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ENFORCING CONTRACTS IN DYSFUNCTIONAL LEGAL SYSTEMS: THE CLOSE RELATIONSHIP BETWEEN PUBLIC AND PRIVATE ORDERS

A Reply to McMillan and Woodruff

Ariel Porat*

I. INTRODUCTION

When the public order is dysfunctional, a private order for enforcing contracts will develop. In the absence of courts, transactors will seek ways to secure performance without recourse to legal sanctions. Social and economic sanctions imposed on the party in breach, whether by the aggrieved party or by the economic and social community in which both parties operate, replace legal sanctions. These sanctions sometimes arise within a private order functioning spontaneously, as when ongoing contractual relationships prevail between the parties, or when a close-knit economic or social community exists in which information concerning breaches of contract flows freely. In other cases, sanctions will be enforced within an organized private order, in which market intermediaries and trade associations enable information to flow and thereby provide transactors with the security essential for entering contracts. John McMillan and Christopher Woodruff have examined the characteristics of the private order that emerges in response to a dysfunctional public order, and the private order's influence on transactors.¹ Their article relies mainly on em-

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1. See John McMillan & Christopher Woodruff, *Private Order Under Dysfunctional Public Order*, 98 MICH. L. REV. 2421 (2000). Writers differ on the priority of public order over private order. For the view that “the justification for centralized law [which is similar to the “public order” terminology used in these comments] begins with the identification of a failure in the incentive structure of social norms,” see Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1643-44 (1996); Robert D. Cooter, *The Theory of Market Modernization of Law*, 16 INT’L REV. L. & ECON. 141 (1996). For a preference of public order, see Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697 (1996). For a critical comment on both Cooter and Posner, see Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745 (1996). For a preference of private order over public order because the latter produces legitimate and illegitimate rules, while the former generally produces legitimate rules, see Jonathan R. Macey, *Public and Private Ordering and the Pro-*

pirical studies conducted by the authors in Vietnam and in several Eastern European countries. They start with the assertion that, for various reasons, the public order is dysfunctional in these countries, and legal sanctions enacted against the party in breach are therefore ineffective. They examine how private order arises in response to this purported deficiency, and analyze the interaction between public and private orders when both function concurrently. This paper responds to their work by focusing on some of the contours of the relationship between public and private orders.

In the real world, one cannot draw a distinct line between countries where a public order operates and countries where a private one obtains — both orders tend to function in every country, in varying degrees. This occurs because, when enforcing contracts, no public order is ever perfect to the point of making the private order redundant. Indeed, the public order need not be at the brink of collapse in order for a private order to materialize. A private order may emerge even when the public order is only partially dysfunctional, or when dysfunctionality is limited to specific types of transactions. The character of the private order, its scope, and its components, are inextricably related to the reasons leading to the emergence of a private order in the first place. Hence, a comprehensive theory about the emergence of a private order, whether as replacement for or complement to public order, needs to consider the various reasons for the dysfunctionality of the public order, which resulted in the creation of the private order in the first place.

In Part II, I suggest reasons for the dysfunctionality of the public order, and show that dysfunctionality is usually partial. I then examine the relationship between the reasons for the dysfunctionality of the public order and the characteristics of the private order emerging in response; this may be considered a proposal for further empirical research aiming to examine the nature of this relationship.

Since a private order always operates beside the public one, a question arises concerning the interaction between them.² In Part III, I examine how the content of the law operating within the public order might affect the concurrent private order. The law operating within the public order may support the private order, repress it, or, at times, acknowledge its existence but endorse a neutral attitude toward it. At the same time, the private order may also affect, through its own mechanisms, the character and content of the public order. In the course of discussing the interaction between the two orders, I also consider whether, when the court awards damages for breach of con-

duction of Legitimate and Illegitimate Legal Rules, 82 CORNELL L. REV. 1123 (1997). The classic, pioneering work that discusses the advantages of private order is ROBERT C. ELLICKSON, *ORDER WITHOUT LAW* (1991).

2. See McMillan & Woodruff, *supra* note 1, at 2446-55.

tract within the framework of the public order, it should deduct from it the value of the sanction imposed by the private order on the party in breach. I point out the advantages of such a deduction, particularly the efficient incentives it provides to the contractual parties.

I touch briefly on the interaction between the public order and the social networks functioning within the private order in Part IV. I attempt to explain McMillan and Woodruff's finding that social networks constitute a substitute for the public order in the sense that, when the public order is stronger, reliance on social networks lessens.³ Part V provides a brief conclusion.

II. REASONS FOR A DYSFUNCTIONAL PUBLIC ORDER AND THE RESPONSE OF THE PRIVATE ORDER

Parties will consider a public order ideal if the courts (and the enforcers of the courts' decisions) enforce all contracts according to the substantive law preferred by the parties without incurring costs of litigation, with great speed and expertise, without bias, without mistakes, and without the parties incurring damages through litigation proceedings.

No empirical studies seem required to determine that these conditions are never actually present to a perfect degree. Hence, parties to a contract will never view a public order as ideal, and potential transactors will naturally seek ways of overcoming the failings of the public order. Typically, their work takes place at two levels: to amend the flaws of the public order directly, and to develop a private order acting beside, or altogether replacing, the public order.

The reaction of potential transactors depends on the character of the flaws affecting the public order and hindering its functioning. These flaws may be "generalized" — that is, equally relevant to all potential transactors, such as when all judges in a system are corrupt. More frequently, however, at least in Western legal systems, flaws may be deemed "partial" — that is, their harmful effects are context-bound or industry-specific. Thus, in a given industry, such as the diamond industry, where transactors may be particularly sensitive to the public exposure entailed by litigation, they may develop a private order to avoid the need for litigation in the courts.⁴ In contrast, in an industry where the risk of exposure is lower (or nonexistent), transactors may not be as reluctant to resort to the courts. Similarly, another industry,

3. *See id.* at 2451.

