

# TRANSACTIONAL RISK AND CONTRACTUAL RISK ACCOMMODATION IN CONTRACT DRAFTING: MORE THAN AN INDEMNITY PARAGRAPH

Harold Weston\*

## I. INTRODUCTION

Business transactions are the reasons for contracts. Risk in transactions is more about uncertainty in fulfilling the transaction, on both sides, as the businesspeople see it, than blame shifting at the end, as the lawyers see it. The contract is to support a transaction. The risks in the transaction are multiple and multidimensional risks, some of which can be planned for, as contingencies; others not, as exigencies. The transactional risks, as I call them here, should be the underlying purpose for how we draft the contract using the drafting techniques of representations, warranties, conditions, covenants, defaults, and rights.

This is different than the typical legal drafting approach to deal with the two risks that lawyers know, a first-party risk of failure to perform, and a third-party risk of harms to third-parties resulting in liability to the contracting party. These are contractual risks, dealt with through the ominous and omnibus indemnity section. Most lawyers deal with contractual risks because they have learned about contractual risks from reading cases about contract breaches and contract losses, and because they usually do not really understand the business process. Thus, the drafting techniques of representations, etc., are sorted into slots in the contract, perhaps not really relevant to the transaction, though they are loaded to trigger blame and indemnity when the performance fails. The contract ought to specifically address contract risks and ought generally to accommodate transactional risks.

---

\* Clinical Associate Professor, Georgia State University, Robinson College of Business, Department of Risk Management and Insurance, and College of Law (secondary appointment), Atlanta, Georgia.

The title here has evolved from the title at my presentation of this conference, "Contract Drafting and Risk Shifting in the Transaction: More than an Indemnity Paragraph."

The suggestion here is to view the contract as supporting the business process and dealing with the various uncertainties of transactional risks, rather than the contract being the cause and purpose of the transaction. A business perspective, and an understanding of the business process, is therefore important in drafting the contract to address transactional risks.

This paper develops the thesis of transactional risk and contractual risk accommodation for drafting contracts using several domains: relational contracts, enterprise risk management, options and the theory of incomplete contracts; the expanding role of inhouse counsel in applying the forgoing, contract management and its evolving counterpart contractual management;<sup>1</sup> and the inadequacies of the typical indemnity provisions drafted by lawyers to address transactional risk. These domains can inform contract drafting and how to teach contract drafting beyond technical aspects.

## II. IS THE POINT A TRANSACTION OR A CONTRACT?

Business transactions are the reasons for contracts. A desired business transaction generates a contract; a contract does not generate a transaction,<sup>2</sup> although the absence of a contract may delay the transaction. For businesspeople, the contract (if they have one, and if it really applies, and if they follow it, which are all too frequently lacunae in the transaction),<sup>3</sup> is about implementing the transaction. The transactions might be singular, to obtain a service or a product in a single transaction; these may be called spot contracts, and these are the epitome of classical contract theory that looks to *a contract*.<sup>4</sup> The transactions might be prolonged, for repetitive or multiple services or delivery of multiple goods over an extended period, or due to the time to accomplish a singular service or to manufacture a good; these reflect an ongoing relationship between the parties, later encompassed in the studies and theory of

---

<sup>1</sup> Ralph Schuhmann & Bert Eichhorn, *From Contract Management to Contractual Management*, 11 EUR. REV. CONT. L. 1 (2015).

<sup>2</sup> The classical doctrines of contract law were “purely, or almost purely, objective. . . . Classical contract law carried objectivism so far that it overrode the actual shared intentions of the parties,” even to the point that a contract could be formed that did not reflect the intentions of either party. Melvin Aron Eisenberg, *Symposium on Law in the Twentieth Century: The Emergence of Dynamic Contract Law*, 88 CALIF. L. REV. 1743, 1754–57 (2000).

<sup>3</sup> Stewart Macaulay, *Symposium: Law, Private Governance and Continuing Relationships: An Empirical View of Contract*, 1985 WIS. L. REV. 465, 467 (1985).

<sup>4</sup> D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 4–6 (2009).

relational contracts, discussed below.<sup>5</sup> Thus transactions run a spectrum from discrete to relational, as Smith and King say,<sup>6</sup> and (similarly) static to dynamic reflecting the past, present and future of the transaction, as Eisenberg says.<sup>7</sup>

The business perspective is to implement the transaction, which may also be fulfilling a contract.<sup>8</sup> For businesspeople, the contract is the scaffold to regulate the transaction; it is not the transactional edifice itself. No one enters into a contract without some underlying purpose. “Business people often do not plan, exhibit great care in drafting contracts, pay much attention to those that lawyers carefully draft, or honor a legal approach to business relationships.”<sup>9</sup> In fact, the transaction may be ongoing, yet the contract may be incomplete in describing the transaction—thus the place for gap-filling remedies of Uniform Commercial Code Article 2<sup>10</sup> and for the various common law fixes of common counts (quantum meruit, quasi- or implied contract, etc.) applied post-loss to splint a transaction that lacked a contract up front.<sup>11</sup> Or contracts are patched on

---

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 9.

<sup>7</sup> Eisenberg, *supra* note 2, at 1762, 1748–49 (“A contract law doctrine lies at the static pole if its application turns entirely on what occurred at the moment in time when a contract was formed. A contract law doctrine lies at the dynamic pole if its application turns in significant part on a moving stream of events that precedes, follow, or constitutes the formation of a contract.”).

<sup>8</sup> Sonja A. Soehnel, Annotation, *What Constitutes a Transaction, a Contract for Sale, or a Sale Within the Scope of UCC Article 2*, 4 A.L.R.4th 85 (1981) (discussing and collecting cases explaining that a contract for the sale of goods is one type of transaction).

