Dividing the Surplus upon Termination: The Case of Relational Contracts

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INTRODUCTION

Relational contracts\(^1\) typically create value that survives the end of the contractual relationship. Married couples accumulate matrimonial property that remains valuable long after they cease to value each other. Employees perform tasks that still benefit their employers long after they move to another workplace. Agents and distributors develop the markets for the products they distribute, thus creating goodwill that will outlast their commercial relationships with the manufacturers. In all such cases, a similar question arises: how to distribute the value that survives after the contractual relationships are dissolved.

This paper aims to offer descriptive and normative insights into this allocative dilemma. Descriptively, it argues that the way such allocation problems are dealt with in the common law world was considerably transformed during the 20\(^{th}\) century. Under classical contract law,\(^2\) the value that survived after the termination of any contract (including relational contracts) was allocated according to the property rights of the parties upon termination, unless the parties agreed otherwise. In other words, the default rule, which the parties could modify at will, was that each party received his or her property at the end of the contractual relationship, without having to compensate the other party for any value that was added during the contractual period. Today, in contrast, the allocation rules in common law jurisdictions for many long-term relational contracts are different. They are frequently based on either a just division of the surplus between the former contracting partners (e.g. in the case of marriage) or on monetary restitution of the fair value of the surplus (e.g. in the case of agency) or on compensations that are not based on the value of the surplus, but on some secured payments that are promised in advance (e.g. in the case of employment contracts). Furthermore, the ability of the parties to deviate from the "default rule" has been considerably limited, and in some cases even forestalled (e.g. agency agreement in England or employment contracts in Israel), at least if the private arrangement provides less than some minimal legal benchmark.

\(^1\) Throughout this paper, I will assume that the term "relational contract" refers to long-term contracts that aim to ensure cooperation between the parties, and not merely an exchange of goods and risks between them. Compare Melvin Eisenberg, *Relational Contracts* in *GOOD FAITH AND FAULT IN CONTRACT LAW* (Jack Beatson & Daniel Friedmann eds., 1994) 291, 291-296.

\(^2\) The term "classical contract law" refers to a conception of the law of contract that evolved in the common law during the 18\(^{th}\) and 19\(^{th}\) century, and was based on the power of the individual will to bind itself. Two fascinating accounts of the formation classical contract law are Patrick Atiyah, *THE RISE AND FALL OF CONTRACTUAL FREEDOM* (1979) and Roy Krietner, *CALCULATING PROMISES* (2007).
My normative claims provide economic arguments that support the above transformation from the traditional property-based default rule to modern fairness-based quasi-mandatory rules. It offers first a justification for switching the default from property to fairness, by employing an extension of Ayers & Gertner’s concept of penalty-default rules. Typically, the party who is expected to benefit from a property-based default rule is the more informed and sophisticated contractor (i.e., husband, manufacture, employer, etc.). It is thus justified, according to the penalty-default theory, not to base the division of the surplus that would survive after the contract is terminated (an issue that parties to relational contracts tend to avoid) on the method that the strong party would prefer, but on a scheme that would make him negotiate an inefficient default. Given this justification for the fairness-based default rule, the paper goes on to argue that partly limiting the possibility to contract-around the default rule is not necessarily inefficient. As long as the parties are able to choose between different contractual regimes, which allocate the risk for the value of the surplus according to their preference, they will be able to adapt the distribution to reflect the efficient mix of incentives and risk bearing. The fact that their choice is limited, in the sense that the contract must provide for a minimum level of protection to the weak party, is thus not a reason to assume that the parties will not be able to efficiently regulate their contractual relationship.

I. THE TRANSFORMATION FROM PROPERTY-BASED DEFAULT RULES TO FAIRNESS-BASED MANDATORY RULES

Long-term relational contracts often serve as a vehicle to achieve cooperation for the duration of the contractual relationship. Marriage is probably the most prominent example of such relational contracts, but other types of long-term contracts, such as commercial agencies and employment contracts, demonstrate the same general pattern. The Parties enter long-term relational contracts (or at least, are expected to do so) for the benefits that they can gain from cooperation while it lasts, not for the profits that they can extract upon their termination. Again marriage is a prominent example – we expect people to get married in order to enjoy their life together (irrespective of whether love has anything to do with it),

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and thus treat with shame "gold-diggers," who enter into the relationship in order to make a profit upon its dissolution.\(^4\)

Nonetheless, relational contracts, like any contractual form, are not perpetual. All relational contracts, even those entered into with the purest of hearts, must come to an end. When they do, there is often the question of how to divide the value that survives. Matrimonial property that was accumulated during the marriage, needs to be divided between the couple (or their heirs) upon divorce or when death does its part. Goodwill and knowledge attained during the successful operation of a commercial agency must be assigned after the agreement is terminated, by either the agent or the manufacturer. The contributions of a productive employee to the operation of her workplace must be reallocated when she decides to quit or has been laid off. Put more generally, the termination of a long-term relational contract frequently leaves value that survives the end of the contractual relationship (henceforth; "the surviving value"). It thus raises the legal question of how to allocate the surviving value between the parties.

