FAUX CONTRACTS

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In deals, parties sometimes enter into agreements that look like contracts but lack the legal bite of formal contracts. What value can these agreements add that formal contracts cannot? This Article shows how parties use these agreements to mitigate so-called mundane transaction costs and to build a small relational ecosystem for future steps in the same transaction.

Parties use non-binding agreements in a variety of unsurprising contexts, like when binding agreements are too expensive or illegal, or when informal enforcement suffices. Use of non-binding agreements is puzzling, however, when parties are sophisticated—that is, when parties have the financial means and technical sophistication to enter into real, binding legal contracts, but choose to use non-binding ones instead. Early-stage mergers and acquisitions ("M&A") is one such situation: parties enter into non-binding term sheets, which often look like contracts, but intentionally opt out of formal enforcement. Informal enforcement is also unlikely, because many M&A parties are not repeat players in the market. Yet, despite lack of enforcement, parties abide by the terms of the non-binding term sheet.

This Article makes two contributions to the literature. First, it shows that sometimes, enforcement is not necessary or even preferred: rather, parties prefer to decouple ex ante contracting from ex post enforcement through "faux contracts" like M&A term sheets. In doing so, parties

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can leverage the benefits of engaging in a contracting exercise, without actually subjecting themselves to enforcement. Because complex business deals are highly collaborative design processes, using a contract-like tool, even (or especially) without enforcement, helps parties organize, clarify, and understand the metes and bounds of their deals and obligations, whether or not they plan to, or can, enforce them. Second, through original interviews, this Article shows how parties use these early agreements and other activities to build a small relational ecosystem in which they feel enough trust to make further investments. Ultimately, parties' reputations still matter to them—not on the broader M&A market, but within the individual deal.

INTRODUCTION

In contexts ranging from the mundane to the momentous, parties turn to documents that look like enforceable formal contracts, but that fall short of being legally binding—and also seem unmoored from formal *or* informal enforcement. In business transactions, this is particularly odd: parties have the means and sophistication to use binding, formal contracts,[1] but appear to elect not to use them. Why do parties go through the trouble of drafting formal-looking agreements that they do not enforce? And if there is no formal or informal enforcement, what motivates parties to abide by contractual terms?

This Article shows how these "faux contracts"—formal-looking documents that explicitly exclude enforcement of any kind—add value in ways that real contracts cannot. Non-binding term sheets in mergers and acquisitions ("M&A") are the driving example, but non-binding documents like term sheets are found in many complex business transactions. These faux contracts allow parties to harness the organizational and clarification benefits of creating a contract, while excluding most consequences of breach. This Article also explains how and why non-binding term sheets motivate M&A parties to play by the rules, even though the parties are not part of a tightly knit community.

Non-binding or unenforceable agreements can be found in many contexts. Non-competition clauses in California employment agreements are good examples. These agreements restrict an employee's ability to work for a competitor for some time after leaving the original employer. Non-competition clauses are valid and enforceable legal contracts in most states.[2] In 2008, however, the California Supreme Court reaffirmed, in a

[1] For clarity, when this Article discusses contracts, it means agreements that create a binding and enforceable obligation under the law. In contrast, agreements are documents that fall short of that—they might be contracts, but they might also be documents that are not meant to, or that do not, create a legal obligation.

[2] Non-competition agreements are permitted and enforceable in every state except California, Oklahoma, and North Dakota. In many states where they are allowed, they are subject to review by courts for reasonableness. See Beck Reed Riden LLP, Employee Noncompetes: A State by State Survey (2017), https://www.faircompetitionlaw.com/wp-content/uploads/2017/07/Noncompetes-50-State-Survey-Chart-20170711.pdf [https://perma.cc/5REZ-JX86] (reporting on the permissibility of non-competition employment provisions in all fifty U.S. states). As with other contracts, legal enforceability means that when one party breaches a non-competition agreement, the non-breaching party is entitled to damages. See, e.g., 24 Richard A. Lord, Williston on Contracts § 64:1 (4th ed. 2002) ("The primary if not the only remedy for injuries caused by the nonperformance of most contracts is an action for damages for the breach . . . .").

splashy and well-publicized case, the state's long-standing position that non-competition clauses are unenforceable.[3] Nonetheless, California employers and employees continued to sign them—even though an employer cannot take the issue to court if an employee breaches the clause.[4] Surrogacy contracts where they are outlawed,[5] contracts for illegal activity,[6] Internet click-wrap agreements with unconscionable

[3] Edwards v. Arthur Andersen LLP, 189 P.3d 285, 288, 290 (Cal. 2008) (invalidating a non-compete agreement signed by an accounting employee as a condition of employment). In that agreement, the employee was prohibited from performing certain professional accounting services for a period of eighteen months after termination from his employer, Arthur Andersen. The court held that the agreement's non-compete provisions unlawfully restricted the employee's ability to practice his profession. The court relied on California Business and Professions Code § 16600 (noting that with limited exceptions, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void"). This holding confirmed the state's long-standing policy favoring employee mobility.

[4] See Nina B. Ries, Understanding California's Ban on Non-Compete Agreements, Huffington Post (Feb. 23, 2017), https://www.huffingtonpost.com/entry/understanding-californias-ban-on-non-compete-agreements_us_58af1626e4b0e5fdf6196f04 [https://perma.cc/4DGU-3RFQ] (noting that the author is "always surprised at how many companies *still* think that forcing employees to sign [non-competes] will prevent them from later working for the company's competitors, or setting up a competing business themselves"). *Edwards v. Arthur Andersen LLP* confirmed long-standing public policy in California that favored an employee's mobility, and was not necessarily a surprise. See Robert B. Milligan & D. Joshua Salinas, Non-Compete Agreements, Cal. Law. (May 17, 2017), https://www.callawyer.com/mcle/222-non-compete-agreements [https://perma.cc/P5S8-BMZ5] (describing *Edwards* as a case in which "the California Supreme Court reinforced the state's long-standing public policy favoring employee mobility and confirmed, as a general rule, that employee non-competition agreements are unenforceable in California").

[5] See Kimberly D. Krawiec, Price and Pretense in the Baby Market, *in* Baby Markets: Money and the New Politics of Creating Families 41 (Michele Bratcher Goodwin ed., 2010) (describing the extralegal world of baby selling); Kimberly D. Krawiec, Egg-Donor Price Fixing and *Kamakahi v. American Society for Reproductive Medicine*, 16 Virtual Mentor: AMA J. Ethics 57 (2014) (describing oocyte donation, the laws and regulations that surround compensation of donors, and a case challenging limits on compensation as illegal price-fixing).

[6] Henry Hansmann, The Economics and Ethics of Markets for Human Organs, 14 J. Health Pol. Pol'y & L. 57, 58, 84 (1989) (describing the laws that outlaw trade in human organs, and arguing that it may be possible to design a system in which human or cadaver organs are traded in a way that is ethically sound and a marked improvement over an outright ban on trade).

terms,[7] and certain prenuptial agreement provisions[8] offer just a few more examples of parties entering into non-binding or unenforceable agreements.

Non-binding or unenforceable agreements in these situations, however, are unsurprising. In these contexts, unequal bargaining power between the parties, lack of knowledge about the contract's unenforceable nature, or lack of viable binding alternatives can often explain why parties turn to non-binding agreements.

In M&A deals, the situation is different: parties are business-savvy, and have both the technical sophistication and financial means to negotiate and enter into binding contracts. They are also often advised by sophisticated counsel and experienced bankers who can help them make contracts that are binding and enforceable. Yet, prior to signing a definitive contract, M&A parties often negotiate, agree to, and even sign a non-binding term sheet outlining critical deal terms.[9]

While term sheets have many formal-looking bells and whistles—they are written in legal language, often with the advice of counsel, and signed by parties—parties agree that the "business terms" are legally non-binding and unenforceable.[10] In other words, parties can breach those business terms—terms about price, what is sold, and how—without being taken to court. Why do sophisticated parties enter into non-binding agreements? And if enforcement is off the table, what accounts for the fact that once a term sheet is signed, parties proceed to act as though they have signed a binding document, usually later entering into a definitive formal document on terms that closely resemble the term sheet's?

[7] See generally Paul J. Morrow, Cyberlaw: The Unconscionability/Unenforceability of Contracts (Shrink-Wrap, Clickwrap, and Browse-Wrap) on the Internet: A Multijurisdictional Analysis Showing the Need for Oversight, Pitt. J. Tech. L. & Pol'y, Spring 2011, at 1 (arguing that courts should require a manifestation of intent for all Internet agreements—in part to police against unconscionable click-wrap agreements).

[8] See generally Elizabeth R. Carter, Rethinking Premarital Agreements: A Collaborative Approach, 46 N.M. L. Rev. 354, 369 (2016) (noting that unconscionability doctrine has been adopted by most states in the context of premarital agreements but arguing that this application is based on unduly paternalistic assumptions).

[9] Cathy Hwang, Deal Momentum, 65 UCLA L. Rev. 376, 380 (2018) (describing how deal lawyers use preliminary agreements in M&A deals). M&A parties call these documents "term sheets" or "letters of intent," and the literature calls them "memoranda of understanding" or "preliminary agreements." For ease, this Article, for the most part, calls them "term sheets."

[10] Id. Note that while business terms are specifically called out as non-binding, these term sheets sometimes also include binding non-business terms. These binding terms might include exclusivity, confidentiality, and other negotiation-related terms. Parties are clear that they do want those binding terms to be binding. Id. at 396 n.69.

Much of contract law assumes that enforcement is an important way to motivate behavior.[11] This assumption also underlies much of legal scholarship and theory: jail time for committing crimes,[12] fines imposed for infringing intellectual property rights,[13] and sanctions for violating regulations and treaties[14] are all examples of formal enforcement mechanisms that are believed to motivate behavior.

Where formal enforcement is unavailable, inadequate, or not preferred, informal enforcement, such as reputational sanctions, can fill the gap or provide support for formal enforcement.[15] The importance of informal enforcement is especially well-documented in tightly knit communities,

[11] See Lord, supra note 2.

[12] See Bidish Sarma, Using Deterrence Theory to Promote Prosecutorial Accountability, 21 Lewis & Clark L. Rev. 573, 596 (2017) (describing deterrence as "a justification for punishment premised on the theory that the threat of punishment can deter individuals from breaking the law").

[13] See, e.g., Dmitry Karshtedt, Causal Responsibility and Patent Infringement, 70 Vand. L. Rev. 565, 620–21 (2017) (describing the role of enforcement in deterring unlawful behavior in both products liability and patent infringement); Aron M. Levin et al., Deterring Illegal Downloading: The Effects of Threat Appeals, Past Behavior, Subjective Norms, and Attributions of Harm, 6 J. Consumer Behav. 111, 117 (2007) (finding that stronger threats of punishment, such as fines or jail time, were more effective than weaker threats in reducing illegal music downloads).

[14] See Tseming Yang, International Treaty Enforcement as a Public Good: Institutional Deterrent Sanctions in International Environmental Agreements, 27 Mich. J. Int'l L. 1131, 1134–39 (2006) (describing traditional and non-traditional sanctions as ways to motivate state actors—especially coercive states—into compliance with international treaties).

[15] See Ronald J. Gilson et al., Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine, 110 Colum. L. Rev. 1377, 1398 (2010) (discussing the "rivalry" between formal and informal enforcement for contracts, and noting that the two can substitute for each other, or complement each other); see also Lisa Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 J. Legal Stud. 115, 124 (1992) [hereinafter Bernstein, Opting Out] (describing trade association enforcement of contractual breaches); Lisa Bernstein, Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions, 99 Mich. L. Rev. 1724, 1725 (2001) [hereinafter Bernstein, Private Commercial Law] (describing the cotton industry's alternative system of enforcement to the typical legal system).

such as those of rural ranchers,[16] whalers,[17] high-seas pirates,[18] and diamond merchants,[19] among others. In these communities, individuals are repeat players, so poor behavior in one transaction will sully their future transactions—a result that many individuals wish to avoid. Robust relational contracting relationships also exist in a variety of businesses on the West Coast,[20] in the Midwest,[21] and in Hollywood filmmaking.[22] Because M&A parties can be one-off players in the M&A market (and therefore do not have the same reputational concerns as a repeat player in a tightly knit community), the non-binding and unenforceable nature of these business terms is particularly surprising. Moreover, like the formal contracting scholarship, the relational contracting scholarship also relies on enforcement (although of the extralegal variety) as an important motivator.[23]

This Article takes a different route. Existing literature largely focuses on enforcement—the back end of contracting—but some contracts have no "back end." For one thing, contracting parties often simply abide by the terms to which they agreed. For another, even when disputes arise,

[16] Robert C. Ellickson, Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County, 38 Stan. L. Rev. 623, 628, 677 (1986) (describing how rural cattle ranchers in Shasta County, California, abide by norms rather than rules, and how animal trespass disputes are settled by self-help, rather than formal legal enforcement mechanisms).

[17] Robert C. Ellickson, A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry, 5 J.L. Econ. & Org. 83, 84 (1989) (presenting evidence of informal enforcement—norms—overtaking formal enforcement in the whaling industry).

[18] Peter T. Leeson, An-*arrgh*-chy: The Law and Economics of Pirate Organization, 115 J. Pol. Econ. 1049, 1051 (2007) (describing the extralegal systems that pirates developed to provide checks on captain predation and to "create piratical law and order").

[19] Bernstein, Opting Out, supra note 15, at 124 (describing how a diamond-merchant trade association in New York City helps to enforce breaches of contract).

[20] See Gillian K. Hadfield & Iva Bozovic, Scaffolding: Using Formal Contracts to Support Informal Relations in Support of Innovation, 2016 Wis. L. Rev. 981, 987 (describing the way in which commercial contracting parties across a variety of industries use a mix of formal and informal contracts to support their business relationships).

