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## Rules vs. Standards in Private Ordering

TOMER S. STEIN†

*The tradeoff between bright-line rules and general standards is one of the bedrocks of law design. This tradeoff determines how legal norms are composed. The tradeoff between rules and standards pervasively affects private ordering as well: it determines how contractual norms are composed. Yet, scholars exploring the rule vs. standard dichotomy have either entirely overlooked the tradeoff taking place in private orderings or equated it with the public tradeoff that dominates lawmaking.*

*This Article is the first to systematically examine the rule vs. standard tradeoff in private orderings. The Article carries out this task by identifying and analyzing the fundamental asymmetries between the contractual rule vs. standard tradeoff and the parallel tradeoff taking place in lawmaking. The two tradeoffs differ from each other in three fundamental respects: (1) contractual standards, unlike legal standards, do not gradually transform into rules over time; (2) the*

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*standards' indeterminacy at the onset of contractual relationships allows the parties to generate and realize the benefits of mutual trust and collaborative knowledge acquisition—a benefit never present in legal standards; and (3) the enforcement of contractual rules and standards does not generate a linear aggregation of social welfare: rather, it involves a strategic give-and-take bargaining that accounts for the benefits of all contractual parties.*

*The Article explains these asymmetries and unfolds a comprehensive analysis of the rule vs. standard tradeoff in private orderings. This analysis generates a recipe for the choice between contractual rules and standards and yields several insights critical for understanding the design and interpretation of contracts generally and, in particular, for understanding the design and interpretation of sophisticated corporate contracts. Specifically, the Article reveals the impact of the rule vs. standard tradeoff on the choice between debt and equity financing and governance and on the design of the most intensely negotiated provisions in corporate acquisition agreements.*

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## INTRODUCTION

This Article uncovers and analyzes the fundamental—yet, thus far unacknowledged—differences between the legislative and private choices of rules over standards, and vice versa. The rules vs. standards tradeoff carried out in the public domain, which includes legislation and common law, differs from the parallel tradeoff taking place in private orderings such as contracts and corporate governance. Yet, scholars have paid scant attention to the differences between rulified and standard-based private orderings; and those scholars who did address those differences did so from a narrow economic-efficiency perspective and have treated the two tradeoffs—public (legislative) and private (contractual)—as essentially the same.[1] This postulated similarity was a byproduct of the assumption that the rules vs. standards tradeoff depends on the total sum of three costs, which are similar across public and private norms: the cost of formulating and promulgating the underlying rule or standard; the cost of enforcing it in court; and the private cost of complying with the underlying norm. When the choice of a bright-line rule—such as "drivers shall not exceed fifty-five miles per hour"—over a general standard—such as

1. *See* Jason Scott Johnston, *Bargaining Under Rules Versus Standards*, 11 J.L. ECON. & ORG. 256 (1995) (analyzing the choice between contractual rules and standards in terms of efficiency and Bayesian equilibriums); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 820 (2006) ("Our analysis of the tradeoff between front-end transaction costs and back-end enforcement costs owes an intellectual debt to the work of legal scholars who have analyzed the choice between rules and standards in legislation and administrative regulation. . . . In a similar manner, we frame the choice between precise terms (rules) and vague terms (standards) as the decision to give content to legal obligations either on the front end or back end of the contracting process.");Albert Choi & George G. Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 856–94 (2010) (applying the analysis of vague standards as efficient interpretation proxies in acquisition agreements).

"drivers shall not drive with an excessive speed"—reduces this sum to a minimum, the lawmakers should opt for the rule.[2] Conversely, when setting up a broad standard is cheaper than formulating and promulgating a bright-line rule, and the costs of enforcing and complying with the standard are the same, the lawmakers should opt for the standard.[3] Arguably, parties to a private ordering, such as contract or corporate charters and bylaws, should proceed in the same way.[4] Their choice of rules over standards, and vice versa, ought to derive from the total sum of the same drafting, enforcement, and compliance costs they stand to incur. When a particular rule, as opposed to a standard, minimizes this sum, the parties should write this rule into their agreement. When a standard, as opposed to a rule, brings this sum to a minimum, the parties should let the standard govern their contractual rights, duties and obligations.

Alas, the assumption that the legislative and contractual tradeoffs between rules and standards are the same is fundamentally mistaken. Contractual rules and standards differ from legislative rules and standards in both form and function. As far as form is concerned, unlike legislative standards that courts gradually clarify and refine, contractual standards do not generally transform into rules over time. Typically, a court's decision as to what a contractual standard requires the parties to do is case-specific, rather than precedential. A contractual standard only determines what the parties owe each other under the given factually unique circumstances. Furthermore, when courts are called upon to make such decisions, the parties'

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2. The rich literature regarding the choice between public rules and standards often utilizes this driving law illustration. Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559–60 (1992) (introducing the driving law example).

3. *Id.* at 562–67.

4. *See* sources cited *supra* note 1.

mutual trust is broken, and they are about to end their transactional relationship. Correspondingly, when a court makes a case-specific endgame decision, it does not set up a rule that purports to guide future conduct, because there is none. Admittedly, parties contemplating a long-term contractual relationship may agree among themselves to set up a broad standard in the expectation that, over time, courts will transform it into a set of granular rules. Such contractual mechanisms, however, are quite rare. Critically, under such mechanisms, the cost of the courts' applications of the broad standard one way or another will be allocated between the parties ahead of the courts' decisions, that is, ex ante rather than ex post. On the other hand, under statutory or common law standards, the costs of the courts' decisions transforming the applicable standard into granular rules are always allocated ex post by the decision itself.

As far as function is concerned, given the presence of uncertainty as to what the future holds, the narrow understanding of contractual rules and standards as geared toward the same allocation of the parties' drafting, enforcement, and compliance costs is profoundly misguided. First, contractual rules and standards require a fundamentally different analysis of formulation, enforcement, and compliance—one that takes into account the negotiated and strategic choices between the contractual parties. Second, contractual rules and standards facilitate the formation and enforcement of the parties' mutual trust and help generate expertise and collaborative acquisition of information that the parties often need in order to decide whether to continue or discontinue their relationship, and how so. That is, when parties form a contractual relationship where uncertainty remains as to how the course of performance should and will be conducted, the choice of a contractual standard helps facilitate the back-and-forth formulations of the optimal conduct by anchoring it to the interpretation of the chosen standard. Hence, when parties to a transaction have a need to preserve the choice between

the continuation of or the getaway from their relationship without default, breach, or amendment, they should prefer standards over rules. Legislative tradeoffs of rules vs. standards, on the other hand, virtually never account for the private benefits and risks associated with cooperation and trust. In legislation, as well as at common law, the choice between rules and standards is global, impersonal, and deindividualized.

The distributional effects of contractual and legislative tradeoffs between rules and standards are also not the same. Under legislation that applies across the board, those effects are assumed to be symmetrical or mutually offsetting. Legislative tradeoffs have only one beneficiary to account for: society at large. Under contracts, on the other hand, the choice between rules and standards does not always affect actors in the same way: oftentimes, one party is better off under a standard and another party under a rule. In such cases, the contractual tradeoff follows the sell-and-buy approach that produces an equilibrium. Furthermore, contractual rules and standards set up a framework that allocates risks and reflects the parties' attitudes toward risk. For this reason, too, the rules vs. standards tradeoffs in contracts do not emulate the legislative preferences of rules over standards and standards over rules. In a nutshell: Contractual tradeoffs between rules and standards are determined by the transactional environment and the parties' business incentives, far removed from the pursuit of the general public good that characterizes the lawmaking processes in legislation and at common law. This private tradeoff manifests itself in strategic choices that can, and often do, facilitate or dispel mutual trust and collaborative information gathering.

While the analysis carried out in this Article applies to all contracts, the corporate arena provides particularly telling and consequential illustrations of the tradeoffs between private rules and standards. For example, a covenant in an acquisition agreement requiring the target

company to maintain its business such that it has at least $20,000,000 in earnings between signing and closing is a bright-line rule that leaves no room for judgment. Under this rule, the parties' relationship does not depend upon the formation of mutual trust, expertise, learning, and collaboration. When the company's earnings go below the $20,000,000 threshold, the acquirer will be allowed to rescind the agreement and impose penalties. On the other hand, a covenant in a similar agreement requiring the company to maintain its business and financial viability by acting "in the ordinary course of business" between signing and closing is a standard that sets up a framework for building mutual trust and collaborative expertise acquisition. Under the chosen standard, the buyer awaiting the closing of the transaction will begin extensive communications and learning to find out how the company's business should be carried on and identify board members and employees deserving and not deserving of trust. While the chosen standard, as contrasted with the clear-cut $20,000,000 rule, will not be optimal from an enforcement perspective, it may still be preferable due to the benefits of trust, learning and expertise, as well as a quicker adaptation to changes in the underlying business environment. Importantly, parties may well accrue these benefits notwithstanding—and oftentimes, due to—the unspecified formulation of the standard.[5] The fact that the standard will not transform into bright-line rules over time will often allow the parties to generate and realize mutual benefits in trust and collaboration that would never accrue under the $20,000,000 threshold (or another rigid rule). For that reason, taking mutual trust and knowledge development into

5. This benefit of private standards is similar to the observation made about some of the benefits of relational contracts. *See* Ian R. Macneil, *Economic Analysis of Contractual Relations: its Shortfalls and the Need for a "Rich Classification Apparatus,"* 75 NW. U. L. REV. 1018, 1041 (1981) (describing how contractual parties "gather increasing information and gradually agree to more and more as they proceed").

account shows that private ordering standards often outperform rules even when the underlying drafting, enforcement, and compliance[6] costs are equal—a beneficial effect not present in lawmaking.

With all this in mind, this Article analyzes the tradeoffs between private—or contractual—rules and standards and outlines the implications of those tradeoffs for negotiated transactions. Structurally, the discussion proceeds in three Parts. Part I explains the public, or legislative, tradeoffs between rules and standards. Part II lays out the theoretical foundations for the private rules vs. standards tradeoff. This Part also repudiates the widespread assumption that the legislative and contractual rules vs. standards tradeoffs are analogous. Part III transitions from theory to application. This Part illuminates common corporate contract provisions such as debt covenants, the "ordinary course" covenant, and the Material Adverse Change (MAC) condition precedent under the rules vs. standards framework. A brief conclusion follows.

## I. PUBLIC RULES VS. STANDARDS

Legal norms can be structured as rules or as standards.[7] The structural difference between rules and standards centers on the level of specificity incorporated into a legal norm at the time of its formulation.[8] Rules are specific and brimmed with content at the outset.[9] Standards, on the other

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6. That is, compliance that doesn't take the mutual trust and learning features into account. As explained in *infra* Section II.C, the mutual trust and learning benefits of private standards are to be hereinafter modeled as part of the compliance benefits.

7. Non-legal norms can also embody similar features. *See, e.g.*, John Rawls, *Two Concepts of Rules*, 64 PHIL. REV. 3, 3–13 (1955) (distinguishing between moral norms that justify specific acts and moral norms that justify general practices).

