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“Should Courts Always Enforce What Contracting Parties Write”

by

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Should Courts Always Enforce What Contracting Parties Write?*

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Abstract. We find an economic rationale for the common sense answer to the question in our title — courts should *not* always enforce what the contracting parties write.

We describe and analyze a contractual environment that allows a role for an active court. An active court can improve on the outcome that the parties would achieve without it. The institutional role of the court is to maximize the parties' welfare under a veil of ignorance.

We study a buyer-seller model with risk-neutral agents and asymmetric information. The court must decide when to uphold a contract and when to void it.

The parties know their private information at the time of contracting, and this drives a wedge between ex-ante and interim-efficient contracts. In particular, if the court enforces all contracts, inefficient pooling obtains in equilibrium. By voiding some contracts the court is able to induce them to separate, and hence improve ex-ante welfare.

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1. Introduction

Courts are active players in contractual relationships between economic agents. They routinely intervene in contractual disputes, excusing performance called for in the contract because of intervening events. Yet, in most of modern economic theory courts are treated (often not even modeled, but left in the background) as passive enforcers of the will of the parties embodied in their contractual agreements.

This simplistic view of the role of courts stems from the fact that in a world with complete contracts, to behave as a passive enforcer is clearly the best that a court that is interested in maximizing contracting parties' welfare can do. In the "classical" world of modern economic theory, contracts *are* complete.

In a world in which complete contracts are not feasible it is no longer obvious that a court should be a passive enforcer, and in fact it is no longer true. For example, the contracting parties may face some uninsurable risk and the court may improve their welfare if it is able to use some information available ex-post and excuse performance in some eventualities.¹

Once the way for an active court is open, a host of related questions naturally arise. The aim of this paper is to address the following one. Suppose that the court *cannot* condition (ex-ante or ex-post) on any variable that cannot be contracted on by the parties themselves. Is it then the case that the court's intervention can play any welfare-enhancing role?

The answer to the question above is "yes" if the parties are asymmetrically informed at the time they contract and the court maximizes their ex-ante welfare, that is, their expected welfare *before* either party gets information not available to the other. Asymmetry in the parties' information at the time they contract can lead to a "lemons-like" situation in which adverse selection leads to inefficient contracts. Courts that do not simply enforce contracts as they are written can sometimes ameliorate the inefficiency that results from asymmetric information.

We provide an example in which this is indeed the case. We also derive the optimal

¹This is the case, for example, in Anderlini, Felli, and Postlewaite (2007).

decision rule for an active welfare-maximizing court. This rule implies that the court in equilibrium voids contracts that the contracting parties, at the contracting stage, would like the court to enforce.

The potential benefit of a court's voiding explicit contractual clauses stems from asymmetry of information between the parties at the time they contract. Because of asymmetric information, when the court does not intervene, inefficient trades may take place. This is because in the absence of court's intervention the contracting party that does have private information may have an incentive not to disclose it. This will force the other party to accept the contract while still uninformed possibly luring him into an inefficient trade. In other words, in equilibrium some (inefficient) pooling may obtain. By intervening and voiding some contractual clauses, the court may be able to negate the incentives for the informed party to hide his private information, thus making the pooling no longer profitable for him. In other words, voiding contracts in some cases will decrease the expected gain from withholding private information, thereby promoting disclosure and hence increasing ex-ante welfare.² In the example below court's intervention takes the form of voiding *extreme contracts*: trading contracts that specify exceedingly high prices.

