

Contractual Enforcement Mechanisms and the Structure of Information

Comment

by

ALAN SCHWARTZ

1 Introduction

An early question to ask about a paper is who the addressees of the paper are. This paper (KATZ [2008]) answers the question.

“The motivating question [...] is how parties should choose among the various enforcement regimes available to them. [...] the primary audience for such analysis likely consists of private parties engaged in transactional planning, who need to decide whether to prepare for public or private enforcement, for monetary remedies or merely a termination right, and for a series of independent and sequential exchanges as opposed to a unified installment contract. It is those actors who are most likely to [...] choose optimally among them.” (p. 136)

“The main purpose of this essay is to argue that parties can also choose among the enforcement institutions in which to pursue remedies for breach of contractual commitment, and on analogous criteria.” (p. 152)

That the paper is intended for persons in business and lawyers – the “private parties” – raises an initial question, not answerable by me, as to why the paper is presented at this conference. Private parties and lawyers seldom read *JITE*. It raises a second question, how to write an academic comment on a paper that is not intended for an academic audience. This Comment struggles with the second question for a while and then briefly takes the paper on its own terms, to ask whether it is useful to its intended audience. The Comment concludes, using academic criteria, that the paper is too sketchy for the academy and, using practical criteria, that the paper is too abstract for the business world.

2 The Academic Part

The academic genre that this paper most closely resembles is the review. Three criteria are used to assess reviews: whether a review (a) brings to scholars’ attention heretofore neglected papers; (b) draws heretofore neglected connections between known papers; or (c) raises new questions. Using these criteria, the author should do

more work. Regarding criterion (a), the papers cited here are well known to scholars in the field.

Regarding criterion (b), the connections this paper suggests between possible enforcement mechanisms seem well known. A paper by Pearce and Stachetti, not cited here, models the interaction of formal and informal mechanisms (PEARCE AND STACCHETTI [1998]). Shavell and others have considered when reputation and legal enforcement are substitutes (e.g., SHAVELL [1984], [1987]). The literature on self-enforcing contracts considers the interaction between creating rents or quasi-rents and the role of legal institutions, including courts (e.g., KLEIN [1996], MAZÉ AND MÉNARD [2007]). Much of the contract theory literature models the parties' choices when some variables of interest are contractible – i.e., enforceable by a third party – and some variables are not. The corporate governance literature considers the relative contributions of markets and the law to the creation and the enforcement of optimal governance structures (e.g., GILSON AND SCHWARTZ [2001]). The paper also does not review the much analyzed choice between public and private decision makers, such as a court or an arbitrator.

To be sure, no one has considered, in one model, all of the interconnections that are mentioned in this paper, but there is a limit to how much a single model can do. It is the reviewer's task to show that richer models are feasible with current techniques.

Regarding the third criterion, of raising new research questions, the analysis seems too preliminary to be helpful. For example, the paper suggests, as a possible solution to the hold-up concern, that “contractual commitment can be enhanced by assigning relatively contractible duties to the party who is best socialized into the relevant norm [...] and reserving scarce legal enforcement resources to motivate the party who is least socialized” (KATZ [2008, p. 143]).¹ This is an interesting thought, but it apparently is backwards: contractible duties are enforceable in court, so it seemingly is the noncontractible duties that should be assigned to the better socialized party. Also, the well socialized party may not have a comparative advantage at doing the “relatively contractible” tasks. Thus, parties may, or may not, face a tradeoff between assigning tasks on the basis of an informal norm and assigning tasks on the basis of productive efficiency. It is unclear whether there is an interesting research question here without more being said about task assignment and tradeoffs.

For a second example (more could be chosen), the paper recites: “From an *ex ante* perspective, accordingly, whether it pays to use a particular enforcement mechanism depends on whether the cost of using that mechanism are justified by the improved incentive effects it provides [...] it might be that different mechanisms work better [...] in different circumstances” (pp. 144f.). These thoughts are sound, but would occur fairly quickly to anyone thinking about enforcement issues. Again, more should be said to illuminate the possible directions such a contextual, cost–benefit analysis could take.

¹ There is recent work on economic incentives to enhance commitment. For a short review and an extension, see HART [2007].

These concerns may reflect a category mistake on the part of this commentator, however. The paper is not addressed to an academic audience so such academic comments may be misplaced. This raises the question how useful the paper is for the business people and transaction lawyers for whom it is primarily intended.