4. *See* Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 134-35 (1992) [hereinafter Bernstein, *The Diamond Industry*].

such as the grain and feed industry,⁵ may find dissatisfaction with the actual substantive law operating in the public order, and consequently traders may seek an alternative system applying a different law. This sense of dissatisfaction may not be shared by traders in another industry, with different characteristics, who are comfortable with the substantive law applied by the courts.

In the following sections, I examine several typical flaws impairing the functioning of the public order. These flaws fall under three rubrics: flaws relating to judges, flaws relating to court decisions, and flaws relating to legal proceedings. The discussion will consider several possible responses to these flaws within both the public and the private orders. Note that several flaws may operate simultaneously, either as "generalized," or as "partial" flaws.

A. *Flaws Relating to Judges*

A potential and particularly serious reason for dysfunction in the public order relates to the corruption of the judges, their biases, or their lack of professionalism. In these cases, it may be assumed that plaintiffs who believe they will profit from these flaws will use legal proceedings, whereas those who fear they will lose because of these flaws will not. Plaintiffs who cannot foresee whether they will benefit or suffer from the corruption or the lack of professionalism may be deterred by the uncertainty and forego legal proceedings altogether. Others may forsake recourse to the public order because they are outraged by the corruption of the system, regardless of whether or not it works in their favor. Finally, since these disputes involve contracts, a party fearing unfair treatment in legal proceedings may attempt, *ab initio*, to preclude recourse to the public order.

A private order may develop in all these cases, as private actors attempt to overcome the problems of a corrupt or unprofessional public order. If the problem is limited to the judges' lack of professionalism, without necessarily entailing general corruption in the public order, and provided that judgments are plausibly enforced, we may expect institutions of arbitration to develop, staffed by professional (and assumedly uncorrupt) arbitrators. As long as the public order provides a reasonable way of enforcing the arbitrators' rulings, the problem of unprofessional judges might be solved.

If, however, corruption in the public order extends to enforcement, arbitration alone will not suffice because its effectiveness depends on a proper system of enforcement. A more extensive private order will develop. Potential transactors will seek ways of implementing non-

5. See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996) [hereinafter Bernstein, *Immanent Business Norms*].

legal economic and social sanctions, which will replace legal sanctions and which will be imposed by the aggrieved parties and by the community, either spontaneously or in organized fashion.⁶

B. *Flaws Relating to Court Decisions*

Enforcement of contracts by the public order may be impaired also because of flaws relating to court decisions. Three types of flaws may fall in this group: flaws resulting from information problems in the courts; flaws due to the application of a substantive law that the parties find unsatisfactory; and flaws due to courts' refusal to enforce certain agreements.

1. *Information Problems Impairing the Court's Ability to Enforce Contracts Effectively*

Courts sometimes lack information required to rule on contractual disputes, thus making it highly questionable whether their decisions can properly reflect the parties' rights and duties. For example, in the diamond industry, as we learn from Lisa Bernstein's study, it is extremely difficult for the seller to prove lost opportunities due to the breach.⁷ Consequently, courts ruling on this type of transaction award low amounts of damages, resulting in undercompensated sellers and underdeterred buyers. Sellers will therefore seek alternative forms of protection, *ex post* and *ex ante*.

Several consequences may ensue when the functioning of the public order is impaired due to information problems leading to undercompensation. In the public order, we may expect improvements in the courts' handling of information problems. Courts awarding damages may become more accommodating when applying the certainty of damages requirement,⁸ or may tend to award compensation for lost chances more frequently,⁹ or may be more generous when the sum of the damages is at the discretion of the court (for instance, when

6. See McMillan & Woodruff, *supra* note 1, at 2426-32.

7. See Bernstein, *The Diamond Industry*, *supra* note 4, at 136. Sometimes the secrecy consideration will make sellers reluctant to disclose this information in the courts. See *id.* at 134-135. See also Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 YALE L.J. 1885 (2000) (arguing that secrecy interest deters aggrieved parties from suing for breach of contract, leading to underdeterrence of parties in breach).

8. On the requirement of certainty and the courts' tendency to relax it in certain cases, see U.C.C. § 1-106 (1999); RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981); E. ALLAN FARNSWORTH, CONTRACTS 829-34 (3d ed. 1999); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 379-81 (4th ed. 1995).

9. See FARNSWORTH, *supra* note 8, at 834. The classic case in which an English court awarded damages for lost chances to a winner in a preliminary round in a beauty contest is *Chaplin v. Hicks*, 2 K.B. 786 (1911); see also *Rombola v. Cosindas*, 220 N.E.2d 919 (Mass. 1966).

awarding damages for nonpecuniary losses or when deciding on the validity of a liquidated damages clause).

Furthermore, we may expect parties potentially affected by problems of information to adopt measures to preempt them. Classic contractual tools offer a relatively moderate measure, such as setting a liquidated damages clause covering damages hard to prove in court. Assuming courts will not insist on the aggrieved party proving actual losses as a prerequisite for enforcing the liquidated damages clause,¹⁰ information problems relating to the magnitude of the losses — but not to the existence of a breach — will be alleviated.

At times, however, this may prove insufficient. Parties facing problems of proof may prefer to send their disputes to arbitrators who are familiar with the relevant market and who remain unconstrained by rigid rules of evidence.¹¹ We may also expect an expansion of mechanisms used to gather relevant information (for arbitrators or judges), such as prices and quality, the types of losses caused by breach, the ability of the aggrieved party to cover or mitigate damages, and so on. For instance, if diamond sellers have difficulty proving losses incurred due to breaches of contract, information-gathering mechanisms may provide the court or the arbitrator with statistical data enabling them to award compensation for lost opportunities or for lost chances.

The most far-fetched response to the information problem is the development of a full private order imposing social or economic sanctions by the relevant community. Information channels, some spontaneous and some organized (such as business networks or trade associations), should emerge.¹² Information channels created for enforcing economic sanctions may also serve two additional purposes. First, they allow transactors to locate suitable contractual parties.¹³ Second, they supply information to arbitrators or courts. For example, a trade association that gathers information necessary for the imposition of a nonlegal sanction may, in the course of its work, acquire information about prices, quality of products, trade usages, courses of performing contracts, courses of mitigating damages, and types of losses entailed by breach of contract. This information may be used by the court (or

10. See U.C.C. § 2-718(1) (1999); RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981). Both sections direct courts to consider the reasonableness of the liquidated damages clause in light of the anticipated or actual loss caused by the breach and the difficulties of proving loss. The U.C.C. adds another consideration which is “the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.” U.C.C. § 2-718(1). Accordingly, courts can use the anticipated damages and the difficulties of proof as the main considerations, and ignore the exact amount of the actual loss, when proof is so problematic.

