

A Practical Role for Theory in Commercial Dispute Resolution

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Three years ago I found myself teaching a large upper year class on Sales Law and Advanced Contracts. Now I confess that the Sales Law portion of this course was slightly coerced and not my first choice. But the theory of contracting, which prompted me to include "advanced contracts" in the title, was. As a law professor who is also an economist, my work in contracts is very much informed by theoretical considerations, particularly with respect to commercial contracts. And these considerations I attempt to impart to my upper-year students : what economic theory helps us to understand about the goals commercial parties have when they enter into a contract, what obstacles strategic behaviour or uncertainty might pose to the achievement of these goals, what types of contracting environments give rise to what types of obstacles and what solutions there might be, in abstract terms, to the contracting problems the parties face. I teach my students about sunk costs and opportunistic behaviour, alternative mechanisms for adaptation in the face of uncertainty, simple game theoretic understandings of strategic behaviour, the impact of information asymmetries on bargaining and performance, the theory of incomplete contracting, and so on.

During one such theory-minded class, I noticed that my usually diligent and attentive class, who seemed to take down everything I said about doctrine, had "switched off". Most people were listening rather vacantly; few people were taking notes. So I stopped and asked why. Luckily an articulate and fearless student gave me a quick, blunt, response : "You're talking policy; it's question four on the exam and frankly isn't that important. We just don't understand why you spend so long on this stuff rather than telling us about the law here".

My students that day were making a common mistake; they thought that the "theory" component of the course was a bit of a frill, a luxury if you ever thought you might be in a position to decide what you thought the law "ought" to be, but removed from the basic lawyer's problem of what the law "is". The students had compartmentalized theory, distinct from law. I had seen this when I judged student moots : those who knew I was on the panel of judges and knowing of my connection to law and economics, would include a few paragraphs at the end of the *factum* telling me what the efficient result would be. But as I explained to my students, judges, particularly lower court judges, won't be very much interested in arguments from efficiency unless it appears to them that the law they are applying specifically invites such arguments. What they want and need are good legal arguments and that's where the theory can be useful. Students are a bit

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mystified by this. What follows is what I offer by way of explanation for my view that theory is an integral part of legal argument.

It is useful to employ a basic distinction that economists rely on, between positive theory and normative theory. Positive theory is descriptive or predictive theory. It is behavioural theory : this is how people act, this is how you can expect them to act. Positive theory is directed at answering questions such as, "What will happen to the price in this market if an injunction is denied?", "Is it likely that a strategic profit-maximizing contracting partner will live up to this promise if the consequences for default are these?", "What agreements about price or conduct are such contracting partners likely to be able to agree to in the event that the contract becomes commercially impracticable?", "What kinds of contracts are parties in these situations likely to write?"

Normative theory, on the other hand, is evaluative : it assesses outcomes relative to some criterion that allows us to say, this is a good result or this is a bad result. Economics usually uses efficiency as the criterion.¹ Normative economic theory is directed at answering questions such as, "Will denial of an injunction promote efficiency in this market?", "Is the contract the parties can be expected to write efficient?", "Will these consequences for breach promote efficient breach?", "Will these contract terms promote efficient adaptation to changing circumstances?"

I believe the first part of the mistake that my students made and that is frequently made by lawyers generally is equating economic theory with normative theory, overtly "policy" oriented. "Theory" includes positive theory and it is this portion of theory that is of particular practical value in commercial dispute resolution. The second part of the mistake is seeing that theory, even positive theory, as alien to ordinary legal reasoning; that there is a sharp "law" "theory" divide; that one can do good legal reasoning without good theory. In my view, positive theory is of great value to a lawyer working to resolve a commercial dispute. Indeed I believe it is essential. And, most importantly, I believe it is entirely of a piece with ordinary legal reasoning : relevant to law on law's own terms.

Many lawyers working in commercial areas will already be familiar with one sense in which positive theory (and I'm going to focus on economic theory but I believe the argument is more general) is relevant to law on its own terms. This is the case in which extrinsic theory is relevant as a matter of expert evidence. Familiar examples are presented by competition law, in which economic theorists can be called on to testify about the likely impact of a merger or particular trade practice on competition in the area. The *Competition Act*,² for example, prohibits regional price discrimination only where the practice has "the effect or tendency of substantially lessening competition or eliminating a competitor."³ Theory is directly relevant here because the substantive law turns on determinations about facts that are accessed by theory. Other examples include expert

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1. I am firmly of the view, however, that efficiency is not the only relevant normative criterion and that it is a mistake for those doing law and economics to focus exclusively on efficiency.
 2. *Competition Act*, R.S.C. 1985, c. C-34.
 3. *Ibid.* s. 50.

testimony about the likelihood of irreparable harm if a preliminary injunction is denied, or the assessment of damages or profits in the remedial phase of a commercial dispute.