The classical concepts of contract law provided a very simple solution to the post-contractual allocation dilemma: it was decided either by the agreement, or, if the agreement is silent, according to the law of property. In other words, classical contract law adopts a property-based default rule for allocating the surviving value. Such a rule view contracts as a temporary suspension of the proprietary regime. Both before and after the contract, the parties’ legal relationships are governed by the law of property. It is only for the duration of the contract that the parties are assumed to adopt a different legal regime – one that is regulated by the terms of the agreement. Naturally, the parties are free to agree upon the structure of the post-contractual property regime, and they are also allowed to circumvent the rules of property for the post-contractual era, but as long as they are silent about the matter, they are assumed to accept the allocation that is achieved by applying the law of property.

While the property-based default rule remains the governing allocation rule for most contracts, it seems to be losing its grip with respect to long-term contracts in general,\(^5\) and relational contracts, in particular. Typically,

\(^4\) The contempt/fear of "gold-diggers" is well reflected in popular culture. "Gold diggers" were a very popular subject in the comic literature of the early 20th century (see, e.g., PG Wodehouse, \textit{A Damsel in Distress} (1919) and Anita Loos, \textit{Men Prefer Blondes} (1925)). Recently it reappeared in popular culture through Kanye West's excellent 2005 song by the same name.

\(^5\) An example of long-term contracts that are typically not categorized as relational contracts, but went through at least part of this transformation are leases. According to classical contract law, a landowner was not required to pay for the tenant's fixtures after the lease was surrendered. The reason for this was that, as a matter of property law, tenant's fixtures were part of the freehold, and thus belonged to the landowner after the
although not always, the process has two stages: In the first stage, the content of the default rule was transformed in a way that equitably divides the surviving value between the parties, regardless of their post-contractual property rights; in the second stage, the default status of the allocation rule was restricted, and it was turned into a mandatory (or quasi-mandatory) allocation rule. The upshot of these developments was the creation of mandatory (or quasi-mandatory) division rules that guarantee an ex-post equitable division of the surviving value, regardless of the post-contractual proprietary regime.

It is important to note that the transformation from the traditional property-based default rule to modern fairness-based quasi-mandatory rules was not achieved through some general evolution of a new principle that applied to all relational contracts, but through specific and seemingly sporadic changes in the rules that regulate specific kinds of relational contracts. Furthermore, in many cases, these modifications were affected through legislation, and not by the courts. The following sub-sections demonstrate both the transformation and its segmented nature through two distinct forms of relational contracts: marriage and commercial agency.

A. Marriage

Until the 19th century, Anglo-American law adored the concept of "couverte," according to which during the marriage, the wife's legal personality merged into her husband's legal personality. As Blackstone famously stated, "the husband and wife are one, and that one is the husband." This legal concept did allow women to regain legal control over their own property upon divorce, but since any property acquired during the marriage was owned by the husband, the rule applied only to property that belonged to the wife before entering the marriage. In fact, a wife was only entitled to part of the property that was acquired during the marriage upon the husband's death (i.e. the Right of Dower), and this

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6 The full citation reads as follow: "By marriage, the husband and wife are one person in law: that is, the very being or legal existence of the woman is suspended during the marriage, or at least is incorporated and consolidated into that of the husband; under whose wing, protection, and cover, she performs every thing; and is therefore called in our law-french a feme-covert" BLACKSTONE'S COMMENTARIES ON THE LAWS OF ENGLAND, Book I, Chapter 15, at p. 430.

7 The right of dower allowed the widow to claim 1/3 of the land accumulated during the marriage upon waiving her share in the inheritance of her husband. See R.S. Donnison Roper, A TREATISE OF THE LAW OF PROPERTY ARISING FROM THE RELATION BETWEEN HUSBAND AND WIFE (2nd ed., 1826) 332.
only if she was married to him at the time of death, or if the dissolution of the marriage was not her own fault.\footnote{For the effect of divorce on the Right of Dower, see Collins Denny Jr., \textit{Effect of Divorce upon the Inchoate Right of Dower}, 9 VA. L. REV. 58 (1922).}

The abolition of the "coverture" system by legislation ("Married Woman's Property Act"), first in the United States and later in England,\footnote{See Richard Chused, \textit{Married Woman's Property law: 1800-1850}, 71 GEO. L. J. 1359 (1983).} did not do much to improve the state of women’s claims to the matrimonial property.\footnote{In fact, in some states in the USA, the abolition of the "coverture" system was accompanied by an abolition of the dower right.} Indeed, it was now possible for married women to accumulate property during their marriage, but since most of the matrimonial property (especially land) was recurrently registered solely in the name of the husband, the wife still had no rights to it upon divorce.\footnote{See Isabel Marcus, \textit{Locked In and Locked Out: Reflections on the History of Divorce Law Reform in New York State}, 37 BUFF. L. REV. 375, 406-409 (1983) (pointing to the fact that even after the enactment of The Married Woman's Property Act, "strict title governed the ownership of property brought to or acquired during a marriage, as well as distributed at divorce" (at p. 407)).}