11. See David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 409-10 (1990) [hereinafter Charny, *Nonlegal Sanctions*].

12. See McMillan & Woodruff, *supra* note 1, at 2426-32.

13. This also holds true for social networks. See *infra* Part IV.

the arbitrator) when dealing with the dispute before it. In this fashion, mechanisms operating in the private order contribute to the strengthening of the public order. In the course of time, a more effective public order may lessen the need for a private order. By using information gathered under the private order, however, the public order increases the overall benefits accruing from these private-order mechanisms. In turn, these mechanisms may expand and reinforce the private order. Hence, this is a dynamic process, with one order supporting and strengthening the other but, at the same time, itself becoming stronger and decreasing the need for the other.

2. *The Parties' Dissatisfaction with the Substantive Law Applied in Court*

Parties to a contract may seek alternatives outside the public order because they find the substantive law applied in the courts unsatisfactory. First, the parties may fear that the substantive values upheld by the courts differ irreconcilably from their own. Thus, Orthodox Jews may be suspicious of courts, knowing them to be guided by secular law rather than by Jewish Law. Second, parties to a contract may fear that the court will not enable them to realize their will as expressed in the contract. Thus, traders in the grain and feed industry, who wish their legal disputes to be decided strictly according to the express terms of the contract, may fear that the court will permit course of performance, course of dealing, and usage of trade to trump express written terms.¹⁴ Third, the parties may not be satisfied with the remedies provided by the court. Fourth, parties to a contract may find that the law applied by the court is ambiguous and uncertain, dominated by vague standards instead of bright line rules, thus impairing their reliance and planning ability.¹⁵

The parties' reluctance to resort to the public order may be confronted in two ways — either the courts or the parties will adapt. First, the public order may try to improve its ways to make them acceptable to the parties. For example, if traders expect application of the express terms of the contract, the court will refrain from imposing norms of good faith and cooperation on their relationship. If the parties do not expect the written contract to exhaustively delineate their rights, the court will develop rules and doctrines intended to meet this expectation. Thus, courts will develop rules of interpretation for ex-

14. See Bernstein, *Immanent Business Norms*, *supra* note 5, at 1787-815.

15. See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Value Creation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. (forthcoming June 2001) [hereinafter Bernstein, *The Cotton Industry*] (arguing that the clarity of the rules applied by tribunals operating in the cotton industry makes them more attractive to parties than courts applying the more vague legal rules of the U.C.C.).

aming the course of dealing and the course of performance;¹⁶ they will introduce flexibility in applying the parole evidence rule;¹⁷ they will apply broadly the principle of good faith in performance;¹⁸ and they will develop the principle of interpretation presently applied to standard contracts, according to which the reasonable expectation of the parties can trump the written terms of the contract.¹⁹ If traders expect usage of trade to apply to their relationships, the court can recognize this usage as part of the contract between them.²⁰

Second, for their part, parties to a contract can attempt to have the substantive law desirable to them applied by courts. Thus, they will state in the contract the rules that will apply to their relationship, and hope that the court will respect it. At times, the public order may consider their statement void when the chosen substantive law appears to violate public policy (for instance, when it discriminates against women, limits basic freedoms, or is injurious to third parties). The parties may also find it too difficult and onerous to clarify their wishes, and will renounce this attempt beforehand.

Notably, both these responses, by the courts and by the private parties, occur within the public order only. They do not require the development of a private order. One may nevertheless emerge, however — for example, a private order may offer arbitrations that ensure the parties the application of their desired substantive law.²¹ Arbitration mechanisms available in the diamond, grain, feed, and cotton industries provide examples.²² Tribunals in the Jewish Orthodox community (called “Courts of Justice”) are another example. In these tribunals, rabbi-judges rule according to Jewish Law and often resort to social sanctions (such as boycotting and exclusion). Dissatisfaction with substantive law may also contribute to the development of a wider private order where we will find economic and social sanctions.

16. U.C.C. §§ 1-201(3), (11), 1-205, 2-208 (1999); RESTATEMENT (SECOND) OF CONTRACTS §§ 219-223 (1981).

17. The trend in modern contract law is toward a less formal application of the parole evidence rule. This trend is reflected in U.C.C. § 2-202 (1999), and in RESTATEMENT (SECOND) OF CONTRACTS §§ 209-217 (1981); see also FARNSWORTH, *supra* note 8, at 435; *Masterson v. Sine*, 436 P.2d 561 (Cal. 1968).

18. See U.C.C. § 1-203 (1999); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

19. See RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981); *Darner Motor Sales v. Universal Underwriters*, 682 P.2d 388 (Ariz. 1984).

20. See U.C.C. §§ 1-201(3), (11), 1-205 (1999); RESTATEMENT (SECOND) OF CONTRACTS §§ 219-222 (1981).

21. See Charny, *Nonlegal Sanctions*, *supra* note 11, at 409-10.

22. See Bernstein, *The Diamond Industry*, *supra* note 4, at 126-27; Bernstein, *Immanent Business Norms*, *supra* note 5, at 1771-78; Bernstein, *The Cotton Industry*, *supra* note 15.

3. *The Public Order Consciously Refuses to Enforce Certain Agreements*

In some areas, the litigating parties are not reluctant to resort to the public order, but the public order refuses to enforce their agreements. The refusal may be due to legislators' or judges' perceptions of these contracts as detrimental to third parties (agreements to commit a tort²³), to the parties themselves (agreements made under duress or unconscionable agreements), or to society at large (agreements in restraint of trade²⁴). In other cases, the courts will not enforce agreements because judicial interference might be harmful to the relations between the parties (agreements between spouses²⁵). In some cases, the courts' refusal to enforce agreements may be justified by the policy against encouraging litigation or interfering with the judicial process.²⁶ Potential transactors, who may nevertheless wish to enter into legally unenforceable agreements, must rely on nonlegal sanctions.

