–71 (discussing WARNER-LAMBERT/LIGAND AGREEMENT). Commercial con-

reduction in uncertainty is substantial, the creation of property rights through the use of nested options.[21]

In other settings, furthermore, repetition results in a learning process that reduces uncertainty, permitting a shift from a contextualizing regime to a contingent contract: Accrued experience substitutes for collaborative exploration so that it is possible to identify the relevant contingencies going forward. Here, contracts become more complex and complete as time goes on.[22] When either successful exploration or

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tracts often include both precise rules and general standards, and courts will then actively interpret and enforce such standards by reference to context evidence. For example, contracts may state one party's performance obligation as making "commercially reasonable efforts," "reasonable efforts," or "reasonable best efforts." Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 835 (2006). Parties choose their mix of rules and standards so as to optimize the admissibility of context evidence over two dimensions: *when* the court will look to context and *who* decides what context matters. The combination of general and specific terms, therefore, offers parties the ability to braid the text with context evidence that is revealed over the course of contract performance. Scott, *supra* note 1 (manuscript at 20); Scott & Triantis, *supra*, at 842–43.

[21] *See, e.g.*, PHARMACOPEIA/BMS AGREEMENT, *supra* note 18, art. 2.1.3 (granting Bristol-Myers Squibb (BMS) an option to develop, subject to Pharmacopeia's right to terminate if BMS discontinues development); Gilson, Sabel & Scott, *supra* note 19, at 1408–10 (discussing the role of nested options in contracts). In the case of these pharmaceutical collaborations, as uncertainty is reduced the separation of formal process terms from informal substantive terms gives way to formal contracting over substance: Once the product is identified, collaboration is replaced by an allocation to the pharmaceutical company of the responsibility to use commercially reasonable efforts to bring the drug to market. Gilson, Sabel & Scott, *supra* note 4, at 470–71. There is additional complexity in the case of large pharmaceutical company/biotech collaborations. One problem is that the biotech firm, which typically has a number of research projects with other companies as well as proprietary research, may use the contractual payments to cross-subsidize other projects to the disadvantage of the pharmaceutical company and its project. Another is that the biotech company may skew research to its benefit and to the detriment of the commercially oriented research desired by the pharmaceutical. Here the problem is not uncertainty per se—both parties know and understand the object of the contract and the desired inputs to performance, and the pharmaceutical company will know when the biotech is, from the commercial point of view, misdirecting the project. Rather, the problem is that the pharmaceutical company will not be able to prove the misbehavior to the court at a reasonable cost. But because uncertainty is low, the parties can still use innovative contingent contracting to police the biotech company by granting the pharmaceutical company an unconditional option to terminate the relationship, and thereby secure broad property rights to the research output on payment of a termination fee. The termination fee, in turn, constrains responsive opportunism by the pharmaceutical company. This use of options may viably substitute for the ex ante incorporation of performance specifications in a low-uncertainty environment because the inputs that may be subject to opportunism are fully observable by the contracting parties. Josh Lerner & Ulrike Malmendier, *Contractibility and the Design of Research Agreements*, 100 AM. ECON. REV. 214, 215 (2010) ("[T]he payments associated with termination prevent the financing firm from exercising the termination option opportunistically.").

[22] *See* Nicholas S. Argyres, Janet Bercovitz & Kyle J. Mayer, *Complementarity and Evolution of Contractual Provisions: An Empirical Study of IT Services Contracts*, 18 ORG. SCI. 3, 15 (2007) ("[C]ontractual partners . . . that had a longer history of transacting with

repetition results in a reduction in uncertainty, the parties are able to write contracts that provide relatively explicit instructions to courts indicating what context to consider and what context to ignore.[23] The parties are, thus, less reliant on informal mechanisms created by the contextualizing regime and can instead turn to a variety of contract clauses to deal with what is now the kind of low-uncertainty environment in which the enforcement role of the court figures most prominently.[24]

When uncertainty is reduced in either of these ways, current law, despite the ongoing battle over interpretive styles,[25] faces familiar and tractable problems. It is in this thin-market, low-uncertainty environment that we observe the state-contingent contract—the discrete contract in legal terminology[26]—that is the canonical case for parties contracting under stable conditions. Because parties can anticipate the environment in which performance will occur, the contract itself will reflect it. Even if bespoke contracting can seldom be completely prescient, where uncertainty is low the parties can specify in the formal contract the relevant context within which specific performance obli-

each other were more likely to include contingency planning in their contracts."); Kyle J. Mayer & Nicholas S. Argyres, *Learning to Contract: Evidence from the Personal Computer Industry*, 15 ORG. SCI. 394, 396 (2004) (finding that successive contracts between the same two contracting partners become more complex over time as the partners learn how to address contracting hazards); Michael D. Ryall & Rachelle C. Sampson, *Do Prior Alliances Influence Alliance Contract Structure?*, *in* STRATEGIC ALLIANCES: GOVERNANCE AND CONTRACTS 206, 206–07 (Africa Ariño & Jeffrey J. Reuer eds., 2006) (finding that contracts are more complete or detailed when firms have prior alliances, whether with the same firm or other firms).

[23] For examples of contractual language providing contextual instruction, see *infra* notes 27–29 and accompanying text. There are good reasons to believe that commercially sophisticated parties prefer a regime that follows the parties' instructions specifying when to strictly enforce formal contract terms and when to delegate authority to a court to consider surrounding context evidence. By eliminating the risk that courts will erroneously infer the parties' preference for contextual interpretation, such a regime reduces the costs of contract enforcement and enhances the parties' control over the content of their contract. That control, in turn, permits sophisticated commercial parties to implement the most efficient design strategies available to them. Ex post, preferences may change for the party disfavored by the resolution of uncertainty, who may then prefer the right to persuade a court of a different result. Of course, that is the point of the ex ante focus. Kraus & Scott, *supra* note 1, at 1028; Scott, *supra* note 1 (manuscript at 3).

[24] *See* Scott & Triantis, *supra* note 20, at 851–56 (discussing acceleration and termination rights, best efforts obligations, force majeure, and liquidated damages clauses as examples of contract terms in low-uncertainty environments that delegate to courts the task of applying general standards as constrained by precise rules).

[25] *See supra* note 1 (discussing tension between textualist and contextualist methods for interpreting formal agreements between sophisticated parties).

[26] The categorization in contract law scholarship of discrete versus relational contract is generally attributable to the work of Ian Macneil. *See* Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 693–96 (1974) (describing the distinction between discrete and relational contracts).

gations are measured. Innovation in these relatively complete contracts thus takes the form of discursive exposition of goals, expectations, and business plans, whether in the contract's preamble or in particular sections. Contract clauses that embed context in the written agreement include "whereas" or "purpose" clauses that describe the parties' business plan and the transaction,[27] definition clauses that ascribe particular meanings to words and terms that may vary from their plain meaning,[28] and appendices that provide more precise specifications governing performance as well as any memoranda the parties want an interpreting court to consider in interpreting the contract's text.[29] This additional context can supplement precise specifications of outcomes while still constraining a future court's discretion to range more widely than the parties want ex ante.[30]

But there is a substantial and apparently growing range of situations in which uncertainty is persistent or recurrent—that is, uncertainty starts high and remains so. Researchers have found parties trying to cope with high levels of uncertainty in a variety of diverse settings and industries: for example, in the co-development of successive generations of innovative components by automobile, construction, or agricultural equipment manufacturers and their leading suppliers; in the regular, joint redefinition of "service levels" by the providers of business process outsourcing (typically "back office" services ranging from human resources management to account or treasury management); and in successive collaborations between large

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[27] *See, e.g.*, APPLE/SCI SYSTEMS AGREEMENT, *supra* note 18, at 1 ("The parties desire that Apple engage SCI to assemble, test and package certain Products, Service Units and Spare Parts, as defined below, on a turnkey basis at Fountain on the terms and conditions of this Agreement.").

[28] *See, e.g.*, ALLSTATE INS. CO. & ACXIOM CORP., DATA MANAGEMENT OUTSOURCING AGREEMENT art. 2 (Mar. 19, 1999) [hereinafter ALLSTATE/ACXIOM AGREEMENT], *available at* http://contracts.onecle.com/acxiom/allstate.outsource.1999.03.19.shtml (defining thirty-four technical or nonstandard meanings including specialized meanings of "Affiliate," "Agreement," "Confidential Information," "Current Projects," "Data Integrity," "End-User," "Material Default," "Party," "Person," "Problem," "Term," "Work Order," and "Work Product").

[29] *See, e.g.*, *id.* at xi (listing appended schedules which set out services, key personnel, reports, and other contract details).

[30] *See* Scott & Triantis, *supra* note 20, at 848–56 (discussing parties' inclusion of both precise terms and general standards to determine the boundaries of judicial discretion). There is empirical evidence that most commercial parties prefer the freedom to choose how and when to delegate discretion to courts to interpret commercial contracts. *See* Geoffrey P. Miller, *Bargains Bicoastal: New Light on Contract Theory*, 31 CARDOZO L. REV. 1475, 1478 (2010) ("New York's formalistic rules win out over California's contextualist approach. As predicted by theory, sophisticated parties prefer formalistic rules of contract law.").

pharmaceutical firms and different biotech companies.[31] The challenge facing transactional lawyers in these circumstances is to craft a contractual structure—what we are calling a contextualizing regime—that supports ongoing collaboration, allows adjustment of the parties' obligations under conditions of *continuing* uncertainty, and limits the risk of opportunism inherent in open-ended goals. Unaddressed, such risk undermines the incentive to make efficient relation-specific investments in the first place. Absent a successful design for innovative contractual safeguards, the substantive innovation fails.[32]

B. Innovation in Bilateral Contractual Design

1. The Case of Collaborative Agreements

The common challenges facing parties contracting across organizational boundaries when uncertainty makes specification of the product impossible yield solutions with common elements: A process of collaboration substitutes functionally for ex ante specification of the desired product—the process defines the specification, not the other way around.[33] Through this process each party makes relation-specific investments in learning about the other's capabilities. These

[31] *See* Gilson, Sabel & Scott, *supra* note 4, at 472–94 (describing how parties use collaborative contracting to cope with uncertainty); *see also* Iva Bozovic & Gillian K. Hadfield, *Scaffolding: Using Formal Contracts to Build Informal Relations in Support of Innovation* 7–10 (Univ. of S. Cal. Law & Econ. Research Paper, No. C12-3, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984915 (finding empirical support for the institutional structure of collaborative contracting in a study of governance structures conducted through interviews with a group of innovative firms). For a list of specific contracts discussed in *Contracting for Innovation*, see *supra* note 18.

[32] *See* Gilson, Sabel & Scott, *supra* note 4, at 472 (discussing elements that comprise the contracting problem for firms engaged in collaborative innovation).