The view that courts should maximize ex-ante welfare is a compelling one. If the parties were able to meet at the ex-ante stage (when they are symmetrically informed), agreements could be reached that circumvent inefficiencies that are unavoidable at the interim stage when the parties have private information. A court that maximizes ex-ante expected welfare will choose the same contingent rules of behavior as the parties would have chosen at that stage, had it been possible. In other words, if the parties *could* meet at that point, they might *instruct* the court to void some contracts they might subsequently write. They will do this precisely because the parties will understand that while they may regret this in some circumstances, it may promote the disclosure of private information and in expectation they will be better off. The problem that the court is solving is that the parties are often *unable* to meet before the

²In our example below the court's intervention is not just welfare-enhancing; it achieves the actual first best. Obviously, this need not be the case in general. For example, in Anderlini, Felli, and Postlewaite (2007) the court's intervention is welfare-enhancing, but does not achieve the first best.

arrival of their private information. In other words, a court that maximizes ex-ante welfare acts as a *commitment* device that remedies the parties' inability to contract at the ex-ante stage.

We model the court as a "Stackelberg leader." Before any uncertainty is realized and any contracts are drawn up, the court publicly announces the rules that it will follow to settle a possible dispute. Courts do not in actuality commit to the rules by which disputes will be settled; instead, courts decide after they know the details of the dispute. Nevertheless, over time the accumulated decisions that courts have made in a broad array of cases creates a set of precedents that shape how future disputes will be settled. The rule of precedents (*stare decisis*) guarantees that a court, when asked to rule on a dispute is bound, at least to some extent, by the ruling implied by the accumulated precedents.³ Rather than model this gradual evolution of the way contractual disputes are resolved we treat the court as choosing, once and for all, an optimal rule.⁴

Our aim is not to suggest that there is an easy rule that courts can apply to void particular contracts that come before them. Indeed, in the example below, a court would need substantial detail of the parties' circumstances to know precisely when contractual performance should be excused. Rather, the central point is that there *are* circumstances in which voiding contracts that parties would like the court to uphold can be welfare enhancing.

1.1. *The Role of Courts in Promoting Disclosure of Information*

Our aim is to highlight how the rules that courts use in adjudicating contractual issues can potentially increase the information available to contracting parties, and

³The definition of *stare decisis* from the Wex on-line legal dictionary and encyclopedia at the Law School of Cornell University, (http://www.law.cornell.edu/wex/index.php/Stare_decisis) reads as follows: "Latin for 'to stand by things decided.' *Stare decisis* is essentially the doctrine of precedent. Courts cite to *stare decisis* when an issue has been previously brought to the court and a ruling already issued. Generally, courts will adhere to the previous ruling, though this is not universally true."

⁴See Anderlini, Felli, and Riboni (2008) for a paper that explicitly models the dynamic evolution of precedents and its implications for the efficiency of court rulings.

consequently, affect the parties welfare. Historically, courts have had an interest in promoting disclosure of information at least since the English case of *Hadley vs. Baxendale* in 1854.⁵ The court held in that case that a defendant who breached a contract was liable only for damages that might reasonably have arisen given the known facts rather than the higher damages that were actually suffered because of circumstances known only to the plaintiff. As argued in Adler (1999), the limitation on damages implicit in the *Hadley* rule is a default that is often viewed as promoting disclosure: “A party who will suffer exceptional damages from breach need only communicate her situation in advance and gain assent to allowance so that the damages are unmistakably in the contemplation of both parties’ at the time of contract.”⁶ The discussion of the role of courts in promoting information disclosure, to our knowledge, focusses primarily on the benefit of disclosure to the contracting parties. In the absence of disclosure, resources will be wasted in writing needless waiver clauses and inefficient precaution.

Courts will have an interest in promoting disclosure of information in our model, but for a very different reason, and with very different consequences. Courts will affect the amount of information that is revealed by informed parties through their treatment of contracts that reveal little information. While contracts may reveal little information simply because the parties *have* little information, courts will treat such contracts more harshly than they otherwise might because of the incentive effects such treatment will have on informed parties. Those with relevant information will reveal it in order that courts will more likely enforce the agreements that are made. Thus, courts are not examining a contract brought before them solely to uncover the parties’ intent. They also take into consideration how the treatment of the contract will affect contracting parties different from the parties before them but affected by the court’s ruling via precedents.

In this paper, the Court achieves its goal of enhancing efficiency by means of “mandatory” or “immutable” rules. These are rules that the contracting parties

⁵ 9 Exch. 341, 156 Eng. Rep. 145. (Court of Exchequer, 1854).

