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**PAUL G. MAHONEY***

# Scott and Goetz: The Collaboration that Transformed Contract Law

* Brokaw Professor of Corporate Law and Albert C. BeVier Research Professor, University of Virginia School of Law. I thank Paul Stephan for helpful comments.

Bob Scott arrived at the University of Virginia School of Law in 1974 from his first faculty position at William & Mary. Charlie Goetz, a professor of economics at Virginia Tech, arrived a year later as a visiting scholar, soon to become a permanent member of the faculty. This was, in itself, an extraordinary event. While the seeds of the law and economics movement had been sown at the University of Chicago, the methodology had made only modest inroads elsewhere, and it was certainly not common for a law school to hire an economist to teach law. It is a powerful statement both about the University of Virginia and Charlie Goetz that this unusual event happened at Virginia at a time when law and economics was in its infancy.

Goetz was determined to learn enough law so that he would not be an economist on a law faculty, but a law professor who happened to be an economist. Although early work in law and



economics focused primarily on antitrust law, regulated industries, and tort law, Goetz found contract law fascinating. He began to discuss contract doctrine with his new colleague Bob Scott. Scott had, in turn, concluded that economic theory could illuminate some of the most vexing problems in contract law. Thus began one of the most remarkable collaborations in American legal scholarship. In just under a decade of work, Goetz and Scott transformed the field of contract law and defined a research agenda that influences contract scholars to this day.

Along with their formidable intellectual gifts, Goetz and Scott had the advantage of impeccable timing. The beginning of their collaboration in 1977 coincided with an explosion of law and economics scholarship on contract law. The period 1976-79 saw the publication of such deeply influential articles as Anthony Kronman's analyses of specific performance[1] and mistake,[2] Richard Posner's articles, some co-authored with economist William Landes, on gratuitous promises,[3] implied contracts and restitution,[4] and impossibility,[5] George Priest's analysis of remedies under the Uniform Commercial Code,[6] and Michael Trebilcock's thoughtful discussion of standard-form consumer contracts,[7] just to name a few. Law and economics scholars were just beginning to look to contract law as a new source of raw material. Goetz and Scott not only led the way, but covered the field more systematically and thoroughly than any other scholar or team of scholars.

Goetz and Scott's first co-authored article, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554 (1977) took up an old and still vigorous debate. Courts had long refused to enforce liquidated damages clauses that were deemed "penalties," typically defined as damages exceeding a reasonable estimate of the actual harm resulting from a breach. This reluctance to enforce a bargained-for promise provided considerable fodder for debate. Adherents of freedom of contract argued that absent fraud or other flaws in the bargaining process, courts should enforce bargains freely made rather than presume to know the parties' interests better than the parties themselves. The opposing view was that penal-

ty clauses were classic examples of overreaching because they provided one party a windfall (that is, an amount in excess of his reliance expenditures). Moreover, as the first edition of Posner's *Economic Analysis of Law* noted, a penalty might induce performance in circumstances where breach would be socially preferable.

Goetz and Scott's analysis took a different approach from the prior scholarship. They began by asking whether and why rational, well-informed contracting parties would go to the trouble of negotiating for a specific damage measure. The motivation for liquidated damages measures, they argued, lies in the many doctrines in contract law, such as certainty and foreseeability, that make it difficult for a promisee to recover idiosyncratic value.

This recognition led to the article's central insight: a liquidated damages provision is, in essence, an insurance policy that protects the subjective value the promisee expects from the performance. Of course, in a legal regime that does not enforce this insurance provision, the promisee can purchase insurance from a third party. However, there is ample reason to suspect that the promisor can provide the insurance more cheaply. After all, the promisor knows his own probability of breach with greater precision than does a third party insurer. The promisor, then, is in the best position to calculate, and therefore price, the risk of non-performance.

By identifying a plausible reason why rational and well-informed parties might agree to a "penalty" clause, Goetz and Scott refuted the commonly-held view that such a clause necessarily demonstrated fraud or overreaching by the promisee. Thus, they conclude, "In the absence of unfairness or other bargaining abnormalities, efficiency would be maximized by the enforcement of the agreed allocation of risks embodied in a liquidated damages clause."

The article not only considerably enhanced the sophistication of the debate over liquidated damages, but employed a heuristic device that scholars draw on frequently. This was the ingenious idea that a contract might have an embedded, although non-obvious, insurance provision. Subsequent scholars would find embedded options and other financial instruments in seemingly mundane contractual provisions.