These are the cases in which a role for theory is familiar. There is, however, a much broader role for (positive) theory in commercial disputes, a role for theory in legal reasoning itself and not merely in the assessment of the facts to which law is applied. An appreciation of how commercial relationships and markets work runs through legal reasoning in the area of commercial dispute resolution; the role for theory is to bring formal theoretical reasoning to bear on the implicit theories that judges routinely rely on in their reasons.

I want to demonstrate this point by looking at the legal reasoning employed by the Supreme Court in the much-contested area of commercial fiduciary duties. This is an area in which I have done theoretical work, analysing the problem of fiduciary duty from the perspective of the theory of incomplete contracting that economists have developed.⁴ The work draws on the insights of bargaining theory, in particular bargaining under conditions of private information and strategic behaviour. As I see it, such theory is directly relevant, as legal argument, to the legal reasoning employed by the Supreme Court in this area.

Consider first the reasoning of the late Justice Sopinka in *Lac Minerals Ltd. v. International Corona Resources Ltd.*⁵ The cornerstone in Justice Sopinka's reasons for determining that no fiduciary duty arose between LAC and Corona was this :

*If Corona placed itself in a vulnerable position because Lac was given confidential information, then this dependency was gratuitously incurred. Nothing prevented Corona from exacting an undertaking from Lac that it would not acquire the Williams' property unilaterally. [...] If Corona gave up confidential information, it did so without obtaining any contractual protection which was available to it.*⁶

In putting forward reasons such as these Justice Sopinka was, I contend, drawing on theory. Implicit theory, perhaps, but theory nonetheless. He was making assumptions and predictions about how commercial contracting practices work, in particular, the

4. G.K. Hadfield, "An Incomplete Contracting Perspective on Fiduciary Duty" (1997) 28 Can. Bus. L. J. 141.

5. *Lac Minerals Ltd. v. International Corona Resources Ltd.* [1989], 2 S.C.R. 574, 61 D.L.R. (4th) 14 [hereinafter *Lac Minerals* cited to S.C.R.]. This case is so well known that I won't elaborate on the facts. For the uninitiated, the case involved a junior mining company — Corona — which sought to interest a major mining company — Lac Minerals — in joint development of a gold find. In the course of negotiations Corona revealed that it had discovered reason to believe that the find extended onto adjacent property, namely the Williams' property. While negotiations continued, Lac acquired the Williams property without Corona's knowledge, indeed even as it knew Corona was attempting to acquire the property for the joint venture. Lac was ultimately held not to have violated a fiduciary duty but to have committed a breach of confidence.

6. *Ibid.* at 607.

feasibility of negotiating and drafting a contract to protect Corona's interests. There is nothing "unlawlike" about his doing this. Indeed, it is precisely my point that ordinary legal reasoning in commercial cases is woven with theoretical threads.

Now, as it turns out, the subject on which Justice Sopinka was perhaps unselfconsciously waxing theoretical has kept many academics in economics and law busy for some time now. The Lac-Corona situation can be seen as a species of incomplete contracting, albeit at the extreme of no contracting. With respect to such contracts, theorists have explored questions such as, "What are the obstacles to complete contracting?", "Why do contracts not include all the provisions that one might think ahead of time they should or could?" There are a variety of answers. Contracting is costly, for example. But the answer that has greatest salience in the Lac and Corona case is an answer that looks to strategic behaviour in bargaining situations with information asymmetries between the parties.

Drawing both on common sense and, at times, some rather fancy mathematical analysis, economists have analysed in detail the impact that information asymmetries have, in theory, on the bargaining and contracting processes. The analysis emphasizes that contracting about transfers of information faces some fairly formidable obstacles.

First, it is difficult to negotiate contracts to govern the transfer of private information because the very process of raising an issue for negotiation and making contract offers or proposals can reveal, at least partially, the information that the one party wants to keep to itself until the other party has agreed to contractual protections. The economics of information looks at how information can be extracted from signals such as contract offers.

For example, suppose in the Lac case that Corona had approached Lac to negotiate contractual protections to govern the information exchange. What Corona knows and Lac does not at this point is that the discoveries on Corona's land probably extend to neighbouring land such as the Williams' property. Corona wants to share this information with Lac in order to interest Lac in financing a joint venture to develop the claims. Suppose in approaching Lac, Corona offers to tell Lac what it knows but only if Lac signs an agreement that it will not purchase adjacent land such as the Williams' property. Clearly, this contract offer reveals quite a bit to Lac. And so Justice Sopinka's *legal reasoning* — "Nothing prevented Corona from exacting an undertaking from Lac that it would not acquire the Williams' property unilaterally"⁷ — can be countered by challenging the implicit theoretical claim: in fact, the risk of signalling what it wanted to keep private could have prevented Corona from exacting such an undertaking. The counter, like the claim, is also legal reasoning, albeit informed by appeal to the theoretical reasoning of information economists.

