

# VERTICAL INTEGRATION, RELATIONAL CONTRACTS, AND SPECIALIZED INVESTMENT: A RESPONSE TO BAKER AND KRAWIEC

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## I. INTRODUCTION

Long-term relational contracts are widely recognized as posing special problems for contract law.<sup>1</sup> Such contracts are frequently incomplete in some sense.<sup>2</sup> Of course, short-term contracts may also be incomplete, and courts and legislatures have developed various tools for filling gaps and resolving ambiguities in such contracts, but those tools may not be well suited to long-term contracts.

If a long-term contract is incomplete and the relationship is expected to continue, the missing terms or ambiguous obligations must be renegotiated when the situation requires it. Although such renegotiation always presents the possibility that one or both of the parties will attempt to behave opportunistically, whether or not the relationship is vertical, the power to “hold up” the other party is particularly strong in a vertical relationship in which a party has made a specialized investment.<sup>3</sup>

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1. See, e.g., Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 *passim* (1981); Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 751 (2000).

2. As Baker and Krawiec point out, all contracts must be “obligationally” complete to be enforceable. Scott Baker & Kimberly D. Krawiec, *Incomplete Contracts in a Complete Contract World*, 33 FLA. ST. U. L. REV. 725, 726 (2006).

3. All contracts present some opportunity for opportunistic behavior, even if they are short-term and fully specified. A party may behave opportunistically so long as enforcement costs and the costs of delay are sufficiently high and/or reputational costs are sufficiently low. The holdup power involved in specialized investment is (or may be) different in magnitude and, therefore, in the incentive to behave badly.

In their article for this Symposium, *Incomplete Contracts in a Complete Contract World*,<sup>4</sup> Professors Scott Baker and Kimberly D. Krawiec argue that this holdup power creates incentives for economically inefficient contracting by encouraging both under- and overinvestment.<sup>5</sup> They maintain that this problem is best eliminated by vertical integration—that is, by sole ownership rather than contract.<sup>6</sup> However, sole ownership is not always possible; when it is not, they say, the parties must perforce rely on contract.<sup>7</sup> Accordingly, they argue, contract law should seek to approximate the incentives, investments, and production levels that would be reached in an integrated firm.<sup>8</sup>

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4. Baker & Krawiec, *supra* note 2.

5. *See id.* at 731-33. They note, however, that the overinvestment incentive is created by the measure of damages in contract actions when parties have not specified the level of their joint investment and is not therefore limited to the problem of vertical relationships. *See id.* at 735-38.

6. *See id.* at 731-33. According to Baker and Krawiec, sole ownership eliminates the incentives for under- or overinvestment created by contracts. At some point they suggest that sole ownership does this by “allocating” bargaining power to the owner. *Id.* at 733.

I hope it is possible to appreciate their point while quibbling with their terminology, because I am about to quibble. Human participants in firms may bargain with each other over the terms of their participation, but owners do not bargain with their physical assets. Ownership is a substitute for bargaining, not a method for allocating power within a bargaining process.

Baker and Krawiec, like many economists and law professors, look at firms as a “nexus of contracts.” *See* Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani-Miller Forty Years Later*, 1998 U. ILL. L. REV. 1039, 1062. While this terminology is useful, it can also be misleading. The primary utility of firms is that they are a substitute for contracts. In that sense, they are a nexus of not-contracts, at least when the word “contract” is given its usual legal meaning.

7. Baker & Krawiec, *supra* note 2, at 731, 733. In fact, however, these are not the only alternatives. In addition to long-term contracts and vertical integration, parties may also use (1) short-term contracts bonded by reputation, (2) joint ownership of the process and output, as in a partnership or joint venture, (3) partial ownership of one by the other, and (4) cross ownership. More than one method can be used simultaneously, as when a firm pays a consultant in stock or stock options pursuant to a formal long-term contract. No one method dominates. RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 283-84 (2d ed. 1995); *see also* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 905 (1993) (arguing that “cross-ownership reduces the risk of opportunism”).

We do not know very much about why firms use the methods they do, but apparently the different methods have different cost-benefit tradeoffs that make them appropriate (or not) in different circumstances. All of the methods must have survival value, or they would long since have been removed from the menu of options. Their survival value may well depend on the fact that they are *not* like each other. Thus, any move toward making one method more like another—such as making a long-term contract more like sole ownership—would be a move in precisely the wrong direction. It is not clear whether that is what Baker and Krawiec are attempting to do.

8. *See* Baker & Krawiec, *supra* note 2, at 735 n.27. Baker and Krawiec recognize that many vertical contracts do not involve a specialized investment by either party and therefore do not create more than the usual opportunities for a holdup in the renegotiation process. *See id.* at 731.

To accomplish this, Baker and Krawiec propose a new default rule for contracts in which one party has made a specialized investment. This new rule, the “relationship-specific investment” (RSI) default, would apply when (1) a party gives notice that it is making or has made a specialized investment which relates to the contract and (2) the other party consents or at least does not object.<sup>9</sup>

Briefly, the RSI default is a rule of construction. It directs courts, when deciding between two conflicting but credible interpretations of (1) ambiguous language, (2) the content of a missing term, or (3) the meaning of the background obligation of good faith, to adopt the interpretation proffered by the relationship-specific investor.<sup>10</sup> The default applies to every term of the contract, whether or not that term is significantly related to the investment.<sup>11</sup> Parties bargaining in the shadow of the default, either before formation or thereafter, will know in advance who is likely to win if the contract is unclear or negotiations break down. That knowledge will affect their bargaining behavior.<sup>12</sup>

In this Article, I evaluate Baker and Krawiec’s proposal by first asking whether, given their definition of a relationship-specific investment, either the parties or the courts will know whether it applies in any given case. I conclude that they will not. Second, I evaluate whether the RSI default, if intelligibly defined and adopted, would reduce holdups without creating more costs than benefits. I conclude that it is unlikely.

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9. *Id. passim*. Apparently, the notice need not be formal, or even actual, and may be given after the investment is made. A post-investment notice would not operate retroactively, but the default would apply to any new terms.

10. *See id. passim*. I am agnostic on the propriety of calling a rule of construction a “default rule.” I tend to think that it is not, but contracts scholars are entitled to their own vocabulary, even if it is unintelligible to those of us who reserve the “default” modifier for rules that commence with an “unless otherwise agreed” clause.

11. *See id.* at 728. This apparently means that a party who has made a relatively small specialized investment would prevail in a dispute involving potential damages that dwarf that investment’s size.