<sup>9</sup> Macaulay, *supra* note 3, at 467.

<sup>10</sup> See *Apex v. Sharing World, Inc.*, 206 Cal. App. 4th 999, 1011 (2012) (“[t]he Uniform Commercial Code provides gap fillers to cover time and place of payment and delivery when those terms are not expressed in the parties’ agreement.” (citing WHITE & SUMMERS, UNIFORM COMMERCIAL CODE §§ 3-5, 3-7 (2006))); *Bethlehem Steel Corp. v. Litton Indus.*, 468 A.2d 748, 766–67 (Pa. Super. Ct. 1982) (“The intent of the Code, as clearly expressed by 13 Pa.C.S.A. § 2204(c), is to preserve a contract and fill in any gaps, ‘if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.’”); Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 870 (1992); Timothy E. Travers, Annotation, *Construction and Application of UCC § 2-305 Dealing with Open Price Term Contracts*, 91 A.L.R. 3d 1237 (1979). *But see* Allen R. Kamp, *Downtown Code: A History of the Uniform Commercial Code 1949-1954*, 49 BUFF. L. REV. 359, 475 (2001).

<sup>11</sup> 7 C.J.S. *Action of Assumpsit* § 2 (2018). “General assumpsit is an action of assumpsit brought upon the promise or contract implied by law in certain instances. In this form of action, plaintiff ignores the express undertaking, if any, and grounds the action on an implied contract springing from a consideration received. In general assumpsit, the court,

after the deal is underway to memorialize an undertaking, thus “deeming” the contract effective on a date prior to execution. Or contracts are ambiguous or contradictory when badly drafted, sometimes because the contract form is misapplied, or the contract is cribbed from bits of other bad contract forms that never are properly fitted and blended to the transaction. Or contracts are skeletons that are given shape and body later by amendments, policies and procedures, memorandums of understanding, change orders, purchase orders based on a master contract, and sometimes only by an invoice. “Because contracts always evolve, or at least may always evolve, interpretation should take account of the way in which the parties live and grow their contracts.”<sup>12</sup>

Businesspeople see risk in transactions as uncertainty in fulfilling the transaction going forward. It is an anticipatory risk. Can we do what we are agreeing to do? What resources (labor, capital, time, licenses, suppliers, materials, skills, management) do we need to accomplish that, what obstacles and other conflicts are there to obtaining those resources? What downsides exist? What other opportunities do we forego, or opportunities will these lead to? The same questions are asked of the other side’s ability and commitment, which leads to protective questions of what if other side does not perform as planned.

Lawyers, on the other hand, tend to see risk in transactions as contractual risks that lead to breach, blame, and therefore blame-shifting, including liability due to breach or other defective performance. For lawyers, the contract is the transaction: the contract they write provides the terms of performance, the excuses (such as conditions and defaults), and who accepts the blame for breach (the indemnities). The lawyer’s perspective—and related disciplines of contract management and compliance—is about contract compliance. Compliance with the contract is what the litigation will be about later. For lawyers lacking the business perspective of the transaction, the contract is the result of the doctrines that arose in contract law cases that resulted from gaps in the contracts, not the result of the transaction in place or in planning. For lawyers, the drafting and reviewing of a contract is *their* transaction.

---

in its equitable powers, will either construct a contract from the facts proven, if sufficient facts are in fact proven, or impose a contract on the facts proven where such a contract exists as a matter of law. . . . Common counts is an alternate theory of recovery based on a contract that is either implied in fact or implied in law. A common count is proper whenever the plaintiff claims a sum of money due either as an indebtedness in a sum certain or for the reasonable value of services, goods, etc., furnished.” *Id.* (citations omitted).

<sup>12</sup> Eisenberg, *supra* note 3, at 1770.

A business perspective is therefore useful in drafting the contract. The perspective is also useful—essential, really—to address transactional risks that do not fit neatly into the lawyer’s blame-shifting concerns. Understanding transactional risks gives meaning to why a good contract really does need representations, warranties, covenants, conditions, amendment, rights, and all the other techniques for drafting a contract. Otherwise, these drafting techniques<sup>13</sup> are merely a taxonomy that give a nice formality to a contract, and later serve as triggers for blame-shifting. The business perspective also explains why contracts get amended and renegotiated: because the transaction changes.

This business perspective is also useful in teaching contract drafting, a developing subject in some law schools (as this conference and its previous conferences have been facilitating for several years). The classic doctrinal contract classes use highly abridged cases to show what went wrong with contracts, and thus are backward looking—what went wrong, let’s not get blamed for that again. The contract drafting class should be forward looking and dynamic<sup>14</sup>—what is this transaction and how does the contract support the transaction. The contract should also embody the guidance of experience from looking backward from case law and experience to insert provisions (boilerplate, sometimes) that recognize the efficiency of routines<sup>15</sup> and then to buttress some contractual structures that may prove weak when under pressure later on when things turn out badly.

Other domains of contract theory and practice can illustrate the need for forward-looking and dynamic contractual accommodation of transactional risks, rather than the contract risks of classical contract theory. *Relational contracts*: because the parties have long-standing relations to maintain. *Enterprise risk management*: because businesspeople have to consider all risks to the firm, not only the pure operational ones that typically give rise to first-party losses to property and third-party losses to other people and their property. *Options and incomplete contracts*: because transactions are always in adjustment, thus contracts are not and cannot be perfect. *Contractual management*: because contract management is too

---

<sup>13</sup> Finally and ably explained in Tina Stark’s essential book to teach contract drafting, *Drafting Contracts: How and Why Lawyers Do What They Do*, the canon for teaching contracting drafting. It is also worth noting that the book does include commentary on the risk shifting concerns of contracts.

