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CONTRACTS MEET HENRY FORD

*Barak Richman**

I. INTRODUCTION

It takes less than twenty-four hours to assemble a car. We all know about automobile assembly lines, so this fact comes as no surprise. Why then are we aghast to hear that a complex contract can be produced in “three and a half minutes?”

I submit that the reason is because we do not equate law firms with factories, lawyers with assembly-line workers, and contracts with homogeneous goods that are subject to mass production. Legal scholars and legal educators instead exclusively view contracts as a welfare-maximizing (or optimal risk-allocating) device for two or more parties. Because we cling to this principal-driven paradigm, we think of lawyers only as the proverbial “transaction cost engineers,” the loyal agents of parties to a transaction. And whenever we observe contracts that appear to be suboptimal, we blame agency costs.

It is time to abandon this paradigm, and Mitu Gulati and Robert E. Scott’s delightful uncovering of the machinations and self-delusions in the sovereign bond legal market offers a biting illustration of how urgently we need to do so.¹ Yet the “new” paradigm we need just might be the very paradigm that scholars of innovation and organization have long used to understand other products and industries. Gulati and Scott’s reports from the front line suggest not only that much of how we understand lawyers and contracts is wrong; they also suggest that much of how we understand economic organizations is right.

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1. See generally MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (forthcoming 2012) (on file with the Hofstra Law Review).

II. SOMETHING MUST BE WRONG

Gulati and Scott comb through the world of theory to find explanations for what seems like monumental stupidity. Why, they ask, would anyone write a multi-billion dollar bond contract with a clause that no one thinks is useful, no one understands, and yet everyone (when answering honestly) admits can cause—and *has* caused—enormous damage to a signatory?²

How could such high-paid lawyers be *so stupid*, they ask. They plow through the literature, offer nine possible rational-actor hypotheses and reject each one, concluding simply that the entire legal industry is making an enormous mistake.³ Worse, they are drawn to conclude that something is seriously amiss in the legal profession, where cogs in the machine are producing socially suboptimal—and perhaps dangerous—legal products despite compelling incentives to act otherwise.⁴ A severe case of groupthink, of professional perfidy, of a previously noble profession turned upside down. Their quest for a rational explanation likens to Marge Simpson's effort to make sense of the world, and it ends with Lisa Simpson's simple conclusion that no moral can explain the surrounding chaos:

HOMER: Save a guy's life, and what do you get? Nothing! Worse than nothing! Just a big scary rock. [Homer is complaining about a present—an absurdly large stone sculpture of a tribal head that takes over the family's living room—that the Simpsons received from Mr. Burns after a blood transfusion from Bart saved Mr. Burns's life.]

BART: Hey, man, don't bad-mouth the head.

MARGE: Homer, it's the thought that counts. The moral of this story is a good deed is its own reward.

BART: Hey, we got a reward. The head is cool!

MARGE: Well then, I guess the moral is no good deed goes unrewarded.

HOMER: Wait a minute. If I hadn't written that nasty letter, we wouldn't've gotten anything.

MARGE: Well, hmmm, then I guess the moral is the squeaky wheel gets the grease.

LISA: Perhaps there is no moral to this story.

HOMER: Exactly! It's just a bunch of stuff that happened.⁵

2. *See id.* (manuscript at 9).

3. *See id.* (manuscript at 42-52, 155, 180-82).

4. *See id.* (manuscript at 101-21, 156-68).

5. *The Simpsons: Blood Feud* (Fox television broadcast Aug. 11, 1991).

I offer a far less ambitious, and admittedly less interesting, hypothesis (or, if you prefer, moral). If we understand the literature on organizational economics, and if we apply that literature to the large law firm, we will conclude that the creation of mass-produced goods that do not ideally meet consumer demands should come as no surprise. This is not the consequence of agency costs or a lack of attorneys' fidelity to their clients; it merely illustrates the limits—and, indirectly, the strengths—of large organizations. Indeed, observing that legal products do not perfectly match contemporary needs might be no less provocative than observing that Detroit is long overdue to produce high-mileage cars.