[21] See Lisa Bernstein, Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts, 7 J. Legal Analysis 561, 562 (2015) (describing how original equipment manufacturers in the Midwest have used a mix of formal contracts, relational contracts, and other tools to build and support their business relationships).

[22] See Jonathan M. Barnett, Hollywood Deals: Soft Contracts for Hard Markets, 64 Duke L.J. 605, 607 (2015) (discussing the use of non-binding agreements—or "soft contracts"—in modern Hollywood filmmaking).

[23] See W. Bentley MacLeod, Reputations, Relationships, and Contract Enforcement, 45 J. Econ. Literature 595, 596 (2007) (discussing informal enforcement as a mechanism by which a "harmed party unilaterally decides that breach has occurred and then carries out actions that harm the reputation of the breaching party").

many contracts are not formally enforced through litigation—parties simply renegotiate or settle.[24] In modern contracts between corporate and commercial parties, formal enforcement is perhaps even rarer, as parties have become leerier of high litigation costs and the disclosure of sensitive information during the discovery process.[25] Even the cheaper, faster, and more private arbitration processes have become very expensive.[26] Without dispute, there is no documented enforcement, no opinion, and no evidence that a scholar can examine to draw conclusions about contracting, breach, or enforcement—so studying contract law from the back end necessarily gives insight into only a small sliver of contracting practice.

Because studying ex post enforcement paints an incomplete picture, studying ex ante contract design has become an important way to understand some of the basic questions of contract law and theory: How do parties enter into contracts?[27] This Article adds to the contract design

[24] See Oliver Hart & John Moore, Incomplete Contracts and Renegotiation, 56 Econometrica 755, 755 (1988) (noting that because contracting parties have a hard time contracting for every relationship contingency ex ante, they build mechanisms into the contract that allow them to renegotiate the contract later as they each learn more about the relationship's costs and benefits).

[25] See Norton Rose Fulbright, 2016 Litigation Trends Annual Survey: Perspectives from Corporate Counsel 3 (2016), https://www.nortonrosefulbright.com/en/news/0d75357b/-norton-rose-fulbright-releases-2016-litigation-trends-annual-survey [https://perma.cc/UD4R-TUUV] (noting that "[t]he whole area of discovery, more specifically eDiscovery, is increasingly painful and costly to manage" and that "the resources required to . . . resolve litigation are ever increasing").

[26] Daniel E. González et al., Controlling the Rising Costs of Arbitration, Financier Worldwide (Oct. 2014), https://www.financierworldwide.com/controlling-the-rising-costs-of-arbitration#.XI5uDihKhPY [https://perma.cc/UR2E-JPBS] (noting that although lower cost is often described as one of arbitration's advantages over traditional litigation, "with the rise in popularity of this dispute resolution alternative, especially among sophisticated parties in complex international matters, many of those having gone through an arbitration procedure can attest that this is more of a myth than a reality and that arbitration may not be so inexpensive after all").

[27] A recent strand of contracts literature has focused on the question of how parties enter into contracts ex ante. See, e.g., Hwang, supra note 9 (describing how deal lawyers use preliminary agreements in M&A deals); Cathy Hwang & Matthew Jennejohn, Deal Structure, 113 Nw. U. L. Rev. 279 (2018) (discussing how parties use modular or integrated contracting structures to create networks of contracts to govern a single relationship or deal); Cathy Hwang, Unbundled Bargains: Multi-Agreement Dealmaking in Complex Mergers and Acquisitions, 164 U. Pa. L. Rev. 1403 (2016) (describing how parties use a set of agreements and contracts to document one unified business transaction); Anthony J. Casey, The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement, 124 Yale L.J. 2680 (2015) (describing how sophisticated corporate entities sometimes use complex contract structures to isolate their assets for purposes of limiting liability with regard to

literature. In particular, this Article takes a close look at a particularly odd type of contract—the formal-looking but non-binding and unenforced "faux contract"—and asks why sophisticated business parties willingly choose to enter into them and adhere to them.[28]

This Article builds on my own previous work, which asks a related question: Why do parties use *preliminary* agreements in mergers and acquisitions?[29] There, interviews with deal lawyers revealed that parties use preliminary agreements after most material deal uncertainty and complexity have been resolved, rather than very early in the deal's lifecycle. This time proximity accounts for why preliminary agreements are often followed up with full, binding acquisition agreements on substantially similar terms. That Article also noted that parties use preliminary agreements not because they want to enforce them, but for a variety of organizational and signposting functions. Left under-explored, however, are many questions surrounding the preliminary agreements' *non-binding* nature. This Article picks up where that one left off and tries to tease out the meaningfulness, if any, of using *non-binding*, *unenforced* contract-like devices in complex business transactions. In theory, the ideas here could extend to non-binding contract-like devices used outside of the preliminary context: for example, M&A lawyers have mentioned, at various times, the stickiness of jointly-prepared issues lists, shared checklists, and funds flow memoranda, which are not preliminary, but are also formal-looking and non-binding.

creditors' rights); Albert H. Choi & George Triantis, The Design of Staged Contracting (Feb. 2018) (unpublished manuscript) (on file with author) (discussing how commercial parties enter into deals in stages, in part so that they can engage experts to help them unpack complexity in the time between contracting stages).

[28] This builds on a robust modern contracts literature, in which scholars have shown, compellingly, that there is often a link between how a contract is drafted, ex ante, and how it will be litigated, ex post. Albert Choi & George Triantis, Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions, 119 Yale L.J. 848 (2010) (arguing that parties can use vague contract provisions efficiently—for example, material adverse change clauses in acquisition agreements may remain vague because they are rarely litigated); Robert E. Scott & George G. Triantis, Anticipating Litigation in Contract Design, 115 Yale L.J. 814 (2006) [hereinafter Scott & Triantis, Anticipating Litigation] (examining the efficiency of investment in the design and enforcement phases of the contracting process, and arguing that parties can lower overall contracting costs by using vague contract terms ex ante and shifting investment to the ex post enforcement phase); Robert E. Scott & George G. Triantis, Incomplete Contracts and the Theory of Contract Design, 56 Case W. Res. L. Rev. 187 (2005) (considering the role of litigation in motivating contract design).

[29] Hwang, supra note 9.

The remainder of this Article proceeds as follows. Part I considers a puzzle: other scholars have focused on contracts as tools for enforcement—and enforcement, in turn, is understood to mitigate economic transaction costs, such as incentive misalignment and information asymmetry. Relatedly, some minor enforcement of these contracts—perhaps through the award of reliance damages for breach—is meant to mitigate opportunism and holdups in the early dealmaking process.[30] But this focus on enforcement does not explain why parties enter into non-binding agreements that attach no enforcement. This Part investigates the shortcomings of the conventional focus on enforcement and asks: Why do parties incur the costs of drafting an agreement, if not to make a contracting relationship enforceable? Part II uses interviews with practicing lawyers to tease out several reasons parties use and adhere to non-binding agreements. Interview participants highlighted the multi-stage nature of complex dealmaking and reported that good-faith performance of early non-binding terms played a role in building a long-term relationship of trust within the ecosystem of a particular deal. Trust is necessary because complex deals are incompletely contracted, and trust fills the gaps left by contract provisions. Individual contract negotiators are also motivated to behave reasonably throughout the early deal process, even without a binding document, because they expend social capital within their own institutions to shepherd the deal through to completion. Interview participants also emphasized the collaborative process of dealmaking and described non-binding agreements as useful tools for facilitating collaboration. Ordinary frictions of trade, such as organization and coordination costs—what others have termed "mundane" transaction costs—present significant hurdles to dealmaking, and the process of drafting a shared document helps parties collaborate. Finally, interview participants described the process of bundling binding and non-binding terms in term sheets as substantively or formally nudging deal parties toward abiding by non-binding terms. Part III considers implications of faux contracting for contract theory, enforcement, and design.

[30] Alan Schwartz & Robert E. Scott, Precontractual Liability and Preliminary Agreements, 120 Harv. L. Rev. 661, 665–67 (2007) (arguing that contract law should encourage relationship-specific investments in preliminary agreements in certain instances, and describing the sequential or simultaneous nature of early-stage investments).

I. WHY USE A CONTRACT?: THE CONVENTIONAL UNDERSTANDING

Across many areas of the law, enforcement (or the threat of it) is understood as a way to motivate behavior. Fear of imprisonment, for instance, may deter crime.[31] The imposition of damages for faulty product design may motivate product designers to create better products.[32]

In contract law, the same conventional wisdom holds: formal enforcement, such as reliance and expectation damages imposed by a court, is understood to deter parties from breaching a contract unless there is a case for efficient breach.[33] Modern contract law scholarship has also shown that informal—that is, non-judicial or arbitral—enforcement can also do important work in motivating parties to adhere to contracts when formal enforcement falls short.[34] In fact, contracting parties sometimes so prefer informal enforcement over formal enforcement that they select informal enforcement, even when formal enforcement is available.[35]

Much of the existing legal scholarship on contracts, however, has focused intensely on enforcement. Indeed, much of legal scholarship is focused on enforcement, and for good reason: If enforcement does not matter, then what roles do courts, judges, lawyers, and lawmakers play in society?

In later Parts, this Article shows how faux contracts add value, even without enforcement. This Part, however, highlights the shortcomings of enforcement, which lays the groundwork for understanding when and why parties might exclude enforcement by turning to faux contracting. Section I.A discusses formal enforcement, and Section I.B focuses on informal enforcement.

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[31] Sarma, supra note 12, at 596.

[32] Karshtedt, supra note 13, at 620–21. Karshtedt also notes that where the deterrent effect is weak, tort law functions to provide compensation and ensure loss spreading. Id. at 619.

[33] For a thorough discussion of efficient breach in contract law, see Gregory Klass, Efficient Breach, *in* Philosophical Foundations of Contract Law 362 (Gregory Klass et al. eds., 2014).

[34] Ellickson, supra note 16 (showing that neighbors in a rural California ranching community abided by norms, even when those norms were at odds with the law, and that those norms exist because of thickly connected social networks that allow for informal enforcement through reputational sanctions).

[35] Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 Am. Soc. Rev. 55 (1963) (showing, through interviews of businesspeople, that although businesspeople seldom draft complete contracts, they also rarely use legal sanctions to adjudicate disputes when they inevitably arise). An even newer strand of contract scholarship has shown that a contract's structure can be harnessed to help parties further their enforcement preference. Hwang & Jennejohn, supra note 27.

A. The Limits of Formal Enforcement

Formal contracting—and formal enforcement—is most easily understood as the traditional type of contracting that law students learn in their first year of law school. The *Frigaliment* case is a good example of formal contracting.[36] In that case, parties entered into a supply contract for chicken. The supplier then proceeded to provide tough old stewing chickens. The buyer, who believed the contract was for choice young frying chickens, sued in federal court in the Southern District of New York.

In litigation, the parties did not dispute whether the contract was meant to be binding and enforceable—they both appeared to agree that they had entered into a formal legal contract. In agreeing that they had a formal contract, the parties had also implicitly agreed to formal enforcement of that contract: a court, not the parties, would decide who was in the right, and the wrongdoer might be subject to certain formal sanctions, such as an injunction or liability for money damages.

While the parties in *Frigaliment* sought adjudication of their formal contract in a government-created court, courts are not the only place where parties can seek formal enforcement of their contracts. Parties can also agree to use binding arbitration to enforce their contracts.[37] And, while the categorization of these forums as "formal" or "informal" begins to get a bit fuzzy, binding mediation[38] and adjudication through trade association forums[39] present other formal (or at least formal-adjacent) enforcement options. Parties can also mix and match dispute resolution forums throughout a dispute. When Uruguayan soccer star Luis Suárez bit another player during the 2014 World Cup, for example, he was first

[36] Frigaliment Importing Co. v. B.N.S. Int'l Sales Corp., 190 F. Supp. 116, 117 (S.D.N.Y. 1960).

[37] Gilson et al., supra note 15, at 1389 n.31 ("Arbitration is also a formal enforcement strategy. While arbitration displaces some of the legal rules associated with litigation, it still requires the intervention of the state to enforce the arbitration award.").

[38] Robert C. Leventhal, Between Mediation and Arbitration—Binding Mediation: The Third Alternative, LexisNexis Legal NewsRoom (Aug. 2011), https://www.lexisnexis.com/-legalnewsroom/insurance/b/reinsurance/archive/2011/08/30/foley-lardner-between-mediati-on-arbitration-binding-mediation-third-alternative.aspx [https://perma.cc/XNV7-QEEL] (noting that arbitration is binding, mediation is not binding, and binding mediation—"a procedure under which a mediator is appointed and is responsible for attempting to get the parties to voluntarily settle their dispute" and where "the mediator has the power to impose a resolution on the parties"—is a middle-ground alternative).

[39] Bernstein, Opting Out, supra note 15, at 138–39 (describing New York diamond merchants' resolution of disputes through a trade association).

disciplined by an internal disciplinary committee of the Fédération Internationale de Football Association ("FIFA").[40] After a series of appeals through FIFA's internal formal enforcement bodies, the case was finally heard by the Court of Arbitration for Sport, after which the arbitration panel briefly suspended Suárez from competition and ordered him to pay a fine to FIFA.[41]

Scholars have noted that formal enforcement has many benefits, the most obvious of which is that courts (or arbitrators) can "unpack[] complex behavior and assess[] responsibility."[42] In their roles as fact-finders, formal enforcers can also serve as impartial verifiers of information that parties provide.[43] At the end of the adjudication, formal enforcers—especially courts backed by the government—can also enforce their sanctions.[44] Another benefit of formal enforcement is that it allows parties to make credible promises. As Alan Schwartz and Bob Scott have noted, parties want the power to make contracts legally enforceable because "[e]nforcement . . . permits parties to make believable promises to each other when reputational or self-enforcement sanctions will not avail."[45] Thus, they note that formal enforcement does not just protect the party who suffers from a broken promise—it also benefits the party who wants to make the promise.[46]

Relying on formal enforcement, however, has its own problems. Others have noted, for instance, that "the court's power to compel disclosure is

[40] Jethro Mullen, FIFA Starts Disciplinary Action Against Luis Suarez After Biting Claims, CNN (June 25, 2014), http://edition.cnn.com/2014/06/25/sport/football/luis-suarez-biting-incident/index.html [https://perma.cc/SHS7-A9H5] (noting that FIFA had begun disciplinary proceedings against Suárez after his 2014 biting incident).

