ALBERT CHOI, now entering his second decade on the Virginia Law faculty, is one of the leading young scholars in the field of law and economics. Much of his work focuses on contract law and corporate law, but Choi has written broadly—tackling topics as diverse as litigation strategy, products liability, and nonprofit activity. In all of these areas, Choi seeks to refine sweeping legal theories by conducting a nuanced analysis of real-world activity and incentives. By observing and explaining how parties actually behave, he is able to transform broad-brushed theories and models into a more accurate understanding of how our laws shape complex economic activity.

Choi’s interest in this work began with graduate training in both law and economics. While pursuing his Ph.D. in economics at the Massachusetts Institute of Technology—where he was a National Science Foundation’s graduate fellow—Choi was drawn to contract theory and game theory. “What made the study of contract theory so interesting to me was that it was not just about examining bilateral commercial relationships, but also about analyzing other fascinating issues like choice between markets versus hierarchies and organizational structure,” Choi explained. And when he was at Yale Law School to earn his juris doctorate, Choi naturally gravitated toward courses in contract and corporate law. At Yale, he began exploring the relationship between economic contract theory and contract law, earning the John M. Olin best paper prize (awarded for work in the field of law and economics) and several research scholarships.

Much of Choi’s scholarship has continued to examine this relationship between economic contract theory and contract law. Choi has, in particular, focused on problems related to incomplete contracting and
verifiability. According to the theory, efficient contracting is not feasible when it is difficult or impossible for a non-contracting party, including the court, to verify whether a relevant event in an agreement has taken place. Scholars have argued that when efficient contracting is not possible, contracting parties are likely to adopt other methods in organizing economic activities, for instance, through allocation of residual control rights or through relational sanctions. The theory has had much influence not just in thinking about corporate hierarchies but also on contract law, leading some scholars to argue that the courts should be more formalistic in their interpretation of commercial contracts.

Notwithstanding the influence that the incomplete contract theory has had on contract law, Choi recognized that there are certain limitations on how the theory can explain real-world contracting behavior. In a series of influential articles, Choi introduced a richer notion of verifiability to better bridge the theory and practice. For instance, even among sophisticated commercial entities, contracts containing open-ended, vague language, such as “best efforts” and “material adverse change,” are quite common. If the events such as whether a contracting party put in “best efforts” or whether a “materially adverse” event has taken place are difficult or impossible to verify in court, how do we explain the common presence of such vague language in commercial contracts? Choi recognized that part of the disconnect between the theory and the practice stems from the fact that existing notions of verifiability are too simplified. Theorists had modeled verification like an on-off switch: either the underlying event is fully verifiable or impossible to verify. The real world, of course, is much more complicated.

In “Completing Contracts in the Shadow of Costly Verification,” 37 J. Legal Stud. 503 (2008), written with George Triantis, Choi introduced a richer notion of verifiability and demonstrated the role played by costly verification—which includes both the cost of adjudication and adjudication error—in optimal contract design. When contracting parties realize that proof of verification may involve expenses and even court error, they will seek to harness that cost to their advantage by designing a better incentive system ex ante. Choi argued that parties will incorporate both verifiable measures (such as pay-for-performance) and measures that are more difficult to verify (such as “commercially reasonable efforts”). Further, he offered an explanation for why the parties might actually prefer a regime where some measures
are more, rather than less, costly to verify. “Litigation expenses can function as a powerful deterrent against misbehavior, when properly tailored damages can screen non-meritorious suits from meritorious ones,” Choi explained. The first conclusion helps us understand why many commercial contracts, including executive employment and franchise contracts, contain both incentive terms based on verifiable measures (such as stock options or revenue sharing) as well as other provisions that are more difficult to verify (such as obligation to put in “best efforts” or to maintain the property in conformity with franchisor’s “high standards and public image”). Similarly, the second conclusion offers a solution to the puzzle of why commercial entities often contractually agree to litigate, rather than arbitrate, their cases, even though arbitration is often perceived to be a cheaper and more accurate dispute resolution mechanism.