C. *Flaws Relating to Legal Proceedings*

Flaws relating to legal proceedings may lead potential transactors to refrain from using the public order for enforcing contracts. These flaws include the costs of litigation, the long waiting periods until enforcement takes place, and the damage incurred by the legal proceedings.

1. *The Costs of Litigation*

Certain types of disputes do not reach the courts due to the high cost of legal proceedings on the one hand, and the low value (to the parties) of the issue involved on the other. This forms a prominent feature of many consumer transaction disputes. The public order may respond by enabling class action suits or by awarding generous punitive damages, thus increasing the profitability of turning to the courts and creating an effective sanction against traders. The public order alternatively may establish small claims courts, where legal proceedings are not costly. Finally, a private order (such as consumer organi-

23. See, e.g., *Williams v. Wilson*, 181 F. Supp. 351 (E.D. Ark. 1960); *Sayres v. Decker Auto. Co.*, 145 N.E. 744 (N.Y. 1924).

24. See RESTATEMENT (SECOND) OF CONTRACTS § 186 (1981).

25. See FARNSWORTH, *supra* note 8, at 337-43.

26. See, e.g., *Plumlee v. Paddock*, 832 S.W.2d 757 (Tex. Ct. App. 1992) (refusing to enforce contract whereby attorneys would pay owner of ambulance company for injury case referrals); *Garden State Plaza Corp. v. S.S. Kresge Co.*, 189 A.2d 448 (N.J. Super. Ct. App. Div. 1963) (refusing to enforce contractual provision that forbade using previous negotiations and dealings between the parties to interpret the contract).

zations) may develop, mainly designed to provide information about traders' reputation.

2. *Long Waiting Periods until the Enforcement*

Long waiting periods at the courts also contribute to the dysfunctionality of the public order, and result in enforcement that comes years after the conflict erupted. Transactors thus may find the litigation procedure in the public order irrelevant to their needs. They will prefer arbitrations with shorter waiting periods,²⁷ they will develop a private order for enforcing arbitration rulings implementing nonlegal sanctions,²⁸ or at times they may be satisfied with the imposition of economic or social sanctions without using arbitration.

3. *The Damage Incurred by Legal Proceedings*

Often parties to a contract do not want to go to court because legal proceedings, as such, are damaging. Damages incur primarily from the public exposure entailed by a legal proceeding, because this exposure may harm the litigants' privacy or reputation, or it may reveal trade secrets. The public order may respond by allowing proceedings in certain disputes to take place "behind closed doors." This presents a problematic solution, however, constitutionally as well as practically. A more viable solution involves the development of legal rules that strengthen the parties' substantive and procedural rights of privacy, that protects their trade secrets, and that protects their reputation.

In the private realm, we may expect many referrals to arbitration, where confidentiality is more easily maintained. Lisa Bernstein's study of the diamond industry shows that the secrecy ensured in arbitration proceedings provides a strong incentive for parties to refrain from turning to the courts.²⁹ Of course, parties often will develop a private order that imposes economic and social sanctions without resorting to involvement with a third party (either a judge or an arbitrator), and thereby avoid any potentially injurious exposure that could result therefrom.

Legal proceedings may also break up relationships, whether business or social. For this reason, parties to relational contracts establish various mechanisms that enable them to contend with setbacks with-

27. See Bernstein, *The Cotton Industry*, *supra* note 15 ("The availability of a fast and inexpensive way of obtaining and enforcing a judgement, transforms some meritorious claims that would have had a negative expected value had they been pursued in litigation into claims with a positive expected return.").

28. See *id.*

29. See Bernstein, *The Diamond Industry*, *supra* note 4, at 124, 134-35.

out destroying the relationship.³⁰ When no such mechanisms are available, economic and social sanctions imposed under the private order may preserve their relationships.

III. RESPONSES OF CONTRACT LAW TO THE PRIVATE ORDER

The type of private order developed is contingent not only on the flaws affecting the public order, but also on the attitude of the law (as applied by courts within the public order) toward the private order. The law applied by courts can influence the private order in several ways. It can encourage it and even seek its support, it can fight it and attempt to repress it, and it can recognize it and show consideration for it without attempting to influence its existence or its scope.³¹ The less serious the flaws of the public order and, consequently, the more effective its operation, the higher the chances that the attitude of the law operating within it will influence the private order.

This Part explores the influence of the law applied by courts on the development of the private order. Section III.A describes how the public order actively encourages the private order, and Section III.B describes how it also represses the private order. In Section III.C I make a normative suggestion regarding how the public order can adapt itself to an existing private order by taking nonlegal sanctions into account when meting out legal ones. This would constitute a neutral attitude toward the private order, the third type of stance a public order might — or does — take.

A. *Encouraging the Private Order*

Contract law supplies the parties with tools for mutual protection without requiring them to resort to the courts. These arrangements presuppose that, since the public order does not act immediately and its protection is often lacking and incomplete, the parties must take steps to enforce contractual obligations by themselves. The rules dealing with order of performance provide a good example. These rules guide the parties as to how to protect themselves from nonperformance by the other party. Thus, parties to a contract can condition their performance so that one will not be under a duty to perform its

30. See IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* 24-25, 31 (1980); Stewart Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465 (1985); Stewart Macaulay, *Non-Contractual Relations in Business*, 28 AM. SOC. REV. 55 (1963).