So there is a moral, and a rather mundane moral at that. The moral is that law firms, legal products, and lawyers are all subject to the same laws of organization and innovation as the rest of the economy, and that lawyers should not be presumed to be all that different from assembly-line workers.

III. BOILERPLATE CONTRACTS AND ORGANIZATIONAL ECONOMICS

Perhaps Gulati and Scott's mistake is to look to conventional microeconomics and classical contract theory for explanations.⁶ This approach presumes that contracts are reflections of the economic interests of the signing parties, and that every element within the contract is—or should be—a product of the parties' interests.⁷

Things immediately look different once we consider that law firms have multiple clients with similar needs and produce large numbers of contracts for similar purposes. Accordingly, constructing a contract rarely begins with the principal—the client—articulating his or her contractual needs; rather, it begins with the accumulated knowledge that the law firm has amassed from its past production experience.

What do law firms know about sovereign debt contracts? Gulati and Scott indicate that the law firms—the embedded structures of the firm themselves—know a great deal, even if some of the attorneys they interviewed fail to reflect that knowledge.⁸ Above all, firms know that each sovereign debt contract they draft must conform to a boilerplate that has been proven and tested over time.⁹ This is not terribly different from other mass producers that strive to assure consumers of consistent quality and reliable products. Moreover, scholars of innovation in product markets have identified several externalities and efficiencies that

6. See generally GULATI & SCOTT, *supra* note 1.

7. See *id.* (manuscript at 42).

8. See *id.* (manuscript at 11-12, 136).

9. See *id.* (manuscript at 38-39).

lead to industry standardization, and a rich literature describes the emergence of technological paradigms that cause product markets to conform to dominant designs.¹⁰

The need to generate consistent and predictable products might be even greater for lawyers, who operate in a legal world that relies on precedent and certainty. The basic legal principles of *stare decisis*¹¹ and collateral estoppel¹² create reliable value for familiar and predictable legal instruments while ascribing ominous uncertainty to unfamiliar products. For contracts, this explains the emergence of boilerplate language.¹³ And among legal products, debt contracts might have the greatest need for familiarity and standardization since only then can buyers and sellers of debt comfortably participate in rapid and liquid markets that rely on being able to price products quickly. In sum, these features of legal products create network externalities that heighten the value of the familiar, while making the unfamiliar deeply risky, thus creating strong forces towards industry-wide standardization.¹⁴

This demand for predictability and standardization, as well as the reciprocal fears of difference and uncertainty, are reflected in the structure of law firm operations. The literature on organizational behavior, very unlike classic microeconomic theory, suggests that firms and related economic institutions perform well by being rigid and creating environmental certainty; consequently, structures arise to ensure that firm employees act within well-defined roles.¹⁵ Law firms conform to this theory almost too perfectly. Gulati and Scott describe in

10. William J. Abernathy & James M. Utterback, *Patterns of Industrial Innovation*, *TECH. REV.*, June–July 1978, at 40, 43–44; Paul A. David, *Clio and the Economics of QWERTY*, 75 *AM. ECON. REV.* 332, 334 (1985); Paul A. David, *Why Are Institutions the ‘Carriers of History’?: Path Dependence and the Evolution of Conventions, Organizations and Institutions*, 5 *STRUCTURAL CHANGE AND ECON. DYNAMICS* 205, 214 (1994); Michael Gort & Steven Klepper, *Time Paths in the Diffusion of Product Innovations*, 92 *ECON. J.* 630, 633 (1982).

11. BLACK’S LAW DICTIONARY 1537 (9th ed. 2009) (“The doctrine of precedent, under which a court must follow earlier judicial decisions when the same points arise again in litigation.”).

12. *Id.* at 298 (“The binding effect of a judgment as to matters actually litigated and determined in one action on later controversies between the parties involving a different claim from that on which the original judgment was based.”).

13. Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 *VA. L. REV.* 713, 718–27 (1997) (discussing the benefits of adopting standard contract terms).