[41] Luis Suárez v. FIFA, Court of Arbitration for Sport (2014) (CAS 2014/A/3665, 3666 & 3667) (Fumagalli, L. & Balmelli, M.), http://jurisprudence.tas-cas.org/Shared%20Documents/3665,%203666,%203667.pdf (suspending and fining Suárez via a binding arbitral award).

[42] Gilson et al., supra note 15, at 1389 ("When formalized contractual exchanges break down due to the opacity of the interactions or the guile of one or more of the parties, courts—or arbitrators—serve a valuable function by unpacking complex behavior and assessing responsibility." (footnote omitted)).

[43] Id.

[44] Id. (noting that in order for judges to obtain information about complex interactions between the parties, courts must "have the power to impose sanctions in order to force the disputants to provide essential information known only to them").

[45] Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 Yale L.J. 541, 562 (2003).

[46] Id.

limited,"[47] which means that even a court cannot always verify information, accurately gauge wrongdoing, or impose an efficient level of sanction. This is especially true when courts are structured as an adversarial system: if neither party brings forth or seeks relevant factual information, the court may simply be unable to access that information.

Formal enforcement is also expensive—and perhaps no enforcement is more expensive than modern formal enforcement of complex corporate and commercial contracts in public courts.[48] In corporate contexts, parties also worry about more than the astronomical cost of hiring experienced lawyers, months of motion practice, and potentially high payouts. They also worry that commercial litigation will distract management[49] and lead to an invasive discovery process that airs corporate dirty laundry or exposes corporate secrets.[50]

Modern contracting parties—especially sophisticated commercial parties—have developed some new strategies to deal with the high costs of formal enforcement. Opting into binding arbitration is a common and well-documented strategy that still relies on formal enforcement.[51] Parties rely on arbitrators to have specialized expertise that reduces the court's learning time and reduces mistakes in the outcome, or to have expedited

[47] Gilson et al., supra note 15, at 1390.

[48] Id. ("In practice, therefore, the expense of formal verification limits its use, and parties to formal contracts routinely aim to structure their relations to economize on the expected costs of verification."); see also Hwang, supra note 9, at 398 (reporting on an interview with a deal lawyer who had noted that commercial litigation between sophisticated parties was extremely expensive); Hwang, supra note 27, at 1420 n.70 (citing to an application for fees from a bankruptcy proceeding by a major New York law firm, which notes the high billing rate of attorneys at that firm).

[49] David G. Bates, Here's How Entrepreneurs Can (and Should) Avoid Litigation, BizJournals (Aug. 28, 2014), https://www.bizjournals.com/bizjournals/how-to/growth-strategies/2014/08/heres-how-entrepreneurs-can-avoid-litigation.html (noting "the arduous and lengthy litigation process that will inevitably distract your management team from focusing on improving your business").

[50] Jadd F. Masso, How to Get (or Avoid) Direct Access to ESI in Discovery, Mondaq (Feb. 26, 2015), http://www.mondaq.com/unitedstates/x/377700/trials+appeals+compensation/-How+to+Get+or+Avoid+Direct+Access+to+ESI+in+Discovery [https://perma.cc/W255-B-QGS] (discussing the invasive nature of discovery during litigation, and noting that one concern of litigants is that "litigants often doubt that their opponents can be trusted to thoroughly search their ESI for relevant data").

[51] E. Norman Veasey, The Conundrum of the Arbitration vs. Litigation Decision, Bus. L. Today, Dec. 2015, at 1 ("The conventional wisdom for many years had been that arbitration promised to be superior to court litigation because of confidentiality, presumed cost savings, quicker results, and more flexibility.").

discovery rules that limit cost and time spent on the dispute.[52] Arbitration awards are also often confidential, which protects the parties' privacy.[53]

In an influential paper, Judge Richard Posner posited that the cost of a contract is the combination of the drafting cost, the (formal) enforcement cost, and the judicial error cost.[54] Arbitration (and other forms of alternative dispute resolution) can clearly help reduce enforcement cost by reducing time spent in litigation. Arbitration can also help to reduce judicial error cost by, for instance, allowing parties to use decision-makers who are more attuned to industry norms, or by creating space for parties to bring forth relevant confidential facts that they may not have wanted to expose in a public court.

In recent years, other scholars have also shown that attention paid to the front-end contract drafting process can also reduce back-end enforcement costs. A series of papers by Bob Scott and George Triantis,[55] and also by Albert Choi and George Triantis,[56] have focused on the relationship between drafting and enforcement. Their view is that, when drafting a provision, parties can choose to draft a provision as a rule or as a standard.[57] Rules are precise and leave less room for interpretative differences, argument, and litigation.[58] When litigated, disputes over rules resolve more quickly. As a result, rules can lower overall contract costs by lowering enforcement cost. On the other hand, rules, when compared to standards, are more expensive to draft: it takes longer for parties to negotiate and agree on specific rules ex ante.[59] Using a cheaper-to-draft standard might be more cost-effective when a provision is unlikely to be litigated and enforced. Choi and Triantis note, for instance, that material adverse change clauses in M&A contracts—among the most important

[52] Scott Baker & Albert Choi, Contract's Role in Relational Contract, 101 Va. L. Rev. 559, 563 (2015) ("Furthermore, parties in a long-term relationship can contain the cost of dispute resolution, for instance, by using arbitration and through tailoring of rules on procedure and evidence . . . .").

[53] See, e.g., Veasey, supra note 51, at 1–3.

[54] Richard A. Posner, The Law and Economics of Contract Interpretation, 83 Tex. L. Rev. 1581, 1583–84 (2005) (defining the cost of a contract as the ex ante negotiating and drafting costs, plus the probability of litigation multiplied by the sum of the parties' litigation costs, the judiciary's litigation costs, and judicial error costs).

[55] Scott & Triantis, Anticipating Litigation, supra note 28.

[56] Choi & Triantis, supra note 28.

[57] Id. at 852 (noting that "recent work frames the choice between vague and precise contract terms as a tradeoff in information costs: precise contract provisions raise contracting costs on the front end, but reduce enforcement costs at the back end").

[58] Id.

[59] Id.

provisions in the contract—are often vague and standard-like, because they are unlikely to be litigated.[60]

This line of scholarship makes a major contribution by showing, explicitly, that there is often a connection between contract drafting and contract enforcement. It sets the stage for other important questions: Can parties intentionally sever the relationship between drafting and enforcement? What happens when they do?

This literature also sees enforcement as a way to motivate party behavior. One of its main arguments is that when parties have little fear of enforcement—that is, when the risk of enforcement is low—there is less need to spend time and money in upfront drafting to rein in bad behavior.[61] But what happens when courts are not as precise at fact-finding or adjudication as parties assume? And if formal enforcement is so useful, why do parties enter into faux contracts that they do not intend to have enforced?

B. The Limits of Informal Enforcement

In contrast to formal enforcement, which relies on courts and arbitrators to determine right from wrong, informal enforcement relies on parties themselves to enforce the contract and to levy appropriate sanctions.[62] Other scholars have documented the ways in which parties use informal enforcement to curb bad behavior. While informal enforcement offers an alternative (or, by some accounts, a complement)[63] to formal enforcement, it too relies on the threat of ex post sanction to curb ex ante opportunism.

In her seminal study of New York diamond merchants, for example, Lisa Bernstein described a tight-knit community where parties agreed to abide by the rulings of an internal arbitration body (formal enforcement),

[60] Id. ("If a provision matters only in remote contingencies, for instance, then the back-end costs should be discounted by that remote probability, and it may be correspondingly efficient to save front-end costs by using a standard (or a vague term) rather than a rule.").

[61] Note that while this scholarship focuses on formal enforcement, informal enforcement would also work to cabin opportunistic behavior.

[62] Gilson et al., supra note 15, at 1379–82; MacLeod, supra note 23, at 596 (noting that "under informal enforcement the harmed party unilaterally decides that breach has occurred and then carries out actions that harm the reputation of the breaching party" (emphasis omitted)).

[63] See Hadfield & Bozovic, supra note 20, at 988 (noting that parties sometimes go through the expensive process of creating formal contracts, only to use informal means, exclusively, to enforce them).

but the body's decisions were enforced through social and reputational bonds (informal enforcement).[64] In another classic study, Robert Ellickson showed that ranchers in rural Shasta County, California, ignored laws in favor of continuing to abide by the community's long-standing norms. Ellickson noted that the tightness of the community, which meant that individuals had multiple points of contact with each other, facilitated the proliferation of norms.[65] Similar informal enforcement mechanisms exist amongst whalers,[66] pirates,[67] and cotton merchants,[68] just to name a few. In these situations, parties perform their obligations, at least in part, out of "[a] fear of reputational or relational sanctions."[69]

As compared to formal enforcement, informal enforcement has some benefits. For instance, parties in close-knit communities can often observe breaches better and at a lower cost than a court or outside observer. Gilson et al. note that "[i]n compact and homogenous communities . . . the community as a whole can sanction the breach of one member's obligation to another by ostracizing the malefactor, cutting off not just business ties but all the social benefits of belonging to the group."[70] Case studies of small communities, such as Ellickson's study of rural ranchers, support this view: because the community members have multiple points of contact with each other, they can easily enforce a shortcoming in one point of contact with a sanction in another point of contact.[71] Moreover,

[64] Bernstein, Opting Out, supra note 15, at 138–39 (describing the merchants' system of formal adjudication, followed by informal enforcement).

[65] Ellickson, supra note 16, at 671–85 (discussing California trespass law, which allows for formal enforcement in cases of cattle trespass, and how neighbors actually resolved cattle trespass disputes informally through self-help).

[66] See Ellickson, supra note 17.

[67] See Leeson, supra note 18 (describing norms and their informal enforcement amongst pirates).

[68] See Bernstein, Private Commercial Law, supra note 15 (describing norms and their informal enforcement in the cotton industry).

[69] Baker & Choi, supra note 52, at 561 (noting that "research by several influential scholars led to the birth of what is known as the 'relational contract' theory, which fundamentally questions what role, if any, contract law plays in promoting and maintaining trade" (footnote omitted)).

[70] Gilson et al., supra note 15, at 1393–94 (citing Schwartz & Scott, supra note 45, at 557 (noting that in small homogenous communities, "everything that happens soon becomes common knowledge, and boycotts of bad actors are easy to enforce")).

[71] Ellickson, supra note 16, at 675–76 ("A person in a multiplex relationship can keep a rough mental account of the outstanding credits and debits in each aspect of that relationship.").

informal enforcement can also "ha[ve] the benefit of reducing enforcement costs because punishment can be inflicted immediately."[72]

But, as others have noticed, there are pitfalls. One of the biggest is that parties might over-enforce.[73] For example, consider a supplier who breaches a contract by failing to deliver the correct breed of chicken to a buyer. That supplier is otherwise a good supplier—one who completes her orders on time, who sells at fair prices, and who regularly contributes to the chicken-trading community in other socially beneficial ways. When the supplier delivers the wrong breed of chicken, a slap on the wrist may be most appropriate. For example, a court could award damages to the buyer. If the same contract was enforced informally, however, the community of chicken traders might over-enforce: they might spread the word that the supplier's chickens were rubbish, that she was untrustworthy, and that nobody should do business with her. As a result of this word-of-mouth informal enforcement, the chicken supplier is driven out of business, when she might otherwise have continued to be a trustworthy, contributing, reliable member of the chicken-trading community.

For informal enforcement to be effective, the party whose reputation is harmed must also care about the harm to his or her reputation, which is not always the case.[74] For example, where trading relationships are one-off, one might easily imagine a party behaving opportunistically without fear of tarnishing their reputation.

C. Mixing Formal and Informal Contracting

As a way to deal with the shortcomings of both formal and informal enforcement, some parties have begun to use mixtures of the two to accomplish their contracting goals.

In their pathbreaking article on the interaction between formal and informal contracting, Ronald Gilson et al. describe the ways in which sophisticated parties "braid" formal and informal mechanisms to form a strong enforcement system. They note that formal and informal enforcement strategies are not, as some scholars have argued, substitutes

[72] MacLeod, supra note 23, at 596.

[73] Baker & Choi, supra note 52, at 564 ("One reason that relational sanctions are costly is that they can misfire. . . . A shoddy product by a manufacturer or an unsatisfactory experience at a restaurant is not necessarily the result of negligence or lack of care, but can nevertheless lead to a decrease in demand or a cessation of customer traffic.").

[74] MacLeod, supra note 23, at 596.

for each other.[75] Rather, the two strategies can complement each other. In sophisticated contracting situations, Gilson et al. describe parties drafting contracts "that intertwine elements of formal and informal contracting in a way that allows the parties to assess each other's disposition and capacity to respond cooperatively and effectively to unforeseen circumstances."[76] They note that parties might draft formal contracts to exchange information about the progress and prospects of their deal, and that information-sharing process "supports the informal enforcement of the parties' substantive performance."[77] For example, parties might agree, through a formal contract, to exchange certain proprietary information with each other in order to determine if their joint deal is worthwhile. Failure to meet the relatively minimal obligations of that formal contract might result in reduced trust between the parties, which, in turn, results in the loss of valuable collaboration opportunities that the parties contemplated when they entered into the formal contract.[78]

Gilson et al.'s description seems accurate in many circumstances, including in M&A preliminary agreements. In my prior work, I describe most preliminary agreements as having a mix of binding and non-binding terms.[79] The binding terms relate to the *process* of the deal—for example, parties often agree to binding exclusivity and confidentiality terms and to terms in which they agree not to solicit each other's employees for employment.[80] Non-binding terms relate to the substance of the deal, such as price terms and deal structure.[81] This maps onto Gilson et al.'s description—process terms are governed by formal contracts, while substantive terms may not be.

