

**CONTRACTS: A TRANSACTIONAL PERSPECTIVE**  
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1. Introduction
  1. Two different courses
  2. Basic contracts: using transactional economics to put the contract in perspective
    1. Analyze the decision
    2. Analyze the doctrine
    3. Aid to interpretation
  3. Deals: the Economics of Complex Transactions
    1. Develop concepts explicitly
    2. Conceit: there are a set of problems that recur in a wide range of seemingly dissimilar transactions
    3. By developing a core set of concepts and skills, students will be better prepared when they are first thrust into the middle of a complex transaction
    4. Mechanics of Deals
      1. First 2/3 develop skills and concepts
      2. Last third, class is divided into teams with each team responsible for analyzing a real transaction
        - (1) give class presentation and write a paper—one draft before presentation and final draft afterwards
      3. Each transaction gets two class sessions
        - (1) class 1: student team presents to the class
        - (2) class 2: lawyer (and often a client) presents transaction from its perspective
          - (1) relate lawyer's experiential knowledge to concepts developed
          - (2) students get feedback for final draft
    4. In Deals we spend time developing the specific concepts
      1. In Contracts I develop them almost entirely in the context of the cases
  2. The building blocks
    1. The Coase Theorem and Rent-seeking
      1. Value creation and value division
    2. Reputation; renting reputation
    3. Moral hazard
    4. Adverse selection
    5. Production and protection of costly information
    6. Adaptation to change
      1. Flexibility-reliance tradeoff
      2. Real options
      3. Adjustment, termination, "efficient breach"
    7. Types of transactions
      1. One time sale of a complex asset

1. Real Estate, Merger, Sale of an office building
2. Adjustment to change, contracting over time
  1. Long term coal contract, Joint venture, Venture capital, Long-term lease of office space, Movie or play
3. Financing
  1. Capital structure
    - (1) leverage, priority, dilution
    - (2) sale of an earning stream: securitization, project finance
8. What about risk aversion?
  1. Attitudes toward risk are not, in general, helpful in analyzing complex transactions involving large commercial entities
  2. More significant point is risk management, designing structures that alter the outcomes
  3. Role of insurance in a risk neutral world
3. Applications in the Contracts course
  1. *Bloor v Falstaff*
    1. Falstaff bought two sets of assets from owners of Ballantine Beer
      1. Brand name and distribution system
      2. 50 cent per barrel royalty with Falstaff promising to use best efforts
    2. Falstaff losing money; new ownership reduced advertising and adopted new strategy
      1. Resulted in reduced sales
      2. Ballantine's owners went bankrupt and trustee sued Falstaff for violating "best efforts"
    3. J Friendly held that it had violated best efforts; it had responsibility to produce sales even if that meant losing money (but not "too much")
      1. Cannot pursue "profit über alles"
    4. Court had no understanding of the transaction or of the purpose of the royalty and best efforts clause
      1. Focused on ex post tradeoff between sales volume and profits
      2. Relevant question: why would Falstaff restrain its options after sale is consummated?
      3. Any restriction, like the best efforts clause, should immediately raise a red flag: how might the particular restriction *raise the value of the Ballantine assets, ex ante?*
    5. Falstaff was buying assets of uncertain value
      1. Asset might be a lemon
      2. Strategies to deal with lack of knowledge
        - (1) Reps and warranties
        - (2) Due diligence
        - (3) Make price contingent on value of assets—earnout
        - (4) This was an "as is" deal
    6. Royalty is imperfect measure of the value of the brand name—it is a meter
      1. Falstaff could "cheat" by diverting use of assets away from the

- meter
- 2. Instead of selling Ballantine, it could have sold Falstaff through the Ballantine network
- 3. Best efforts can be interpreted as an attempt to police this diversion
- 4. In fact, distribution network was no good; dismantled it
  - (1) there was no diversion
- 2. Feld v. Levy
  - 1. Levy baked and sold rye bread
  - 2. Feld bought and sold bread crumbs
  - 3. Levy purchased toasting oven to convert waste loaves into bread crumbs
  - 4. Entered into one-year evergreen contract with Feld to take its full output
  - 5. Dispute over price—Levy losing money
  - 6. Levy dismantled toaster oven and produced no bread crumbs
  - 7. Feld: it had good faith duty to produce some crumbs
  - 8. Court agreed with Feld, as long as Levy wasn't losing "too much" money
  - 9. Q: why full output contract?
    - 1. Levy making specific investment in oven
    - 2. Needed to protect its reliance and assure prompt removal
    - 3. Levy did not want its primary business, baking bread, to be affected by its trash removal obligations
    - 4. Levy needed flexibility, Feld did not
    - 5. Feld had to deliver a "faithful performance bond"
  - 10. Since the deal was structured to protect Levy's reliance and to give it discretion, the removal of the oven should have been sufficient to grant sj to Levy
- 3. Parker v Twentieth Century Fox {Bloomer Girl}
  - 1. Contract to make movie
  - 2. 20<sup>th</sup> Century chose not to make it
  - 3. Offered her alternative movie; she refused
  - 4. Court: issue was whether her refusal was failure to mitigate
    - 1. Was substitute different and inferior
    - 2. Yes; thus, she need not accept it and she receives \$750,000
    - 3. Decision misses the point
  - 5. Contract was "pay or play"
    - 1. Studio had option to use Shirley Maclaine in particular film
    - 2. Paid her \$750,000 for the option
    - 3. Discretion is valuable to studio—willing to pay for it
      - (1) reliance valuable to her—need to pay a lot for it
    - 4. There was no breach, just the exercise of an option to abandon
  - 6. General question that *Bloomer Girl* is supposed to illuminate is the responsibility of a terminated employee to find substitute employment
    - 1. Should earnings of terminated employee be offset against severance payment?
    - 2. Must employee seek alternative? Are there restrictions on where

- she must [or cannot] look?
- 3. Default rule where contract is silent: she must seek alternative and if one that is not “different and inferior” is available she must be treated as having taken it
- 7. Firms often contract out of default rule, especially at the high end of the market
  - 1. Golden parachutes
  - 2. Sometimes severance pay is conditioned on not working in a related field–non-compete covenant
  - 3. Sometimes severance pay is unconditional on future employment
  - 4. Any employment contract that is not at-will must have some package of compensation and impose some responsibilities or limitations concerning the employee’s subsequent search for work
    - (1) Severance pay and the conditions thereon are decision variables

1. Concluding Remarks