REGULATING CONTRACTS

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The Construction of Markets

How does social behaviour move from taking to trading? In order to get what we want, we can either grab it even though someone may already possess it, or we can seek to exchange some item in our possession for the desired object. Taking something merely requires the ability to use force or deception. The reluctance to use these abilities depends upon respect for a normative system of property rights. No doubt the law plays a significant role in establishing and policing this system through criminal regulation, such as the laws of theft and fraud, and the private law which allocates property entitlements. But the establishment of these conditions regarding ownership is not sufficient for the construction of trading relations. An exchange of goods or services requires a complex social interaction. The exchange or contractual relation relies for its success upon communication, co-operation, and shared normative standards or expectations.

As a consequence, contractual relations inevitably carry a risk of disappointment or of betrayal. In an exchange, each party is always vulnerable to the decision of the other to mislead expectations or to fail to fulfil them. In a simple purchase of an item, the buyer may be disappointed by the quality of the product, or may be misled by advertising into believing that the product has qualities that it does not possess, or suffer the betrayal of never receiving possession of the goods. The seller may equally experience the betrayal of default in payment. In a long-term contract, such as an employment relation, the expectation of the employer for a productive employee may be dashed, or the employee may find the job less satisfactory than expected.

What convinces people to take the risks of trading? How do they select a particular contracting partner? How do they determine when the risks of disappointment and betrayal have been overcome sufficiently to warrant entry into an exchange relation? In the language of game theory, how do people overcome the problems of co-ordination and first mover? More broadly, how do exchange transactions become commonplace, so that we are able to describe their prevalence and frequency as the formation of a market?

These broad questions deserve no doubt a book in themselves. Our particular focus concerns the role of law in assisting the social relation of exchange. Is law necessary for the evolution of routine patterns of exchanges that amount to a market, or can markets exist without a state? Even if law is not essential, does a system of legal rules, sanctions, and courts supply a valuable ingredient in the construction of markets? If so, what kinds of legal regulation best contribute to the construction of successful markets. A development of answers to these questions occupies the chapters of Part 3 of this book.

Trust and Sanctions

The risk of loss from disappointment and betrayal can never be entirely eliminated. Disappointment arises when the reasonable expectations that describe the expected benefit from the transaction are not fulfilled. Betrayal occurs when the reciprocal performance is not forthcoming at all. These risks may be low in transactions performed simultaneously and instantaneously, as in the case of a purchase of goods in a shop, but even then the goods may lack the expected quality and therefore cause disappointment. The risks will be high in the case of a sale of goods between geographically remote parties on the basis of deferred payment or credit, which is the common situation in international trade. Every exchange therefore represents the taking of a calculated risk that the likelihood of potential gains from exchange exceeds the probability of losses occurring due to disappointment or betrayal.

This calculation of risk provides the axis for the decision to enter a contract. The calculation involves both sides of an equation. On the one side is the estimation of the expected benefits from the transaction, that is, the profit to be made or the satisfaction of wants. On the other side lies the fear of betrayal or disappointment. In making the calculation, one crucial variable will always be the value attached to the expected benefit. Where dazzling profits beckon or urgent needs such as hunger must be satisfied, then greater risks of loss can be countenanced. In addition to this variable of the value attached to the expected benefit, two other significant variables determine the outcome of this calculation. We will call these variables 'trust' and 'sanctions'. By the term 'trust', I mean a situation where each party places faith in the other to perform the transaction and to avoid or minimize disappointment. By the term 'sanctions', I mean the situation where each party can make a credible threat of punishing the other, usually by causing economic loss in the event of betrayal or disappointment. Although both trust and sanctions alter the calculation of risk by tending to favour entry into contracts, they differ in the way in which they affect the balance of the equation.

Trust operates on both sides of the equation of risks of loss and expected benefits, whereas sanctions merely suppress the risk of betrayal or loss. In a relation of trust, both parties wish to avoid disappointment by ensuring that the expected gains to both are realized. In the case of sanctions, however, the threat of punishment in the event of betrayal merely reduces the risk of loss. In the example of an employment relation, if trust exists between employer and employee, both parties seek to avoid betrayal by failure to perform work or make the payment due, but also they try to avoid disappointment by such actions as the employee making sure that the work is performed carefully and the employer eliminating unnecessary dangers from the workplace. Where sanctions alone sustain the transaction, then the implicit threat of 'no work, no pay' is likely to ensure that the work is performed by the employee, but the incentive does not extend to encouraging performance of the job to the highest standards possible. Due to the way in which trust bears on both sides of the equation in the calculation of risk, it is likely to provide superior foundations for the construction of markets. Yet trust is much harder to establish and sustain in market relations than sanctions, so that in practice sanctions provide the second best, though more prevalent, solution to the problem of the risk of betrayal or disappointment.

The core idea of trust is that each party places faith in the other to perform the transaction and to avoid or minimize disappointment. The source of this faith in the other party does not derive from general conventional moral standards, such as the idea that promises ought to be kept, but rather is always personal to the relationship between the parties. Trust involves placing reliance upon one's knowledge of the character of the other party. This knowledge derives either from intimacy established through past dealings and social interaction or from certain attributes of a person's identity.

From a knowledge of the past, one can infer that, at least in dealings with oneself, the other party will be concerned to avoid betrayal and minimize any disappointment regarding the exchange. This past experience may comprise previous transactions that proved satisfactory. The inference of trustworthiness may equally be drawn from other types of social interaction, such as gifts, co-operative work, or respectful behaviour.

From a knowledge of a person's identity, one can discover attributes that again permit the inference that, at least in dealings with oneself, the other person will be concerned to avoid betrayal and minimize disappointment. The crucial attributes concern membership of a group or association to which the other party to the transaction is also a member, or where membership confers a reputation for trustworthiness. Joint membership of a kinship group or a trade association signals to both parties the presence of an attribute that encourages them to put their faith in the other. Membership by one party of a professional group that regulates standards of conduct, such as an architect or an accountant, also supplies an attribute which supports trust. Membership of the group only confers this attribute, of course, if the group itself has established the reputation for trustworthiness, and where continuing membership is important to the self-esteem and prosperity of its members.

As between these two sources of trust, past dealings and personal attributes, Lorenz observes correctly no doubt 'that reputation is important but no substitute for experience'.[1]

Where trust is available as the basis for an intended transaction, it has three main effects. First, it guides the selection of the other contracting party. There is usually a strong preference to enter transactions with persons with whom one has enjoyed previous positive experiences and to prefer them over strangers. It is wrong to think of markets as comprised of large numbers of transactions between strangers. A deeper analysis reveals that markets are comprised of a constellation of repeated patterns of transactions between familiar parties.

The second effect of trust is to overcome the problem of the vulnerability of the first mover. The vulnerability to betrayal remains, but the presence of trust encourages the parties to discount this risk as one of low probability and therefore enter the contract and commence performance. Luhmann describes the way in which trust operates as the reduction of the complexity of the available information. By extrapolating from existing information about the other party, participants in markets who share trust reduce the complexity of the information to be considered with respect to a transaction by deciding that the actions of the other with respect to performance of the undertaking are to a considerable degree predictable.[2] In other words, when making the decision to enter a transaction and commence performance, the presence of trust permits the exclusion of concerns about the risk of betrayal or disappointment, thereby enabling the parties to concentrate their attention on the projected economic benefits of the contract.

The final effect of trust between the parties is that it reduces the need to guard against disappointment by specifying in detail the precise content of the reciprocal undertakings and then monitoring performance closely. In the presence of trust, it will be assumed that the intention to minimize disappointment will lead the other to fulfil reasonable expectations without the need to supply particulars of every aspect of those expectations and then check upon compliance with the terms of the contract. In other words, the transactions costs of contractual specificity and monitoring can be reduced by the presence of trust, which lowers the height of this potential barrier to

[1] Lorenz, E. H., 'Neither Friends nor Strangers: Informal Networks of Subcontracting in French Industry, in D. Gambetta, (ed.), *Trust: Making and Breaking of Cooperative Relations* (Oxford: Blackwell, 1989) 194.

[2] Luhmann, N., *Trust and Power* (Chichester: Wiley, 1979).

entry into transactions. In short, trust functions as an antidote to transaction costs.