12. *See id.* at 728, 734. For this or any contractual default rule to succeed in modifying behavior, the parties must be rational actors. It is unclear to me why the parties are presumed to be smart enough to reason back from the impact of a default rule but too dumb to protect themselves in the contract itself. *See generally* Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829 (2003). In this connection, I note that although Baker and Krawiec say they assume rational actors, their hypothetical examples of the RSI in action all seem to involve parties who are so cognitively impaired that they are either insane or about to sprout leaves.

## II. DEFINING THE PROBLEM

### A. *What Do (Most) Economists Mean by a Relationship-Specific Investment?*

The particular problem with long-term vertical contracts that Baker and Krawiec are attempting to solve (or at least ameliorate) is the incentive for opportunistic behavior<sup>13</sup> created by specialized investment.<sup>14</sup>

To see why specialized investment is a problem, and with apologies to those readers who are already familiar with the literature, the time has now come for some economics jargon: specialized investments create appropriable quasi-rents that provide an incentive for opportunistic behavior.<sup>15</sup> In their classic article, Benjamin Klein, Robert Crawford, and Armen Alchian define the appropriable “quasi-rent value” of an asset as the difference between its value in its current, contracted-for location and use and the higher of its salvage

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13. See Baker & Krawiec, *supra* note 2, at 738. In the transactions costs literature, opportunistic behavior is generally defined as the unilateral attempt by one party to change the terms of a bargain after it has been struck. See, e.g., Jonathan Klick et al., *Incomplete Contracts and Opportunism in Franchising Arrangements: The Role of Termination Clauses* (Jan. 9, 2006) (unpublished manuscript, on file with the author); see also *Original Great Am. Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 281 (7th Cir. 1992) (characterizing opportunistic behavior as “behavior designed to change the bargain struck by the parties in favor of the opportunist”). As noted earlier, every contract, after formation but before complete performance, presents some possibility of opportunistic behavior, if only because enforcement costs are more than zero. See *supra* note 3.

Baker and Krawiec appear to be using the term much more loosely. “Opportunism” in their lexicon is sometimes just a synonym for bad behavior, and bad behavior in turn is any departure from joint profit maximizing—including, perhaps, the rational pursuit of self-interest by engaging in distributive bargaining. This is particularly puzzling given their explicit reliance on the agency costs literature, which focuses on *ex post* opportunism. They correctly observe that opportunism costs and agency costs may usefully be viewed as two different terms for the same phenomenon, divided only by a firm’s boundary. Both in turn are subsets of the general problem of moral hazard. Agency costs, however, do not arise before the firm is formed.

The difference between Baker and Krawiec’s definition of opportunism and the more traditional use of that term is not merely semantic. If courts are to be directed to distinguish between contracts that present the possibility of opportunistic behavior and those that do not, they must have a definition of opportunism that explicitly links it to specialized investment. The risk of *ex post* opportunism can furnish that link, although it remains to be seen whether a default rule is best suited to deal with that risk. More generalized notions of “nonjoint profit maximizing behavior” have no obvious link to specialized investment.

14. In a somewhat different context, Baker and Krawiec have noted that the choice of a default rule for incomplete contracts should depend on the source of the incompleteness. See Scott Baker & Kimberly D. Krawiec, *The Penalty Default Canon*, 72 GEO. WASH. L. REV. 663, 666-67 (2004).

15. This is not, of course, the only incentive. For example, market concentration is another potential source of holdup power. If the price mechanism is subject to rigging, then purchasers of a product subject to the rigged price may prefer building the product to buying it. This sort of holdup, however, is not subject to the RSI default.

value (if it must be moved) or its value to an alternative user (if it can remain in place).<sup>16</sup>

For quasi-rents to be worth appropriating, the size of the disparity between the contract price and the alternative use must be substantial. If an asset has multiple possible buyers or users at about the same price, either the owner of the asset will find a new contract partner or the prospective buyer or user of the asset will find someone else to take over the obligation. Further, even if market conditions have changed so that alternative contracting partners cannot be found at the same price, no unusual holdup power is present if the asset's owner can cheaply transact at a lower price and then sue the other party for damages.

What gives contracts involving a specialized investment their particular bite is the absence of readily available market alternatives.<sup>17</sup> Thick markets require at least semistandardized products, and standardization is the opposite of specialization.<sup>18</sup> Thus, appropriable quasi-rents are created not by the costs of an investment but by a combination of the costs of disinvesting, the costs of monitoring, and the costs of enforcement.

In this focus on the quasi-rent created by specialized investment, however, it is easy to overlook the fact that the absence of a market alternative creates mutual holdup power precisely because neither party to the contract can easily substitute an unrelated party's performance. If no one else is buying a customized good, then no one else is selling it either.

To demonstrate this mutual holdup power, Klein, Crawford, and Alchian hypothesize a printing press manufactured and owned by *A* and rented by *B*, a publisher.<sup>19</sup> *A* will do the actual printing for *B*,

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16. Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 298 (1978).

17. It is quite important to differentiate between a specialized investment and an ordinary reliance expenditure. Many parties make reliance expenditures, but if those expenditures can be easily recouped in a market transaction, there is no particular holdup power associated with them.

18. Mobility may also be a factor. Even a noncustomized asset, once fixed in a specific location, may cost a great deal to dismantle and move. Klein et al., *supra* note 16, at 324. The amount of appropriable quasi-rent in such a case will depend on moving costs.

19. *Id.* at 298-99. Their printing press example may be technologically out of date, but it serves to illustrate the problem. Klein et al. (and Baker and Krawiec) also use the real-world acquisition of Fisher Body by General Motors, a merger whose purported reasons have assumed the status of near-myth. *Id.* at 308-10. However, as Baker and Krawiec note, several comparatively recent studies of the Fisher-GM merger have cast doubt on that myth. Baker & Krawiec, *supra* note 2, at 732 n.19. I suspect its major utility is therefore to serve as an example of the difficulty in recognizing a holdup when it is argued one exists.

and *A* will also pay the operating expenses.<sup>20</sup> Once the press has been customized for *B*, it cannot easily be used by someone else.<sup>21</sup>

*B*, the publisher, knows this, and therefore has an incentive to “renegotiate” the contract terms, seeking a lower rent once the press has been customized and installed.<sup>22</sup> If there is another publisher, *C*, willing to rent the press, but only at some lower amount, then *B* may attempt to reduce the agreed-upon rate to that amount, knowing that *A* has no choice but to give in if *A* finds litigation too costly an alternative.<sup>23</sup>

However, *A* is not the only one facing a potential holdup. *B*, the publisher, needs that press and needs *A* to operate it. If *B* is trying to publish on a regular schedule, then *A* can try to increase the rent, either in absolute terms or by reducing the quality of *A*’s services, knowing that *B*’s business cannot quickly be transferred to another press owner. *A*’s ability to extort *B* is capped only by the dollar amount of losses to which *B* would be exposed by a delay. Further, it may be quite difficult for *B* to detect an expropriation which takes the form of reduced services; at the very least, *B* would have to engage in costly monitoring and then, if necessary, costly litigation. All things considered, it might be better for *B* to own and operate its own press or for *A* to own and operate its own publisher.<sup>24</sup>

Thus, the relationship between *A* and *B* is one of *mutual* dependence. Either party may attempt to appropriate the quasi-rent created by specialized investment and specialized need;<sup>25</sup> it is not a one-way street.<sup>26</sup>

20. Klein et al., *supra* note 16, at 299.

21. *Id.* at 298-99.