8. *See* Kaplow, *supra* note 2, at 559–60.

9. *Id.* at 560–63.

hand, are general and unspecified at this ex ante junction.[10] The choice between rules and standards is an essential part of elementary legal education and is present—expressly or implicitly—in virtually any discussion of law design.[11] The rule-standard dichotomy is famously illustrated by the following example, taught in many law school classes[12] and found in the seminal scholarly examinations of the phenomenon.[13] Imagine that you are responsible for designing your city's traffic code and are choosing between a norm providing that highway drivers should drive at or below "fifty-five miles per hour" and a norm ordaining highway drivers to drive at a "reasonable speed."[14] The choice between these two options is a choice between legislative, or public, rules and standards.[15] In weighing the two formulations, the lawmakers would have to consider how certain they are, at the outset, that "fifty-five miles per hour"

10. *Id.*

11. *See, e.g.*, Douglas G. Baird & Robert Weisberg, *Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217, 1221 (1982) (applying the "fundamental" question between rules and standards to the Uniform Commercial Code).

12. *See, e.g.*, MARCO JIMENEZ, CONTRACT LAW: A CASE & PROBLEM-BASED APPROACH 77–79 (2d ed. 2021) (citing WARD FARNSWORTH, THE LEGAL ANALYST: A TOOLKIT FOR THINKING ABOUT THE LAW, at 57–65, 163–71 (2007)) (introducing the rules and standards dichotomy).

13. *See generally* Kaplow, *supra* note 2; Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685–87 (1976) (describing adjudicatory rules and standards); Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 67–71 (1983) (analyzing rules and standards in administrative law); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 383–90 (1985) (analyzing the pros and cons of rules and standards); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 604–10 (1988) (analyzing the rhetorical impact of "clear" and "muddy" laws); Jonathan Remy Nash, *On the Efficient Deployment of Rules and Standards to Define Federal Jurisdiction*, 65 VAND. L. REV. 509, 527–37 (2012) (comparing the uses of rules and standards in federal jurisdiction).

14. Kaplow, *supra* note 2, at 560.

15. *Id.*

is a desired speed, as compared to how confident they are that courts will interpret "reasonable speed" appropriately at the backend; how hard it would be for constituents to comply with "fifty-five miles per hour" as opposed to "reasonable speed;" whether they expect to know more about the desired highway speed in the future; how confident they are that the highway police would be able to enforce the "fifty-five miles per hour" rule more effectively then the "reasonable speed" standard; and, finally, how costly or difficult would it be to formulate the appropriate rule with precision, as compared with setting up the appropriate standard.[16] These considerations are aptly modeled as costs and benefits of formulation; costs and benefits of enforcement; and costs and benefits of compliance.[17]

A. *Formulation*

It is easier and less time consuming to ask for something to be done well than to specify what it means for something to be done "well." We all want optimal results, but oftentimes lack the requisite knowledge as to what an optimal result would be or otherwise struggle to come up with the right words to describe and measure the optimal results by.[18] For the same reason, with everything else being equal, it is easier and less time consuming for a lawmaker to ask drivers to use "reasonable" speed than it is to figure out what the desired speed amounts to and then find the right words to express it for all conceivable circumstances.[19] On the other hand, while

16. *Id.* at 579–85.

17. This conceptual framework is an integration of the various considerations brought about by the sources cited in *supra* note 13.

18. *See, e.g.*, Kaplow, *supra* note 2, at 590–93 (describing over and under inclusiveness in rules); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 272–73 (1974) (analyzing rules and standards in terms of inclusiveness and costs).

19. *See* Kaplow, *supra* note 2, at 600–05.

the reasonableness standard would require minimal formulation costs from the legislature, it would impose heavy formulation costs on the courts.[20] When the law merely requires reasonable speed, courts will bear the cost of having to carry out case-by-case examinations of whether particular speeds (e.g., sixty miles per hour) in particular circumstances (e.g., during sunrise and medium-to-light traffic) are reasonable or not.

In addition to deciding whether to incur the formulation costs on the front or back end, the lawmaker must also compare the benefits of ex ante versus ex post formulation.[21] Sometimes we expect to know more about the relevant conduct in the future.[22] For example, we may anticipate that over time we will know more about the frequency of accidents at particular speeds and their correlation with vehicle congestion and driving conditions. This type of added knowledge would, in turn, allow us to formulate the driving code without embarking on a time consuming and costly investigation of the desired levels of speed.[23] In any such scenario, if we find out that the formulation costs for the legislature and the courts are roughly equal, the formulation benefits generated by the incrementally added knowledge would favor the choice of the reasonableness standard.[24] A

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20. *See, e.g.*, Schlag, *supra* note 13, at 382–89 (describing the rules-standards tradeoff between costs of legislative formulation and costs of adjudication).

21. *See* Kaplow, *supra* note 2, at 585–86 ("But if there are advantages in delay because information will be easier to acquire at the time individuals act or cases are adjudicated, *ex post* investments would tend to be preferable.").

22. *Id.*

23. *Id.* at 569 (illustrating the expense and difficulty of designing a rule that captures all instances of toxic discharge).

24. *See, e.g.*, Charles P. Curtis, *A Better Theory of Legal Interpretation*, 3 VAND. L. REV. 407, 424 (1950) ("your words should be as flexible, as elastic, indeed as vague, as the future is uncertain and unpredictable. I say vague, because both flexible and elastic imply sharp edges and

comprehensive cost-benefit analysis of formulation therefore encompasses a comparison between the ex ante and the ex post costs of formulation, under which the formulation costs incurred ex post—at the adjudicative stage—are offset by the value of the future knowledge that courts will incrementally accrue.

B. *Enforcement*

When a driver goes way too fast—for instance, two-hundred miles per hour across a residential cul-de-sac—it is clear, even to the untrained eye, that the driver is exhibiting unreasonable speed. In such extreme cases, a police officer would be able to form the choice to enforce the driving code with relative ease. Regardless of whether the code is formulated as the "fifty-five miles per hour" rule or as the "reasonable speed" standard, a police officer would be able to correctly commence enforcement in a split-second decision. In close cases, however, the choice of enforcement will not always be as easy. For example, when a driver is driving ninety miles per hour on a highway, it may take significant enforcement expertise on the part of the officer and the court in order to decide whether it was an unreasonable speed, but it would only take a traffic camera or radar to decide whether the driver's speed exceeded fifty-five miles per hour. Hence, in close cases it would be much cheaper and easier to enforce the fifty-five miles per hour rule than the reasonableness standard.[25] Moreover, the standard's vagueness and flexibility may allow for too many errors in its application, and it may also be incorrectly applied due to malice, bias, or negligence.[26] In close cases, therefore, the cost of enforcing

definite contours.").

25. *See, e.g.*, Kaplow, *supra* note 2, at 570 (arguing that when other costs are held equal, it is cheaper to enforce rules than it is to enforce standards).

26. *See, e.g.*, FREDERICK SCHAUER, PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW

rules is cheaper than the cost of enforcing standards.

Having said that, the enforcement benefits accrued under rules, as opposed to standards, are also not the same. Under the fifty-five miles per hour speed limit or a similar rule, enforcement becomes a fairly technical factfinding exercise. Enforcement of standards, on the other hand, leaves a heightened degree of discretion and deference to the enforcing agency.[27] The reasonable speed standard, for example, leaves ample room for the police officer's and, subsequently, the judge's discretion in deciding whether to enforce the driving code against the drivers who drove their vehicles at ninety miles per hour. Discretion provides benefits when there are good reasons for deferring to the enforcement agency's decision.[28] We have such reasons when the agency knows or will know more about the desired conduct than we do.[29] For example, a police officer may be in

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AND IN LIFE 30–35 (1991) (arguing that rules are often preferable to standards as they minimize judicial mistakes and misuse). *See also* Ward Farnsworth, Dustin Gunzior & Anup Malani, *Policy Preferences and Legal Interpretation*, 1 J. L. & CTS. 115, 125–30 (2013) (providing empirical evidence of normative bias in staturoy interpretation).

27. Outside the scope of the rules and standards dichotomy, legislative deference to the judiciary is a focal point of policy and political debate. *See, e.g.*, Mark A. Graber, *The Nonmajoritarian Difficulty: Legislative Deference to the Judiciary*, 7 STUD. AM. POL'Y DEV. 35, 37 ("Legislative deference to the judiciary is, thus, not an isolated occurrence, but one way that established politicians have fought the 'conflict between conflicts' that Schattschneider and others recognize as endemic to American politics, if not to any political regime.").

28. In the case of deference to police, these benefits are often very limited and outweighed by the aforementioned costs of enforcement bias and misuse. *See generally* Anna Lvovsky, *The Judicial Presumption of Police Expertise*, 130 HARV. L. REV. 1995 (2017) (examining the historical roots and emergence of the judicial presumption of police expertise and its negative implications on the criminal justice system).

29. Broader issues regarding the granting of authority to others are beyond the scope of the rules-standards tradeoff. For a rich discussion of these issues, see generally Joseph Raz, *The Problem of Authority: Revisiting the Service Conception*, 90 MINN. L. REV. 1003 (2006)

possession of expert knowledge that allows her to accurately distinguish between dangerous and benign drivers. The officer's discretionary decisions will consequently outperform any rulified speed limit that will necessarily rely on general statistics. Similarly, an experienced traffic court judge will scrutinize people's driving better under the reasonableness standard than under any chosen bright-line rule. Hence, a comprehensive cost-benefit analysis of enforcement ought to account not only for the cheaper cost of enforcing rules, but also for the benefits and the costs of discretion that standards bestow upon law enforcers and judges.

### C. *Compliance*

For an individual who wants to drive lawfully, doing so is much easier when she knows what the exact speed limit is. When the law limits the speed to fifty-five miles per hour, a driver only needs to look at the traffic sign in order to know how to comply with the law. By contrast, if the law were to limit the speed to a reasonable speed, the driver would have to make a judgment call in order to comply with the law. This judgment call may, at times, be easy, as in the case of a person who considers driving at two-hundred miles per hour across a residential cul-de-sac. At other times, however, it would require substantial experience and knowledge.[30] For instance, driving a semitruck down an interstate highway at dusk may require significant training and advice from more experienced drivers in order to determine the confines of a "reasonable" speed. Compliance calls that people make under standards may thus require substantial investment that will

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(conceptualizing conditions that justify and behoove the granting of authority); LINDA TRINKAUS ZAGZEBSKI, EPISTEMIC AUTHORITY: A THEORY OF TRUST, AUTHORITY, AND AUTONOMY IN BELIEF (2012) (examining the role of epistemic deference in the context of rationality and autonomy).