Whereas trust serves to reduce the complexity of the information to be considered about a transaction, sanctions tend to augment complexity by requiring the construction of a credible threat of punishment with which to deter betrayal or disappointment. An effective sanction must alter the incentives in such a way that the option of breach of contract by betrayal or causing disappointment always remains unattractive compared to supplying the expected performance. Yet the potential sanction must not be so great that fear of it deters entry into the contract altogether. One does not enter a contract willingly where the threatened sanction for causing disappointment is death or financial ruin. Making oneself vulnerable to a sanction represents a calculated risk in which the chance of causing disappointment and incurring the sanction appears small compared to the chance of reaping the expected benefits from the transaction. The ability to punish default encourages each party to enter the transaction, since the risk of betrayal or disappointment has been substantially reduced. But the price of this incentive structure is the new risk of incurring an additional sanction oneself.

We can distinguish three forms of sanction. A legal sanction comprises a process concluding in an order by a court either to perform the contract backed by a threat of punishment for disobedience or to pay compensation for breach of contract backed by a threat to seize property to the value of the compensation due. The effectiveness of a legal sanction to deter betrayal or disappointment depends on many factors including the expense of invoking the legal process, the predictability of the imposition of the sanction by a court, and the cost of the sanction to the party in breach of obligation. Where the legal process proves expensive, unpredictable, and leads only to small sanctions, then the legal sanction will not serve the function of encouraging entry into transactions.

A second form of sanction may be described as a non-legal sanction, for it may be imposed without invoking the legal process. Non-legal sanctions seek to impose economic costs (and in some cases psychological costs such as distress) without invoking a legal procedure. Perhaps the most pervasive and effective non-legal sanction comprises a refusal to deal with the other party in the future. This sanction does not punish betrayal when it occurs, but rather removes the possibility of deriving any benefits in the future from subsequent transactions between the parties. The effectiveness of this sanction depends upon the possibility of excluding future transactions without incurring greater loss than by continuing to enter contracts with the risk of further betrayal. Another powerful non-legal sanction is the ability to damage the business reputation of the party in default by spreading this adverse news among participants in the market. This sanction aims to discourage others from taking the risk of betrayal or disappointment, thereby preventing the party in breach of contract from obtaining benefits in the future from a wide range of potential transactions. In effect, the sanction of damage to business reputation functions as the opposite of trust by serving as a signal that the risk of betrayal or disappointment should be regarded as sufficiently grave as to exclude consideration of the potential benefits of the transaction.

It is useful to delineate a third form of sanction that has great importance in commercial transactions. The sanction is constructed by using legal rules, but it can be imposed either without incurring the costs and the uncertainties of the legal process or by using a perfunctory, reliable, and inexpensive legal process. An example is a transaction with a pawnbroker. The borrower may obtain a loan of money by giving possession of a valuable item such as a ring to the pawnbroker. If the borrower fails to repay the loan, the pawnbroker may sell the ring and keep the proceeds up to the amount of the debt. Legal rules serve to construct this sanction, for the pawnbroker will be regarded as entitled under the law of property to sell the ring without becoming liable for legal sanction for theft or conversion. Yet the sanction of selling the ring occurs without the need to invoke an uncertain and costly legal process. As in the example of the pawnbroker, the principal form of this third type of sanction comprises a 'hostage', that is, a valuable asset that the betrayer will lose to the injured party by breaking the contract. We may describe this third form of sanction as one that is constituted by legal rules but applied without invoking a legal process by means of self-help as security.

All three types of sanction, legal, non-legal, and security, may be present in a particular instance and serve the function of providing an incentive to perform the contract according to expectation. In business relations where a high degree of trust sustains the practice of entering contracts, various sanctions may be available and serve as a kind of insurance or long stop against betrayal without any serious expectation that the sanctions will need to be invoked. By means of this combination of trust and sanctions, the risks of betrayal or disappointment can be countered to an extent sufficient to provide the necessary conditions for entry into contracts with others. In the absence of trust or sanctions, however, it is unlikely that voluntary transactions will occur unless the expected benefits are so great in value that caution is thrown to the winds. The presence of trust or effective sanctions (or a combination of both) provide the necessary conditions for the constitution of markets.

Markets Without a State

It is often the conceit of lawyers that legal sanctions supply the crucial bulwark against disappointment and betrayal in contractual undertakings.

This view of law as the instrument of state power which guarantees the order of civil society has also comprised a core assumption of Western political thought. A famous passage in Hobbes' *Leviathan* exemplifies this reasoning:

> . . . he that performeth first, has no assurance the other will perform after; because the bonds of words are too weak to bridle men's ambition, avarice, anger, and other Passions, without the fear of some coercive power; which in the condition of her Nature, where all men are equal, and judges of the justness of their own fears cannot possibly be supposed.[3]

The vital 'coercive power' must be provided by an external force or agency such as the state through its laws. We also discover this theme in modern jurisprudence, as in H. L. A. Hart's description of the 'minimum content of natural law', where he describes the basic legal institutions which are necessary to hold a society together. In addition to the institution of ownership of property,

> the division of labour, which all but the smallest groups must develop to obtain adequate supplies, brings with it the need for rules which are *dynamic* in the sense that they enable individuals to create obligations and to vary their incidence. Among these are rules enabling men to transfer, exchange, or sell their products; for these transactions involve the capacity to alter the incidence of those initial rights and obligations which define the simplest form of property. The same inescapable division of labour, and perennial need for co-operation, are also factors which make other forms of dynamic or obligation-creating rule necessary in social life. These secure the recognition of promises as a source of obligation. By this device individuals are enabled by words, spoken or written, to make themselves liable to blame or punishment for failure to act in certain stipulated ways. Where altruism is not unlimited, a standing procedure providing such self-binding operations is required in order to create a minimum form of confidence in the future behaviour of others, and to ensure the predictability necessary for co-operation. This is most obviously needed where what is to be exchanged or jointly planned are mutual services, or wherever goods which are to be exchanged or sold are not simultaneously or immediately available.[4]

In this passage, Hart argues for the necessity of a 'standing procedure' to enforce contracts based upon the natural fact of the division of labour. This procedure has to be an external coercive power because the altruism of individuals is limited. The conclusion reached is that legal or law-like enforcement of contracts is a necessary feature of any social order.

The thesis that legal enforcement of contracts is necessary for markets and the division of labour also infuses many of the classics of sociological

[3] Hobbes, T., *Leviathan* (Oxford: Oxford University Press, 1955) (first published 1651), 89–90.

[4] Hart, H. L. A., *The Concept of Law*, 2nd edn. (Oxford: Clarendon Press, 1994), 196–7.

thought. Durkheim's analysis of modern society as united principally by 'organic solidarity', as opposed to previous social orders bound together by 'mechanical solidarity', is described by reference to different types of law. He contrasts, on the one hand, 'penal law' that enforces mechanical solidarity by reinforcing the 'conscience collective', with on the other hand, 'co-operative' and 'restitutive' law that supports the modern form of 'organic solidarity'. The central example of this co-operative law is the law of contract: 'the contract is, par excellence, the juridicial expression of co-operation'.[5] Durkheim appears to infer from the fact that the law of contract occupies a prominent position in modern legal codes that this legal phenomenon reflects the significance of 'organic solidarity' in binding modern societies with their market economies together.

On closer inspection, however, these assumptions about the significance of law in the constitution of market economies do not appear warranted. When we examine closely the way in which people decide to enter transactions the role of law appears at best peripheral and in many instances wholly irrelevant. In order to overcome the risks of betrayal and disappointment, trust and sanctions are vital, but within these mechanisms the legal sanction available for breach of contract appears to occupy only a marginal role. Other devices designed to construct trust and non-legal sanctions play a more prominent part in enabling the parties to overcome the problem of first mover or co-operation.

We can observe this relative lack of importance of legal sanctions most clearly in markets unsupported by state power in the form of law. In traditional societies social anthropologists have observed sophisticated patterns of exchange developed without any institutions resembling state law. During his enforced sojourn in the idyllic Trobriand islands of the South Pacific at the beginning of this century, the social anthopologist Malinowski described extensive patterns of trade in fish, yams and other basic commodities occurring without courts, rules of contract law, and legal sanctions.[6] The exchanges relied primarily upon trust, and each gift in anticipation of exchange serves to reinforce that trust. In the modern world, we can discover markets without a state in the shanty towns of the third world poor, where the dispossessed and displaced people of the world create their own local economic order without the assistance of state power.

