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PRUDENCE, INDETERMINACY AND THE NEED TO DEAL: The Conditions of an Ethic of Business

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The positive duty resulting from one man's reliance on another is among the slowest conquests of advancing civilization. *Henry Maine, Ancient Law*

To breed an animal that is able to make promises is that not precisely the...task which Nature set for itself as regards Man. Friedrich Nietzsche, *The Genealogy of Morals*

The definition of injustice is no other than the non- performance of Covenant. *Thomas Hobbes, Leviathan*

I. INTRODUCTION

Consider the following scenarios. Both are taken from life, the lives of colleagues of mine. Scene One: A lawyer confronts a contractor, a friend and neighbor, regarding the construction of the lawyer's new house. He notes several inadequacies and some omissions. The contractor is unconcerned. The lawyer indicates that a contract binds the undertaking, a contract which includes a $25,000 penalty clause for non-performance. Still unconcerned, the contractor replies that he has no intention of meeting the lawyer's objections. Not only will he not build the house as specified but he plans to omit other features and cut corners throughout. Before the lawyer could object, the contractor blandly says, "I'll be happy to give you your $25,000 and what you paid for the lot and take over the property. And we can remain friends." As those astute in real estate might surmise, property prices in the neighborhood +were skyrocketing. There was no chance the lawyer would invoke the penalty clause. He swallowed his pride, professional and personal, consoled himself with his paper profits and thought of other ways to get even.

Scene Two: A big Eastern city restaurant. Three high level executives are finishing their meal. Two, a major commercial contractor and major banker, are puzzled by the third, an insurance executive vice-president, who has been leading the discussion. "What are the real objections to the deal?" the insurance executive asks. There were no objections. The idea of a ten story office complex with the insurance company as the principal tenant and major financial backer seemed sound.

"It's just that my board," the banker said, "is used to seeing numbers before they approve several million dollars in loans."

"I would like to be precise" the contractor offers, "but I can't. Too many imponderables." "I don't believe uncertainty is a problem," the insurance executive responds blandly.

"If any of us believed that, we might as well say goodbye to our MBA's."

"To say nothing of our jobs," the banker adds.

"I don't know why this is so hard to understand. Uncertainty is not the problem. In fact, it may be our major opportunity, the only advantage we have over our competitors."

The insurance executive explains that if the deal were susceptible to the precision normally required for a conventional deal, a lease construction agreement, then everyone in the city would be able to evaluate it and

what's more important be able to justify the project's obvious merits to those whose approval was necessary to proceed. "We would then be in a competitive environment, instead of having a pleasant luncheon." The executive continues, explaining that the uncertainty of construction costs, rents and other factors which affect the market for commercial space are significant only if opportunistic advantage were sought by the parties. "Uncertainty is not the issue, opportunism is."

On a napkin, which is now framed on his office wall, he sketches out the terms of the deal. In brief it provides for the sharing of all risks, no matter on whose shoulders it might otherwise fall, and for the sharing of all benefits, no matter whose coffers such might accrue. "Basically, we're partners, though none of our lawyers would call it that."

Legally, the contractor was responsible for construction, the banker for providing a line of credit and the insurance executive for some financing and for leasing the building. They were only joined in an unconventional way should an untoward event occur, some dramatic change beyond their control. In the consequences of this event they would all share whether to mitigate loss or to distribute benefits. The only noteworthy part of the agreement was that opportunistic advantage was seen to be the common enemy, an enemy that had to be eliminated if the deal were to proceed.

It is important to note that the men who consummated the deal were not friends. They knew of each other's reputation, but they had no ongoing relationship. What they had was a desire to undertake the project and an ability to conceive, understand and to sell to their superiors the desirability of proceeding before the normal degree of certitude could be ascertained. The linch- pin of the entire process was the mode of eliminating opportunistic advantage, of spreading the risk and rewards, which after all is what insurance is supposed to be about.