The first step toward a more equal division of matrimonial property upon divorce came only during the 20\textsuperscript{th} century, with the confused case-law that evolved with respect to beneficial ownership in matrimonial property. Courts in many common-law jurisdictions found it unacceptable that the division of property upon divorce must be decided strictly according to legal title. They thus developed a very complex and incoherent body of law regarding beneficial ownership, which allowed for a just division of family assets based on conceptions of equity and inferred intents.\footnote{See Marcus, \textit{ibid}, at pp. 434-458; Scott Greene, \textit{Comparison of the Property Aspects of the Community Property and Common-Law Marital Property Systems and Their Relative Compatibility with the Current View of the Marriage Relationship and the Rights of Women}, 13 CREI. L. REV. 71 (1979).} It is interesting to note that such endeavors assume as given the property-based allocation rule, and attempt to circumvent its unjust result by redefining the law of property. Put differently, courts found it easier to reallocate property rights during the marriage, than to replace the traditional property-based allocation rule that regulated the division of property upon its dissolution. That is certainly a very clear indication of the stronghold that the traditional rule has on the minds of jurists in the Anglo-American world.

While the effort to offer redress through property was partially successful, it created numerous problems and uncertainties.\footnote{The English precedents on this issue are notoriously vague and hard to reconcile: See, e.g., Pettitt v. Pettitt [1970] AC 777 [H.L.]; Gissing v. Gissing [1971] AC 886 [H.L.].} In any case, since the 1970s, usually through legislation, a new approach has been adopted to
deal with the problem of dividing matrimonial property upon divorce or death. At the heart of this new approach is the recognition that property-based allocation rules are inapt to achieve just distribution of the surplus that was created during the marriage. As the House of Lords put it, the prevailing view in many common-law jurisdictions is that "The question of who owns what takes second place to the statutory criteria" when deciding on the distribution of property if the couple divorce or if one of them dies.  

The recognition (albeit mostly through legislation) that property-based rules should not dictate the way we allocate the matrimonial property after the marriage is dissolved is a clear departure from the traditional approach to allocating the surviving value. It is based on the conviction, now shared by all, "that the outcome on these matters, whether by agreement or court order, should be fair." In essence, it represents the view that dissolving the marriage contract merits reallocation of the surviving value, in a way that may conflict with the manner by which the parties managed their assets while they were married. Married couples do not simply suspend the rules of property vis-à-vis each other for the duration of the contract; marriage creates a shared value, which upon its dissolution, must be reallocated from scratch.

Is this move from property-based allocation to fairness-based allocation strictly a matter of defining the default? In a weak sense it is. In most jurisdictions, couples are allowed, both before and during the marriage, to sign a contract (prenuptial and postnuptial agreements), by which they settle, among other issues, the division of property in case of divorce or death. Hence, if they wish to alter the allocation rule, they have a legal way to do so. However, at best, this possibility changes the option to deviate from the fairness-based rule into a quasi-mandatory rule. Not only may it be extremely difficult to ask one's partner to sign such agreement at the start of the relationship, it is not always enforced by the courts upon divorce or death (especially if the agreement seems unconscionable).

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14 Stack v. Dowden [2007] UKHL 17, Sec. 43 (per Baroness Hale) (a case which dealt with an unmarried couple).
16 Compare Carolyn Frantz & Hanoch Dagan, Properties of Marriage 104 COLUM. L. REV. 75, 96-96 (2004) ("Making specific marital agreements is difficult; romance and hard-headed business bargaining are not easily blended together, which may explain why explicit contracts in the marital context are not very frequent").
17 Courts’ willingness to enforce prenuptial and postnuptial agreements varies among jurisdiction. In England, such agreements used to be "of very limited significance," but in recent years courts have been willing to "take the terms of the agreement into account." See BROMLEY’S FAMILY LAW (10th ed., by N. Lowe & G. Douglas, 2007) 1012-1014. In contrast, courts in the United States usually give more weight to such agreements, but most of them still retain considerable discretion to intervene in case they seem unfair. See Robert Roy, Enforceability of premarital agreements governing support or property
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B. Commercial Agency

Much like marriage, a successful commercial agency requires long-term cooperation between the parties. These mutual efforts, if successful, create market value in the form of goodwill, which the principal and his agent share during the contractual period through the agreed commission structure. The termination of the agency leaves the agent with the personal reputation that she made for herself, but with no legal title to the goodwill of the product. Thus, according to the classical property-based concept of dividing the surviving value, unless the parties agreed otherwise, the agent had no claim to a share in the market that she helped to develop after the termination of the contract. Indeed, until the mid-20th century, the common law position was that "[P]rima facie the liability to pay commission in cases of this kind ceases as to future trade with the cessation of the employment in the absence of a reasonably clear intention to the contrary." 18

The first crack in this stern property-based attitude came through creative contractual interpretations, which recognized the agent's right to commissions or other forms of compensation in the post-contractual period even without any explicit provision. For instance, in the English case of Roberts v Elwells Engineers Ltd, 19 Lord Denning MR found that although the issue of termination "was never discussed between the parties," the agent was "entitled to commission on repeat orders when such orders are for the same lines, i.e. for substantially the same goods as had been bought by the customer during the agency." A comparable result, based on different doctrinal grounds, was achieved by the Israeli Supreme Court in the leading case of Zohar v. Travenol Labs. 20 CJ Barak ruled that the reasonable notice period that should be given before ending an agency should be calculated in a way that would allow the agent to capture her investment in developing the market, and thus should extend to one year (and not only 70 days, as the principal argued). The evident upshot of such decisions is that they change the default rule: the parties are allowed to negotiate a different division of the surplus (e.g. by agreeing that commissions will be paid only on sales that occur before termination or by setting a short notice period); however, if they fail to do so, the agent will be able to capture part of the surviving value through inferred contractual obligations.