Goetz and Scott's second collaborative effort, *Measuring Sellers' Damages: The Lost-Profits Puzzle*, 31 Stan. L. Rev. 323 (1979), also took up a longstanding debate. The standard measure of a seller's damages when the buyer repudiates is the difference between the contract price and the market value of the contracted goods. Retail sellers, however, frequently argue that this measure is inadequate. They may resell the goods to another buyer at the market price (which is the same or nearly the same as the contract price), leading to no apparent damages. However, the sellers argue, they have been deprived of the profit on one unit—absent the breach, they would have made the subsequent sale in addition to, rather than in substitution for, the sale to the breaching buyer. Although the common law treated this "lost-volume" argument skeptically, the Uniform Commercial Code authorizes recovery of lost profits where the normal damages measure is insufficient to put the seller in the same position as would performance.

Goetz and Scott pointed out that the assumption that the seller could make an additional *profitable* sale is likely false. In the standard competitive-market paradigm, the seller faces a horizontal marginal revenue curve and an upward-sloping marginal cost curve. The seller cannot affect the market price, but can choose to sell that number of units at which the marginal cost curve just crosses the marginal revenue curve. Any additional sales would cost the seller more than the revenue generated.

In a competitive market, then, the additional sale, while physically possible, would not be profitable. Goetz and Scott accordingly argue that market damages adequately compensate the seller. They repeat the analysis for the case where the seller has market power and accordingly faces a downward-sloping marginal revenue curve. Although the analysis is somewhat more complicated, there are two key insights. First, the downward-sloping demand curve assures that additional sales reduce prices, reducing revenue from inframarginal sales as well. Second, the breach, by reducing the quantity sold, also moves the seller to a region of lower marginal cost, thus making possible additional profitable sales that would not be profitable starting from a greater baseline quantity. Both factors will tend to make lost-profit damages overcompensatory.

Goetz and Scott also analyzed the mirror-image case in which the buyer claims that the seller should receive lost-profit rather than market damages. These are cases in which the market value falls significantly—in fact, falls below the seller's cost of manufacture. The buyer's repudiation saves the seller the cost of making the good, and the buyer may claim that the seller's damages should be capped at the seller's expected profit, rather than the (larger) difference between the contract price and market value. A sufficient answer, as Goetz and Scott pointed out, is that the seller could have saved the cost of manufacture in any event, by simply acquiring the goods on the market at the now-reduced market price.

Goetz and Scott's analysis set the stage for a continuation of the lost-profit debate using more sophisticated economic logic. An article by Robert Cooter and Melvin Eisenberg and another by Victor Goldberg argued that lost-profit damages for the volume seller represents compensation for the "fishing" costs needed to produce an additional sale.[8] Bob Scott responded in a 1990 article,[9] which noted that a retail seller could adopt a lenient cancellation policy, which would be equivalent to market damages, or a strict non-cancellation policy coupled with a deposit, which would approximate lost-profit damages. Scott argues that most sellers would (and in fact do) choose the former in order not to deter purchases by risk-averse buyers. He also makes the powerful observation that the buyer has an alternative to breach—he can take delivery and resell in competition with the seller, which would deprive the seller of the "additional" sale.

Having looked in depth at two longstanding doctrinal disputes, Goetz and Scott then turned to the more fundamental question of the purpose of contract law in *Enforcing Promises: An Examination of the Basis of Contract*, 89 Yale L.J. 1261 (1980). Any analysis of the purpose of legal enforceability of promises must begin with the observation that not all promises are enforced. Most notably, under the consideration doctrine, a gratuitous promise—even one made in earnest and for high stakes—is not generally enforceable.

Prior to Goetz and Scott's analysis, Lon Fuller had provided the most influential justification for the consideration doctrine.[10] Fuller argued that the process of bargaining served a purpose much like that of the seal in a prior era—it reminded the promisor that his actions had legal significance.





Goetz and Scott, like Fuller, sought an instrumental justification for the failure to enforce gratuitous promises. As in all of their work, they focused on the parties' joint perspective at the time of contracting. Why, they asked, would anyone pay attention to a gratuitous promise (and therefore, why would anyone make one) if it is not legally enforceable? The answer is that a host of informal mechanisms, including reputation and the desire to preserve family harmony, serve to assure that most people don't make gratuitous promises unless they intend to fulfill them. Instead, promisors tend to renege on such promises only when circumstances have changed. In Goetz and Scott's now-famous phrase, the promisor may experience a "regret contingency" that makes him desire not to carry out his promise. Such an event may occur for either a bargained-for or a gratuitous promise. The practical line between enforceable and unenforceable promises is that when a regret contingency occurs, the promisor must nevertheless perform or pay damages with respect to the former but not the latter.