[33] In an earlier article, we described the character of the contracting problem facing parties in the rapidly innovating industries that we investigated. Gilson, Sabel & Scott, *supra* note 4, at 433–36. The key variable is the substantial increase in uncertainty occasioned by the rapid pace of technology such that no firm is capable of producing state of the art technology by itself. *See id.* at 449 (describing how, in high-uncertainty environments, collaborative contracting substitutes for the more traditional risk-allocation provisions of conventional contracts). This has led to collaborative agreements in which parties, by sharing private information across organizational boundaries, have combined know-how and specialization to produce a product. Innovation is thus "the product of a joint effort by two or more organizations; it is metaphorically situated between them and is dependent on both." *Id.* at 450. Tracy Lewis and Alan Schwartz model a simpler version of high-uncertainty contracting arrangements. They address innovation that contemplates alternative phases of effort, first by one party and then by the other, rather than the ongoing simultaneous involvement of both parties, as has been observed in high-uncertainty contexts. *See* Tracy Lewis & Alan Schwartz, *Long Term Contracting with Private Information* 4–5 (Yale Law & Econ. Research Paper No. 446, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2016375.

investments raise the costs to each party of replacing its counterparty with another—its switching costs—and so restrain both parties from taking advantage of their mutual dependency.[34]

The key design innovation in these collaborations is to use a *formal* contract to create a governance structure that is sufficiently robust to support iterative joint effort.[35] The goal is to jointly discover the characteristics of the product the parties contemplate making. The formal contract creates a bilateral contextualizing regime designed to regulate only the collaboration commitment itself, not the course or the outcome of the collaboration.[36] Consequently, legal enforcement is limited to protecting each party's promised investment in the collaborative process rather than expanded to include, for example, a division of the surplus from the commercialization of a product that might

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[34] Ronald J. Gilson, Charles F. Sabel, & Robert E. Scott, *Contract, Uncertainty, and Innovation*, *in* RULES FOR GROWTH: PROMOTING INNOVATION AND GROWTH THROUGH LEGAL REFORM 223, 228 (2011) [hereinafter Gilson, Sabel & Scott, *Contract, Uncertainty, and Innovation*]; Gilson, Sabel & Scott, *supra* note 4, at 449.

[35] The following paragraphs in this Part draw on our previous work in Gilson, Sabel & Scott, *supra* note 19, and Gilson, Sabel & Scott, *Contract, Uncertainty, and Innovation*, *supra* note 34.

[36] *See* Gilson, Sabel & Scott, *supra* note 4, at 448–58 (discussing why and how parties formalize their contracts in the face of uncertainty and information costs). For a non-exhaustive and non-random sample of collaborative contracts that combine these elements see, for example, BOEING CO. & SPIRIT AEROSYSTEMS, INC., GENERAL TERMS AGREEMENT (June 17, 2005) (on file with the *New York University Law Review*) (general terms agreement covering purchase orders by Boeing for particular products to be supplied by Spirit Aerosystems); NANOSYS, INC. & MATSUSHITA ELECTRIC WORKS, LTD., DEVELOPMENT AGREEMENT (Nov. 18, 2002), *available at* http://contracts.onecle.com/nanosys/matsushita.rd.2002.11.18.shtml (collaboration agreement to develop photovoltaic devices with nano components in Asia); JOHN DEERE/STANADYNE AGREEMENT, *supra* note 18 (five-year supply contract for the purchase of fuel filtration systems, injection nozzles, and related products by John Deere from Stanadyne); ALLSTATE/ACXIOM AGREEMENT, *supra* note 28 (contract for Axciom to develop a data acquisition system to support Allstate's underwriting of new business in auto and property insurance); AVSA S.A.R.L. & NEW AIR CORP., AIRBUS A320 PURCHASE AGREEMENT (April 20, 1999), *available at* http://contracts.onecle.com/jetblue/airbus.a320.1999.04.20.shtml (JetBlue and Airbus purchasing agreement); APPLE/SCI SYSTEMS AGREEMENT, *supra* note 18 (contract manufacturing agreement for SCI to produce designated products for Apple on a turnkey basis); PHARMACOPEIA/BMS AGREEMENT, *supra* note 18 (pharmaceutical research and development collaboration between "big pharma" and "little pharma"); PHOENIX TECHNOLOGIES LTD. & INTEL CORP., AGREEMENT (Dec. 18, 1995), *available at* http://contracts.onecle.com/phoenix-tech/intel.supply.1995.12.18.shtml (supply contract for Phoenix to be a principal supplier of system-level software to Intel); WARNER-LAMBERT/LIGAND AGREEMENT, *supra* note 18 (pharmaceutical research and development collaboration between "big pharma" and "little pharma"); AM. AXLE & MFG., INC. & GEN. MOTORS CORP., COMPONENT SUPPLY AGREEMENT (Mar. 1, 1994) (on file with the *New York University Law Review*) (requirements contract for motor vehicle components to be supplied by AAM to GM). *See also* George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. 99, 103–05, 128–29 (2009) (citing examples of collaborative contracts).

result if the collaboration succeeds.[37] Two closely linked components determine the formal governance arrangement's success.

The first element is a formal commitment by both parties to the ongoing mutual exchange of private information: This process will determine if a project is feasible, and if so, how the parties' joint objectives can be best implemented.[38] The second element is a procedure for resolving disputes that arise during the course of this collaborative exchange. Under the conditions of continuous uncertainty typical of the collaboration, the parties can anticipate encountering unpredicted problems that require both cooperation and know-how to solve and that can be expected to generate occasions of disagreement. The key feature, therefore, is the "contract referee mechanism" that requires the collaborators to solve these problems by reaching unanimous (or near unanimous) agreement on crucial decisions; persistent disagreement among the group is resolved (or not) by unanimous agreement at higher levels of management from each firm.[39] These two components together make observable, and avert misunderstandings about, each party's character traits and substantive capabilities. As a direct result of the processes specified in the formal contract, each party thereby gains valuable knowledge of its counterparty's capacities and problem-solving type. This contract-specific knowledge creates the conditions for informal enforcement of the collaboration: It builds trust and, in turn, creates the switching costs that constrain future opportunistic behavior. Innovation thus occurs at both the substantive and contractual levels: The bilateral contextualizing regime "braids" formal and informal contractual elements in novel ways that respond to the technological innovation the contract is designed to support.[40]

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[37] *See, e.g.*, Eli Lilly & Co. v. Emisphere Technologies, Inc., 408 F. Supp. 2d 668, 696–97 (S.D. Ind. 2006) (holding that the contractual remedy for breach of a collaborative agreement is limited to the right to terminate and retain accrued scientific information).

[38] *See* Gilson, Sabel & Scott, *supra* note 4, at 476–79 (describing the iterative processes of information exchange that comprise a fundamental aspect of specific contracts).

[39] *See id.* at 479–81 (describing the role and effects of the contract referee mechanism). Requiring unanimity for project decisions makes it easy for reasonable skeptics to require more information from enthusiasts; the desire to avoid escalating disagreements up to impatient superiors discourages obstinacy among subordinate collaborators. Gilson, Sabel & Scott, *supra* note 19, at 1403; *see* Gilson, Sabel & Scott, *supra* note 4, at 480 n.126 ("[N]ot exercising the option to behave opportunistically by taking advantage of the unanimity rule is a credible signal of cooperation.").

[40] In an earlier article, we described the concept of a braided contract as a response to the endogenous uncertainty inherent in contracts for innovation that makes the performance obligations under the agreement difficult both for counterparties to observe and for third parties to verify. Gilson, Sabel & Scott, *supra* note 19, at 1386. The solution is for parties to combine formal and informal elements by creating a formal governance structure that specifies processes that render each party's actions under the agreement more

The formal element of a braided contract is, thus, distinctively bounded in its goals. It operates to allow the parties jointly to learn about each other's skills and capacity for collaborative innovation, and to develop jointly the routines required to collaborate in the service of substantive innovation. This limited commitment anticipates a significant constraint on the potential damages to which the formal contract can give rise. Production and purchase commitments—the substantive outputs of the collaboration—result only from the informal contract that is supported by the increased switching costs generated by the collaboration process itself.[41] Thus, collaborative contracting represents the braiding of two forms of contracts that the academic literature treats as substitutes, while real contracting parties treat them as complements. In effect, contractual braiding endogenizes trust by formalizing the process that builds trust and supports informal contracting based on the trust created.[42] In this setting, we see just the opposite of the behavioral literature's concern that formal contracting will drive out informal contracting by inducing the parties to make calculating decisions where they otherwise would have been guided by norms of reciprocity.[43] Rather, the formal

transparent and thus observable to the counterparty. Enhancing the ability of each party to observe the actions of the counterparty allows each one to learn about the other's capacity to innovate successfully as well as their disposition to cooperate. *See id.* at 1402–03 (discussing how braiding works in the prototypical case). In turn, "continuing cooperation builds trust . . . and . . . protects each party's reliance on that trust in its substantive performance by increasing . . . the costs of finding an alternative partner capable of reliably doing, and learning, as much as the current one." *Id.* at 1403. For an extended analysis of a prototypical braided contract, see *id*. at 1405–10, where the author discusses the Pharmacopeia/BMS Agreement.

[41] Only where the subject of the braided contract is a discrete project do we see formal contracting over the output of the process. In the discrete project setting, switching costs discourage opportunism during the collaborative period, but the parties have to fear opportunistic renegotiation once the cooperative stage of the project is completed and switching costs no longer provide protection. The only issue then remaining is division of the gains from prior cooperation. As a result, an explicit constraint on opportunism must be employed, but at this stage, the uncertainty having been resolved, the contract theory solution of allocating rights to decisionmaking is feasible. Gilson, Sabel & Scott, *Contract, Uncertainty, and Innovation*, *supra* note 34, at 230 n.15. For a specific contractual example, see the WARNER-LAMBERT/LIGAND AGREEMENT, *supra* note 18, arts. 4.2, 5.3.1–.2 (allocating to "big pharma" the first option to develop, and upon their decision to abandon, granting residual rights to "little pharma").

[42] Gilson, Sabel & Scott, *supra* note 19, at 1402–05.

[43] For examples of the behavioral literature analyzing the crowding out problem, see Iris Bohnet, Bruno S. Frey & Steffen Huck, *More Order with Less Law: On Contract Enforcement, Trust, and Crowding*, 95 AM. POL. SCI. REV. 131, 132 (2001) ("At intermediate levels [of enforcement], honesty is crowded out; more second movers breach, and resources are wasted in trials."); Edward L. Deci, Richard Koestner & Richard M. Ryan, *A Meta-analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation*, 125 PSYCHOL. BULL. 627, 659 (1999) ("[R]eward contingencies undermine people's taking responsibility for motivating or regulating themselves."); Ernst Fehr

contract creates the conditions that allow informal contracting to function.

2. *Supporting the Search for Partners: The Case of Preliminary Agreements*

Similar innovations are underway in certain types of preliminary agreements. The increasing rate of technological change means that parties functioning in an uncertain environment cannot depend on the next generation of solutions emerging directly out of current practice. Rather, solutions are likely to come from unexpected places, far removed from the established development path.[44] As a result, parties must constantly search for unanticipated alternatives to current ways of doing business. In this way, uncertainty and search are inextricably linked: Under uncertainty, searching for partners who are capable and willing to participate in an incompletely specified collaboration is essential to doing business rather than merely a preliminary step toward a possible future contract. In this sense, contracting for innovation as canvassed in the previous section is just a special, albeit extreme, case of the impact of the increased velocity of changes.

Thus, in domains as diverse as commercial contracting, corporate acquisitions, and complex construction projects,[45] parties increasingly

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& Simon Gächter, *Do Incentive Contracts Crowd Out Voluntary Cooperation?* 26 (Univ. of S. Cal. Ctr. for Law, Econ. & Org., Paper No. C01-3, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229047 ("This paper shows that reciprocity-driven voluntary cooperation may indeed be *crowded out by incentive contracts.*" (emphasis added)); Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, 29 J. LEGAL STUD. 1, 3, 15–16 (2000) (arguing that "the introduction of the fine changes the perception of people regarding the environment in which they operate," but does not necessarily reduce penalized behavior); Daniel Houser et al., *When Punishment Fails: Research on Sanctions, Intentions and Non-cooperation*, 62 GAMES & ECON. BEHAV. 509, 522 (2008) ("Credible threats of sanctions often failed to produce cooperative behavior, and our evidence is that incentives, not intentions, underlie this effect.").