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19 [1972] 2 Q.B. 586 (C.A.)
20 CA 442/85, PD 44(3) 661.
The second stage of the process came in England through legislation. Following the European directive, which was heavily influenced by French law, the Commercial Agents (Council Directive) Regulations 1993 provided agents (although not distributors) with a mandatory right to either compensation (which is based on French law, and serves as the default) or indemnity (based on German Law). These monetary rights reflect the view that though the product's goodwill must remain the property of the principal, the agent is entitled to compensation due to her contribution to its development.  

It is interesting to note that English judges find it easier to explain this development through property, rather than to recognize that it in fact rejects the property-based allocation rule for the surviving value. Lord Hoffmann, for example, explains the statutory regime based on the fiction that "[the] agent has thereby acquired a share in the goodwill, an asset which the principal retains after the termination of the agency and for which the agent is therefore entitled to compensation." It seems that a much simpler understanding of the legislation is as a fairness-based division of the surviving value, rather than as a factitious reallocation of property rights – but the lure of the traditional property-based allocation rule seems very powerful to common-law lawyers.

To sum up, a general legal principle that applies the fairness consideration to dividing the surviving value after the termination of relational contracts has not yet been formulated. However, the traditional property-based allocation rule, which was universally employed in the past, and that is still being used, by and large with respect to discrete contracts, has been gradually eradicated in various common law jurisdictions with respect to distinct types of relational contracts. In its place, judges and legislators have introduced a complex set of modern allocation rules, which are based on fairness rather than property. Furthermore, while fairness-based regulation of the post-contractual period at first was only the default, it has tended to become mandatory (or quasi-mandatory) over time.

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22 Lonsdale v. Howard & Hallam td [2007] UKHL 32
II. Normative Evaluation

Assuming that Part I accurately identified the trend of the law, the obvious question is whether we can normatively justify it. An evident challenge to any fairness-based allocation rule is that while it may achieve just distribution ex-post, it can also create serious inefficiencies ex-ante. Equity may come at the cost of efficiency, or, to use the well-known metaphor, the desire to divide the pie more evenly may cause the pie to shrink. Thus, in order to evaluate the transformation from property-based default rules to efficiency-based mandatory rules, we must consider not only the distributive gains, but also the possible efficiency losses.

The division of the surviving value affects the parties' actions (and thus the size of the pie), both in the contractual period and in the post-contractual period.

While the contract is in force, the expected division of the surviving value may influence the incentives of each party to invest in carrying out the contract, and his incentive to terminate the contract (or cause the other party to terminate it). Consider, for example the case of marriage. The willingness of each party to invest in creating matrimonial property may be affected by the rules that regulate its distribution upon divorce (e.g. one partner will be more willing to sacrifice his or her own career if he or she is guaranteed an equal share in the "career asset" of the other partner in case of divorce). In addition, the amount each of them is expected to receive if they separate affects their incentive to end the marriage (a property-based division may encourage the weak party (usually the wife) not to divorce the strong party (typically the husband), even if the marriage no longer works for her; while a fairness-based division may cause her to be much less vulnerable). Generally speaking, it seems that fairness-based rules are better suited than property-based rules to encourage constructive cooperation for the duration of the contract. Ensuring a just distribution ex-post provides each party with incentives to invest in the relationship, knowing that she will be allowed to reap the benefits of her cooperation even in case of contractual failure. Furthermore, such a rule provides some protection against abuse, since

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23 Needless to say, that I do not claim that such transformations are either universal (in the sense that they occurred in each and every common law jurisdiction) or general (in the sense that they relate to all types of relational contracts in a given jurisdiction). I only point to a trend that seems to be shared by various common-law jurisdictions and with respect to different types of relational contracts.


25 Arguably, the division of the surviving value might also influence the decision as to whether or not to enter into the contract. However, with respect to long-term relational contracts, such effects should be minimal because the raison d'être for contracting is (or at least is assumed to be) the benefits that the parties can gain from cooperation while the contract is in force. See also text to note 4 *supra*, and text to note 40 *infra*.
each party can credibly threaten to step out of the contract if the other party tries to take advantage of her ongoing investments in the relationship. 26

Conversely, in the post-contractual era, an efficiency-minded rule-maker will be mainly interested in the way the allocation rules affect the ongoing use of the surviving value. For instance, whether dividing the "career asset" of the working-partner will adversely affect his or her incentive to invest in the workplace after the divorce. From this perspective, it seems that the traditional property-based allocation rule is more efficient than fairness based rules. Assuming that property rights are allocated efficiently, reallocating the control over the assets that represent the surviving value based on distributive considerations may be inefficient, especially if such a division confers excessive veto-powers that may cause disuse of the property. 27

The possible conflict between different efficiency considerations makes it difficult to assess whether, in the general case, it is more efficient to divide the surviving value after the termination of a relational contract by the traditional property-based allocation rule or by modern fairness-based allocation rules. 28 The indeterminacy of the first order efficiency consideration may suggest the following normative assertions:

A. The traditional property-based allocation rule should be preferred as a default rule based mainly on second-order considerations such as generality, certainty and simplicity. Henceforth I will refer to this assertion as "the claim that the default rule should be property-based" or "Assertion A."