14. For an in-depth discussion about boilerplate language, see “Boilerplate”: *Foundations of Market Contracts Symposium*, 104 *MICH. L. REV.* 821 (2006). See also GULATI & SCOTT, *supra* note 1 (manuscript at 43–44) (discussing the network externalities that explain the reluctance to revise boilerplate language as well as the uncertainty that would result from bonds with different terms whose risk would have to be evaluated individually).

15. See Michael T. Hannan & John Freeman, *Structural Inertia and Organizational Change*, 49 *AM. SOC. REV.* 149, 154 (1984).

fascinating detail attorneys' fears of deviating from a proven text.¹⁶ The paradigmatic question each attorney asks regarding a new legal product is, "Has this worked before?" not "How can we make this work best?" or even "What is it that we are making?" In the world of law, there are good reasons to be preoccupied with past results, because past practices are invoked as an authority to uphold the status quo. Lawyers are aware of this and thus encourage their firm's routines to, above all, produce identical products.

Law firms also know how to economize on production costs while creating those predictable products. Like automobile assembly plants, law firms develop systems to deal with similar assignments in large numbers without consuming much of the firm's most expensive resources, namely, the time and energy of the head lawyers.¹⁷ In the parlance of organizational economics, law firms—like other firms—develop organizational linkages that implement its resources in efficient "routines."¹⁸ As firms mature, and as these assignments become increasingly familiar, firm systems build information filters and rigid structures that facilitate efficient practices.¹⁹ The routine becomes the firm's operating unit—the structure around which it is hard-wired—and it becomes extremely competent at executing the familiar operations without, to put it colloquially, stopping to think. The routine, with all its predictability and consistency, is emblematic of the firm's efficiency.

It is precisely because of the information filters and the unthinking habits that underlie these routines that lawyers might have difficulty describing what they are doing. They are told, or they learn, only to continue as before without deviation. This is good—a reflection of efficiency—since firms rest their reputations on the reliability and consistency of their products, but it produces some embarrassing moments when the lawyers are asked by two curious academics to explain why they craft their product as they do. How would an automobile assembly-line worker explain why the car he is assembling needs a catalytic converter? It is not his job to know why, and perhaps he would do his job more efficiently if he does not—otherwise, he might improvise and try to make unwise "improvements" to a well-established

16. GULATI & SCOTT, *supra* note 1 (manuscript at 103-04).

17. *Id.* (manuscript at 102-03).

18. See RICHARD R. NELSON & SIDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE 14 (1982).

19. *Id.* at 99-100; Rebecca M. Henderson & Kim B. Clark, *Architectural Innovation: The Reconfiguration of Existing Product Technologies and the Failure of Established Firms*, 35 ADMIN. SCI. Q. 9, 14-15 (1990).

routine. Lawyers similarly have found it wise not to deviate from well-beaten paths.

Thus, basic organizational economics suggests that when a law firm, like any firm, has to produce large numbers of similar products, it constructs routines that are dedicated to the mass production of homogeneous goods.²⁰ These routines establish stable operations and limit employee discretion, and thus the products are neither tailored to idiosyncratic consumer preferences nor immediately responsive to changes in consumer demand. Organizational economics further explains that these well-designed routines limit information flow within the firm, and that the firm enhances efficiency by routinizing and simplifying its employee tasks.²¹ Thus, production thrives in spite of, and perhaps because of, the ignorance of employees regarding the ultimate product. Gulati and Scott's tales reveal that this "evolutionary" theory of the firm applies to automobile factories and law firms alike, and that the modern law firm has achieved scale economics and organizational efficiencies that would have made Henry Ford proud.²²

Thus, the situation is not nearly as gloomy as Gulati and Scott suggest. Law firms are not necessarily incubators of ignorance and insularity but instead merely rely on routines to filter out potentially damaging discretion; lawyers are not parasitic creators of agency costs but instead merely the singularly focused producers of homogeneous goods; and legal products might not be dangerously deaf to the needs of clients but instead are simply produced according to routines that, for good reasons, resist change.