[44] *See* Gilson, Sabel & Scott, *supra* note 4, at 442 ("Precisely because their experience teaches them how to improve on what they already know and how to provide what their similarly focused customers believe they need, dominant producers do not see a threat coming from an entirely different direction.").

[45] In the construction industry, collaborative contracts calling for iterative information exchange are commonly used to facilitate coordination during complex projects, and especially to target problems as they emerge in order to respond effectively to them. *See, e.g.*, GEORGETOWN 19TH ST. DEV., LLC, & TURNER CONSTR. CO., AGREEMENT art. 5.2 (Apr. 1, 2003) (on file with the *New York University Law Review*) (providing that the construction manager's trade contractors shall meet at least once a week with the owner and the architect to review the work and prepare a list of decisions or actions which the owner must make or take in the next sixty days to avoid delays). For a detailed account of how such mechanisms function in practice, see ATUL GAWANDE, THE CHECKLIST MANIFESTO: HOW TO GET THINGS RIGHT 54–71 (2009). Similar collaborative arrangements appear to be proliferating in business process outsourcing. *See, e.g.*, NEW CENTURY FIN. CORP. & ACCENTURE LLP, PROFESSIONAL SERVICES AGREEMENT (Jan. 25, 2006), *available at*

realize that the feasibility of many projects can only be determined by joint investment in the production of information to evaluate whether a project is profitable to pursue.[46] These types of bilateral arrangements typically take the form of preliminary agreements or letters of intent, as they are termed in the context of corporate acquisitions.[47]

The common feature of these regimes is to facilitate joint exploration and search without imposing legal consequences on the outcome of the parties' collaborative activity. In the contextual framework of this relationship, neither party can demand performance of the transaction that the parties hope will result if collaboration is successful. If in the end the parties cannot agree on a final contract, they may abandon the deal. In effect, by entering into a preliminary agreement both parties obtain an option on (each future round of) the deal: The price of the option is the cost of undertaking the preliminary investment, and the option can be exercised once the parties learn the information that their preliminary investments have produced.[48] Agreements of this kind place demands on generalist courts to recognize new forms of contracting that heretofore were denied legal enforcement.

C. Collaborative Contracting and Preliminary Agreements in Generalist Courts

1. Judicial Enforcement of Emergent Innovations

Contracting parties must be able to count on the state's enforcement monopoly if they are confidently to rely on novel forms of agreement. Ideally, generalist courts should respond to exogenously induced innovations by enforcing the chosen methods of mutual

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http://contracts.onecle.com/new-century-financial/accenture-services-2006-01-25.shtml. The agreement provides that Accenture will supply defined human resource services to New Century and periodically improve them. *Id.* at Exhibit 7.4. Moreover, under the agreement Accenture will conduct surveys of New Century employees to determine their level of satisfaction with the services provided. *Id.* at Exhibit 7.6(a). If the results of those surveys show that the level of satisfaction has dropped below the target level, Accenture will analyze the cause of the drop, develop an action plan to improve the level of satisfaction, present the plan to New Century for comment and approval, and implement the approved plan. *Id.* at Exhibit 7.6(c). This discussion is adapted from Gilson, Sabel & Scott, *supra* note 19, at 1423 n.156.

[46] Gilson, Sabel & Scott, *supra* note 19, at 1422–23.

[47] For a discussion of the range of preliminary agreements, see RALPH B. LAKE & UGO DRAETTA, LETTERS OF INTENT AND OTHER PRECONTRACTUAL DOCUMENTS (1989). For a discussion of letters of intent—a preliminary agreement of sorts—in corporate acquisitions, see Gilson, Sabel & Scott, *supra* note 19, at 1439–44.

[48] *See* Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 665–66, 680–82 (2007) ("Preliminary agreements thus commonly are exploratory; that is, the performance of a preliminary agreement sometimes is a necessary condition for parties to pursue an efficient project later.").

cooperation on terms consistent with the arrangements themselves. A court's ability to achieve this consistency will depend very generally on (1) its expertise in the domain of innovation, (2) the conspicuousness of the contextualizing regime (that is, the salience of the industry codes or other markers that indicate to outsiders that insiders have given distinctive meaning and effect to usages they agree on by creating a regime), and (3) the extent to which the court respects the purposes and values to which the regime is dedicated.

As we will see in the case of the Delaware Court of Chancery, courts that are expert in the innovators' domain can see contextualizing regimes through the participants' eyes and give effect to novel forms of agreement.[49] Conspicuously marked multilateral contextualizing regimes that arise in thick markets put courts on notice that particular kinds of expertise are in play and that generalist knowledge of doctrine and the effects of its application in the usual run of cases may be an insufficient or erroneous guide to decisionmaking. The more clearly marked the regime, the more likely it is that the court will be alerted to the possibility that doctrine may not be applicable as usual. However, in the case of innovations that emerge from the bilateral arrangements discussed in this section, the unique governance structures are less visible to a reviewing court.[50] Moreover, unlike bespoke contingent contracts between sophisticated parties, here the courts cannot simply follow the instructions of the parties in deciding what context, if any, should be relevant in resolving disputed transactions.[51]

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[49] *See infra* Part III.B.

[50] To be sure, disputing parties can introduce their novel contracts into evidence, but these contextualizing regimes typically rely on a complex combination of formal and informal mechanisms that are unlike traditional contractual forms and have not been previously analyzed by scholars specializing in contract theory. In the absence of an emerging academic consensus as to how and why these novel forms function as they do, a generalist court is placed at a severe disadvantage if called upon to determine the respective obligations of the parties. That disadvantage is exacerbated by the fact that the dispute will result in the court being presented with two self-serving accounts of the novel contract where the existence of the novelty degrades the court's capacity to determine which account (or combination of accounts) is "right." *See* Schwartz & Scott, *Contract Theory*, *supra* note 1, at 601–05 (discussing the difficulties that courts face in determining whether to fill gaps in contracts between sophisticated parties with established legal standards or to assume that the parties had intended to reject such standards); Gilson, Sabel & Scott, *supra* note 9, at 26–29 ("Generalist courts are removed from the context and impaired in their ability to divine how and when parties would braid both text and context in their contracts.").

[51] Despite the academic debate over whether the default rule of interpretation for generalist courts should encourage scrutiny of context or limit it to the text of the agreement, the overwhelming majority of common law courts continue to follow the traditional "formalist" approach to contract interpretation, in which courts respect the instructions of sophisticated commercial parties as found in merger clauses and reject appeals by plaintiffs to consider extrinsic evidence not found in the integrated written contract. Schwartz & Scott, *Contract Interpretation*, *supra* note 1, at 928 n.1.

As a consequence, it becomes more important for the court to independently affirm values and methods that accord with those of the bilateral regime. The more the court does so, the more likely it will arrive at concordant decisions, whether or not it expressly takes note of the regime's existence. But courts that disavow the goals and methods of a contextualizing regime may, either knowingly or inadvertently, set aside the results determined through the parties' regime in favor of outcomes closer to their own preferences.[52]

Seen this way, courts are not well positioned to interpret contracts for innovation and search-supporting preliminary agreements in accordance with the parties' intentions. Most contemporary courts are generalists. They operate in a heterogeneous and rapidly changing economy, of which their institutional situation affords little detailed knowledge or experience.[53] Unsurprisingly, such courts are prone to undermine an emergent innovation by inadvertently failing to extract the correct meaning from the signals that the parties have given.[54]

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[52] Contextualizing regimes can be fragile and, as a result, the innovations they produce can be short-lived. A much discussed example of this vulnerability is insurance law. In insurance litigation from roughly the 1960s through the end of the 1980s, courts modified general rules of contract to reach decisions protecting consumer interests while also creating incentives for insurers and regulators to clarify and strengthen the overall regime. One of the most important adjustments of general doctrine was the elaboration of a strong variant of *contra proferentem*, under which a court, encountering an ambiguity in an agreement, immediately decides for the policyholder, rather than undertaking the usual interpretive efforts to determine the parties' meaning. Another was judicial defense of the policyholder's reasonable expectations of coverage, explicit language in the agreement notwithstanding. However, after a long period in which generalist judges modified common law doctrines to create, in effect, a contract law for insurance, recent courts have undermined the doctrinal structure they had created. This outcome might have been avoided if courts, instead of re-imposing general contract doctrines, had instead used their power of administrative review to induce regulators to seek clarification of insurance terms and policies. In that case, the doctrinal adjustments would have functioned as a judicially administered incentive system—rewarding clarity achieved by the parties under the regulator's aegis, and penalizing failure to achieve this result—rather than as an open-ended invitation to judges themselves to determine in particular cases what the parties ought to have intended. For discussion, see Gilson, Sabel & Scott, *supra* note 9, at 53–56.

[53] The claim of generalist judicial competence was true under historical circumstances that no longer prevail: The early English courts of equity were effectively able to contextualize contracts because they functioned within homogeneous communities, and thus were able to recover the context surrounding interpretive disputes. *See* Gilson, Sabel & Scott, *supra* note 9, at 18 ("In effect, fifteenth century courts of equity were specialized in the narrow range of activities that came before them. In contrast, contemporary courts are operating in a heterogeneous and rapidly changing economy . . . ."). At the same time, the institutional posture of contemporary courts, which requires them to wait for parties to bring a dispute to them, affords them no window on larger commercial practice and, hence, "little detailed knowledge or experience." *Id*.

[54] Generalist courts can err in several different ways. They can, for example, interpret formal terms that are intended merely to supplement the underlying context (including the default rules of contract such as the doctrine of excuse) as trumping the context and its

There is no reason to think that judges, exceptionally, will have knowledge of the circumstances that motivate the innovation expressed in collaborative contracting and novel types of preliminary agreements. Nor will the bilateral contextualizing regime created in the contract necessarily put them on notice that they are entering unknown territory. The information-exchange regime created within collaborating firms and between collaborating partners by the innovative braiding of formal and informal contracting elements is the most inward-facing and the least outwardly visible form of such regimes. Moreover, preliminary agreements in their traditional form—in which, for example, two commercial parties agree to investigate together the prospects of a commercial project *and* agree to negotiate the remaining terms of the contract once they can observe the fruits of their efforts—are historically unenforceable under the indefiniteness doctrine of the common law of contracts.[55] So to the extent that

defaults. *See, e.g.*, Publicker Indus., Inc. v. Union Carbide Corp., 17 U.C.C. Rep. 989, 992 (E.D. Pa. 1975) (concluding that while "the contract contemplated that foreseeable cost increases would be passed on to the buyer," its inclusion of "a specific provision which put a ceiling on contract price increases resulting from [cost increases] impels the conclusion that the parties intended" for the seller to bear "the risk of a substantial and unforeseen rise in . . . cost[s]"); Mo. Pub. Serv. Co. v. Peabody Coal Co., 583 S.W.2d 721, 728 (Mo. Ct. App. 1979) (denying seller's claim for excuse because seller "agreed to the use of the Industrial Commodities Index"). Alternatively, courts can commit the converse error by interpreting formal terms that were intended to serve as trumps—and thus signal parties' intent to opt out of the normal context—as merely supplementing the typical regime. *See, e.g.*, Brunswick Box Co. v. Coutinho, Caro & Co., 617 F.2d 355, 360 (4th Cir. 1980) (stating that course of performance and surrounding context suggest that standard meaning of F.A.S. term might not be applicable); Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3, 10–11 (4th Cir. 1971) (finding that course of dealing and usage of trade, if admitted in evidence, demonstrate that express price and quantity terms in written contract were only fair estimates); Modine Mfg. Co. v. N.E. Indep. Sch. Dist., 503 S.W.2d 833, 837–41 (Tex. App. 1973) (finding that the lower court erred in excluding trade usage testimony as to the meaning of the express term "[c]apacities shall not be less than indicated" (quoting Modine's bid)). For further discussion, see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 283–86 (1985).