Keith Hart's study in 1965–8 of trade in the shanty town on the edges of Accra between the 'Dickensian mob, of water carriers, bread sellers, shit shovellers, taxi drivers, pickpockets, and prostitutes' is interesting because

[5] Durkheim, E., *The Division of Labor in Society* (New York: Free Press, 1933) (originally published 1893), 123.
[6] Malinowski, B., *Crime and Custom in Savage Society* (London: Routledge & Kegan Paul, 1926).

neither the ties of kinship of traditional societies nor legal sanctions are available to the traders.[7] In seeking the means of subsistence the slum dwellers 'lacked effective sanctions; the state's presence in the slum was intermittent and punitive (occasional police raids)'.[8] The market economy in this context works rather on the basis of personal relations described by Hart as a kind of friendship, though plainly the claims of friendship and familiarity were routinely exaggerated by the participants in order to promote transactions and to gain access to markets. For a similar reason transactions were routinely facilitated by gifts and bribery, that were designed to establish signals of friendship and confidence. The pretensions of friendship established trade between the parties by encouraging trust. Here is a revealing example of the role of trust in the absence of legal or non-legal sanctions:

> Atia had been hawking a camera around with intermittent success: the problem was that it was 35 mm and his customers were often unwilling to wait until the film was used up. His breakthrough came when he went to a girls' secondary school with 600 pupils and persuaded the principal to allow him to take the girls' photographs at weekends. Many others had tried and failed; but, as he put it, his sweet approach worked. He spent over £10 on chickens, eggs, and gifts of money before she agreed and gave him exclusive photographic rights in the school.
>
> Trade was brisk; every weekend he got through two or three films 'cutting' the girls . . . He used to try to get an advance where possible, usually half. Those who gave him an advance were asked to write their names in a book, although he was himself illiterate. This was to stop any false claims; but in general he worked on a degree of mutual trust. If no advance had been paid and he made two copies which were refused, he couldn't force them to pay. If he had tried force, he said, maybe they would have ganged up against him and stopped buying his pictures altogether. So he relied on goodwill. Some girls would pay for a bad photo and later tear it up. If he heard of this, he would do them a new set free. Sometimes he 'fell down' when he spoiled the whole negative and had to refund all the advances.[9]

The interesting point about this story is that trade proceeded briskly without the possibility of either party imposing sanctions for breach of trust.

The parties to transactions in the shanty town of Accra were often bound together, however, by credit. In the absence of regular sources of income, the purchase of daily items such as food was impossible without a high level of credit. Breach of contract therefore risked the dissolution of the credit relation on which the debtor relied for access to basic goods and services. Preservation of the credit relation, which entails close fidelity to contractual arrangements, provides the incentive of non-legal sanction to deter betrayal by failure to pay for goods received. Within this credit

[7] Hart, K., 'Kinship, Contract, Trust: The Economic Organization of Migrants in an African City Slum', in D. Gambetta (ed.), n. 1 above, 176, 177.

[8] Ibid.

[9] Ibid. 181.

relation, we discover a long-term business relation, which as it survives becomes the basis for genuine trust and confidence. The research reveals stable patterns of trading relations without legal support, though the business relations are constantly vulnerable to deception, opportunism, and external shocks to the market. A fragile combination of trust and non-legal sanctions keeps this economic order lurching along.

Hart concludes the study by asking 'the question of what takes the place of law as the major source of sanction in economic relations?'[10] He found that systemic use of violence was rare. 'Reputation, name, honour, the macho complex offered much more scope for creditors and rentiers hoping to shame their clients into payment.'[11]

> Above all, economic life depended on the discovery of complementary or shared interest which might make commercial agreements self-reinforcing in the short and medium term.
>
> Nevertheless, a significant part of all this wheeler-dealing hinged on friendship, on the trust generated by shared experience, mutual knowledge and the affection that comes from having entered a relationship freely, by choice rather than status obligation. Whenever my landlord introduced me to one of his 'good friends', I knew that he was almost certainly a crook, probably from another ethnic group, a member of a criminal fraternity stretching back decades with a common background of gambling dens, police raids, gaols, diamond smuggling, drug rings, and all the rest. These were the men he turned to when he needed to trust someone, not his family or his fellow tribesmen.[12]

This passage illustrates the earlier contention that, when the chips are down, trust based upon experience is more reliable than trust based on membership of an association.

The contrast between this unreliable market economy and the markets of Western economies with strong state power is not in fact as great as might be assumed. There are fascinating parallels in the way credit binds parties together into more or less trusting relations in Greenberg's study of the market for consumer goods in a poor neighbourhood in the United States.[13] He examines the operations of Walker-Thomas Furniture Co., an 'easy credit' retailer selling items such as furniture and electrical goods through door-to-door sales representatives. The store has about 20,000 credit accounts with customers drawn almost exclusively from the poor and unemployed who cannot obtain credit from other retail stores. In fact credit is the only method of payment for most items, which permits far

[10] Hart, K., 'Kinship, Contract, Trust: The Economic Organization of Migrants in an African City Slum', 185.

[11] Ibid., 185.

[12] Ibid., 185.

[13] Greenberg, D. I., 'Easy Terms, Hard Times: Complaint Handling in the Ghetto', in L. Nader (ed.), *No Access to Law: Alternatives to the American Judicial System* (New York: Academic Press, 1980) 379.

higher prices to be charged than those demanded in ordinary retail stores. The sales representative can transform the customer's standard of living by supplying goods on credit, thereby establishing a bond of friendship, augmented by small gifts for regular paying customers and a speedy repair service, and then this relationship is invoked in order to obtain priority in payment over other creditors. The sales representative ensures this advantage by cashing the government benefits check and deducting the repayment at source. The credit relation then establishes a relation of dependency. The sales representative can permit flexibility in payments, such as a temporary abatement, which reinforces the perception of customers that they have to rely upon and trust the representative. The sales representative also uses the payment record to determine whether complaints about the products will be rectified. Once repayments have been made to cover costs, however, the flexibility disappears:

> That customers perceive the merchant—not the law—as arbiter emerges most clearly in situations in which they have 'lost', that is, failed to convince the salesperson to extend payments. At that point, Walker Thomas initiates all sorts of harassing activity: threatening letters, scaled on a continuum of increasing nastiness; early-morning and late-evening phone calls from the collection manager demanding immediate payment and vowing to send out the truck that very day; attempts to force payment through contacting customers' friends and relatives (whose names are conveniently provided on the 'Buyer's Financial Statement,' which all customers fill out before making any purchase); and repossession of goods from the customers' homes when they are absent . . . After the customers revealed these tactics to me, I asked them whether the tactics were illegal. They all replied, to the last one—no matter how angry or upset they may have been—'Oh, no, I missed my payments.'[14]

In this retail market, therefore, the initial contractual relation is established and sustained by trust, but when it turns sour, non-legal, or rather illegal sanctions are routinely employed. Great efforts are expended in excluding the legal system, so that if a customer threatens to take a complaint to an outside consumer protection agency, the salesperson may offer to pay for the repair himself.[15] In this way, the salesperson both restores trust and reputation in the market, and avoids legal scrutiny of unlawful practices such as excessive interest rates and breach of warranty. No doubt the cost of the repair is already included in the price, though the consumer perceives the repair as a favour. Although this retail market is untypical in western economies, it reveals how a market may be constituted outside the law, indeed in contravention of the law, on the basis of trust and non-legal sanctions.

[14] Ibid., 385–6.

[15] Ibid., 388.

This evidence of markets without a state or operating outwith the state suggests that the assumption that law plays a crucial role as an external enforcer in the construction of markets is misplaced. The key elements which encourage transactions are the presence of trust and sanctions, but those sanctions certainly do not have to be provided by a legal system. The availability of a legal sanction is rarely the key determinant in encouraging the parties to enter a legal transaction, and nor is the legal sanction the principal way in which the parties seek to protect themselves against the risk of disappointment. When we examine the reasons given by parties for entering transactions with particular persons, the reasons tend to emphasize foremost the importance of trust, and then secondly, the practical economic considerations, which we have called non-legal sanctions, as the effective discipline. The available legal sanctions are viewed at best as a last resort, to be employed, if ever, when the performance of the contract and possibility of future business relations between the parties seems improbable. In addition, when we examine the incidence of litigation about contracts in Chapter 14, we shall discover that resort to the legal process is a luxury item beyond the purse of most participants in markets.