B. Since the parties may have private information that could allow them to choose the efficient allocation rule based on the first-order consideration, it is inefficient to prevent them from modifying the allocation rule. Thus, irrespective of the allocation rule set by the law of contracts, it should only serve as a default, and not as a mandatory or quasi-mandatory rule. Henceforth, I will refer to this assertion as "the claim that the allocation rule should be strictly a default" or "Assertion B."

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28 Melvin Eisenberg argued that because of the diversity of relational contracts, "no special legal rules, however, can be formulated for relational contracts as a class. Rather the general principles of contract law can and should be formulated to be responsive to relational as well as discrete contracts" (*Relational Contracts* in GOOD FAITH AND FAULT IN CONTRACT LAW (Jack Beatson & Daniel Friedmann eds., 1994) 291, 304). While I accept the premise of Eisenberg’s argument (relational contracts vary), as will be explained below, I respectfully disagree with his broad conclusion (relational contracts as a group should always be governed by the legal rules that regulate discrete transactions).
In what follows, I will first elaborate, and then refute, assumptions A and B. In doing so, I will present arguments that vindicate the transformation described in Part I from claims of inefficiency. Note, however, that my arguments do not justify the transformation from the traditional property-based default rule to modern fairness-based quasi-mandatory rules on efficiency grounds, but only defend this transition against claims of inefficiency. I believe that distributive considerations are the main motivating forces that cause and support the move. My modest claim is that efficiency-minded jurists need not oppose this two-phase transformation (first from property to fairness and then from default rules to mandatory rules), not that they necessarily need to support it.

III. STRUCTURING THE DEFAULT RULE

Assertion A - the claim that the default rule for relational contracts should be property-based – builds mainly on second-order arguments of the following nature:
1. **Generality** – as explained in Part I, the property-based rule is the traditional and conventional default rule for allocating the post-contractual surplus. If we assume that there is no clear indication that parties to relational contracts should prefer a different rule, then the general default rule should also cover the case of relational contracts.\(^{29}\)
2. **Certainty** – using settled principles of property law to divide the surviving value is much more predictable than the *ex-post* case-by-case analysis that is required by fairness-based allocation rules. Thus, most contracting parties are likely to prefer, at the time of contracting, to regulate their relationship through the certainty and predictability of property-based allocation rules.
3. **Simplicity** – any deviation from the property-based allocation rule will require factual evaluation as to the value of the surplus, and thus will encounter evidential difficulties. Most contracting parties wish to avoid these complications, and would thus prefer a clear-cut separation rule that will not necessitate further dealings between them.\(^{30}\)

These second-order arguments can be supplemented by first-order considerations that refer to the realities of many relational contracts, and utilize them in order to downplay the importance of the discussed rule

\(^{29}\) Compare Ewan McKendrick, *The Regulation of Long-Term Contracts in English Law* in GOOD FAITH AND FAULT IN CONTRACT LAW (Jack Beatson & Daniel Friedmann eds., 1994) 305 (arguing that adjustments to the general principles of contract law should be inserted by the contracting parties, and not by court recognition of a formal category of relational contracts); Eisenberg, *ibid.*

\(^{30}\) Compare Hanoch Dagan, *The Law and Ethics of Restitution* (2004) 272-277 (arguing that parties will not adopt a rule that transfers the profits from a breach of contract to the injured party due to the high costs of verifying such profits).
during the contractual period, and to highlight its crucial role in the post-contractual period. For instance, one might suggest that since parties to successful on-going relational contracts tend to disregard legal norms, and to conduct their mutual relationship based on social norms that rest on cooperation and trust, the effects of the allocation rule for the surviving value on their actions during the contractual period, at least until they understand that they are approaching the end-game, should be minimal. In contrast, the effects of the rule that allocates the surviving value to the parties’ post-contractual actions are considerable, and should be given much more weight in the evaluation process. For instance, as long as the agent believes in the endurance of her agency, she will have sufficient incentives to invest in developing the market, regardless of the legal rules that regulate the parties' rights upon termination. In contrast, the allocation of surviving value has a considerable effect on the way the principal and the agent behave after terminating the agency (e.g. it may give the agent access to information and share in the profits, and thus could distort the principal’s incentives to efficiently run his business).