This article undertakes to explore the potential for such agreements to provide the beginning of ethical relationships in corporate enterprise. This may seem harsh, even cynical, as if there were no ethics in business as a matter of course. If one, however, defines ethical activity as that which cannot be accounted for by either the risk of legal or other social sanction or by prudential (instrumental, not Aristotelian) requirements, then it may not seem cynical to say that it does not define the norm of business transactions. We suspect Scene One captures the central tendencies of commerce. Scene One is where business after all is business, that is, in its most predatory sense, the struggle for opportunistic advantage. However aberrant Scene Two is, and it may not be so infrequent as it might seem, it may describe the margin between prudential and ethical activity or in other words it might indicate how modern business may be making the realization of Aristotle's ethical ideal more realistic.

> It is probably only with the marginal person, excluded from full associative life by accident, injustice or moral obliquity, that specific legal sanction attain substantial importance.
> Julius Stone, *Province and Function of Law*

II. SOCIETAL OBLIGATION

Recall Scene One. The lawyer had many commercial and social relations with the contractor. They were friends and neighbors. Nevertheless, the attorney thought a contract would be prudent, if only to avoid misunderstanding. It soon became clear that the contract was not considered binding by the contractor, not if he could make a better deal. The contract could not protect either party against opportunistic advantages. Indeed the terms of the contract suggested that such advantages were legitimate. What else could the penalty clause convey but the monetization of these opportunities? Any protestation that the house was to be built in good faith runs into the objection that the penalty clause presumed good faith was not an operable concept. Suppose building had been delayed through no fault of the contractor, would the lawyer have shared the expenses with him? Was the lawyer will to share opportunistic real estate appreciation with him?

Of course such considerations are reducible to contract. Consider Scene Two. But they were not considered prudent, not assuming the zero sum Hobbesian world, by either party. There are many reasons for why the lawyer and his friend, the contractor, did not draw up such an agreement, but the most important seems to be that somehow it seemed proper to both of them to extract all they could from a real estate project, even if it was to be a personal residence. In other words they were comfortable with instrumental rationality or prudence narrowly conceived. Or, perhaps they could conceive of no alternative even between friends. Had they been brothers one doubts a different outcome.

It should be clear why this contract is a contract in form only. Whatever the initial intentions of the parties, it is undeniable that the contractor considered the contract inconvenient and felt no obligation to it or to any of the other values of his relationship with the lawyer. This contract is in the Hobbesian, not Lockean, state of nature; it is a war of all against all, not a prelude to civil society.

Perhaps a word or two about contracts is necessary to put these considerations in a more meaningful context. Although in common law nations the idea of contract cannot be divorced from the promises courts are likely to enforce, we wish to emphasize that "we do not have promises because we have contracts; we have contracts because we have promises. Contract-in-fact is primary [Havinghurst, p.10]". It is more primary than property and less dependent on law than personal and relational security. "Contract can do much better without law than the other interests I have mentioned. Without legal sanctions for the breach of promise the contract institution would be under a disability, but we should not be confronted with the spectacle of the wolf eating himself up [Havinghurst, p.24]." Contract-in-fact has been considered the basis of civilization itself. According to Henry Maine: "Nor is it difficult to see what is the tie between man and man which replaces by degrees those forms of reciprocity in rights and duties which have their origin in the family. It is contract [Havinghurst, p.18]." The reason is two-fold: Contracts have proven effective in the "achieving of cooperation in the conduct of enterprise" and have afforded some protection from the risks thereby undertaken [Havinghurst, p.24].

Underlying these prime functions of contract-in-fact is the sense of obligation. This is no mere legal requirement given reality by judicial sanction. So clear-eyed an observer as Adam Smith put it thus: "When our passive feelings are almost always so sordid and so selfish, how comes it that our active principles should often be so generous and so noble? When we are always so much more deeply affected by whatever concerns ourselves, than by what concerns other men; what is it that prompts the generous upon all occasions, and the mean upon many, to sacrifice their own interests to the greater interests of others? It is not the soft power of humanity; it is not that feeble spark of benevolence which Nature has lighted up in the human heart, that it is thus capable of counteracting the strongest impulses of self-love. It is a stronger power, a more forcible motive, which exerts itself upon such occasions. It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct. It is he who, whenever we are about to act so as to affect the happiness of others, calls to us, with a voice capable of astonishing the most presumptuous of our passions, that we are but one of the multitude, in no respect better than any other in it; and that when we prefer ourselves so shamefully and so blindly to others, we become the proper objects of resentment, abhorrence and execration" [Smith, p.106].