31. Cf. Robert Cooter, *Normative Failure Theory of Law*, 82 CORNELL L. REV. 947 (1997) (discussing, inter alia, the ways law or state can ignore, strengthen, or undermine social norms); Posner, *supra* note 1, at 1725-36 (discussing several approaches to the problem of dealing with inefficient social norms).

obligation without receiving equivalent performance by the other.³² Even if the parties do not condition their performance, contract law enables one party who has reasonable grounds to believe that she will not receive performance from the other to demand adequate assurance of due performance, and even suspend performance until she receives such assurance.³³ These rules, then, rely on the assumption that the public order cannot supply immediate and effective protection to a contractual party — since if it could, the order of performance would be dictated solely by the needs of the transaction rather than by the parties' need for assurance. The public order, then, acknowledges the limitations of its enforcement, and encourages the parties to protect themselves without it.

Furthermore, the public order supplies the parties with self-enforcing remedies that also strengthen their ability to enforce their mutual obligations without recourse to courts. Examples of such remedies include offset, price deduction,³⁴ and possessory lien.³⁵ In some cases, the power to rescind a contract also protects the parties without resorting to the court, as does the power to forfeit a deposit.³⁶ True, all these arrangements take place under the aegis of the public order, which controls their implementation and sets their boundaries. Hence, this is not strictly private order, although it does bear the marks of one.

The public order further supports and encourages the private order by giving effect to norms and institutions that control the private order within the framework of the public order. It thereby increases the benefits of these norms and institutions to its consumers, and promotes their improvement and development. For example, the public order allows arbitrations. The lesser its involvement in the arbitrators' decisions, the stronger the institutions of arbitration and the greater their usefulness. The public order also offers the contractual parties default rules for their contracts, compatible with their trade usages, and courts interpret their contracts relying on these usages. Courts also take into account the parties' "course of dealing" and "course of performance" when interpreting the contract and filling its gaps.³⁷ Assuming that contractual parties consider it advantageous to settle their

32. See FARNSWORTH, *supra* note 8, at 561-62.

33. See U.C.C. § 2-609 (1999); RESTATEMENT (SECOND) OF CONTRACTS § 251 (1981); FARNSWORTH, *supra* note 8, at 613-16.

34. See U.C.C. § 2-717.

35. See U.C.C. §§ 7-209, 7-307.

36. See U.C.C. § 2-718(2).

37. U.C.C. §§ 1-201(3), (11), 1-205, 2-208; RESTATEMENT (SECOND) OF CONTRACTS §§ 219-223 (1981).

disputes according to these norms of behavior,³⁸ and that they are aware of the possibility of finding themselves within the public order, their benefit from using private-order norms will increase. The public order thereby contributes to the development of norms within the private order, and ultimately strengthens the private order as a whole.

The ability of the public order to influence the development of norms within the private order can be illustrated as follows. Let us assume that the prevalent practice in the furniture industry is that, when certain defects in the manufacturer's goods appear, retailers need not pay, whereas they do when other defects appear. Assume further that this practice remains in the initial stages of development, and some vagueness prevails concerning its mode of implementation. If the public order shows willingness to enforce this practice in contractual disputes, potential transactors interested in court enforcement of this practice will want it to be verifiable, namely, provable in court. As a result, the trade association may attempt to document the practice and perhaps even to regulate it precisely, thus contributing to its entrenchment and strengthening.

The public order may further reinforce the private order indirectly by using information-gathering mechanisms that work within the private order and that yield information useful to the functioning of the public order.³⁹ Although the private order thereby will support the public one, the private order itself may strengthen as the augmented usefulness (to both orders) of the information-gathering mechanisms increases the incentives to create and support those mechanisms in the first place.⁴⁰

B. *Repressing the Private Order*

The public order will repress the private order when it perceives the latter as bad and damaging, either to its participants or to third parties. In extreme cases, it will use criminal law or antitrust law to

38. *But see* Bernstein, *Immanent Business Norms*, *supra* note 5, at 1796-802 (arguing that traders in the grain and feed industry would expect that course of performance and course of dealing will not trump the express terms of the contract at an end-game dispute). For a critical view of Bernstein's argument, see David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. PA. L. REV. 1841, 1853-57 (1996).

39. *See supra* Section II.B.1.

40. McMillan & Woodruff, *supra* note 1, at 2450, write: "Effective courts . . . lower the benefit of information gathering, resulting in less well-informed manufacturers." I believe that this is not necessarily the case. In fact, a functioning public order suffering from information problems may increase the benefits of information gathering, since this information is useful not only to the private but also to the public order. Actually, there is a trade-off here: Effective courts lower the benefits of information gathering for the use of the private order, but, at the same time, increase the benefits of information gathering to a public order that has become functional yet retains inadequate methods of information-gathering. McMillan & Woodruff's claim, then, becomes stronger as the need for information in the public order lessens.

repress the private order, although less radical means can also be envisaged.

One way to repress the private order involves limiting the application of private-order norms within the public order (that is, in courts), even when the parties wish otherwise. The courts may refuse to apply the private-order norms by finding them illegal or against public policy, or by ignoring them when interpreting the contract or filling its gaps.⁴¹ Assuming that parties find these norms desirable, the lack of recognition by the public order will decrease the expected benefits of those norms and consequently the incentives to develop them; as a result, the private order will be weakened. On the other hand, the opposite is also possible, namely, that parties acting according to these norms will redouble their efforts not to reach the public order and will settle their disputes outside it. Hence, in that situation, the hostility of the public order to the parties' wishes would actually strengthen the private order.

Another approach that represses the private order, usually unconsciously, grants legal effect to parties' behavior according to private-order norms that the parties had not wanted effectuated. This deters parties from behaving according to these private-order norms. For example, traders sometimes act according to norms of cooperation created within the framework of a private order that go beyond the express terms of the contract, yet they nonetheless wish disputes between them to be settled according to the express terms only.⁴² If the court, oblivious to this desire of the parties, grants legal effect to their cooperative behavior toward each other and permits the "course of performance" to trump the contract's express terms, the parties may neglect cooperation norms a priori and thereby impair the functioning of the private order that relies on these norms.