22. *See id.*

23. *See id.*

24. Then again, it might not. Printing press companies do not generally rush out to buy publishers; the economies of scope apparently do not outweigh the costs of the quite different management competencies involved. Whether, in fact, publishers own and operate their own presses apparently depends on the kind of publishing; newspapers, with high costs of delay, usually do own their presses, while book publishers, whose schedules are more flexible, frequently do not. Klein et al., *supra* note 16, at 301 n.6.

25. That mutual dependence also sets some constraints on the amount of the otherwise possible appropriation. Self-interest, even if untrammelled by concerns for reputation, might induce a party to pluck the golden goose, but only a fool would kill it.

26. The RSI default ignores this essential mutuality. If both parties are making RSIs, Baker and Krawiec claim the default would not apply; they are currently working through what should happen in that circumstance. *See Baker & Krawiec, supra* note 2, at 736 n.29. They acknowledge that if both parties are investing, then favoring one party over the other would exacerbate the holdup problem. *See id.* at 731. If, however, appropriate quasi-rents always create mutual incentives to engage in opportunistic behavior, then favoring one party over the other because one is making a specialized investment while the other has a specialized need would also seem to exacerbate the problem. I will come back to this later.

*B. What Do Baker and Krawiec Mean by a “Relationship-Specific Investment”?*

As noted earlier, Baker and Krawiec propose a new RSI default rule for contracts in which one party has made a specialized investment.<sup>27</sup> In order to gain the benefits of the default, one party must give notice that it is making or has made a specialized investment which relates to the contract, and the other party must consent or at least not object.<sup>28</sup>

If the default applies, then in any litigation between the parties—including any dispute as to the interpretation of ambiguous language, the contents of an allegedly missing term, or the meaning of the background obligation of good faith—the court should favor the version proffered by the relationship-specific investor so long as it is not absurd.<sup>29</sup>

If the concept of a relationship-specific investment is going to do that much heavy lifting, it is essential to define it in a way that is intelligible to parties and courts. Without such a definition, the proposed default rule is unworkable and indeed could be pernicious.

The difficulty here is distinguishing a relationship-specific investment from an ordinary, “plain vanilla” investment. Every commercial contract is in some sense an investment, since it involves the commitment of resources to a transaction or project with the expectation of a positive return on those resources.<sup>30</sup> Further, because every commitment of resources to one contract precludes their commitment to alternative contracts,<sup>31</sup> every commitment is in that sense contract specific.

If the contract involves a long-term relationship, then every resource commitment is relationship specific, because the resources were committed to that relationship rather than others. If the RSI default is not intended to apply to every term of every contract under the sun,<sup>32</sup> then there must be some way of distinguishing a relationship-specific investment from these other investments.

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27. *Id.* at 728.

28. *Id.* at 728, 736.

29. *Id. passim.* The default applies to every term of the contract, whether or not that term is significantly related to the investment. *See supra* note 11 and accompanying text.

30. It does not matter, for my purposes, whether parties correctly estimate the probability of gain and the associated risk. It merely matters that they expect to gain from trading.

31. This is the familiar notion of opportunity cost. MARK SEIDENFELD, *MICROECONOMIC PREDICATES TO LAW AND ECONOMICS* 21 (1996).

32. Or indeed every noncontract in which a party has invested something in the process of an unsuccessful attempt to form a contract. If that party gives notice of an investment—which may be quite informal—and the other party does not object, then the RSI default will supply the “missing terms,” even if those missing terms may be those essential to formation. Baker & Krawiec, *supra* note 2, at 743 n.60.

Baker and Krawiec recognize the difficulty and have given both a general definition of an RSI and some examples of their rule in application.<sup>33</sup> I applaud their attempt to give concrete guidance, but I do not think they are successful in demarcating the line. The problem is that although the general definition seems correct,<sup>34</sup> their examples either do not fall within it or involve contracts that do not and will not exist.

I turn now to their examples of an RSI to see whether the relationship-specific investments they describe create appropriable quasi-rents. If they do not, then there is no holdup power that needs balancing, and the application of their default rule is at best unnecessary and at worst creates its own holdup potential.

### III. THE RSI IN ACTION

#### A. *Krantz v. BT Visual Images, L.L.C.*<sup>35</sup>

Steven Krantz was (and presumably still is) a small businessman in Northern California.<sup>36</sup> He sold videoconferencing systems, which he assembled from various components.<sup>37</sup> He obtained some—but by no means all—of those components from BT<sup>38</sup> pursuant to a formal “reseller agreement.”<sup>39</sup> The reseller agreement permitted Krantz to buy components from BT at a wholesale price and to resell them to his customers at a specified higher price.<sup>40</sup> The agreement explicitly

33. *Id. passim.*

34. Baker and Krawiec never actually explicitly define a “relationship-specific investment” and therefore do not overtly connect it to specialization or customization. However, that connection is implicit in their statements that the RSI either loses significant value or has no value if the parties do not continue to trade. *See id.* at 731, 735-36. It is also implicit in their recognition that a contract for the sale of a fungible commodity does not implicate the RSI. *See id.* at 751.

35. *Krantz v. BT Visual Images, L.L.C.*, 107 Cal. Rptr. 2d 209, 211 (Cal. Ct. App. 2001).

36. *Id.* at 211.

37. *Id.* at 211-12.

38. *Id.* at 212. The BT group marketed British Telecom systems and equipment in North America and offered maintenance contracts on those systems. Brief for Respondent at 3-5, *Krantz*, 107 Cal. Rptr. 2d 209 (Cal. Ct. App. 2001) (No. A087341) (filed Oct. 19, 1999). Although Krantz was the appellant for purposes of the summary judgment, he was the respondent in a consolidated appeal of a related matter; the trial court denied BT’s request for attorneys’ fees pursuant to California statute. Thus, Krantz’s opening brief is denominated a “respondent’s” brief, although a later “respondent’s” brief on the summary judgment issues was filed by BT. The date of the filing is therefore included to distinguish between them.