<sup>14</sup> Eisenberg, *supra* note 3, at 1796.

<sup>15</sup> Smith & King, *supra* note 5, at 29–33.

limited to compliance with the contract requirements rather than the realities of the transaction.

### III. RELATIONAL CONTRACTS – DOCTRINE TAKES A HIT

The theory of relational contracts was conceived by Stewart Macaulay from his study in 1963 of business practices while trying to understand how to teach contracts. It was an empirical study of real contracts and practices,<sup>16</sup> a rare idea in the legal doctrinal academy (although economists showed some interest).<sup>17</sup> Smith and King explain how this study came to be:

When Stewart Macaulay began teaching Contracts at the University of Wisconsin Law School in 1957, he was twenty-six years old. He had never practiced law, and he did the sensible thing by adopting the casebook used by his more experienced colleagues: Lon Fuller, *Basic Contract Law*. Macaulay's father-in-law—Jack Ramsey, the retired General Manager of S.C. Johnson & Son—was not impressed with the casebook. According to Macaulay, Ramsey “thought that much of it rested on a picture of the business world that was so distorted that it was silly.”

To assist Macaulay in gaining real-world perspectives on contracts, Ramsey arranged for a series of meetings with corporate executives that became the basis of Macaulay's seminal article, *Non-Contractual Relations in Business: A Preliminary Study*. As indicated by the title, Macaulay focused on noncontractual relations—how parties regulated their behavior without the assistance of written contracts.<sup>18</sup>

Macaulay studied sixty-eight businessmen and lawyers representing forty-three companies and six law firms. The study stressed, “among other things, the functions and dysfunctions of using contract to solve exchange problems and the influence of occupational roles on how one assesses whether the benefits of using contract outweigh the costs.”<sup>19</sup> His study found that sales people typically did not know what the boilerplate provisions on the back of the purchasing orders were about (the

---

<sup>16</sup> Macaulay, *supra* note 4, at 468.

<sup>17</sup> Smith & King, *supra* note 5, at 19–24; Ian R. MacNeil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 508–09 (1985).

<sup>18</sup> Smith & King, *supra* note 5, at 7–8 (citations omitted).

<sup>19</sup> Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 55–56 (1963).

purchasing orders seemed more for the accounting department than for the legal department),<sup>20</sup> that an acknowledgement by the seller could be on a form having significantly different provisions than the buyer's form without ever agreeing on which form controlled,<sup>21</sup> that a manufacturer's own audit of its contracts found that from 1953 through 1956 the contract terms were never agreed upon between 59.5% and 75% of the time,<sup>22</sup> and disputes were "frequently settled without reference to the contract or potential actual legal sanctions."<sup>23</sup>

Contract planning and contract law, at best, stand at the margin of important long-term continuing business relations. Business people often do not plan, exhibit great care in drafting contracts, pay much attention to those that lawyers carefully draft, or honor a legal approach to business relationships. There are business cultures defining the risks assumed in bargains, and what should be done when things go wrong. People perform disadvantageous contracts today because often this gains credit that they can draw on in the future. People often renegotiate deals that have turned out badly for one or both sides. They recognize a range of excuses much broader than those accepted in most legal systems.<sup>24</sup>

Ian McNeil is the other leading scholar on relational contracts and the temporal spectrum that these transactions embody. Paul Gudel summarizes the view:

[T]he participants never intend or expect to see the whole future of the relation as presentiated [sic] at any single time, but view the relation as an ongoing integration of behavior to grow and vary with events in a largely unforeseeable future . . . . It follows that planning for relational contracts is often tentative rather than entirely binding and often involves not simply the substance of the exchange, as in discrete transactions, but also planning of structures and processes to govern the relation in the future.<sup>25</sup>

---

<sup>20</sup> *Id.* at 58.

<sup>21</sup> *Id.* at 59.

<sup>22</sup> *Id.* at 60.

<sup>23</sup> *Id.* at 61.

<sup>24</sup> Macaulay, *supra* note 4, at 467–68.

<sup>25</sup> Paul J. Gudel, *Relational Contract Theory and the Concept of Exchange*, 46 *BUFF. L. REV.* 763, 765 (1998) (quoting IAN R. MACNEIL, *CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS* 13 (2d ed. 1978)).

This brings us back to the focus on the transaction rather than the contract. As Macaulay explained of his research, “In most situations contract is not needed. Often its functions are served by other devices. . . . Although the parties fail to cover all foreseeable contingencies, they will exercise care to see that both understand the primary obligation on each side.”<sup>26</sup> Further, buyers and purchasing agents have personal relations and “something to give the other,” and “Both business units involved in the exchange desire to continue successfully in business and will avoid conduct which might interfere with attaining this goal. One is concerned with both the reaction of the other party in the particular exchange and with his own general business reputation.”<sup>27</sup> Thus, as Macaulay wrote later in 2006, the norms of mediation and arbitration and alternative dispute resolution evolved for most types of disputes.<sup>28</sup>

One might smile at the old-fashioned custom of these businesses and their disfavor of litigation to resolve contract disputes due to costs and the severing of relationships,<sup>29</sup> but another contracts professor found a similar disdain of contracts and contract details when she presented at a conference of purchasing managers in 1995.<sup>30</sup> The contract then might oftentimes seem to be more important for setting expectations and as symbolic and ceremonial value.<sup>31</sup> If that is the case, then we are back to classical contract doctrines that focus on the contract without addressing the place of contracts in transactions.

Given the difference between the transaction and the formal contract, drafters of contracts (and their instructors) should keep in mind that the

---

<sup>26</sup> Macaulay, *supra* note 20, at 62.

<sup>27</sup> *Id.* at 62–63.