Others, too, have described situations where formal and informal contracting can work together. In their article on the role of contracts in relational contracting, Scott Baker and Albert Choi tackle the question of why parties write formal contracts and design expensive formal

[75] Gilson et al., supra note 15, at 1381.

[76] Id. at 1382.

[77] Id. at 1384.

[78] Id. at 1407–09 (describing the prototypical case of braiding, in which two pharmaceutical companies used a combination of formal contracting and informal enforcement to memorialize their collaboration).

[79] Hwang, supra note 9, at 381 n.9 ("To the extent parties include binding and enforceable provisions, they are provisions related to the process of the deal, and not to the material business terms. For example, provisions related to confidential exchange of information during initial investigation may be marked binding, and breaches may be enforceable.").

[80] Id.

[81] Id.

enforcement mechanisms (such as bespoke dispute resolution systems) when parties appear to be entering into a relational contracting relationship.[82] This is particularly puzzling in contexts where parties rarely resolve disputes using the formal contract and enforcement mechanisms that they labored to create.[83] Using a game theoretic model, Baker and Choi show that, even in a relational context, formal enforcement can be better than informal sanctions because they "decouple the deterrence benefit of a legal sanction from its execution cost."[84] Put another way, in the informal enforcement context, deterrence and sanctions go hand-in-hand. They are, by necessity, the same size: the deterrence for bad behavior is loss of future business, which is also the sanction for breach. Carefully calibrated formal enforcement, however, decouples the two: it can set a size of sanction that is different from the size of deterrence.[85] For example, loss of business might be the deterrent, and damages might be the sanction—and those can be of differing size. In addition, a well-crafted formal enforcement process might help to reveal information that parties can use in other contexts within the same relationship to tailor their informal sanctions.[86]

In a way, the arrangements that Baker and Choi describe—relational contracting buttressed by heavily negotiated but rarely triggered formal contracts and enforcement mechanisms—start to resemble faux contracts. Their account, however, raises some questions. For example, they note that formal enforcement can do a good job of forcing information, which parties can then use to better calibrate their informal sanctions.[87] But if formal enforcement is used rarely, how can it effectively force information? Put another way, what use is an information-forcing mechanism if it is rarely triggered, and therefore rarely forces information?

[82] Baker & Choi, supra note 52 (examining the role of formal contracts and sanctions in long-term relationships).

[83] Id. at 562 ("The parties haggle over terms and procedures, they hire lawyers, and they send multiple drafts back and forth. That is a lot of trouble if, in fact, the formal contract or the dispute resolution process will not be used or will be used rarely.").

[84] Id. at 563.

[85] Id. at 563–64.

[86] Id. at 564 ("[L]egal sanctions allow the parties to uncover relevant information that enables them to better tailor relational sanctions.").

[87] Id. ("Furthermore, through the dispute resolution process, legal sanctions allow the parties to uncover relevant information that enables them to better tailor relational sanctions.").

Most recently, Gillian Hadfield and Iva Bozovic studied the role of formal contracting in a variety of business relationships through a series of interviews with Southern California businesses.[88] They found that companies engaged in different levels of (self-identified) innovation used formal contracts to hash out the details of their expected relationship, but did not actually enforce those contracts when there was a breach.[89] Instead, when there was a breach, parties turned to informal enforcement—threat of termination and damage to reputation—to try to bring their counterparties in line with contractual terms.[90] Hadfield and Bozovic note that this kind of relationship "use[s] . . . formal contracts to structure an external relationship important to innovation, apparently for reasons other than court enforcement."[91] Their account, instead, argues that "formal contracting is valuable even when formal contract enforcement is not" and that "formal contracting provides essential scaffolding to support the beliefs and strategies that make informal means of enforcement such as reputation and the threat of termination effective."[92]

Hadfield and Bozovic present a very believable account of real-world contracting. Like Scott and Choi, they begin to decouple aspects of formal contracting that have conventionally been paired together. They illustrate that creating a formal contract can be valuable, even if parties never act on the threat of formal enforcement.[93]

Their study brings to light important questions. For example, Hadfield and Bozovic note that formal contracting is a valuable tool to set the stage for informal enforcement.[94] In the M&A context, however, the circumstances are sometimes not ripe for informal enforcement. For example, some deal parties are one-off players rather than repeat players. Even if their reputations are tarnished by reneging on a deal, they care very little—their reputations are not valuable assets to them in the M&A

[88] Hadfield & Bozovic, supra note 20, at 986 (describing their methodology, in which they conducted "semi-structured interviews with thirty businesses in California and asked them to discuss how they managed an important external relationship").

[89] Id. at 1007 (noting that interviewees sometimes used formal contracts that "do[ ] not depend on formal contract enforcement").

[90] Id. at 988 ("[F]ormal contracting provides essential scaffolding to support the beliefs and strategies that make informal means of enforcement such as reputation and the threat of termination effective.").

[91] Id. at 987.

[92] Id. at 988.

[93] Id. at 987–88.

[94] Id. at 997–1000.

sphere.[95] In these cases, where formal contracting is *not* setting the stage for informal enforcement, what does the process of drafting a formal contract do?

Hadfield and Bozovic's description highlights another interesting feature of the current state of contract scholarship: the fuzzy line between formal and informal enforcement. In their work, Hadfield and Bozovic identify the threat of terminating a contract as a type of informal enforcement.[96] It is well-understood that the loss of future opportunities is a paradigmatic form of informal enforcement in a relational contract.[97] A termination ends a relationship early and necessarily deprives a misbehaving counterparty of the opportunity for future interactions. In the world that Hadfield and Bozovic describe, however, the parties are not solely in a relational contract—they also enter into a formal contract. When one party misbehaves, the other party does not actually threaten to end their relational contract—rather, the other party threatens to end their *formal* contract.[98] Viewed in that light, then, it seems that at least part of what Hadfield and Bozovic describe is a fairly familiar formal contracting relationship: parties enter into a formal contract, and the threat of some kind of loss, dictated by their formal contract, motivates their behavior. In this case, the loss that the formal contract spells out is termination. In other words, a formal contract is paired with formal enforcement (termination).

Hadfield and Bozovic's contracting story is persuasive and important. It also aligns with work that has been done in fields outside of corporate contracts that shows that the act of promising, even if not backed by a real threat of enforcement for breach, can motivate behavior. In psychology, for example, a rich literature describes the importance of oath-taking and other formalities in motivating individuals to behave well.[99] In other areas of the law, too, scholars have studied oath-taking and argued that it is

[95] Others have noted that "in a free market, sellers of high quality goods treat their reputation as an asset that losses [sic] its value should they choose to supply goods of low quality." MacLeod, supra note 23, at 596.

[96] Hadfield & Bozovic, supra note 20, at 987.

[97] Id. ("[Respondents] relied not on litigation but on informal means of enforcement—reputation and the threat of cutting off future business—to secure compliance.").

[98] Id. at 996 ("[Some parties] relied heavily on informal means of assuring performance: reputation and the threat of terminating a relationship.").

[99] Stephanie Plamondon Bair, Try These Simple Tricks for Better Patents (Mar. 2019) (unpublished manuscript) (on file with author) (providing an overview of the psychology literature about how to motivate truthful behavior).

important in motivating behavior. In studying judges, for instance, Richard Re has argued that oath-taking affects (and should affect) behavior.[100] In studying taxation, Joe Bankman, who is both a tax scholar and a practicing clinical psychologist, shows that changing the structure of taxpayer affirmations of honesty in individual tax returns motivates more honest tax filing.[101]

In consumer contracts, too, legal scholars have shown that the formalities surrounding contract formation are important, even in the absence of real enforcement or threat of it. In a series of influential papers that study the views of the consumers who enter into consumer contracts, Tess Wilkinson-Ryan, David Hoffman, and others have shown that the formality of contracting, rather than an actual substantive assent to terms, is one of the most important ways to make consumers feel bound to contracts.[102] Moreover, consumers' belief that they have been treated fairly in the contracting process causes them to behave better.[103] In other words, it is the process of creating a formal contract that makes parties adhere to contract terms.

Despite all of this work—on formal contracting, informal contracting, and mixes of the two—scholars have yet to understand fully the nuances of ex ante contracting as a creature separate and apart from enforcement. In each of these realms, scholars have largely tread on familiar ground: that some kind of enforcement—whether it be a court-ordered sanction, an arbitration award, a slap on the wrist from an industry intermediary, reputational sanctions, or some mixture of these—motivates parties to play by the rules.

But what happens when enforcement is out of the picture? Can contracts still do important work—and, if so, what is that work? The next

[100] Richard M. Re, Promising the Constitution, 110 Nw. U. L. Rev. 299, 301–04 (2016) (discussing the constitutional oath that legislators, judges, and executive officers take before assuming office and how it can help to delineate the bounds of their constitutional duty).

[101] Joseph Bankman et al., Using the "Smart Return" to Reduce Evasion and Simplify Tax Filing, 69 Tax L. Rev. 459, 466–67 (2016) (noting that having taxpayers sign a statement affirming honesty at the top of the first page of the return was more effective at deterring dishonest filings than not requiring a signature, or requiring a signature at the bottom of the return).

[102] Tess Wilkinson-Ryan & David A. Hoffman, The Common Sense of Contract Formation, 67 Stan. L. Rev. 1269, 1286–87 (2015) (citing to experimental evidence to show that although contracts are formed, as a doctrinal matter, at the moment of actual assent, "most subjects thought that the contract was formed by the signature").

[103] Id. at 1276 n.40 ("Even when an agreement appears materially beneficial to both sides . . . , it may be rejected if one or both parties believes that it is objectively unfair.").

Part tackles that question and tries to understand how and why contracting is important, even in the absence of enforcement.

II. OPTING OUT OF ENFORCEMENT

This Part presents data from original interviews with deal lawyers to explain why M&A parties use non-binding agreements.[104] Non-binding agreements present two interesting and related questions. First, why do parties use non-binding, rather than binding, agreements? Second, why do parties abide by the terms of non-binding agreements, even when enforcement is not part of the equation?

Non-binding or unenforceable agreements are commonplace: illegal contracts, such as those governing the production of adult films,[105] surrogacy contracts,[106] and contracts with minors,[107] are easy examples.

[104] Previous work discussed why M&A parties used non-binding *preliminary* agreements. Although this Article also uses term sheets in the M&A context as its core example, its focus is on these agreements' *non-binding* quality. In addition to interview data that was gathered for a previous paper, this Article adds additional original interviews that focus on the non-binding question specifically. Appendix A provides more information about methodology and interview participants.

[105] Andrew Gilden, Note, Sexual (Re)consideration: Adult Entertainment Contracts and the Problem of Enforceability, 95 Geo. L.J. 541, 542 (2007) (describing the difficulties that courts have in enforcing adult entertainment contracts between producers and performers, because of the "long-held prohibitions on sexual consideration under the contractual doctrines of illegality and public policy").

[106] In some states, for instance, contracts for surrogacy services—or even specific provisions of surrogacy contracts—are illegal. Nonetheless, parties enter into them. See Ken Alltucker, Arizona Law and Surrogacy: What You Need to Know, AZ Central (Dec. 11, 2017), https://www.azcentral.com/story/news/local/arizona-health/2017/12/11/arizona-law-and-surrogacy-what-you-need-know-trent-franks/935578001/ [https://perma.cc/RQE9-WT2X] (noting that although "Arizona law prohibits the use of legal contracts between couples and surrogates. . . . such arrangements routinely occur in Arizona").

[107] In some religious communities, teenage girls sometimes enter into "abstinence pledges"—agreements in which they agree to abstain from sexual activity until they are married. These pledges have the look and feel of legal commitment: they are drafted to look like serious legal documents, parties sign them, and signing events are often accompanied by some formality. But these pledges, unlike formal contracts, cannot be enforced: they lack consideration, cover unenforceable subject-matter, and are signed by minors who have the option to void the contract. In general, the ability of minors to enter into enforceable contracts is fairly narrow. Kaiponanea Matsumura notes, for instance, that "[a]t common law, individuals under age twenty-one could only incur voidable contract duties." Kaiponanea Matsumura, Binding Future Selves, 75 La. L. Rev. 71, 124 n.261 (2014) (citing Restatement (Second) of Contracts § 14 cmt. a (Am. Law Inst. 1981)); see also Wayne R. Barnes, Arrested Development: Rethinking the Contract Age of Majority for the Twenty-First Century Adolescent, 76 Md. L. Rev. 405, 406 (2017) ("In the United States, an individual generally is considered to be an adult for contract purposes when he or she is eighteen years old. Most

But these examples are also unsurprising. In these and other contexts, non-binding agreements are a second-best solution: parties might prefer formal contracts, but something stands in the way of their ability to form them.