Choi continues to develop and expand this theory of costly verification in a follow-up article titled “Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions,” 119 Yale L.J. 848 (2010). The paper, written again with George Triantis, was selected by the Corporate Practice Commentator as one of the Top 10 Corporate and Securities Articles of 2010. It attempts to tackle the puzzle over the common presence of vague clauses, such as “material adverse change,” or MAC, conditions in mergers and acquisitions agreements. As the name suggests, a MAC condition allows a buyer to walk away from the deal when a significant adverse event occurs to the seller after an agreement is signed but before closing. Given the high-stakes nature of M&A agreements, most contracts contain highly sophisticated and carefully thought-out terms and conditions, often with clear, accounting-based thresholds. What advantage does such an ambiguous MAC condition confer? Choi again took up the concept of costly verification to show how an ambiguous condition can actually be beneficial to the contracting parties. The article shows that by appropriately tailoring the termination fee, the “strategically vague” MAC condition can better help the parties in achieving three goals: providing a stronger pre-closing incentive to the seller to preserve the value of the assets; allowing the seller to better signal the value of the assets to the buyer; and more successfully renegotiating the deal when completing the deal no longer remains in both parties’ interests.

Thinking more carefully about issues of verification and incomplete contracts has also led Choi into the world of relational contract-
ing. Over the past forty years, many scholars have observed and emphasized that parties in long-term contractual relationships rely primarily (or even exclusively) on informal, relational sanctions, such as suspension or termination of the relationship, rather than formal contractual enforcement through litigation. This has led to the emergence of the “relational contract” theory, the focus of which is to examine the informal relationships between parties and also to argue for more minimal involvement of the court in long-term relationships. What the existing scholarship has been unable to explain, however, is the fact that commercial parties in long-term relationships still execute a detailed contract or establish a formal dispute resolution mechanism. Why bother with all that formal contracting if the relational sanctions and not the formal sanctions will be the primary deterrent?

In “Contract’s Role in Relational Contract,” written with Scott Baker and forthcoming in the *Virginia Law Review*, Choi attempts to answer this question, and also more broadly examines the relationship between formal and informal sanctions. The article argues that there are two important benefits that formal, contract-based sanctions possess that relational sanctions often lack. First is the flexibility of the parties to decouple the benefit of deterrence from the cost of providing that deterrence. By using privately stipulated damages, while containing the dispute resolution cost through various procedural mechanisms (including arbitration), formal sanctions can maximize the deterrence bang-for-the-buck. For relational sanctions, on the other hand, because sanctions require undertaking some inefficient behavior (such as suspension or termination of a productive relationship), the deterrence bang-for-the-buck is close to one: the larger the future benefits, the larger the deterrence value, but also the larger the cost of carrying out that threat. “If you threaten to terminate a relationship after a poor outcome, for instance, while the threat could be a strong deterrent against misbehavior, carrying out that threat can also impose a lot of cost on you, especially when the relationship has much productive potential for both parties,” Choi explained.

Second, formal adjudication can provide valuable information for the contracting partners and other third parties related to the alleged misbehavior. This information can, in turn, enable the parties to better tailor relational sanctions. For instance, these benefits can explain why parties in long-term relationships often include fault-based liability standards, such as “best efforts” and “good faith.” It is an empirically
well-documented fact that a company that experiences a liability judgment against it also suffers a market sanction, usually evidenced by a drop in stock price, and the size of the market sanctions tend to be larger when the court determines that the company was at fault. Choi explains that this empiricism is quite consistent with how the markets process information generated through litigation. The article goes on to demonstrate that when both types of sanctions are costly, the optimal regime will often combine both formal and informal dispute resolution mechanisms, which is, of course, what we typically observe in the real world.