Further support for this insight about the marginal significance of legal sanctions may be discovered in instances of common transactions in developed economies normally supported by reliable state power, but which are of doubtful legal validity. Although a legal sanction may not be available, the presence of trust, non-legal sanctions, or a combination of both, ensures that disappointments prove rare. In a path-finding survey of contractual behaviour in the United States in the 1950s, Macaulay gives several examples of unenforceable contracts that were routinely employed to govern contractual relations:

> Moreover, it is likely that businessmen are least concerned about planning their transactions so that they are legally enforceable contracts. For example, in Wisconsin requirements contracts—contracts to supply a firm's requirements of an item rather than a definite quantity—probably are not legally enforceable. Seven people interviewed reported that their firms regularly used requirements contracts in dealings in Wisconsin. None thought that the lack of legal sanction made any difference. Three of these people were house counsel who knew the Wisconsin law before being interviewed. Another example of a lack of desire for legal sanctions is found in the relationship between automobile manufacturers and their suppliers of parts. The manufacturers draft a carefully planned agreement, but one which is so designed that the supplier will have only minimal, if any, legal rights against the manufacturers. The standard contract used by manufacturers of paper to sell to magazine publishers has a pricing clause which is probably sufficiently vague to make the contract legally unenforceable. The house counsel of one of the largest paper producers said that everyone in the

industry is aware of this because of a leading New York case concerning the contract, but that no one cares.[16]

In these examples of commercial relations, the long-term economic interests of both parties bind them together regardless of any potential legal sanction. Another example of frequent contractual relations without legal sanctions concerns 'quotations' for commercial work; a court would probably not regard these estimates as amounting even to a formal offer, let alone a binding contract, but a business will often regard itself as bound by its quotation in order to protect its reputation.[17] These phenomena are hardly new: the Statute of Frauds 1677 required sales of goods worth more than £10 to be recorded in writing and signed, but this requirement was certainly not observed in specialized markets and exchanges during the nineteenth century.[18]

These examples of markets unsupported by state sanctions for breach of contract can also be extended to consumer transactions. Although a publican could not sue a consumer for debts,[19] the English pub thrived on the simple principle of cash on the spot. Similarly, betting shops proliferate in every high street in England despite the unenforceability of the transactions. The consumer guarantee issued by a manufacturer in the box containing its product may also not be legally binding on the manufacturer unless the consumer can demonstrate that the existence of the guarantee was a reason for purchasing the particular product from a retailer. Nevertheless, manufacturers will invariably comply with their guarantee, albeit strictly construed against the consumer, for failure to do so will result in damage to their business reputations.

International trade, that is, trade between citizens of two different states across the border, has always presented the participants with the problem of creating a market without the reliable support of state power. The risk of disappointment or betrayal is accentuated because there is a danger that the state will not impose sanctions for breach of contract when one of its own nationals is sued by a foreigner. Merchants engaged in international commerce overcame these difficulties by developing extensive international networks of trust based upon kinship and personal knowledge. Building on these relations, the merchants developed legal

[16] Macaulay, S., 'Non-Contractual Relations in Business', *American Sociological Review* 28 (1963) 45, 60.

[17] Macaulay, S., 'The Use and Non-use of Contracts in the Manufacturing Industry', *Practical Lawyer* 9(7) (1963) 13, 17.

[18] Ferguson, R. B., 'Commercial Expectations and the Guarantee of the Law: Sales Transactions in Mid-Nineteenth Century England', in G. R. Rubin and D. Sugerman (eds.), *Law and Economy: Essays in the History of English Law 1700–1920* (London: Professional Books, 1984), 192, 201. See also Comment, 'The Statute of Frauds and the Business Community: A Re-Appraisal in Light of Prevailing Practices', *Yale Law Journal* 66 (1957), 1038.

[19] Under the 'Tippling Act', 24 Geo. 2, c.40, (1750).

devices of credit, such as the medieval 'tratta' or letters of payment which evolved into the modern Bill of Exchange. These documents were negotiable (or could be alienated), so that when debts came to be settled, the debtor and the creditor were within the same legal jurisdiction and many legal and non-legal sanctions (such as damage to reputation) would be available to the creditor.[20] Ordinary state courts often lagged behind in recognition of the effectiveness of documentary credit arrangements, but the merchants' own courts would enforce them.[21]

A remarkable feature of contemporary international trade in the context of the globalization of the economy is the extent to which the contracts seek to establish their own non-state systems of adjudication and normative standards through commercial arbitration clauses.[22] The terms of the contract enable the parties to select their judges (arbitrators) and the rules applicable to their transaction which can be the laws of any state or even a set of rules which are not part of any state legal system, the so-called 'lex mercatoria'.[23] It is only when the debtor chooses to ignore the award of the arbitrator, and run the risk of damage to reputation which would effectively exclude them from international trade, that the creditor may seek recourse to state law to enforce the award of the arbitrator.

These observations throw considerable light on the general issue of the role of the law in the constitution of markets. They suggest that markets can flourish where there is trust without the need for sanctions. But such a level of trust is only likely to exist in a small closed community. More commonly, the market will deter disappointment and betrayal by a combination of trust and non-legal sanctions. We can therefore discover flourishing markets where no effective state power exists to impose legal obligations. Even where a powerful modern state is present, the legal sanctions are likely to play only a minor role in deterring behaviour which causes disappointment.

The Construction of Trust

It is important to notice that trust is constructed through social interaction. The most fruitful source of trust comes from prior dealings or

[20] Braudel, F., *Civilization and Capitalism*, ii, *The Wheels of Commerce*, trans. S. Reynolds (London: 1982), 142; Trakman, L. E., *The Law Merchant: The Evolution of Commercial Law* (Colorado: Rothman, 1983), 109 (samples of medieval bills of exchange *etc.*)

[21] Postan, M. M., *Medieval Trade and Finance* (Cambridge: Cambridge University Press, 1973), 49–54.

[22] Teubner, G., 'Global Bukovina: Legal Pluralism in the World Society', in G. Teubner (ed.), *Global Law Without a State* (Aldershot: Gower, 1997) 3.

[23] Mertens, L., 'Lex Mercatoria: A Self-applying System beyond National Law?', in G. Teubner (ed.), n. 22 above, 31; Trakman, L. E., n. 20 above; Dezalay, Y., and Garth, B. G., *Dealing In Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order* (Chicago: University of Chicago Press, 1996), 85–91.

experience. Trust is also likely to be present where the transactions occur within kinship groups or within an ethnic group which has an identifiable membership within a broader society.[24] There are many careful studies of the way ethnic groups create bonds of trust, such as the Jewish diamond merchants of New York,[25] and the Chinese ethnic community involved in marketing smallholders' rubber in Singapore and West Malaysia.[26] Membership of the kinship or ethnic group serves as a signal of trustworthiness, an indication of a reputation for reliability, provided of course the transaction occurs between two members of the same group. In economic terms, by limiting transactions to the kinship or ethnic group, the parties eliminate the costs of finding out about the other's reliability, though at the price of foregoing some potentially worthwhile transactions with strangers. Members of the group will conform to these expectations not only because of the social obligations of kinship but also because the implicit threat of exclusion from the group for disappointing expectations will entail both exclusion from the market and from a social community.

In addition, it is possible for participants in markets to augment levels of trust by initiating deliberate patterns of social interaction.[27] They can devise institutions such as trade associations, codes of practice for industrial sectors, 'umbrella contracts', or framework agreements that describe the expected course of the business relation. A particularly elaborate form of the institutional creation of trust occurs in exchanges or 'bourses', membership of which can only be achieved and maintained by demonstrating the practice of trustworthy behaviour. These 'club markets', such as Stock Exchanges, futures markets, the Baltic Exchange for shipping in London, the Liverpool cotton market in the nineteenth century,[28] and the diamond merchants of New York,[29] comprise formal codes of conduct, private arbitration and mediation systems for the resolution of disputes, and the power to exclude from membership and to impose punitive sanctions for deviant behaviour. The advantage to the members is not only the facilitation of trade which the trust engenders, but also a reduction of transaction costs because deals can be struck informally. Another device for augmenting trust consists in the establishment of industrial sector

[24] Winn, J. K., 'Relational Practices and the Marginalization of Law: Informal Financial Practices of Small Businesses in Taiwan', *Law & Society Review* 28 (1994) 193.

[25] Bernstein, L., 'Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry', *Journal of Legal Studies* 21 (1992) 115.