Moreover, in many of these contexts, there is another overlay: the non-binding agreements are made in situations where informal enforcement is strong. And sufficient informal enforcement can create the right kind of environment for a non-binding agreement to work, even where parties are sophisticated. In his 2015 study of Hollywood contracting, for instance, Jonathan Barnett found that major Hollywood films are often produced only on the basis of non-binding term sheets.[108] In Hollywood contracting, like in M&A deals, parties are sophisticated and presumably have the means and knowledge to enter into real contracts. Nonetheless, they appear to *choose* to use non-binding agreements, even though their deals are high-stakes and one party's reneging can cause serious and unrecoupable damage to the other.[109] In Hollywood, however, personal networks can be thick, and Barnett describes Hollywood contracting as being enforced by "significant but limited reputational pressures."[110] He further notes that, where reputational sanctions might be weak in Hollywood deals, more formalization sometimes fills the gap.[111]

This Article, then, investigates a special case: where non-binding agreements appear to be used, and even adhered to, despite there being

contracts entered into by a person that is underage (referred to as 'minors' or 'infants') are voidable at the minor's option." (footnote omitted)). When parties lack sophistication, they may, as in the case of abstinence pledges, unintentionally create contracts that lack consideration. Because consideration is required for the formation of a legally binding contract, the parties have failed to form a legally binding contract. See Contract, Wex Legal Dictionary (2017), https://www.law.cornell.edu/wex/contract [https://perma.cc/3LSM-E54B] ("The basic elements required for the agreement to be a legally enforceable contract are: mutual assent, expressed by a valid offer and acceptance; adequate consideration; capacity; and legality.").

[108] Barnett, supra note 22, at 618–21 (discussing the production of Hollywood movies on the basis of only "deal memos," rather than on the basis of binding formal contracts).

[109] Id.

[110] Id. at 610.

[111] Id. ("In particular, parties adjust formalization levels depending on the reputational capital and transactional knowledge of their counterparties, the holdup risk at any particular stage of a transaction, and the specification costs required to formalize any particular element of a transaction. This approach accounts for observed differences in formalization levels within studio-star transactions, across the larger set of transactions in the Hollywood film industry, and, preliminarily, in other markets that employ a mix of more and less formalized contractual instruments.").

low or possibly even non-existent reputational sanctions associated with non-adherence. Section II.A begins with a short primer on M&A term sheets. Section II.B establishes that M&A term sheets—the primary example—are, indeed, non-binding, adhered to, and not formally or informally enforced. Section II.C discusses why this is the case, based on interviews of deal lawyers. In particular, it shows that term sheets are valued for their ability to facilitate collaboration and mitigate mundane transaction costs. It also reframes M&A deals in a way that explains why parties adhere to non-binding contracts: while deal parties may not be repeat players on the M&A market, the multi-stage nature of M&A dealmaking ensures that they are repeat players within their particular deal. Thus, good behavior in early-stage negotiation increases one's reputation in future interactions, which can be valuable to parties.

A. M&A Term Sheets

It is useful to take a brief pause to describe the paradigmatic faux contract, and the primary motivating example of this Article—the M&A term sheet. In private M&A deals—that is, deals where parties do not file securities disclosures about the deal terms[112]—parties often enter into a non-binding preliminary agreement before entering into a binding acquisition agreement.[113] These preliminary agreements are variously called term sheets, letters of intent ("LOIs"), or memoranda of understanding, but for ease, this Article generally calls them term sheets. While term sheets exist in a variety of business contexts—venture financing, bank financing, joint ventures, and the like—there are industry norms, regulatory overlays, and other factors that make those term sheets somewhat different than M&A term sheets. In addition, because the interview participants here have primarily U.S.-based M&A practices, the findings here focus on term sheets in U.S. deals—international deals often have term sheets that look different and do different work.

Term sheets vary in how they look, but generally come in three varieties. Some are simple, unsigned documents that list material business terms: a document that simply "lays out terms."[114] Others look more like contracts: they have formal language and signatures. These often also

[112] George S. Georgiev, Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation, 64 UCLA L. Rev. 602, 605 & n.2 (2017).

[113] Barnett, supra note 22, at 618.

[114] Telephone Interview with N.Y. Firm Attorney I (May 7, 2016) [hereinafter N.Y. Firm Attorney I].

include a combination of binding and non-binding provisions, and contain an additional provision noting which provisions are binding and which ones are not.[115] Still another type of term sheet tries to create some physical separation between the binding and non-binding parts, but note that the two are related. For example: "There's a binding agreement . . . and you put everything that's non-binding in a [separate] attachment. You have one paragraph [in the binding agreement] that says . . . Exhibit A, which has the [business] terms, is not binding."[116] In the second and third varieties—which account for most of the term sheets that interview participants described—there appears to be some bundling of binding and non-binding terms into the same document or a set of related documents.

Term sheets often have additional features that make them look like formal, legally binding, and enforceable contracts: they are often written in legal language, made to look serious and formal, and contain space for parties to sign their names.[117] Parties spend time negotiating them. While it is hard to get a precise estimate of how many term sheets lead to real contracts, M&A lawyers report that once term sheets are signed, parties tend to sign acquisition agreements, and on similar terms to those in the term sheet.[118] But despite their formal bells and whistles, and the fact that parties adhere to their terms, the term sheets' business terms are *not* binding and enforceable.

While previous work investigates why parties who sign term sheets seem to complete deals, and on substantially similar terms as the term sheets' non-binding ones, that work focused more on the *preliminary* nature of term sheets.[119] Previous work also began to explore the value of term sheets in general.[120] This Article's questions are related: it investigates, through interviews with deal lawyers, what value term sheets' *non-binding* nature brings to the table, and why parties might abide by provisions even when enforcement is not part of the equation. Because this Article's question is related to the previous article's, this

[115] Telephone Interview with In-House Attorney II (May 25, 2016) [hereinafter In-House Attorney II]; N.Y. Firm Attorney I, supra note 114.

[116] Telephone Interview with In-House Attorney IV (Feb. 7, 2019) [hereinafter In-House Attorney IV].

[117] Hwang, supra note 9, at 396 n.69 (describing the signatures and other trappings that make an M&A term sheet look like a formal, legal document).

[118] Id. at 393–94.

[119] Id. at 393.

[120] Id. at 404.

Article revisits some of the previous article's interviews and also builds on it with new original data.

B. Separation of Contracting and Enforcement

In Part I, this Article described the importance of enforcement as a way to motivate parties' behavior. An easy way to think about enforcement is with the old analogy of sticks and carrots. Formal enforcement acts like a stick: parties who behave poorly will be punished in court, usually by being liable for some kind of damage payment to the wronged counterparty. Informal enforcement is a bit like a stick, but also like a carrot. When a party misbehaves, their reputation might be damaged, causing them to lose future business or social capital within their community—the stick. When a party behaves well, however, their reputation might be enhanced, and they might gain more business or social capital. In that way, informal enforcement is a carrot.

In the contract theory literature, informal enforcement is useful as a motivator in two ways. Sometimes, it fills the gap when a formal enforcer is absent. In fact, others have observed that parties will design arrangements specifically to exclude formal enforcers. Lisa Bernstein, for instance, describes Midwestern manufacturers' supply contracts, which are "long and detailed," as "designed to keep the law—in the sense of legal enforcement of contractual obligations—largely out of their relationship with their suppliers."[121] Other times, informal enforcement works in concert with formal enforcement by adding a little more "stick" atop the one that formal enforcement provides. Whether parties rely on formal or informal enforcement, however, the conventional wisdom is clear: a stick or a carrot motivates behavior.

In particular, sticks and carrots are understood to mitigate certain transaction costs that arise during dealmaking, such as search and information costs, bargaining costs, and enforcement costs.[122] In a transaction, parties inevitably have different information and incentives. In any sort of buy-sell transaction, for instance, the seller has the best

[121] Bernstein, supra note 21, at 562.

[122] According to Richard Langlois, Carliss Baldwin and Kim B. Clark attribute the term "mundane transaction costs" to Oliver Williamson. Langlois notes, however, that Williamson does not use the term in the cited paper. Nonetheless, the term has stuck, and is used to describe ordinary frictions of dealmaking. See Richard N. Langlois, The Secret Life of Mundane Transaction Costs, 27 Org. Stud. 1389, 1406 n.7 (2006); Oliver E. Williamson, Transaction Cost Economics: How It Works; Where It is Headed, 146 De Economist 23, 23 (1998).

information about the asset being sold, including the asset's shortcomings. At the same time, the seller wants to obtain the highest price, while the buyer wants the lowest. Together, information asymmetries and misaligned incentives motivate a seller to withhold negative information about the asset in order to obtain the highest price. A contract allows parties to introduce provisions, along with related enforcement mechanisms, that are understood to bridge some of the information and incentive gaps of contracting.[123] In acquisition agreements, for example, earnout, indemnification, and representation and warranty provisions create obligations for sellers to disclose negative information about the asset, and pair those obligations with threats of enforcement and liability when sellers fail to do so.[124] In a house or car sale, agreements might include similar disclosures and warranties that attempt to mitigate misaligned incentives and close information gaps.

Faux contracts begin with a different premise. As a first step, the front- and back-ends of a faux contract appear to be decoupled. Deal lawyers, for instance, uniformly reported that M&A term sheets, while formal-looking, are almost never binding or formally enforceable.

One deal lawyer, for instance, noted that when she drafts term sheets, they often contain a paragraph stating, "This [term sheet] is merely a statement of our mutual understanding and does not constitute a binding obligation on the parties."[125] She noted that her term sheets "are, as a general proposition, non-binding."[126] Another noted that "pretty much on every page we have something that says that this is a non-binding agreement—this is non-binding except exclusivity/no shop, confidentiality, governing law, fee sharing."[127] This view was shared by another deal lawyer, who explained, "I tend to say that the presumption [is that] this is a non-binding letter of intent, except for sections [such as] confidentiality and sometimes exclusivity."[128]

[123] Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 262–80 (1984) (describing provisions of typical acquisition agreements, such as earnout and indemnification provisions, which help to deal with information asymmetry and other issues).

[124] Id.

[125] N.Y. Firm Attorney I, supra note 114.

[126] Id.

[127] Telephone Interview with In-House Attorney I (May 23, 2016) [hereinafter In-House Attorney I].

[128] In-House Attorney II, supra note 115.

Several deal lawyers described carefully separating binding and non-binding terms into separate documents that referred to each other, making it clear that the non-binding parts were non-binding:

> There's a binding agreement . . . in a standalone agreement, and you put everything that's non-binding in an attachment. You have one paragraph that says that Exhibit A, which has the term sheet, is not binding. The magical language that says that the non-binding term sheet is not binding is in the binding agreement.[129]

On the issue of enforcement, lawyers were clear that they did not consider these documents legally enforceable. One noted: "I don't think anyone ever enforces it, in my opinion."[130] Others echoed this view, noting that "I think things would need to be pretty egregious to warrant any kind of legal response,"[131] and, more explicitly, "[p]reliminary agreements are something you can't enforce, but you'd still look like a [expletive] if you walked away."[132] Another elaborated that even when formal enforcement was discussed for egregious behavior, parties never pursued formal enforcement:

> We had some conversations on some deals about whether we can sue someone for equitable reliance or promissory estoppel, but we never went through. I had some circumstances where owners woke up and simply said, 'I don't want to sell' or 'I went to my minister or my astrologist and decided not to sell.' . . . I never remember a circumstance where we seriously considered wanting to sue them for reliance or whatever.[133]

In many circumstances, where parties opt out of formal enforcement, informal enforcement steps in. In M&A, however, lawyers were mixed about the effectiveness of informal enforcement—in particular, the effectiveness of using reputational sanctions on the M&A market—to deter bad behavior.

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[129] In-House Attorney IV, supra note 116.

[130] In-House Attorney II, supra note 115.

[131] Telephone Interview with Silicon Valley Firm Attorney II (June 2, 2016) [hereinafter SV Firm Attorney II].

[132] Telephone Interview with N.Y. Firm Attorney II (May 17, 2016) [hereinafter N.Y. Firm Attorney II]. See infra Subsection II.C.2 for a discussion of the informal consequences of breaking non-binding term sheets.

[133] In-House Attorney IV, supra note 116.

Asked whether the potential for reputation loss would deter parties from deviating from a term sheet or walking away from a deal, one lawyer reported:

> As outside counsel, no, it wouldn't deter me much. . . . One really important dynamic is not solely reputation, but it's also what are the dynamics between the parties. If the seller had already decided that they are going to sell the company, they're probably going to [allow deviations to the deal].[134]

Others noted that reputation was only important for some types of M&A parties, and certainly less important for non-repeat players.[135] One lawyer, for instance, noted that repeat offenders would gain a bad reputation on the M&A market, but when they wanted to participate in the market again, "the color of their money is the same as everyone else's."[136] Another lawyer noted that "reputation can be an issue for some people and not for others."[137] Another said, "I can't think of anyone who would do a deal that's a bad deal for them just for the sake of reputation."[138] In short, lawyers, in general, felt that reputation was not entirely irrelevant, but when push came to shove, a bad reputation did not prevent a player from reentering the market for a future deal.

One explanation for the apparent ineffectiveness of reputational sanctions is that the market disagrees about what is considered a good or bad reputation. One lawyer noted that in the context of dealmaking, reneging on an informal promise might not be a "bad reputation."[139] In fact, reneging may actually *increase* a party's reputation: "I absolutely worked with people where [if] you said 'I find you lacking in integrity or acting in bad faith,' [they] would say 'others would say that I am a tough negotiator, I'm using the structure to extract the best deal for my client or my board of directors.'"[140]

In summary, entering into an M&A term sheet does not seem to clearly attach any sort of enforcement. Certainly, it does not create a formal legal

[134] Id.

[135] Telephone Interview with Silicon Valley Firm Attorney VI (Feb. 7, 2019) [hereinafter SV Firm Attorney VI].

[136] Telephone Interview with N.Y. Firm Attorney III (May 26, 2016).

[137] Telephone Interview with Silicon Valley Firm Attorney VII (Feb. 8, 2019) [hereinafter SV Firm Attorney VII].

[138] SV Firm Attorney VI, supra note 135.

[139] In-House Attorney IV, supra note 116.