⁶See also Ayres and Gertner (1989) and Bebchuk and Shavell (1991) for a discussion of the *Hadley* rule and it’s role in promoting disclosure of information. See Maskin (2006) for a critical view.

cannot modify at the negotiation stage. These rules need to be mandatory given the conflict of interest, described above, between the objectives of the parties at the contracting stage and the court's objectives. The discussion of Hadley vs. Baxendale, on the other hand, has mainly focused on the use of "default" rules, rules that apply only in the absence of explicit contractual provisions by the parties.

1.2. Related Literature

There is a growing literature that explicitly models the role of courts in contractual relationships. In a moral-hazard set-up, Bond (2007) analyzes optimal contracting between parties when judges can impose an outcome other than the contracted outcome in exchange for a bribe. Bond shows that in a simple agency model, this possibility will make the contracting parties less likely to employ high-powered contracts. Usman (2002) also focuses on a moral-hazard environment. He lays out a model in which contracts contain variables that are not observable to courts unless a rational and self-interested judge exerts costly effort. His analysis concentrates on contracting behavior and the incentive to breach when judges value the correct ruling but dislike effort. Levy (2005) analyzes the trade-off that arises when the judge in ruling on a dispute is, at the same time, trying to influence the perception of the public (or an evaluator) about his own ability. This trade-off can induce the judge to distort his decision to avoid his decision being appealed and possibly reversed.

The courts in these papers are governed by a judge who maximizes his or her personal utility. In contrast to these papers, there is a literature that analyzes courts that maximize the expected welfare of the contracting parties. Posner (1998) analyzes whether a court should consider information extrinsic to the contract in interpreting the contract. Closer to the current paper, Ayres and Gertner (1989) and Bebchuk and Shavell (1991) analyze the degree to which courts' interpretation of contracts affect incentives to reveal private information. The focus of this work is the effect of different court rules regarding damages for breach of contract on the incentives for parties to disclose information regarding the costs of breach at the time of contracting. Shavell (2006) presents a general examination of the role of courts in interpreting contracts.

The present paper analyzes the role of a welfare-maximizing court that can affect the type of contracts that are written by excusing performance (voiding the contract) in some circumstances. The possibility of welfare improvements are a consequence of the effect of the court's rules for enforcing contracts on the parties' incentives to reveal private information. Our paper differs from Ayres and Gertner (1989), and Bebchuk and Shavell (1991) in that we focus on the externality that informed contracting parties may impose on uninformed contracting parties, which is absent from these papers. In fact in both of these contributions, the welfare gains from information disclosure stem from the fact that once information is disclosed a different *action* can be implemented by one of the contracting parties.⁷ By contrast, in this paper, failure to disclose leads to a transaction with negative surplus being executed which is to the advantage of the "bad type" of one of the contracting sides (seller), but decreases overall welfare at the same time.

In various different contexts, several papers have made the point that in the presence of asymmetric information inefficiency may arise Aghion and Hermalin (1990), Hammond (2005), Spier (1992). These papers show that cream skimming (Hammond, 2005) and in general, the incentive to signal private information can yield inefficient (and possibly incomplete) contracts (Spier, 1992) and hence welfare can be enhanced by limiting (by means of the law or regulations) these signalling possibilities (Aghion and Hermalin, 1990). Our paper differs from this branch of the literature in that in our environment the inefficiencies arise because of the *lack* of disclosure of private information, rather than a tendency to inefficiency-generating signaling. Our Court, by not enforcing certain contracts, may enhance ex-ante efficiency by facilitating and not hampering the disclosure of private information.

A paper that similarly addresses the role of a court in dealing with contractual issues is Schwartz and Scott (2003). In that paper the authors advocate a Commercial Law that differs from current US arrangements in three main respects. When disciplining trade between sophisticated parties in the absence of any externalities,

⁷In both cases, this is the level of effort of one of the parties; specifically the level of "care" exercised by Baxendale in *Hadley vs. Baxendale* — see footnote 5 above.