Contracts work, people keep promises, because they feel obliged to do so—as much from an inner compulsion as from an outer sanction. Most often obligation coincides with the interests of the parties. Few enter contracts without expectations of mutual benefit. Nevertheless, contracts do not depend upon coincidence of interests to work; obligation is necessary. Even should the balance of benefits swing to one or the other of the parties, the sense of obligation—sufficiently powerful to overcome the temptation of opportunistic gain—normally guarantees performance. Only very exceptionally is external enforcement necessary [Havinghurst, p.91]. This is the meaning of Julius Stone's words which serve as the epigraph to this section. A criminal sanction is only necessary for those outside civil society and thereby immune to its non-criminal sanctions. Contracts thus settle comfortably in the vast spectrum of obligations typical in Western societies. They seem the very measure of moderation, implying equality of parties, voluntary undertakings in the pursuit of mutual material benefits [Havinghurst, pp.34-5]. Only at the extremes, which really are denials of the central premises of contract-in-fact, would one expect to find a source of insight into the human condition, even if restricted to economic concerns.

Without minimizing the importance of normal behavior and central tendencies as measures of social reality, these in themselves explain nothing. Description yes, explanation no. Yet it is in this humdrum world of contract-in-fact that explanatory concepts must be found, for it is this world that must be accounted for. To look at the extremes, or even to look at litigated cases, is to suffer from the methodological weakness of studies of pathology. It is difficult, if not impossible, to explain or even describe health from instances of sickness and death. At the same time routine affairs by their very nature mask the concepts which may lead to a deeper comprehension of them. An analysis—whatever that may mean beyond a taxonomic study—of of ordinary leases, for example, seems a particularly fruitless mode of inquiry. But what of non-traditional leases? What if they indicate the conditions of ethical relations among business partners?

III. THE NON-TRADITIONAL LEASE

Leases seem the paradigm of the standard contract: They provide protection for the parties to an uncoerced commercial agreement. They are of particular interest to this analysis because the source of protection is seen to reside in the properties of a mutual agreement which seems to formalize the intentions of the parties. My colleague, the lawyer, tried to provide safeguards for an arrangement he believed fell within routine commercial parameters. If he had been correct his house would have been built and the contract would have been fulfilled. He turned out to be wrong not because he did not draw his contract properly but because the contract was wrongly premised. It did not recognize the catastrophic possibilities of a volatile real estate market on the intentions of the parties to the agreement. No shift in degree of the provisions of the contract could have availed. A much larger penalty clause, say $250,000, would have been unlikely to secure the contractor's assent.

Protection for the parties had to be found in the proper understanding of the project including factors beyond the parties' control or not at all. If it cannot be found, no contract-in-fact can exist. This is of course so basic an idea, so fraught with common sense, that we hesitate to reduce it to print. Its importance, however, cannot be overemphasized. "Although in the whole population there are many more persons with no inhibitions than there are thieves, relation disrupters and cutthroats, yet when one is in a position to refuse to deal, it is easier to prevent an evil person from doing him injury through breach of contract than it is to stop a depredation upon these other interests. A man by selection can limit the circle of those in a position to hurt him by failing to keep a promise [Havinghurst, p.70]."

This self-protection by selection is not only the best way to prevent injury; it may be the only way to undertake complex projects. The more complex the project, the more indeterminate the relations and the greater the premium placed on a proper understanding of the entire context of the undertaking, including the parties to it. The wisdom and ingenuity of the insurance executive was not his appreciation of the indeterminacy of his proposed project. Everyone understood the risks involved. The executive alone saw that the risk entailed in indeterminacy could be under certain circumstances turned to mutual advantage. It kept out competitors, allowing him to choose the time and circumstances for proceeding, as well as, enabling him to select partners on terms conducive to his appreciation of the project's requirements.

