COMMENTARY

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In *Contracts as Organizations*, Professors D. Gordon Smith and Brayden G. King make an important and much-needed contribution to the empirical study of contracts. As they document in their article, empirical studies of real-world contracts have flourished in recent years, making it appropriate to pause and consider the intellectual framework that has motivated this growing body of scholarship. Not surprisingly, to accomplish this task they conduct their own empirical study; not of contracts per se, but of contracts scholarship. What they find is an overwhelming bias in the analytical framework used to examine contracts across a variety of disciplines. In short, economic theory—in particular, concern with addressing the risk of what the authors call "advantage taking"—has reigned supreme as the intellectual paradigm for examining contracts. Indeed, among the fifty-two articles they identify as empirical studies of contracts, forty-eight (about 92%) address research questions motivated by economic theory. In many ways, it is a surprising finding considering the assortment of non-economic theories that have come to characterize the study of contract law.[1]

After documenting the dominance of economic theory in the study of contracts, Professors Smith and King then pose an all-too-reasonable query: has economic theory been crowding out alternative frameworks that can also inform our understanding of contracts? In particular, they contend that organizational theory is one such framework that can "enhance our understanding of the various functions and purposes of contracts in organizations and markets" and which has hitherto been underutilized.[2] Moreover, because organizational theories tend to manifest themselves in particular contract provisions, Professors Smith and King

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1. Examples of non-economic theories of contract law include a host of deontological theories, including those of CHARLES FRIED, CONTRACT AS PROMISE (1981) (providing an autonomy-based theory of contracts); Randy Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986) (providing a consent-based theory of contracts); and Dan Markovits, *Contract and Collaboration*, 113 YALE L.J. 1417 (2004) (providing a collaborative theory of contracts). For a more extensive discussion of non-economic theories of contract law, see Brian Bix, *Contract Law Theory* (Univ. Minn. Law Sch. Legal Studies Research Paper Series, Research Paper No. 06-12, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892783.

2. D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 24 (2009).

suggest that organizational theory should be especially appealing to that peculiar breed of contracts scholar who has the formal training, experience, and (perhaps most importantly) intestinal fortitude to hunt down, analyze, and code page after page of real world contract provisions—in other words, it's perfect for the legal academic. Their paper is thus a not-so-gentle nudge for contracts scholars in general, and legal scholars in particular, to move beyond the prevailing economic framework that has historically motivated the empirical study of contracts and explore the potential insights of organizational theory.

In my eyes, to lay bare the silent authority of an intellectual paradigm that dominates a field of study and then challenge that authority is critical to the development of any field. Just imagine the field of physics without the development of wave-particle duality; the field of psychology without the "cognitive revolution"; or the field of finance without the challenge of behavioral economics. By definition, an intellectual paradigm necessarily limits the types of questions scholars pose, the phenomena deemed worthy of academic study, and the interpretation of those phenomena actually studied. Having identified the dominance of the economic paradigm in the field of contracts scholarship, Professors Smith and King are therefore right to ponder whether it might be constraining the field. Has it caused us to overlook certain types of contracts? Has it limited our understanding of those contract provisions that have been previously studied? These concerns seem to underlie their desire to offer organizational theory as a supplement to the dominant economic account of contracts.

Yet while there is clearly intellectual benefit in questioning the prevailing economic framework that has to this point motivated contracts scholarship, I wonder about the marginal benefits of moving beyond it in terms of understanding real world contracts. As Professors Smith and King note, the economic framework does "not purport to provide a comprehensive account of contracts."[3] But given the way they frame the prevailing economic framework, it is possible that it does provide a fairly comprehensive account of why we have contracts and the terms that are included in them. In other words, while it's true that the dominance of the economic framework could reflect some sort of inadvertent mimetic drift, it seems equally plausible that it might simply reflect the power of the framework to explain contracts. Specifically, I wonder *how much* the framework has caused us to overlook certain contract provisions. *How much* has it caused us to misconstrue the meaning and significance of particular contracts?