A decision of the Israeli Supreme Court may illustrate the damage that could be inflicted on a private order by "legalizing" behaviors that were not intended to lead to legal consequences of any kind. In *Levin v. Levin*,⁴³ a husband and wife reached an alimony agreement stating that the husband would pay alimony beyond the minimum sum prescribed by law. The couple was going through a crisis, but they still trusted one another and strove to settle their disputes without recourse to the courts. For this purpose, they specifically stated in the agreement that it did not create a legal relationship and should not be presented to the court. Later, when the wife relied on this agreement

41. See, e.g., *Flower City Painting Contractors, Inc. v. Gumina Constr. Co.*, 591 F.2d 162 (2d Cir. 1979) (preferring the reasonable understanding of one party to the usage of trade prevailing in the industry).

42. See Bernstein, *Immanent Business Norms*, *supra* note 5, at 1796-802 (distinguishing relationship-preserving norms from end-game norms).

43. C.A. 3833/93, *Levin v. Levin*, 48(2) P.D. 862 (1994).

in an alimony suit, the question arose as to whether the court should enforce it. The Supreme Court of Israel answered in the affirmative, finding the provision that denied the creation of a legal relationship unenforceable for public policy considerations.⁴⁴ Recognizing the legal validity of the agreement, held the court, serves the worthy purpose of enforcing promises.

The objection to this decision is that, in “legalizing” the agreement, the Supreme Court of Israel weakened the moral and social institution of nonlegal promises. Whereas the private order prevalent before the ruling enabled spouses to make mutual promises confining sanctions to the social realm, in light of this ruling they can no longer do so without incurring the risk of ultimately reaching the courts. The “legalization” of their behavior and the drawbacks of the legal proceedings they must expect because of this behavior are thus detrimental to the private order and contribute to its repression. After the decision in the *Levin* case, a husband considering giving or making a promise to give more than the minimum amount of alimony may decide not to do so, fearing that such behavior or promise would subsequently expose him to a law suit.⁴⁵

C. *Recognizing the Private Order: The Mutual Relations Between Sanctions*

Even if the public order does not adopt a value-based position vis-à-vis the private order, and does not attempt to influence it, the public order should nevertheless adapt itself to the existence of a private order functioning beside it. In this Section, I try to address the following question: Should sanctions imposed by the private order on the party in breach be deducted from the compensation awarded by the court for breach of contract?⁴⁶ This question is complex and deserves further elaboration; what follows are merely preliminary thoughts on this matter. The following example illustrates the problem.

John breached his contract with Tony. Tony suffered losses of 100. The breach of contract led to the imposition of a nonlegal sanction on John in the shape of injury to his reputation, which is valued at 40.⁴⁷ Should the court award Tony damages for an amount of 100, or only of 60?

44. *See id.*

45. For the view that courts should respect the parties' determination that their commitments would not be legally enforceable, see Charny, *Nonlegal Sanctions*, *supra* note 11, at 383-84. Cf. Melvin Eisenberg, *The World of Contract and the World of Gift*, 85 CAL. L. REV. 821 (1997) (arguing, *inter alia*, against legalization of the world of gift).

46. For a thorough discussion of nonlegal sanctions — monetary, reputation-based and hybrid sanctions — see Bernstein, *The Cotton Industry*, *supra* note 15.

47. Actually, evaluation is quite problematic in these cases, but I ignore this issue here.

The argument in favor of awarding 60 focuses on optimal deterrence to the party in breach. Given perfect information, optimal deterrence will be attained if John pays a price equivalent to the full loss caused by his breach, no less but also no more. Awarding damages of 60 will lead to this result. In contrast, awarding damages of 100 will lead to the party in breach paying a price of 140, 40 higher than the loss caused by his breach. This results in overdeterrence.⁴⁸ The objection to this argument, apparently supporting damages of 100, focuses on the undercompensation to the aggrieved party if he receives only 60. Indeed, if the purpose of awarding damages for breach of contract is compensation, this objection is powerful. As we will see immediately, however, awarding damages of 60 is more efficient than damages of 100 and, therefore, the *ex ante* interest of both parties actually will be to deduct the private sanction from the public one.

This conclusion rests in part on the different incentives supplied by the public and private orders. The nonlegal sanction imposed by the private order differs from the legal sanction in that it does not actually compensate the aggrieved party. How does this difference affect the incentives of the potentially aggrieved party?⁴⁹

Under contract law, aggrieved parties are entitled to full compensation for the foreseeable losses they suffer due to breach of contract.⁵⁰ Given full compensation and perfect information, the deterrence to the party in breach is optimal. Because she receives full compensation, however, the aggrieved party remains indifferent to the breach of contract. She will not mitigate the damages before a breach occurs, even if it might be efficient to do so (the defense of mitigation of dam-

48. However, a counterargument could be raised, that the total losses caused by the breach are in the amount of 140, which includes losses to the aggrieved party and losses to the party in breach. Accordingly, efficiency requires the party in breach to internalize the total amount of 140; otherwise, he may breach inefficiently. Thus, to achieve perfect internalization of losses, he should pay 100 to the aggrieved party. Cf. Robert Cooter & Ariel Porat, *Does Risk to Oneself Increase the Care Owed to Others? Law and Economics in Conflict*, 29 J. LEGAL STUD. 19 (2000) (arguing that in determining the duty of care in negligence law courts mistakenly ignore the reduction in the injurer's self risk caused by the injurer's precautions).

This counterargument deserves further elaboration, in which I cannot engage here. The main weakness of the counterargument is that it treats the injury to reputation suffered by the party in breach as a social cost, while it is actually a private cost with a correlative benefit to society at large: the breach supplies information to society about the trustworthiness of the party in breach. For further elaboration, see Robert Cooter & Ariel Porat, *Should Court Deduct Non-Legal Sanctions from Damages?* (October 2000) (unpublished manuscript on file with author).

For the argument that nonlegal sanctions may supplement legal sanctions and prevent underdeterrence, see Charny, *Nonlegal Sanctions*, *supra* note 11, at 407.

49. For a discussion of the differences between legal and nonlegal sanctions with regard to the incentives they supply to parties to a contract, see *id.* at 400-03.

50. Subject to some limitations, such as the requirement of certainty of damages and the "duty" to mitigate damages. Farnsworth, *supra* note 8, at 806-07, 829-30.

ages applies only from the time of the breach), she will overrely on the contract, and she will not take efficient precautions to prevent the breach (by cooperating with the other party, supplying him with information necessary to performance, and so on).

