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Keynote Address: Modern Supply Chains and Outmoded Contract Law

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REMARKS

KEYNOTE ADDRESS: MODERN SUPPLY CHAINS AND OUTMODED CONTRACT LAW

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Thank you, Nick, for the introduction and for inviting me to speak. I am grateful to talk at the *American University Law Review*'s Annual Symposium, particularly because it is such a well put together and thoughtful symposium. This is evident from the scheduled panels for later today and for those that happened this morning. It is great to talk to such a distinguished and very large audience.

A subject of this conference is supply chain management. Thus, I thought it would be apt to talk about supply chain management. This is a subject that initially seems very close to the ground for theoretically-oriented lawyers and professors, but it turns out that supply chain management, in its various forms, has attracted a lot of attention recently from contract theorists and applied economists, as well as from business people.

So, unusually for me, I will talk about a hot topic. The question I will ask, put broadly, is: What roles can contract law and actual contracting behavior play in improving the efficiency of the modern supply chain? While I am giving a "current events" talk, I am also going to link my thoughts to commercial patterns of the past. My

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topic also raises a question about lawyers: What role can lawyers now play, and what role did they once play, in supply chain management?

My premise is that contract law presupposes particular commercial patterns, and the lawyer's role also is importantly a function of those patterns. Hence, contract law and the lawyers can become outmoded if the commercial patterns materially change. In recent years, the commercial patterns, especially as they relate to supply chain management, have changed materially from the older economic patterns that our modern contract law, or not so modern contract law, presupposes.

I will argue that neither contract scholarship, nor contract law, nor what common thinking about what lawyers do, have caught up with what modern business people are doing. It is helpful to begin with the nineteenth century, when industrial commerce began in western countries. The paradigm transaction then was the trade of a standard good, a simple rake, or a hoe, or a commercial commodity such as oil, wheat, or corn. Particular features of the goods that were traded in the nineteenth century deserve remark. The first feature is that the goods came complete from the manufacturer, the maker, or the farmer. Second, buyers had little to do with designing, creating or assembling the goods. The third feature is that many of the goods on which contract law operated were commonly traded in markets.

These features importantly influenced the creation of nineteenth century damages law. The relevance of markets is that a disappointed promisee—the seller or the buyer—could make a substitute transaction and then be compensated for her economic loss by a legal award of the difference between the contract price and the market price plus the cost, which usually was small, of making the second transaction. I will illustrate how the law functioned with a simple numerical illustration. People know that math appears in some of my papers, but today I am going to do math on the second grade level. When I say, "I am going to do math," my students think the second grade level is okay. When I get up to the fourth grade, there can be a revolution in the classroom.

So suppose that the buyer of certain goods valued them at $100, and the market price was $75. Because parties transact at the market price when there is one, the buyer's expected net gain from the seller's performance would be $100 – $75 = $25. Now let the market price rise to $90 and the seller breach. The commercial premise underlying nineteenth century law was that the buyer would make a substitute transaction in the market at the $90 price and then earn $10: his valuation of $100 value minus the new higher price. But the legal damages were the difference between the market and the contract prices: $90 less $75 equals $15. And even today in our troubled times, adding $15 to $10 gives you $25, which was the profit the buyer expected to make.

I want to focus on three things about this simple example. First, the contract remedy became standard by the end of the nineteenth century. It was made famous in an opinion by Oliver Wendell Holmes.[1] The compensation premise underlying the law was that the promisee was entitled to the gain that she could have made under the contract—no more, but no less. Second, and this is especially important, the remedy—the contract/market difference—was easily administered because the judge had only to observe two numbers: the market price, which was usually public, and the contract price, which was usually written down. Finally, the lawyer had a very small role to play, at least at the initiation of the transaction, because the contracts were so simple. The lawyer just had to write down a price, a simple product description, and maybe a date of delivery. Sometimes the business people would write these contracts themselves. Nineteenth century lawyers' main entry into this contracting process, thus, usually occurred when a transaction failed—the promisor neither delivered the goods nor transferred the required damages ($15 in the example).