<sup>28</sup> Stewart Macaulay, *Contracts, New Legal Realism, and Improving the Navigation of The Yellow Submarine*, 80 TUL. L. REV. 1161, 1170 (2006); *see, e.g.*, Yehuda Adar & Moshe Gelbard, *The Role of Remedies in The Relational Theory of Contract: A Preliminary Inquiry*, 3 EUR. REV. CONT. L. 399 (2011) (although it is not relevant to this paper, this source discusses the question of how to deal with legal remedies, and their relevance, in the relational contract scheme); *see also* Omri Ben-Shahar, “*Agreeing to Disagree*”: *Filling Gaps in Deliberately Incomplete Contracts*, 2004 WIS. L. REV. 389 (2004) (addressing this problem with incomplete contracts).

<sup>29</sup> Macaulay, *supra* note 20, at 64–65.

<sup>30</sup> Marianne M. Jennings, *The True Meaning of Relational Contracts: We Don’t Care About the Mailbox Rule, Mirror Images, or Consideration Anymore—Are We Safe?*, 73 DENV. U. L. REV. 3 (1995).

<sup>31</sup> Robert C. Illig, *The Dog that Didn’t Bark: Private Investment Funds and Relational Contracts in the Wake of the Great Recession*, 2 MICH. BUS. & ENTREPRENEURIAL L. REV. 49, 78, 81–83, 85 (2012).



transaction is the focus and goal, and the contract must support that. Business changes, transactions change, the contract must have flexibility and reflect these realities.

#### IV. TRANSACTIONAL RISKS AND ENTERPRISE RISK MANAGEMENT – MINDFUL OF EVERYTHING THAT CAN GO WRONG IN THE BUSINESS

Business transactions also have risks, again meaning uncertainties. In the domains of finance and enterprise risk management, the risks might be positive (we make money) or negative (we lose money), and thus the businesspeople must assess and anticipate the obstacles to their own performance, and the obstacles to the counterparty's performance. Will we be able to obtain the raw materials and components at the price we expect in the time we expect and have the right labor to achieve this? Do we have the resources, can we obtain them? What opportunities do we give up, what opportunities will we gain? Will the other side have the resources and ability and incentive to perform? Will both parties have the financial ability to perform, and to sustain themselves if the other side fails to perform? What can go wrong before, during and after? What are those impacts? These are business process questions that the businessperson must work out and plan for. If the likelihood of success is greater than the likelihood of failure, and the rate of return is adequate to generate a profit, then do the transaction, otherwise skip it.

Short-term fixed price contracts put more of the risk on the seller, who must deliver a product or service by a specified time within a specified price; at least here the input prices are likely known when entering into the contract. Long-term fixed price contracts probably split the risk between seller and buyer, because the long-term input prices might vary a lot up or down over the time period, to either side's benefit or detriment, and if research and development are needed, these too may be uncertain. Long-term cost-plus (or cost-reimbursement plus profit) contracts put more risk on the buyer, who has little control over the final and multiple input costs, and may never see a product delivered or delivered anywhere near the initial anticipated price due to cost-overruns<sup>32</sup>—although these types of contracts may make most sense for research and development programs than for actual deliverable products.

If the transaction succeeds—meaning here the contract was performed—what happens if one of the parties seek to continue it, to buy more stuff, to continue to contract for services? From a legal perspective,

---

<sup>32</sup> See generally Yong Woon Kim & Trevor L. Brown, *The Importance of Contract Design*, 72 PUB. ADMIN. REV. 687, 689–90 (2012).

this is either another contract or an amendment, or the exercise of an option or right. But other commitments by one party may be an obstacle to doing more, consequently disappointment and default looms or prices might have to increase to meet this expanded transaction. This is yet another uncertainty (risk) both sides might need to anticipate; the inability to perform more because of the new demand, which should count as success, not failure, although now failure is the right word. Yet had the party planned for such higher levels and the demand did not materialize, then the investment would be a loss.

These are the challenges of looking at risk as uncertainty and looking at risk holistically. Enterprise risk management is the concept that synthesizes all the firm's risks—operational, financial, speculative (business)—to look at interrelationships among them, and identify correlations where a risk in one area may amplify a loss in another area.<sup>33</sup> ERM “attempts to manage all risks, including operational and reputational risks that normally cannot be hedged. It is this examination of all risks facing the firm and the attempt to manage the risks in a holistic manner that separates ERM from traditional silo-based risk management.”<sup>34</sup> The theory of ERM is that by integrating risk management and related decision-making across the entire organization, companies can avoid duplication of expenses and can consolidate hedging, insurance purchasing and other mitigation efforts. With integrated, enterprise-wide data on risk, companies should be able to make better resource allocation decisions and improve capital efficiency and return on equity.<sup>35</sup> Because the focus of ERM is now to manage risk from an integrated approach, the focus of risk management has shifted “from primarily defensive to increasingly offensive and strategic.”<sup>36</sup>

---

<sup>33</sup> See ENTERPRISE RISK MANAGEMENT §§ 1.3–1.4 (Michael W. Elliot ed., 2014); SIM SEGAL, CORPORATE VALUE OF ENTERPRISE RISK MANAGEMENT 24–29 (1st ed. 2011); Nadine Gatzert & Michael Martin, *Determinants and Value of Enterprise Risk Management: Empirical Evidence from the Literature*, 18 RISK MGMT. & INS. REV. 29, 32 (2015); *What is ERM?*, RISK MGMT. SOC'Y, <https://www.rims.org/resources/ERM/Pages/WhatisERM.aspx> (last visited Sept. 19, 2018).

<sup>34</sup> Donald Pagach & Richard Warr, *The Characteristics of Firms that Hire Chief Risk Officers*, 78 J. RISK & INS. 185, 188 (2011).