Commercial Law should limit considerably the use of default rules (rules that apply in the absence of explicit prescriptions by the contracting parties). The rationale for this prescription is that general default rules simply increase the transaction costs faced by the sophisticated contracting parties. Moreover, Contract Law should limit any ambiguities in the way contractual clauses are enforced, and therefore minimize the chances of having to resort to a Court’s (uncertain) interpretation of existing rules. Finally, Commercial law should specify no “mandatory” or “immutable” rules that the parties cannot change.

Clearly the prescriptions in Schwartz and Scott (2003) differ substantially from the conclusions we draw in this paper. In the environment we describe, in the presence of sophisticated but asymmetrically informed parties mandatory rules are desirable; they are welfare enhancing.

2. A Simple Example

2.1. Basics

Our central point can be made via a simple example.⁸ There are a buyer \mathcal{B} and a seller \mathcal{S} , with a single indivisible object (a “widget”) potentially available for trade.

The seller has private information at the time of contracting. He knows his type, which can be either $b(ad)$ or $g(ood)$. Each type is equally likely, and the buyer does *not* know \mathcal{S} ’s type.

Depending on \mathcal{S} ’s type the value and cost of the widget are either v_b and c_b or v_g and c_g respectively. A seller of type b is “bad news” in two ways. First, the cost of the widget is higher. Second, while the surplus for a good seller is positive, it is *negative* when the seller is bad. In other words, we assume that

$$c_g < c_b \quad \text{and} \quad v_b - c_b < 0 < v_g - c_g \quad (1)$$

⁸We are grateful to an anonymous referee of this journal for suggesting that a set up as simple as the one we use here suffices for our main point. We refer the interested reader to our working paper (Anderlini, Felli, and Postlewaite, 2006) for a richer model that allows some additional points to be brought to the fore. In particular, our set up here does not allow us to focus on the possibility that an *ambiguous* Court may also be welfare improving. We return to this point in Section 3 below.

To make the model interesting we also assume that

$$\frac{v_b + v_g}{2} > c_b \quad (2)$$

which of course — together with (1) — implies that expected surplus is positive.

The informed seller makes a take-it-or-leave-it offer of a price p to the uninformed buyer.⁹ The buyer then accepts or rejects. If the offer is rejected both earn a payoff of zero.

2.2. Courts

As we mentioned above, our courts are Stackelberg leaders. They announce which contracts will be enforced and which will be voided. To see specifically what effects a voiding rule will have on the equilibrium of the model, we need to specify the — off-path as it turns out — payoffs associated with contracts that the court will void.

Suppose that the seller offers a contract that the court has announced it will void, possibly with a buyer who accepts the offer. What are the correct payoffs to the parties in this case? Obviously there is considerable latitude in specifying these values. One could imagine penalties for offering and/or accepting the contract. Or a seller who winds up with positive probability delivering the widget — and thus incurring the cost — but, not having recourse to a court, unable to exact the payment from the buyer. Further, we could imagine relationship specific ex-ante investments that are not recouped once the contract is voided and renegotiation takes place.¹⁰

⁹Extreme bargaining power in favor of the informed seller greatly simplifies the analysis. Results with the same flavor can easily be obtained in situations with intermediate bargaining power. What seems important is that the bargaining power should not reside entirely with the uninformed side.

¹⁰As in Anderlini, Felli, and Postlewaite (2006) a relationship-specific ex-ante investment could yield no trade when the court voids the contractual agreement. Assume, for simplicity, that while the seller has all the bargaining power at an ex-ante stage if the contract is voided and parties trade ex-post the bargaining power shifts to the buyer. Then postulate a relationship-specific investment stage in which the informed seller can invest or not, with the trade surplus vanishing if \mathcal{S} does not invest. If the contract is voided by the court, the parties then enter a renegotiation stage in which the buyer has all the bargaining power so he makes a take-it-or-leave-it offer to the seller. This clearly will expropriate the seller of any surplus (his investment is sunk at that stage) implying that if the seller expects the court to void the contract he will not invest and hence trade will not occur. We

Our results below are robust to the precise specification of payoffs associated with a voided contract. They remain true provided that offering a contract that is accepted and then voided by the court is no better than no transaction at all as far as the seller is concerned. In other words, it is sufficient that somehow a contract that is voided by the court prevents trade from taking place.