Now, these goods were traded in two-level supply chains or three-level supply chains. They were often sold in sealed packages so that an intervening wholesaler just retransferred them. This was a commercial pattern that was essentially set by the end of the nineteenth century. You might be surprised to know that this also was the commercial pattern that the First Restatement of Contracts, which was created in 1932, presupposed. The UCC presupposed the same simple pattern under which agents traded finished goods in markets. The UCC was finished in 1952,[2] and the principal damage sections of it, and in the Restatement, were market damages—the seller's resale remedy, the buyer's cover remedy, or just market damages themselves.

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1. *See* Globe Refining Co. v. Landa Cotton Oil Co., 190 U.S. 540 (1903).

2. *See* UNIFORM COMMERCIAL CODE, TEXT AND COMMENTS EDITION (Official Draft 1952); *see also* Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 800 (1958) (noting that the text of the UCC was approved by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1951 but was not published until 1952).

To understand how this remedy sometimes was inadequate, we introduce the idea of asymmetric information: a party sometimes cannot observe payoff relevant information that the other party possessed. To see why asymmetric created a concern, realize that the substitute transaction which the commercial pattern presupposed, sometimes took a long time to make. In the interim, a buyer/promisee could not realize value. Although my examples mainly concern buyers, sellers have the same problem. There could be an interim during which a seller/promisee would not be compensated for costs incurred and her profit. Thus, a disappointed promisee would not be fully compensated unless she recovered both market damages and delay losses.

The asymmetric information problem, as regards to delay losses, is simple to state but hard to solve. Suppose, then, that a buyer/promisee claimed that the goods would have been worth v^* to him. If it took the promisee T periods to transact elsewhere and the price is p, his delay loss is $T(v^* - p)$. If the seller could not observe v^*, however, the buyer has an incentive to exaggerate. Similarly, if a seller/promisee claimed that her costs were c^* and she had a delay loss, but the buyer could not observe c^*, she has an incentive to exaggerate. Because the promisor in these cases is uninformed, the disappointed promisee may recover too much. On the other hand, when information is hard for a promisor to observe, it often is hard for the promisee to prove in court. Because the promisee has the burden of proof, in this version of the problem, a disappointed promisee may recover too little. We are about 120 years away from when this asymmetric information problem first arose, and we are not much closer to a good legal solution.

It may be helpful to say a little more about why sophisticated parties may be uninformed. In our example, the buyer valued the goods at $100. Consider a seller selling standard goods to buyers in several markets, including our illustrative buyer—a modern example might be selling a computer, which could be used in a variety of industries. Such a seller could not know what the valuation is of the many buyers in these different markets. Similarly, a computer buyer may know little about how computers are made or what their production cost is.

This asymmetric information concern also presents before litigation. Contract law gives the seller, say, the choice between performing the contract or breaching and paying expectation damages. The seller, as we said, could know market damages, but if the seller could not observe the buyer's value, she could not predict the delay damages: they would be the difference between the buyer's value and the price for the relevant period. Hence, the seller can be in a position of not knowing whether breach and paying damages or performing at a loss is her least costly alternative. Thus, if her costs turn out to be high, she is bearing substantial risk. And, turning to the time when the parties contract, if the seller cannot anticipate potential damages, she does not know how to price. Asymmetric information thus can create problems for parties at every stage of their relationship. So, even though our simple goods transaction is ancient, it poses a very modern problem.

The nineteenth century common law attempted to solve this problem in a simple way. It created an incentive for the informed party to tell. To see how, consider *Hadley v. Baxendale*,[3] which all of you have read in law school. In that case, the court focused on the time the parties contracted. There the railroad, the seller of carrying services, could not know the buyer's valuation, i.e., what the buyer's lost profit would be if delivery was delayed.[4] As such, the buyer could not recover the profit. And the incentive was this: if a buyer knows that the seller is unlikely to know his valuation, he must disclose that valuation at contract time or be unable to recover value damages later. So, essentially, the common law tried to handle the asymmetric information problem by requiring the party who knew things to tell the other party who did not know things. Now, you may think that this solution would be good enough, but it really is not good enough because telling poses problems of its own.

It may be costly for a party just to describe in a believable way what she expected to get out of the transaction—that is, her valuation or profit. Sometimes, that information is soft and not entitled to belief because it is projections about future gains and losses.[5] Further, buyers, as do sellers, but I will focus on buyers, have reason to conceal their valuations. Suppose that I am a buyer, and I am dealing with a seller with market power. The seller would want to know what my valuation is because that would then turn out to be the price. The seller would extract all of the buyer's gain by charging the highest price the buyer could pay. So, while telling is the common law solution, telling is not a complete solution. This raises the question: What else the law and the lawyers could do to fix this basic, ancient, but very deep, commercial problem? There are two things.

