PRECEDENT TERMS

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MOTIVATION

Some contract terms puzzling because:

- Do not seem to affect prices
- Vary across otherwise similar contracts
- Are negotiated intensely

These terms don't seem to fit into existing categories:

- "Best possible" (priced efficiently)
- Boilerplate (fixed)

THIS PAPER

Define category between “best possible” & boilerplate: <u>precedent terms</u>

Argue why they arise

Bring survey evidence to bear on the category

Argue cannot be explained by existing theories

MODEL À LA HART–MOORE 04

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Two parties: Seller (S) and Buyer (B)

Think: S is issuer of loan and B is lender

B chooses investment i at cost $\frac{ki^2}{2}$

Outcome is a pair (p_i, τ_i), p_i is transfer and $\tau_i \in [0, 1]$ a contractual term

Think: p_i is loan price and τ_i is tightness of covenant

Parties bargain over outcomes on list $\mathcal{L} = \{(p_i, \tau_i)\}_i$ but nothing off it

State $s \in \{0, 1\}$; $\mathcal{L}$ cannot depend on s

MODEL: PAYOFFS

Payoffs if trade (net of investment):

$$u_B = i + s\tau - p$$

$$u_S = p - c\tau$$

$\uparrow \tau$ hurts S, benefits B; degree depends on s; $c < 1$

Payoffs if no trade (net of investment): Both get zero

MODEL: TIMING

$t = 0$: Parties agree on a list of $\mathcal{L} = \{(p_i, \tau_i)\}_i$

$t = 1$: B chooses i

$t = 2$: State s realized; 50-50 Nash bargain over outcomes on list

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Investment i: $i_{fb} = \frac{1}{k}$

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"Boilerplate" terms: Price & terms fixed ex ante, before s realized

Fixed price: Price fixed, all τ_i on list

"Precedent" terms: Price fixed ex ante but terms chosen ex post

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<u>Solution</u>: Fix everything ex ante: Boilerplate terms!

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<u>Solution</u>: Precedent terms! Fix p ex ante and let τ adjust

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$\implies$ Precedent: Protect investment incentives & preserve some flexibility

DISTORTIONS AND PREDICTIONS

Best possible distorts ex ante incentives: Underinvestment

Prediction: Arise when value of investment low (k high)

Boilerplate distorts ex post allocation: Doesn't respond to state

Prediction: Arise when value of flexibility low ($\mathbb{P}[s = 1]$ near 0 or 1)

Precedent distort ex post too: Responds imperfectly to state

Prediction: Arise otherwise: Value investment and flexibility

EXPLAINING PAPER W/ HART–MOORE

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Tradeoff between incentives and flexibility

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Explains why bargaining may persist even in optimal contracts

Explain cross-sectional variation in terms even with fixed price

COMMENTS

COMMENT 1: THEORY

Authors suggest that model inconsistent with theory

But Hart–Moore 04 seems like good start

Question: Model explain facts?

Matters: Explains why precedent arise

They are not about valuation difficulty but about tradeoff

Suggestion: Develop predictions and test them

COMMENT 2: OTHER THEORIES

Authors might reject Hart–Moore but other theories come to mind:

E.g. could signal at initial negotiation anticipating renegotiation

E.g. could have strong tastes for goods with same production cost

E.g. Higbee, Jennejohn, Jones, and Tally 26

Question: Can you rule out these theories?

Matters: Determines what we learn (about)

Suggestion: Consider broader set of theories and try to falsify them

COMMENT 3: FALSIFIABILITY

Authors suggest anything goes

> parties cannot form...estimates of...value.... A reader who believes...better...empirical strategies will reveal price sensitivity...will not share this premise. But this is a difference in judgment about markets...
>
> A critic might imagine that the terms we highlight are simply gestating boilerplate.... Whether that domain [of precedent terms] is narrow or wide is a question on which readers can and should differ

<u>Question</u>: Prec. terms unmeasured best possible or approx. boilerplate?

<u>Matters</u>: Set of actual precedent terms could be empty

<u>Suggestion</u>: Take clearer stand with falsifiable statement

CONCLUSIONS

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Super interesting paper on super interesting phenomenon

Relevant for new and existing theory and for empirical work