[55] *See generally* ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 29–41, 299–303 (4th ed. 2007) (discussing indefinite agreements). Two factual patterns typify unenforceable indefinite agreements at common law. The first, illustrated by *Varney v. Ditmars*, 111 N.E. 822 (N.Y. 1916), is the indefinite bonus contract. In *Varney*, the New York Court of Appeals found a bonus agreement for "a fair share of [the] profits" to be too indefinite and thus unenforceable. *Id.* at 823–24 (quoting plaintiff testimony). The second archetype is a variation on the first, extending the common law rule to agreements where essential terms were explicitly left to further negotiation. For example, in *Petze v. Morse Dry Dock & Repair Co.*, 109 N.Y.S. 328 (App. Div. 1908), the New York appellate court held that an agreement providing that "the method of accounting to determine the net distributable profits is to be agreed upon later" was unenforceable under the indefiniteness rule. *Id.* at 329–33. Since then, common law courts have consistently found "agreements to agree" unenforceable if any essential term was open to negotiation. SCOTT & KRAUS, *supra*, at 35.

generalist courts might be said to have a prior and independent disposition concerning the outcome produced by the innovative contextualizing regime, that disposition is unfavorable to the emergent innovation.

Despite these impediments, courts have in some cases enforced collaborative contracts and new preliminary agreements in terms that support the purposes of the contextualizing regime that the parties have created.[56] As we discuss below, however, the doctrinal recognition of innovation in contract remains incomplete and in some regards murky.[57] This lack of clarity can further impede innovation by making the innovation's fate even more uncertain.

2. Low-Powered Enforcement of Collaborative Contracts

The effectiveness of the collaborative contracts discussed in this Part depends centrally on courts enforcing the chosen methods of mutual cooperation on terms consistent with the underlying arrangements. The function of collaborative contracts is to address the high level of uncertainty confronting the parties—neither the products nor their specifications can be set out ex ante—by creating a process through which the parties will jointly develop this information and learn about each other's capabilities. This function and the parties' decision to locate the process of collaboration in a formal contract dictates the scope of legal enforcement: A party to such a formal collaboration contract is legally obligated to adhere to its commitment to invest concurrently in the information that will determine the feasibility of a proposed project. As in *Eli Lilly & Co. v. Emisphere Technologies, Inc.*,[58] the key is to discourage parties from defecting early in the relationship, before a robust pattern of cooperation has had the time to develop.[59] But once the investments are made, formal

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[56] *See infra* notes 58–59 and text accompanying notes 63–72.

[57] *See* cases cited *infra* notes 62, 72. For an analysis of the litigated preliminary agreement cases and of the ambiguous doctrinal formulations of contemporary courts, see Schwartz & Scott, *supra* note 48, at 691–702.

[58] 408 F. Supp. 2d 668 (S.D. Ind. 2006). The court held that the parties to this pharmaceutical/biotech collaboration had entered into a form of cooperative agreement that had important—and legally enforceable—limits. *Id.* at 690, 696–97. When Lilly subsequently undertook secret research projects, using information that had been jointly developed, it not only risked a claim of patent infringement, but it breached the contract that gave it the limited license in the first place. *Id.* at 691–93. Holding that Lilly had therefore forfeited its investment in the joint project, the court concluded that "Lilly has asserted theories to justify its actions under the contracts, but those theories are not supported by the evidence or the law." *Id.* at 697. For discussion, see Gilson, Sabel & Scott, *supra* note 19, at 1416–18.

[59] A result similar to that in *Emisphere* was reached in the analogous case of *Medinol Ltd. v. Boston Scientific Corp.*, 346 F. Supp. 2d 575 (S.D.N.Y. 2004), which we have previously discussed in Gilson, Sabel & Scott, *supra* note 19, at 1417 n.132. In *Medinol*, the

enforcement should not influence whether the project should go forward and on what terms. Put differently, the parties have created a regime to determine the context of their relationship, with the court's role limited to policing the relationship, not enforcing the outcome.

It then follows that a reviewing court's primary focus should be on character rather than capability: Has one party reneged on its promise to invest in open information exchange and, if so, what is the appropriate sanction? Low-powered sanctions that encourage compliance with the information-exchange regime (and the informal relations it supports) should be imposed. High-powered sanctions like expectation damages, which might function to crowd out the informal mechanisms that support performance, should be avoided.[60] Indeed, we are beginning to see just this distinction: In leading cases, courts are punishing overt abuse of information-exchange regimes.[61] But because the formal sanction applies only to the commitment to collaborate, only reliance damages are awarded for the breach of that commitment; the sanction does not extend to the award of profits that might have been earned had the project gone forward. Within this framework of limited sanctions, the collaboration commitment can achieve its goal of generating both information and trust.[62] While

parties entered into a "close and extensive contractual relationship, relating to research, development, manufacturing, and distribution of stents . . . ." *Medinol*, 346 F. Supp. 2d at 581. The contract contemplated ongoing collaboration in research as well as the development and production of the resulting product. Medinol was to manufacture the stents and Boston Scientific was to sell them in the United States under license from Medinol. The parties agreed that Medinol would establish an "Alternative Line" for manufacturing stents, which Boston Scientific would be permitted to operate under license from Medinol so as to reduce the risk of supply disruptions. *Id.* at 584–85. That license was limited to "the operation of the Alternative Line." *Id.* at 597–98. Boston Scientific then set up a secret manufacturing operation outside the scope of the Alternative Line. Although there was no express covenant against such manufacture, the court found that the parties' close collaborative relationship showed that the unauthorized manufacturing amounted to a breach of contract, *id.* at 598, without limiting Medinol to a patent infringement suit. The court further found that Boston Scientific's stealth and secrecy showed it had acted in bad faith by setting up the unauthorized line. *Id.* at 596. The court granted summary judgment for Medinol on liability for the breach, leaving only the issue of damages for trial. *Id.* at 592–600. *See also* Shaw v. E. I. DuPont De Nemours & Co., 226 A.2d 903, 906–07 (Vt. 1967) (affirming a damage award for the breach of an implied covenant not to use a patent beyond the scope of the license).

60 For a discussion of the risk of crowding out and the ways in which formal enforcement of collaborative contracts can function as a complement rather than as a substitute for informal enforcement, see Gilson, Sabel & Scott, *supra* note 19, at 1398–402.

61 *Id.* at 1416–21; *see, e.g.*, *Emisphere*, 408 F. Supp. 2d at 689–91 (granting contractual remedy for breach of collaborative agreement); *Medinol*, 346 F. Supp. 2d at 609 (same).

62 Gilson, Sabel & Scott, *supra* note 19, at 1416. As might be anticipated in an emergent area of law, the decisions of courts called on to enforce braided contracts are not uniformly consistent with the enforcement theory we have developed here. Some decisions invite the award of damages for parties who participate faithfully in the information

there is some evidence that courts are wisely limiting the sanctions they impose on parties who breach their commitment to collaborate, these institutional forms of innovation remain fragile, and the degree to which courts will properly respect the parties' own design is still far from settled.

3. Preliminary Agreements in the Courts

Recently, perhaps as a general response to increased uncertainty and the need to search for a collaborator discussed above, courts have effected a major shift in the common law's aversion to preliminary agreements by relaxing the rule under which parties are either fully bound or not bound at all. Instead, a new contract rule has emerged that enforces "a mutual commitment to negotiate together in good faith in an effort to reach final agreement . . . ."[63] But the new rule governing preliminary agreements to collaborate—creating a legal

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exchange regime but then decide that it is not profitable for them to pursue the joint project. *See, e.g.*, Tan v. Allwaste, Inc., No. 96 C 3558, 1997 WL 337207, at *4 (N.D. Ill. June 11, 1997) (finding the plaintiff's claim survived summary judgment because a reasonable jury could conclude that the defendant "simply backed out of the deal for reasons unrelated to Geotrack's actions, omissions, or financial status"). Other decisions contemplate, or at least invite the possibility of, the award of full expectation damages—that is, high-powered enforcement—for breach of the information-exchange obligation. *See, e.g.*, Venture Assocs. Corp. v. Zenith Data Sys. Corp., 96 F.3d 275, 278 (7th Cir. 1996) ("[I]f the plaintiff can prove that had it not been for the defendant's bad faith the parties would have made a final contract . . . the defendant is liable for that loss—liable, that is, for the plaintiff's consequential damages."); VS & A Commc'ns Partners, L.P. v. Palmer Broad. Ltd. P'ship, Civ. A. No. 12521, 1992 WL 339377, at *8–9 (Del. Ch. Nov. 16, 1992) (discussing cases in which expectation damages were awarded against parties who were found not to have negotiated in good faith). In both instances, these courts have failed to appreciate the importance of limiting formal enforcement to low-powered sanctions focused on willful violations of the collaboration agreement itself and thereby create the kind of incentives that undo braiding by inducing strategic crowding out of informal enforcement. For discussion, see Gilson, Sabel & Scott, *supra* note 19, at 1423–24.

63 Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491, 498 (S.D.N.Y. 1987). The rule originated with the opinion of Judge Pierre Leval in this case, which we have discussed previously in Gilson, Sabel & Scott, *supra* note 19, at 1426 & n.163. *Id.* Judge Leval identified two separate types of "preliminary agreements." He characterized the first type as those cases where the parties have agreed on all material terms but have also agreed to memorialize their agreement in a more formal document. *Id.* Disputes arise primarily because parties have failed to express clearly their intention as to *when* their arrangement would be legally enforceable. Here, the question is solely one of timing—when have the parties manifested an intention to be legally bound? In contrast, the second category of agreements concerns "binding preliminary commitments," the preliminary agreements we analyze here. *Id.* In this latter case, the parties agree on certain terms but leave possibly important terms open to further negotiation. This requires courts to determine *whether* such an agreement had been made, *what* the duty to bargain in good faith entails, and *which* remedy should be awarded for breach of that duty. This framework has been followed in at least thirteen states, sixteen federal district courts, and seven federal circuits. *See* Schwartz & Scott, *supra* note 48, at 691–93 & n.7.

duty to bargain in good faith but not requiring the parties to agree—is only a first step in solving the parties' contracting problem.[64] The courts must now give content to this rule by determining the nature of the sanction to be imposed when one party seeks to use the novel form of collaborative agreement to opportunistically exploit the counterparty.

In re Matterhorn Group, Inc. is an example.[65] Swatch determined that greater watch sales (and profits) were available if it could expand its franchise operations in the United States. To this end, Matterhorn and Swatch agreed to collaborate, each investing in the exploration of the possibility of a long-term relationship.[66] The parties signed a letter of intent that granted Matterhorn the exclusive franchise to distribute Swatch watches for thirty possible sites.[67] In turn, Matterhorn agreed to invest in finding appropriate retail locations from among the list in the letter of intent. Swatch committed to process diligently Matterhorn's applications for franchises at potentially profitable locations, and then to seek financing and approval of franchises at Matterhorn's chosen locations from its parent firm. Thereafter, Swatch engaged in just the form of strategic behavior that might be expected under these circumstances: It delayed processing several franchise applications and did not secure the necessary approvals.[68] The court found that Swatch breached its preliminary agreement to bargain in good faith and awarded Matterhorn reliance damages—measured by the cost it had incurred in investigating the locations in question.[69] Importantly, however, the court declined to award Matterhorn expectation damages based on lost profits, concluding that "there is no guarantee that it would have opened a store in [that location]."[70] In essence, Swatch was ordered to pay for the option on new locations that Swatch had in effect purchased from Matterhorn. However, the court also did not protect Matterhorn from Swatch's decision not to exercise that option. Had the court done so, the result could have had crowding out effects by attaching a risk of large damages to a formal agreement that established a contextualizing regime.