3. 9 Exch. 341, 156 Eng. Rep. 145 (1854).
4. *Id.*
5. *See generally* Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2 (2004).

One solution would be to create a liquidated damage clause; the parties write in the contract a number (value less price or price less cost) that the breacher would have to pay. This would solve the asymmetric information problem because a court could once again compare two numbers. To be sure, a buyer would not want to disclose if he was dealing with a monopolist, but otherwise the liquidated damage clause was helpful for communicating information because it was a nice summary statistic. The other solution would be to request specific performance. If a party could get specific performance, he did not have to disclose anything. All he had to do was get an order that the other party should deliver the goods or pay the price. So, a party could keep her valuation secret, but at the same time, be fully compensated.

Now, these contractual fixes are supposed to supplement the common law "make the promisee tell rule," but the fixes run into two ancient doctrines that plague us today. First, penalties are not permitted in contracts. This means that the liquidated damage clause is subject to judicial review as not being a reasonable expectation of a party's valuation. That raises greatly the cost of using these clauses and creates uncertainty as to whether a particular clause is enforceable or not. The other ancient legal doctrine that plagues us today is that the equitable remedies such as specific performance are discretionary with the court. This essentially means that judges will not enforce terms in contracts that ask for specific performance.

At this stage of the game, I want to make an interim point, which is that we have a transaction—a simple procurement sale—that originated in the nineteenth century. Current contract and sales law is premised on that transaction but, even today, cannot fully solve the problems the transaction poses. So, as you can see, when we get to modern supply chain management, we can be in very deep waters.

At this point it is helpful to discuss the lawyer and the lawyer's role. That role has changed materially because the lawyer now can help at the initiation stage, as well as the litigation stage of a transaction. For example, if a party wants to get specific performance, she should tell her lawyer. The lawyer can then write a "whereas clause" that will say just why no legal remedy would be adequate. If both parties agree to a "whereas" clause that explains why damage remedies would be under compensatory, judges today are predisposed to grant specific performance. So, today we can overcome at least the reluctance of judges to enforce specific performance clauses because they can be persuaded by good lawyering that specific performance is needed. The penalty doctrine on the other hand remains a big obstacle.

I want to make what may seem a brief digression now and discuss an article that Juliet Kostritsky talked about earlier, by Stewart Macaulay.[6] I think you will see that there is a transition to what we will discuss later. Stewart surveyed Midwestern manufacturers in the 1960s, and he found that the operating employees never talked about the formal contracts that were supposed to govern their relationships.[7] The business people worked out disputes through renegotiation and one of the famous quotes he published was that the business people say they take the lawyer's contract and put it in the drawer.[8]

Now, this should not have been surprising in 1960, when Stewart got his data, because, you recall, the contracts then were simple. They had a price and a description—one widget, or a lathe, or something like that. They had a delivery date and maybe a quantity, and that would be it. So, if the subject of sale was a complicated product, which started to happen in the 1950s and 1960s when people started trading complex machines, the business people would find little in the contract to help them. So, why look at it? People had to work things out because at that stage of the game, the contracts did not catch up with the new commercial patterns that had begun to emerge in the early post-World War II economies.

There also was a problem that Stewart elided. If you make a deal today because you think it is a good deal, and the world does not change very much when you are supposed to perform, usually you will be happy to perform. Otherwise, because the world is much like it was, it is easy for parties to settle difficulties informally. In settled times, legal enforcement of the underlying contract is unnecessary. And as a corollary, it isn't necessary to refer to the contract. So, there is a question about what role the contract plays, and the answer is that the contract becomes important when the world changes a whole lot. Things turn out to look much worse to a party at performance time than they looked at contract time. And then the contract functions to structure the renegotiation that the parties will attempt and to control the lawsuit if renegotiation fails.

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6. *See generally* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 21 AM. SOC. REV. 55 (1963).
7. *Id.*
8. *Id.* at 59.