39. *Krantz*, 107 Cal. Rptr. 2d at 211-12. He had apparently been buying components from BT since 1993 but did not have a formal agreement prior to October 1994. *See id.* at 211.

40. *See* Brief for Respondent, *supra* note 38, at 18-19. The parties sometimes called the difference the “product margin” and sometimes called it a “commission.” *See id.* at 19. A securities lawyer would think of it as a “spread.”

stated that Krantz would be an independent contractor and not BT's agent for the purpose of resales.<sup>41</sup>

One of Krantz's videoconferencing customers was Kaiser Permanente, a nationwide health care provider in Oakland.<sup>42</sup> Krantz's relationship with Kaiser allowed him to acquire "know-how" in customizing systems for it.<sup>43</sup>

At some point in 1994, Kaiser decided to request proposals to supply twenty-four videoconferencing systems in Kansas City and Denver.<sup>44</sup> According to Krantz, these systems were intended to be a "pilot project" which, if successful, would then be installed nationwide.<sup>45</sup> Krantz approached BT about teaming up to submit a bid on those initial systems and, again according to Krantz, to continue to team up on all subsequent Kaiser business if the pilot project succeeded and Kaiser thereafter installed systems in all its other offices.<sup>46</sup>

Krantz alleged that the parties agreed to this ongoing teaming arrangement<sup>47</sup> but did not agree on either the duration of the "team" past the initial bid or the amount of the "product margin"<sup>48</sup> Krantz would get on any future, post-pilot project business.<sup>49</sup> That was all to be left to future negotiation.<sup>50</sup> Nevertheless, according to Krantz, this agreement created both an enforceable contract and a joint venture.<sup>51</sup>

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41. See *Krantz*, 107 Cal. Rptr. 2d at 218. Whether a particular distribution agreement creates an agency or is a "mere" contract for resale is a recurring problem in agency law. In this case, neither Krantz nor BT apparently sought to characterize the reseller agreement as an agency relationship. I use the word "apparently" advisedly, however. Krantz did claim that his relationship with BT eventually became a joint venture, *id.* at 218-19, which (like all partnerships) creates mutual agency within the scope of the venture, but when or how the alleged joint venture was formed is not clear from the opinion or the briefs.

42. See *Krantz*, 107 Cal. Rptr. 2d at 212.

43. Some of that know-how was apparently obtained from a subcontractor. *Id.* As we shall see, there is frequently a problem with assigning property rights in human capital. If Krantz has some claim to the exclusive use of the Kaiser know-how, the subcontractor would seem to have an equally strong claim.

44. See *id.* at 212.

45. Brief for Respondent, *supra* note 38, at 3-4.

46. *Id.*

47. *Krantz*, 107 Cal. Rptr. 2d at 212. This agreement, if it existed at all, was not memorialized in any kind of writing. *Id.*

48. The product margin is sometimes referred to in the opinion as the "profit margin." *Krantz*, 107 Cal. Rptr. 2d at 212. The difference between a "product margin," as in a spread or allowable commission, and a "profit" is quite important on the question whether the arrangement constituted a partnership, and the court's conflation of the two is confusing. BT's petition for rehearing asked for clarification on this, but the court declined the request. Petition for Rehearing at 13-16, *Krantz*, 107 Cal. Rptr. 2d 209 (No. A087341).

49. *Krantz*, 107 Cal. Rptr. 2d at 218. The missing margin term is sometimes referred to as a missing "price" term. In this context, a missing price term and a missing margin term are really the same thing. The margin, at least if expressed in absolute dollars rather than percentages, would depend on the wholesale versus resale price of the components.

50. *Id.*

51. See *id.* at 217-20. BT denied the existence of any such agreement, but of course, for purposes of summary judgment, whether it existed was a disputed question of fact. BT therefore relied instead on various legal arguments that it was unenforceable, one of which

Krantz then shared his know-how and his designs for a custom, modular, Kaiser-friendly videoconferencing system with BT.<sup>52</sup> Once BT had obtained this valuable information, it was in a position to cut Krantz out. It did not do so, or at least not right away, but it did present him with a written teaming agreement for the Kaiser pilot project bid which, he alleged, differed substantially from the previous oral agreement.<sup>53</sup> The most important difference was that the written agreement omitted any mention of his participation in any future, post-pilot project Kaiser business.<sup>54</sup>

The written agreement was presented on the eve of Kaiser's deadline for proposals, and BT told Krantz that if he did not sign, it would go it alone.<sup>55</sup> At that point, he consulted an attorney and decided to sign it rather than be cut out altogether.<sup>56</sup> In the ensuing litigation, he claimed duress.<sup>57</sup>

The BT-Krantz bid was successful, and so, apparently, was the pilot project.<sup>58</sup> BT continued to do business with Kaiser, but without Krantz.<sup>59</sup> He sued, claiming, among other things, breach of contract and breach of fiduciary duty.<sup>60</sup> After protracted and acrimonious pre-trial skirmishes, BT moved for summary judgment.<sup>61</sup> BT argued, among other things, that the alleged interim, oral agreement, which

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was that it was merely an "agreement to agree" and therefore too indefinite to be enforced. *Id.* at 218.

52. *Id.* at 212. There was apparently no confidentiality agreement, written or oral. *See id.* at 211-13. Interestingly, Krantz did not claim a property interest in his custom designs (or if he did, it is not intelligible from the briefs). He did, however, claim ownership of some of the other information he gave BT. *See* Brief for Respondent, *supra* note 38, at 7-8. Because the custom configuration also relied on components from other suppliers, the bid required knowing the cost of those other components. *See id.* at 7. Krantz had that information; BT apparently did not. *See id.* Krantz shared that information with BT and later claimed that it was his own "proprietary" information. *Id.*

53. *Id.* The written teaming agreement contained an integration clause. Petition for Rehearing, *supra* note 48, at 8. BT relied heavily on this in its motion for summary judgment, essentially arguing that even if the previous oral agreement did exist, it had been superseded by the written agreement. *Id.*

54. It did not, however, omit any terms as to his payment for the pilot project itself. The court's opinion suggests that BT was arguing that the written teaming agreement was too indefinite to be enforced. *Krantz*, 107 Cal. Rptr. 2d at 211, 217-18. In fact, however, BT had already paid Krantz for his participation in the pilot project pursuant to the written terms; one of its defenses to the allegation that it had breached the written teaming agreement was that it had been fully performed. *Id.* at 218.

55. Brief for Respondent, *supra* note 38, at 7-8.

56. *Id.* at 8.

57. *Krantz*, 107 Cal. Rptr. 2d at 218.