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64 Gilson, Sabel & Scott, *supra* note 19, at 1427.

65 No. 97 B 41274, 2002 WL 31528396 (Bankr. S.D.N.Y. Nov. 15, 2002). We have previously discussed this case in Gilson, Sabel & Scott, *supra* note 19, at 1428–29.

66 *Id.* at 2.

67 *Id.* at 3.

68 *Id.* at 16–17 (holding that Swatch "unilaterally rescinded the exclusivity that the Letter of Intent had granted" and "breached the Letter of Intent by rejecting the Vail application for improper reasons").

69 *Id.* at 17.

70 *Id.*

Matterhorn, thus, supports the view that narrowly defined duties of a good-faith commitment to a formal collaborative process complement a regime primarily dependent on informal enforcement of substantive obligations.[71] A braiding mechanism, such as the one that the court in *Matterhorn* appears to have validated, reinforces the informal mechanisms on which the ultimate business arrangement is built; it creates an opportunity for reciprocity and trust to evolve by imposing a low-powered complement during the early stages of collaboration.[72] By limiting formal enforcement to only the collaborative aspect, the crowding out phenomenon can be avoided.

But generalist courts have not uniformly understood the limited role of legal enforcement in these preliminary agreements. In several notable cases, the court has failed to fully embrace the notion that an enforceable preliminary agreement only requires a party to undertake a promised investment in acquiring and sharing information.[73] And in cases involving letters of intent in corporate acquisitions, very good judges have held out the potential for expectation damages for failure to negotiate in good faith.[74] Limiting the obligation narrowly to the commitment to a process rather than to an outcome in this way should permit a party to properly obtain summary judgment even though it walks away from the transaction for reasons wholly unrelated to the actions of the counterparty. And, even if the promised investment in

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[71] For a further example of a court declining to impose legal sanctions to enforce a preliminary agreement in the absence of evidence of opportunism, see *Kandel v. Ctr. for Urological Treatment & Research, P.C.*, No. M2000-02128-COA-R3-CV, 2002 WL 598567, at *7–8 (Tenn. Ct. App. Apr. 17, 2002), which held that a defendant physician's group did not breach its duty to negotiate in good faith with the plaintiff over an agreement to purchase stock.

[72] Gilson, Sabel & Scott, *supra* note 19, at 1429. In *Braiding*, we apply this analysis to the interpretation of letters of intent in connection with corporate acquisitions. *Id.* at 1439–44. As we note in that connection, courts have not been uniformly modest in limiting the level of enforcement for breach of these agreements. In several notable cases, courts have held out the possibility that high-powered sanctions for breach of preliminary agreements could be imposed in some cases, suggesting a misunderstanding of the limited role that they should play in superintending these contextualizing regimes. *Id.*; *see also, e.g.*, Venture Assocs. Corp. v. Zenith Data Sys. Corp., 96 F.3d 275, 278 (7th Cir. 1996) (noting that expectation damages may be available in proper cases); VS & A Commc'ns Partners v. Palmer Broad. Ltd. P'ship, Civ. A. No. 12521, 1992 WL 339377, at *3 (Del. Ch. Nov. 16, 1992) (same).

[73] *See, e.g.*, *Venture Assocs. Corp.*, 96 F.3d at 278 (noting that expectation damages may be available in proper cases); JamSports & Entm't, LLC v. Paradama Prods., Inc., 336 F. Supp. 2d 824, 847–48 (N.D. Ill. 2004) (arguing that insistence on new conditions could constitute a violation of duty to negotiate in good faith, depending on the circumstances); Tan v. Allwaste, Inc., No. 96 C 3558, 1997 WL 337207, at *4 (N.D. Ill. June 11, 1997) (finding that the question of whether the defendant, in breaking off negotiations, acted in bad faith was a question of fact for the jury to resolve). For further discussion, see Gilson, Sabel & Scott, *supra* note 19, at 1440–44.

[74] *See* cases cited *supra* note 72.

collaboration is not made, the defendant's liability is properly limited to the plaintiff's investment in the collaborative process and not to the expectancy that might result from a concluded deal.[75]

4. Summary

In sum, courts support the innovation in these bilateral regimes by recognizing the braiding of an enforceable formal contract covering collaborative assessment of a business opportunity and an unenforceable informal contract covering the substantive transaction should both parties exercise their respective options to go forward. No legal consequences flow from a party's decision not to proceed; neither party has a right to demand performance of the contemplated transaction. If the parties cannot ultimately agree on a final contract, they may abandon the deal. Both parties thus enter into an option on the ultimate deal, which is exercisable after the parties learn the information produced through the preliminary investments, and the price of which is the cost of the preliminary investment.[76]

In the case of disputes arising under contracting for innovation, or the related arrangements for collaborative search, the courts that support the innovation are those that, in effect, discern the existence of these innovative governance structures and conform their decisions to the parties' purposes by respecting the arrangements the parties have created. As we have noted, however, in many other settings contextualizing regimes are institutionalized outside of firms and the bilateral relations they create. Here, the outputs of the regimes are more conspicuous, though not necessarily easier for courts to interpret; indeed, these structures often may not involve courts at all. It is to those multilateral settings that we turn next.

III
Multilateral Contextualizing Regimes: The Effect of Scale

All else equal, the higher the level of uncertainty, the more difficult it is for parties to write, and courts to interpret, complete, state-contingent contracts. If the parties cannot predict probabilistically the range of future outcomes, the if-then framework of a state-contingent contract necessarily will be incomplete. All else equal, the greater the number of traders engaged in the same kind of a transaction, the more

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[75] Gilson, Sabel & Scott, *supra* note 19, at 1444.

[76] For a formal model supporting this argument, see Schwartz & Scott, *supra* note 48, at 676–91, in which the authors show that an award of reliance damages rather than expectancy damages for breach of a preliminary agreement resolves the ex post holdup problem.

likely that the contracting infrastructure—both terms adapted to current need in the form of standard contracts and industry codes, as well as a mechanism for adjusting terms as needs change—will be provided jointly as a club- or industry-specific public good by a trade association alone or in collaboration with public authorities. We have just seen how shocks in the economic environment produce innovations in contractual form in bilateral relationships. These regimes arise when markets are thin and uncertainty is high. Similarly, exogenous factors can stimulate the creation of innovative contractual forms in multilateral contextualizing regimes. In such a case, the regimes are institutionalized outside the participating firms and arise when markets are thick—many contracting parties are affected by the same exogenous event or, even in the absence of an exogenous event, many parties are acting in the same commercial environment.

In this Part, we consider those contextualizing regimes that are external to the specific contracting parties to a transaction—multilateral regimes that arise under conditions of low through high uncertainty. In Part III.A, we consider the type of multilateral regime that arises when uncertainty is low and the problem is profound official ignorance of insider practices within a common environment. The exemplar here is the contextualist regime governing the U.S. cotton market. We also discuss the rules developed for fast-track construction and construction management. In these thick general transaction markets, as uncertainty increases, important idiosyncrasies associated with particular transactions arise. Part III.B considers a particularly interesting multilateral contextualist regime: the Delaware Court of Chancery. Here we find an environment of thick general transactions but with greater uncertainty and, thus, particular transaction idiosyncrasies. Finally, Part III.C takes up the type of multilateral contextualist regime that evolves when uncertainty is high, and ignorance of the precise nature of threats and opportunities presented by the change in the business environment is universal. In the market for leafy greens, all actors can (and must) collaborate in the joint elaboration of innovative procedures to mitigate the risks to food safety that they confront.

A. Low Uncertainty and the Problem of Ignorance

Take first the setting where commercial practices are stable and well understood by a substantial community of traders. Uncertainty is low and markets are thick. But despite the regularities of dealings, and the trading community's easy familiarity with both patterns of dealing and the distinctive vulnerabilities to which they can give rise, the

generalist judge cannot reasonably be expected to have knowledge of such trade practices or be able to obtain it conveniently. The problem here, in other words, is that the state's designated decisionmaker is (and will likely remain) largely ignorant of the common knowledge of the trade, and unthinking application of traditional contract law principles will disrupt, rather than buttress, trade practice.[77] Coping with the adverse consequences of judicial ignorance, including moral hazard–based litigation brought by parties who have been disadvantaged by trade practices in a particular transaction and seek to take advantage of that ignorance, stimulates innovation by the affected trade association or other collective body.[78] The goal of the contextualizing regime that emerges is to innovate in ways that (1) render insider understanding in terms that can be incorporated into everyday contracting, (2) establish methods for the expeditious resolution of disputes arising under these agreements, and (3) institutionalize a process for keeping terms and forms of dispute resolution abreast of developments in the economic environment.

One variant of this kind of contextualizing regime is based on private ordering, to the de facto exclusion of courts and administrative

[77] To be sure, one might argue that in a low-uncertainty, multilateral environment, generalist courts can entertain evidence from the disputing parties as to the common practice or trade. But the problem is that in modern heterogeneous economies, trade practices are both complex and widely varied across industry groups. Some parties may, for example, wish to separate the legal norms that govern their written agreement from the informal norms that govern their actions. Under these circumstances, courts err if they permit the evidence of common practice to trump the formal terms of the agreement. Moreover, the available evidence suggests that courts, perhaps mindful of the risks, generally do not undertake careful evidentiary hearings to determine the precise nature of the relevant context in a contractual dispute. *See* Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF COMMERCIAL AND CORPORATE LAW 149, 166–67 & n.68 (Jody S. Kraus & Steven D. Walt eds., 2000); Imad D. Abyad, Note, *Commercial Reasonableness in Karl Llewellyn's Uniform Commercial Code Jurisprudence*, 83 VA. L. REV. 429, 452 (1997) ("The courts in effect are abrogating the responsibility that the Code drafters assigned to them by treating commercial reasonableness as garden-variety reasonableness, left for the lay juries to decide on a case-by-case basis with no systematic structure resulting from their decisions."); Lisa Bernstein, Trade Usage in the Courts: The Flawed Evidentiary Basis of Article 2's Incorporation Strategy 20–21 (2012) (unpublished manuscript) (on file with the *New York University Law Review*) (offering empirical evidence to show that courts typically rely on unreliable evidence to establish usages). This evidence suggests that many courts, lacking expertise, fall back instead on interested party testimony and generic concepts of reasonable commercial behavior rather than a careful evaluation of complex evidentiary submissions. The lack of any systematic inquiry into actual practices may also reflect the fact that any context evidence that is introduced must be evaluated in an environment of extreme moral hazard where one party who is disappointed by fate seeks to persuade the court to shift the relevant risk to the counterparty.

[78] *See infra* text accompanying notes 90–94.

agencies. Trade associations not only establish procedures for fixing and updating trade rules and technical terms, but also establish arbitral bodies to resolve disputes that arise under the collectively specified rules and terms. The contextualizing regime in the U.S. cotton industry, which originated in the mid-nineteenth century and took on its modern form in the 1920s, is a prominent example of this cluster of functions.[79]

Dealers in cotton are organized in the American Cotton Shippers Association (ACSA); the textile mills to which they sell are organized in the American Textile Manufacturers Institute (ATMI).[80] The ACSA and the ATMI have jointly adopted the Southern Mill Rules (SMRs) to govern transactions between their members.[81] The SMRs are revised annually, and changes are announced at annual meetings and widely circulated.[82] New members are encouraged to attend a summer course to familiarize themselves with the most important rules.[83] The two trade associations have established a joint arbitration

[79] Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1749–54 (2001) [hereinafter Bernstein, *Cotton*]. For discussion of analogous multilateral regimes, see generally Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1771–77 (1996) (discussing rules of the National Grain and Feed Association, which requires that all disputes among members must be submitted to the Association's arbitration system); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relationships in the Diamond Industry*, 21 J. LEG. STUD. 115, 115 (1992) ("[D]iamond industry disputes are resolved not through the courts and not by the application of legal rules announced and enforced by the state.").