In addition to closely examining the incomplete contract theory and the notions of verifiability, a separate line of research Choi has undertaken over the years examines how a contractual relationship between two parties can directly or indirectly affect third parties (a phenomenon known as “contractual externality”). Unlike conventional externalities, such as environmental pollution, a contractual externality is created through a contracting relationship. In “Allocating Settlement Authority under a Contingent Fee Arrangement,” 2 J. Legal Stud. 585 (2003), Choi examines the effect that a contingency fee contract between a plaintiff-client and her attorney has on the settlement bargaining outcome with the defendant in litigation. The article highlights an important tradeoff: when the client attempts to minimize the rent captured by the attorney and retain more of the surplus for herself, she may become more vulnerable to rent extraction from the counterparty, particularly when she has relatively weak bargaining posture against the defendant. In such circumstances, she may want to (de facto) delegate the settlement authority to her lawyer and allow her lawyer-agent to capture a larger rent to maximize her own return from litigation. Leaving a larger rent to the lawyer can actually benefit the plaintiff-client.

In “Golden Parachute as a Compensation Shifting Mechanism,” 20 J. L. Econ. & Org. 170 (2004), Choi examines the contractual externality mechanism in a corporate takeover setting. Large severance payments to executives that are triggered by a takeover, often called golden parachutes, have generated enormous controversy among practitioners, scholars, and lawmakers. What makes a golden parachute payment different from other types of executive compensation, however, is that there usually is a third party with a direct or indirect interest: the buyer attempting to purchase the corporation. Choi analyzes how
golden parachutes can be strategically used by target shareholders in shifting the compensation burden to the prospective buyer, increasing the takeover premium, and maximizing the target shareholders’ return. Choi argues that this can explain why golden parachutes are adopted early, even in the absence of any takeover attempt, and as a part of the overall compensation package.

While the themes of incomplete contracts and contractual externality have remained two important strands in Choi’s scholarship, he has also written in many other diverse topics in contract law, products liability, and litigation strategy. Choi has examined, for instance, what impact the allocation of bargaining power or surrounding market conditions have on non-price terms of a contract. In “The Effect of Bargaining Power on Contract Design,” 8 Va. L. Rev. 1665 (2012), Choi and Triantis tackle the conventional law and economics argument that the allocation of bargaining power should be irrelevant in determining non-price terms of a contract. The so-called “irrelevance proposition” has been used most heavily in the context of the unconscionability doctrine. The article shows that the conventional argument relies on a set of strong assumptions and in more complex, realistic informational settings, lopsided bargaining power can lead to inefficient, one-sided non-price terms even when the actors are assumed to be fully rational.

Similarly, in “Market Conditions and Contract Design: Variations in Debt Contracting,” 88 N.Y.U. L. Rev. 51 (2013), Choi and Triantis show why non-price terms in debt contracts, such as business covenants, tend to fluctuate (leading to “covenant-lite” or “covenant-heavy” deals) with changing market conditions. Applying the concepts of moral hazard and adverse selection, Choi demonstrates how changes in market conditions affect the severity of the moral hazard and adverse selection problems which, in turn, necessitate adjustments on non-price terms in the debt contract. Finally, in “Should Consumers Be Permitted to Waive Products Liability? Product Safety, Private Contracts, and Adverse Selection,” co-authored with Kathy Spier and forthcoming in the Journal of Law, Economics, and Organization, Choi demonstrates the desirability of mandatory products liability when manufacturers of potentially hazardous products have an incentive to chisel on product quality and reduce the price to attract safer consumers.

Currently, Choi is working on several research projects that focus
on mergers and acquisitions, non-profit organizations, and class action litigation. In “Facilitating Mergers and Acquisitions with Earnouts and Purchase Price Adjustments,” he analyzes the role played by post-closing contingent payment arrangements, such as earnouts and purchase price adjustments, in allowing the transacting parties to better avoid bargaining failure and successfully close a deal. In “Relational Sanctions against Non-Profit Organizations: Why a Selfish Entrepreneur Would Organize a Non-Profit Enterprise,” Choi takes on the influential theory that non-profit organizations are chosen as a commitment to (or signal of) providing high quality when quality is non-verifiable and examines how introducing market-based sanctions (such as relational sanctions) can affect the organizational sanctions choice. Lastly, Choi is working on a project that analyzes the welfare implications of class action (or class arbitration) waiver provisions, an important issue that has received much attention recently due to the U.S. Supreme Court’s rulings in AT&T Mobility and American Express. In all of these endeavors, his focus is again on gathering insights from real-world contracting to shape and refine generalized legal theory.

