

Beyond Good Faith:

Contract Clauses that Build Strong
Commercial Relationships©

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Acknowledgments

- This presentation is especially indebted to the work of several individuals:
- Steven R. Salbu
 - *Evolving Contract as a Device for Flexible Coordination and Control*, American Business Law Journal, 1997;
 - *The Decline of Contract as a Relationship Management Form*, Rutgers Law Review, 1995; and
 - *Joint Venture Contracts as Strategic Tools*, Indiana Law Review, 1991.

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- Ian MacNeil and Paul Gudel
 - *Contracts: Exchange Transactions and Relations* (3rd Ed. 2003)
- Donald Smythe
 - *Bounded Rationality, the Doctrine of Impracticability, and the Governance of Relational Contracts*, Southern California Interdisciplinary Law Journal, 2004
- Ichiro Kobayashi
 - *The Interaction between Japanese Corporate Governance and Relational Contract Practice*, NYU Journal of Law & Business, 2005

Contracts Could Serve Many Functions:

- 1. Securing mutual benefits through exchange;
- 2. Reducing risks;
- 3. Increasing efficiency;
- 4. Building demand for products and services;
- 5. Aiding product development and quality control;
and
- 6. Advancing internal company management and planning.

Contracts Could Serve Many Functions

- However, at least some of that functional potential remains unrealized, especially as one moves down the list.
 - Although Contracts and contracting behaviors have certainly advanced the security and profits of reciprocal exchange, even while reducing risks, more could be accomplished along each of the six functional domains.

Contracts Could Serve Many Functions

- Which raises two questions:
 - 1. Why has contracting failed to realize its full potential; and
 - 2. How can your contracts and contracting practices more comprehensively serve all of these functions?

Why has contracting failed to realize its full potential?

- 1. In part the failure may be due to the confining framework of contract law.
 - Having evolved from within traditional agricultural economies lacking sophisticated needs, contract rules may impede the development of structures and processes that are more institutionally-advancing.

Why has contracting failed to realize its full potential?

- Traditional contract rules were first formed within an agricultural economy:
 - Mostly episodic, relatively local transactions.
- Contract rules then co-evolved with the Industrial Revolution:
 - Apart from franchises, output and requirements contracts, however, most commerce was still conceived as episodic transactions. The Industrial Era did expand exchange geographically, resulting in contracts being made more frequently among strangers.

Why has contracting failed to realize its full potential?

- Perhaps because of this growth of exchange among strangers (and the commensurate elevation of moral hazard risks), contract law evolved a new duty that came to be implied broadly in the performance and enforcement of contracts:
 - the implied duty of “good faith.”

The Implied Duty of Good Faith

- As interpreted, this implied duty of good faith:
 - 1. Prohibits one party from interfering with the performance of another party; and
 - 2. Limits the possibility of one party exploiting another
 - where contract language is unclear, or
 - where a contract explicitly grants discretionary powers to one party.

The Implied Duty of Good Faith

- Only *occasionally*, however, will the duty of good faith imply a responsibility to:
 - 3. Use one's "best efforts" in discharging contractual responsibilities; or
 - 4. Share information with a contracting partner.
- 5. And only *very* rarely will the duty of good faith include a requirement to *cooperate affirmatively* with another party to help achieve that other party's goals.

The Implied Duty of Good Faith

- The “good faith” duty in other words, is more of a negative duty to refrain from certain behaviors, rather than a prompting toward proactive, cooperative, communication and understanding between the parties.

The Implied Duty of Good Faith

- Because of this lack of robustness, the duty of good faith has only slightly shaken the prevalence of a competitive, even adversarial mentality between contracting parties.
- This adversarial mentality may provide a second possible explanation for why contracting has failed to meet its full functional potential.

The Adversarial Mentality

- The adversarial mentality unrealistically conceives of sharp, mutually exclusive distinctions between the following ideas:
 - Winning v. losing;
 - Risk v. reward;
 - Duties v. freedom, or “obligations v. consent”;
 - Competitor v. customer;
 - Selfishness v. selflessness; and
 - Law v. business.
- This binary thinking tends to lock in a zero-sum, positional approach to contracts, both in their formation and their enforcement where a problem arise.

Where Do We Go Next?

- The full functional potential of contracts may never be realized, therefore, so long as contract remains rooted in its two traditions:
 - its law or contract rules, with their limited assumptions about economic exchange; and
 - the adversarial mentality of some who use that law, with their limited assumptions about human and commercial advancement.

Where Do We Go Next?

- The implied duty of good faith, in other words, is helpful but insufficient to unlock the full functional potential of contracting.
- New help may, however, be on the way:
 - Information Age reductions of information costs are enabling more flexible commercial arrangements.
 - This flexibility of business structure may suggest what reforms “beyond good faith” should be undertaken.