[80] Bernstein, *Cotton*, *supra* note 79, at 1726.

[81] *Id.*

[82] *Id.* at 1772 ("Rule changes are announced at annual meetings, publicized through association circulars, and are sometimes discussed in the trade press. New merchants are strongly encouraged to attend the eight-week summer Cotton Institute that includes courses on the content of the most important sets of trading rules."). The most recent revision of the SMRs was adopted in 2004. *See* Am. Cotton Shippers Ass'n, Southern Mill Rules (2004), *available at* http://www.acsa-cotton.org/rules-and-policies/southern-mill-rules. According to prominent representatives of the relevant trade organizations polled in an informal telephone survey on condition of confidentiality, this is because no one has since felt the need to propose any amendments. Thus, the procedure recited in the text is still in place. According to the respondents, increased consolidation of the industry over the last fifteen years on both the buyer and seller sides has essentially eliminated the need (for now) to amend the SMRs. More specifically, as more and more of the industry operates overseas, the domestic textile community has grown smaller and more tightly knit. Fewer players but bigger players are left, and "everyone knows the rules." The merchant response implies that the SMRs have not been amended not because the industry has not changed, but rather because the extralegal enforcement mechanisms followed in the industry have been strengthened due to domestic industry consolidation. Telephone Interviews by Kalliope Kefallinos with Industry Representatives and Cotton Merchants (May 8–10, 2012) (interviews were conducted on condition of confidentiality).

[83] Bernstein, *Cotton*, *supra* note 79, at 1772.

panel, the Board of Appeals (BoA), to hear all disputes under the SMRs except those concerning quality, which are referred to a separate body, the Cotton States Arbitration Board (CSAB).[84]

Annual review by the trade associations assures that regularities in trade practice that contribute to generally beneficial outcomes are identified and incorporated into the SMRs.[85] As Bernstein notes, "given the amount of detail in the trade rules, cases involving contractual gaps are uncommon."[86] In fact, given the clarity and comprehensive character of the rules, disputes of any kind under the rules are infrequent. The BoA hears on average just two cases per year.[87] Low uncertainty allows for the development of the collective equivalent of state-contingent contracting, and an expert arbitration process reduces the likelihood of arbitrator error. Thus, there remains little to be resolved by litigation.

Here, too, we observe a variant of the braiding of formal and informal enforcement mechanisms. Decisionmaking by the BoA is textualist, with great attention to the letter of the contract in dispute and next to none for the context of the transaction it governs.[88] Contextual variations in individual transactions—for example, the willingness (or not) of a dealer to accommodate a mill by delivering before or after the contracted date—are assumed by the BoA to be the informal and reciprocal adjustments that both parties make to maintain dealings in a world that neither can fully control.[89] Parties will normally make several such adjustments before resorting to arbitration.[90] If there were any risk that the BoA would interpret such adjustments of the agreement as binding in the future, parties would be more reluctant to make them, and relations would become more brittle—again, as the behavioralists fear, formal contracting would drive out informal contracting.[91] Instead, the expectation of adjustments from trade terms in particular transactions represents an informal contract enforced by the expectation of repeated dealings between the parties and the importance of reputation in dealings with

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[84] *Id.* at 1727.

[85] *See id.* at 1726 n.7 (indicating that rules committees meet at least annually but that revision is slow when interests are not aligned).

[86] *Id.* at 1736.

[87] *Id.* at 1762. *But see infra* note 112 (citing recent evidence in the cotton industry showing that higher uncertainty correlates with an increased number of disputes, as parties' potential losses rise).

[88] *See* Bernstein, *Cotton*, *supra* note 79, at 1735–37 (contrasting the adjudicative approach of courts with that of cotton industry arbitration tribunals).

[89] *See id.* at 1743–44 (describing the informal flexibility of transactors and the importance of adjudicative unwillingness to transform this flexibility into an obligation).

[90] *Id.* at 1775–76.

[91] *See supra* note 43 and accompanying text (reviewing behavioralist literature).

future industry counterparties. These informal adjustments are ignored by the textualist arbitrators; the presence of formal contracting supports the operation of informal contracting.

Damage rules in the formal enforcement process are also set to encourage braiding of formal and informal contractual elements. Monetary damages are set high enough to make it unprofitable to breach a contract to take advantage of price volatility, but are generally "under-compensatory" in making no provision for recouping foregone profit through expectation damages.[92] Formal penalties are then supplemented by private ones imposed by members of the community of transactors, resulting in what Bernstein calls "hybrid" (or in our terms "braided") sanctions that remind wrongdoers of their obligations and allow the parties to transactions in distress to arrive, informally, at mutually acceptable remedies, but that provide no inducement to manipulate the formal rules for selfish gain.[93]

The innovations in contractual processes that are created by trade associations such as the ACSA and ATMI are customarily protected by their formal removal from the supervision of generalist courts—most merchant-to-mill contracts provide for arbitration by the BoA.[94] But regimes of this type are not inherently private in the sense of depending on complete insulation from public institutions. Rather, the trade associations themselves set the terms of engagement with public institutions. We see this in the cotton industry. To take advantage of the recent improvements in quality measurement instruments, the SMRs have incorporated reference to a grading system maintained by the Department of Agriculture, and the CSAB accordingly relies on the public grades as well.[95] Moreover, when collective

[92] Bernstein, *Cotton*, *supra* note 79, at 1733 ("[T]he damage measures in the SMRs and the MCE Trading Rules tend to be under-compensatory."). There has been a great deal of price volatility in cotton since 2011, with the price rising to an all-time high in March 2011 ($2.2967/lb) and coming down to less than $0.90/lb today. *Cotton Monthly Price – U.S. Cents Per Pound*, INDEXMUNDI, http://www.indexmundi.com/commodities/?commodity=cotton&months=60 (last visited Feb. 13, 2013). This price volatility has led to an extraordinary surge in breaches of sales contracts between farmers and merchants and merchants and mills, and a corresponding increase in strain on the arbitration system. Michael Rothfeld & Carolyn Cui, *Plague of Broken Contracts Frays Cotton Market*, WALL ST. J., Aug. 30, 2012, at A1.

[93] *See* Bernstein, *Cotton*, *supra* note 79, at 1783–85 (describing the process of encouraging cooperation through "hybrid-sanctions").

[94] *Id.* at 1727.

[95] *See Cotton States Arbitration Rules*, AM. COTTON SHIPPERS ASS'N, http://www.acsa-cotton.org/rules-and-policies/smr-cotton-states-arbitration-rules (last visited Feb. 13, 2013) ("Rule 15: The basis of all arbitrations for grade and/or staple shall be the Official Universal Cotton Standards of the United States Department of Agriculture for grade and/or the Official Cotton Standards of the United States Department of Agriculture for length of staple . . . .").

action problems thwart private coordination, contextualizing regimes of this type can also be created by statute and administered by public agencies.[96]

Multilateral contextualizing regimes may also use common law courts to create precedents as a means of standardizing novel terms as they evolve. In contrast to the cotton industry's walling off of generalist courts through mandatory expert arbitration, such standardization has been stimulated in construction contracting through the offices of key intermediaries such as the American Institute of Architects and the Associated General Contractors.[97] One particularly instructive illustration is the response of these two trade organizations to the contracting challenges produced by the development of fast-track construction and the construction management model of design-build contracting.[98] During the 1970s, each of these two rival organizations produced a competing set of model forms that defined the contractual obligations and risks associated with the use of a

[96] In "The Significance of an Institutional System: The Case of the Spoiled Cantaloupes," an extended section in HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW 10–68 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994), the authors describe just such a contextualizing regime for the regulation of contracting in perishable agricultural commodities. The regime was initially created to respond to "the rejection evil." *Id*. at 40. When prices fell against them, buyers evaded their commitments by using minor nonconformities as pretexts to reject. Small shippers were typically unable to salvage rejected goods or to pursue litigation in distant locales. The dispersed and fragmented character of the industry impeded trade associations' efforts to address the problem for decades. *Id*. In 1930, Congress passed the Perishable Agricultural Commodities Act (PACA), which makes it a violation of federal law for "any dealer to reject or fail to deliver . . . without reasonable cause any perishable agricultural commodity" in an interstate transaction. 7 U.S.C. § 499b(2) (2006). The Act instructs the Secretary of Agriculture to promulgate regulations to guide interpretation of contract terms allocating risks specific to the industry between buyers and sellers, operate an arbitration process to adjudicate claims at reasonable costs, and administer a licensing scheme to screen irresponsible buyers and sellers from the industry. HART & SACKS, *supra*, at 33–34. In practice, contract terms were elaborated with the close cooperation of private trade associations. *Id.*, at 41–42, 44. Thus, in this case, too, sanctions are set so as to facilitate braiding. For further discussion of this case, see Sabel & Simon, *supra* note 2, at 1277–78.

[97] *See* Goetz & Scott, *supra* note 54, at 303 ("Trade organizations provide a mechanism to internalize at least some of the gains from contractual innovation."). For further discussion of standardization of contractual terms and subsequent testing of such terms in courts, see Scott, *supra* note 77, and Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 868–69 (2000) [hereinafter Scott, *The Case for Formalism*].

[98] The fast-track process is a "method of construction by which actual construction is commenced prior to the completion of all design, planning, bidding and subcontracting stages in order to alleviate the effects of inflation." Meathe v. State Univ. Constr. Fund, 410 N.Y.S.2d 702, 703 (App. Div. 1978).

construction manager.[99] Versions of these forms have been widely adopted by contracting parties within the industry and subsequently have been tested in both litigation before generalist courts and consensual arbitration where the parties select the presumably expert arbitrators.[100]

An evolving set of standardized "official" context-specific terms that are easily observable by parties has emerged from this process.[101] Once standardization has been achieved, these forms typically specify arbitration as the means of dispute resolution, thereby allowing the parties to increase the experience of the decisionmaker who will resolve disagreements over the terms of the standard forms.[102] Importantly, these context-specific terms differ in critical ways from the collective equivalent of state-contingent contracting arising in the cotton industry. In the construction and construction–management contexts, the transactions covered share general characteristics but differ significantly in ways peculiar to the particular project—unlike easily gradable cotton, every building is different and the terms apply to construction projects with very different scale and complexity. Because there are more idiosyncrasies associated with this activity, the multilateral contextualizing regime responds by emphasizing process rather than specific outcomes, thereby taking advantage of generally low uncertainty concerning the general transaction form while retaining flexibility to address particular transactional features.

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[99] Scott, *supra* note 77, at 168; Scott, *The Case for Formalism*, *supra* note 97, at 869–70; *see also* Goetz & Scott, *supra* note 54, at 296–97 & n.86, (citations omitted).

[100] Scott, *supra* note 77, at 168; Scott, *The Case for Formalism*, *supra* note 97, at 870; *see also, e.g.*, Bolton Corp. v. T.A. Loving Co., 380 S.E.2d 796, 800–01 (N.C. Ct. App. 1989) (applying plain meaning legal principles to an industry-wide prototype contract). For a review of the testing of contract terms through arbitration, see Thomas J. Stipanowich, *Beyond Arbitration: Innovation and Evolution in the United States Construction Industry*, 31 WAKE FOREST L. REV. 65 (1996).