Now, to some this response will look "obvious"; who needs fancy information theory to see that if Corona asked Lac ahead of time to agree not to purchase the Williams' property it would give away its secret? I suppose one can point out that Justice Sopinka did not think this was obvious and his experience in commercial contracting

7. *Ibid.*

matters suggests that this was not mere naïveté on his part. But more to the point the "obviousness" of the reasoning, once it has been laid out, also goes to make my point : ordinary legal reasoning is implicitly theoretical and therefore theoretical responses, if presented lucidly,⁸ will have the character of ordinary legal reasoning. The role for theory here is that theory is a structured way of identifying and then thinking about implicit theoretical claims. Attention to information theory and the economics of bargaining under information asymmetries leads one to a category of "things that could have prevented Corona from exacting an undertaking". Theory here tells you where to shine your flashlight in a dark room; what you find may indeed be obviously lying there. The point is, without the theory it may have taken you a lot longer to find "the obvious".

Having seen the "obvious" response, many lawyers will refine Sopinka's argument, namely that Corona could have negotiated for a more general confidentiality agreement, without specifically identifying the Williams' property or the adjacent land. Again, however, theory will suggest important considerations in assessing this legal reasoning.

Another of the obstacles to contracting over information is the fact that it is difficult to reach agreements about the price at which information will be conveyed when the value of the information is unknown. I have an unopened envelope. I tell you that the information it contains will make you a lot of money. How much are you willing to pay for it? Not much, I suspect. Negotiations over confidentiality agreements can have a similar quality, depending on the context. In the Lac-Corona context, if Corona seeks a broadly worded confidentiality agreement, in which Lac agrees not to use the information it receives in any way, Lac is being asked to pay an unknown price for information of unknown value. Lac may be, for example, one week shy of developing the information about the Williams' property from its own research and discoveries; it may learn something from Corona of only minor significance. And yet, a confidentiality agreement may prohibit it from making use of its own information investments. Even efforts to word the confidentiality agreement to permit Lac to use preexisting information will impose obstacles. The cost of establishing what is a legitimate use of its own information and what is a prohibited use of Corona's information is often, as most commercial litigators in the area can tell you, very high. Again, Lac is being asked to pay an uncertain (not to say unbounded) price for information of unknown value. Theory suggests that this is an obstacle to contracting, one that parties in some contexts can get over (as Lac and Corona could have if Lac in fact had little existing interest in the area) and in others cannot (as Lac and Corona perhaps could not if the reason Corona approached Lac was precisely because of existing mining interest and investment in the area).

The overarching point is that, contrary to the implicit claim in Justice Sopinka's reasoning, theory has suggested that there are systematic difficulties, in given contexts, in writing complete contracts under conditions of information asymmetry. Legal reasoning that relies on implicit claims about the ease of contracting is open to the claims of this

8. This is an important proviso : whereas proof of an economic claim, to satisfy economists, can often require sophisticated mathematical techniques, in my view a good economic claim is one that can be expressed in a common sense way. This is especially true of claims that have relevance to law : if it is too complex to make sense to non-economists, its probably not much practical use.

theory. Moreover, the lawyer who is knowledgeable about the relevant theory in a given case is the lawyer who has more tools with which to craft a legal argument.

I do not want this point to appear to be restricted to a particular comment that Justice Sopinka happened to drop in the *Lac Minerals* case, so let me turn to the core of the argument on the other side of the fiduciary duty debate, put forward by Justice La Forest in *Hodkinson v. Simms* :

[T]he relative "degree of vulnerability", if it can be put that way, does not depend on some hypothetical ability to protect one's self from harm, but rather on the nature of the parties' reasonable expectations. Obviously, a party who expects the other party to a relationship to act in the former's best interests is more vulnerable to an abuse of power than a party who should be expected to know that he or she should take protective measures[...]. Thus in Lac Minerals [...] I felt it perverse to fault Corona for failing to negotiate a confidentiality agreement with Lac in a situation where the well-established practice in the mining industry was such that Corona would have had no reasonable expectation that Lac would use the information to its detriment.⁹

Noting that Justice La Forest chooses not to challenge, as we now see he could, Justice Sopinka's formulation of the law on the basis of the ability to protect one's self from harm through contracting, I want to consider what theory has to say about the "reasonable expectations" formulation.