The common ground for both first and second order arguments in support of Assertion A is that default rules should be selected based on our evaluation of the ex-ante agreement that would have been achieved between the majority of contracting parties, assuming they had fully negotiated the issue at hand ("the majoritarian default rule"). It is possible to offer counter-arguments against Assertion A based on the majoritarian default rule methodology, but I doubt whether they are sufficient to even the scales. Instead, I suggest that the reason to reject Assumption A is not that the traditional property-based allocation rule is not what the majority of contracting parties would have agreed on, but that this allocation rule usually serves the strong and informed party, and thus has the disadvantage of reducing the probability that the issue of dividing the surviving value will be adequately negotiated between the parties. In other words, adopting some sort of fairness-based allocation rule as a default can be understood as a "penalty default rule." The aim of penalty default rules is not to reconstruct the hypothetical intention of the contracting parties, but to give one party incentives to negotiate certain terms during the pre-contractual stage. It can be argued that fairness-based default

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31 This is the basic insight of the literature concerning relational contracts. The canonical article is Stewart Macaulay, *Non-contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).
34 Ayers’ and Gertner’s analysis of penalty default rules concentrates on information revealing defaults. However, the general framework that they offer can be utilized to
rules perform exactly this role – they oblige the strong and informed party, the one who enjoys the advantage provided by the law of property, to discuss an issue which the parties have a tendency to neglect – their mutual rights and liabilities in case the contract succeeds at first, but fails afterwards.

In order to support the claim that fairness-based default rules for allocating the surviving value from relational contracts should be understood as efficiency-advancing penalty default rules, we need to address two questions: First, why it is desirable to provide the parties with incentives to negotiate the allocation of the surviving value; Second, why fairness-based allocation rules function better than the traditional property-based rule in providing incentives to negotiate inefficient allocation of the surplus.

The answer to the first question is seemingly simple: if we believe that the division of the surviving value is important (either because it affects the incentives of the parties or due to distributive considerations), but that the "right way" to divide the surplus is highly contextual and should be tailored to the specific needs and interests of the parties, then we have good reasons to want the parties to negotiate the matter in advance and not stick to some general default rule that may or may not fit their needs and interests.

However, this explanation is insufficient since it raises the question as to why the parties themselves would not realize the importance of the matter, as they understand the necessity to negotiate other idiosyncratic matters, such as the division of profits for the duration of the contract. There are two possible answers to this puzzle: First, the question of how to divide the surviving value seems, at the contracting stage, a hypothetical issue – a partly positive (the contract will create value), partly negative (despite its economic success it will not endure) occurrence, that is better dealt with under the rubric of "we’ll deal with this when we get to it." Second, in many kinds of relational contracts, raising the issue of how to divide the surviving value after termination is costly, since it may create doubts as to the negotiator’s commitment to the joint project. The reluctance to raise the issue of a prenuptial agreement is an obvious example that was already mentioned, but to a somewhat lesser degree, similar difficulties can appear with respect to many relational contracts (e.g. a potential employee

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35 For the claim that efficiency considerations may justify paternalistic measures in order to deal with cognitive biases, see Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229 (1998).

36 See supra note 16.
who is eager to be hired will not be enthusiastic about raising the issue of his rights upon termination).

Assuming that the parties need to be pressed to negotiate the division of the surviving value, it is quite straightforward that the incentive to negotiate the matter should be provided primarily to the more informed and sophisticated negotiator. The traditional property-based allocation rule has the obvious disadvantage of doing exactly the opposite. The party who enjoys a greater share of property rights in the surviving value *ex-post* is usually also the one who has a better bargaining position *ex-ante*. Reflecting on the examples of relational contracts discussed above demonstrates this point: men, principals and employers, who usually have an advantage in allocation of the surviving value through property, typically have strong bargaining power, while women, agents and employees, who are disadvantaged by allocation through property, are also, by and large, the weaker side around the negotiation table. Given this undesirable correlation, allocation through property is more likely to remove the issue of how to allocate the surviving value from the negotiation table, than to encourage its open discussion in the pre-contractual stage.

Transforming the default rule from property-based to fairness-based provides the strong party with incentives to negotiate the allocation of the surviving value whenever it is inefficient. Silence is no longer beneficial for him, since he attains no distributive gains from an inefficient default rule. Thus, if we assume that either because of cognitive biases or due to negotiation costs, parties may inefficiently fail to negotiate the allocation of the surviving value, we have a convincing economic reason to prefer that the default rule for allocating the surviving value be fairness-based and not property-based. Fairness-based defaults tend to provide the strong and informed party with incentives to bargain over inefficient terms, while the property-based default may give him a strong reason not to do so. In a nutshell, the traditional property-based rule is likely to leave relational contracts silent with respect to the allocation of the surviving value (whether or not the default is efficient); if we wish to change this reality, we need to change the default to one that is fairness-based.

IV. TURNING THE DEFAULT RULE INTO A MANDATORY RULE

The rejection of Assertion A does nothing to refute Assertion B – the claim that the allocation rule should be strictly a default. On the contrary, if indeed structuring the allocation rule as a fairness-based default is defensible on the ground that it encourages the parties to negotiate inefficient allocations of the surviving value, then the straightforward conclusion should be that the parties must be allowed to agree on any reallocation that serves their idiosyncratic preferences. Indeed the second
phase of the transformation described in Part I, the move from a default rule to a mandatory (or quasi-mandatory) rule, is much more difficult to explain on efficiency grounds. I believe, however, that under certain conditions, this move is not necessarily inefficient. Allow me to explain my position.