[140] Id.

obligation. In addition, it does not appear to attach clear informal sanctions for breach. And term sheets do not appear to be unique in this way: deal lawyers report using formal-looking and non-binding agreements of various types throughout the deal, including funds flow memos and the occasional shared issues list or checklist.[141] This lack of enforcement presents a new and interesting question: If an agreement does not attach enforcement, what is the point of entering it?

C. Motivations for Entering Faux Contracts

This Section offers explanations for why parties enter into and abide by faux contracts in early-stage M&A dealmaking. Interviews with deal lawyers revealed several common reasons and one small additional nuance about term sheet practice.

This Section first discusses why parties use non-binding agreements at all. M&A deals are, ultimately, complex and collaborative processes that are full of mundane transaction costs. Non-binding term sheets help to mitigate these mundane transaction costs and allow parties to come to a deal. More importantly, the *non-binding* nature of a term sheet seems to do a better job of mitigating mundane transaction costs than a binding agreement would: parties use term sheets precisely because they allow parties to organize without creating legal obligations for the parties.

Even without a legal obligation to perform, however, parties appear to find M&A term sheets somewhat sticky. One reason relates to the multi-stage nature of M&A dealmaking. M&A deals are always completed in stages. This means that even parties who plan not to be repeat players in the larger M&A market—and who might otherwise not care about their reputations—will care about their reputations within the microcosm of their particular deal. Behaving in an expected and reasonable way builds one's reputation within the deal ecosystem, thereby accruing benefits for later stages in the dealmaking process.

Another reason is that the reputation of the individual who is guiding the deal through each counterparty's corporate structure factors into the stickiness of faux contracts. In particular, the individuals who guide deals through the labyrinth of internal corporate approvals are motivated to see deals completed.

A third reason is that deal lawyers report bundling binding and non-binding provisions together in term sheets in order to motivate adherence.

[141] SV Firm Attorney VI, supra note 135.

This bundling can either occur structurally, by putting two types of provisions into one physical document, or substantively, by making binding and non-binding provisions depend on each other to some extent. For various reasons, deal lawyers report that this bundling of provisions can steer deal parties toward taking the non-binding provisions more seriously.

Finally, while not a reason for entering into term sheets, this Section ends with a nuance that deal lawyers discussed about the practice of entering into a term sheet. In particular, deal lawyers reported caring about their own reputations, even if their clients were non-repeat players. The fact that deal lawyers cared about their own reputations caused them to advise clients to approach term sheet deviations carefully. In general, deal lawyers reported that term sheet changes are best accompanied by carefully crafted justifications for the deviations.

The remainder of this Section discusses each of these findings in more detail.

1. Mitigating Mundane Transaction Costs

An important reason parties use term sheets is to allow themselves to go through the process of creating a contract, without actually *forming* a legal contract. It is important to distinguish here between how this Article uses the terms contract "formation" and contract "creation." Contract formation is a term of art that describes the process of creating a legally binding contract.[142] Contract formation leads to a real contract. Contract creation, however, does not lead to a real contract. It is simply the process of negotiating a bargain—but in this context, the parties do not mean to be bound by that bargain in any legal sense.

The purpose of contract creation appears to be to mitigate mundane transaction costs—the ordinary frictions of transferring assets, for instance, from one person to another. In the words of economist Richard Langlois, "[s]tories about friction in trade are not nearly as intriguing as stories about guileful trading partners"—the latter of which bring to mind the economic problems that face deals, such as information asymmetry—but these frictions are both important and overlooked.[143] In term sheets, the process of putting pen to paper helps to mitigate those mundane

[142] See Restatement (Second) of Contracts chs. 3–4 (1981) (addressing "Formation of Contracts-Mutual Assent" and "Formation of Contracts-Consideration").

[143] Langlois, supra note 122, at 1393.

transaction costs. By engaging in the time-consuming action of negotiation and drafting, parties begin to signal seriousness to counterparties, create a time and space to engage decision-makers and advisors, and think seriously about the feasibility and logistics of their project.

In complex transactions, the ability to organize is paramount, and deal lawyers engage in a variety of organizational activities throughout the dealmaking process. Transactional lawyers, for example, frequently use detailed checklists to organize their deals.[144] It is also common for lawyers to share their checklists with other parties' lawyers, to ensure that they are on the same page about what needs to be done and who is responsible for doing it. These checklists are entirely unenforceable, and also not meant to be enforceable—but they are common, and serve as a focal point and central organizational document. Similarly, one lawyer described funds flow memos—memoranda about the payment of consideration at closing—as another organizational document that is "not technically binding, but people act like they are."[145] Issues lists are another example of an organizational document that operates this way. Often, when reviewing an agreement, each side creates a list of "issues" with the agreement and how they wish to address them. However:

> Sometimes, occasionally, you do circulate [your] issues list to the other side, and you get on a call [to discuss] five to ten issues that are out there that we don't agree on, and then you [both] come up with something [that you agree on]. It's not binding, but it does help further things along.[146]

Term sheets appear to take on a similar "focal point" role. One lawyer noted that while term sheets are not always used, using a term sheet usually means "[b]oth parties have gone through general approving authority, whether it's a board or shareholders or bankers. Everyone has gone through some formal steps to say we are, formally within our organization, sure that we can work within these parameters."[147] Another described how term sheets can mitigate early deal jitters: "The parties

[144] See Hwang, supra note 27, at 1413 (noting that M&A lawyers often use a checklist—"a detailed grid that keeps track of all deal documents and action items"—to stay organized in a deal); see also SV Firm Attorney VI, supra note 135 (explaining that checklists typically are not binding).

[145] SV Firm Attorney VI, supra note 135.

[146] Id.

[147] In-House Attorney IV, supra note 116.

have some trepidation. . . . It's the process of putting pen to paper and thinking about the different topics and kind of outlining what you think will likely be the result. [A term sheet] forces them to think more seriously about the deal, to progress further."[148]

This description comports both with my previous work and other theoretical literature. In previous work on M&A term sheets, for example, I discussed how M&A term sheets can help parties begin essential organization.[149] Lawyers who draft them repeatedly discussed term sheets as an opportunity for organization. One lawyer interviewed for that project called a term sheet an opportunity for the deal team to "focus on whether there's a deal to be had," and noted that businesspeople often think they have a good idea for collaboration but fail to have an opportunity to think about logistics like packaging, employees, and marketing before they sit down to discuss the term sheet.[150] As a result, the term sheet "helps both sides knock out the material terms and figure out if there's a skeleton to get the deal done."[151] Additionally, term sheets are something that business people can bring to the board of directors for discussion and approval,[152] and lawyers might also use them to start regulatory preapproval processes.[153]

It is also important that term sheets represent a natural opportunity for parties to engage outside experts. As Choi and Triantis explain, after entering into a term sheet, parties often begin to engage experts, such as lawyers and accountants, to weigh in on the deal's details, and the parties might then begin to share the deal with the company's board of directors.[154] Experts' services are expensive, so the willingness to engage experts might also signal to a counterparty that one is serious about continuing with the collaboration. One attorney noted that the term sheet was important and that in a recent deal, the term sheet process made "clear that the parties [wer]en't ready [to reach an agreement], so they said let's

[148] SV Firm Attorney VI, supra note 135.

[149] Hwang, supra note 9, at 408.

[150] Id.

[151] Id.

[152] See id. ("[P]reliminary agreements can be a tool for getting the attention of upper management by creating a central document on which the board of directors can vote.").

[153] See id. at 409.

[154] Choi & Triantis, supra note 27, at 13; see also Hwang, supra note 9, at 408–09 (indicating that interview subjects noted that having a basic agreement justified the parties' engagement of lawyers and bankers, and also justified engagement of informal internal corporate players of the potential deal).

go back . . . let's do some internal talk[ing] amongst ourselves."[155] Moreover, sharing part of the deal with the company's highest-level managers—the board of directors—also signals to a counterparty that one is serious about the deal.

When lawyers talked about the work that term sheets do to mitigate mundane transaction costs, it was clear that term sheets' special blend of formality and lack of enforcement was *more valuable* than other types of contracts. M&A term sheets' formality, for instance, allows company executives to have something to focus on and negotiate. At the same time, executives often cannot bind the company to the M&A deal without director approval, so the faux contract's lack of enforceability is also necessary. Put another way, the term sheet must be formal enough for early negotiators to take seriously, but also non-binding and unenforceable at least until it is approved by the board. A faux contract, which has formality without enforceability, is the only tool that works for a term sheet.

2. Multi-Stage Contracting and Reputation Within the Deal

If term sheets are not binding, how can they be taken seriously at all? For deal parties who regularly enter the M&A market, reputation in that broader market clearly plays a role. One lawyer noted "in the business community, where people are multiple-times-transactors, there's a reputational hit . . . from backing away from a . . . term sheet."[156] Lawyers differed, however, in their reports of what kinds of parties care about their M&A market reputations. In response to a question about whether private equity firms cared about their reputations, one deal lawyer remarked that they did not, because

> [t]he sellers they are dealing with aren't in such a small world . . . . [By contrast,] in the tech world, if some serial buyer approaches the seller, . . . one phone call and they know the buyer and kind of know what to expect. . . . If one buyer has a bad reputation, like a reputation for reneging [on] the purchase price at the eleventh hour before signing the agreement, that will be taken into account.[157]

[155] SV Firm Attorney VI, supra note 135.
[156] SV Firm Attorney VII, supra note 137.
[157] Telephone Interview with Silicon Valley Firm Attorney I (May 31, 2016).

The same lawyer agreed that private equity buyers had a reputation for changing agreed-upon terms.[158] Another lawyer, however, specifically singled out private equity players as caring about their reputation on the market: "[R]eputation in the market for . . . PE firms or [a particular major strategic buyer]"[159] is important.[160]

For M&A parties who are *not* repeat players on the M&A market, however, what accounts for adherence to non-binding term sheets? One explanation appears to be that parties care about their reputations within a particular deal. As other scholars have noted, M&A (and other complex transactions) involve a multi-stage process.[161] Early-stage processes can require simultaneous investment by both deal parties or require sequential investment by alternating parties.[162] In any case, however, deal parties end up having to make unrecoupable, relationship-specific investments into deals through a multi-stage process.

One lawyer explained, for example, that "[i]n order to get to step #3, you have to get through step #1 and step #2," and that a term sheet is one of the earlier interactions between clients.[163] Another lawyer noted that reputations mattered within the deal because there is almost always another phase of the deal to negotiate: "Let's say someone doesn't care [about their reputation] and [they are negotiating] the last open point of the deal. . . . You don't [then] want to be in a spot where [ ] you are going to have further meetings."[164] Because deal parties interact with each other many times throughout the same deal, the reputation that they build throughout the deal process matters—ideally, parties want to enhance their reputations in earlier stages, so they can have more successful interactions in future stages.

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[158] Id.

[159] To protect anonymity, I have redacted the name of this company.

[160] SV Firm Attorney VI, supra note 135.

[161] Michael D. Benson & Jeffrey S. Shippy, The M&A Buy Side Process: An Overview for Acquiring Companies, Stout, Risius, Ross (Aug. 2013), at 2, https://pdfs.semanticscholar.org/9807/85c34fd3416e6a40c48e5ac36d9b6b7204a0.pdf [https://perma.cc/K748-9QGS] (describing M&A as a multi-round process); Choi & Triantis, supra note 27, at 3–4 ("For complex merger or finance transactions, for instance, it is practically impossible for the parties to execute a fully binding contract in a single meeting or over a very short period of time.").

[162] Schwartz & Scott, supra note 30, at 677 (arguing that contract law should encourage relationship-specific investments in preliminary agreements in certain instances, and describing the sequential or simultaneous nature of early-stage investments); Choi & Triantis, supra note 27, at 2–3 (discussing the relationship-specific nature of early deal investments).

[163] SV Firm Attorney VII, supra note 137.

[164] Telephone Interview with N.Y. Firm Attorney V (Feb. 13, 2019) [hereinafter N.Y. Firm Attorney V].

Even for parties where reputation on the broader market does not matter, deviation from the way deals are usually done would cause issues within the microcosm of the particular negotiation at hand. One deal lawyer noted that in any negotiation,

> [E]ven if it's not a reputational issue, you're supposed to close in [on agreement]—that's the usual negotiation. If someone in that negotiation seriously deviates without even an agreement at all—non-binding, no letter of intent—it's highly likely that the negotiation collapses. . . . [I]t's not so much honoring the letter of intent, it's really [understanding] how you get to a deal.[165]

This explanation suggested that even if parties did not care about their reputations on the broader market, they cared that, within their particular deal, they were behaving in a normal and expected way.

Repeatedly, deal lawyers compared the dealmaking process to dating, noting that a party's presentation of oneself, especially in early-stage negotiation, was important. One lawyer compared the early non-binding deal process to online dating, noting that individuals asked themselves, "What should I do with these initial presentations of myself? Do you go in shirtless holding a dog? Or do you go in wearing a suit? There are some similar dynamics going on in the courtship of companies."[166] Another said that at the term-sheet phase, "[t]he parties are in the process of mentally getting ready to commit [to a binding contract]. I think of this as dating—I kind of like this person, but I don't want to call this a relationship yet."[167] She noted that, because parties cared about how they presented themselves in the early stages of the deal, "nobody thinks [it's a good idea] to negotiate a term sheet and do a one-eighty."[168] In other words, adherence to early deal terms could contribute to building one's reputation within the deal.

Another lawyer went as far as to note that adherence to the early *non-binding* terms in the term sheet, in particular, was more important even than adhering to binding terms. Entering into a non-binding term sheet, and adhering to it, had the effect of creating a reputation that "[w]hen they say that they will agree to something, [they will] agree with these terms,

[165] SV Firm Attorney VII, supra note 137.
[166] In-House Attorney IV, supra note 116.
[167] SV Firm Attorney VI, supra note 135.
[168] Id.

[even when] it's not binding."[169] In effect, adhering to non-binding term sheets shows the other side that one is such an integrity player that one will even adhere to non-binding terms—thereby building trust that one will be a good business partner for future activities, binding or not.