<sup>35</sup> Robert E. Hoyt & Andre P. Liebenberg, *The Value of Enterprise Risk Management*, 78 J. RISK & INS. 795, 795–796 (2011).

<sup>36</sup> Andre P. Liebenberg & Robert E. Hoyt, *The Determinants of Enterprise Risk Management: Evidence from the Appointment of Chief Risk Officers*, 6 RISK MGMT. & INS. REV. 37, 40 (2003); Gatzert & Martin, *supra* note 34, at 32.

This is the role of the chief risk officer. The lawyers mostly still deal with liability risks due to failure to perform and thus causing a first-party loss to the firm, whose “reasonable” or “reliance” expectations were not met, and deal with third-party losses when injuries result to other people. These mostly arise from the operational risk: something went wrong.

But some chief legal officers (in-house counsel, primarily), have moved into addressing, or at least being sensitive to, the full spectrum of risks whether these are transferable by contracts or insurance.<sup>37</sup> This inside understanding of the full spectrum of transactional risks also means a keener appreciation of the whole dynamic spectrum of the transactions and the place of contracts within that spectrum rather than as pinnacle of the deal. Simmons and Dinnage provide the best account of the many ways that in-house counsel perform different, more strategic, and more holistic work for a firm:

Generally, in-house counsel function in a strategic capacity whereas outside counsel primarily play a tactical role.”<sup>38</sup>

....

In-house counsel have the distinct advantage of understanding this business context and choosing among a range of tactics to achieve inter-temporal business objectives.<sup>39</sup>

....

The role of in-house counsel is not simply to promote compliance with the law, but also to assist corporations with their broader objectives and strategies on an ongoing basis. To be clear, a lawyer must understand the relevant business context in order to adequately detect and solve problems. . . . In-house counsel do not operate in a legal vacuum but must consistently weigh both legal and business concerns in a dynamic environment plagued with uncertainty.<sup>40</sup>

---

<sup>37</sup> Margaret B. Sherman et al., *Risky Business: Managing Risk in a Complex and Connected World* 159–73, 2ème Assises de l’enseignement et de la recherche en droit dans les grandes écoles, Troyes, France (forthcoming No. 74, 2014); Donald C. Langevoort, *Getting (Too) Comfortable: In-house Lawyers, Enterprise Risk and the Financial Crisis*, 2012 WIS. L. REV. 495 (2012); Omari Scott Simmons & James D. Dinnage, *Innkeepers: A Unifying Theory of the In-House Counsel Role*, 41 SETON HALL L. REV. 77 (2011); Robert E. Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479 (1989).

<sup>38</sup> Simmons & Dinnage, *supra* note 38, at 113.

<sup>39</sup> *Id.* at 117.

<sup>40</sup> *Id.* at 141.

This insight into the transaction as existential purpose, rather than the contract as purpose, becomes another connection to relational contract theory.

This also means that contracts should be drafted mindful of these transactional risks, some of which can be addressed in contract, some of which cannot. A party's ability to expand the contract can be an option, a right, or a condition (which may depend on some external verifiable event<sup>41</sup>). A party's ability to end a contract can be an option, a right, a condition, an effect of default, or the failure of a representation or covenant. What is needed for the transaction is what goes into the contract—maybe. What is needed for the contract might not be part of the transaction. Understanding the business flow, transactional risks, and enterprise risk management allows the contract to be functional rather than merely formal. Being functional, the drafting techniques of conditions, covenants, etc., have purpose rather than being merely a formal taxonomy of things that go into contracts.

Even using enterprise risk management analysis does not eliminate all risks. Some risks are nontransferable. Some are ordinary business risks. Some will fall back to the party even with the best indemnity provision against the other side, where the other side is unable to meet that indemnity obligation. This is why indemnity provisions are backed up by insurance. But even getting these two sections right is hard. The wrong insurance might be specified, or the wrong insurance obtained, or the particular exposure is excluded from the policy by an endorsement or the failure to remove an exclusion that one or both parties did not realize, or the policy is exhausted by other claims leaving it empty when our client's claim is tendered to the insurer. Or the indemnity section and the insurance section may be badly integrated, so the insurance does not fully cover the indemnity, or the indemnity is limited by the insurance available under the additional insured coverage. Then the indemnity fails and the insurance fails, and the risk is back on our client.

---

<sup>41</sup> Keith J. Crocker & Scott E. Masten, *Mitigating Contractual Hazards: Unilateral Options and Contract Length*, 19 RAND J. ECON. 327, 329 (1988) ("One way in which parties provide for low-cost adaptation to changing circumstances is by using unilateral options. Whereas contingent clauses require both the parties and the courts to establish the state that has actually transpired, properly authorized orders and receipts may be all that is necessary to verify that an option has been invoked and its terms fulfilled.").

## V. INCOMPLETE CONTRACTS AND OPTIONS – THEORY, REALITY AND APPLICATION

This insufficiency of contracts to address everything, and the reality of contract limitations for the transaction, brings us to the economic theory of incomplete contracts and the finance theory of options. These are theories we can use to enhance the understanding of the limitations of the classical legal contract doctrine for transactions and transactional risks, by reconsidering the law’s view that the contract is the transaction—the parties wrote their deal and now must follow the contract. In incomplete contracts theory, the contract provides a reference point for the parties’ trading relationship.<sup>42</sup> First we must realize that lawyers and economists mean different things when they talk about incomplete contracts.

Legal scholars use the term “incomplete contracting” to refer to contracts in which the obligations are not fully specified. A contract to sell a good would be “obligationally” incomplete, for example, if it failed to specify the price, quantity, or date of delivery. In contrast, a contract is obligationally complete if the obligations of the parties are fully specified for all future states of the world. A contract that failed to specify the seller’s obligations in the event of a flood or the buyer’s breach would thus be obligationally incomplete. Default rules respond to obligational incompleteness by filling these obligational gaps.