3 The Business Part

In addressing this question, I put on my business hat: I am a director of a publically traded company, and I have been on the board of another such company. I have participated as a director in reviewing the significant contracts my companies make, and in retaining transaction lawyers. This record causes me to doubt the utility of this paper for boards, managers and lawyers for two reasons: the paper either suggests strategies that these private parties are unable to pursue; or it suggests strategies that the private parties already know.

As an example of the former reason, the paper remarks: “An obvious alternative to repeat dealing as an enforcement device is to embed relational bonding in a multilateral network of trade, so that breach of commitment can result in exclusion from the network” (KATZ [2008, p. 141]). The paper also observes that contract breaches vary in their degree of seriousness. Courts “can be used for particularly egregious breaches [...]. For more moderate breaches, [...] relational bonding enforced by norms of fairness may be the best mechanism. (And within this category, multilateral bonding can be used for relatively significant breaches, which require a larger bond to deter, and which can be detected by community members not immediately involved in the transaction [...].)” (p. 151).

This is not helpful advice. A “relational bonding network” is a public good. Thus such networks either emerge spontaneously (see GREIF [1998]) or require government assistance to create. When a network exists, parties need not be told to use it. To the contrary, the point of such networks is that they are hard for persons in the trade to escape. When a network is absent, no individual party or contracting dyad can create one. As a consequence, telling a business person who lacks access to a relational bonding network that she has a better chance to enforce her company’s contracts if she can persuade other companies in the industry to boycott breachers (and perhaps to shun their families in church) will not be regarded as useful advice.

As an example of both the beyond one’s control or already known concerns, the paper advises parties that in order to use social norms to facilitate enforcement, a party must know “the counterparty’s normative, emotional and cognitive commitments” (KATZ [2008, p. 149]). In one sense, this advice often cannot be followed. Companies may develop reputations for fair dealing, but otherwise do not have “emotional and cognitive commitments.” In another sense, the advice is unnecessary. Business people know that, other things equal and when possible, they should contract with cooperative and reliable counterparties.

As a final example, the paper observes that “there are various ways to allocate the rents and quasi-rents arising” from a deal and that “the parties can choose the one

that maximizes the value of contractual enforcement" (p. 141). This advice might be helpful if it were followed by a showing of what current parties do not know, but should know, about rent allocation. In the absence of such a showing, the plausible assumption is that firms are optimizing with regard to rent allocation today.

4 Conclusion

This is a well researched and well written paper, but it could be better focused. Judged by academic criteria, the review aspect gives too little credit to the prior literature and proceeds on too high a level of generality to be the basis of further research in the field. These defects are unsurprising; the paper is primarily addressed to a business, not to an academic, audience. Taking the paper on its own terms, however, too often the paper either tells business people to do things that they cannot do, or tells business people to do things that they are already doing. The paper could use less academics and more practicality, or the reverse.

References

- GILSON, R. J., AND A. SCHWARTZ [2001], "Sales and Elections as Methods of Transferring Corporate Control," *Theoretical Inquiries in Law*, 2, 783–814.
- GREIF, A. [1998], "Informal Contract Enforcement Institutions: Lessons from Late Medieval Trade," pp. 287–295 in: P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, vol. 2, Macmillan Press: London.
- HART, O. [2007], "Hold-Up, Asset Ownership, and Reference Points," Manuscript, Department of Economics, Harvard University, Cambridge, MA.
- KATZ, A. W. [2008], "Contractual Enforcement Institutions and the Structure of Information," *Journal of Institutional and Theoretical Economics*, 164, 134–154.
- KLEIN, B. [1996], "Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships," *Economic Inquiry*, 34, 444–463.
- MAZÉ, A., AND C. MÉNARD [2007], "Private Ordering, Collective Action, and the Self-Enforcing Range of Contracts," Manuscript, ATOM, University of Paris-Panthéon Sorbonne.
- PEARCE, D., AND E. STACCHETTI [1998], "The Intersection of Implicit and Explicit Contracts in Repeated Agency," *Games and Economic Behavior*, 23, 75–96.
- SHAVELL, S. [1984], "The Design of Contracts and Remedies for Breach," *Quarterly Journal of Economics*, 99, 121–148.
- [1987], "The Optimal Use of Nonmonetary Sanctions as a Deterrent," *American Economic Review*, 77, 584–592.

Alan Schwartz
 Yale Law School
 Yale University
 P.O. Box 208215
 New Haven, CT 06520
 U.S.A.
 E-mail:
 alan.schwartz@yale.edu