Of course, the answer to these questions depends a great deal on how one views the "economic theories" that currently dominate contracts scholarship. I tend to agree with Professors Smith and King that incomplete contract theory and agency theory have had probably the most profound effect on contracts scholarship and that the two theories represent close cousins insofar as they share a similar perspective on the function of contracts in society. Although the theories differ in focus (agency theory on incentive alignment; incomplete contract theory on ways to mitigate ex post opportunism arising from contract incompleteness), each focuses on the challenge of managing discretion in cooperative relationships. That is, in any cooperative relationship one party inevitably holds some amount of

3. *Id.*

discretionary and unobservable decision-making authority that can affect the welfare of the other party, which can result either from an express delegation of authority (as in an agency relationship) or implicitly from the inability to draft a fully complete contract. It is this discretion, in turn, that creates the fundamental contracting challenge in the traditional economic framework: how to rein in the possibility of "advantage taking." As summarized by Professors Smith and King, "[t]hough the implications of advantage taking vary between agency theory and incomplete contract theory, the take-home lesson . . . is that under both of these economic theories, the central purpose of contracting is to address the risk of advantage taking by the contracting parties."[4]

Once the prevailing research paradigm is framed in this way, however, it is difficult for me to disagree with the contention that the central purpose of contracting is to address the risk of advantage taking. The reason stems from the breadth of this risk (at least as I discern the risk in the article). Although similar in spirit to Oliver Williamson's risk of "opportunism," which motivates much of incomplete contract theory, it strikes me that the concept of advantage taking must be considerably broader than Williamson's notion of "self-interest seeking with guile"[5] to cover both incomplete contract theory and agency theory. In contrast to the risk of opportunism, the risk of advantage taking (or "agency costs") in agency theory arises from basic self-interest seeking coupled with the delegation of authority (either expressly or implicitly) in any cooperative relationship.[6] More concretely, I need not be particularly guileful for my dean to worry about my productivity during the summer; the mere fact that I—a presumably self-interested individual who enjoys a day in the sun as much as anyone—have discretion to decide how I spend my summer months is sufficient for her to design an incentive structure that induces me (as well as my colleagues) to be productive. Accordingly, the risk of advantage taking in agency theory is both more expansive and more common than the risk of opportunism.[7] For this reason, Jensen and Meckling emphasize that "agency costs arise in any situation involving cooperative effort

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4. *Id.* at 19.

5. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 255 (1975).

6. *See* Kenneth Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 44 (1985) (Arrow describes an agency relationship as one in which "[t]he action [of the agent] affects the welfare of both the agent and another person, the principal" and notes that in agency theory, "the underlying principles are impeccably neoclassical, in that both parties are acting in their own self-interest . . . ."); John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 1, 2 (John W. Pratt & Richard J. Zeckhauser eds., 1985) ("Whenever one individual depends on the action of another, an *agency relationship* arises.").

7. *See* Arrow, *supra* note 6, at 37 ("The agency relationship is a pervasive fact of economic life . . . . [E]conomic theory has recently recognized that [agency relationships] are virtually universal in the economy, representing a significant component of almost all transactions.").

(such as the co-authoring of this paper) by two or more people even though there is no clear cut principal-agent relationship."[8]

To the extent advantage taking reflects this more basic concern with self-interest seeking in cooperative ventures, however, it seems the risk of advantage taking boils down to the most fundamental justification for the legal institution of contract. After all, absent the risk of self-interest seeking, there would be little need to incorporate parties' promises into a formal agreement that might be enforced by the state. For in such a world, we would be incapable of utilizing our freedom of action in a way that would unilaterally impair the expectations of those with whom we have entered into relationships.[9] Rather, we would do as we promised—or at least try to do as we promised in the event things do not work out as expected. It is this reasoning that led Williamson to claim that, in a world without the risk of opportunism, executory contracts would contain little more than a "general clause, to which both parties would agree, to the effect that 'I will behave responsibly rather than seek individual advantage when an occasion to adapt arises . . . .'"[10] Yet it's not entirely clear why even this basic promise would need to be legally enforceable in a world without the risk of advantage taking; a non-binding statement of intentions and preferences should suffice to guide the parties in their relationship.

In my view, it is because we do not live in this world that we need the institution of contract and, similarly, why organizations routinely turn to this institution to effect mutually beneficial exchange. The very concept of a contract as a legally enforceable promise presumes a situation where a contracting party no longer finds it in her interest to honor a promise and must be forced to do so (or at least pay for the resulting damage). And just as self-interest may encourage a party to break a promise in the first instance, it may also compel a party to use what other discretion she has in a relationship to seek individual advantage in less direct ways that can nonetheless adversely affect the welfare of other parties in that relationship. Indeed, as both a student and drafter of contracts, I am repeatedly surprised at how the architecture of contracts across a variety of domains consistently maps onto these two basic real-world challenges. Be it a bond indenture, an acquisition agreement, a supply agreement, or even a home purchase agreement, I expect a short provision (usually early in the agreement) outlining the basic bargain ("The undersigned Lenders promise to loan . . . ."; "I promise to sell . . . ."; "Buyer promises to purchase . . . .") followed by a cascade of ancillary promises, representations, and express conditions that seek to cabin the ability of a party to use its residual discretion in a manner that might impair this bargain ("Seller represents that it has full right and title in all Trademarks listed on Appendix A . . . ."; "Target agrees that Buyer may terminate this Agreement if any

8. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

9. More generally, absent the risk of self-interest seeking, it is difficult to imagine why parties would enter into cooperative relationships at all aside from those relationships involving reciprocal commitments to protect or advance the welfare of one another.

10. Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 241 (1979).

representations are materially inaccurate as of the Closing Date"; "Seller represents that the premises are free of all rodents"). That over 90% of empirical contract studies are motivated by economic theory is thus hardly surprising; concern over advantage taking most likely occupies 90% or more of a transactional lawyer's time!

Moreover, many of the contract provisions that arguably instantiate organizational theory strike me as also reflecting concern about advantage taking. Consider, for instance, the covenant that Pixar extracted from Disney that "[t]he Pixar sign at the gate shall not be altered."[11] Turning to social identity theory, Professors Smith and King suggest that the covenant illustrates how an organization such as Pixar can use contracts to express and maintain organizational identity in the face of an acquisition by a much larger, publicly-traded corporation. Yet while the covenant no doubt reflects the importance of Pixar's unique identity, social identity theory says little about why Disney's promise to maintain the Pixar sign should be set forth in a legally enforceable agreement. No doubt, the reason stemmed largely from concern that Disney might seek to back out of its commitment ex post; having a contractual commitment allowed Pixar greater assurance that Disney would honor its promise.

Likewise, while the resource-based view (RBV) helps account for why firms seek to secure access to particular resources, the need to use legally enforceable contracts to secure these resources makes sense only against a backdrop of advantage taking. For instance, contract provisions that seek to limit an employee's use of a firm's proprietary information or a long-term supply agreement each seem motivated primarily by concerns that the counter-parties will refuse to honor non-binding commitments. More subtly, RBV suggests that contract provisions might often be calibrated based on a firm's contracting environment, for example contracts might be more (less) complete in certain (uncertain) environments. But even here, such calibration makes sense only against a backdrop of advantage taking; in some cases a firm will want to protect against the risk of advantage taking (e.g., by securing long-term commitments when uncertainty is low), while in other cases it will want to engage in advantage taking itself (e.g., by using incomplete contracts "in an attempt to become more flexible and adaptive" when uncertainty is high).[12]

None of this is meant to detract from the significance of the contribution of Professors Smith and King; rather, the point is to understand better how we can use organizational theory to advance the empirical study of contracts. Based on the foregoing, my strong sense is that advantage taking will continue to reign supreme as the primary reason why we have contracts as well as why contracts contain the provisions they do. In many cases, however, advantage taking will fail to provide a compelling explanation for the shape and form of particular provisions. It is in this latter set of cases that I believe organizational theory holds considerable promise as an analytical framework.

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11. Smith & King, *supra* note 2, at 35 (quoting Walt Disney Co., Principles for Management of the Feature Animation Businesses, (Form 8-K Ex. 99.1) (Jan. 24, 2006), *available at* http://www.secinfo.com/d14D5a.vbpt.b.htm).

12. *Id.* at 28.

Imagine, for instance, two firms in a pharmaceutical joint venture. No doubt, considerations of advantage taking will induce them to memorialize their plans in a contract. But how can we best understand the particular wording they choose? RBV's theory of causal ambiguity might help explain why certain provisions are less completely specified than one might expect.

Likewise, organizational theory provides helpful insights into some of my own findings regarding the effect of the Sarbanes–Oxley Act of 2002 (SOX) on firms' decisions to go private.[13] In a study of 468 going-private transactions, I document the persistent use, before and after SOX, of indenture covenants that compel the surviving, privately-held firms to subject themselves to the reporting requirements of the Securities and Exchange Act of 1934 (Exchange Act), notwithstanding the significant cost of doing so after SOX was enacted. Concern about advantage taking might explain why indenture covenants require issuers to provide bond investors with financial information; however, advantage taking provides a less compelling explanation for why investors should demand this information take the form of Exchange Act reports filed with the SEC, thereby subjecting a firm to the considerable costs of SOX.[14] For instance, one possible "advantage taking" explanation for the covenant is that it serves a bonding function (i.e., bond investors might believe a commitment to file signals less credit risk), but if so, why don't more issuers offer a higher interest rate for a less onerous provision? In light of this puzzle, learning theory provides a useful, alternative explanation: perhaps the provision reflects another one of those "sticky," suboptimal boilerplate provisions that has yet to adjust in the post-SOX environment. Certainly, such an explanation is consistent with many of the conversations I had with transactional lawyers about why the provision has not changed in light of its post-SOX costs.[15]