Economics scholars, on the other hand, use the term “incomplete contracting” to refer to contracts that fail to fully realize the potential gains from trade in all states of the world. These contracts are considered “contingently” incomplete or “insufficiently state contingent.”<sup>43</sup>

Actual contracts, “as lawyers have realized for a long time . . . are poorly worded, ambiguous, and leave out important things. They are incomplete.”<sup>44</sup> Well, some contracts are poorly worded, often when written by the parties themselves, frequently when written by lawyers not skilled in contract drafting. Even the best written contracts cannot possibly provide for every imaginable and unimaginable situation

---

<sup>42</sup> Oliver Hart & John Moore, *Contracts as Reference Points*, 123 Q.J. ECON. 1, 3 (2008).

<sup>43</sup> Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992).

<sup>44</sup> Oliver Hart, *Incomplete Contracts and Control*, 107 AMER. ECON. REV. 1731, 1732 (2017).

(exigencies, as I call them), thus an “optimal contract is incomplete.”<sup>45</sup> Incomplete contracts can lead to problems later when the parties need to change things and one party has superior bargaining ability, what theory calls the “hold-up” problem.<sup>46</sup> The hold-up problem can be addressed by diversifying reliance on that customer, both operationally and strategically.<sup>47</sup> This is a basic risk management technique, an enterprise risk management technique, as well as an economic technique. The contract cannot fully address this transactional risk, but a contract built to accommodate the transactional risk of hold-up (as the economists call it), and options (as the finance discipline calls something similar), can put boundaries on the negotiations and the price ranges,<sup>48</sup> and can even put a price on the exercise of that option, which would give “both parties a piece of the upside, but would still leave them with the flexibility to adapt.”<sup>49</sup> Lawyers would call this an exercisable right, perhaps triggered by a condition. (The unilateral adjustment—termination, mostly—of a contract is a breach, for which the unstated and unbargained-for default “option” price is benefit of the bargain (performance) damages,<sup>50</sup> which defeats the other party’s perhaps greater interest and reliance of performance.<sup>51</sup>)

---

<sup>45</sup> Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115, 116 (1999).

<sup>46</sup> Hart, *supra* note 45, at 1732–33.

<sup>47</sup> *Id.* at 1733. Hart uses economic terminology rather than risk management and enterprise risk management terminology.

<sup>48</sup> Nabil I. Al-Najjar, *Incomplete Contracts and the Governance of Complex Contractual Relationships*, 85 AMER. ECON. REV. 432, 432 (1995).

<sup>49</sup> Victor P. Goldberg, *Protecting Reliance*, 114 COLUM. L. REV. 1033, 1045 (2014).

<sup>50</sup> Paul. G. Mahoney, *Contract Remedies and Options Pricing*, 24 J. LEGAL STUD. 139, 140 (1995) (“[T]he availability of money damages is tantamount to granting the promisor (or Seller) an option to buy back his performance by paying an amount of money awarded by the court.”).

Used this way, option theory is like adding an implied additional clause; yet the consequence is that “true breach never happens unless the promisor neither delivers nor pays damages.” Michael D. Knobler, *A Dual Approach to Contract Remedies*, 30 YALE L. & POL’Y REV. 415, 418 (2012). The promisor’s decision to breach and pay damages is “presumptively rational, and allowing the promisor to choose between performance and so-called efficient breach allows for maximization of gains from trade.” *Id.* at 421.

<sup>51</sup> Goldberg, *supra* note 50, at 1038. This also leads to questions of good faith performance, the implied duty of good faith, and willful misconduct. *Id.* at 1063–65. This also leads to the economic doctrine of “efficient breach,” which has many problems fitting within contract doctrine, and problems when juxtaposed with relational contract theory, and is a topic for another paper.

The theories of incomplete contracts and options provide a better understanding of why contracts are not static and need to adjust to the transaction that has generated the contract. As Hart and Moore state, the contract then is a reference for the situations that governs later feelings of entitlement, limits their disagreements, and provides for flexibility.<sup>52</sup> Making rigid contracts has its own problems because it may be impossible to adapt to unforeseen events.<sup>53</sup> A fixed contract for a future performance, when things change a lot, can be wasteful, and result in lost investments; it may therefore be better to make the contract contingent before all the expense of (impossibly) acquiring all the perfect and complete knowledge about the future to make the contract complete.<sup>54</sup> These incomplete contracts in economic terms are about contingencies of economic efficiency, not about missing terms for performance as lawyers understand them.<sup>55</sup> Having flexibility allows for renegotiation after uncertainty dissolves.

From the perspective of lawyers and legal scholars, therefore, the most important contribution of economic contract theory is arguably this systematic incorporation of renegotiation and its feedback effects into the analysis of contracting. Contract theory now examines the promisor's strategy among three options: performance, breach, or renegotiation. From this perspective, a contract sets the field for future renegotiation of the terms of exchange after uncertainty has been resolved. As noted above, a challenge for parties designing contracts is to preordain or at least constrain the course of future renegotiation so as to yield both ex ante and ex post efficiency.<sup>56</sup>

All of which sounds good until we are back to the hold-up problem of the cost and renegotiating and the risks of renegotiating. This problem can be solved by granting a party a right to do something, whether expand or contract the scope or extend or shorten the performance: this legal right is the finance idea of options, specifically real options. The use of options in real estate is familiar to real estate lawyers, as an option to purchase

---

<sup>52</sup> Hart & Moore, *supra* note 43, at 32. Ulrika Badenfelt, *Fixing the Contract After the Contract is Fixed: A Study of Incomplete Contracts in IT and Construction Projects*, 29 INT'L J. PROJECT MGMT. 568 (2011).