A private order based on nonlegal sanctions supplies incentives for performance to the party in breach⁵¹ but, at the same time, supplies incentives to the aggrieved party to take efficient precautions. It creates incentives for the aggrieved party because, if the contract is nevertheless breached, the aggrieved party ends up without compensation. Knowing this beforehand, the aggrieved party will not remain indifferent to a breach of contract. She will consider the possibility of a breach by the other party and will efficiently mitigate her damages even before a breach; she will not overrely and, at times, even will take efficient precautions necessary to prevent the breach.⁵² Thus, we could expect aggrieved parties operating in a private order, unlike those operating in a public order, to demonstrate greater care with regard to mitigation of damages, reliance, and precautions adopted to prevent a breach.⁵³

If the analysis so far is accurate, the following question may arise: If efficiency is attained by charging the party in breach for losses suffered by the aggrieved party, but without granting full compensation to the latter, why should not parties operating within the public order (wherein nonlegal sanctions are irrelevant) agree beforehand that the breaching party will pay the damages to a third party? The answer to this question is that such an agreement, even if it supplies efficient incentives to the parties after the contract is made, typically raises the overall costs of the contract. The reason is obvious: *without* a transferal of the right to compensation to a third party, the consequences of a breach are that the party in breach pays, and the aggrieved party is compensated; *with* a transferal of the right to compensation to a third party, the consequences of the breach are that the party in breach pays, but the aggrieved party is not compensated. The latter arrange-

51. I do not refer here to the question of whether these sanctions are efficient. Cf. Bernstein, *The Cotton Industry*, *supra* note 15.

52. Robert Cooter argues that when precaution is bilateral, parties would be supplied with the most efficient incentives if both were expected to bear the entire burden of the harm caused by the breach (or the wrongdoing). See Robert Cooter, *Unity in Tort, Contract, and Property*, 73 CAL. L. REV. 1, 3-4 (1985). A private order that imposed on the party in breach sanctions equivalent to the losses caused by the breach and, at the same time, left the aggrieved party uncompensated, is very close to the optimal legal regime considered by Cooter.

53. This actually may provide an additional explanation as to why parties to a contract operating within certain types of private orders are more cooperative than parties operating within public order. Indeed, knowing that she will bear her own losses in the event of breach, an aggrieved party will tend to cooperate with the other party and assist him in different ways, even if she does not feel obligated to do so.

ment doubles the costs of breach to the contractual parties since it externalizes benefits to a third party.

This fact alone, however, does not preclude the option that, in certain cases — apparently rare ones — parties to a contract may decide it is in their interest to pay the extra price in order to supply efficient incentives to both parties in the course of performing the contract.⁵⁴ Thus, we can envisage a situation in which the performing party thinks she may require some form of cooperation from the party receiving performance. She may find it difficult to formulate the precise terms of the situation requiring such cooperation, or she may fear that lack of cooperation on the part of the other party may not be verifiable (that is, provable in court) and perhaps even not observable (to the performing party). A solution that may therefore seem acceptable to the performing party is to deny the other party any compensation in case of a breach by transferring the right to compensation to a third party.⁵⁵ This solution will ensure that the other party will not be indifferent to the breach, and that his incentives will be efficient.⁵⁶

To return to our example: Should a court deduct the nonlegal sanction of 40 that the private order imposed on John from the 100 reflecting the losses suffered by Tony? The result of such deduction is to impose a total sanction of 100 on John, which is the equivalent of Tony's losses, but which leaves Tony undercompensated. As noted, however, leaving the aggrieved party completely without compensation encourages her to mitigate damages efficiently before the breach,

54. In the diamond industry, arbitrators may sometimes impose sanctions on the party in breach involving not only compensation to the aggrieved party but also a donation to charity. See Bernstein, *The Diamond Industry*, *supra* note 4, at 127. This system may be justified in that it provided the aggrieved party more efficient incentives than full compensation.

55. For another solution, based on the apportionment of damages between the parties, see ARIEL PORAT, HAGANAT ASHAM TOREM BE-DINE HOZIM [CONTRIBUTORY FAULT IN THE LAW OF CONTRACT] (1997); Ariel Porat, *Contributory Negligence in Contract Law: Toward a Principled Approach*, 28 U. BRIT. COLUM. L. REV. 141 (1994); Ariel Porat, *The Contributory Negligence Defence and the Ability to Rely on the Contract*, 111 L. Q. REV. 228 (1995).

56. This solution obviously raises several difficulties, which cannot be discussed within the scope of these comments. For instance: How does a solution whereby the aggrieved party is not compensated, but the party in breach pays damages, affect compromises between the parties? How does it affect renegotiation? What incentives does it provide for the parties' opportunistic behavior? Another question concerns the incentive of the aggrieved party to initiate the imposition of sanctions on the party in breach when the aggrieved party derives no benefit from the imposition. On the latter issue, see Bernstein, *The Cotton Industry*, *supra* note 15 (clarifying the motivation of the aggrieved party to impose nonlegal sanctions on the party in breach, even if it yields no pecuniary gains to him), and see also McMillan & Woodruff, *supra* note 1, at 2430 (discussing the free rider problem, which decreases incentives to aggrieved parties to impose nonlegal sanctions, and possible ways to overcome it). In another (unpublished) paper I am co-authoring with Robert Cooter, we develop the idea of third party transfer contract, which we call an "anti-insurance contract." We argue that on some occasions, the parties can charge the third party (the "anti-insurer") a premium for transferring him the right to the damages in the event of a breach.

to avoid overreliance, and, at times, to take efficient precautions to prevent the breach. Leaving Tony partly uncompensated, which is the consequence of deducting the 40 from the 100, is more efficient than compensating him in full.⁵⁷ Reducing the compensation imposed on John below 60 would supply more efficient incentives to Tony, but would also result in underdeterrence of John. A third solution, whereby John would be obliged to pay the 60 to a third party rather than to Tony, might have been optimal with regard to the parties' incentives after the contract was made, but would have increased the costs of the contract by increasing the costs of a breach.