Not surprisingly, Choi is also quite active within the law and economics research community. From 2005 to 2008, Choi directed the John M. Olin Program in Law and Economics, which fosters law and economics research at the law school by both students and faculty. Over the years, Choi has given numerous talks at seminars and conferences around the world. He has presented papers at every American Law and Economics Association Annual Conference since 2002, and he serves as a referee for many peer-review journals, both in law and economics and in economics. Since 2012 and 2013, respectively, Choi has served as an associate editor for two prestigious law and economics peer-review journals, the International Review of Law and Economics and the American Law and Economics Review. And in 2011, Choi was nominated and elected to serve, for a three-year term, as a member of the board of directors for the American Law and Economics Association.

Overall, Choi’s scholarship reflects his desire to better understand real-world contracting behavior and to bridge the gap between the existing theory and practice. He is intrigued by how the previous generation of law and economics scholarship has much influenced the debate, particularly in the areas of contract and corporate laws, and how shedding new light on the earlier findings could lead to a more nuanced understanding of the world. So far, this has led him to make
fresh contributions on long-standing debates and has made him a promising scholar in the field of law and economics.
The unprecedented and unanticipated economic and financial shocks of the past couple of years have profoundly altered expected payoffs from executory contracts. Credit markets have frozen, common stock prices have plummeted, and commodities prices have swung wildly. A variety of excuse, or walk-away, provisions such as closing conditions, force majeure clauses, and termination or cancellation rights are being triggered either to cancel the deal at a fee set by liquidated damages or even at no cost. The current economic conditions provide plausible grounds for excuse in a wide range of contracts, so these provisions are currently being actively tested, in court and in renegotiations. The invocation of material adverse event (MAE) or material adverse change (MAC) clauses in corporate acquisition agreements and lending commitments have been particularly noteworthy, as a number of multibillion dollar deals have fallen through. The parties in these deals have been engaged in litigation over the interpretation of these terms and in renegotiation of their agreements. The outcomes should be of great interest to contract scholars and are likely to lead to significant revision or redrafting of these provisions in the next generation of contracts.

Although the interpretation of these provisions has a significant financial effect on the parties to these broken deals, it has an even greater ex ante impact on the contract design of future deals. The contractual allocation of risks plays a role well beyond the simple transfer of risk to the superior risk bearer. It is an essential tool in addressing the goals of contract in a world of asymmetric information. First, it provides incentives for that party to take measures to minimize the risk (efficient investment). Second, a party’s agreement to assume a risk signals private information about the probability and severity of the risk, and thereby promotes efficient decisions to contract (efficient decision to contract). Third, the parties may be asymmetrically informed as to whether the risk in fact materialized, and that information can be elicited through the assignment of risk to the party who is likely to be better informed ex
post. This promotes efficient decisions whether to execute the transaction (efficient trade). Thus, much more is at stake in the design of contract terms that allocate risks than simply exploiting differential risk preferences.

The optimal allocation of risks is complicated further by the presence of transaction costs, both at the drafting and enforcement stages of the contractual relationship. Transaction costs explain why contracts are incomplete and fail to specify fully the optimal obligations in each possible future state of the world. One cause of incompleteness is the cost of litigating and enforcing contracts. Contract theorists focus on the costs of verifying facts and typically posit that parties avoid terms that are costly to verify. Vague contract provisions fall in this category because of the cost and uncertainty of judicial interpretation. Yet, drawing on the line of scholarship that analyzes the rules-standards dichotomy in the design of legal rules, recent work frames the choice between vague and precise contract terms as a tradeoff in information costs: precise contract provisions raise contracting costs on the front end, but reduce enforcement costs at the back end. If a provision matters only in remote contingencies, for instance, then the back-end costs should be discounted by that remote probability, and it may be correspondingly efficient to save front-end costs by using a standard (or vague term) rather than a rule. In some cases, however, this benefit can be outweighed by the cost of protracted adversarial litigation, even if discounted by the low probabilities of the remote contingencies. The choice of precise rules over standards may also be driven by the fact that courts (the back-end decision makers) are usually less informed than the parties themselves (the front-end deciders). This raises the prospect of costly judicial error on the back end.