[101] Scale also matters with respect to designating the forum that will adjudicate disputes concerning the performance of a contract. Analogous to form contracts, scale will support specialized forums that will have the experience and expertise to understand and apply the relevant context. Out of this testing process, a set of standardized terms emerges that collectively reduces the risk of writing construction contracts. *Cf.* Victor G. Trapasso, *The Lawyer's Use of AIA Construction Contracts*, PRAC. LAW., May 1973, at 37 (advising attorneys to "be aware of the wide acceptance of AIA form instruments by the construction industry").

[102] By choosing arbitration, parties are able to select decisionmakers who have expertise in the relevant industry. This is likely to result in more accurate outcomes and, thus, is especially important with regard to novel contractual forms. *See* Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549, 558–61 (2003) (suggesting that parties are more likely to leave contract terms vague when they trust a decisionmaker to fill the gaps).

B. The Delaware Chancery: The Specialized Court as a Contextualizing Regime

Consider now a second circumstance like the construction industry, where there are a large number of highly complex transactions that broadly share general features and therefore reflect a thick market for these features, but where each transaction has significant idiosyncratic features and the common background conditions shift rapidly. Put differently, the market is thick only in general and uncertainty is high with respect to particular transactions. Here we examine how a contextualizing regime—that contemplates a central role for courts to provide a range of generally applicable rules, but which nonetheless allows particularized responses when the idiosyncrasies of a transaction are important—can develop. Like the construction industry case, the emphasis is on process rather than detailed rules.[103]

Consider—from the perspective of a contextualizing regime that responds to uncertainty and scale—how the legal rules governing the obligations of boards of directors in corporate acquisitions are applied. In this context, the uncertainty does not arise from the unforeseeable, unintended consequences of incorporation of new actors, products, and production processes into a highly interdependent endeavor, as we examine in the next section. Rather the uncertainty arises through the strategic interaction of actors intent on advancing their separate interests by manipulating open-ended standards in volatile environments that cannot be addressed by bright-line rules. Actors in such an environment can take collective—if only parallel rather than coordinated[104]—actions to reduce the very uncertainty to which their own behavior contributes by independently choosing to incorporate in the same jurisdiction. The goal is to reduce the chance of judicial error in ex post application of vague standards such as fiduciary duty. This collective action takes the form of reliance on expert judges with significant experience in the field; reliance, that is, on a specialized court of equity.[105] The specialization of the court together with its equitable powers assure parties that, despite the impossibility of codifying particularized decision rules, judicial

[103] *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 803–04 (2003) (describing the Delaware Court of Chancery's preference in freeze-out merger cases for applying fairness review processes over determining the value of minority shares).

[104] *See* Michael Klausner, *Corporations, Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757, 761 (1995) (describing how independent but parallel actions of parties create network effects).

[105] That the Delaware court is one of equity has an additional advantage: There are no juries in a court of equity. A lay jury as the trier of fact is a significant independent source of potential error in complex commercial cases.

decisions will be taken with the fullest possible awareness of current and evolving understandings of good practice. Like the pattern with fast-track contracting,[106] the focus is on process rather than on substantive facts. In turn, the scale necessary to reduce this judicial experience is achieved through parallel action in the choice of a state of incorporation.

One way to understand why a majority of U.S. public corporations choose Delaware as an incorporation state is that it serves to allocate to the Delaware Court of Chancery jurisdiction to resolve fiduciary duty issues.[107] Delaware corporate law is enabling; that is, it gives corporations wide latitude to adopt specific rules governing their behavior.[108] In fact, however, Delaware corporations appear not to accept that invitation, preferring to write articles of incorporation and bylaws that largely address only formal issues such as meeting dates and the like. This is because a corporation's circumstances and the evolution of the market for corporate control are too uncertain to specify ex ante conduct rules that will govern all of the corporation's activities in the future.[109] The result of not specifying tailored rules is that serious issues are covered instead by a vague standard—the director and officer's overriding obligation of fiduciary duty—that is applied by an expert court ex post.[110] Thus, a corporation assures that the gaps in its articles of incorporation and bylaws resulting from uncertainty will be filled by a court with the expertise necessary to reduce the likelihood of erroneous decisions. It does this by incorporating in a jurisdiction where parallel private action has produced a

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106 *See supra* text accompanying notes 97–102.

107 In the United States, the internal affairs doctrine dictates that the law of the state of incorporation governs the corporation's internal affairs, including the scope and application of fiduciary duties. JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS 233–34 (7th ed. 2008).

108 WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 92 (3d ed. 2009) ("The typical corporation statute of today, such as [Delaware's], is a nonregulatory, 'enabling' statute . . . .").

109 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 204 (1991) ("[F]irms go public in easy-to-acquire form: no poison pill securities, no supermajority rules or staggered boards. Defensive measures are added later, a sequence that reveals much.").

110 *See, e.g.*, Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take That Action: The Implicit Corollary to the Rule of* Schnell v. Chris-Craft, 60 BUS. LAW. 877, 879–80 (2005) (arguing that Delaware addresses managerial exploitation by equitable standards, not legal rules).

sufficient scale of incorporations such that its judges have developed the necessary experience and expertise.[111]

The cost of an ex post recourse to context, like its benefit, goes up with uncertainty. Indeed, a crude generalization would be that an increase in uncertainty more than proportionately increases the cost of ex post recourse to context by generalist courts: The uncertainty erodes constraints on judicial misuse of context and augments the incentive for moral hazard–based litigation. But increasing the quality of the adjudicator can change the relationship between uncertainty and resort to context, reducing the probability of error and thus increasing the potential benefits and reducing the potential costs.[112] This is what the Delaware Chancery does for sophisticated corporate litigants attempting to come to grips with the uncertainty caused by the litigants' own behavior in planning transactions ex ante: The judges know the litigants' context well enough to reliably be able to identify and sanction opportunistic behavior. Through this specialization, the Delaware Court of Chancery itself becomes a type of contextualizing regime in which contractual innovation evolves.[113]

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[111] Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 14 (2006), and Klausner, *supra* note 104, at 845–46, address the advantage of a specialized Court of Chancery in applying corporate law.

[112] For example, in Lisa Bernstein's description of the role of the International Cotton Advisory Committee in the cotton industry, industry-specified context operates to avoid conflict in periods of low uncertainty; shared understandings and relational dealings reduce the number of arbitrations. *See* Bernstein, *Cotton*, *supra* note 79, at 1762 ("[O]ne of the most important ways that cotton industry institutions create value is by providing a social and institutional transactional framework that effectively constrains opportunism and promotes commercial cooperation in its shadow."). However, when uncertainty grows, the number of disputes increases as a party's potential losses rise. In 2011, the unusual volatility in cotton prices resulted in more defaults—reportedly some ten percent of all commercial contracts—and more arbitration requests than any time since the start of record-keeping in 2000. Leslie Josephs, *Cotton Contracts, Made to Be Broken*, WALL ST. J., Oct. 25, 2011, at C4. In this circumstance, the International Cotton Advisory Committee, the leading trade group and the designator of context, selects the arbitration panels. *Id.* The use of industry expert arbitrators, who know the context, permits consideration of context even as uncertainty increases, thus extending the range over which context can be usefully incorporated before uncertainty so increases the risk of mistake and moral hazard–based litigation that resort to context makes things worse: Increases in uncertainty reduce, rather than increase, the utility of resort to context, and the curve turns down.

[113] This account of the Delaware Court of Chancery as a contextualizing regime does not address a destabilizing element that is peculiar to corporate law. Much corporate law fiduciary litigation is brought by plaintiffs' lawyers representing shareholders generally, rather than reflecting disagreements between corporations. Because plaintiffs' lawyers can bring such cases in states other than Delaware even though Delaware corporate law and precedent applies, the Delaware Court of Chancery can be avoided in cases where its knowledge and experience would be particularly useful. Early empirical studies suggest that this phenomenon may be significant. *See* John Armour, Bernard Black & Brian Cheffins, *Is Delaware Losing Its Cases?*, 9 J. EMPIRICAL LEGAL STUD. 605, 624–25 (2012) (citing the growth of important corporate cases filed outside of Delaware). We now may be

C. *High Uncertainty and the Problem of Joint Risk Mitigation*

Now we come to the corner position in our typology where markets are thick and uncertainty is high.[114] This domain has attracted less scrutiny than the thick-market, low-uncertainty settings previously discussed, but its significance is rapidly increasing as a matter of practical concern.[115] Unlike the low-uncertainty, thick-market domain, the central problem is not an information asymmetry where judges are ignorant of established trade understandings or practices that are familiar to practitioners. Rather, under conditions of high-uncertainty *neither* generalists *nor* insiders are sure about the correct approach to a particular problem. Hence the regime aims not to elaborate and codify established knowledge, but instead to organize mechanisms for joint problem solving. In this sense, the problem is the thick-market analogue to bilateral contracting for innovation discussed in Part II, but with scale now making possible a collective facilitation of collaboration. This pattern is especially suited to efforts to mitigate exogenous risks that can only be addressed through exacting, common efforts by all market participants—where uncertainty is high (all face a risk to which there is, ex ante, no well-defined and effective response), but idiosyncrasy is low (given that individual solutions are likely to be directly applicable, at least in part, to the problems of others). Put differently, in the bilateral thin-market and high-uncertainty case contracting parties collaborate for joint gains, while in the thick-market and high-uncertainty case their goal is to reduce the chances of the great harm to all industry participants that could be caused by the failure of even one party to take precautions against creating negative externalities affecting the whole industry. The goal of the multilateral regime thus is to bring members together to create bilateral arrangements that minimize the risk of general harm. In this case, collective determination of acceptable practices goes hand in hand with the determination of the conditions for contracting.[116]

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observing the early stages of a round of parallel activity to sustain a working contextualizing regime through the adoption of amendments to the corporation's charter that require fiduciary litigation to be tried in the Court of Chancery. *See* Joseph A. Grundfest, *The History and Evolution of Intra-corporate Forum Selection Clauses: An Empirical Analysis*, 37 DEL. J. CORP. L. (forthcoming 2012), *available at* http://ssrn.com/abstract=2042758 (discussing suits "challenging the adoption of forum selection clauses in bylaw provisions without prior shareholder approval").

114 The following material draws on an unpublished manuscript, Gilson, Sabel & Scott, *supra* note 9, parts of which became portions of this Article.

115 *See* Sabel & Simon, *supra* note 2, at 1278–79 (discussing the intersection of increased uncertainty and heightened public safety concerns).

116 *See id.* at 1284–85 (discussing the respective roles of private contracting and regulation in setting standards).

Food safety illustrates the nature of the risks this type of contextualizing regime addresses. As the supply chains for foodstuffs lengthen and proliferate, the chances for pathogens to enter increase exponentially. Processing rapidly propagates food contamination by mixing of foodstuffs and secondary contamination of equipment. Rapid distribution makes tainted foodstuffs widely available even as first reports of the outbreak of food-borne illness accumulate.[117] All actors in the food supply chain—growers, processors, distributors, and retailers—share an interest in safeguarding their market by developing practices that reduce the chances for contamination and limit its effect. As the failure of any actor to maintain good practices can thwart the efforts of all the others, adhesion to the regime will be a precondition to contracting in the market—collective action will prevent any actor from producing a negative externality that harms the others. Government, as the protector of public health, has complementary interests. So, as in the case of contextualizing regimes addressing judicial ignorance as in the cotton industry, collective responses to high-uncertainty multilateral regimes that seek to mitigate risks rather than maximize gains can be formed either by public or private action, depending on the configuration of collective action problems.