For similar reasons, I believe one of the most fruitful avenues for applying organizational theory will be to examine the particular shape and content of form contracts—the building blocks for virtually any transaction. Indeed, I've already discussed in this Commentary how learning theory might inform the stickiness of form bond indentures, and Professors Smith and King outline how learning theory can also help explain the development of form language in the first place.[16] In addition, social identity theory provides insight not only into the content of specifically negotiated contracts (such as the Disney-Pixar "Policies for

13. *See* Robert P. Bartlett, III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions*, 76 U. CHI. L. REV. (forthcoming Mar. 2009).

14. Specifically, Rule 144A would permit bond investors to write whatever reporting requirements they want in the indenture so long as the investors are provided with the substantive financial information required in Rule 144A. *See* 17 C.F.R. § 230.144A (2008).

15. As one attorney explained, "best practices from both the legal and marketing ends seek the 144A to mimic the public offering disclosure requirements pre- and post-closing. Thus the covenant [*sic*]." E-mail from Michael Michetti, attorney at Cahill Gordon & Reindel LLP, to Robert Bartlett (Oct. 25, 2007, 11:33 EST) (on file with author).

16. Smith & King, *supra* note 2, at 29–33.

Management of the Feature Animation Business") but also into the meaning of form contract provisions more generally.

An example of how social identity theory can advance our understanding of form agreements appears in some recent empirical work currently being pursued by Victoria Plaut and myself on the venture capital (VC) investment agreements discussed by Professors Smith and King. In particular, we believe that a contracts scholar studying a set of VC investment agreements would be well-advised to examine the geographic location of the venture capitalist that negotiated the agreements before drawing conclusions about the meaning of particular contract provisions. The reason stems from what appears to be a significant cultural difference between East Coast and West Coast venture capitalists, with East Coast venture capitalists traditionally demanding more control rights from their portfolio companies than their West Coast counterparts. As the former general counsel to Charles River Ventures (a Boston-based VC firm) once jested, "From the West Coast perspective, [East Coast venture capitalists] look like control freaks, who are simply going to be unhelpfully interfering with and impeding what should just be routine corporate matters."[17] Exactly why this cultural divide exists is beyond the scope of this Commentary,[18] but for present purposes, it is sufficient to recognize that a contracts scholar may draw inappropriate conclusions about VC investment agreements without at least recognizing the cultural and social context in which the agreements were negotiated.

The VC investment contracts of Alteon WebSystems and ArrowPoint Communications provide a simple illustration. Both companies were dot-com era communications companies that went public at the height of the IPO boom (late 1999 and early 2000, respectively). Moreover, both were originally backed by Matrix Partners, a prominent VC firm with offices on both the East and West Coasts. Alteon, however, was based in San Jose, California and received its primary VC backing from the Silicon Valley office of Matrix (in particular, Andrew Verhalen, a general partner at Matrix, led the transaction) while ArrowPoint was based in Acton, Massachusetts and received its primary VC backing from Matrix's Waltham, Massachusetts office (led by Matrix's founding partner, Paul Ferri). Notwithstanding the similarity of the companies (they were direct competitors), the timing of the VC investments, and the fact that both investments came from the same VC firm, the East Coast/West Coast cultural divide was evident in the contract provisions negotiated by the Verhalen and Ferri

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17. Sarah Reed, *Will West Ever Meet East?: Bicoastal Conflict in the Jargon of Venture-Capital Financing*, BUS. L. TODAY, May–June 2002, at 24, 27.