This leads to a profound insight. Legal enforcement would have no allocative impact in the typical settings in which gratuitous promises arise. To see why, first consider a bargained-for promise. A lends $100 to B. B promises to repay principal and interest. Now imagine that B insists that the promise to repay be made conditional on B's not losing his job during the repayment period. Clearly the conditional promise is worth less to A than an unconditional promise and A will accept it, if at all, only in return for a higher interest rate. But in the gratuitous setting the promisor, by definition, does not receive compensation for the promise. Thus, the promisor can attach conditions to the promise without diminishing the price he receives for it. Legal enforcement of gratuitous promises, then, would simply lead promisors to make all such promises conditional. The ultimate transfer of money or property would still occur or not depending on the same external factors, but because those factors would be built into the promise, there would never be a breach in the legal sense. More broadly, contracting parties can adapt to the possi-

bility of regret in many different ways, and legal rules must be understood as working in conjunction with those adaptations.

The article richly deserves its place as one of the foundational works in the contract-law canon. Goetz and Scott demonstrated that careful attention to the problems economic agents solve through contracting and the way in which legal rules affect the substance of their bargains can provide insight into seemingly inscrutable contract doctrines.

In 1976, economists Michael Jensen and William Meckling introduced the term "agency costs" to economics.[11] Agency costs arise when one party (the agent) agrees to act on behalf of another (the principal), but because the principal cannot perfectly monitor the agent, or because the agent knows better than the principal what actions are optimal, the agent has an incentive to shirk or otherwise act in a self-interested way. Goetz and Scott employed this framework to analyze another issue of immense practical and theoretical importance to contract law in a 1981 article, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089.

The term "relational contract" had been around for some time, but scholars tended to define it as a long-term relationship in which the parties' problems arise because of lack of foresight. Goetz and Scott significantly clarified the analysis by recognizing that their essence lies in agency problems rather than time horizons. They defined a relational contract as one in which the parties cannot reduce important terms of their understanding to well-defined obligations. This typically arises in circumstances in which one party has superior information or expertise and accordingly can, in principle, take more nearly optimal actions by exercising discretion than by having his obligations specified in detail ex ante. The danger, however, is that this party will not take optimal actions because he must share the benefits with the other contracting party but bears all of the costs of a marginal increment in effort.

Goetz and Scott used the example of a manufacturer that wishes to sell products through a distributor. Presumably the distributor has superior expertise in selling to retail customers, so it would self-defeating for the manufacturer to specify in detail how the distributor is to act. But the price of flexibility is that the distributor may pursue its own ends at the expense of





the manufacturer by, for example, providing inadequate after-sale service.

Why would parties enter into contracts in such circumstances? Goetz and Scott noted that parties must often choose their poison. Not entering into a contract may deprive a party of the expertise the other can bring to bear. The parties could solve the problem through vertical integration—the manufacturer could buy the distributor's business, or vice versa. But this will often be undesirable or infeasible. The parties must choose from a graduated set of options, from vertical integration to spot transactions, the point at which they can come closest to an optimal outcome.

With this in mind, Goetz and Scott derived an elegant normative lesson. One common term in a relational contract is an obligation to use a party's "best efforts" to achieve some end. Often courts and commentators had discussed best efforts clauses as a contractual analog of the tort-law duty of reasonable care. But Goetz and Scott argued that courts should interpret the duty to mean that the obligor should take those actions that will maximize the joint wealth of the parties rather than the obligor's own wealth. So understood, judicial enforcement of best efforts clauses will help parties reduce agency costs.

Goetz and Scott returned to the joint profit maximization heuristic in their next article, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 Va. L. Rev. 967 (1983). Contract law denies a non-breaching party recovery for damages that he could have avoided by taking cost-justified measures after the breach. But this mitigation obligation is not absolute. In particular, the promisee is under no obligation to mitigate prior to a definite repudiation by the promisor. Courts also do not generally require the non-breaching party to continue to deal with the breaching party, even if it offers the lowest-cost substitute.

Goetz and Scott demonstrated that these contours of the mitigation principle fit nicely into the joint-maximization framework. Contracting parties would, in general, wish that the costs imposed by unexpected contingencies be minimized, regardless of which party bears those costs in the first instance. If the manufacturer of a custom good faces an unexpectedly high cost of

performance, he could perform at a loss or breach and pay damages, whichever causes the smaller loss. But it may also be possible that the buyer can adjust (perhaps by accepting a modified version of the product) in a way that is cheaper still. In that case, the manufacturer would prefer to pay the buyer to make appropriate adjustments.