The California Leafy Greens Products Handler Marketing Agreement (LGMA) is an exemplar of an (initially) private regime of this type.[118] Leafy greens became a public concern after highly publicized disease outbreaks from tainted spinach and lettuce in 2006.[119] Leafy greens are often eaten raw (cooking kills most micropathogens); they are often sold as mixed salads that mingle pieces picked in different locations. These factors, in combination with the increasing scale of production, greatly multiply the chances for cross contamination. Federal food regulation traditionally had focused on

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117 *See Food-Trade Network Vulnerable to Fast Spread of Contaminants*, SCIENCE DAILY.COM (June 7, 2012), http://www.sciencedaily.com/releases/2012/06/120607180241.htm (discussing the international food-trade network's vulnerability to fast-spreading contaminants).

118 State of Cal. Dep't of Food & Agric., California Leafy Green Products Handler Marketing Agreement (effective as amended Mar. 5, 2008) [hereinafter California Marketing Agreement], *available at* http://www.cdfa.ca.gov/mkt/mkt/pdf/CA%20Leafy%20Green%20Products%20Handler%20Agreement.pdf.

119 *See generally* Julie Schmit, *All Bacteria May Not Come Out in the Wash*, USA TODAY, Oct. 5, 2006, at 1B, *available at* http://www.usatoday.com/money/industries/food/2006-10-04-spinach-wash-usat_x.htm (discussing the 2006 outbreak and the special concerns associated with eating raw spinach).

post-farm industrial processing[120] and was ill-prepared to address the numerous points on the farm by which pathogens could enter this food chain.

In 2007, after the outbreaks of illness, the FDA embarked on a program to encourage and assist state and private efforts at regime building.[121] Thereafter, the Western Growers Association of California petitioned the state to recognize the LGMA. The growers were acting under the authority of a state marketing act that confers antitrust immunity for various purposes on organizations of agricultural producers.[122] There are currently about 120 members of the trade association and collectively they account for roughly ninety-nine percent of California leafy green production (which in turn accounts for about seventy-five percent of national production).[123]

The LGMA designates safety standards or "best practices" for the farms from which member handlers buy leafy greens.[124] The standards require growers and processors to prepare plans for identifying all hazardous control points, and to detail the steps they have taken to mitigate the hazard. Members also commit to a monitoring and reporting regime that seeks to verify the efficacy of any precautionary actions that are undertaken.[125] Inspectors from the California Department of Food and Agriculture monitor compliance with the

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120 *See, e.g.*, 21 U.S.C. §§ 342(a)(1), 601(m)(4) (2006) (prohibiting the sale of food that is "injurious to health"); *id.* §§ 601(m)(3) (prohibiting the sale of food that is "unsound, unhealthful, unwholesome, or otherwise unfit").

121 *See* Marian Burros, *Government Offers Guidelines to Fresh-Food Industry*, N.Y. TIMES, Mar. 13, 2007, at A17. The agency also pointed to insufficient enforcement resources. *Id.*

122 Sabel & Simon, *supra* note 2, at 1280.

123 *See* U.S.D.A. Agric. Mktg. Serv., Justification of Proposed Federal Marketing Agreement for Leafy Green Vegetables, http://www.ams.usda.gov/AMSv1.0/getfile?dDocName=STELPRDC5077207. *See generally* Varun Shekhar, *Produce Exceptionalism: Examining the Leafy Greens Marketing Agreement and Its Ability to Improve Food Safety*, 6 J. FOOD L. & POL'Y 267 (2010) (evaluating the benefits and weaknesses of the LGMA in ensuring food safety).

124 The LGMA is governed by a thirteen-member board. Board members are chosen by the state Secretary of Agriculture from nominations by the membership. Between seven and twelve members must be representatives of the handler-members of the organization; the Department of Food and Agriculture may also appoint an additional member who is supposed to represent "the general public." California Marketing Agreement, *supra* note 118, art. III; Sabel & Simon, *supra* note 2, at 1280.

125 *See* California Marketing Agreement, *supra* note 118, art. V (discussing the requirement that members must follow the Agreement's Best Practices in order to use the official Service Mark of the Agreement). *See generally* Cal. Leafy Green Prods. Handler Mktg. Bd., Commodity Specific Food Safety Guidelines for the Production and Harvest of Lettuce and Leafy Greens (Jul. 22, 2011), *available at* http://www.caleafygreens.ca.gov/sites/default/files/LGMA%20Accepted%20Food%20Safety%20Practices%207.22.11.pdf (containing various provisions that impose record-keeping requirements on signatory handlers).

standards specified in the Agreement.[126] Importantly, in order to respond effectively to a later discovery of contamination, the LGMA requires each handler to maintain records that permit inspectors to identify the farm and field from which all components of its products originate.[127] The regime relies critically on informal enforcement: The members commit to deal only with farms that comply with the standards. As in the case of the low-uncertainty contextualizing regimes such as the cotton industry trade associations, the ultimate sanction for noncompliance with formal procedures is suspension or withdrawal of a recalcitrant member's right to use a service mark. In this way, temporary or permanent exclusion from the industry is enforced informally.[128]

As in our previous examples, the success of the LGMA and the durability of the innovation in joint collaboration between private actors and public entities to reduce food safety risks requires a reassessment of the role of generalist courts and the extent to which they can successfully apply traditional common law contract principles to the unique problems that will arise with disputes under this regime. A properly functioning contextualizing regime, we argue, assigns to administrative institutions the responsibility for establishing the baseline of standards of behavior and processes, and assigns to courts the more limited role of identifying significant deviations from that baseline in particular cases.[129]

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126 Sabel & Simon, *supra* note 2, at 1280.

127 *Id.* at 1281.

128 California Marketing Agreement, *supra* note 118. There is a parallel regime in Arizona, and there are other private standard-setting and certification regimes, such as GlobalGAP (for "good agricultural practices"), "an organization formed by major European retailers," and a "private international organization, the Global Food Safety Initiative, [that] assesses certification regimes in accordance with a set of metastandards." Sabel & Simon, *supra* note 2, at 1284. "Once a certification regime has itself been certified at this level, buyers who have previously decided to accept any of the other approved certifications should be willing to accept it." *Id.* For further discussion of the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS agreement), see JOANNE SCOTT, THE WTO AGREEMENT ON SANITARY AND PHYTOSANITARY MEASURES 41–75 (2007) (discussing the SPS agreement as an attempt to mitigate an accountability gap in the area of food safety regulation through, among other things, "the regulation of regulation").

129 The 2010 federal Food Safety Modernization Act reinforces the mechanisms embodied in the LGMA. Food Safety Modernization Act, Pub. L. No. 111-353, §§ 102–105, 201–205, 301–307, 124 Stat. 3885–905, 3923–39, 3953–66 (2011) (amending the Federal Food, Drug, and Cosmetic Act to have more stringent, detailed, and preventive requirements). The Act mandates that each food processing facility develop, implement, monitor, validate, and update a plan for hazard control. *Id.* § 103. The Act also directs the FDA to set standards for fruits and vegetables, *id.* § 105(a), and "it seems clear that such standards will be developed in a way that relies on organizations like the LGMA" to continue and advance the joint exploration of risks and possible mitigations on which this type of regime depends. Sabel & Simon, *supra* note 2, at 1284–85.

Conclusion
Mapping Uncertainty and Scale on Contextualizing Regimes

Contractual innovation is the third step in a dynamic process. Exogenous change in the business environment evokes substantive innovation in business practices as private actors adjust existing structures or procedures to make them efficient under the changed circumstances. Innovations in contract form then arise to stabilize the new arrangements. It is only at this point that generalist courts enter the picture, when they are asked to resolve disputes and standardize the workings of the contractual innovation. Their task is to adapt the application of contract law to the context presented by the contractual innovation.

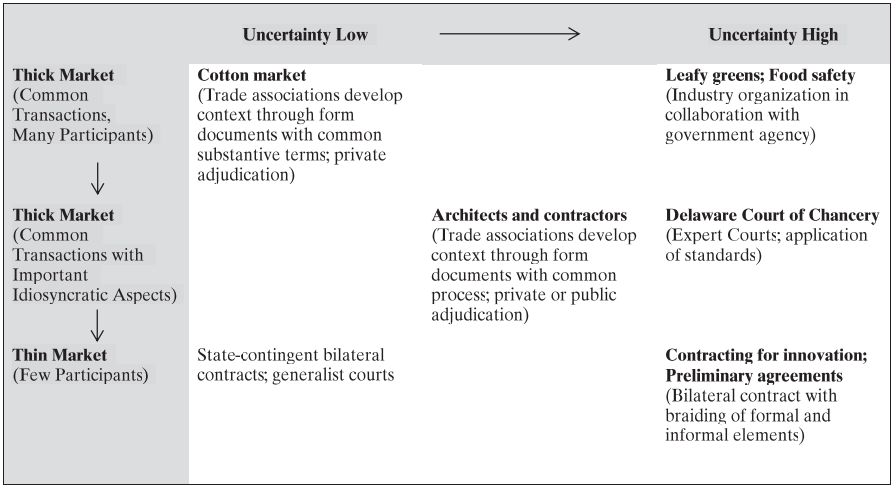
As we have seen, contracting parties increasingly create contextualizing regimes to delineate the context for understanding the relationship into which the parties have entered. These regimes can take different forms depending centrally on the level of uncertainty in the new circumstances and the scale associated with the activities affected. In thin-market conditions, regimes range from bespoke contract design to bilateral collaborative agreements that are interpreted by generalist courts. In thick markets, collective actions can stimulate the formation of trade associations as well as arbitration regimes, expert courts, and public-private partnerships between trade associations and government regulatory agencies. The Figure that follows summarizes the relationship between levels of uncertainty and scale and how these combinations map onto the characteristics of the matching contextualizing regime.

This mapping between uncertainty, scale, and the form of contextualizing regime frames the problem confronting generalist courts in assessing how they can facilitate contractual innovation. As in the case of the effort to create a contextualizing regime for insurance law, a court's ill-considered approach to an innovative contract can undermine the innovation.[130] While the role of generalist courts will differ across the regions of the taxonomy of contractual innovation, in all cases it will be more restricted than the standard account. By that account, courts should strive in the course of adjudicating disputes to incorporate incipient context into the formal structure of commercial law.[131] The error there is twofold. Initially, as we have argued, generalist courts are peculiarly ill-equipped to discover and understand the context that innovative parties have developed. Moreover, by the time

[130] *See supra* note 50 (discussing challenges faced by reviewing courts).

[131] *See supra* text accompanying notes 2–5 (discussing courts' consideration of context).

FIGURE: CONTEXTUALIZING REGIMES AS A FUNCTION OF SCALE AND UNCERTAINTY



a dispute reaches the courts much of the contextualization will already have been undertaken by other institutions, including, most importantly, by the parties themselves.

Thus, the task for generalist courts is to recognize that contextualizing regimes are the institutions through which they first encounter contractual innovation, and that the higher the uncertainty associated with the regime, the more restricted the courts' role. These regimes, including the constraints parties impose on courts in bilateral contracts like preliminary agreements, reflect the methods of mutual cooperation the parties have chosen to provide the context that should govern their relationship. If a central goal of contract adjudication is to enforce the context that the parties have provided, then improvements in the relation between courts and contextualizing regimes—that is, the courts' willingness to defer to the context the parties give them—will put the law more directly in the service of innovation. To do that, both judges and contract theorists will have to attend to the unique characteristics of novel contract forms as they are influenced by the key variables of uncertainty and scale. Thus, as we suggested at the outset, courts must practice the passive virtues in responding to contract innovation driven by changes in the contracting parties' business environment: The parties, not the courts, drive innovation.