58. *See* Brief for Respondent, *supra* note 38, at 8-9.

59. *See id.* at 9-10.

60. The complaint contained thirteen causes of action. *Id.* at 10-11. The breach of contract claims apparently covered the reseller agreement, the interim oral agreement, and the final teaming agreement. *Krantz*, 107 Cal. Rptr. 2d at 217-19. The breach of fiduciary duty claim was based on the "joint venture" allegedly created either by the interim agreement or the written "teaming" agreement or both. *Id.* at 219.

61. *Id.* at 213.

Krantz conceded omitted future product margins and price terms, was too indefinite to be enforced.<sup>62</sup>

The trial court agreed with BT and granted summary judgment on all of Krantz's claims.<sup>63</sup> Krantz appealed, and the appellate court reversed, ruling that dismissal was premature.<sup>64</sup>

The portion of the opinion of most interest to Baker and Krawiec deals with BT's argument that the oral "contract" was merely an "agreement to agree" and therefore unenforceable.<sup>65</sup> The appellate court held that the missing terms did not render the agreement unenforceable as a matter of law.<sup>66</sup> It did so in one short paragraph, saying that the missing terms were "necessarily" indefinite because it remained to be seen whether the joint proposal would be accepted, and those terms were not essential elements of an agreement to jointly prepare and submit a bid on Kaiser's proposals, "dependent as they were on the scope of Kaiser's purchases, if any."<sup>67</sup>

The agreement, assuming that it existed, was certainly highly contingent; it depended on winning the bid for the pilot project, on Kaiser's evaluation of the pilot project's success, and finally on Kaiser's decision to use the Krantz-BT team for any future expansion of the pilot project.<sup>68</sup> However, Baker and Krawiec are surely correct when they say that it is not clear that the necessary information on future product and pricing margins was unavailable to the parties.<sup>69</sup> Because the information was available but not included, the stan-

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62. *Id.* at 217-18. As noted earlier, BT also denied that such an agreement existed, but, of course, BT could not have obtained summary judgment based on that denial. *See supra* note 51.

63. *Krantz*, 107 Cal. Rptr. 2d at 213.

64. *Id.* at 217-20.

65. *Id.* at 218. This part of the opinion is also discussed in Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1656-57 (2003).

66. *Krantz*, 107 Cal. Rptr. 2d at 217-18.

67. *Id.* at 218. The court's discussion is puzzling because it focuses on the written teaming agreement, which was the contract for the joint submission of a bid on the "pilot project." *Id.* at 212-13, 217-18. BT never argued that agreement was too indefinite to be enforced; indeed, it argued that it had been fully performed. *See id.* at 218. The only "contract" urged to be indefinite was the alleged oral agreement to team on any post-pilot project business with Kaiser. *Id.* at 212-13, 217-18. That was the agreement that Krantz conceded said nothing about margins or prices. *See* Brief for Respondent, *supra* note 38, at 6. Indeed, it is hard to imagine how the pilot project bid could have been submitted without the parties having "costed" it, which means that they had to have addressed margins and prices by the time the bid was submitted. Krantz apparently contended that the eventual (written) pilot project agreement—allegedly signed under duress—differed from the previous (oral) agreement as to the margins and prices for that project, not that those terms were missing from that oral agreement—at least as to the pilot project bid.

68. *See Krantz*, 107 Cal. Rptr. 2d at 212-13.

69. Baker & Krawiec, *supra* note 2, at 741. Indeed, the parties could have negotiated a percentage (as they in fact did for the written agreement) without knowing a dollar amount. Krantz's expert witness used just such a percentage in calculating his claimed damages for his exclusion from that additional business.

dard analysis of agreements to agree would have led the court to refuse to enforce the agreement.

Baker and Krawiec nevertheless maintain that the case was correctly decided because their RSI default would have reached the same result.<sup>70</sup> Krantz, they say, made a relationship-specific investment by sharing his expertise about Kaiser's needs with BT; his investment was specific to the missing margin and price terms because he would not have shared his expertise if he had thought BT would use it for its own advantage, with no compensation to him.<sup>71</sup> They also say he gave the requisite notice by telling BT that he had developed this expertise through his relationship with Kaiser.<sup>72</sup> Further, they say, BT was fully aware that Krantz expected his expertise-sharing to pay off in the form of a continued relationship.<sup>73</sup> Thus, they conclude, the missing terms should be supplied in the manner most favorable to Krantz so long as Krantz can support his claim with credible expert testimony.<sup>74</sup>

With all respect, if this is the lesson we are to draw from the case, then I am going to flunk this course, and so, I am afraid, are a plethora of parties and judges. Here is the rub: Krantz "invested" a resource that he already owned.<sup>75</sup> He developed that resource—his know-how—because of his relationship with Kaiser, not because of his relationship with BT.<sup>76</sup> That know-how may very well have been of value to BT, but it was not developed for and because of the contract with BT.<sup>77</sup>

70. *Id.* at 741-42.

71. *Id.* at 741.

72. *Id.* at 741-42. If that is sufficient notice, it is unclear to me how BT could possibly have related it to the missing terms in the alleged contract. Further, if this is an RSI, then what of BT's investment in the components to be used? I presume BT's edge over its competitors in this high-tech industry required ongoing investments in physical and human capital. Krantz knew BT's products were not fungible; he preferred BT components for some purposes, although he used other components as well. *Krantz*, 107 Cal. Rptr. 2d at 212. Did Krantz, therefore, have notice that BT was making a relationship-specific investment too?

73. Baker & Krawiec, *supra* note 2, at 741-42. This assumes, of course, that BT could have understood this as a communication of an intent to make a specialized investment in the first place—which in turn requires an intelligible definition of investment.

74. *Id.* at 742, 744 n.63.

75. I am assuming, for the moment, that he "owned"—had a property right in—the know-how. As noted earlier, *supra* note 43, his subcontractor might also claim ownership, and, of course, Kaiser was free to disclose information about its needs to other suppliers, including BT.

76. See *Krantz*, 107 Cal. Rptr. 2d at 212. Indeed, according to Krantz, BT asked him to be an authorized reseller because of that preexisting relationship. Brief for Respondent, *supra* note 38, at 5-6.

77. Baker and Krawiec observe that BT did not object to Krantz's "notice" that he was making an RSI, see Baker & Krawiec, *supra* note 2, at 741-42, but if the purpose of an objection is to prevent overinvestment, it was far too late for that. Krantz's investment in know-how was by that time a sunk cost.

To see why that makes a difference, let us go back to Klein, Crawford and Alchian's classic example of the printing press.<sup>78</sup> *A* contracts to manufacture and operate a customized press for *B*. Once the press is manufactured and installed, both *A* and *B* have holdup power over each other because they are mutually dependent.