The deduction of 40 does not lead to an externalization of the contract's benefit to a third party in a way that increases the costs of a breach to the parties, which would typically be unacceptable to either of them. Rather, this deduction is just another way, different from the traditional one, to allocate the losses incurred by the breach between the parties to the contract.

In sum, deducting the nonlegal sanction imposed by the private order from the damages which reflect the losses of the aggrieved party supplies both parties with more efficient incentives than non-deduction, without externalizing any benefits to third parties.

IV. SOCIAL NETWORKS AND THE PUBLIC ORDER

McMillan and Woodruff show that social networks function as a substitute for the public order in the sense that, as the public order is strengthened, social networks are weakened. This dynamic contrasts with that of business networks, which work in concert with the public order and supplement it. I will attempt to explain these findings by pointing out an important difference between social and business networks.

Social networks sometimes require no sanction whatsoever in order to be effective. This occurs when contractual parties are drawn from narrow social circles, such as close friends or relatives. In such cases, the choice of partner to a transaction relies on overlapping interests: the partner's interest is not only to maximize her private utility but rather her own and her partner's utility at the same time, as part of her own interest. Indeed, a partner to a transaction will be chosen from a narrow social network especially when the community or even the party to the transaction has relatively small chances of monitoring the partner's behavior. These networks are particularly

57. Some of the problems mentioned in note 53, *supra*, are also present here. The evaluation of nonlegal sanctions is another problem. I also ignore here the effect of the deduction of the nonlegal sanction on the development of the private order. A thorough discussion of the relations between legal and nonlegal sanctions should address all these problems.

advantageous to contractual parties when the breach of the contract or the loss it entails is not verifiable or even observable.⁵⁸

As opposed to this important advantage, social networks present a drawback. Since the circle of potential parties remains relatively small, matching other relevant features of the partners (except for trustworthiness) will usually be less than optimal. McMillan and Woodruff's finding that social networks act as substitutes for the public order, unlike business networks that act in concert with it, thus presents no surprise. Given the high price entailed by contracting through a social network, its use should be widespread, only when legal or nonlegal economic sanctions are not available. Business networks do not present this problem because they increase the chances of finding a good partner in every regard (beyond trustworthiness), and indeed are sometimes strengthened by a functioning public order, whereas a social network may not be.

V. CONCLUSION

Responses in the private order differ according to the underlying reasons for a dysfunctional public order. Hence, if legal systems are dysfunctional due to the corruption of the judges, we may expect all forms of the private order to emerge: relational contracts, arbitration, business networks, trade associations, and social networks.

If, however, the public order suffers mainly from information problems and a private order develops as a result, we may expect arbitrations and various information-gathering mechanisms to arise. The use that the public order makes of the information created by these mechanisms may actually lead to their reinforcement.

If the public order does not function because of its failure to supply the parties with the substantive law they desire, we may expect arbitration mechanisms to develop, applying a substantive law acceptable by the parties. If the public order is dysfunctional because of the costs of litigation, we may expect the emergence of mechanisms chiefly designed to supply information about the transactors' reputation in the market. If the public order is dysfunctional because of the parties' reluctance to bear the damage of legal proceedings in courts, we may expect increased recourse to arbitration as well as reliance on nonlegal sanctions.

The character of the private order and its components depends on the flaws prevailing in the public order, which prompted the private

58. Cf. Bernstein, *Immanent Business Norms*, *supra* note 5, at 1791-92 (arguing that when breach is observable but not verifiable, parties will prefer the extra-legal realm to the legal one). My argument is that social networks are effective even when breach is not observable either by third parties or by the aggrieved party.

order in the first place. A comprehensive theory of the private order must examine these flaws and their relationship with the public order.

The contents of the law operative in the public order may influence the development of the private order. The public order may encourage the private order, and probably will, particularly given its awareness of its own limitations and flaws in contrast to the advantages of the private order, and given its sincere desire to improve the situation. The private order will be repressed when the public order perceives it as more damaging than beneficial. The attitude of the public order toward the private order may depend on the flaws of the public order prompting the emergence of the private order in the first place. Thus, if the private order emerged in response to problems of information, we may assume that the public order will encourage the private one and, at times, even seek its assistance. If problems of substantive law caused the development of the private order, the public order may attempt to reform itself in order to meet the parties' needs, leading sometimes to the repression of the private order, and sometimes to its strengthening.⁵⁹ If the private order developed due to the costs of legal proceedings, the public order may encourage the private one, among other reasons in an attempt to lighten its own burden and to make time and room for disputes that would justify the costs of legal proceedings. If the private order developed due to the parties' fear of incurring damages due to legal proceedings, the public order may also encourage the private one because of its ability to settle real problems that cannot be resolved in the public order. The public order, however, may also try to reform itself, thereby indirectly leading to the repression of the private order.

The most extreme cases, wherein the public order will not encourage the private order and may even attempt to fight it (except for cases when it is socially harmful), occur when the private order was established due to the corruption of the public order. In these cases, judges may approach the private order as a bad idea, even when it proves useful and beneficial to society. As the public order becomes less effective, however, so does its ability to influence the existence of a private order driven by social or economic forces beyond the reach of the courts.

The public order may take into account the existence of the private order even without adopting a normative stand toward it. The public order's recognition of the sanctions imposed by the private order on the parties in breach will enhance efficiency.

59. It could result in repression of the private order because, the better the public order, the less the need for a private one. It could sometimes lead to a strengthening of the private order, because acknowledging the norms of the private order within the public one may make the development of these norms more profitable. *See supra* Section III.A.

The private order that will emerge beside the public order may include social networks, in addition to the economic ones. Yet, the better the functioning of the public order, the lower the chances of extensive recourse to social networks.

The article by McMillan and Woodruff makes an important contribution to the understanding of the functions fulfilled by the private order when the public order has failed, and to an understanding of certain interactions between the two orders. I have attempted to pose some additional questions, as well as offering several answers, concerning the complex relationships between the public and private orders.