30. *See* Kaplow, *supra* note 2, at 577 (arguing that the relative compliance benefits of rules over standards stem from the reduced time it takes to learn the law).

often include costly advice from a trained attorney.[31] For example, directors of corporations keep compliance officers and attorneys on retainer or payroll in order to comply with the law that requires them to exercise reasonable business judgment in "good faith," on an "informed basis," and in the "best interests" of the corporation.[32] The costs of complying with a standard can thus be either equal to the rule-compliance costs (in extreme cases) or higher than those costs (in cases that require a judgment call).[33] The costs of complying with a standard never go below the costs of complying with a bright-line rule.

Compliance benefits, too, differ across rules and standards. When both the fifty-five miles per hour rule and the reasonable-speed standard are fully complied with, it may be tempting to conclude that they produce equal benefits. Alas, that will not always be correct. There are side benefits to standard-compliance that do not exist in rule-compliance. As explained above, standard-compliance requires judgment calls, expertise gathering, and, at times, the consumption of legal services by the individuals endeavoring compliance.[34] When individuals learn how to comply with standards, they learn the intricacies of the underlying normative conduct. Thus, the semitruck driver in

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31. For a comprehensive account of the costs and benefits of legal advice, see Louis Kaplow & Steven Shavell, *Legal Advice About Acts Already Committed*, 10 INT'L REV. L. & ECON. 149 (1990) (presenting the cost-benefit analysis of legal opinions for acts already committed); Steven Shavell, *Legal Advice about Contemplated Acts: The Decision to Obtain Advice, Its Social Desirability, and Protection of Confidentiality*, 17 J. LEGAL STUD. 123 (1988) (presenting the cost-benefit analysis of legal opinions for prospective actions).

32. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

33. *See* Kaplow, *supra* note 2, at 577 (arguing that the relative compliance benefits of rules over standards stem from the reduced time it takes to learn the law).

34. *See supra* notes 30–32 and accompanying text.

my example would have to learn about the speed other semitruck drivers use and how different speeds under different conditions affect their control of the vehicle. By the same token, a director attempting to understand the legal requirements of making a reasonable business judgment in "good faith" would have to acquire knowledge as to how to best assess and respond to the pressures of both friendly and hostile investors, and how other directors have acted in similar situations.[35] Admittedly, such learning benefits would be limited.[36] This is because the incentive to learn the details of the requisite normative conduct is capped at the cost of learning, net of the expected fines, and other penalties that the ill-informed actor will suffer upon being apprehended as a violator.[37] For example, the learning incentive by itself will not motivate drivers to invest in being the best possible driver when that is beyond what is needed to avoid legal penalties.[38] That being said, some educational benefits accrued under a standard are scalable in the sense that they might facilitate actors' compliance with other legal

35. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) ("When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. . . . In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. However, they satisfy that burden 'by showing good faith and reasonable investigation.'") (citations omitted).

36. ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 510–15 (6th ed. 2016) (explaining the basic incentive structure of would-be crime perpetrators as the product of the probability of detection and the cost of punishment).

37. *Id.*

38. In other words, these learning benefits will be limited in the case of individuals acting in conformity with Holmes's "bad man" or solely by self-regarding cost-benefit motivations. *See* Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) ("If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict . . . .").

standards. For example, a firm's director that learns the intricacies of the "good faith" standard is likely to be better prepared to comply with a standard that requires directors to exercise "independent judgment" in corporate affairs.[39] Compliance with rules, on the other hand, virtually never produces scalable learning benefits.

With all this in mind, I now move to consider the private—or contractual—tradeoffs between rules and standards and how they differ from the choices of rules over standards, and vice versa, in the public domain. Specifically, I will demonstrate that private tradeoffs between rules and standards incorporate two critical factors not present in lawmaking. These factors include mutual trust and collaborative knowledge-generation. Bringing these factors into consideration changes the rules vs. standards analysis dramatically by creating a sharp separation between private ordering, on the one hand, and legislation and common law, on the other hand. The interplay of the formulation, enforcement, and compliance costs and benefits under contracts is far removed from the parallel interplay that determines the outcomes of the rules vs. standards tradeoffs in lawmaking.

## II. PRIVATE RULES VS. STANDARDS

Imagine that a cabinet manufacturing company is contracting with a lumber supply company. When the manufacturer and the supplier are negotiating the quantity provision, the manufacturer wants a provision guaranteeing all its lumber needs for next five years. The supply company generally wants to satisfy all of the manufacturer's supply needs as well, but it wants to be protected against supply requirements that are way too large to be satisfied. The two formulations floated by the lawyers included one contractual

39. *See, e.g.*, Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (expounding on lack of independence as acts under the spell of mislead or controlled discretion).

provision calling for satisfaction of all "commercially reasonable" lumber needs, and another provision requiring the parties to quantify a ceiling for how many cubic feet of lumber may be demanded in a given year.[40] The choice between these two formulations is a choice between private—or contractual—rules and standards. The manufacturer and supplier weighing these two formulations would have to consider how confident they are, at the outset, that they can pinpoint the maximum lumber amount needed and suppliable over the course of five years; how confident they are that the other party understands "commercially reasonable" in the same manner that they do; whether they believe the other party will interpret "commercially reasonable" opportunistically, given their needs and capacity; how a court has interpreted and will interpret "commercially reasonable;" how difficult or costly would it be to convince the other party to comply with a given interpretation of "commercially reasonable;" and, prior to having developed both formulations of the provision, how costly or difficult would it be to design the appropriate quantity-threshold rule, as compared with setting up the appropriate quantity standard. As I will now demonstrate, these considerations entirely change the cost-benefit analysis of the formulation, compliance, and enforcement factors.

### A. *Formulation*

As far as formulation is concerned, the cost-benefit tradeoff between private rules and standards fundamentally differs from the parallel tradeoffs taking place in legislation and at common law. To begin with the similarities between the two tradeoffs, as with the tradeoff between public rules and standards, it is cheaper and easier, at the outset, to formulate a contractual provision as a standard rather than

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40. The choice to use the formulation of all commercially reasonable lumber needs would establish a "requirements contract."

as a rule.[41] For instance, it would be easier for the manufacturer and supplier in my example to require that the annual lumber demands will not exceed what is commercially reasonable than it is to figure out the exact formulary for the annual-demand ceiling (e.g., 5,000 cubic feet over last year's annual demand).[42] To be sure, in easy cases—for example, when a manufacturer wants an exact amount of lumber (e.g., 100 cubic feet) to be delivered by the supplier—there will be no substantial formulation-cost savings from using standards. Nevertheless, as long as there is a certain degree of uncertainty, it is easier to formulate a standard than to figure out the specific metrics that a contractual provision should capture and find the right words to describe those metrics.[43] This will also be the case when differently situated contractual parties disagree as to what the "commercially reasonable" demand means. Even when such a disagreement is resolvable, resolving it would be both time-consuming and costly. Unlike the tradeoff between public rules and standards, however, a contractual provision drafted as a standard will not, as a general matter, be subsequently given a rule-like specificity by either the parties or a court. In the ordinary course of contracting, a contractual provision drafted as a standard will avoid the cost of providing specificity ex ante without deferring the formulation cost to the backend. Unlike public standards that are given specificity as they are incrementally interpreted by courts,[44] a contractual provision drafted as a standard will remain a standard that rarely, if ever, transforms into a set of rules.

The standards' ability to reduce the cost of formulation, however, is not a one-dimensional free meal. Because

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41. *See supra* notes 18, 20 and accompanying text.

42. *Cf.* Kaplow, *supra* note 2 and accompanying text (introducing the public driving law example).

43. *See supra* notes 18, 20 and accompanying text.

44. *See* discussion *supra* Section I.A.

contractual standards do not typically develop into contractual rules, they rarely come with the benefits of the ex post formulation similar to those generated by public standards.[45] This general observation is subject to few exceptions. Yet, none of those exceptions make the private and public standards similar to each other. One such exception features a collaboration or a new agreement in the shadow of the standard. Imagine that the manufacturer and the lumber supplier have included in their contract a provision limiting the annual lumber demand and supply by the "commercial reasonableness" standard. After some heated back-and-forth discussions regarding whether the supplier may properly object to the manufacturer's demand for additional 5,000 cubic feet, the two settle on one last supply of 3,000 cubic feet. This new agreement was not formalized in any manner: the two contracting parties have simply agreed on how to conduct their affairs under the guise of their contractual standard. Alternatively, the parties could have agreed to amend their agreement in order to further specify the quantity standard. The first of these two scenarios features *primary* transactional behavior. Under such scenarios, the parties' ad hoc collaboration in the shadow of the standard will keep the standard unmodified. As a corollary, the parties' subsequent conduct may be different from what they collaboratively did while implementing the contractual standard.[46] Furthermore,

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45. *See* discussion *supra* Section I.A.

46. Course of performance is an essential part of contract interpretation in the United States. *See* U.C.C. § 2-208(2) (AM. L. INST. & UNIF. L. COMM'N) (providing that express terms control course of performance and that course of performance controls both course of dealing and usage of trade). RESTATEMENT (SECOND) OF CONTRACTS § 202(4) (AM. LAW. INST. 1981) ("course of performance accepted or acquiesced in without objection is given great weight in the interpretation of the agreement."). The importance of course of performance does not entail, however, that subsequent conduct cannot change. In fact, courts exactly make sure to take all conduct into account when evaluating course of performance. *See, e.g.*, Quasar Energy Group,

under the extant contract interpretation doctrine, prior conduct is an important but not a decisive factor in resolving contractual disputes.[47]

The second scenario, on the other hand, presents a contract-formation event: an amendment of the existing agreement. An amendment that transforms a contractual standard into a rule may be akin to a court decision as to what a public standard requires actors to do under certain specified circumstances. But even this rulification of a private standard does not make it functionally similar to a public standard for a simple reason: the contracting parties have to voluntarily agree to it, which they will only do when their chosen standard ceased working for them as well as they initially expected.[48] Such scenarios involve an entire reconsideration of the contractual tradeoff between rules and standards. They therefore do not qualify the general observation that contractual standards do not transform into rules down the road. Instead, contractual amendments, as their name suggests, are more analogous to legislative amendments than to judicial interpretations.[49]

Another exception to the observation about the non-rulification of contractual standards involves judicial

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LLC v. VGBLADS, LLC, No. 2:16-CV-00402-NT, 2017 WL 3206940, at *7 (D. Me. July 28, 2017) (in rejecting a course of performance argument, the court noted that 'the Defendants point to a single instance of conduct rather than a 'relevant course of performance'").

47. *See Quasar Energy Group, LLC,* 2017 WL 3206940, at *7 (in rejecting a course of performance argument, the court noted that "the Defendants point to a single instance of conduct rather than a 'relevant course of performance'").

48. *See, e.g.*, 22A N.Y. Jur. 2d Contracts § 475 ("a contract cannot be modified or altered without the consent of all parties thereto").