First it is important to notice that, as a purely legal formulation, there is a circularity to "reasonable expectations" here. What it is reasonable to expect, particularly in a setting with substantial legal advice, depends on what the law is. After Lac, it is no longer "reasonable" to "expect" that a commercial actor in a sufficiently similar setting will act in another's best interests. This is true even if it was reasonable, prior to the Court's well-publicized conclusion to the contrary, to expect such treatment in light of an industry practice. This is a weakness in La Forest's legal reasoning. Here my claim is that theory can provide a way of redressing this weakness, by grounding the concept of "reasonable expectations" in an economic analysis of the commercial relationship and the interests at stake.

Begin with the recognition (or assumption) that parties in a Lac-Corona situation have a shared objective of maximizing the value of their joint endeavour. They desire a cooperative and mutually beneficial end, but they seek this end in an environment of self-interest. Put differently, they face strategic obstacles to the achievement of a cooperative goal : whatever they may agree will be best for the joint endeavour will be vulnerable to later efforts by one or both parties to grab a larger share of the benefits of the endeavour. Moreover, in many cases the most valuable arrangement is one in which either or both parties is vulnerable to the exercise of discretion by the other. (As an example, think of the classic partnership arrangement in which partners possess different areas of expertise; an optimal arrangement will maximize the value of diverse expertise by delegating the power to make decisions to the one in the best position to do so). But this most valuable

9. *Hodkinson v. Simms*, [1994] 3 S.C.R. 377, 117 D.L.R. (4th) 161 at 179.

arrangement is only rational for self-interested commercial parties if there is a basis for confidence that one's vulnerability will not be exploited strategically by the other to further self-interest at the expense of joint interest.

This is a point that economic analysis has dealt with in great detail over the past two decades and there is much that can be said about the particular nature of strategic threats and how to recognize what kinds of situation give rise to what kinds of strategic threats. Moreover, theory has focussed extensively on how determining what forms of commitment and protection might prevent or mitigate strategic threats and thereby increase the value of the joint endeavour. For a commercial enterprise threatened by strategic behaviour is less valuable, at the outset, than one that can be relied on to accomplish the cooperative and mutually beneficial objective. Even for the party who anticipates being the beneficiary of strategic behaviour : as long as the other party is able to recognize, perhaps with legal help, the risk that the other will act strategically to grab a larger share of the benefits, that party will be less willing to invest in the project. Moreover, the vulnerable party will insist on less vulnerability than is mutually optimal : it will insist on costly protections that eat into the joint benefits.

This theoretical perspective on the problem of contracting allows us to ground the concept of "reasonable expectations" in something other than the law itself. We can ask the (positive theory) questions, "What would profit-maximizing commercial parties in a situation like this have required in order to rationalize putting themselves in a vulnerable position?", "What forms of protection were available and what forms do the parties appear to have relied on?" This approach interprets "reasonable" as "rational" in the economist's sense, which for commercial parties means, "What makes sense from a profit-maximizing perspective?"

In the *Lac Minerals* case, this approach to "reasonable expectations" focuses on the fact that Corona's vulnerability, through disclosure of valuable private information, is a source of value to the potential relationship between Corona and Lac. But it only makes commercial sense for Corona, it is only "reasonable" for a profit-maximizing commercial actor, if Corona expects some form of protection against exploitation of that vulnerability. Contractual protection is one possibility, although we have already seen what is problematic about that. Reputational protection — counting on the market to punish Lac for exploiting Corona's vulnerability — is another; theory would have something to say about how effective a reputational mechanism might be in these circumstances. And, finally, there may be the protection of an implicit undertaking, implied from the understanding of what the jointly-valuable arrangement requires, not to exploit Corona's vulnerability.

Here the practical role for economic theory is not merely to unpack implicit theory and expose it to careful analysis, it is to give content to a legal concept that is theoretically undeveloped. This is a widely applicable role for theory. As examples, in other works I have looked at how economic concepts and analysis of contracting relationships can help supply content to the concept of "good faith" in franchising contexts

and an approach to interpreting incomplete contracts more generally.¹⁰ I have considered how economic approaches to thinking about the employment relationship can help to identify when workplace conduct amounts to "sexual harassment".¹¹ And, as an expert, I have drawn on theory to elucidate the meaning of "irreparable harm" in an application for preliminary injunction.¹²

Throughout commercial law, economic theorizing in particular, and theories of the behaviour of individuals and institutions more generally, have a role to play in undergirding legal reasoning. Because legal reasoning is implicitly theoretical, this is not an imposition on law from an external discipline. Rather, it is the use of a larger universe of theory to increase the cogency of the informal theories that do indeed inform the law.

10. G.K. Hadfield, "Problematic Relations : Franchising and the Law of Incomplete Contracts" (1990) 42 *Stanford L. Rev.* 927.

11. G.K. Hadfield, "Rational Women : A Test for Sexual Harassment" (1995) 83 *Cal. L. Rev.* 1151.

12. See *826129 Ontario Inc. v. Sony Kabushiki Kaisha* (1995), 65 C.P.R. (3d) 171.