[26] Landa, J. T., 'A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law', *Journal of Legal Studies* 10 (1981) 349.

[27] Zucker, L. G., 'Production of Trust: Institutional Sources of Economic Structure, 1840–1920', *Research in Organizational Behavior* 8 (1986) 53.

[28] Simpson, A.W.B., 'The Origin of Futures Trading in the Liverpool Cotton Market', in P. Cane and J. Stapleton (eds.), *Essays for Patrick Atiyah* (Oxford: Clarendon Press, 1991), Chapter 8.

[29] Bernstein, L., n. 25 above.

standards of quality and safety for products, to which all participants in the market agree to conform.

In advanced industrial societies, the presence of institutions which establish or augment trust may provide a competitive advantage.[30] The competitive advantage derives in part from the reduction of the costs of making contracts, the transaction costs. Where there is trust, it is likely that the parties will dispense with elaborate contracts, will refrain from detailed monitoring of performance, and will not need to create economic incentives and sanctions such as security interests against default. Perhaps more importantly, in a relation of trust the parties may expect each other to co-operate in the performance of the contract by, for example, providing useful information or suggestions for innovation.[31] This co-operation should increase the profitability of the transaction for both parties. A comparative study of German, Italian, and United Kingdom transactions in the same market sectors reveals the important contribution to the formation of trust provided by trade associations, quality assurance organizations, and industry standards for quality and safety of products.[32] These institutional arrangements, which are stronger in Germany and Italy than the United Kingdom, may reduce price competitiveness, but they appear to promote co-operation and the capacity to adapt to a changing environment.[33] They permit the business partners to enter into long-term contractual commitments with less wariness about the allocation of risks and the protection of investments.

One problem confronting businesses and individuals is how to create a signal to others in the market that indeed they are trustworthy in this sense. In the absence of past intimate knowledge or common membership in a trade association, trust in the required sense cannot be convincingly established. Nevertheless, almost equivalent benefits may be obtained by constructing a good business reputation for fair dealing. This requires an economic investment which will be wasted if the reputation is subsequently damaged by publicized default on contracts.[34] One common technique for businesses consists in establishing and advertising heavily a brand name for

[30] Deakin, S., *et al.*, 'Contract Law, Trust Relations, and Incentives for Co-operation: A Comparative Study', in S. Deakin, and J. Michie, (eds.), *Contracts, Co-operation, and Competition* (Oxford: Oxford University Press, 1997) 105.

[31] Collins, H., 'Quality Assurance in Subcontracting', in S. Deakin, and J. Michie, (eds.), n. 30 above, 285.

[32] Lane, C., and Bachmann, R., 'The Social Construction of Trust: Supplier Relations in Britain and Germany', *Organisation Studies* 17 (1996) 365; Lane, C., 'The Social Regulation of Inter-Firm Relations in Britain and Germany: Market Rules, Legal Norms, and Technical Standards', *Cambridge Journal of Economics* 21 (1997) 214.

[33] Arrighetti, A., *et al.*, 'Contract Law, Social Norms and Inter-Firm Co-operation', *Cambridge Journal of Economics* 21 (1997) 182.

[34] Klein, B., and Leffler, K. B., 'The Role of Market Forces in Assuring Contractual Performance', *Journal of Political Economy* 89 (1981) 615.

a product. This investment will be wasted if the product is exposed as unreliable or of poor quality, so there is a strong economic incentive to live up to the reputation for trustworthiness. For individuals, they can invest in obtaining a good credit rating by regularly paying their bills and by working hard to obtain satisfactory references from previous employers and landlords. Another common technique for signalling one's trustworthiness is simply to charge a relatively high price. Manufacturers of products have also sought to signal their trustworthiness and the quality of their product by issuing consumer guarantees about the product, but this technique has not proved successful, since poor quality producers can easily imitate the guarantee without the intention of fulfilling its requirements.[35] Retailers build a reputation for trustworthiness as well by their handling of complaints and returns of goods. The overriding goal of shops seeking to establish their trustworthiness is to maintain good public relations, which leads to the practice of accepting returns of goods without question.[36]

The willingness to take the risk of disappointment by performing one's side of the transaction first also provides a clear signal of trustworthiness. In effect, the first mover offers a gift, like the slum dwellers of Accra, which simultaneously presents a sign of trustworthiness and also places the recipient under a diffuse social obligation to reciprocate.[37] Similarly, in a large commercial transaction, a contractor may commence performance and make irretrievable investments in plant and machinery specific to the expected contract even before formal enforceable contracts have been exchanged. Paley gives the example of a two million dollar investment based upon a combination of personal trust within a history of dealings and the expectation of the continuation of a long-term business relation, without any formal enforceable contractual rights as a protection against the waste of the investment.[38] In response, the second mover can merely perform the promised undertaking, or, in order to signal that the trust should be reciprocated, the second mover can acknowledge a greater

[35] Good quality manufacturers may also weaken their guarantees to deal with the problem of 'moral hazard', that is, consumers may not be careful of products and present fraudulent claims: see Lutz, N. A., 'Warranties as Signals Under Consumer Moral Hazard', *Rand Journal of Economics* 20 (Summer 1989) 239; Arrow, K. J., 'The Economics of Moral Hazard: Further Comment', *American Economic Review* 58 (1968) 537.

[36] Kamkas, A., and Rosenwasser, R., 'Department Store Complaint Management', in L. Nader (ed.), n. 13 above, 283.

[37] Blau, P. M., *Exchange and Power in Social Life* (New York: Wiley, 1964); Rose, C., 'Giving, Trading, Thieving, and Trusting: How and Why Gifts Become Exchanges, and (More Importantly) Vice Versa', *Florida Law Review* 44 (1992) 295; Posner, E., 'Altruism, Status and Trust in the Law of Gifts and Gratuitous Promises', *Wisconsin Law Review* (1997) 567.

[38] Palay, T. M., 'Comparative Institutional Economics: The Governance of Rail Freight Contracting, *Journal of Legal Studies* 13 (1984) 265, 277.

obligation, by for example proving co-operative and flexible in the performance of the contract. Similarly, the risk of loss of sunk or irretrievable investments may provide a signal of trustworthiness. One reason why franchisors demand an irretrievable capital investment from franchisees may be to help to select or screen applicants,[39] for those willing to make the investment thereby signal their trustworthiness. The pursuit of trust therefore provides the parties with an incentive to give priority to the business relation rather than to confine their attention to the precise contractual undertakings.

The Construction of Non-legal Sanctions

The effectiveness of non-legal sanctions depends upon their potential to impose economic loss on a party to a contract who causes disappointment or betrayal. The sanction of a refusal to do business with a person in breach of contract in the future will be very powerful, for instance, where the deceiver derives much of its business or income from the other contractor. Equally in consumer contracts, as the customers of Walker-Thomas Furniture Co. well appreciated, a customer who fails to pay bills runs the risk of being excluded from vital goods and services in the future. Perhaps the key incentive to perform contracts faithfully, particularly with regard to quality, derives from the greater benefits to be achieved from the income from a stream of future sales rather than one-off benefits from defaults. The publican resists the temptation to water down the beer for fear of losing regular customers.

Another important non-legal sanction comprises damage to business reputation, with the consequent loss of confidence and trust. The sanction of damaging the other's business reputation will be augmented where the information about default can be disseminated rapidly to other participants in the market.[40] This power to disseminate damaging news about reputation combined with the threat of the non-legal sanction of expulsion from the market are the key ingredients of the success of 'club markets'. These trade associations combine to monitor actions and then to impose sanctions such as exclusion from the market. In the New York Diamond Dealers Club, which regulates about 80 per cent of the rough diamonds transactions in the United States, a system of arbitration polices fair trade practices and provides a monitoring system of the reputations of dealers.[41]

[39] Dnes, A. W., '"Unfair" Contractual Practices and Hostages in Franchise Contracts', *Journal of Institutional and Theoretical Economics* 148 (1992) 484, 496.
[40] Klein, B., and Leffler, K. B., 'The Role of Market Forces in Assuring Contractual Performance', *Journal of Political Economy* 89 (1981) 615.
[41] Bernstein, L., n. 25 above.