This led Goetz and Scott to observe that a breach may be, in effect, the seller's way of signaling to the buyer that the buyer can adjust to the changed circumstances more cheaply than the seller. In that sense, the buyer's failure to adjust is at least as much a cause of the subsequent loss as the seller's decision to breach. The idea is analogous to Ronald Coase's famous, and famously provocative, claim that the tortfeasor and victim together "cause" a loss, and there is accordingly no reason to allow moral condemnation of the tortfeasor to influence the remedial rules.[12]

The article noted that the doctrinal outlines of the mitigation principle make considerable sense for cases in which there is a competitive market for the good or other performance that is the subject of the contract. In particular, the fact that the breach operates as a signal to the non-breaching party justifies not imposing mitigation obligations until a definite repudiation. The fact that mitigation is a means of exploiting the non-breaching party's comparative advantage in making adjustments also explains courts' reluctance to require the non-breaching party to accept mitigation opportunities offered by the breaching party—after all, if the breaching party can provide a substitute performance at lower cost than any third party, then there is no reason to breach in the first place. But a promisor may exploit the promisee by remaining deliberately vague about whether the promisor will breach, and thereby trigger the mitigation principle. This danger justifies the Uniform Commercial Code's rule that a promisee may, in appropriate circumstances, demand assurance of performance and treat the promisor's failure to provide such assurance as a breach.

The final Goetz/Scott collaboration, *The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261 (1985), turned to yet another fundamental issue in contract doctrine—the interpretation of contractual language. In any contract, the parties' obligations





arise from a mixture of terms that they supply and terms that the state supplies. Typically a state-supplied term applies only if the parties have not expressly provided to the contrary. In the Contracts classroom, the state-supplied rules normally have no significance other than as gap fillers: they are there when the parties say nothing, but the parties can alter them with minimal effort.

What is true in the classroom, however, is not entirely true in real life. Courts seem to invest their gap-filling rules with a sort of moral primacy—they are often reluctant to abandon the default setting unless there is clear evidence that the parties wished to do so.

Goetz and Scott argued that to understand the interplay between state-supplied and customized terms, we must recognize that the former reduce not only the costs of writing the contract, but also the costs of interpreting it. Over the course of resolving many disputes, implied terms acquire a detailed meaning on which courts and contracting parties can rely. A new, customized term, by contrast, lacks an accepted meaning, which increases the probability of an interpretation contrary to the parties' intent.

This view of the process of interpretation generated a wonderfully counterintuitive insight. A standard discussion in contract law contrasts "textualist" and "contextualist" approaches to interpreting contractual language. It is commonplace to assert that the former, through its insistence on objective meaning, provides a uniform solution to recurring problems, while the latter, in its search for the parties' subjective intent, provides an individualistic solution. Goetz and Scott noted, however, that the opposite is more nearly correct. A contextualist reading represents a search for evolving commercial norms that have not yet crystallized into standardized contractual language. It is, in short, part of the mechanism by which collective understandings are created. A textualist reading, by contrast, respects the parties' desire to invoke a settled formula regardless of how other parties may, contemporaneously, be seeking to revise it. Textualism is thus, at root, an individualistic approach. This confident, distinctive take on an age-old problem is a fitting capstone for an extraordinary scholarly collaboration.

Perhaps the best measure of the success of Goetz and Scott's work is this: when I read their articles today, the main points seem obvious. But they were far from obvious in the late 1970s and early 1980s, when the articles were written. Indeed, at that time many of Goetz and Scott's analyses seemed quite radical. But today they have become, quite literally, part of the vocabulary of contract law scholarship. It is therefore with gratitude as well as admiration that the contributors to this issue of the *Virginia Journal* celebrate the contributions of Charlie Goetz and Bob Scott.

*Paul G. Mahoney*





FOOTNOTES

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2 Anthony T. Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. Legal Stud. 1 (1978).
3 Richard A. Posner, Gratuitous Promises in Economics and Law, 6 J. Legal Stud. 411 (1977).
4 William M. Landes and Richard A. Posner, Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism, 7 J. Legal Stud. 83 (1978).
5 Richard A. Posner and Andrew M. Rosenfield, Impossibility and Related Doctrines in Contract Law: An Economic Analysis, 6 J. Legal Stud. 83 (1977).
6 George L. Priest, Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach, 91 Harv. L. Rev. 960 (1978).
7 Michael J. Trebilcock, The Doctrine of Inequality of Bargaining Power, 26 U. Toronto L.J. 359 (1976).
8 See Robert Cooter and Melvin A. Eisenberg, Damages for Breach of Contract, 73 Cal. L. Rev. 1434 (1985); Victor P. Goldberg, An Economic Analysis of the Lost-Volume Retail Seller, 57 S. Cal. L. Rev. 283 (1984).
9 Robert E. Scott, The Case for Market Damages: Revisiting the Lost Profits Puzzle, 57 U. Chi. L. Rev. 1155 (1990).
10 See Lon Fuller, Consideration and Form, 41 Colum. L. Rev. 799 (1941).
11 See Michael Jensen and William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).
12 Ronald H. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 (1960).