IV. SO NOW WHAT?

Even so, all is not well. Even though organizational economics offers a simple, even rational, explanation for Gulati and Scott's findings, it also uncovers what might be called the dark side of efficient routines in mature firms.

One part of this dark side is well-known to scholars of organizational behavior and innovation: mature organizations resist change even when change is necessary for the firm's survival.²³ Interestingly, resistance to necessary change is a reflection of the mature firm's strengths—a firm's routines are designed precisely to filter out

20. NELSON & WINTER, *supra* note 18, at 119.

21. *See id.* at 105 ("While each organization member must know his job, there is no need for anyone to know anyone *else's* job. Neither is there any need for anyone to be able to articulate or conceptualize the procedures employed by the organization as a whole.").

22. *See* GULATI & SCOTT, *supra* note 1 (manuscript at 42).

23. Henderson & Clark, *supra* note 19, at 16-17.

unfamiliar information and produce predictable results, but these strengths become weaknesses when market signals overwhelmingly demand a change of direction.²⁴ During an era of incremental technological change, firms are often well-served by rigid structures, but when “technological discontinuities” or market shocks dramatically alter the market environment, product markets move from one dominant design to a subsequent product generation.²⁵ Often, only new or entrant firms can organize their routines around the new technology or market environment, while incumbent firms continue to produce inferior products and rely on obsolete technologies—even when firm managers *know* that change is needed—and slowly exhibit a fall from grace.²⁶

Gulati and Scott tell us that the sovereign debt bond market is stuck using an obsolete technology.²⁷ Firms continue to produce contracts with inferior language because they are hard-wired to resist change and fear deviating from familiar texts.²⁸ Perhaps the ossification is not only in the law firms since the buyers and sellers of sovereign debt, the countries that issue the debt, and the courts that interpret the debt contracts all contribute to this fear of deviating from the familiar. Given the many market forces that encouraged law firms to produce homogeneous goods and to institute routines that resist change, the legal industry might have unusual difficulty pulling itself out of this inferior technological paradigm. This predicts a troublesome and perhaps costly future for the legal industry that supports the sovereign debt market. Inefficient contracts might continue to burden issuing countries and impose avoidable inefficiencies on the market for some time ahead.

It is ironic indeed that such costly legal services are, by their design, incapable of solving what appear to be rudimentary legal problems. This unfortunate irony reveals another feature of the dark side of organizational efficiency, one that probably is more concerning to legal educators than to economists. Organizational economics might comfort us, that what sounds like a great failure—the failure to meet consumer

24. *Id.* at 15-17.

25. Michael L. Tushman & Philip Anderson, *Technological Discontinuities and Organizational Environments*, 31 ADMIN. SCI. Q. 439, 441 (1986).

26. See RICHARD N. FOSTER, *INNOVATION: THE ATTACKER'S ADVANTAGE* 116-21 (1986); Clayton M. Christensen & Richard S. Rosenbloom, *Explaining the Attacker's Advantage: Technological Paradigms, Organizational Dynamics, and the Value Network*, 24 RES. POL'Y 233, 234-35 (1995). *But see* Jeffrey T. Macher & Barak D. Richman, *Organisational Responses to Discontinuous Innovation: A Case Study Approach*, 8 INT'L J. INNOVATION MGMT. 87, 88 (2004) (observing some instances in which mature firms successfully adjusted to technological discontinuities).

27. See GULATI & SCOTT, *supra* note 1 (manuscript at 180-82).

28. See *id.* (manuscript at 48).

demand and the constant resistance to undergo necessary change to produce better products—is in fact a reflection of certain organizational strengths. But this is faint praise for legal educators who prize problem-solving and innovative thinking and wish to impart these values on to future lawyers. Are the nation’s top law firms—the employers of our top graduates—an ossified, mechanistic workplace? Are successful law firms the ones that squelch creativity and instead assign rote tasks to individual lawyers within a vast organization? Are we legal educators clinging to our own obsolete paradigm and consequently educating our students with skills that do not serve them well in the modern law firm? Do we instead instill them with wishful skills and unnecessary creativity?