But such an association is not essential to establish a mechanism for exposing cheaters. An informal 'coalition' between traders also suffices to establish a mechanism for disseminating information about cheating.[42] On this interpretation, the core ingredient of a coalition comprises an implicit and long-term agreement to share information about the reputation of agents. This exchange of information is then used as the basis for declining to trade with other parties with poor reputations. An example developed by Grief of such a coalition concerns Jewish traders operating throughout the Middle East in the eleventh century without any effective state sanctions to protect their elaborate and risky merchant ventures conducted through agents at a distance:

> The Maghribis employed each other as agents, and all retaliated against any agent who had cheated a coalition member. Their social and commercial network provided the information required to detect and announce cheating, and the multilateral punishment was self-enforcing, since the value of future relations with all the Maghribis kept an agent honest.[43]

In contrast, a club market has institutions for implementing formal sanctions against members who develop poor reputations.

The parties to a contract can, however, devise powerful non-legal sanctions without much assistance from third parties.[44] They can arrange, for example, that one or both parties should incur considerable expense in advance, which would be wasted if performance of the contract is not completed satisfactorily. We have already noted this use of 'sunk investments' in franchise contracts; the franchisee, who wants to be licensed to use a particular trading name and business format, will be required to make substantial investments in plant and machinery that would be wasted if the franchise relation fails to prosper and the right to use the trading name is withdrawn.

We observed above that in commercial dealings a common technique for establishing sanctions uses 'security' or proprietary rights to create the capacity to punish a defaulter. This sanction employs the rules of the legal system with respect to the allocation of ownership of property, but does not invoke the legal process in order to impose the penalty. In order to borrow money, for instance, often a person will be required to give conditional title to some item of valuable property such as a mortgage of a house to the bank, or the pledge of a valuable ring to the pawnbroker. In the event of

42 Clay, K., 'Trade Without Law: Private-Order Institutions in Mexican California', *Journal of Law, Economics and Organization* 13 (1997) 202.

43 Grief, A., 'Institutions and International Trade: Lessons from the Commercial Revolution', *American Economic Review, Papers and Proceedings* 82 (1992) 128, 130.

44 Kronman, A. T., 'Contract Law and the State of Nature', *Journal of Law, Economics and Organisation 1* (1985) 5.

failure to repay the loan, the lender may then sell the asset and recover its money. Similarly, the advance payment of a deposit for a service will be forfeited if the balance is not paid on time. The hostage may either comprise 'an ugly princess', that is something only of value to the debtor, or may have general market value equivalent to the amount of indebtedness. This use of security is a non-legal sanction in the sense that the lender is not required to follow a legal process in order to recover compensation, but may simply recover and sell the property in the market. (This traditional legal position is now generally altered for consumer credit transactions, so that a legal process must be pursued prior to the realization of a security interest, though we observed that these procedures were not followed in the Walker-Thomas Furniture Co. example.) The giving of a security right enables the borrower to provide a credible commitment to the creditor not only by providing an assurance of performance, but also by limiting the borrower's power to obtain additional excessive borrowing, which would reduce the likelihood of compliance with the contract.[45]

These examples illustrate how an important dimension of the discrete communication system of a contract involves the construction of effective non-legal sanctions. The objective of the parties is to render the contract 'self-enforcing' in the sense that the economic incentives favour diligent performance heavily over default and betrayal.[46] The legal system may play a peripheral role in channelling the construction of these non-legal sanctions by, for example, recognizing the validity of proprietary claims contained in security interests. The law of contract can also provide a formal ceremony, such as the Roman practice of 'stipulatio', which contributes to the publicity of reciprocal promises and therefore ensures greater damage to reputation in the event of default. The legal system may also confirm the results of the application of a non-legal sanction if it is employed. In a contract of employment, for instance, the most powerful sanction available to an employer is simply to refuse to pay wages if the employee fails to perform the assigned work. The legal system can confirm this action by endorsing the principle of 'no work, no pay', so that the employee is denied any legal sanction to counter the employer's use of economic power. In the common law, the method used to support this type of sanction is the construction of the contract in order to discover 'conditions' that provide the order of performance of the parties. These interpretations of the contract appear to track closely the relative credit risks presented by the parties, so that the party who presents the higher risk of default, such as the employee, is required to

[45] Mann, R. J., 'Explaining the Pattern of Secured Credit', *Harvard Law Review* 110 (1997) 625.

[46] Klein, B., 'Self-Enforcing Contracts', *Journal of Institutional and Theoretical Economics* 141 (1985) 594.

perform first as a condition of the contract.[47] Breach of this condition entitles the other to withhold performance and terminate the contract. Similarly, in the law of sales, the law supports the non-legal sanction of rejection of the goods for inadequate quantity or quality by granting the buyer a defence to a claim for the price. This self-help remedy of rejection is so powerful, however, that the defence to a claim for compensation may be lost easily, as where a shortfall is so slight that a court regards rejection as unreasonable,[48] or where the buyer fails to reject the goods within a reasonable time after having had the opportunity to inspect them for defects.[49]

These observations concerning the importance of non-legal sanctions in providing the incentive to keep bargains suggest that the legal system only plays a minor role in establishing markets. It is true that many legally enforceable contracts are made in markets, but the sanctions for breach of contract do not appear to be crucial in ensuring that contracts are performed. These contracts often serve another purpose, however, which is to construct the mixture of incentives and penalties which comprise effective non-legal sanctions and security. It can be said with only a little exaggeration that the principal purpose of making contracts is to avoid the need to rely upon the law of contract.

The Significance of Legal Sanctions

These conclusions about the importance of trust and non-legal sanctions in enabling markets to be constituted leave the law playing a minor role. In determining whether the parties will take the risk of entering into a contract, the presence of trust supported by the availability of non-legal sanctions appears much more significant. We should ask therefore what significance, if any, should be attributed to the legal system and the sanctions available in the courts for breach of contract in the constitution of markets?

The role played by legal sanctions depends in part upon their strength. The normal remedy in private law for a breach of a contractual relation consists in damages designed to compensate a party for economic losses caused by the breach. In common law systems, these losses will be calculated as the 'net loss', that is, after offsetting any benefits obtained by making an alternative transaction with another party.[50] Where there is a

47 Patterson, E., 'Constructive Conditions in Contracts', *Columbia Law Review* 42 (1942) 903.

48 Sale of Goods Act 1979, s. 30(2A), as amended by Sale and Supply of Goods Act 1994, s. 4.

49 Sale of Goods Act, 1979, s. 35 as amended by Sale and Supply of Goods Act 1991, s. 2.

50 Harris, D., 'Incentives to Perform, or Break Contracts', *Current Legal Problems* 45(2) (1992) 29, 34.

competitive market for goods and services, these net losses are likely to prove minimal, since an alternative contract at a similar price can be obtained. In general, the law will not award any punitive damages for breach of contract which exceed the net loss, and nor will it permit the parties to the contract to agree to a measure of compensation which is likely to exceed the net loss. These sanctions are therefore rather weak, and it will only be in exceptional cases, as where no market alternative was available, that damages may prove substantial. This weakness of private law sanctions for breach of contract suggests that they provide little incentive to perform contracts, though equally and perhaps more significantly, the possibility of legal sanctions does little to deter entry into legally enforceable contracts either. The popular image of the law as a fierce enforcer of contracts is therefore misleading. As Macaulay once observed, 'Contract law in action is a defective product, promising far more than it can deliver.'[51]

In some jurisdictions, penal regulation, particularly in relation to consumer contracts, provides a more substantial deterrent against misleading trade practices. Similarly, some jurisdictions employ administrative agencies to monitor and deter unfair contractual practices committed against consumers or other protected classes such as employees and tenants. These types of measures seem to be effective on the whole in deterring the kinds of abuses at which they are directed, no doubt because they address the twin problems of access to justice and the weakness of sanctions. They control behaviour in the market to a degree which the ordinary private law compensatory measure of damages awarded by a court cannot. These regulatory measures operate only at the fringes of markets, deterring egregious abuses, but they must contribute to some extent to the willingness particularly of consumers to enter into transactions.