Far from viewing imponderables as obstacles to performance, he saw them as essential to it. Obligation inheres in interdependence made necessary by indeterminacy, not merely by utilitarian considerations. If the lawyer understood this, his house would have had a much better chance of being built according to plan.

If we are correct, the non-traditional lease can becomes part of the substance of business transactions and not just the form. It can make the relational aspects of complex undertakings positive elements rather than obstacles to be overcome or circumvented. When this occurs the non-traditional or relational lease may not only indicate the conditions of an ethic of business but be in fact an illustration of it.

It may be objected that the purpose of business is not to provide examples of ethical activity. The purpose of business is to maximize wealth, particularly the wealth of those who put risky deals together. No sound businessman gives up the advantages of traditional contracts: "Among the advantages claimed for the use of standard form contracts are these: it takes advantage of the lessons of experience and enables a judicial interpretation of one contract to serve as an interpretation of all contracts; it reduces uncertainty and saves time and trouble; it simplifies planning and administration and makes the skill of the draftsman available to all...it makes risks calculable and increases that real security which is the necessary basis of initiative and the assumption of foreseeable risks [Jones, p. 150]." Absent the dangers of standard contracts cited above, one may add there is an essential fairness built into them. No advantage in principle inheres in uncoerced agreements between equals.

Why then non-traditional leases? Why not draw improved traditional leases? The short answer is that it's not always possible. The elements may not be available. As we have seen what could be specified was detailed in our lease. What makes the lease relational is that what could not be specified was not forced to fit into a discrete exchange template. There was no Procrustean attempt to monetize the risks which inhered in the indeterminate elements of the deal. Many of the requirements of a traditional lease were left open. No one wished to undergo unnecessary risks, but under the imperative of the deal what was considered necessary changed. The terms of a traditional lease had to be relaxed to proceed with the project. If the consequent risks could not be contained in the normal form of finding equivalencies for discrete protections, some other way would have to be found or the

deal would die. This was accomplished by recognizing fully the relational nature of the enterprise and by turning these characteristics into protective mechanisms in the first instance.

What was given up was the chance to take advantage of uncontrollable events which might accrue to the benefit of one party at the expense of the other. All such events were to be accommodated in terms of the lease to the mutual benefit of the parties. In effect risks of all untoward events were to be spread among the parties. It is critical to the understanding of the agreement to view it as a substantive element of the project. It is not a mere articulation of otherwise adequate elements of the enterprise. It is more than a formal condition of the deal. It is more than a document drawn in anticipation of litigation. It is more than an attempt to cover one's hind quarters. Put positively, what makes this lease non- traditional is that its comprehension of interdependence, its recognition of the relational character of its undertaking, becomes in itself a sign of the good faith necessary to overcome objections to the project. The lease itself signifies the absence of the normal conflict of interests of the parties. There is no need for market determined prices or negotiated prices to resolve these interests, either instantaneously or over time. The conflict is eliminated at the source by the removal of opportunistic possibilities. It needs to be added that these could only be removed if a significant amount of trust already existed or was considered a possibility. This trust, as Adam Smith pointed out, need not rely on love and affection. It can reside in an understanding of the economic opportunities in the social context where notions of reason, principle and conscience are real, if intangible, factors.

Taken together these factors, including the imperative to make the deal or lose the economic opportunity, locate the relational lease well to the right of the traditional lease. It has more of the characteristics of a prenuptial agreement than an exchange in a big city used care lots. Indeed in many betrothal agreements, a frank discussion of the material aspects of the ensuing relationship is undertaken so that they will not interfere or distort its non-material potential. Our lease is frankly economic. Intimacy or friendship is not foreseen or considered relevant. But one is not thereby forced to the defenses of caveat emptor or the state of nature or war. Selection of associates, however, is critical. To participate in a relational lease one must be certain that all parties are aware of its relational characteristics and who see mutual dependence as a source of security not exploitation or extortion or even as opportunistic advantage. All parties must be able to live with its indeterminacies and be willing to sustain the good faith necessary to see the project through to its completion.