In a recent article, we departed from this tradeoff between drafting and enforcement costs, and focused on the effect of differing litigation costs on performance incentives under precise and vague contractual obligations. In the analysis, the prospect of verification or litigation costs may be beneficial to contracting, in addition to the front-end contracting cost savings. We thereby offered a distinct explanation for the use of vague terms and a different approach to incomplete contracting. A contract will very rarely be able to include terms that invoke perfect and costless signals of desired performance. A challenge of contract design is to choose among signals that vary in
their information content and litigation costs. We suggested that parties may choose a vague standard (such as “best efforts”) that invites costly and error-prone judicial proceedings over a precise proxy that is both less noisy and less costly to litigate. We demonstrated that litigation costs may be beneficial as a screen on the promisee’s incentive to sue and as an effective sanction against the breaching promisor. Without the benefit of this screen, a noisy proxy that is costless to verify raises the possibilities of false positives and false negatives, which, in turn, undermine incentives. So long as the court’s judgment is correlated with the promisor’s actual behavior, the parties can combine a vague term, such as best efforts, with a set of prices (including liquidated damages), so as to provide additional incentive to the promisor through an off-the-equilibrium, credible litigation threat. Indeed, litigation costs may in fact never be incurred when either they encourage settlement or they are harnessed through appropriate contract design to assure contractual performance.

This Article applies and extends significantly our analysis of litigation costs to show that they contribute broadly to the three contracting goals listed above: efficient investment, efficient decisions to contract, and efficient trade under conditions of imperfect information. In other words, we look at problems of adverse selection as well as the moral hazard analyzed in our previous work. Our analysis applies to a wide range of commercial contracts and contexts, but we adopt as our application the design of corporate acquisition agreements, for several reasons. First, these contracts involve sophisticated parties and large financial stakes. Vague clauses, such as MAC conditions, are among the most heavily negotiated nonprice terms and appear to have a significant effect on the level of acquisition premiums. Second, signaling and efficient investment incentives are likely to be important in these transactions because the seller has significant private information. Third, the collapse of financial markets and of corporate earnings over the past two years has put considerable stress on acquisitions: deals are breaking up and buyers (and their lenders) are invoking termination rights and contract conditions, particularly MACs, as the basis for walking away.

MAC conditions permit the buyer to avoid the closing of the deal if a material change has occurred in the financial condition, assets, liabilities, business, or operations of the target firm. We choose to focus on MACs in particular because, at least since the economic
shock following 9/11, commentators have urged greater precision in the language of MACs, including the use of quantitative thresholds. Yet, the typical MAC provision is not quantitative and remains remarkably vague. Vague contract terms invite self-interested and conflicting interpretations. As a result, they fuel disputes, as well as costly and uncertain litigation. Even where MAC provisions have some precision, they nevertheless give rise to substantial litigation costs if the pertinent factors are costly to verify. The uncertainty in MAC application, as well as the considerable resources that are invested in these disputes, prompts commentators to predict that future MAC provisions will be much more precise and simple. In particular, they suggest that future MAC clauses will adopt thresholds in readily proven quantitative measures (which we call “proxies”), such as revenues, customer or employee retention, earnings and stock price.