So, what you have to realize about modern contracts is they play two roles in addition to the roles of facilitating specific performance or specifying the damage remedy in advance. One role is to map out the deal. Lawyers and clients realized that if a contract is going to be helpful at dispute time, it has to have a lot more than a price and a product description. The contract has to describe in detail what each party is supposed to do so that it can guide or prevent disputes. It is a roadmap when parties may have disputes later on. This is one reason why modern contracts tend to be very long. The second new function is that contracts exist to govern the unusual case. The contract is supposed to play a role mainly when parties disagree, and then it tells what the parties should do and what they get if they disagree. These new functions should illuminate how lawyers and courts should understand contracts today. And this modern vision poses complicated problems for lawyers. One relevant implication is that the law school contracts course (or the advanced course) should ask what roles the law and the lawyers can play in connection with modern business problems, as well as teaching what the rules are.

In addition, today trading finished goods remains common, but what is also common is having goods specialized to the needs of particular buyers. In many current procurement situations, what the buyer needs can take a long time to make, and it may have to be made according to detailed specifications. In addition, the buyer may himself have performance obligations. The contract here structures the deal by breaking performance down into stages. The contract will specify the stages at which the seller has to do certain things, the buyer may have to do certain things, and when payments must be made along the way. These "progress payments" will match what the seller does. The crucial point here is that the contract functions more as the parties' constitution than as a simple contract. Also, the commercial pattern of specializing goods to buyers' particular needs raises a new problem, or maybe the old problem in new form.

The problem is that when goods are specialized, the parties are out of the nineteenth century world. The disappointed promisee today often cannot make a substitute transaction because of the goods' unique aspects. So, if the buyer breaches, the seller cannot simply resell, and if the seller breaches, the buyer cannot simply cover. In addition, when the performances are complex, a court may not grant specific performance because the court lacks the capacity to monitor specialized actions over time. So, we now are in a world where the remedies of the UCC and the Restatement presuppose an old commercial pattern and do not naturally fit the new commercial patterns that current legal cases present.

The parties today also face a problem of strategic behavior. If the seller, say, begins to make a specialized product, the buyer may then say, "You know I am not so crazy about the price." The seller would respond: "But we agreed." In return, the buyer says: "Well, yes, we did agree, but I am still not so crazy about the price, and I would like a lower price." Alternatively, the buyer may in bad faith argue that the contract gave him room to renegotiate.

The seller may have produced goods that are much more valuable to the buyer than anyone else, or specialized her factory to produce such goods. The seller thus cannot make a substitute sale and would incur a large loss if the buyer walked away. Now, the seller could sue, but lawsuits take a long time, they are very costly, and their outcome can be uncertain, especially if there is asymmetric information.

I actually have been describing an old problem but dressed in new clothes. The problem, as said, is that valuations and costs often are unobservable to contracting parties and to the court. But now the problem is heightened because we are considering a new product—not a product that exists and as to which there is historical data. Because proving a loss in this context is difficult to do, the seller is vulnerable to exploitation by the buyer.

The problem that I am describing has a name: the economists call it the "hold up problem." The buyer can hold up the seller (or the seller can hold up the buyer) to renegotiate better terms after the seller (or buyer) has specialized resources to the deal. The problem exists because lawsuits are costly and less effective because of asymmetric information between the parties and between the parties and the court, and because courts will not enforce, except after review, liquidated damage clauses and requests for specific performance.

Now, you might think that a holdup is not an important problem, but you would be mistaken. Three Nobel Prizes have been given for economists who worked on hold up problems. Oliver Williamson, Oliver Hart, and Bengt Holmström won Nobel Prizes recently for theoretically elegant, but sometimes hard to implement, solutions to this problem.[9]

9. Oliver E. Williamson won the Nobel Prize in Economic Sciences in 2009. *See Oliver E. Williamson: Facts*, NOBEL PRIZE, https://www.nobelprize.org/prizes/econo mic-sciences/2009/williamson/facts (last visited June 1, 2019). Oliver Hart and Bengt Holmström won the Nobel Prize in Economic Sciences in 2016. *See Oliver Hart: Facts*, NOBEL PRIZE, https://www.nobelprize.org/prizes/economic-sciences/2016/hart/facts

One solution is worth noting, which is to remove the problem from the domain of contract law altogether. A solution to the holdup problem is vertical integration: one of the parties buys the other.