This must seem and to some extent be idealistic. But this lease is not the creation of a professor of ethics. It is the creation of an experienced businessmen who saw an opportunity too promising to let the requirements of a traditional lease or the text-book maxims of lawyers or accountants obstruct its pursuit. These businessmen are neither extreme nor unique, although their document may be one of a kind.

We began this paper with a discussion of fairness. The fairness of equilibrium prices seemed self-evident to classical economists. Although it seems less so today and less likely to exist in a world dominated by large-scale economic units, the concept of equilibrium prices still attract. At least they are not extorted. They leave no room for opportunistic behavior. They are fundamentally rational, predictable, and calculable. Sober virtues perhaps, but virtues nonetheless. Relational transactions, by allowing only heuristic value to discrete exchanges, seem to open the way to irrational elements—which not only seem uneconomic but inevitably unfair. Relational transactions are infused with power, as indeed are all contracts [Havinghurst, p.21]. Without for a moment denying these risks of the prevalence of evil men, it must be stated that perilous as these relations are, they contain the conditions of just relations, including the accommodation of power differentials. Our lease is such an illustration. Indeed it seems a model for large-scale economic transaction. Whether on balance pure competition offers more protection to producers and consumers or any other sector of the economy is a moot question. How to remove destructive, inefficient and adversarial variables from corporate decisional processes with all their enormous impact on the allocation of resources is not. The relational lease may have an important role to play in the development of complex enterprise and in the scholarly appreciation of them. If it does so, it will perform useful and important services. In Adam Smith's terms the relational lease may be the functional equivalent of "friendship." It may not lead to love and affection, it may not deserve the label justice, but if it enables men to transcend the values of the state of nature or the used car lot it will have earned our gratitude.

IV. NICE GUYS FINISH FIRST

Those readers familiar with game theory or socio-biology or evolutionary genetics will recognize that I have appropriated the title of this concluding section from Richard Dawkins, *The Selfish Gene*. It captures the idea, first introduced by Robert Trivers, of reciprocal altruism. The non-relational lease, I believe, can be seen as a specification of this idea. In essence the idea is that cooperation among parties to a game or enterprise can do

better than zero sum competitors, under certain conditions. The first is that the game is not one-off, that it persists through time. The second is that free riders can be detected and punished, if only by being barred from future games. The third is that the counters in the game count more or less the same for all the participants. In other words, external concepts like honor or hate or love, do not interfere with the rationality of the decisions.

In the example that opened this article, it was clear that the contractor saw his relationship as zero sum and one off, his adversary having no ability to punish him sufficiently for him to ignore his opportunistic gain. In the second example, the non-opportunistic or non-traditional lease, the players did not conceive of themselves as competitors, notwithstanding having individual and corporate interests independent of each other. The reason was that the opportunities presented by the project created an overlap of interests that made it prudent to see if non-traditional approaches might overcome traditional obstacles to concluding the deal. Through the good offices and the imagination of the insurance executive, a way was found. Instead of viewing an unusual amount of uncertainty as a deal killer, the executive evaluated the business circumstances positively, as eliminating competitors who did not appreciate the power of non-opportunistic contracts. Instead of viewing divergent interests and viewpoints as deal killers, he imagined a way of proceeding which made these differences less important than the gains consequent upon completing a successful project. Although it is beyond the scope of this article, the further possibilities of non-opportunistic contracts must be noted. Success is likely to build on success. The confidence, to say nothing of the profits, which accrue to a successful project can be built upon, compounded into more successful projects. Not only will trust be built among the parties. Trust in the idea underlying non-traditionally conceived projects will also grow. This will enable the participants to consider deals which will seem too risky to outsiders.

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