One lawyer elaborated that good behavior was particularly important in an auction process: "Particularly in an auction process where you're representing a bidder who has multiple bidders. Particularly if you're the buyer, you want to be on your best behavior so that the seller doesn't pull [out of the deal] and go back to other bidders."[170]

Deal lawyers also described a similar dynamic in other complex transactions—and emphasized that reputation within the deal was important in part because complex deals often cannot be fully contracted. In joint venture transactions, for instance, two deal parties are working to establish a long-term shared project. One lawyer described how hard it was to draft a complete contract dealing with every contingency in a deal that might last years or decades. He emphasized that reputation, built in the earlier stages of a multi-stage transaction, could build trust that fills the gaps in the contract: "A classic example [of when trust is needed] is a joint venture agreement, which is trying to paper over a living breathing thing, [and] keeps going on over a long-term relationship. It's really, really difficult to contemplate everything that would happen and contract for every eventuality that would happen."[171]

The same lawyer noted that in M&A, the same inability to draft some contract provisions with specificity also leads parties to rely on trust as a gap-filler. In many contracts, for example, parties promise to act in accordance with vague terms like "best efforts," or to perform unless there is a vaguely-defined "material adverse effect" ("MAE").[172] The lawyer noted that these non-specific terms are good examples of situations where the formal contract is vague, and having that built-up reputation is important to filling the gap created by contractual vagueness: "Who the hell knows what MAE is? There's a trust element."[173] Another lawyer shared the same view, noting that "[n]o document is going to cover every

[169] In-House Attorney IV, supra note 116.

[170] Telephone Interview with Salt Lake City Attorney I (Feb. 13, 2019) [hereinafter SLC Attorney I].

[171] SV Firm Attorney VII, supra note 137.

[172] Choi & Triantis, supra note 28, at 851–53.

[173] SV Firm Attorney VII, supra note 137.

contingency. . . . [Y]ou have to comply with the spirit of the agreement."[174]

In short, when parties choose to consider an M&A deal, they are entering into a small reputational ecosystem, and their reputation within that ecosystem is valuable to them. Even when parties do not care about their reputations on the broader M&A market—whether because they are not repeat players, or for other reasons—they might still care about their reputations within a particular multi-stage M&A deal. Having a good reputation within the deal is important: it allows parties to fill the gaps left by contractual incompleteness or vagueness.

3. Reputations Within Corporate Structures

There is another reason that reputation matters in an M&A deal: the individuals negotiating the deal care about their personal reputations within their own organizations. One lawyer, for example, remarked that it was important to "[t]hink about the people who are negotiating it—the VP of [business development]. He doesn't want to waste his time."[175] This provides a hint of how an individual negotiator's reputation can influence the deal.

Internally, within a company, deals are often first shepherded by someone on the business development team. At some point, that person needs to seek approval to continue negotiations from a manager, an executive, or even the board of directors. The process of shepherding a deal through one's own organization is not costless—as that interviewed attorney notes, the business development person "doesn't want to waste his time."[176] As a result, especially once she has spent social capital to seek internal approval for a term sheet, a business development person might be incentivized to do what needs to be done to usher the deal to completion—whether that is negotiating in good faith during the early negotiation process or making concessions in order to ensure that the parties reach a definitive acquisition agreement.

One lawyer, for instance, remarked that signing a letter of intent allowed a business development person to "leverage some resources at the business-unit level" and to interact with the board of directors.[177]

[174] SLC Attorney I, supra note 170.
[175] SV Firm Attorney VI, supra note 135.
[176] Id.
[177] Telephone Interview with In-House Attorney V (Feb. 14, 2019).

Signing a letter of intent also triggered "endless reporting on a monthly or quarterly basis at various bureaucratic levels" and required "constant[] socializing and garnering support."[178] Because a business development person spends so much time reporting on one deal and expends so much in-house social capital to shepherd the deal through to completion, she is likely, throughout the deal's negotiation process, to treat deal counterparties well in order to maximize the possibility of the deal's success.

Another lawyer noted that it was important for business development people within large companies to maintain their reputations within that company, which perhaps also motivated them to negotiate more gently or reasonably:

> Think about it this way: maybe I'm senior enough to be running my own deals within [client name redacted]'s business development, but I'm not high enough in the pyramid at [client]. Aside from getting the deal done, you don't want the counterpart from the other side to be talking to their boss [who talks to your boss].[179]

4. Bundling Non-Binding and Binding Provisions

The bundling of binding terms with non-binding terms plays a role in parties adhering to the non-binding terms. While parties appear to want the flexibility of entering into *non*-binding terms, bundling them with binding terms can add some weight to the non-binding terms. One lawyer, when asked about why the binding terms and non-binding terms are presented together in one document, remarked that "[y]ou still want the non-binding ones to have some weight when you're negotiating going forward. . . . Exclusivity [which is binding] with an attached term sheet is 'more legal.'"[180] Another noted that "[w]e did the binding part because we [wanted] the non-binding [part to be] more meaningful."[181] These remarks suggest that, while parties understand that a non-binding term sheet creates no legal obligation, bundling it with a binding provision makes it "more" legal or serious.

Another lawyer noted that he always wove binding and non-binding terms into one document: "[W]e serve them up together, for sure . . . for

[178] Id.
[179] N.Y. Firm Attorney V, supra note 164.
[180] N.Y. Firm Attorney II, supra note 132.
[181] In-House Attorney IV, supra note 116.

convenience, or even just to make it more clear that we really mean what we're saying here. . . ."[182] Still another noted that binding and non-binding terms are presented together because "[t]o sort of separate them, [the question would] be 'what is the context of this exclusivity?' . . . [The term sheet is] devoid of context if you take those non-binding provisions out."[183]

Other lawyers described the fact that parties might adhere to non-binding terms because they wanted the other side to adhere to the related binding terms. One lawyer, for instance, said, "If they came back and said we aren't doing [something in the non-binding portion], we would say we're not held to confidentiality."[184] Another noted that one relatively unusual, but available, way to deter counterparties from walking away from binding terms was "you can tie it [the non-binding terms] to something binding, and if you terminate, something blows up. But that's rare."[185]

In other words, bundling of binding and non-binding agreements appears to be intentional—deal lawyers structured term sheets in these bundles either to attach a sense of additional legality or to substantively tie the non-binding obligations to the binding ones.

5. Deviations with Reason

Interviews with deal lawyers revealed one additional interesting nuance about term sheet practice: that term sheet changes are often made only with "good reason." While this tidbit is not related to *why* parties use non-binding agreements, it does provide information about *how* parties use them.

In general, parties deviate little from the non-binding terms: one lawyer estimates, for instance, that "seventy percent [of the time], a lot of major terms do stick, unless there's a major development."[186]

When deviations do occur, however, deal lawyers uniformly relayed the need to justify deviations. One remarked that if a client wanted to make a change, she might advise her client to think about whether there "is something we can now consider [giving the other side] to make this more palatable? There has to be a reason why, and if there's a logical and

[182] In-House Attorney I, supra note 127.
[183] N.Y. Firm Attorney I, supra note 114.
[184] In-House Attorney IV, supra note 116.
[185] SV Firm Attorney VII, supra note 137.
[186] SV Firm Attorney VI, supra note 135.

non-sensitive reason, we want to explain it to the other side."[187] Another said "when someone wanted to come off the [non-binding] terms, it was almost expected that you'd get something in return. . . . Whenever there was a change that was gonna happen, I spent a lot of time developing the rationale or story that we were going to impose on them."[188] The idea that changes had to be accompanied by a reason was widely shared by interview participants. One lawyer called term sheets "pretty fixed, for the most part. And if you're going to deviate from it, it's for good reason."[189] Another noted that "anything [you wanted to] renegotiate from the term sheet, you always try to come up with some good reason."[190]

This practice of making changes to the term sheet only with good reason seems to be tied to, at least in part, lawyers' (and other individuals') interests in protecting their personal reputations. One lawyer said:

> I have a reputation on the M&A market. I'm a repeat player. But if I show up to one deal, there's a certain expectation of how I'm going to behave. If I start pounding the table and cussing them out, people would say "[SV Attorney VII] is having a really bad day; that's not like him."[191]

Another lawyer noted that it was important to "[t]hink about the people who are negotiating [the term sheet]—the VP of biz dev [business development]. He doesn't want to waste his time. . . . While there's 'legal binding,' there's [also] 'human binding.'"[192]

III. IMPLICATIONS FOR CONTRACT DESIGN AND ENFORCEMENT

This Part considers the implications of faux contracting for theory and practice. Section III.A considers faux contracting from the perspective of contract designers. This Article has focused, in particular, on sophisticated, well-advised business parties—and it continues that examination in this Part. It suggests that even without formal enforcement, and even for parties who are not repeat players on the M&A market, reputational sanctions within the microcosm of a multi-stage

[187] Id.
[188] In-House Attorney IV, supra note 116.
[189] Telephone Interview with Silicon Valley Firm Attorney V (June 20, 2016).
[190] In-House Attorney I, supra note 127.
[191] SV Firm Attorney VII, supra note 137.
[192] SV Firm Attorney VI, supra note 135.

M&A deal seem to do a good job of helping term sheets add value to deals. Another way to think about the benefit of faux contracting is that it allows parties to reap the benefits of negotiating and entering into an agreement, without incurring the costs of potential future enforcement.

Section III.B considers next steps, from legal, regulatory, and societal perspectives. It discusses shortcomings of allowing parties to bargain outside of the law, and it suggests ways to mitigate those shortcomings.

A. Faux Contracting for Contract Designers and Contracting Parties

From the perspective of contract designers, faux contracting offers a different, and perhaps more attractive, alternative to more common forms of contracting.

There are two reasons for this. First, to return to Judge Posner's insight on the cost of contracting, the cost of entering into a contract is the sum of the drafting costs, the enforcement costs, and the judicial error costs.[193] Although Judge Posner's formula contemplates formal contracting and enforcement, it is easy to see how that formula also applies to contracting practices that are less formal, since informal enforcement also involves enforcement and error costs.

Through faux contracting, M&A parties essentially contract around a large part of the contracting cost by electing out of most enforcement and error costs. Already, there is much evidence to suggest that parties do not always prefer the types of default enforcement that attach to formal contracts—many parties, for instance, choose to resolve their contract disputes through arbitration or binding mediation, rather than through courts. The high rate of settlements, especially in disputes involving sophisticated commercial parties,[194] also lends credence to this theory. When cases end up in court, they often settle: this suggests that, even once they have begun formal legal proceedings, parties often elect not to complete their dispute resolutions in court. Rather, through settlements, they negotiate a private resolution. These private resolutions support Oliver Hart and John Moore's theory that contracts are merely a point for renegotiation.[195] Parties that settle their disputes are, essentially,

[193] See supra note 54 and accompanying text.

[194] See Daniel A. Fulco, Note, Delaware's Response to Inefficient, Costly Court Systems and a Comparison to Federal Reform, 20 Del. J. Corp. L. 937, 959–60 (1995).

[195] Hart & Moore, supra note 24.

renegotiating their bargains while, at the same time, pursuing formal dispute resolution by a third party.

Through a non-binding term sheet, M&A parties simply take their preferences one step further: they choose not only to elect out of formal enforcement in courts, but also out of enforcement through arbitration and mediation. Moreover, since M&A parties report at most mild informal sanctions for breaching a term sheet, entering into a term sheet allows them not to be subjected to most informal sanctions, either. At the same time, M&A parties report being able to harness the benefits of negotiating and contracting in a relatively formal way—which means they get the benefits of contracting, while opting out of the costs of enforcement.

Here, it is worth noting that this Article does not assume that enforcement is valueless. Of course, enforcement has both costs *and* benefits; as others have noted, it allows parties to make convincing promises to each other, which is very valuable.[196] It also allows parties to make costly signals to each other, in that parties know they can face consequences if they make promises they do not keep.[197] What this Article *does* recognize, however, is the perhaps obvious point that enforcement is not for everyone. It is already fairly clear that formal enforcement is not for everyone—with a term sheet, it appears that M&A parties are embracing a contractual form that opts out of formal enforcement, and also opts out of most informal enforcement.

Another reason that faux contracting works for business parties in the M&A context is that there are quirks of M&A dealmaking that make the term sheet's blend of formal contracting and mild or non-existent informal enforcement work well.

For example, deal lawyers noted that the way M&A deals are structured—as multi-stage transactions—means that starting an M&A process starts to build a micro-community in which one's reputation matters. Thus, even if parties have no intentions of ever entering the M&A market again, and therefore do not care about their reputations on the broader M&A market, they may still care about their reputations within their new micro-community.

There is an oddity about caring for one's reputation within a particular micro-community, however. In particular, that micro-community only lasts as long as the deal lasts. Do deal parties, in the last stage of a multi-

[196] See Schwartz & Scott, supra note 45, at 562.

[197] See, e.g., Navin Kartik et al., Credulity, Lies, and Costly Talk, 134 J. Econ. Theory 93, 94–95 (2007).

stage M&A deal, behave opportunistically because they know that the micro-community will soon cease to exist? And does a deal party that is thinking about terminating a relationship care that it will sully its reputation within a micro-community that will soon cease to exist?

The answer to the first question is no: the micro-community built in the beginning stages of an M&A deal does not come to an end when the deal closes—rather, it becomes permanent. Throughout the interviews, deal lawyers repeatedly analogized the early M&A process to dating or engagements—and an easy analogy can also be made between a finalized M&A deal and a marriage. Post-M&A, the parties become inextricably linked: M&A lawyers often describe the impossibility of separating the two combined companies as similar to the difficulty of "unscrambl[ing] the eggs."[198] In other words, a potential business partner's reputation gained during the M&A negotiation and contracting process—whether that reputation is good or bad—carries into the permanent relationship.