But here again, I want to point out that contract law is outmoded. Transactions that could give rise to hold up did not figure in the discussions that produced the UCC and the Restatement. That law, as I said, presupposes simple sales of finished goods or commodities. For example, another solution to the holdup problem is to impose a large penalty on the party that first proposes to renegotiate the price or other key terms, but penalty terms are unenforceable. To be sure, penalties can be used to exploit the unwary. So, there might be some justifiable regulation of penalties, but the point I want to make is that penalties also can solve contracting problems.[10]

Penalties can facilitate transactions in which one party has to specialize its resources to the relationship, and so, make itself subject to exploitation. Therefore, the law should take a nuanced view of penalties, but if you look at the UCC or the Restatement, a penalty is just an unrealistic or unreasonable estimate of what the expectation interest of the party would be, or a payoff that seems disproportionate to the recovery a party could get under the contract. But if the penalty must be disproportionate to be effective, the law is very much out of step. Thus, there is a question of how the law can be modernized to solve hold up problems and other problems that the existence of asymmetric information poses.

I am now up to about 1970 in my historical tour. So what did we see in the 1980s and 1990s? The common transactions in which agents trade finished goods or commodities, and still face the classic problems of delay, proving lost profits, or proving costs, and the problems of fighting over what the parties actually agreed to, are still with us. But now the lawyers can help substantially and in fact, have. The legal practice has largely caught up in terms of writing extensive contracts with extensive whereas clauses and justifications for what people contract to achieve. But still, if you actually want to know what your legal rights are and you only looked at the UCC or at the Restatement, you will find that they are unhelpful for giving guidance to commercial actors. Also, you will find that you have to shoehorn

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(last visited June 1, 2019); *Bengt Holmström: Facts*, NOBEL PRIZE, https://www.nobelprize.org/prizes/economic-sciences/2016/holmstrom/facts (last visited June 1, 2019).

10. *See generally* Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHICAGO-KENT L. REV. 33 (2003).

modern lawsuits into statutory or restatement terms that fit very well in 1911 or 1912, but maybe not so much today. As an aside, this raises the question why contracts courses spend so much time with the UCC and Restatement and so little time with what today's lawyers their clients are actually doing.

Finally, I want to move into the twenty-first century. In the twenty-first century, the prior patterns of commerce that I have described still exist, but the newest idea, and I think this was discussed in Juliet Kostritsky's talk earlier today, is that parties come together not to buy or sell something, but to create something. They want to create a new software program, a new drone, a new app, a new type of computer; and here, the parties are not so much at arm's length where you have a seller and a buyer who are separate entities. The parties are still jurally separate entities. They are separate entities at law, but they form what are now called "hybrid arrangements," and what they do in these hybrid arrangements is allocate tasks that contribute to creating a final product among themselves.

One party may do technical R&D, and the other party may study market prospects. Their contracts are called "framework agreements," which are supposed to govern the various stages that the parties have to go through in order ultimately to create something. These framework agreements also sometimes contain their own dispute-resolution procedures. So, the first time that you have a problem, you might try and settle it on the shop floor; next you may appeal to a plant manager. Finally the parties will get up to the chief operating officer or maybe some resolution board composed of seller and buyer representatives. The parties can function in this interrelated way because buyers have personnel inside sellers' factories, and sellers now work with buyer procurement offices. Also, there may be more than two parties engaged in the creation process.[11]

11. These arrangements are extensively described in a serious of articles by Ronald J. Gilson, Charles F. Sable, and Robert E. Scott. *See generally* Ronald J. Gilson et al., *Text* and C*ontext: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23 (2014); Ronald J. Gilson et al., *Contract and Innovation: The Limited Role of Generalist Courts in the Evolution of Novel Contract* Forms, 88 N.Y.U. L. REV. 170 (2013); Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, 110 COLUM. L. REV. 1377 (2010); Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431 (2009); Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661 (2007). For an examination of theoretical treatment, see Tracy Lewis & Alan Schwartz, *Pay to Play: A Theory of Hybrid Relationships*, 17 AM. L. & ECON. REV. 462 (2018).

I am not going to discuss these arrangements in detail. But the point that I want to make about them, and this is really the important current point, is that we now have framework contracts that govern relationships which are engaged in goods creation and extend through time, rather than the simpler procurement contracts of earlier times. And this raises a very important question as to what contract law can do to facilitate hybrid relationships, or at least not get in the way of them. I want to put this question in a simple way. If you look at the introduction to the UCC or the introduction to the Restatement, in the remedy sections, they say that the law's goal is to put a party, the disappointed party, in the same position that party would have been in had the contract been performed.[12] What does that presuppose? It presupposes a final contract and an identified product so a court may be able to construct the position that the party would have been in had the contract been performed.