49. *Cf.* Rebecca M. Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 101, 1057n.215 (2011) ("there are two types of legislative transaction costs: costs incurred when the legislation is enacted, or 'enactment costs,' and costs arising postenactment from efforts to lobby for or against repeals or amendments, or 'maintenance costs'") (citing Jacob E. Gersen, *Temporary Legislation*, 74 U. CHI. L. REV. 247, 262–66 (2007)).

resolution of the parties' dispute as to what the underlying standard requires them to do. If the manufacturer and the supplier in my example fail to form an understanding on how much lumber may be required from the supplier, and the manufacturer sues the supplier, the court would have to decide whether a demand for additional 5,000 cubic feet counts as falling within or outside the bounds of "commercial reasonableness." When the court makes such a determination, it provides specificity to, or rulifies, the "commercial reasonableness" standard. This exception, too, does not render the formulation costs and benefits of private—or contractual—rules and standards similar to the parallel cost-benefit tradeoff in the public lawmaking domain. First, when contractual parties litigate their disputes in court, they are typically about to end their contractual relationship.[50] With public standards, the situation is quite the opposite.[51] When courts interpret public standards, they create precedents for many years and for multiple individuals and firms.[52] In other words, when courts interpret a private, rather than public standard, the rulification does not typically have any impact that transcends the boundaries of the parties' dispute. Moreover, even when a judicial rulification of a standard comes early in the contractual relationship, it would be hard to imagine a follow-up to that decision analogous to a series of judicial interpretations of a general standard set up by statute or common law. While public standards are interpreted by a multitude of judicial decisions that incrementally add some rulified content to the standard,[53] judicial resolutions of

50. *See, e.g.*, STEPHEN B. GOLDBERG, *ET AL.*, DISPUTE RESOLUTION: NEGOTIATION, MEDIATION, AND OTHER PROCESSES 7–9 (7d ed. 2020) (describing the emergence of litigation alternatives as a response to the need for a faster resolution of disputes).

51. *See* Kaplow, *supra* note 2, at 611–15 (describing the role and scalability of precedent).

52. *See id.*

53. *See id.*

private—or contractual—standards tend to be singular and unique even when they come early in the contractual relationship.[54] This is so because repeated litigation is expensive and time-consuming.[55] As a corollary, judicial rulification of public standards creates precedents by which the legal system realizes economies of scale[56]—a benefit not present in the judicial interpretation of private standards.

Yet another exception to the non-rulification of contractual standards has to do with boilerplate standards, that is, standards that are present in multiple agreements between different and mutually unrelated actors. Imagine that the manufacturer and the supplier in my example could not agree on whether an additional demand for 5,000 cubic feet of lumber is "commercially reasonable", and the court decided that "commercial reasonableness" in requirement contracts will be determined by taking into account the total demand in prior years.[57] It could consequently be expected that future adjudications will likely implement the same "prior year's demand" factor into the "commercial reasonableness" standards used in similar requirement contracts. Contracts formed after this decision and utilizing this contractual standard will consequently be affected by the decision's rulification.[58] That being said, while this

54. That is to say, the possibility of litigants continuously appearing in court to spare over the same contractual standard is unrealistic, and very narrow at the most.

55. *See supra* note 50 and accompanying text.

56. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 743–45 (8th ed. 2011) (describing the scalable benefits of precedent); Alex Stein, *Inefficient Evidence*, 66 ALA. L. REV. 423, 434 n.39 (2014) (rationalizing precedent formation by economies of scale).

57. *See supra* note 46 and accompanying text.

58. This impact is part of an effect dubbed contractual "learning benefits" from judicial precedents. *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 718–23 (1997) (coining the term and explaining learning benefits).

dynamic does provide specificity to contractual standards, it works differently from the rulification of public standards that evolves over time.[59] Judicial interpretation of public standards creates formulation costs and benefits ex post.[60] Conversely, when contractual parties adopt an already interpreted contractual standard, they internalize similar costs and benefits of formulation ex ante. This difference altogether changes the underlying cost-benefit analysis. As such, if a particular standard happens to have been previously interpreted with sufficient vigor over many cases, and the contractual parties adopted that "standard," they have in fact chosen to adopt a rule.

Additionally, one cannot reasonably anticipate that courts will deliver a robust set of rulifying precedents after the contract has been formed and during the life of the contract.[61] Court decisions that address the same formulation of a contractual standard and provide guidance beyond the dispute at hand are rare. To give an example, many multibillion-dollar merger and acquisition agreements, governed by Delaware law, utilize the "best

59. *See* discussion *supra* Section I.A.

60. *See* discussion *supra* Section I.A.

61. It is worth noting that this is true even in the face of "network benefits." Network benefits are scalability and epistemic benefits stemming from having a common hub for precedent creation and judicial interpretation of concurrently formed contracts with similar provisions. *See* Kahan & Klausner, *supra* note 58 at 725–27 (describing network benefits as arising when contractual terms are adopted in multiple contracts contemporaneously); *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1909–10 (1998) (arguing that Delaware provides network benefits due to its dominance in the market for corporate charters). While network benefits undoubtedly exist, they do not provide substantial interpretative guidelines for contractual standards *ex post*. This is so for the same reason: there aren't many relevant decisions with precedential value after a particular contract is adopted and during the life of that particular contract. Instead, contractual parties internalize network benefits *ex ante*.

efforts" standard in their covenants and conditions.[62] Notwithstanding the wide use of the standard, Delaware courts proceeded cautiously and avoided the creation of fixed "best effort" rules.[63] As a result, only four industry-famous decisions—namely *IBP*,[64] *Hexion*,[65] *Williams Companies*,[66] and *Akorn*[67]—are generally understood as having provided meaningful guidance with respect to this standard in the last twenty years or so.

B. *Enforcement*

The enforcement-related tradeoff between private rules and standards also calls for an analysis fundamentally different from that of the parallel tradeoff between public rules and standards.[68] Before unfolding this analysis, I briefly explain what "enforcement" and "compliance" mean under contractual rules and standards. In the domain of private ordering, "enforcement" correlates with the power of a contracting party, who forms a certain understanding of the underlying contractual provision, to ensure that the

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62. *See, e.g.*, Michael J. Remmes, *Target Directors' Fiduciary Duty Overrides Contractual Duty in Merger Contracts*, 12 J. CORP. L. 735, 736–37 (1987) ("Merger agreements . . . often include a clause stating that the directors will use their best efforts to secure the approval of their respective shareholders.").

63. *See, e.g.*, Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P., 963 A.2d 746, 763 n.60 (Del. Ch. 2009) (citing LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 13.06 (17th ed. 2001) (explaining that the requirements of "best efforts" clauses are unclear)).

64. *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 80 (Del. Ch. 2001)

65. Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715, 748–51 (Del. Ch. 2008).

66. Williams Cos. v. Energy Transfer Equity, L.P., 159 A.3d 264, 272–75 (Del. 2017).

67. Akorn, Inc. v. Fresenius Kabi AG, 2018 WL 4719347 at *213–14 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

68. *See* discussion *supra* Section I.B.

other party will perform the contract in accordance with that understanding. Compliance, on the other hand, concerns the parties' ability to act in accordance with the underlying contractual provision without an enforcement intervention.

With this in mind, I now move on to analyze the enforcement-related tradeoffs between private rules and standards. In the public domain, enforcement has only one benchmark: the targeted socially desirable conduct.[69] For example, regardless of whether one prefers a driving rule (such as the fifty-five miles per hour speed limit) or a driving standard (e.g., the "reasonable speed" requirement), the underlying regulatory goal is the same: achieving safe and efficient speed on the roads.[70] Contractual rules and standards, on the other hand, have as many enforcement benchmarks as contracting parties. Sometimes those benchmarks overlap each other, and sometimes they do not. The cabinet manufacturer in my example may contemplate the receipt of a particular amount of lumber in exchange for money, and the supplier may contemplate the same exchange. Under the same contract, however, it may well be the case that the manufacturer targets the receipt of 5,000 cubic feet of lumber in exchange for the agreed-upon price per unit, whereas the supplier expects to supply only 3,000 cubic feet of lumber.

Taking these misalignments into account sheds an altogether new light on the cost-benefit analysis of enforcement under the private framework of contracts. Specifically, the familiar cost-benefit analysis of enforcement shifts from a public lawmaking-domain question—how to best achieve the specified societal goal—to an inquiry into how parties design a provision that will encompass their separate, individualized, and oftentimes conflicting transactional goals. By its very nature, this inquiry ought to account for the parties' "give and take" negotiated and

69. *See* discussion *supra* Section I.B.

70. *See* discussion *supra* Section I.B.

strategic dynamics.

Similarly to the enforcement of public rules and standards, private rules are almost always easier and cheaper to enforce than standards.[71] The enforcement of a provision requiring that the manufacturer pay a specified dollar amount for 5,000 cubic feet of lumber is straightforward and consequently inexpensive to enforce. By contrast, a provision requiring that the lumber supplier cater to the commercially reasonable requirements of the manufacturer will require an investigation and careful analysis of what does and does not fall within the scope of "commercial reasonableness." This investigation and analysis will impose substantial litigation expenses on the disagreeing contractual parties. Again, as under the public rules vs. standards analysis,[72] the difference in enforcement costs between rules and standards will be irrelevant in extreme cases,[73] such as the manufacturer's request for more than the global supply of lumber. In close cases, however, this difference will virtually always be consequential.[74]

While the enforcement-cost analysis of rules vs. standards is similar for both public and private domains, things change dramatically when the enforcement *benefits* are taken into consideration. As I already explained, the enforcement of standards in the public domain is socially beneficial whenever there are good reasons to provide law enforcers—officers, courts, and administrative agencies—with discretion and deference with respect to those law enforcers' decisions.[75] This will happen when the lawmaker estimates that the law enforcers will know more about the desired conduct (e.g., adequate driving) ex post than the

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71. *See* discussion *supra* Section I.B.

72. *See* discussion *supra* Section I.B.

73. *See* discussion *supra* Section I.B.

74. *See* discussion *supra* Section I.B.

75. As mentioned above, this benefit is limited in the case of police deference. *See supra* note 28 and accompanying text.

lawmaker can possibly know ahead of time.[76] When it comes to contracts, however, the interests of different parties often conflict with one another. Under the "commercial reasonableness" standard in my lumber-supply example, both the manufacturer and the supplier would prefer their own interpretation as to what quantity demand is commercially reasonable. When they cannot reach an agreement and go to court, the court will have to decide which side of the contract is the winner and which side of the contract is the loser. This ex post decision is unlikely to be more informed than the parties' conflicting understandings of what does and does not constitute the desired conduct under the chosen standard. Under such circumstances, the court will not resolve the parties' disagreement because it knows the definition of "commercially reasonable" amount of lumber better than the parties themselves. Rather, the court will resolve the parties' disagreement according to its understanding because there is no other way to resolve it.