<sup>53</sup> Mathias Erlei & Christian Reinhold, *Contracts as Reference Points—The Role of Reciprocity Effects and Signaling Effects*, 127 J. ECON. BEHAV. & ORG. 133 (2016).

<sup>54</sup> Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 189–90 (2005).

<sup>55</sup> *Id.* at 190.

<sup>56</sup> *Id.* at 194.

(being an extended offer if a stand-alone contract, thus requiring consideration), as an option to purchase during or following a lease, and as an option to expand the lease such as to as a right of first refusal on additional space to lease.<sup>57</sup> Lawyers may also be aware of options in traded securities, primarily puts and calls and complex variations of those, although the principal concern there is valuation.<sup>58</sup> “The value of real options lies in the enhanced ability of the firm to cope with exogenous uncertainty.”<sup>59</sup> Real options, as distinct from the financial options of stock options, refer to investments in real assets, “which confer on the firm the right, but not the obligation, to undertake certain actions in the future.”<sup>60</sup> Real options in business plans “enable firms to reduce downside risk while accessing upside opportunities” because of “the discretionary decision rights that options create, i.e., the right to select an outcome in the future on if it is favorable.”<sup>61</sup> Meaning changes, and sometimes the uncertainty of profitability, is resolved along the way to show either to proceed with the project or abandon it.<sup>62</sup> Real options give the parties flexibility to modify a contract where changes in business activity may require “managers [to] exercise investment timing, abandonment, or temporary shutdown options . . . [or] the capability to switch among alternative inputs and outputs,”<sup>63</sup> or to stage investments or alter scale.<sup>64</sup>

Most short- and medium-term contingencies should be addressed in the contract, while long-term contingencies should probably be set aside

---

<sup>57</sup> 1 MILLER AND STARR CALIFORNIA REAL ESTATE §§ 2:11, 10:117 (4th ed. 2015); 2 RASCH'S LANDLORD & TENANT INCLUDING SUMMARY PROCEEDINGS § 20:1 (5th ed.); GEORGIA REAL ESTATE SALES CONTRACTS § 14:2 (6th ed.).

<sup>58</sup> See generally LAWRENCE G. MCMILLAN, *OPTIONS AS A STRATEGIC INVESTMENT* (5th ed. 2012), in particular the discussion of the Black-Scholes model of pricing options in chapter 28.

<sup>59</sup> Nalin Kulatilaka, *The Value of Flexibility: A General Model of Real Options*, in *REAL OPTIONS IN CAPITAL INVESTMENT* 91 (Lenos Trigeorgis ed., 1995).

<sup>60</sup> Tony W. Tong & Jeffrey J. Reuer, *Real Options in Strategic Management*, in *REAL OPTIONS THEORY* 5 (Jeffrey J. Reuer & Tony W. Tong eds., 2007).

<sup>61</sup> *Id.* at 11. The ability to invest further or expand the contract might be thought of as a call option, and the ability to disinvest or pull out of a contract or investment might be thought of as a put option. Avinash K. Dixit & Robert S. Pindyck, *Expandability, Reversibility, and Optimal Capacity Choice*, in *PROJECT FLEXIBILITY, AGENCY, AND COMPETITION* 50–51 (Michael J. Brennan & Lenos Trigeorgis eds., 2000).

<sup>62</sup> Kulatilaka, *supra* note 60, at 100–01; Trigeorgis, *supra* note 62, at 2.

<sup>63</sup> Kulatilaka, *supra* note 60, at 90.

<sup>64</sup> Trigeorgis, *supra* note 62, at 3–9.



due to uncertainty.<sup>65</sup> Some contingencies are so remote (what I call exigencies) that it makes no practical sense to plan for them. That is how business works. The pragmatic adjustment to the situation requires renegotiation, and renegotiations lead to contract amendments, or novation of the existing contract and replacement with a new one.

## VI. CONTRACTS NEED TO ACCOMMODATE THE RANGE OF TRANSACTION RISKS

Lawyers who draft contracts but lack close knowledge of the client's business, and law students learning the methods of contract drafting, are likely to know little of the business process. When drafters lack insight into the business process, they draft contracts that look more like technical challenges that float above the dirty business of business. Put in the standard representations so we can walk away later. Make everything a covenant so we can show default. Add conditions so the parties can walk away without defaults. Boilerplate follows, sometimes gained from prior bad transactions that led to changes, oftentimes gained from prior transactions that never had a problem and therefore the boilerplate was ignored and perpetuated, causing no harm to the parties or the lawyers, until the deficiency finally erupts. The standard provisions are a taxonomy of things to insert and assure a contract is upheld by the courts, rather than serving a true functional purpose to the transaction.<sup>66</sup>

Lawyers typically look at the transaction as an end-result of failure risks, either failure to perform for which damages are owed, or a failure to avert negligence and harm, thus creating liability risk for which blame is to be shifted. This is the litigation end of things, where risk is blame, not uncertainty. This gives rise to legal remedies like benefit of the bargain, economic loss rule, liquidated damages, limitations of liability, and indemnity. These remedies, taken from experience in contract failures, are then inserted into the contract drafting, making them contract risks. And that's it, the lawyers shifted the blame risk.

But from the beginning, the business people have to deal with the business process risks and transactional risks to keep the process moving, for both sides' benefits. These are the relationships, and the economic and

---

<sup>65</sup> Steven R. Salbu, *Evolving Contract as a Device for Flexible Coordination and Control*, 34 AM. BUS. L.J. 329, 341–43 (1997) (calling the situation “contingent contracting”); Keith J. Crocker & Kenneth J. Reynolds, *The Efficiency of Incomplete Contracts: An Empirical Analysis of Air Force Engine Procurement*, 24 RAND J. ECON. 126, 127–29 (1993).