Despite this insight that legal sanctions play a minor role in the construction of markets, some economic analysis of contract law, sometimes described as the Chicago School and associated most closely with the writings of Richard Posner, often adopts legal sanctions as its central focus. This perspective begins by viewing the entry into transactions from a cost/benefit analysis. The benefit comprises the expected gain from performance of the transaction, and the cost comprises the risk of incurring a legal sanction for breach of contract. This formula differs from my earlier analysis where the benefits were similar but the costs were described as the risk of betrayal or disappointment. In this economic analysis, the legal sanction is regarded as the principal incentive to perform contracts. This

[51] Macaulay, S., 'Long-Term Continuing Relations: The American Experience Regulating Dealerships and Franchises', in C. Joerges (ed.), *Franchising and the Law*, (Baden Baden: Nomos, 1991) 179, 189.

potential cost is treated as the full measure of the cost of betrayal or disappointment. In effect, the legal sanction is regarded as a reliable proxy for the potential costs of entering contracts. The precise measure of the legal sanction then becomes the main focus of enquiry, for the aim is to achieve a legal sanction that secures an efficient level of performance of contracts, by which is understood a pattern of benefits exceeding costs. This economic analysis generates two powerful insights.

The first insight is that the general wealth of the community will be increased if 'efficient breach' of contract is permitted. Although in general full performance of contracts according to expectations will produce the most benefit for the parties at the least cost, in some instances the legal system must tolerate default as the most wealth enhancing outcome. An efficient breach of contract (by the Pareto standard) occurs where default leaves neither party worse off once compensation has been paid, and leaves at least one party better off than would have occurred as a consequence of performance of the contract. From this analysis it can be inferred that according to the regulatory policy of efficiency the law should not seek to compel performance of contracts where a party decides to breach and pay compensation after a suitable cost/benefit calculation. This conclusion rules out the possibility of remedies of compulsory performance, such as injunctions and orders of specific performance, and also indicates that punitive damages should not generally be permitted.[52]

The second insight generated by this economic analysis suggests that the purpose of the legal sanction should be to ensure that neither party is worse off as a result of the breach of contract, so that the remedy should match that loss exactly. This criterion produces a complex (and controversial) formulation for the measurement of compensatory damages including wasted expenditure, the cost of irretrievable investments, opportunity costs, and so forth. This formula rules out the possibility of other kinds of considerations being employed to augment or reduce damages, such as a concern for the redistribution of wealth, the furthering of regulatory objectives of deterring sharp practices, or the protection of vulnerable or socially excluded groups in society. In short, efficient levels of sanctions, judged by reference to the net wealth of the parties to the transaction and ignoring all other considerations (by dubbing them as externalities) favour the private law compensatory remedy.

What importance should be attached to this economic analysis? It is interesting that it conforms quite closely to the conclusions reached by legal doctrine, though the occasional discordance such as orders for

[52] Posner, R., *Economic Analysis of Law*, 4th edn. (Boston: Little Brown, 1992) 131; criticized in Atiyah, P., *Essays on Contract* (Oxford: Clarendon Press, 1990) 131; Friedman, D., 'The Efficient Breach Fallacy', *Journal of Legal Studies* 18 (1989) 1.

specific performance and awards of punitive damages, which are the obsession of economic analysis,[53] provide interesting clues as to the greater sophistication and complexity of legal reasoning than the simple economic models. But if the hypothetical cost/benefit analysis about legal sanctions only rarely occurs in practice, so that what guides the behaviour of the parties is more likely to be the norms of trust in a business relation and consideration of potential non-legal sanctions, then surely the economic analysis sends us down a blind alley. The legal sanction cannot be regarded as an accurate proxy for the costs of entering transactions, that is, the costs of betrayal or disappointment, since the most important sanctions will be contained in the non-legal remedies and the realization of security. In the case of requirements contracts, for instance, it did not matter that there was no legal sanction at all, and therefore no legal costs at risk in entering contracts, for the important sanctions were the non-legal sanctions of a refusal to trade in the future combined with damage to business reputation. The businesses were uninterested in the legal position because they had to hand the more powerful sanction of the capacity to wreck the other's business.

It is possible to rescue this style of economic analysis in part by broadening its hypothetical cost/benefit analysis to include non-legal sanctions. If, for example, the most powerful threat and the most substantial cost of breach consists in the risk that the injured party will refuse to trade in the future with this contracting partner, then it might be argued that the parties have chosen to support their transaction by this economic incentive rather than the possibility of any legal sanction, so that a court should decline to impose a legal sanction. This analysis might justify, for instance, a legal rule which declined to enforce requirements contracts, even though they are routine business transactions, since the non-legal sanctions or incentives are generally sufficient to ensure that the parties abide by their arrangement. The economic analysis might also suggest that the legal sanction should be employed where the expectation that non-legal sanctions would be effective to ensure performance of the contracts turns out to be unfounded or the result of a miscalculation.[54] Here the role of legal sanctions is to supply what the parties believed was already present in their transaction, that is, adequate economic incentives to minimize the risk of disappointment.

[53] Goetz, C., and Scott, R., 'Liquidated Damages, Penalties and the Just Compensation Principle', *Columbia Law Review* 77 (1977) 55; Rea, S.,'Efficiency Implications of Penalties and Liquidated Damages', *Journal of Legal Studies* 13 (1984) 147; Clarkson, K., *et al.*, 'Liquidated Damages v Penalties: Sense or Nonsense', *Wisconsin Law Review* (1978) 351; Kronman, A.T., 'Specific Performance', *University of Chicago Law Review* 45 (1978) 351; Schwartz, A., 'The Case for Specific Performance', *Yale Law Journal* 89 (1979) 271.

[54] Charney, D., Nonlegal Sanctions in Commercial Relationships', *Harvard Law Review* 104 (1990) 373.

Yet this style of economic analysis still seems to misunderstand how contractual relations are constructed. The model views legal and non-legal sanctions as the punishment to be applied in the event of default. But in the construction of market relations, the non-legal sanctions supply more than a threat of punishment. They serve as signals as to the credibility of the commitment, the trustworthiness of the parties. In the case of franchises, the cost of sunk investments for both parties establishes their good faith in the intention to co-operate to bring the business relation to fruition. Without such a signal, the parties would be unwilling to enter into the contract at all, even if adequate legal sanctions were available to compensate for any losses resulting from breach. The form of economic analysis which emphasizes the significance of such incentive structures, signals, and investments in the construction of markets is known as 'institutional economics'.[55]

Institutional economics grasps better the point that the incentive structures of contracts, the devices for establishing the credibility of commitments such as hostages and sunk investments, and the techniques for sustaining co-operation such as governance structures, should not be regarded as sources of potential sanctions, but rather the basis on which the parties achieve the necessary degree of trust for entry into contractual relations. The risks of disappointment or betrayal are not countered typically by the display of even more threatening sanctions, but rather the parties to the contract seek to minimize the perception of those risks in order to induce beneficial contractual relations.

That is not to say that the possibility of obtaining financial compensation for breach of contract will never assist in the construction of markets. But we should be cautious in assuming that it is the legal sanction or a payment equivalent to the measure of legal damages that supplies this incentive towards performance of undertakings. In studies of informal settlements of commercial disputes, we discover that it is rare that the compensation demanded or expected amounts to the legal entitlement. The informal settlement rather focuses upon such items as wasted expenditure in carrying out an order and rarely considers the dimension of loss of profits.[56] The preference is for a settlement under which no money changes hands, and in which compensation takes the form of credit on future transactions.[57] We should infer from this evidence that even where the

[55] For an overview: Wiggins, S. N., 'The Economics of the Firm and Contracts: A Selective Survey', *Journal of Institutional and Theoretical Economics* 147 (1991) 603; Goldberg, V. P., *Readings in the Economics of Contract Law* (Cambridge: Cambridge University Press, 1989).

[56] Comment, 'The Statute of Frauds and the Business Community: A Re-Appraisal in Light of Prevailing Practices', *Yale Law Journal* 66 (1957) 1038, 1061–2.

[57] Beale, H., and Dugdale, T., 'Contracts between Businessmen: Planning and the Use of Contractual Remedies', *British Journal of Law and Society* 2 (1975) 45.

potential imposition of a financial penalty helps to constitute the market relation, the legal sanction remains insignificant because it does not guide or determine expectations with respect to the amount or form of compensation payable. Thus the assumption of some economic analysis of contract law that the measure of the legal sanction determines the level of incentives for performance of contracts, as in the theory of efficient breach, seems to bear little relation to the actual practice of commercial parties, for whom the expected measure of compensation is often much lower.