These sentiments are understandable as ex post reactions to the dissolution of deals in the current environment. We argue, however, that the ex ante case for vague provisions is underappreciated and parties should be cautious in substituting precise quantitative thresholds. The conventional analysis posits that vague terms are justified only when the expected larger litigation costs are outweighed by savings on the front end, in lower drafting costs. In acquisition agreements, this would suggest that vague MAC clauses yield benefits only by reducing the ex ante cost of providing for excuse conditions based on easily verifiable proxies. In contrast, our analysis demonstrates that the existence of litigation costs may in fact improve contracting by operating as a screen on the seller’s decision to sue. The litigation mechanism elicits the seller’s private information about the truth because the court’s judgment will be correlated (albeit imperfectly) with the truth and the seller must choose to invest in the litigation in order to reveal the court’s judgment. This screen facilitates the allocation of risk ex ante and thereby improves the signaling and incentive attributes of the acquisition agreement. Thus, when faced with a choice among noisy indicators, a vaguely phrased MAC may be valuable, whether in combination with verifiable proxies or on its own. Increased accuracy in judicial determinations is a good thing, but our analysis suggests counterintuitively that this may not be so when it decreases the cost of litigation.
A long line of legal scholarship has emphasized the prevalence and importance of using non-legal, informal sanctions to deter misbehavior and maintain cooperation among private entities. Celebrated examples include the ranchers in Shasta County, the whalers of New England, the cotton traders in the South, the diamond merchants in New York, and even sophisticated commercial entities. Particularly with respect to the last group, Professor Stuart Macaulay famously posed the question: “What is the point of written agreements in a world of long-term relationships?” Based on surveys of corporate executives, he found that commercial parties in long-term relationships rarely relied on, or even looked at, the written agreement. Instead, according to the survey respondents, they performed obligations out of the need to preserve a reputation as a good business partner; someone who could be trusted with future deals. Inspired by such observations, research by several influential scholars led to the birth of what is known as the “relational contract” theory, which fundamentally questions what role, if any, contract law plays in promoting and maintaining trade.

While the relational contract theory has had much influence on the legal scholarship over the past fifty years, one important question has remained unanswered. If the parties perform obligations, or fulfill their promises, out of the fear of reputational or relational sanctions, why do they bother to write enforceable formal contracts in the first place? Why do they often set up a private dispute resolution mechanisms with bells and whistles that resemble those of court-based litigation? After all, writing a long-term commercial agreement or setting up a dispute resolution system isn’t free. The parties haggle over terms and procedures; they hire lawyers; they send multiple drafts back and forth. That is a lot of trouble if, in fact, the formal contract or the dispute resolution process won’t be used or will be used rarely. What role does the formal contract and the accompanying dispute resolution mechanism play in an “informal” relationship? What is the relationship between the formal sanctions available under the contract and the informal sanctions that are utilized outside the dispute resolution system?
This paper attempts to answer some of these puzzles with the help of simple, repeated game theory. Contracting parties in a long-term arrangement need a mechanism to control opportunism. Imagine a buyer and a seller engaged in a sale of goods transaction. Both the buyer and the seller fear that the other will take the benefit of the exchange and, then, not live up to her end of the bargain. The seller might take the buyer’s cash and provide a sub-standard product or service in return. The buyer might take delivery on credit and subsequently not pay on time, perhaps arguing opportunistically that the delivered good is non-conforming. To assuage these fears and thereby promote a mutually beneficial relationship in the long run, both the buyer and seller must anticipate and suffer negative consequences for a decision not to honor commitments.

In a long-term relationship, these negative consequences could flow from (1) formal or legal sanctions, such as monetary damages imposed by court or arbitrator following a lawsuit; (2) informal or relational sanctions, such as suspension or termination of trade, or (3) a combination of the two. To make the analysis interesting and realistic, we consider settings where both legal and relational sanctions are costly to impose. Legal sanctions, on the one hand, require spending resources, including time, money, and opportunity cost on dispute resolution. Relational sanctions, on the other hand, involve failure or refusal to trade even when trade may be beneficial. Indeed, imposing relational sanctions often means switching contracting partners and incurring the start-up costs of a new relationship. In theory, parties would desire a system that deters opportunistic conduct at the lowest possible cost, understanding that neither sanction is free. When both types of sanctions are costly, it is a priori unclear which sanctions the parties will rely on more heavily in a given relationship.