Even if Gulati and Scott introduce questions that are answered rather easily with organizational economics, they illustrate problems with which the legal profession and legal educators will wrestle fiercely in the years to come.

V. CONCLUSION

Gulati and Scott tell us the tale of the experimenter and the frog, wherein the frog represents the simple laws of nature and the experimenter is an allegory for misplaced theory.²⁹ The tale fits. I argue here that contract theory is misplaced when trying to understand economic organizations and mass-produced goods, even when the organization is comprised of lawyers and the good is a boilerplate

29. Many of us who purport to study and explain human behavior secretly dread becoming the punch line of the story about the jumping frog. In that tale, a scientist sets out to measure how far a bullfrog can jump. On the first day of the experiment, the scientist prods the creature’s posterior while commanding “jump frog, jump.” The frog jumps nine feet. The scientist records in his notebook: “Day One—frog jumps 9 feet.”

On the second day, the scientist cuts off one of the frog’s legs. When prodded with the instruction “jump frog, jump,” the frog jumps five feet. The notebook entry for that day reads: “Day Two: frog with three legs, jumps five feet.”

Day Three is a repeat of the experiment, but the poor frog now has two of its legs surgically removed. “Jump frog, jump.” Notebook entry: “Day Three: with two legs, frog jumps 18 inches.”

On Day Four, the frog loses yet another leg in the interests of science. “Jump frog, jump.” Notebook entry: “Day Four: with one leg, frog jumps 1.5 inches.”

The scientist removes the last of the poor frog’s legs on Day Five and issues the by-now familiar command, “jump frog, jump.” No response. The scientist says in a louder and more imperious voice, “jump frog, jump!” And again, “jump frog, jump!!” The animal still does not stir.

Notebook entry: “Day Five: frog went deaf.”

Id. (manuscript at 7).

contract. But the tale of the frog only mocks misplaced theory. I close with a parable that offers a counter-theory:

Two job applicants are ushered into an interviewer's office. The first is presented with the following puzzle: "You are in a kitchen with a stove, a sink, and a bucket hanging on a wall. Tell me how you would boil water."

He answers, "I would first take the bucket off the wall, then bring it to the sink, fill it up with water, then place it atop the stove and turn on the burner. The water should boil soon after."

The second is then asked, "You are in the same kitchen, but now the bucket is on the floor. Tell me how you would boil water."

She answers, "I would hang the bucket on the wall and then do what he did."

Which applicant would Henry Ford hire? Which would Cleary Gottlieb Steen & Hamilton LLP hire? The first individual, who clearly has a strong grasp over the physics of turning liquid water into a gas and methodically articulated a solution, or the second who—perhaps knowing nothing about physics or water at all—observed what works and carefully follows a protocol? (An added factor: simple labor economics suggests that the second individual, unschooled in physics, would command a lower wage.) Although "one can't fix what one doesn't understand,"³⁰ one might also be less likely to screw up what one does not understand. Humans routinely do not understand what they are doing in complex organizations, and those organizations might function better because of that.

The real shortcoming of the tale of the frog is that it portrays a human who thinks too much, when often humans function at their best in large organizations when they do not think at all. Henry Ford and the developers of the assembly line understood this and designed economic organizations to utilize the human preference to follow routines, rely on heuristics, form habits, and unthinkingly rest on information filters.³¹ Law firms evidently are doing the same. Underlying boilerplate contracts—and underlying the automobile assembly line—is what might be called the efficiency of unthinking mimicry.

30. *Id.* (manuscript at 51).

31. See Abernathy & Utterback, *supra* note 10, at 44; Henderson & Clark, *supra* note 19, at 15-16.

So, we need to revise the classic paradigm used to understand the production of contracts and the role that lawyers and law firms play in creating those contracts. Contract theory has significant limits, and organizational economics explains a lot of the Gulati-Scott conundrum. While we are at it, we might want to consider tackling the sources of deep disaffection in the legal profession. Although unthinking habits might be a contributor to short-term efficiency, it appears to stymie both necessary change and more fulfilling careers.