Now suppose that *B* is struck by lightning, goes bankrupt, or otherwise disappears from the scene. *B* no longer has holdup power over *A*, although that does not mean that *A* is a happy camper. *A* is now stuck with the press and has to decide what to do with it. *A* might enter into a contract to sell or lease it to *C*, who might be another publisher or, for that matter, a scrap dealer. *A* is committing a resource—the press—to the contract with *C*, and *A* hopes to profit from that commitment. Thus, *A* is, in some sense, investing in the contract. But *A* is not, repeat not, making a specialized investment with respect to the contract with *C*.<sup>79</sup> *A* is simply selling an existing asset to the highest bidder.

I hope that by now it is obvious that if Krantz is *A*, the owner of the asset in our hypothetical, then Kaiser, not BT, is *B*, the party for whom the asset was custom-manufactured. Krantz “invested” in learning about Kaiser's specialized needs in order to do business with Kaiser. If Kaiser decided to use someone else for its videoconferencing systems—which Kaiser was free to do, since it did not have a long-term contract with Krantz—then Krantz would lose the value of that investment. Kaiser therefore had some holdup power in the relationship.<sup>80</sup>

But Krantz's beef is not with Kaiser, it is with BT. So, if Kaiser is *B* in the hypothetical, who is BT? The answer is that BT is *C*, the party—think second publisher or scrap dealer—to whom Krantz tried to sell his preexisting asset. The *C*s of the world may behave badly, but their power to do so is not a result of specialized investment.

What gave BT the power to (allegedly) behave badly in the contracting process was the nature of Krantz's asset. Know-how is a form of human capital. Some of it is acquired by doing and is, therefore, not

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78. See *supra* notes 21-28 and accompanying text.

79. If *C* is another publisher to whom *A* decides to lease the press, and *C* requires some custom modifications to meet *C*'s needs, then the cost of the modifications would be a specialized investment. However, *C* would not have holdup power—or at least not more holdup power than any contracting party has—as to the original investment made because of *A*'s relationship with *B*. Those costs are sunk.

80. Krantz's investment in learning about those needs might serve as a barrier to entry by another competitor, giving him an advantage which would make it less easy for Kaiser to switch to someone else. Thus, if Kaiser had some holdup power over him, he could have had some over Kaiser. Kaiser, however, was perfectly willing to open up its pilot project to competitive bids. *Krantz*, 107 Cal. Rptr. 2d at 212. This suggests that Krantz's know-how was not very valuable to Kaiser, who could easily communicate its needs to another provider.

easily transferable to a novice purchaser. Some of it takes the form of information that can be used by anyone. Krantz's knowledge about Kaiser and his system designs fall into the latter category.

Valuable information is an odd kind of property; the process of transferring it can destroy its value to the prospective seller. Information wants to be free—or at least the law wants information to be free unless its status as property is very carefully protected.<sup>81</sup> Krantz gave BT his information and designs without a confidentiality agreement.<sup>82</sup> If he did so before any contract had been formed, then he is the victim of a self-inflicted wound.<sup>83</sup> If he did so after an enforceable agreement had been reached, then he is a justifiably aggrieved plaintiff in an ordinary contract action. Under either scenario, however, he is not someone who made a specialized investment because of his relationship with BT.

#### B. *Eastern Air Lines, Inc. v. Gulf Oil Corp.*<sup>84</sup>

This case involved a requirements contract under which Gulf Oil agreed to supply Eastern's aviation fuel requirements at certain airports.<sup>85</sup> When the price of crude oil rose dramatically in the early 1970s, the contract price was lower than the market value of the fuel.<sup>86</sup> According to Baker and Krawiec, Eastern responded to the price differential by "fuel freighting"—that is, by taking on more fuel than it needed at Gulf-serviced airports in order to avoid paying higher prices at non-Gulf airports, thus manipulating its requirements.<sup>87</sup>

81. I do not propose to wade further into the murky waters of intellectual property here.

82. Perhaps Baker and Krawiec's real concern is that BT did not warn Krantz that he should protect himself with a confidentiality agreement. In that case, Krantz's "RSI notice" would trigger the contractual version of a Miranda warning: You have the right not to give away valuable information, and if you give it away, we can use it without compensating you.

Parties to commercial contracts are not, however, usually required to explain the law to each other, and Baker and Krawiec do not explain why that kind of information sharing should be forced through a default rule. Indeed, using a default rule to correct ignorance about the law would seem to undercut the basic premise of the default rules literature: parties are rational actors who can predict legal outcomes and adjust their behavior accordingly.

83. At least from the perspective of contract law. Krantz also alleged that his agreement with BT was joint venture, which is a species of partnership. *Krantz*, 107 Cal. Rptr. 2d at 212. Partnership law can yield a different result, depending on whether the jurisdiction operates under the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA). Under the UPA, fiduciary duties—including the duty not to appropriate information—exist during the negotiation period preceding the formation of a partnership, UNIF. P'SHIP ACT § 21 (1914); under RUPA, fiduciary duties do not commence until the partnership is formed. REVISED UNIF. P'SHIP ACT § 404 (1997). At the time in question, California was a UPA state.

84. 415 F. Supp. 429 (S.D. Fla. 1975).

85. *Id.* at 434-35.

86. *See id.* at 433.

87. Baker & Krawiec, *supra* note 2, at 745-46.

Gulf tried to renegotiate the contract price for its fuel, but Eastern refused.<sup>88</sup> According to Baker and Krawiec, Gulf was locked in to its relationship with Eastern because it had built a new refinery and needed to continue to trade with Eastern; it had no readily available alternative customer.<sup>89</sup> The new refinery was, or may have been, a relationship-specific investment and—had the RSI default existed at the time of the case—a court would have used it to rule that Eastern's conduct was not in good faith.<sup>90</sup> Knowing that Gulf would win if it came to litigation, the airline would have renegotiated the price.<sup>91</sup>

There are two problems with this account of the case. The first is that it does not comport with the facts. Gulf did not build the refinery so that it could supply Eastern,<sup>92</sup> and Eastern did not dramatically increase its requirements to take advantage of the price differential.<sup>93</sup>

The second problem is that the refinery investment did not create quasi-rents that could be appropriated by Eastern. Aviation fuel is not a customized product; Gulf's fuel was fungible with that produced by other suppliers. If it were not, Eastern could not have fuel freighted. Further, refineries are not usually limited to one type of fuel. Gulf wanted out of its contract with Eastern precisely because it could get a higher price for its refinery products elsewhere.<sup>94</sup> In short, the Eastern-Gulf contract involved a standardized product with a readily available market alternative. Eastern could not hold up Gulf,

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88. *Eastern Air Lines*, 415 F. Supp. at 431-32.