Hence, there are no enforcement benefits from private standards to the party attempting to enforce a particular contractual provision. Consequently, when it comes to the enforcement of private standards, the enforcing contractual party will never benefit, on the enforcement front, from choosing a standard over a rule. Again, this is so because the enforcing agency (i.e., a court) is not an agent of either party and hence cannot be expected to expand a contractual provision to the benefit of either party. The mirror image of this weakness in the enforcement of standards is a benefit accrued by the contractual party who is subject to the underlying standard. This party can get away with more contractual violations than a similarly situated contractual party who is subject to a rule. Since contractual standards are more expensive to enforce, they are bound to be underenforced—relative to rules—whenever the added cost

76. *See supra* notes 21–22 and accompanying text.

of enforcement exceeds the enforcement's benefits.[77] For example, imagine that a contractual rule such as "X shall supply Y with 2,000 cubic feet of lumber" costs $10,000 to enforce, and a contractual standard such as "X shall supply Y with Y's commercially reasonable lumber needs" costs $15,000 to enforce. When X is subject to the rule, X can breach the contract up to the point at which Y's expected return from enforcing the rule is $10,000.[78] By contrast, when the contract is governed by the standard, X can breach that standard when Y's expected return from enforcing it is $15,000. Consequently, X enjoys a $5,000 "breaching latitude" under the chosen standard.[79]

### C. *Compliance*

Compliance with private—contractually agreed-upon—rules and standards has a number of unique features that separate it from compliance with public rules and standards set by legislators and common-law courts. These features include the benefits of bonding, formation of mutual trust, and development of collaborative knowledge. As the analysis below reveals, the formation of mutual trust and development of collaborative knowledge are the key benefits of private standards that public standards do not produce.

To have a concrete illustration of how these dynamics unfold, imagine that the manufacturer and the lumber supplier in my example form a one-year supply agreement instead of each of them committing itself to require and supply the annual lumber quantity for the next five years. The one-year agreement comes to an end, and, at this new juncture, the manufacturer still needs lumber and the supplier would still benefit from selling lumber, but neither

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77. *See* COOTER & ULEN, *supra* note 36, at 388–91 (explaining the basic mechanics of calculating the expected value of legal claims).

78. See *id.*

79. *See id.*

party has knowledge about the other party's needs and desires. Consequently, the manufacturer and the supplier must start negotiating anew. Would this way of contracting be as effective as committing to a multiyear contract? According to the conventional wisdom, the answer to this question would typically[80] be "no" simply because having pre-committed to a multiyear contract would reduce the transaction costs of having to negotiate a new agreement every year.[81] This observation is too simplistic. Clearly, when a contractual standard such as "commercial reasonableness" governs the demand for and the obligation to supply lumber, this observation holds true whenever the cost of having and resolving a disagreement as to what the standard means (e.g., 5,000, as opposed to 3,000 cubic feet of lumber) is lower than the cost of negotiating the supply-and-demand agreement anew. But what exactly makes this cost lower?

The conventional wisdom does not address this critical question and as a result glosses over the parties' *benefits* of governing their business relationship by a standard. As I will now show, these benefits oftentimes reduce the parties' cost of having and resolving a disagreement over what the standard requires. In my example, when the cost and the availability of lumber, as well as the level of demand for lumber, are all well known, the parties should always be able to arrive at the same agreement and at the same cost. However, under uncertainties and asymmetrical information that are present in the lumber and virtually every other market, the contracting parties' cost of finding themselves in a disagreement becomes a significant factor that cannot be

80. The conventional response is qualified by "typically" because there comes a point in which the cost of negotiating a new contract is lower than the potential costs of being committed to one supplier or manufacturer for a certain amount of lumber.

81. *See, e.g.*, Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005, 2010–11 (1987) (explaining the choice of long-term contracting over sequential bargaining as preferable when there are planning and negotiation savings from precommitment).

left unaccounted. At this point, contractual standards might become handy due to their hitherto under-appreciated benefits: the benefit of trust formation and the benefit of collaborative development of knowledge.[82] These two benefits allow contracting parties to make the costs of their potential disagreement lower than the cost of new negotiations.

The critical difference between the scenario in which parties disagree over the interpretation and the meaning of the chosen standard and a new negotiation is that under the former scenario the parties are *pre-committed to negotiate*. Under the new contract scenario, the parties are not obligated to negotiate and are free to shop around in the market. The commitment to negotiate imposed by a contractual standard, on the other hand, promotes the creation of mutual trust as well as the collaborative generation of knowledge. When both parties are committed to interpret a standard repeatedly, they are incentivized to do so in a reasonable manner and in an effort to arrive to a swift agreement. Under the commitment to negotiate over the chosen standard, the cost of acting opportunistically and without regard to the commitment is high as compared to a negotiation without a commitment. This is so because negotiating opportunistically and, at some point, refusing to accept the other party's reasonable interpretation of a standard, would expose the opportunistic party to contractual liability.

The standard's agreed-upon interpretation at an early point of the parties' relationship would also affect the parties' ability to argue for a different interpretation in the future.[83]

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82. It is worth noting that these benefits are similar to the coordination benefits observed in long-term and relational contracts. *See generally* Macneil, *supra* note 5; Scott, *supra* note 81. To be clear, however, the benefits of private standards qua standards can be realized in all contracts—relational, long-term, or otherwise.

83. *See supra* note 46 and accompanying text.

In my example, it might be much harder for the lumber supplier to argue that 5,000 cubic feet of lumber is not commercially reasonable in a given year if the supplier agreed to supply 6,000 cubic feet of lumber in the prior year. This beneficial effect will result from the legal significance of the prior conduct, as well as from the practical difficulty to renege on the previous understanding.[84] Consequently, the manufacturer and the supplier will have a strong incentive to articulate why they believe certain lumber requirements in a given year are commercially reasonable or not. Thus, when supplying the 6,000 cubic feet of lumber in a given year, the supplier will have an incentive to tell the manufacturer that, in this particular year, the market for raw materials has been exceptionally accessible due to a relatively dry winter season. This explanation will allow the supplier not to fulfill the manufacturer's subsequent demand for 5,000 cubic feet of lumber if the market conditions have changed. Or, if the market conditions have tilted the other way, the manufacturer might be able to quickly point out that this year there have been far fewer forest fires and the cost of raw materials has not changed. This standard-driven exchange of information will eventually develop into both formal and informal "rules of the game" for compliance with the standard.[85]

To sum up, when the parties are pre-committed to live by their privately chosen standard, they are disincentivized

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84. As noted above, prior conduct is legally significant, but not determinative. *See supra* note 46 and accompanying text.

85. The rules of the "game"—that is, an interpretation of a standard—are affected and created both by the reasons given for an interpretation of a standard and by the ensuing commercial action of the parties. In philosophical circles, this feature is famously analogized to how conversations and games like baseball are both affected by what happens on the field (i.e., the conversation, the hits and outs, or, in this case, the standard's interpretation) and by the score itself (i.e., the previous supply of lumber or being out after the third strike). *See* David Lewis, *Scorekeeping in A Language Game*, 8:3 J. PHIL. LOG. 339, 342–46 (1979).

from acting opportunistically. Instead, they have a strong incentive to reveal their contractual reasons and exchange the information upon which those reasons are formed. This informal exchange improves the parties' understanding of what the standard means and creates norms for what sorts of reasons may be brought to the table in the future. The improvement in the understanding of what the standard requires encapsulates the mutually beneficial collaborative knowledge that parties to a standard-based contract develop over time. In my example, parties acting under the "commercial reasonableness" standard become able to articulate that seasonality and weather conditions impact the level of the "reasonable" annual demand for lumber. As a result, the parties are better prepared to make predictions that help them achieve critical contractual understandings and run their respective businesses.

This collaborative knowledge generation is sensitive to—and, indeed, derives from—the changing transactional environment, which affords the parties flexibility in compliance. The creation of norms in the discussion of the standard, or informal "rules of the game," captures the development of mutual trust. For illustration, the fact that both parties acknowledged seasonality and weather conditions as valid reasons for what is or is not "commercially reasonable" necessitates the acknowledgment that, absent such reasons, a certain lumber quantity would be supplied, and that such reasons can be used by both of the parties and as both a sword and a shield in future interpretations of the standard.

My compliance-focused analysis of primary transactional behavior under contractual standards can be usefully recast in game-theoretical terms. When parties to a contract are repeatedly playing the game of interpreting a standard, they are able to develop dominant strategies that mutually enforce trust. Since the game of interpreting a contractual standard would be repeated, the dominant strategy for both parties would be to respect the other party's

valid interpretations of the standard in the expectation that one's own valid interpretations would be respected as well. Under game theory, this prototype of a cooperative strategy is called a "tit-for-tat" model.[86] Some might argue that this model will unravel without producing the anticipated cooperation due to the problem of "backward-induction."[87] Under the backward-induction scenario, mutually reinforcing collaborative strategies do not work in repeated games that are played for a fixed number of times, rather than indefinitely.[88] In such games, the parties would always worry that the other party would defect in the very last game; and so, in order to avoid being beaten as the last non-defecting party, the parties will reason backward and defect at the outset of their relationship.[89] Arguably, therefore, there is no point in time at which it makes sense to cooperate.[90]

This objection is mistaken for two reasons. First, the parties can dynamically change their position until they are able to *simultaneously* ensure cooperation. Or, in other words, this is a game that allows the players to change their minds and positions and reconfigure their strategy in light of what the other party choses to do, until they are able to coordinate non-defection.[91] Under real world business

86. *See* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 27–54 (1984) (explaining the functions and merits of the tit-for-tat strategy). This is not the only possible model of cooperative strategies of this progeny. *See id.* at 39, 45 (explaining the tit-for-two-tats strategy).

87. *See generally* Philip J. Reny, *Backward Induction, Normal Form Perfection and Explicable Equilibria*, 60 ECONOMETRICA 627 (1992) (explaining the various conceptions of the backward induction model).

88. COOTER & ULEN, *supra* note36, at 36–37.

89. *See id.*

90. *See id.*

91. The fact that the parties can continuously change their interpretive stance means that the last interpretive stance, or move made by the other player, is never knowable by the other party. In turn, this lack of knowledge defeats backward induction. *Cf.* DOUGLASS G.

scenarios, parties interpreting a standard are able to continuously talk with one another (e.g., send another email or make another phone call) and continuously change their interpretation decisions rather than making their interpretation decision once and without knowledge of the other party's decision. Second, and more importantly, the backward-induction scenario features games that repeat themselves for a fixed number of times under a fixed set of rules.[92] In games that encompass a repeated interpretation of private standards, however, the rules of the game are not fixed. Rather, those rules change from one game to another to secure the mutual commitment to cooperate.[93] This is exactly what happens in my lumber-supply example. In this example, the rules of the games change because the parties' prior agreement as to what the "commercial reasonableness" standard requires with respect to the supply of lumber in a given year will limit, and at some point, altogether abrogate, the parties' legal ability to argue for opportunistic interpretations in future dealings.[94]

Notably, the backward-induction scenario has never been replicated nor observed with meaningful consistency in empirical studies of people's real world transactions.[95] As I

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BAIRD, *ET AL.*, GAME THEORY AND THE LAW 63 (1994) ("Backwards induction, however, is not available in those cases in which the last player must move without knowing the other player's previous move.").