18. For instance, recent evidence suggests that the East Coast/West Coast divide may reflect a heightened need for autonomy in the New England region of the country where residents pursue "a feeling of being one's own person and not being constrained by others." Victoria C. Plaut et al., *Place Matters: Consensual Features and Regional Variation in American Well-Being and Self*, J. PERSONALITY & SOC. PSYCHOL., July 2002, at 160, 169–70; *see also* Peter J. Rentfrow et al., *A Theory of the Emergence, Persistence, and Expression of Geographic Variation in Psychological Characteristics*, 3 PERSP. PSYCHOL. SCI. 339, 350, 353 (2008) (finding in a national study of differences in personality profiles that statewide neuroticism was highest in the Northeast and Southeast states and lowest in the Midwest and West Coast states).

teams. For instance, typical of many West Coast transactions, Alteon issued Matrix shares of preferred stock that were nonredeemable while ArrowPoint issued preferred shares that were mandatorily redeemable at the option of Matrix.[19] Likewise, typical of many East Coast deals, ArrowPoint's stock purchase agreement included a variety of "founders representations" (e.g., regarding the absence of litigation against the founder) as well as a host of covenants by the company often found in more traditional loan agreements (e.g., a commitment to apprise the investors of new litigation, a commitment to keep all assets insured, and the like).[20] In contrast, Alteon's financing documents contained none of these provisions.[21]

Of course, it is possible that Verhalen and Ferri simply perceived different types of "advantage taking" risks when negotiating the transactions and asked their lawyers to draft the documents accordingly. But my own experience working for both East Coast and West Coast venture capitalists suggests that the cultural explanation is the more compelling one. In particular, working on different coasts, Verhlaen and Ferri were represented by two different law firms whose form VC financing documents most likely reflected the socio-cultural environment of their clients. Indeed, when the National Venture Capital Association (NVCA) first began its effort to compile a set of "model form" financing documents, there was no shortage of discussion about how to reconcile the well-known conflict between East Coast/West Coast form financing documents relating to matters such as redemption rights, founder representations, and ongoing company covenants.[22] Moreover, even after discussion, no single, uniform set of covenants was acceptable to all members of the drafting group, underscoring the power that socio-cultural norms can exert on firms' identities, and by extension, the contract provisions that would be acceptable to particular venture capitalists.[23]

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19. *See* Alteon WebSystems, Inc., Registration Statement Under the Securities Act of 1933 (Form S-1) (July 9, 1999), Exhibit 3.1 at 13, [hereinafter Alteon Form S-1], *available at* http://www.sec.gov/Archives/edgar/data/1089925/0001012870-99-002263.txt; ArrowPoint Commc'ns Inc., Amendment No. 1 to Form S-1 Registration Statement Under the Securities Act of 1933 (Mar. 9, 2000), Exhibit 3.01 at 13–14, [hereinafter Arrowpoint Amendment No. 1], *available at* http://www.sec.gov/Archives/edgar/data/1039198/0000950135-00-001286.txt.

20. *See* ArrowPoint Amendment No. 1, *supra* note 19, Exhibit 10.14 at 13–19.

21. *See* Alteon Form S-1, *supra* note 19, Exhibit 4.2 at 13.

22. I was part of the original working group of transactional lawyers and venture capitalists that assembled in the Boston office of Ropes & Gray during the winter of 2004 to establish the NVCA's model financing documents. The documents can be found at NVCA Model Venture Capital Financing Documents, http://www.nvca.org/model_documents/model_docs.html (last visited Jan. 25, 2009).

23. As of this writing, the NVCA's model documents continue to reflect the cultural divide. *See, e.g.*, NAT'L VENTURE CAPITAL ASS'N, CERTIFICATE OF INCORPORATION 32 n.53 (2008), *available at* http://www.nvca.org/model_documents/Certificate_of_Incorporation_V5.doc ("Redemption provisions are more common in East Coast venture transactions than in West Coast venture transactions."); NAT'L VENTURE CAPITAL ASS'N, STOCK PURCHASE AGREEMENT 22 n.40 (2008) ("Founders' representations are controversial and may elicit significant resistance. They are more common in the Northeast and counsel should be warned that they may not be well received elsewhere.").

To be sure, the divide between East Coast and West Coast drafting conventions never came close to destroying the overall project to create a set of uniform model financing documents. There was simply too much agreement among all participants about the fundamental economic conflicts that apply in venture capital finance—that is, the central goal of the project was to address the risk of advantage taking in a uniform manner. Nonetheless, these two different approaches to redemption rights, founder representations, and ongoing company covenants demonstrate how organizational theory can supplement economic analysis in our understanding of the shape and content of real world agreements. In particular, when it comes to VC financing agreements, examining the manner in which socio-cultural context can shape the identities of venture capitalists and their law firms represents an important step in understanding the form contracts routinely used by venture capitalists in practice.

Thus, while I am doubtful that organizational theory will ever displace economic theory as the primary framework for examining contracts, the organizational theories discussed by Professors Smith and King provide an important, supplemental approach with which to understand the shape of contract provisions. In this regard, they represent critical analytical tools that can enlighten our understanding of how contract provisions operate in the real world.

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