89. Baker & Krawiec, *supra* note 2, at 746.

90. *Id.*

91. *Id.*

92. Baker and Krawiec state that it is not clear from the facts of the case whether the refinery was built specifically to fit the needs of Eastern. *Id.* I agree that the opinion is muddled at best. However, as Victor Goldberg has noted, the court's reference to the refinery as the reason for the contract "cannot be right. The claim that requirements contracts were widely used by other refineries and were used by Gulf at other refineries and at earlier times is inconsistent with this explanation." Victor P. Goldberg, *Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith*, 35 U.C. DAVIS L. REV. 319, 334 (2002). Indeed, Gulf would have been crazy to build a refinery just for Eastern. Eastern bought only ten percent of its total fuel requirements from Gulf, *id.* at 333, and the refinery came online when the most recent contract between them had only one year to go. *See Eastern Air Lines*, 415 F. Supp. at 432.

93. *Id.* at 335 ("[T]he variation in quantity appears to have been rather modest."). This is not surprising; Eastern could not suddenly change its routes or its schedule. It was in business to be an airline, not a fuel jobber.

Gulf's real problem was that the escalator clause in the contract, which provided a variable price depending on the price of crude, did not anticipate that the government would impose a new form of price control and that the published price would not reflect the "real" price of crude. *See Eastern Air Lines*, 415 F. Supp. at 439-40. Gulf wanted the escalator clause rewritten to correct the disconnect between the published price and reality. *See id.* at 431-32, 439-40. The court was unsympathetic; it held that the language was not ambiguous, noting that it was Gulf's form contract and Gulf had chosen the pricing measure. *See id.* at 432, 439.

94. *See Eastern Air Lines*, 415 F. Supp. at 441 (noting Gulf Oil's "rational desire to maximize its profits").

and there is no reason to apply a default rule that would change the outcome of the case.<sup>95</sup>

Although Gulf's refinery did not involve a specialized investment, there are other contracts that do. For example, how would the RSI default work in commercial leases? Baker and Krawiec do not attempt to answer this question. Nevertheless, commercial leases present the claimed virtues (and potential vices) of the RSI default in a useful real-world context and are therefore worth exploring.

Commercial leases come in a variety of flavors, ranging from "build to suit" to bare walls. Their terms are intensively negotiated. A tenant's relationship-specific investment in supplying the interior (for a bare walls lease) or a landlord's relationship-specific investment in building to suit will presumably be reflected in those negotiated terms and will take into account the fact that a customized interior may increase the value of the premises to the landlord when the tenant leaves—but may also decrease the value if the landlord must remove or rearrange the interior in order to lease to a new tenant.

Commercial leases, particularly in shared spaces like malls, usually assign the landlord considerable control over the tenants' activities. The landlord's exercise of that control is subject to the implied condition of good faith, as is the landlord's discretion to renew the lease, to permit subleasing, or to evict for cause.

How would the RSI default affect commercial landlord-tenant disputes about the landlord's exercise of control or discretion? The answer appears to be that the landlord would win in a "build to suit" lease, and the tenant would win in a bare walls lease—assuming, of course, that the counterparty had not objected to the invocation of the default when the lease was negotiated.

It is not at all clear that this result is allocationally efficient. Consider the bare walls tenant who intends to invest in a customized interior. If Baker and Krawiec are correct, the RSI default would encourage this investment by permitting the landlord to credibly commit not to hold up the tenant while simultaneously discouraging

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95. Baker and Krawiec suggest that even if the refinery itself was not a specialized investment, other facts might have been developed to demonstrate that Gulf had made a specific investment in its relationship with Eastern. For example, they say, Gulf might have trained its workforce to work on Eastern jets or located fueling stations at Eastern hubs. Baker & Krawiec, *supra* note 2, at 747. However, unless Eastern was operating non-standard jets, or no other airlines were using the hub airports, any such investments would not have specialized.

Indeed, if either party in this relationship was vulnerable, it was Eastern. The opinion does not say whether other sources of aviation fuel were available at those particular airports. That does not, however, require the invention of a default rule to protect Eastern. It could have (and indeed may have) entered into standby contracts with alternative suppliers.

overinvestment by giving the landlord an incentive to monitor the level of the tenant's expenditure.

The landlord, however, is not in a particularly good position to observe the appropriate level of investment for any given tenant. If the landlord were an expert in running the various businesses on the leased premises, it would operate them itself.<sup>96</sup>

Further, if customized interiors produce an appropriable quasi-rent, that may be exactly why the parties chose the sort of lease that required them. A tenant's specialized investment may be a bonding expenditure designed to permit the tenant to credibly commit not to hold up the landlord.

Commercial leases, at least when the premises are shared with other tenants, produce a "double moral hazard" problem. While the possibility of a landlord holdup should theoretically lower the rent, the landlord's ability to control the tenants and the tenant mix can actually increase rents. All tenants benefit when the landlord maintains the overall quality of a mall or any other shared commercial premises. That benefit can be captured in the form of higher rents than would otherwise obtain in a low-quality environment. Whether assigning discretion to the landlord actually lowers rents depends in part on the market's assessment of the relative likelihood of bad landlord behavior versus bad tenant behavior.

One bad tenant can reduce the communal value of high-quality premises. A tenant who is leaving has no continuing interest in mall quality. If, for example, the lease were freely assignable, a departing tenant would have an incentive to hold up the landlord (or the other tenants) by threatening to sublease to a low-quality tenant. That threat is (or at least may be) more likely than a landlord's threat to hold up a departing tenant by refusing consent to sublease to a high-quality tenant. The landlord is a repeat player whose investments in reputation and sustained profitability make it less likely that the consent provision will be used solely to hold up one tenant than that a departing tenant will use free transferability to hold up the landlord.

Thus, assigning discretion to the landlord can increase the value of commercial leases generally. Specialized investment by tenants can also increase the value of commercial leases because it reduces any given tenant's incentives to hold up the landlord.

The problem with the RSI default in this situation is that it fails to recognize that the very existence of the rule reduces the tenant's ability to use specialized investment as a commitment device. Fur-

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96. The same dynamic is at work in franchise arrangements. If the franchisor could operate the component businesses itself, it would not franchise. Much of my analysis here of the role of specialized investment in commercial leases builds on Klick, Kobayashi, and Ribstein's work on opportunism in franchising agreements. See Klick et al., *supra* note 13.

ther, since the default would favor the landlord in a “build to suit” lease, it would reduce the value of the landlord’s investment in reputation as a bonding expenditure if there are other tenants who would later pay a higher rent for that particular configuration.<sup>97</sup>

I suspect that the net result of the RSI default for commercial leases would be that landlords and tenants would routinely waive its dubious protections in order to preserve their own carefully crafted balancing of the costs and benefits of specialized investment. In any event, I wish Baker and Krawiec had focused their considerable talents on “good faith” in contracts that actually involve such investments rather than on implausible hypotheticals—which leads me to their next example.