92. *See, e. See, e.g.*, Prajit K. Dutta, *A Folk Theorem for Stochastic Games*, 66 J. ECON. TH. 1, 1 (1993) ("A drawback of the repeated game paradigm is that it is premised upon a *completely unchanging environment*.").

93. *See, e.g.*, Christian Hilbe et al., *Evolution of cooperation in stochastic games*, 559 NATURE 246, 246 (2018) ("In the stochastic game, cooperation evolves because defectors loose out twice: once, because they risk to receive less cooperation from their reciprocal co-player in future, and second because players collectively move towards a less beneficial game.").

94. *See supra* note 46 and accompanying text.

95. Steven D. Levitt et al., *Checkmate: Exploring Backward Induction among Chess Players*, 101 AM. ECON. REV. 975, 975 (2011) (summarizing

already mentioned, the contractual standards' ability to foster mutual-trust and galvanize collaborative knowledge has been underappreciated and largely unacknowledged in the contemporary contracts literature.[96] The benefits of private—or contractual—standards may explain some of these studies.[97] Remarkably, a similar connection between beneficial strategic coordination and social conventions appeared in the work carried out by the philosopher David Hume in the eighteenth century.[98] Hume wrote that:

> I observe, that it will be for my interest to leave another in the possession of his goods, provided he will act in the same manner with regard to me. He is sensible of a like interest in the regulation of his conduct. When this common sense of interest is mutually express'd, and is known to both, it produces a suitable resolution and behaviour. And this may properly enough be call'd a *convention*

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the research showing that backward induction does not replicate well empirically).

96. Outside the context of private rules vs. standards, bonding and information benefits in private ordering has been developed as part of the explanation for extralegal contractual relations. *See generally* Lisa Bernstein, *Opting Out of The Legal System: Extralegal Contractual Relations in The Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (examining the diamond industry and theorizing extralegal contractual coordination); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) (examining extralegal cooperation in the cotton industry); Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328 (2004) (developing a model of cooperation through the private ordering of norms).

97. It is noteworthy that, in those instances where this explanation is applicable, the benefits of standards can potentially cast doubt on some, but certainly not all, findings of bounded rationality in the face of a "failure" to exude backward induction. For an example of such a bounded rationality explanation, see Richard D. McKelvey & Thomas R. Palfrey, *An Experimental Study of the Centipede Game*, 60 ECONOMETRICA 803, 803–06 (1992) ("One class of explanations for how such apparently irrational behavior could arise is based on reputation effects and incomplete information. This is the approach we adopt.").

98. DAVID HUME, A TREATISE OF HUMAN NATURE 490 (David F. Norton and Mary J Norton., 2020).

*or agreement betwixt us, tho' without the interposition of a promise.*[99]

## III. THE CASE OF CORPORATE CONTRACTS

As I demonstrated in Part II, contracting parties negotiating over rules and standards must take into consideration the non-rulification of contractual standards;[100] the "give-and-take" costs and benefits associated with the enforcement of contractual standards;[101] and, last but not least, the potential trust and knowledge benefits associated with compliance with contractual standards.[102] Armed with this newfound understanding of private rules and standards, this Part re-theorizes the conventional understanding of some of the most important contractual provisions in the corporate area. By way of illustrating the operation of private rules, in the paragraphs ahead, I explain the structure of typical debt covenants as provisions calling for ex ante specificity, clear-cut enforcement, and minimal need for future learning and trust building. By way of exemplifying the workings of private standards, I then move on to explain the "ordinary course" covenant as a provision calling for low specificity at the outset and for the enforcement and compliance mechanisms that prioritize the building of trust and expertise between contracting parties. Subsequently, I reconfigure our understanding of the Material Adverse Change (MAC) provision as a provision that lies in the middle between rules and standards. More precisely, I demonstrate that the MAC provision encapsulates a tradeoff between certainty in articulation and enforcement, on one hand, and the building of trust and expertise, on the other hand.

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99. *Id.* (emphasis added).

100. *See* discussion *supra* Section II.A.

101. *See* discussion *supra* Section II.B.

102. *See* discussion *supra* Section II.C

A. *Debt Covenants*

To understand why debt covenants are typically structured as contractual rules rather than standards, one must first understand the business needs of the debtholders and the borrowing corporation. Corporations are often financed by both equity and debt.[103] Debt investments are typically structured as contracts for cash injections into the company in exchange for the promise to return the money and pay interest payments at a later date.[104] As such, debt investors do not ordinarily stand to gain much by a corporation's appreciation in value beyond the corporation's ability to pay back the debt and make the interest payments.[105] Equity holders, on the other hand, internalize financial gains and losses by the corporation's appreciation or depreciation in value, respectively, which may be monetarily expressed by dividends or stock price changes.[106]

The corporation itself is managed by a board of directors.[107] The board of directors, in turn, oversees the corporation's officers, who are responsible for the day-to-day management of the firm's business.[108] This division between the financiers or owners of the corporation and the managers that control the corporation is famously dubbed "the

103. In a world without transaction costs such as irrational or boundedly rational behavior, asymmetric information, and other transaction costs, the choice between debt and equity is inconsequential. In the real world, it is a difficult financial question. For the seminal work on this equality between equity and debt, see Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

104. *See* ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 140–44 (4th ed. 2015).

105. *Id.* at 2.

106. *See id.* at 2–5.

107. *Id.* at 15–16.

108. *Id.*

separation between ownership and control."[109] When equity and debt holders finance a corporation, they have to negotiate for appropriate contractual provisions that will protect their interests and investments. Put differently, both equity and debt holders utilize contractual provisions that limit the actions of the managers in control. While equity holders generally allow managers ample breathing room to exercise their professional business judgments, debtholders have incentives to negotiate for far more restrictive contractual provisions.[110] Since debtholders will not gain any value from a corporation's successful performance beyond the corporation's ability to pay back the debt and meet the interest payments, debtholders prioritize certainty in the financial viability of the corporation over risky endeavors with potentially large windfalls.[111]

Correspondingly, debt covenants are structured to limit with specificity the incurrence of additional debt, the transferring of assets, and the movement of cash payments such as dividends.[112] For example, a typical bank-issued leveraged loan will include a covenant that specifies the exact measurements of how much debt a corporation may have as compared to that corporation's earnings.[113] The covenant will include a formula that has to be met and tested for at pre-determined intervals.[114] For instance, a frequent structure of such a covenant would specify that the ratio of

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109. For one of the seminal works on the separation of ownership and control, see generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

110. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 337–38 (1976).

111. *Id.* at 341–43.

112. *See id.* at 350.

113. RAJAY BAGARIA, HIGH YIELD DEBT AN INSIDER'S GUIDE TO THE MARKETPLACE 83 (2016).

114. *Id.* at 84.

total debt to earnings before interest, tax, depreciation, and amortization (EBITDA) cannot exceed 3.5:1 and that this ratio must be tested on a quarterly basis.[115] This level of contractual specificity stands in stark contrast to the arrangements of equity holders, who are generally satisfied by the protection of standard-like norms that require managers to exercise a reasonable business judgment in good faith.[116]

Given the tradeoffs between private rules and standards, this choice of utilizing contractual rules, rather than standards, is not surprising.[117] From a formulation perspective, while it would be easier and cheaper to design a contractual standard to govern the rights of debtholders, the non-rulification feature of the would-be standard is particularly impactful.[118] For illustration, imagine that, instead of the aforementioned EBITDA to total debt covenant,[119] the debt agreement only contained a covenant by the company to not issue debt beyond what is "commercially reasonable." In such a scenario, disputes between debtholders and the company regarding appropriate levels of debt will likely become unmanageable.[120] Settling such a dispute in court would require extensive investigations and reports by financial experts regarding

115. *See id.* at 83–84.

116. *See supra* note 32 and accompanying text (providing support for the public standards governing equity ownership and governance).

117. *See generally* Zohar Goshen & Richard C. Squire, *Principal Costs: A New Theory for Corporate Law and Governance* 117 Colum. L. Rev. 767 (2017) (analogizing debt to rule-based enforcement and equity to standard-based enforcement).

118. *See* discussion *supra* Section II.A.

119. *See supra* note 115 and accompanying text.

120. *See generally* Charles W. Haley & Lawrence D. Schall, *Problems with the Concept of the Cost of Capital*, 13 J. FIN. & QUANT. ANALYSIS 847 (1978) (introducing the broad conceptual difficulty and limiting assumptions for calculating an optimal capital structure for particular companies).

"reasonable" capital structures, and the time needed to settle such a dispute would be incompatible with the practical need to ensure and meet interest payments in regular intervals.[121] Moreover, it is unlikely that a settlement of such a dispute as to one level of debt issuance will be of much guidance for a different level of debt issuance, as both the economic conditions and the corporation's needs are constantly changing over time.[122] As a further consequence, the pricing and marketing of the debt interests in both the primary and secondary markets would be uncertain at best, as debt investors will be hard pressed to calculate the probabilities of bankruptcy and default in the absence of dependable information regarding permissible debt levels.[123] For similar reasons, from an enforcement perspective, such a contractual provision would be near impossible to continuously and timely enforce in a court of law.[124]

From a compliance perspective, the cost of determining an appropriate level of debt under such a provision will also be extremely high.[125] As a preliminary matter, it is worth noting that compliance with the specified and rule-like debt covenants already requires extensive work by the company's legal advisors, CFO, and treasurer.[126] This extensive work is due to the fact that, while the covenant is specified, it requires careful navigation of both the relevant contractual

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121. *See id.*

122. *See* DAMODARAN, *supra* note 104, at 329 (illustrating the changes in capital structure needs of firms as the firms mature over time).

123. Probabilities of bankruptcy and default are an essential part of debt valuations. *See id.* at 377–79 (explaining the role of such probabilities and illustrating the basics mechanics of calculation).

124. *See* discussion *supra* Section II.B.

125. *See* discussion *supra* Section II.C.

126. *See* BAGARIA, *supra* note 113, at xii-xiii ("I met with many individuals responsible for high yield investments who had surprisingly little understanding of the market. . . . Seeing the knowledge gaps even at the Chief Investment Officer level made me realize that there is a broad-based need for better information on the high yield market.").

provisions and the rules of accounting.[127] Absent such guidance, however, it would take an enhanced, and perhaps unattainable,[128] financial modeling to decide whether particular levels of debt fall above or below the line of "commercial reasonableness."[129] Additionally, and most fundamentally, the need for the galvanization of mutual trust and knowledge development is limited in debt transactions. This is so because the discrete desires of debtholders are fixed at the time of contract formation.[130] Debtholders are far more interested in securing their interest in repayment at regular intervals, and far less, if at all, in learning how the company would or should respond to new business opportunities.[131] Lastly, for the narrow set of ad hoc situations in which (1) the company has a need to stray from the confines of the specified debt covenant and (2) the debtholders are agreeable to the deviation, the debtholders are always able to forego the enforcement of their contractual entitlements.[132]

### B. *The "Ordinary Course" Covenant*

In many pubic merger and acquisition agreements, such as stock and asset purchase agreements (collectively, henceforth, "acquisition agreements"), there is a period of

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127. *See supra* notes 113, 117 and accompanying text.