Now here is a very common hybrid relationship dispute. One party is supposed to research financing, marketing opportunities, and the like. The other party is supposed to research the feasibility of various designs. Then the parties are supposed to report to each other what they found and go on to another stage. In these situations—and I am not talking about hypothetical cases, I am talking about litigated cases—one party has an incentive to shirk: to not do its part. The party would rather wait to see what the other party comes up with. If what the other party came up with, say, is that it is going to be very hard to create a feasible product design, the party who was supposed to research financing and market opportunities is happy that he did not do that because there is going to be no ultimate product. Its investment would have been wasted.

Under current law, what is the remedy for shirking behavior? The law cannot protect the counterparty's expectation because there was no contract and thus nothing for him to expect. You can look at the UCC in vain for a remedy term that deals with a case where one party shirks and does not do what it was supposed to do under a complicated framework agreement, and the other party is really

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12. *See, e.g.*, U.C.C. § 1-305(a) (AM. LAW INST. 2001) (stating that "remedies provided by [the Uniform Commercial Code] must be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed" (alteration in original)); RESTATEMENT (SECOND) OF CONTRACTS § 344 cmt. a (AM. LAW INST. 1981) (commenting that courts will enforce remedies to protect a party's expectation interest "by attempting to put him in as good a position as he would have been in had the contract been performed, that is, had there been no breach").

angry. The Restatement also says nothing about this situation. On the other hand, my coauthor and I found approximately 110 appellate cases on this problem in a casual scan search, and we know that appellate cases are only the tip of the iceberg.[13]

An economically minded analyst would not worry about the disappointed party, the party who spent a lot of money trying to produce designs only to find out that the other party had not done anything. Ex post, this is just a business loss. The real problem is ex ante: when parties anticipate that there is no legal remedy if somebody breaches the framework agreement, parties may be reluctant to enter into these agreements initially. Today, a disappointed party cannot get expectation damages, and the law is very unclear as to whether the party can even get reliance damages for the costs that it has expended. Thus, there is a well-grounded view that there is less R&D done in our economy than there should be. So, the point that may be becoming clear is that we have a nineteenth century contract and commercial law that must be applied to twenty-first century legal problems. This is not working well. On the other hand, the lawyers today are starting to become very helpful. They create ever more detailed framework agreements.

The new contracting idea, which time precludes me from discussing, is to make it costly for parties to walk away from the framework, but this kind of lawyering is at a very early stage because it is not taught in law schools, and it is all being made up on the fly by smart people who want to help their clients out but who have no blueprints. So, I think that there ought to be a lot more thought given to twenty-first century lawyering and what twenty-first century contract law should look like.

I want to conclude with one more new commercial pattern parties now conduct affairs in networks. As a consequence, network economics has become a very big academic field over the last fifteen or so years. Unfortunately for lawyers, it is very complicated and very mathematical. But nevertheless, networks pose very serious problems for the law. For example, suppose you think that you are in one, but the other people do not think you're in. What do you do then? Let me give you a concrete example.

Suppose a bank makes a deal with a merchant where the bank will process the merchant's credit cards, and the merchant promises to be careful when it is extending credit to its customers. The bank then

13. *See* Alan Schwartz & Robert E. Scott, *Market Damages, Efficient Contracting, and the Economic Waste Fallacy*, 108 COLUM. L. REV. 1610, 1624 (2008).

makes an agreement with other banks to create a network. The other banks will process this bank's credit card receivables and this bank will process the other bank's receivables. So, you have, say, a network of ten banks. Now let the merchant be careless and not monitor customers. Later banks in the network suffer losses because some receivables are bad. The merchant, however, only dealt with bank #1. Can bank #6 sue the merchant for violating its agreement with bank #1 to be careful about extending credit card debt? That is a very wide open question.

My thesis is that the law and the lawyering should be brought up to date, but when you look at contract law casebooks, the only legal doctrine that is relevant is third-party beneficiary law. The question apparently is whether bank #6 is a third-party beneficiary of the contract that bank one made with the merchant. Now, first of all, I want to note, third-party beneficiary law is hardly ever taught because it is always the last chapter in the casebook. And this is because the common view is that the subject is not important.