Notwithstanding the theoretical indeterminacy, this paper shows that legal sanctions have two benefits relational sanctions often lack. First, parties can decouple the deterrence benefit of a legal sanction from its execution cost. Relational sanctions deter misconduct largely by taking away (or threatening to take away) the benefits or the surplus from future transactions: parties behave because they don’t want to lose future business. The larger the value of the future business, the more the threat to take it away will cause a party to think twice about reneging. At the same time, however, following
through on that threat means that the parties will have to forgo a larger potential surplus from a productive relationship. The larger the value of the future transactions between the two parties, the higher the cost the parties suffer by stopping or suspending that relationship. In short, the deterrence benefit and the imposition cost of informal sanctions are closely intertwined.

The story, however, differs for legal or formal sanctions. When the parties adopt monetary damages as formal sanctions, for instance, the amount of deterrence is largely dictated by the size of the damages that the losing party has to pay. At the same time, the dispute resolution cost incurred by the parties will often be smaller than the damages. This will be particularly true since litigation is usually brought when the size of the (expected) recovery is larger than the (expected) cost of litigation. Furthermore, parties in a long-term relationship can successfully contain the cost of dispute resolution, for instance, through arbitration and through tailoring of rules on procedure and evidence, while keeping the size of monetary damages sufficiently large. Through proper tailoring of monetary recovery (e.g., liquidated damages) and successful control of dispute resolution cost (e.g., arbitration), formal sanctions can deter contractual opportunism at a lower cost.

Second, through the dispute resolution process, legal sanctions allow the parties to uncover relevant information that enables them to better tailor relational sanctions. One reason that relational sanctions are costly is that they can misfire. In an ideal world, transacting parties would be fully aware of one another’s behavior and the relational sanctions will get carried out only when one misbehaves. In fact, termination of the relationship would never happen since, with sufficient deterrence, no one misbehaves in equilibrium. Unfortunately, knowledge and monitoring are imperfect in reality. Parties have to rely on indicators—rather than perfect knowledge—of misbehavior in imposing relational sanctions and with imperfect indicators, relational sanctions will sometimes misfire. Examples are easy to find. A shoddy product by a manufacturer or an unsatisfactory experience at a restaurant is not necessarily the result of negligence or lack of care but can nevertheless lead to a decrease in demand or a cessation of customer traffic.

Given the tendency of relational sanctions to misfire, transacting parties will naturally want to increase the reliability of any indicators
of poor performance. A formal dispute resolution helps by allowing them to uncover relevant evidence of true behavior and to condition relational sanctions on more accurate indicators. For instance, instead of using poor quality as the only signal of misbehavior, the parties or other market actors might impose relational sanctions upon observing both poor quality and a finding of insufficient effort or bad faith. To the extent that the adjudicator’s finding is correlated with the true behavior, relational sanctions misfire less frequently and become a more effective deterrence. In fact, parties can require the judge or arbitrator to make findings about behavior by conditioning liability on fault-based standards, such as “best efforts” and “good faith” in performance of a contract. While such vague standards have generated substantial amount of controversy among scholars and practitioners, in a long-term relationship, such terms can improve the performance of relational sanctions.

Although we emphasize these two important benefits provided by legal sanctions, there are, of course, costs to harnessing these advantages. Larger damages will likely induce larger litigation expenditure, either due to more suits being filed or because parties spending more in a given suit. It may very well be the case that providing $100 of deterrence through damages might actually require litigation expenditures of more than $100. In such cases, the parties will be better off relying more on relational sanctions. Similarly, adopting a fault-based and open-ended standard, such as “best efforts,” could also lead to additional expenditure in dispute resolution, as parties will have to litigate over what the standard means and whether one or both parties have abided by that standard. This will induce the parties to think more carefully about the tradeoff between the informational benefit and the additional cost of dispute resolution, leading them, on occasion, to adopt no-fault (strict liability) standard rather than fault-based (negligence) standard.

“Should Consumers Be Permitted to Waive Products Liability? Product Safety, Private Contracts, and Adverse Selection” (with Kathryn E. Spier), J.L. Econ. & Org. (forthcoming).


“Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions” (with George Triantis), 119 Yale L.J. 848 (2010).