128. This is because it is unclear if, and if so how, cost of debt can be modeled without a reasonably certain way to calculate probabilities of default. *Cf.* DAMODARAN, *supra* note 104, at 366–79 (illustrating the role of probabilities of default in evaluating the cost of debt).

129. *Id.*

130. *See* discussion *supra* Section II.C.

131. *See* Jenson & Meckling, *supra* note 110, at 341–43.

132. Indeed, there are empirical data that show that debtholders do exercise their waiver rights frequently. *See* Jeremy McClane, *Corporate Non-Governance*, 44 DEL. J. CORP. L. 1, 3 (2020) (arguing that debtholders' monitoring of management has reduced as a result of waived enforcement in the face of events of default).

time separating the signing and the closing of the transaction.[133] The signing event takes place when the acquisition agreement is executed, and the closing event occurs when the money payable for the company is exchanged for the control over the company.[134] This separation between the signing and the closing of an acquisition is typical for many reasons, including the need for shareholder votes and regulatory approvals (e.g., the Hart-Scott-Rodino antitrust approval).[135] During this period between the signing and the closing, often referred to in the industry as the "pre-closing period," there are covenants and provisions that govern the conduct of both the buyer and the seller.[136] In particular, the vast majority of acquisition agreements contain a covenant that requires the company being bought to operate in the "ordinary course of business" between the signing of the transaction and the closing of the transaction.[137] As shown below, conceptualizing this covenant as a contractual standard illuminates its purpose and function.

The typical structure of the "ordinary course" covenant requires the seller to operate its affairs as it is done in the ordinary course of business.[138] A notable variation will also add that this ordinary course of business needs to be

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133. *See, e.g.*, Guhan Subramanian & Caley Petrucci, *Deals in the Time of Pandemic*, 121 COLUM. L. REV. 1405, 1417–23 (2021) (explaining the mechanics of the ordinary course covenant).

134. *Id.*

135. *See, e.g.*, Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2016–23 (2009) (explaining the typical need for a time window to obtain the various corporate and regulatory approvals).

136. *Id.*

137. *See, e.g.*, *id.* at 2039 (describing the typicality of the covenant).

138. *Id.*

consistent with the seller's "past practice."[139] In addition, the "ordinary course" covenant will typically work in tandem with a condition to closing provision that will excuse the buyer from closing the transaction if the seller does not adhere and comply with the "ordinary course" covenant (subject to materiality thresholds, such as "all material respects,"[140] if any).[141]

The fact, that this provision is regularly adopted instead of an alternative contractual rule is telling. Parties adopting an "ordinary course" covenant could have instead chosen to exclusively use two different private rules that, at least at first glance, appear to achieve the same purpose more efficiently. First, the parties could have chosen to only rely on a contractual rule that provides the buyer with a walk-away right in case the valuation of the seller drops below a certain dollar amount. Second, the parties could have chosen to bolster the covenant package to include exact measurements for how the seller must conduct its business between signing and closing. Since typical acquisition agreements already contain other covenants that prescribe what a company may and may not do between signing and closing (e.g., limitations on dividends and indebtedness), the parties could just work on drafting further requirements into these covenants.[142] For instance, the parties could incorporate provisions similar to those included in the debt agreements discussed above,[143] which delineate with specificity the amounts and conditions for the moving of

139. Nicholas V. Perricone, *Pre-Closing Covenants: Operating in the Ordinary Course of Business*, MINTZ, https://www.mintz.com/insights-center/viewpoints/2871/2020-01-29-pre-closing-covenants-operating-ordinary-course-business (last visited Nov. 22, 2021).

140. *Id.*

141. *Id.*

142. *See* Miller, *supra* note 135, at 2039 (describing such interim covenants).

143. *See supra* notes 113–115 and accompanying text.

assets, debt, and cash.[144] The parties could also further specify and impose operational requirements on the seller, such as exactly how many points of sale must be met, at what price, and under what conditions.[145]

While the abovementioned contractual rules would be cheaper and easier to enforce, the virtues of private standards reveal why the choice of the parties to acquisition agreements to use the "ordinary course" standard is par for the course in most cases.[146] First, the use of the "ordinary course" language provides formulation benefits.[147] It is a lot cheaper and easier to ask the seller to conduct its business as like companies would do in like circumstances[148] (or to conduct its business in the way it has done so in the past)[149] than to develop a precise contractual formula for what that will entail.[150]

Second, the "ordinary course of business" covenant provides compliance benefits by way of mutual trust and knowledge development.[151] This is for two reasons. First, when an acquirer agrees to and is expecting to take control over the company, the acquirer will typically have a learning curve in terms of how to best manage the company on a day-to-day basis and which of the existing directors and employees it would be better to retain or replace.[152] Second,

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144. *See* discussion *supra* Section III.A.

145. That is to say, holding everything else equal, the only real limits for how specific and demanding an interim covenant can be are the costs of formulation and the ability to negotiate for such a provision.

146. *See* discussion *supra* Section II.B.

147. *See* discussion *supra* Section II.A.

148. *See supra* notes 135, 137 and accompanying text (describing the demands of the ordinary course covenants).

149. *See supra* note 139 and accompanying text (describing the "past practice" formulation).

150. *See* discussion *supra* Section II.A.

151. *See* discussion *supra* Section II.C.

152. This learning curve exists even for experienced professional

after signing, the current management of the seller would generally lack an incentive to manage the company as they would prior to the signing of the acquisition agreement.[153] Utilizing the "ordinary course of business" covenant sets up a legal regime that both places a check on any opportunistic behavior of the existing management and encourages discussion and learning between the acquirer and the seller. Operating under this covenant, the incumbent and incoming managers would have an incentive to collaboratively discuss why their favored business decisions are the appropriate responses to the ensuing business events and why they should not pursue a different business strategy instead. These discussions, in turn, will allow the incoming managers of the company to both better understand the company's operations and which employees and managers are worthy of trust. The current employees and managers of the seller, too, would be able to develop relationships with the buyer's personnel and figure out whether they would be interested in continuing to work in the company once it is under new management. As this window of trust and information acquisition is unfolding, the company would be able to continue to run properly and with sufficient flexibility to address unexpected business situations.

### C. *"Material Adverse Change"*

Many contractual provisions, like statutes, do not conform with the strict analytical requirements for being

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acquirers. *See* Francesco Castellaneta & Raffaele Conti, *How Does Acquisition Experience Create Value? Evidence from a Regulatory Change Affecting the Information Environment*, 35 EURO. MANG. J. 60, 60 (2017) (arguing that experienced acquirers learn how to better select targets but do not have much learning gains that are reflected in the restructuring and management of targets).

153. *See* Miller, *supra* note 135, at 2038–40 (describing the problem of moral hazard during the interim period); Subramanian & Petrucci, *supra* note 133, at 1409.

exactly a rule or exactly a standard.[154] At times, legal norms are designed to embody some of the merits and demerits of rules and some of the virtues and vices of standards.[155] For example, while a rule-like driving law would limit speed to "fifty-five miles per hour" and a standard-like driving law would impose a "reasonable" speed requirement,[156] an in-between or "mezzanine" provision would limit speed to "reasonable speeds, including speeds below fifty-five miles per hour in regular traffic, below thirty miles per hour during rush hours, and below eighty miles per hour at night."[157] This formulation provides a guiding standard for future behavior alongside specifications that guide and structure the understanding and future interpretations of the standard.[158] Another archetype legal norm that sits between rules and standards is one that combines a standard with a non-exclusive list of typical instances:[159] for example, a law

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154. *See, e.g.*, Aaron D. Twerski, *Seizing the Middle Ground Between Rules and Standards in Design Defect Litigation: Advancing Directed Verdict Practice in the Law of Torts*, 57 N.Y.U. L. REV. 521, 521–26 (1982) (arguing that a positive development in tort law embodies a middle ground between rules and standards).

155. *See* Kennedy, *supra* note 13, at 1701 ("[T]he discussion presented a pro-rules position and a pro-standards position, but there was nothing to suggest that these were truly incompatible. . . . He might make up his mind to adopt . . . one of the infinite number of intermediate positions, by assessing the net balance of advantage in terms of his underlying legislative objective.").

156. *See* Kaplow, *supra* note 2.

157. *See* discussion *supra* Part I.

158. *Cf.* Kennedy, *supra* note 13, at 1702 ("The second, and I think more important, approach ignores both the question of how rules and standards work in realistic settings . . . . The purpose of the second line of investigation is to relate the pro-rules and pro-standards positions to other ideas about the proper ordering of society . . . .")

159. These archetype provisions, dubbed "catalogs," were first identified by Gideon Parchomovsky and Alex Stein. Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 165 (2015) (discussing how a catalog is provision that embodies "a specific enumeration of behaviors, prohibitions, or items that share a salient

that prohibits every fraud, embezzlement, duress *and similar dishonest acts*.[160]

Mezzanine norm structures are also present in private ordering. To have a simple illustration, imagine a contract provision that gives a "broker the exclusive right to sell a farm's 'oranges, lemons, grapefruit, *and other fruit*.'"[161] Understanding these structures is part and parcel of the comprehensive analysis of private rules vs. standards. This understanding reveals the nature, benefits, and shortcomings of important contractual provisions, such as the MAC provision. Mezzanine norms are designed as a balance between the specificity advantages of rules and the flexibility advantages of standards.[162] Private mezzanine provisions are more expensive to formulate than standards, but cheaper to formulate than rules.[163] The enforcement advantages and disadvantages of such provisions also fall between the alternate contractual rules and the alternate contractual standards.[164] From the compliance perspective, the mutual trust and knowledge benefits of standards will continue to accrue, but they will be confined to the predetermined, and oftentimes narrowly tailored, list of instances.[165]

The MAC provision provides a particularly useful

common denominator and a residual category—often denoted by the words 'and the like' or 'such as'—that empowers courts to add other unenumerated instances.").

160. This example is loosely based on a real-life "catalog" found in the Bankruptcy Code and identified by Parchomovsky & Stein. *Id.* at 169.

161. AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, C.A. No. 2020-0310-JTL, 2020 WL 7024929, at *58 n. 215 (Del. Ch. Nov. 30, 2020) (citing KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING 360 (4th ed. 2017)), *aff'd*, 268 A.3d 198 (Del. 2021).

162. *See* discussion *supra* Part II.

163. *See* discussion *supra* Section II.A.

164. *See* discussion *supra* Section II.B.