So, nobody knows anything about how the doctrine actually functions, including law professors, because it is always the last chapter. What is worse, when you read the last chapter, you find that the chapter is basically two cases, one decided in 1857[14] and the other decided in 1918.[15] My co-author Bob Scott and I—well, it was not us, it was the wonderful research assistants we pay—found, between 2004 and 2014, 1400 appellate cases raising third-party beneficiary claims.[16] Now, you would think that people would be writing about this because it is a hot topic. Think of how many disputes we are having in society if we have 1400 appellate cases over ten years. But there are only these two cases in the casebooks, and the last article we found before our own that was written on third-party beneficiaries appeared in 1992.[17] So our point is that if commercial significance is a criterion for casebook organization, the third-party beneficiary chapter could be placed earlier, and then maybe a few of these 1400 cases would be in it. But neither the casebooks nor the law treat network cases. Again, commerce is ahead of the law.

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14. Lawrence v. Fox, 20 N.Y. 268 (1859).

15. Seaver v. Ransom, 224 N.Y. 233 (1918).

16. *See* Alan Schwartz & Robert E. Scott, *Third-Party Beneficiaries and Contractual Networks*, 7 J. LEGAL ANALYSIS 325, 329–30 (2015).

17. *See generally* Melvin Aron Eisenberg, *Third-Party Beneficiaries*, 92 COLUM. L. REV. 1358 (1992); *see also* Schwartz & Scott, *supra* note 16, at 329 (commenting that the "last serious article" written about third-party beneficiaries was published twenty-three years ago).

I want to conclude with two thoughts. First, contract and commercial law is the law that is in UCC Article Two, which has not been revised since 1952, or the Restatement Second of Contracts, which was finished in 1974. But to an observer of the patterns of commerce that we have today, contract law is wildly out of date. It gives very little guidance to courts, and it gives very little guidance to lawyers. And when you think about what the lawyer's role was in the old days when the parties could not settle, you either represented the plaintiff or the defendant, and you ran a lawsuit. While litigation is still important, the business lawyer's role today is to create framework agreements in complicated industries to reduce the probability of disputes, merger agreements that govern complex business combinations, and contracts that govern networks. These tasks require the lawyer to understand a lot about many very difficult business situations. Neither the law nor the contracts course have caught up.

The last thing that I want to say to tie this to what we heard this morning, which is that people are very worried about, legitimately worried about, human rights violations. You have a buyer and you have a seller, but down the supply chain, people noted there may be subcontracting. And some of the subcontracting today is to firms that use slave labor or child labor or otherwise are violating environmental laws. What people said this morning is that attention has to focus on the process—not just the end state. And what I am really talking about here is that attention has to focus on the process. Today the major issue is not so much, in at least a lot of industries, what does the finished product look like, and did people deliver it on time?

Today the issue is how was it made? Did people do everything they were supposed to do in the factory? How do you know? What happens if someone walks away early in a preliminary arrangement? So, you have to get behind the last piece of paper in the sequence and get to the process. Now, what I think is that this is a very exciting time for lawyers and for contract scholars. The question is how can we create a twenty-first century contract law that would be relevant to what people actually do, and from the point of view of law professors and lawyers, the question is how can we teach potential lawyers to function in the modern supply and management chain?

So, now I am really going to stop but with one more example. When you think about the recovery of reliance costs, in most contracts casebooks, there is a famous case. The case involves a guy in Alabama in the 1840s who asked someone to come and care for him and his spouse.[18] But the parties did not write a formal contract. This person, however, did come and care for the promisor and his spouse or maybe his aunt, I think, but was not paid. The legal question is whether the person who moved to Alabama could recover her costs. And that is how reliance is taught in the contracts course. Now, I have talked about current reliance cases. What happens when somebody does not do the R&D they promised to do in a hybrid relationship and then years down the line just walks away? What about this person's (or firm's) reliance costs? Do you think the case about the woman who moved to Alabama in 1840 or so has much to teach students about how to practice contract law today? So, I think that there should be a lot of changes in contract teaching, in contract practice, and in contract law.

18. Kirksey v. Kirksey, 8 Ala. 131 (1845).