2.3. *Equilibrium With A Passive Court*

As we suggested above, when all contracts are enforced inefficient pooling can obtain in equilibrium. When the value of the good widget, v_g , is sufficiently high, there will typically be multiple pooling equilibria in which both types of seller offer the same price. When the seller types pool, the buyer will not know which type of widget is being offered, and will value it at the average of the values of the good and bad widget. As long as the price offered by the seller is below this average value, the buyer will accept the offer. The optimal pooling contract for the seller is than one in which the price at which the widget is offered, p , is the average value: $(v_g + v_b)/2$, since any offer at a higher price will be rejected.

There may also exist a separating equilibrium in which the two types of seller offer different prices, $p_g \neq p_b$ and in doing so they reveal their type. When the prices offered by the two types of seller differ, the buyer will not accept the offer at price p_b if $p_b > v_b$. Since $v_b < c_b$, any price p_b at which the buyer would be willing to buy would result in a loss for the seller. Hence, for there to be a separating equilibrium with different prices offered by the two types of sellers, the buyer must reject the offer from the bad seller, which results in a payoff of 0 to that seller. This can be optimal for the bad seller if $p_g \leq c_b$; in this case, the price offered by the good seller is less than or equal to the cost of the bad seller, and consequently the bad seller cannot gain by offering the good seller's price p_g . We have assumed that $c_g < c_b$, so there can be separating equilibria in which the two types offer prices $p_g \neq p_b$, $p_g \in [c_g, c_b]$, with the buyer accepting the offer at p_g and rejecting the offer at p_b .¹¹

do not make explicit the formalities of this "addition" to the model since they are straightforward and do not add much to the intuitive outline we have just given here.

¹¹If the buyer's beliefs are that prices other than p_b and p_g are offered by a bad seller, offers at

The payoff is 0 to the bad seller in any separating equilibrium, while the payoff to the good seller in any separating equilibrium is obviously highest when $p_g = c_b$. If $(v_g + v_b)/2 > c_b$, the optimal pooling equilibrium described above is the best possible equilibrium for both types of seller. We summarize this argument in the following proposition.

Proposition 1. *Equilibrium with a Passive Court: Suppose the court enforces all contracts. For v_b sufficiently large, there is a unique equilibrium that is optimal for both types of seller in which they pool in offering to trade at the same price $p = (v_b + v_g)/2$.¹²*

A pooling equilibrium in which the buyer is accepting the offer from both types of seller is clearly inefficient. The expected surplus in this case is equal to

$$\mathcal{W}_P = \frac{v_b - c_b + v_g - c_g}{2} \quad (3)$$

which, by (1) is obviously lower than what expected surplus would be in a first best scenario in which trade takes place if and only if \mathcal{S} is of type g . In this case, expected surplus would be

$$\mathcal{W}_F = \frac{v_g - c_g}{2} \quad (4)$$

2.4. Equilibrium With An Active Court

We now consider a court that actively intervenes and voids some contracts. In so doing the court will be able to induce separation between the two types of seller and increase expected welfare. The court can adopt a simple policy of voiding “extreme” contracts by imposing a price cap. This will rule out the range of prices at which the bad seller wants to pool, thus forcing separation, and hence preventing the sale from

these prices will be rejected.