We should therefore sustain our argument that legal sanctions play only a minor role in the constitution of markets. The insights provided by the Chicago school of economic analysis should be limited to their contribution to the design of a strategy for regulating markets. They reveal that private law remedies correspond closely to a particular policy of securing the efficiency of markets. We then have to weigh up this regulatory policy against other concerns, such as the exclusion of traders who routinely employ deceptive practices, which may suggest other kinds of deterrent remedies. But in the design of legal regulation of markets more generally, the more important objective must be to establish conditions, facilities, and legal institutions that permit the making of credible commitments and the construction of trust between the parties.

The place of legal sanction in that objective appears deeply ambiguous. Here we encounter the paradoxical relation between trust and legal sanctions. On the one hand, the presence of a readily accessible powerful system for imposing sanctions against contractual default can certainly contribute to the establishment of trust between parties. The depiction of a market without a state by Keith Hart, with its tactics of bullying, humiliation, and the experience of frequent disappointment, suggests that in contrast markets with state sanctions can contribute to an environment of trust. Within a market with an effective legal system, the possibility of binding oneself to legal sanctions will certainly assist new businesses without a trade reputation to encourage trust in their promises. On the other hand, it is apparent from studies by Macaulay,[58] and Beale and Dugdale,[59] amongst others, that the invocation of legal sanctions, the threat to sue for breach of contract, can rapidly displace norms of trust and co-operation and replace them with antagonistic self-interested assertions of rights. The vulnerability to the imposition of state sanctions for breach of contract assists in establishing the credibility of the commitment and constructs a source of trust, but once the legal process is invoked by either party, the reliance upon trust is fractured and displaced by contractual reasoning about rights to legal sanctions or the invocation of non-legal sanctions.

[58] Macaulay, S., n. 16 above, 45.

[59] Beale, H., and Dugdale, T., n. 57 above.

Once we recognize that the parties to a contract are unlikely to wish to pursue legal sanctions even in the event of breach of contract, then we can also appreciate that they will pay little attention to the question of whether the agreement is legally enforceable in the first place. What is far more important is whether or not the other party is perceived as trustworthy. If there is trust, then the parties will not wish to displace this by an insistence upon securing a legally enforceable transaction with its implicit threat of legal sanctions for disappointment. Legal enforceability will only become a matter of concern when trust is absent and there are no clear incentives (non-legal sanctions) for fulfilment of expectations. For example, in an American study of whether manufacturers in Connecticut complied with the requirement for contracts of sale to be in writing, the survey found that manufacturers only insisted upon written contracts or acknowledgements when either the customer was unknown from prior dealings, or the manufacturer 'lacked confidence in the customer's integrity'.[60] The legal sanction was plainly insignificant in this commercial context:

> Since almost all the manufacturers never resort to litigation as a method of resolving their disputes, and since all but a handful usually either seek no compensation at all or are satisfied to settle for less than their legal right of recovery, the legal enforceability of the promises of the parties with whom they deal apparently means little to them.[61]

The Adjudication Process

Another common mistake of some types of economic analysis is to confine an examination of the role of law in markets to the application of legal sanctions. Although the application of a state sanction provides the occasional dramatic conclusion of the legal process, the more pervasive effect of the legal system in steering social behaviour derives from the dissemination of its legal reasoning into other communication systems. This impact concerns how the law thinks about issues, how it expresses its reasoning, and the place in which these ideas are propounded.

During the legal process regarding a contractual dispute, the legal system provides a system of reasoning which selects information about the events which have occurred. Legal reasoning, as we have discussed in Chapter 3, is closed in the sense that it gathers information selectively, regarding much as irrelevant and some points as crucial. The reasoning occurs ultimately in a court setting. The court provides an authoritative statement of what has happened. This statement is usually regarded by the community as reliable, as fact, as truth. Moreover, it is a public statement,

[60] Comment, n. 56 above, 1054.

[61] Ibid. 1062.

which can be heard and acted upon by all members of the trading community.

These features of the legal process become especially important when the constitution of a market depends heavily upon business reputation as a source of trust. A judicial determination that a person has broken a contract transforms the position from one of murky mutual recrimination and rumour to one of an authoritative declaration of untrustworthiness. Members of the community will then adopt the typical non-legal sanctions of refusal to trade with the merchant whose reputation has been so damaged. In this context, it is not the legal sanction which serves the purpose of providing incentives to fulfil undertakings, but the court's declaration of right and wrong. In other words, the court serves the function of collecting and disseminating what participants in the market regard as reliable information about trustworthiness.[62]

This function of the legal process need not be performed by an institution which possesses all the trappings and powers of a modern court. What is required is rather a body that is respected by the trading community as an impartial and reliable finder of fact or truth. This body could be a committee of a trading association, such as a medieval guild, an arbitrator, or an Ombudsman charged with the role of consumer watchdog. In particular, the body does not require the power to impose effective sanctions itself. Its influence upon contractual behaviour stems instead from the independent reactions of participants in the market to its authoritative judgements about business reputation. In game theory this institution is therefore described as a 'reputation mechanism', for in the case of repeated games (transactions) where the individual cannot enforce the contract, a reputation mechanism which observes behaviour and confers good and bad business reputations for compliance with contracts can be used to help to establish a credible commitment not to cheat on a particular transaction.[63] During medieval times, for instance, many international trade fairs held their own courts, such as the Champagne courts. The courts had no real power to impose a sanction against traders found to be in default, for the merchants came from all over Europe and might be only intermittent traders at the fairs. Nevertheless the courts were respected as arbiters of truth, so that a judgement against a trader either had to be met expeditiously and publicly, or that trader would be ostracized and excluded by the private actions of other merchants. The

[62] Bendor, J., and Mookherjee, D., 'Norms, Third-party Sanctions, and Co-operation', *Journal of Law, Economics & Organization* 6 (1990) 33.

[63] Clay, K., 'Trade Without Law: Private-Order Institutions in Mexican California', *Journal of Law, Economics and Organization* 13 (1997) 202.

court's pronouncement activated a multilateral reputation mechanism amongst all traders.[64]

The legal process, or equivalent types of umpires, can therefore play an important role in creating trust in markets and facilitating the application of non-legal sanctions, without ever invoking the power to impose legal sanctions. It is this adjudication mechanism that may be the most important contribution of the legal system to the construction of markets. Even so, it is not an indispensable mechanism, for alternatives to legal adjudication can provide an equivalent service. Furthermore, trading can take place without any such mechanism at all. We noticed in connection with Walker-Thomas Furniture Co. that the company took considerable steps to avoid customers resorting to any such authoritative mechanism so that it retained the power to insist upon its own version of when it had breached its obligations. As long as the customers retained trust in the sales representatives, they were prepared to accept these unilateral determinations of right.

Conclusion

This chapter has addressed the large question of the contribution of law to the construction of markets. We shall return to this theme several times. In the next chapter, we examine in closer detail the determinants of the behaviour of individuals in contractual relations, which throws further light on how the legal system interacts with the social practice of entering transactions. Later chapters include studies of the role of lawyers, the importance of markets constructed without the state in modern economies, and the optimal form of legal regulation. At this stage, however, we can reach some tentative conclusions.

Markets are comprised of patterns of entry into transactions by individuals. They choose to do so where the perceived benefits of the transaction outweigh the perceived risks of disappointment or betrayal. When transactions take place, the risks of disappointment or betrayal have not been eliminated, but they have been displaced, so that they no longer present a formidable obstacle to trade. Displacement occurs when the parties have a relation of trust based upon either a personal relation or a business reputation. Much activity in relation to contracts should be understood as creating the conditions under which this trust can be established. To make a commitment credible, a party may have to demonstrate that a valuable business reputation is at stake, or that investments will be lost.

64 Milgrom, P. R., *et al.*, 'The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs', *Economics and Politics* 2 (1990) 1.

Alternatively, the parties can construct non-legal sanctions or security, so that the evident risk of loss from betrayal or disappointment is heightened, the commitment becomes more tangible, and the contract becomes effectively self-enforcing.

Aside from the construction of the normative system of property rights that is presupposed in all trading activity, the legal system makes a marginal contribution to this construction of markets. Legal sanctions rarely make a significant contribution to the construction of trust, and the invocation of the legal process can often damage perceptions of trust-worthiness. Legal adjudication, on the other hand, like other systems of authoritative determinations of right, can contribute to the construction of trust by providing an ingredient in the enforcing of non-legal sanctions regarding business reputations. Contrary to many assumptions in political theory and classic sociological thought, the enforcement mechanism provided by the state seems to be a dispensable element in the construction of markets, as illustrated by the many examples of markets without a state.