As explained in Part II, the allocation of the surviving value affects the parties' actions during the contractual stage and during the post-contractual stage. Designing the efficient allocation rule is thus an attempt to balance between these frequently conflicting considerations in a way that causes the least aggregated harm. Assume, for instance, that we wish to provide a commercial agent with efficient incentives to invest in developing the goodwill of the product while the contract is in force, but to give the principal the full benefits from sales that occur after the contract is terminated. Our first goal (motivating the agent in the contractual period) justifies giving the agent a large share in the surviving value, while our second goal (motivating the principal in the post-contractual period) supports denying her any of it. If the parties are free to adopt any division rule, they will probably choose some middle ground that reflects the efficient balance that they conceive between the two goals. To be more precise, they will compare the marginal utilities that can be derived from allocating a greater share of the surviving value to the agent and to the principal, and choose the allocation in which the marginal utility from assigning an additional share of the surviving value to the principal is equal to the marginal utility from allocating this share to the agent.

Forcing the parties to adopt a certain allocation rule can thus be inefficient, since it prevents the parties from tailoring the allocation rule to their specific needs. If indeed the efficient allocation of the surviving value is idiosyncratic, and depends on the unique characteristic of both the contractual relationship and the post-contractual setting, then it must be inefficient to oblige all contractors to accept the same mandatory allocation rule. However, some limitations on the division of the surviving value are not necessarily inefficient. As long as we allow some flexibility in structuring the type of benefits each party receives according to the allocation rule, we can ensure fair allocation without sacrificing efficiency. Consider the following scheme:

Let us assume that in order to achieve our distributive goals, we wish to ensure that each party be entitled to receive at least a minimum share of the expected surviving value (denote this monetary value as $K$). From an \textit{ex ante} perspective, we can ensure that a party will receive her minimum just share by providing her with a right to participate in the profits in the post-contractual period ("participation"), or through an assured lump sum that will be paid to her upon the termination of the contract ("fixed payments"), or through some combination of participation and fixed
payments. In fact, as long as the expected value of the combination of participation and fixed payments is higher than K, we achieve our distributive goal. Hence, we can allow the parties to freely alternate between participation and fixed payments without jeopardizing the cause of distributive justice, as long as we ensure that the combined expected value of participation and fixed payments at the time of contracting is higher than the minimum just share (K).

For example, assume that at the time of formation, the surviving value can be worth 0 or 100 with equal probability, and we wish to ensure an equal division of it. One way to do this is to assign 50% of the surviving value to each party. Another way, equally just from an ex-ante perspective, is to assign 100% of the surviving value to one party, subject to his commitment to pay the other party 50 upon termination. Actually, any combination that promises each party an expected value of 50 (i.e. X% as participation + (50-X) as fixed payments), will achieve the distributive goal that we set for ourselves.

Limiting the parties' contractual freedom to allocation rules that respect the above scheme (i.e. choosing a combination of participation and fixed payments with an expected value that is higher than some minimum just share) allows them sufficient flexibility to choose the efficient allocation rule, and thus does not conflict with the goal of efficiency. Recall that the efficient allocation rule for the surviving value is the one that equalizes between the marginal benefits from allocating the surviving value to each of them. Since the option of providing a party with fixed payments has no effect on the behavior of the parties during the contractual or the post-contractual periods (by definition, their actions after the contract is formed cannot affect the size of these payments37), they can always complement the efficient allocation of the surviving value with fixed payments that ensure the minimum just share.

Consider the numerical example given above. Assume that the efficient allocation of the surviving value is that one party (P) will receive 80% of the surviving value and that the other party (A) will receive only 20%. The distributive limitation of equal division should not cause inefficiency as long as we allow the parties to agree on the efficient unequal share of participation (80% to P and 20% to A), subject to payment of a secured sum of 30 from P to A upon termination. Such fixed payments will not affect the party's actions, but will ensure that from an ex-ante perspective they will receive a just share in the surviving value.

One argument that can be raised against the proposed scheme is that courts will have difficulties enforcing such a flexible limitation. The obvious

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37 The fixed payments may, however, influence the willingness of the parties to remain in the relationship. See below.
difficulty is that courts are required to evaluate in retrospect whether the fixed payments provided by the contract guarantee adequate compensation for the waiver of the right to participation (e.g. whether a prenuptial agreement that provides for payment of a lump sum is adequate compensation for relinquishing all rights with respect to the matrimonial property). However, efforts to evaluate the reasonableness of a tradeoff at the time of contracting are required of courts in other contexts (e.g. in order to decide whether a liquidated compensation clause is a penalty\textsuperscript{38}), and they can be facilitated through rules of thumb that are based on easily ascertained data, such as the monetary benefits that were gained during the contractual period (e.g. a percentage of the income that was earned by an employee while the employment contract was in force).