<sup>66</sup> The idea of contracts, and many aspects of the law, being defined in classical legal doctrine as doctrines and expectations of what a court will uphold, rather than serving a truly functional purpose, is expounded in Felix Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809 (1935), in particular, pages 820–29, 839–41.

business realities. The contract deals with short- and medium-term contingencies and uncertainties and serves as reference point for the ongoing transaction, which can span years.

These contractual remedies to shift blame are not why we have all those other things in the contract. Those other things should reflect and arise out of the broader risks of uncertainty in the transaction and how to get the transaction done or be ready when the transaction is not done. If we view the contract as supporting the business process, rather than the reason for the business process, then the technical things we put into contracts make more sense to the businessperson and to the lawyers. These transactional risks are why we use the contractual provisions of representations (what induces the one party to make the contract with this other party), conditions (the what-ifs the parties need to have, or need to avoid, or need to stop), warranties (representations as to the future, like guarantees, as Tina Stark describes them,<sup>67</sup> or representations that abate reliance that a representation otherwise requires to be enforceable or grounds to rescind, as courts look at warranties particularly in applications for insurance<sup>68</sup>), covenants, opportunities to cure (how do we keep going), options (conditions that allow a party to expand or contract the transaction, or extend or cancel the contract), standards and specifications (what the performance must exactly achieve, stated as declarations in the contract or possibly covenants rather than mushy legal incantations of “reasonable,” which lawyers insert based on law school training and oblivious to the fact that engineers and specialists and technical standards-setting organizations have a precise meaning for things to be done for performance), audit and compliance (rights to assure the standards and specifications are being met<sup>69</sup>), all of which are necessary so the parties

---

<sup>67</sup> Stark, *supra* note 14, at 142; *see, e.g., In re Hardieplank Fiber Cement Siding Litig.*, No. 12-md-2359, 2018 U.S. Dist. LEXIS 90, at \*51 (D. Minn. Jan. 2, 2018); *CBS v. Ziff-Davis Pub. Co.*, 75 N.Y.2d 496, 501 (1990).

<sup>68</sup> DAVID B. GOODWIN, P. BENJAMIN DUKE & R. GREGORY RUBIO, 5 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 41.04 (2018). Stark also notes this possibility: “A party may also warrant that a state of facts will exist in the future. It may do so because the issue of the recipient’s justifiable reliance disappears with respect to a warranty.” Stark, *supra* note 14, at 142.

<sup>69</sup> “Compliance is the process by which an organization adheres to its internal policies and procedures and to its external legal and regulatory requirements.” Elliot, *supra* note 34, at 8.8. “Although both functions [compliance and internal audit] are involved with assessing risk, they do it from different perspectives. Compliance primarily assesses regulatory and legal compliance risk, while internal audit performs risk-based audits that assess internal controls.” *Id.*

themselves can manage the transactional risks and get the transaction to the finish line.

Schuhmann and Eichhorn move the focus from the contract to the contractual relationship and the contractual process. “Its goal is to enhance management with the help of the contract and not, as in contract management, to ensure an optimal management of the contract.”<sup>70</sup> “[T]he contract must work as an element of risk management, transaction, and knowledge management throughout its entire life cycle.”<sup>71</sup> Looking at contracts as contract management, or project management, can reflect both compliance problems and flexibility opportunities.<sup>72</sup> Looking at contracts as contractual management, as they call it, “integrated into the relevant corporate processes throughout its entire life cycle,”<sup>73</sup> presents a different role of the contract—how business uses the contract rather than how lawyers make a contract under classical contract doctrine—which brings in these other domains of enterprise risk management, risk management, corporate governance, and compliance management.<sup>74</sup>

The lawyer who appreciates the transactional risks and the business realities will draft a contract that fits within that transaction, use drafting techniques with functional business purpose rather than boilerplate, and appreciate that the parties will operate in furtherance of the transaction rather than to the details of the contract and only look to the contract when things fall apart. That is the challenge in drafting the contract: the lawyer does not want to be blamed for missing something, the parties do not want to be blamed for performance failure or harm, the lawyer may not understand the deal, and the parties may not understand the contract. But we can still write a better contract, placed within the transaction, and be accommodative of the transactional uncertainties, even if economically incomplete.

## VII. IMPLICATIONS FOR TEACHING CONTRACT DRAFTING

Teaching contract drafting is about learning techniques of drafting, but that is only technique. How do these techniques apply to transactions? Here, creating scenarios to draft a contract, as might a lawyer with only a few years of experience, can serve as case studies in what to do. It can force students to think of the business process and the deal flow, and the

---

<sup>70</sup> Schuhman & Eichhorn, *supra* note 2, at 18 (italics omitted).

<sup>71</sup> *Id.* at 18.

<sup>72</sup> *Id.* at 7–8.

<sup>73</sup> *Id.* at 11.

<sup>74</sup> *Id.* at 8–9.

decision tree logic that requires the technique: if X happens, then is that a right, a condition, a default? What representations do we really care about? What happens if they fail? What are the contingencies of this transaction and are they better handled as rights or conditions? Defaults make more sense when we link them to whether the parties really want to continue and get back on the road, or whether they really intend to give up the ride and get off.

Thus, for both understanding the role of the contract, how to draft it, and how to teach drafting it, the lawyer must look at the transaction and transactional risks, and how the contract fits in that world, rather than how the contract fits within the contract world. The drafting techniques must serve a function to the transaction, not merely a function to assuring a legally enforceable contract unhinged to the transaction.