The answer to the second question—does the risk of sullying one's reputation within a soon-to-be-terminated micro-community deter a deal party's bad behavior?—is more complicated. On one hand, if a deal party has decided to terminate the relationship already, it should not care about its reputation within the micro-community. On the other hand, some features of the deal parties themselves might also play a small role in deterring opportunistic behavior even when a deal might soon be terminated. In particular, deal parties are not monolithic. An individual—perhaps a vice president of business development—is often involved in the early-stage dealmaking process. When the cost of the deal becomes too expensive for a single mid-level business development person to approve, she must seek approval from her manager, or perhaps even the board of directors. The bureaucratic nature of many M&A parties, in this case, has the effect of making the process of entering into a term sheet expensive—not just in terms of dollars and cents, but also in terms of the amount of social capital an individual business development person needs to spend, within her own organization, in order to propel the deal forward.

In other words, even in large commercial transactions, an individual (or small team of individuals) is actually engaged in the negotiation process. In addition to making decisions on behalf of the company, the individual also makes decisions based on personal preferences. Those preferences might include, for instance, the desire not to behave badly and

[198] SV Firm Attorney VII, supra note 137.

not to be thought of, personally, as a person of poor business reputation. These personal preferences can influence how individuals behave on behalf of the company—perhaps providing a check on the company's bad behavior even if a deal is about to be terminated.

It bears noting that this is, essentially, a classic agency story. The individual negotiator's preference for certain things—in this case, being thought of, personally, as a person who has a good reputation—can cause her to make decisions in a certain way. If those decisions ultimately propel her to make decisions on behalf of her principal that are good—economically valuable or otherwise valuable to the company—that agency story may not be a bad thing. However, if the individual's decision-making causes her to make choices that are bad for her principal, it may be more important in early M&A dealmaking, as in other contexts, to consider how better to align the principal's and the agent's interests.

There is some evidence to suggest that other agents do influence the early M&A process. Consider, for example, the fact that deal lawyers talk about how their reputation impacts the advice they give to clients: specifically, they advise clients to come up with good reasons for deviating from term sheets. Deal lawyers note that this is in part because of norms within dealmaking—and, in the same breath, the same deal lawyers will also discuss the importance of their reputation on the M&A market. It is not a stretch to imagine that a mid-level business development manager working at one of the parties to the deal might, similarly, bring her personal preference to preserve her reputation into the decision-making process, for better or for worse.

A few final thoughts about faux contracting's blend of formal contracting with low enforcement: in some cases, parties are unable to use a fully formal *or* a fully informal contract, and term sheets provide a nice alternative. For instance, as described more fully in previous work, M&A parties often need to begin work that runs simultaneous to continuing deal negotiations, such as seeking regulatory approval or deal financing.[199] Documents required for regulatory approval or deal financing require some evidence that M&A parties are engaging in something serious; third parties may need something more concrete than a purely informal agreement. Even seeking internal approval from a board of directors might require the formality of a term sheet. At the same time, parties are loath to enter into a document that veers too close to formality, because

[199] See Hwang, supra note 9, at 385–86.

the deal still has many open items to discuss. In these cases, a formal-looking but non-binding and unenforceable faux contract is a good alternative.

Perhaps a good question to ask at this point is: When and how *should* parties use faux contracts? It is easy to be comfortable with sophisticated, well-advised business parties who choose to enter into these kinds of contracts on their own, with all of the material facts at hand. One can easily imagine, however, other situations in which unenforceable or unconscionable terms are memorialized in a formal way, causing some parties to the deal to believe that they have entered into a formal contract, and to behave as such. Outside of the business context, interpersonal contexts have many good examples of where unequal bargaining power, or unequal levels of sophistication about law and contracting, might steer parties to use faux contracts in an exploitative way.

B. Toward Better Contracting

By its nature, it would be challenging—if not impossible—to police faux contracting. This kind of contracting often exists in the shadows, because lack of formal enforcement makes it hard to review caselaw and see evidence of its existence. As discussed in the previous Section, especially amongst sophisticated business parties, policing this kind of contracting might also not be necessary or optimal—institutional quirks within deal parties, the self-interest of individuals who are involved in the process, and other factors may do enough to steer parties toward welfare-enhancing good faith dealings in non-binding agreements. This Section, then, does not argue for more oversight of these types of contracts—rather, it discusses a few areas of concern, and suggests that further research would be useful.

1. Norms-Based Contract Formation

First, just as norms can play a role in contract enforcement, they can also play a role in contract formation. In particular, it may be useful for industry organizations—associations of lawyers, private equity players, or acquisitive strategic players—to more widely disseminate information about the norms of entering into term sheets. This idea builds on the work

of other scholars, who have already shown, convincingly, that norms can substitute for formal rules.[200]

Outside of the M&A context, where parties use formal-looking but unenforceable agreements perhaps in situations of unequal bargaining power, enforcing "good" norms might be particularly useful. For example, in California, statutes, regulations, and caselaw seem to have done little to stop non-competition employment agreements, which are still common.[201] Suppose, however, that community norms could step in to do the work that statutes and regulations cannot. A push against non-competition agreements might be driven by employees—for example, potential employees could refuse to work for companies that used these agreements, or perhaps a university's career services department could disallow on-campus interviewing by employers who use these agreements. The push could also be employer-driven: Google, for instance, might publicize the fact that a competitor required its employees to sign non-competition agreements, and it could use that fact to convince potential employees to choose to work at Google over its competitors. This type of norms-based policing is particularly promising in an increasingly interconnected world, where information can be easily spread, even if individuals are not physically close to each other.[202]

2. Curbing Faux Contracting's Tendency to Reward Risk-Takers

A related observation is that faux contracting tends to favor parties with a greater appetite for legal risk—and those companies tend to be established players in a market. Consider, for instance, regulatory entrepreneurs—corporations, like Lyft and Airbnb, that make their money by operating in a legal gray area.[203] A corporation's relationship with the government can be understood as an implicitly contractual one: the

[200] Gilson et al., supra note 15, at 1398–99.

[201] See, e.g., Brett Bunnell, Are Non Compete Agreements Enforceable in California?, San Jose Bus. Law. Blog (Mar. 30, 2018), https://www.sanjosebusinesslawyersblog.com/are-non-compete-agreements-enforceable-in-california/ [https://perma.cc/X84E-QLS3]; Ries, supra note 4.

[202] Lior Jacob Strahilevitz, Reputation Nation: Law in an Era of Ubiquitous Personal Information, 102 Nw. U. L. Rev. 1667, 1669–70 (2008) (discussing the dissemination of personal reputational information in an era where such information can be easily spread).

[203] Elizabeth Pollman & Jordan M. Barry, Regulatory Entrepreneurship, 90 S. Cal. L. Rev. 383, 393 (2017) (discussing companies, which they call "regulatory entrepreneurs," that pursue business lines that carry high amounts of legal risk and rely on changing the law to make their lines of business legal).

government allows incorporation and limited liability, and, in exchange, the corporation pays taxes and plays by the rules. When corporations misbehave, the government takes action to enforce its rules through sanctions, fines, and other penalties.

Regulatory entrepreneurs, however, have turned their implicit contracts with the government into faux contracts. Specifically, these corporations enter into the usual implicit contract with the government—they enjoy the protection of limited liability, they pay taxes, and they often play by the rules. At times, however, these corporations flaunt the rules in a big way, and face no consequences for doing so. Lyft, for instance, has ignored transit regulators—but has been able to succeed and flourish nonetheless.[204]

In many cases, the parties that can flourish as regulatory entrepreneurs are also bigger, more established corporate parties. Certain entrepreneurs can afford to take the legal risk of turning an implicit contract with the government into a faux contract. Backed by venture capitalists, and guided by venture capitalists' sophisticated counsel, some companies are better able to take on legal risk. Smaller, less sophisticated entrants to the market will find it harder to enter into these faux contracts with the government. The challenges faced by smaller entrants might explain, in part, why there have been so many entrants to the ride-sharing market,[205] but in city after city, it appears that Uber and Lyft dominate.[206] Over time, these kinds of systems can lead to industry consolidations that hurt the market.

[204] Id. at 399–400 (noting that in a court filing, the New York State Office of the Attorney General described Lyft as having "simply waltzed into New York and set up shop while defying every law passed whose very purpose is to protect the People of the State of New York").

[205] See Ryan Young, Austin Ridesharing Companies Did Not Succeed Where Uber and Lyft Fail, Daily Texan (June 4, 2017), http://www.dailytexanonline.com/2017/06/04/austin-ridesharing-companies-did-not-succeed-where-uber-and-lyft-fail [https://perma.cc/ZE2E-QZNH] (discussing the reentry of Uber and Lyft into the Austin, Texas, market after a yearlong absence during which several ride-share services, including Fare, Fasten, and Ride Austin, attempted to fill the local demand).

[206] Madeline Farber, Uber and Lyft Dominating Business Travel, Fortune (July 21, 2016), http://fortune.com/2016/07/21/uber-and-lyft-q2-2016/ [https://perma.cc/ZV9Q-3RST] (citing a study that showed that "Uber and Lyft took 49% of the ground transportation market in [the second quarter of 2016]").

CONCLUSION

Parties in a wide variety of contexts enter into non-binding contracts. In M&A, however, a particular permutation exists: the "faux contract," which looks like a formal contract, but intentionally removes formal *and* (most) informal enforcement. Through interviews with deal lawyers, this Article provides an account of when and why these types of agreements flourish. Among other things, they allow parties to use contract-like devices to mitigate mundane transaction costs without subjecting themselves to the expense and process of enforcement. Moreover, because M&A deals are multi-step in nature, good behavior in early stages of the deal allows parties to increase their reputation in later stages, which curbs bad behavior, even from parties that are relatively inactive in the M&A market.

APPENDIX A: INTERVIEWS AND METHODOLOGY

The findings throughout this paper were informed by interviews. Interview participants are transactional attorneys who have extensive experience in M&A practice. Some participants also have experience in other corporate transactions or working in-house.

For brevity and anonymity, each attorney is identified within the text of the Article by a reference term, which is noted below. Data from some of these interviews are used in a previous article, *Deal Momentum*.[207] For ease, the same reference terms are used in both articles—so, for example, N.Y. Firm Attorney I in *Deal Momentum* and in this Article is the same person.

To identify interview participants, I used a snowball sampling technique, in which I asked interview participants to introduce me to additional potential participants. A shortcoming of this method is that it is hard to obtain an unbiased sample. However, this technique helped me gain access to busy deal lawyers—the kind of lawyers who have a high enough deal volume to be able to speak knowledgeably about transactional practice—who might otherwise be disinclined to participate in this kind of research without a personal connection.

Another shortcoming of interview data is that an interview participant's memory about past deals might be faulty. It is also hard to see whether interview participants' answers are informed by their desire to maintain their reputations as good deal lawyers. To help mitigate some of these issues, I assured deal lawyers that their responses will be anonymized. This protects their reputations and perhaps allows them to speak more freely. In addition, I often asked lawyers if they had encountered a deal where X happened, or if they could recall something like X happening in a friend or colleague's deal. In phrasing the question this way, my goal was to nudge deal lawyers toward speaking more freely about actions that are against industry norm (or that could be considered bad-faith behavior). For example, I expected that they would feel freer to admit that they knew people who negotiated in bad faith, than to admit that they themselves negotiated in bad faith.

[207] Hwang, supra note 9.

Date	***Participant Description***	***Reference Term***
New York Attorney Interviews		
May 7, 2016	Recently retired from top legal position at investment bank; previously M&A partner in New York; 25+ years of experience	N.Y. Firm Attorney I
May 17, 2016	Senior M&A associate with experience in New York and Chicago; 12+ years of experience	N.Y. Firm Attorney II
May 26, 2016	Senior M&A associate in New York; 15+ years of experience	N.Y. Firm Attorney III
May 26, 2016	Senior M&A associate in New York; 7+ years of experience	N.Y. Firm Attorney IV
February 13, 2019	M&A partner in New York; 11+ years of experience	N.Y. Firm Attorney V
Silicon Valley Attorney Interviews		
May 31, 2016	M&A partner in Silicon Valley; 20+ years of experience	SV Firm Attorney I
June 2, 2016	M&A partner in Silicon Valley; 25+ years of experience	SV Firm Attorney II
June 15, 2016	M&A partner in Silicon Valley; 25+ years of experience	SV Firm Attorney III
June 13, 2016	M&A partner in Silicon Valley; 25+ years of experience	SV Firm Attorney IV
June 20, 2016	M&A partner in Silicon Valley; 25+ years of experience	SV Firm Attorney V
February 7, 2016	M&A associate with experience in New York and Silicon Valley; 6+ years of experience	SV Firm Attorney VI
February 8, 2019	M&A partner in Silicon Valley; 30+ years of experience	SV Firm Attorney VII
In-House Attorney Interviews		
May 23, 2016	In-house counsel at Silicon Valley company; previously	In-House Attorney I

	M&A attorney practicing in Silicon Valley and Virginia; 10+ years of experience	
May 25, 2016	In-house counsel at Texas company; previously senior corporate associate practicing in Texas (firms and in-house); 20+ years of experience	In-House Attorney II
June 20, 2016	In-house counsel at Silicon Valley company; previously senior M&A associate at Silicon Valley firm; 10+ years of experience	In-House Attorney III
February 7, 2019	Former firm attorney at national firm's Dallas office for 16 years; former in-house attorney at private company for 6 years	In-House Attorney IV
February 14, 2019	Former in-house attorney for 12+ years at Russell 3000 company; currently practicing corporate/transactional law at a law firm in Nevada	In-House Attorney V
Additional Attorney Interviews		
February 13, 2019	Corporate partner with extensive M&A experience in Salt Lake City; 9+ years of experience	SLC Attorney I