A flexible-mandatory allocation rule, which is mandatory in the sense that it provides for a just division of the expected surviving value, but is flexible in the sense that it allows the parties to alternate between different types of benefits (participation v. fixed payments), is thus a scheme that can advance distributive goals without jeopardizing the cause of efficient allocation of the surviving value. Nevertheless, certain inefficiencies may still be created even by a flexible-mandatory allocation rule. First, such a rule can affect the incentive to form an agreement, since it may make the contract unattractive (in comparison with alternatives) to one of the parties.\textsuperscript{39} For instance, if principals have to share the surviving value equally with their agents, they might prefer other forms of distribution (e.g. creating a subsidiary) that allows them to keep a greater share of the surplus. Second, a promise to pay fixed payments upon termination does not influence the parties’ behavior while the contract is in force or their actions after it is terminated, but it may influence their decision whether or not to terminate the contract. For instance, a principal who made a commitment to pay considerable amounts upon termination of the agency may be reluctant to end even an unproductive commercial agency, while the agent, who has much to gain in case of termination, may be overzealous about acting to end the under-performing agency. Such a consideration restricts the amount of protection that can be provided on distributive grounds, without paying the cost of inefficiency. However, as long as the size of the minimum just share is sufficiently small as not to tilt one party to refrain from contracting,\textsuperscript{40} or to cause the other party to

\textsuperscript{38} See C\textsc{hitty on Contracts} (30\textsuperscript{th}. ed. 2008) vol. 1 pp. 1681-1185; E. Allan Farnsworth, \textsc{Contracts} (3\textsuperscript{rd} ed., 1999) 841-847.

\textsuperscript{39} Alternatively, if the fixed payments can be transferred to consumers, they may increase the price of the product or the service. However, it must be borne in mind that if parties to an agreement can increase their profits at the expense of consumers (i.e. bite into the consumer surplus) simply by restructuring the agreement between them, they are likely to do so anyway.

\textsuperscript{40} The protection provided to the weak party should be correlated to the size of the expected surviving value. Accordingly, even if the efficient allocation is that the agent will receive only fixed payments (and no participation rights), the size of the payments
terminate an otherwise beneficial contract, a flexible-mandatory requirement of the sort that was described above need not tamper with the attempt to attain efficient outcomes.

CONCLUSIONS

Courts and legislators are often criticized by law and economics scholars for adopting an *ex post* perspective on contractual disputes. The gist of such criticism is that courts and legislators often concentrate on the parties' relative positions after a dispute arises, rather than to their interests and incentives at the time of forming and performing the contract. The case at hand, the division of the surplus that remains after the termination of relational contracts, seems like another easy target for such an attack. As Part 1 of this paper demonstrates, modern courts and legislators are clearly influenced by the parties' relative equities *ex-post*, and are thus inclined to create rules that protect the weak party in the relationship. Such protective measures, which in some cases are confined to the realm of "setting the default," but more often than not have mandatory features, seem like another example of "the big tradeoff" between distributive justice and efficiency. As such, they could be subject to the ongoing debate about if, and to what extent, distributive goals should be advanced at the cost of efficiency through the private law\(^{41}\) – a debate on which one's stand is often in clear correlation with one's academic and political agenda.\(^{42}\)

The tendency to give considerable weight to *ex-post* considerations can be explained by the fact that courts, and sometimes legislators as well, enter the picture at a late stage, and thus encounter the parties in their post-dispute positions, to which they find themselves unable to turn a blind eye. If so, then whether or not we should criticize them for their tendency to take distributive considerations into account, such human inclinations seem hard to change. Thus, instead of condemning courts and legislators will be only part of the expected surviving value. Assuming that relational contracts are entered into for the benefits made while the contract is in force (i.e. that parties enter relational contracts because the profits they expect to make during the contractual period are sufficiently high to make them beneficial), fixed payments that are only part of the surviving value will not deter any of them from entering the agreement.


\(^{42}\) Formalists, such as Ernest Weinrib and Peter Benson, and Law and Economics scholars, such as Steven Shavell and Louis Kaplow, typically support the claim that distributive justice should be achieved strictly through the public law (though they do so, of course, on different grounds), while scholars associated with the Law and Society movement (formally Critical Legal Studies), such as Duncan Kennedy and Joseph Singer, strongly argue that redistribution should be achieved through every possible means, including the doctrines of private law.
for their inability to disregard information that is available \textit{ex-post}, it might be better to devise legal rules that are not only efficient from an \textit{ex-ante} perspective, but also just and fair even with the benefit of hindsight.

The proposal to set flexible-mandatory rules to allocate the surviving value from relational contracts – rules that mandate a fair division of the surplus, but allow flexibility as to the method of division (i.e. participation v. fixed payments) – should therefore be understood as an attempt to balance between the aspiration to allow contracting parties sufficient freedom to shape their legal relationship in the way that suits them best, with the natural tendencies of modern courts and legislators to protect the party that seems to them deprived. In a sense, it is another attempt to structure contractual rules in a way that reconciles the requirements of distributive justice and efficiency, and to refute the widespread belief that doing so is an hopeless attempt to eat one’s cake and have it too.