165. *See* discussion *supra* Section II.C.

illustration of that balance. During the pre-closing period in acquisition agreements, there is a risk that the value of the acquired company will fall significantly below the value it had upon signing.[166] One of the most important methods by which parties to acquisition agreements allocate the risks associated with such depreciation is through MAC clauses.[167] Those clauses operate as follows: the buyer of the target company will secure the benefits of a condition precedent to closing by requiring the company to provide a certificate that states that its representations and warranties, in the aggregate, are not false to the extent that is deemed a Material Adverse Change.[168] In acquisitions that involve stock consideration in lieu or in addition to cash payments, both parties to the agreement would typically be able to rely on a MAC condition precedent to closing.[169] Furthermore, one of the customary representation and warranties is a representation that the company has not suffered a MAC.[170]

The definition of MAC usually adopts the mezzanine structure. Under this definition, MAC occurs when there is any event, effect, change, or occurrence that "would [or 'could'] reasonably be expected"[171] to (A) hinder [ordinarily, "prevent" or "materially delay"] the consummation of the acquisition or the compliance by the company with its obligations under the acquisition agreement or (B) have a material adverse effect on . . . [various MAC instances that typically include business, financial condition, results of operations, and assets, taken as a whole],[172] . . . *provided, however,* [that a list of MAC carveouts do not count as MAC

166. *See* Miller, *supra* note 135, at 2038–39.

167. *See id.* at 2050–52.

168. *See id.* at 2041.

169. *See id.* at 2042.

170. *See id.*

171. *Id.* at 2045.

172. *Id.* at 2045–46.

events. The list usually includes general economic and market conditions, industry conditions, force majeure events, and changes in applicable laws][173] . . . *provided further, however,* [that certain events will count as exceptions to the carveout themselves. Generally, it will be stated that (A) some carveouts, while not themselves a MAC, can still be used as evidence for a MAC, and that (B) some carveouts could still nonetheless count as a MAC if the event's negative impact falls disproportionally on the target company].[174]

The MAC definition sits between a rule and a standard because it both utilizes an unspecified standard—"material adverse effect"—and a set of rules detailing MAC events and MAC non-events.[175] This mezzanine provision was recently litigated before the Delaware Chancery Court.[176] The dispute involved an acquirer who argued that they were entitled to walk away from closing the acquisition because Covid-19 caused the target company to suffer a MAC.[177] The target company argued in response that any Covid-19 repercussions fall within both the MAC carveout for events generally affecting the economy and the MAC carveout for "natural disasters or calamities."[178] The acquirer insisted that the category of "pandemics" was specifically not included in the list of MAC carveouts,[179] but the court sided

173. *Id.* at 2047.

174. *See* Akorn, Inc. v. Fresenius Kabi AG, C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *52 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

175. *See* discussion *supra* Part II.

176. *See generally* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, C.A. No. 2020-0310-JTL, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

177. In this particular case, it was a material adverse "effect" instead of "change." *Id.* at *48.

178. *Id.* at *55.

179. *Id.*

with the target company upon reasons that exemplify the mezzanine nature of the provision.[180] Specifically, the court used one line of reasoning that interpreted the MAC provision as a rule and another line of reasoning that treated the MAC provision as a standard.[181] By treating the provision as a rule, the court held that a pandemic such as Covid-19 falls under the plain meaning of "natural disasters or calamities."[182] By treating the provision as a standard, the court decided that the Covid-19 repercussions, being a market rather than company-specific risk, are more aligned with the list of MAC carveouts than with the list of MAC events.[183]

The drafting of the MAC provision as a combination of a rule and a standard bodes well with the optimal private rules vs. standards tradeoffs.[184] From the formulation standpoint, it would have been a very costly endeavor to specify and agree upon what financial, business, and stock price threshold events should trigger the walkaway right.[185] For the same reasons, though, such formulations would be much easier to enforce in court.[186] On the other hand, formulating a pure private standard such as "material adverse effect as a result of idiosyncratic risks" would result in very uncertain and costly enforcement.[187] To determine that an event caused or did not cause a sufficiently severe financial damage to the company and categorize that event as a

180. *See infra* notes 182–183 and accompanying text.

181. *See infra* notes 182–183 and accompanying text.

182. AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, C.A. No. 2020-0310-JTL, 2020 WL 7024929, at *57–59 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

183. *See id.* at *59–63.

184. *See* discussion *supra* Part II.

185. Choi & Triantis, *supra* note 1, at 833 (noting the same); *Cf.* discussion *supra* Section II.A.

186. *See* discussion *supra* Section II.B.

187. *See* discussion *supra* Section II.B.

materialization of a systemic rather than idiosyncratic risk, or vice versa, would require a well-trained and expensive team of legal and financial experts and substantial diligence and discovery efforts.[188] From the compliance perspective, the utilization of the mezzanine MAC provision generates important mutual trust and knowledge benefits.[189] This provision forces the buyer and the seller to discuss how unwelcome events will affect the company in the long run and whether those events qualify as market or company-specific problems.[190] Assume, for instance, that a private equity firm signed an agreement to acquire a large, and chicken-based, fast casual restaurant chain. Shortly after signing, a global shortage of chicken ensued, and it is now predictable that the restaurant will not be able to sell chicken-based food for at least a year. In this situation, if governed by a MAC provision, the buyer and the seller will have an incentive to discuss the impact of the chicken shortage.[191] Specifically, the parties will discuss whether they believe the cash-flow impact to be a multi-year or single-year impact;[192] whether they believe the company can adjust

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188. While expert testimony is not required of litigants addressing the MAE provision, the use of expert testimony is nearly essential as a matter of practice even in ordinary uses of the MAE provision. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 69–70 (Del. Ch. 2001) ("Tyson's arguments are unaccompanied by expert evidence. . . . The absence of such proof is significant.");*See* Akorn, Inc. v. Fresenius Kabi AG, C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *4 (Del. Ch. Oct. 1, 2018) ("A five-day trial took place . . . the parties introduced 1,892 exhibits into evidence and lodged fifty-four deposition transcripts—forty from fact witnesses and fourteen from experts. Nine fact witnesses and seven experts testified live at trial."), *aff'd*, 198 A.3d 724 (Del. 2018).

189. *See* discussion *supra* Section II.C.

190. *See* discussion *supra* Section II.C.

191. *See* discussion *supra* Section II.C.

192. Issues of duration have taken center stage in MAC disputes. *See Akorn*, 2018 WL4719347, at *53 ("[T]he effect should 'substantially threaten the overall earnings potential of the target in a durationally-significant manner.'"). That is not to say, however, that durational

its product and pricing models to weather the storm, and if so, how; and whether they see the chicken shortage as an issue peculiar to the company as compared with the entire industry that includes the company's competitors. As a result, the buyer and the seller will be able to learn about each other's understanding of the company's operations and the market and form the relationship of trust (or, alternatively, distrust) around the future prospects of the potentially peaceful turning-over of the company and its long-term management.[193] The buyer also will be able to learn which managers and employees honestly and adequately communicate the problems posed by the chicken shortage, and who is able to come up with creative solutions. On the flip side, the seller and its employees will be able to learn, by observing how the private equity personnel treat the time horizon of the shortage's impact; how long the private equity firm plans to hold the company before it unloads it to other owners; and under what conditions.[194]

Understanding the MAC provision as a balance between a private rule and a private standard also facilitates the understanding of how the provision should be interpreted in future cases.[195] Interpretations of the MAC provision should follow a two-pronged approach that parallels the rule and standard features of the provision.[196] First, the interpreter should examine whether any potential MAC events fall within the plain meaning of one of the specified MAC events

significance is always required. *See* Choi & Triantis, *supra* note 1, at 877 ("[T]he requirement of durational significance may not apply when the buyer is a financial investor with an eye to a short-term gain.").

193. *See* discussion *supra* Section II.C.

194. *See* discussion *supra* Section II.C.

195. This understanding can be reflected as either learning or network benefits. *See supra* notes 58, 61 and accompanying text.

196. This exemplifies the point that judicial interpretations can provide rulifications that would be internalized *ex ante*, rather than *ex post*, by the drafting parties. *See supra* notes 58, 61 and accompanying text.

or one of the specified MAC carveouts.[197] Second, any ambiguity as to the classification of an occurrence as a MAC event or MAC carveout should be resolved through a standard. That is, by identifying the occurrence's proximity to market risks or, conversely, to company-specific risks.[198] The second prong may facilitate further specifications. While one important account of MAC stops at the division between market and company-specific risks,[199] another important account brings into play "agreement risks" and "indicator risks"—namely, risks attributable to the announcement of the deal and risks attributable to the difference between the company's performance and projections, respectively.[200] Under this framework, the agreement risks are allocated to the buyer, while the indicator risks—triggering the buyer's walkaway right or another penalty—are generally borne by the seller.[201]

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197. Delaware courts do exactly that, and alternate, depending on the practical needs of the case, between first running through the list of MAC events and first running through the list of MAC carveouts. *Compare* Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715, 737 (Del. Ch. 2008) ("[U]nless the court concludes that the company has suffered an MAE . . . the court need not consider the . . . carve-outs.") *with* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, C.A. No. 2020-0310-JTL, 2020 WL 7024929, at *55 (Del. Ch. Nov. 30, 2020) ("'(Having concluded that [the seller] fits within one of the MAE carve-outs, it is not necessary for the Court to decide whether an MAE has occurred.'). This is one of those cases.") (citing Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007)) *aff'd*, 268 A.3d 198 (Del. 2021).

198. *See supra* notes 180–183 and accompanying text. This two-pronged approach was essentially followed by the Delaware Chancery Court decision in *AB Stable VII LLC*. *See supra* notes 180–183 and accompanying text.

199. *See generally* Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330 (2005) (conceptualizing MAC events and carveouts as distributing market and company specific risks).

200. *See* Miller, *supra* note 135, at 2082–89.

201. *See id.*

## CONCLUSION

The rules vs. standards dichotomy, to which all legal practitioners and scholars owe much intellectual debt, has generated organizing principles for law design that cut across jurisdictions and generations. This Article uncovers a different and equally important dichotomy: the tradeoffs between rules and standards in contract design. As I demonstrated, these tradeoffs involve the balancing of the virtues and vices of stagnant contractual standards; the strategic "give-and-take" of enforcing contractual rules and standards; and the trust and learning benefits that contractual standards oftentimes afford. All this makes the tradeoffs between rules and standards in private orderings altogether different from the parallel tradeoffs taking place in the formulation of laws.

Further research into the nature and functioning of private rules and standards is still in order. First and foremost, this research should examine, both theoretically and empirically, how the choice between private rules and standards should account for attitudes toward risk, for both rational and boundedly-rational actors. Second, further research should examine the tradeoffs that individuals make across public and private rules and standards. Hopefully, the tradeoffs between private rules and standards uncovered and analyzed by this Article will improve contract design and interpretation and generate future work that will explore—theoretically and empirically—the multifarious preferences of rules over standards, and vice versa, in private orderings.