### *C. A Hypothetical Requirements Contract*

Baker and Krawiec posit a requirements contract with no specified quantity range.<sup>98</sup> After the contract is signed, the seller makes “a substantial investment in targeting its production to the buyer’s needs,” and the buyer does not object.<sup>99</sup> Later, in an attempt to lower the price, the buyer claims that it requires very little of the product.<sup>100</sup> The seller’s investment triggers the RSI default rule, although perhaps merely in order to flip the burden of proof on the buyer’s good faith.<sup>101</sup>

It is not clear whether this “targeted” production means that the resulting product is so specialized that no one else will buy it. If the product is not customized, there is no appropriable quasi-rent. Further, the hypothetical does not explain why the buyer can so easily make a credible threat to do without it, given that the reciprocal of the seller’s specialized investment is the buyer’s specialized need. The holdup power would be mutual and the buyer would be vulnerable too—yet the RSI default would increase the seller’s rebargaining power at the expense of the buyer.

Baker and Krawiec do not have a supporting case for their hypothetical, which is not surprising. Requirements contracts with a missing quantity term are a null set. In any event, if the hypothetical seller did not protect itself with a “take or pay” clause, payment in advance, or any of a number of other available contractual devices, then we have another case of a party whose managers are either crazy or closely related to potted plants—and businesses run by such

97. In such a situation, of course, the landlord’s specialized investment would not create an appropriable quasi-rent.

98. Baker & Krawiec, *supra* note 2, at 747-48.

99. *Id.* at 748.

100. *Id.*

101. *Id.* at 749.

people are unlikely to have the wherewithal to make substantial investments in targeted production.

D. *Raffles v. Wichelhaus*<sup>102</sup>

Baker and Krawiec's final example of a relationship specific investment is based on the classic case of the good ships *Peerless*.<sup>103</sup> A buyer and seller contracted for the sale of cotton to be transported on a ship named "Peerless."<sup>104</sup> As it happened, two ships of the same name plied the Bombay to London route, one arriving in October, the other in December.<sup>105</sup> The seller shipped on the December *Peerless*, and the buyer refused to accept delivery because it was not the October *Peerless*.<sup>106</sup> The court held that the mistake as to the ship name meant there was no contract.<sup>107</sup>

Baker and Krawiec suggest that a modern court should ask whether either party has made a relationship-specific investment in the cotton contract and given the necessary notice.<sup>108</sup> If one has, then that party's interpretation of *Peerless* should win.<sup>109</sup>

I have no idea what form of relationship-specific investment the authors have in mind, but unless it results in customized cotton with no readily available alternative market, there is no quasi-rent to appropriate. I have a very hard time imagining modern parties who are capable of bioengineering cotton and using it in a way valuable to no one else, but are nevertheless incapable of particularizing the shipping method, using a tracking number (or a global positioning transmitter on the container), or electronically communicating a shipping confirmation. I suspect that, once again, such parties do not exist.

IV. CONCLUSION

Without an intelligible definition of a relationship-specific investment, I cannot tell whether the RSI default would solve or even ameliorate the holdup problem created by appropriable quasi-rents. Even with an intelligible definition, the fact that the default operates only on behalf of the party making the investment would be deeply troubling, since it ignores the bilateral dependency created by the relationship.

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102. (1864) 159 Eng. Rep. 375 (Exch. Div.).

103. Baker & Krawiec, *supra* note 2, at 750.

104. *Raffles*, 159 Eng. Rep. at 375.

105. *Id.*

106. *Id.*

107. *Id.* at 376.

108. Baker & Krawiec, *supra* note 2, at 750-51.

109. *Id.*

I am also generally skeptical about the apparent assumption in much of the default rules literature that courts can do a better job of protecting the economic interests of the parties than the parties themselves can.<sup>110</sup> I am therefore dubious about the claimed benefits of the RSI default. I can, however, briefly sketch some of its more obvious costs.

First, I can foresee a cottage industry in litigating whether a claimed RSI is really relationship specific and whether the notice was in any event sufficient.<sup>111</sup> The costs of enforcement are real costs and ought not to be lightly increased. The costs of legal error are real costs too, and—at the risk of impermissible academic hubris—I do wonder how an overburdened state court judge is supposed to distinguish between relationship-specific investments that create holdup power, relationship-specific investments that do not create holdup power, ordinary reliance expenditures, and the mere commitment of resources—when some very talented law professors and economists cannot.<sup>112</sup>

Second, if an RSI notice given during the negotiation period is enough to convert a not-yet-contract into a contract, it may deter a valuable negotiating technique, the agreement to agree.<sup>113</sup> That, in turn, would result in less, not more, efficient contracting.

Third, the RSI default may reduce the utility of specialized investment as a bonding mechanism, particularly in situations of double moral hazard like franchising and commercial shopping center leases.

Finally, if the RSI default applies to the acquisition and dissemination of information, it permits the party possessing the information to evade the generally understood mechanisms for protecting intellectual property. Confidentiality agreements, to which both sides must agree, will be augmented and perhaps replaced by a unilateral claim of specialized investment. It is possible that those who specialize in intellectual property law would consider this a good thing, but I doubt it.

110. In this, I am at least in good company. In addition to the previously cited work of Eric Posner, *supra* note 12, and Victor Goldberg, *supra* note 92, see Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003).

111. This is likely even if parties do not engage in strategic notification and confine themselves to good faith claims. If no one can be sure what an RSI is and if benefits flow from invoking the default rule, then anything that could plausibly be an RSI will be called one. Of course, it is also possible that routine notice will be followed by routine objection, in which case the default rule would enrich the purveyors of paper and ink without producing any other discernible costs or benefits.

112. One has only to recall the persistent dispute over the reasons for the GM-Fisher Body acquisition, *supra* note 19, to get a sense of the problem.

113. The fact that such an agreement is not enforceable does not make it useless. See Omri Ben-Shahar, "Agreeing to Disagree": Filling Gaps in Deliberately Incomplete Contracts, 2004 WIS. L. REV. 389, and the authorities cited therein.

In short, there is a very real question whether the RSI default, intelligibly defined, would reduce the costs of contracting within the sphere in which it will operate without producing other, even higher costs. At best, the answer must be a definite “maybe” and at worst, a resonant “no.”