¹²We focus on the equilibrium in this example that is optimal for both types of seller because it is eminently plausible. We should note, however, that it is the *unique equilibrium* in this example that satisfies the undefeated refinement criterion. (See Mailath, Okuno-Fujiwara, and Postlewaite (1993)).

taking place when the seller is bad. This, as we remarked above, will raise expected surplus from $\mathcal{W}_{\mathcal{P}}$, as in (3), to $\mathcal{W}_{\mathcal{F}}$, as in (4).

Proposition 2. *Equilibrium with an Active Court:* Suppose that the court announces that it will void all contracts with a price p exceeding some price cap \bar{p} such that $c_g \leq \bar{p} < \min\{v_g, c_b\}$. Then there is a unique equilibrium payoff that weakly Pareto dominates all other equilibrium payoffs for both types of seller. This payoff is obtained when the two types of seller separate: the good seller offers a price \bar{p} and the bad seller does not transact.

Suppose that we have a pooling equilibrium at an offered price $p = p_b = p_g \leq \bar{p}$. Since $\bar{p} < c_b$, the bad seller will have a negative payoff if the offer is accepted. He can do better by not trading, which he can accomplish by setting a sufficiently high price. Hence, the only possibility of a pooling equilibrium at which \bar{p} is offered by both types of seller must involve the buyer refusing.

There will be separating equilibria in which the good seller announces a price $p_g \in (c_g, \bar{p}]$ and the bad seller does not trade (say, but announcing a price $p_b > v_g$).¹³ Since $p_g > c_g$ assures that the good seller has a positive payoff at this price, $p_g \leq \bar{p}$ guarantees both that the seller will accept the offer and the court will not void the contract, and $p_g \leq c_g$ assures that the bad seller cannot get a positive payoff by replicating the good seller's offer.

Thus, when the court uses this rule to void contracts, the bad seller cannot obtain a positive payoff at any equilibrium. The unique equilibrium payoff that weakly Pareto dominates all other equilibrium payoffs entails the good seller setting $p_g = \bar{p}$ and the bad seller not trading.

3. Conclusion

When contracting parties are asymmetrically informed a benevolent court, that maximizes the parties' ex-ante welfare, can enhance efficiency by voiding certain aspects of the contract that the parties at the negotiation stage would like the court to uphold.

¹³We assume that any other offered price is believed to come from the bad seller.

In particular, our example above shows that the court can accomplish this by voiding *extreme contracts*: trading contracts that specify very high prices.

In a more general setting the welfare enhancing role of the court can take different forms of intervention. For example in Anderlini, Felli, and Postlewaite (2006) the court can enhance efficiency by voiding the trade of a specific widget whatever the specified price. Moreover, efficiency can be further increased if this court's intervention does not occur with certainty. In other, words the incentives of the informed party to reveal his private information at the negotiation stage is enhanced by the mere possibility (but not necessarily the certainty) of the court's intervention. In Anderlini, Felli, and Postlewaite (2006) this is achieved by the court committing, at the ex-ante stage, to randomize with a given probability between voiding and upholding the trade of a given widget. The randomizing behavior of a court may appear at first glance an unrealistic one. We do not think so. Indeed, for the purpose of creating the right incentives to the parties to disclose the relevant private information it is enough that the existing body of precedents is ambiguous enough to lead the parties to believe that the relevant aspect of the contract will be voided by the court with the desired probability. It is undeniable that in reality laws and the body of precedents are sufficiently ambiguous in many cases.

Our main result (Propositions 1 and 2) can be viewed as identifying a kind of "second best" phenomenon in an incomplete contract world. We start with a model in which some degree of contractual incompleteness is assumed (the costs and values of each widget are not verifiable and hence not contractible). In this world it is in fact welfare-improving to *impose* further incompleteness by making some contracts effectively impossible in equilibrium. This is what our active court does. This is similar to the finding in Bernheim and Whinston (1998) that under some conditions, when one assumes that contracts are exogenously coarse, equilibrium contracts may be even coarser than the constraints impose. However, our main result differs from theirs in that it does not assert that contracts will be coarse (or incomplete) in equilibrium. Rather it asserts that *imposing* incompleteness can increase expected welfare.

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