Premise:

- Rather than seek precision through traditional command-and-control “discrete” contracts, coupled with resorting to adversarial behavior when trouble arises, contracts may more fully function through:
 - 1. creating flexible “relational” bilateral contracts;
 - 2. contracting within strategic networks; and
 - 3. engaging in good relationship behaviors in the event of problems or disputes.

1. “Relational” vs. “Discrete” Contracts

- In contrast to “discrete” contracts, “relational” contracts are characterized by:
 - 1. Terms that are open-textured, rather than specific and absolute;
 - 2. Persistence through many transactions rather than confined by a single-transaction;
 - 3. Mutual understanding by the parties that terms and behaviors will evolve according to changing conditions; and
 - 4. A duty that parties will confer with one another throughout the life of the contract.

2. Strategic Alliances

- Salbu describes strategic networks or alliances as characterized by:
 - “mutual access and communicational connectivity”;
 - delivering benefits of “strategic responsiveness, flexibility, and operational efficiency”; and
 - differing widely in their “degree of integration or differentiation.” -- *34 Amer. Bus L. J. 330, 380*

3. Good Relational Behavior When Trouble Arises

- When problems arise, good relational behavior can steer the parties to one or more of the *substitutes* to formal litigation:
 - 1. compromise;
 - 2. re-structuring and substitution; and
 - 3. efforts to prevent the problem from recurring.

Strong Relational Qualities

- All three of these contract function-enhancing devices, i.e.,
 - bilateral relational contracts;
 - strategic alliances; and
 - substituting prevention and cooperation for litigation

are advanced through building strong relational qualities among the participants: mutual trust, respect, admiration, and gratitude for past generosity and understanding.

How Can Your Contracts Reflect these Structures, Behaviors, and Mentality?

- 1. Under what circumstances should you consider using relational contracts or strategic alliances?
- 2. What sorts of provisions can you insert into contracts to advance either of these approaches?

When to Use the Relational/Alliance Approaches

- Ichiro Kobayashi's excellent article notes the strong use of relational contracts and "keiretsu"—a collaborative form of strategic alliances involving banks, suppliers, assemblers, and distributors in post-War Japan.
- He suggests that the uses of relational contracting and keiretsu were a necessity under post-War conditions, a response to prohibitively high drafting costs. The drafting costs of open-textured relational contracts are less than the precision of terms found in creating "discrete" contracts.

When to Use the Relational/Alliance Approaches

- Conversely, however, Kobayashi says that relational contracting carries higher enforcement costs in the event of trouble.
- Firms move toward discrete contracts, he says, "once they find that incomplete terms make legal enforcement too costly or that self-enforcement is more costly than legal enforcement."

When to Use the Relational/Alliance Approaches

- These high drafting costs were the consequence of the lack of business lawyers and the general weakness of Japanese law following the War.
- Turning necessarily to relational contracts because of the limited business infrastructure, Japanese corporate governance then took its characteristic shape (stressing stability of employees and long-term cooperation relationships with suppliers and banks) as a way of reducing contract enforcement costs.

When to Use the Relational/Alliance Approaches

- Where relational contracts prevail in business practice, he observes, the *reputation* of contracting companies is crucial. "Japanese corporate governance has functioned primarily as a signal of reputation." 2 NYU J. L. & Bus. 269 (2005).
- Reputation leads to the sort of mutual trust and long-term predictability that works as a self-enforcer of contracts, rather than relying on courts.

When to Use the Relational/Alliance Approaches

- Interestingly, Kobayashi maintains that as economic enterprises become more sophisticated, they build up transactional experience. This makes contract drafting costs go down, as firms more easily can add precision to their agreements.
- As that happens, he says, the reasons for adopting the relational approach fade in favor of discrete contracts:

When to Use the Relational/Alliance Approaches

- “Firms create relational contracts primarily because unknown contingencies, or the complexity of the required response to anticipated contingencies, prevent the specification of precise performance standards.”

When to Use the Relational/Alliance Approaches

- As firms accumulate transaction experience, however, they “may be able to write discrete contracts more cost-efficiently” They will then add more discrete performance standards rather than rely on relational contracts.
- He concludes that “contract practice ultimately should converge into a discrete regime.”

When to Use the Relational/Alliance Approaches

- It is certainly true that our economy is increasingly complex, and even populated by more and more sophisticated players.
- But do unfolding conditions really favor discrete contracts over relational contracts?

When to Use the Relational/Alliance Approaches

- Greater experience can translate into the ability to incorporate more precise performance standards, but this happens most readily where firms continue to do the same sorts of transaction (and with the same contracting partners).
- And that sort of continuity may be shrinking as the Information Age unfolds.

When to Use the Relational/Alliance Approaches

- The Information Age economy is characterized by accelerating rates of change in various factors like consumer demand, capital costs and availability, just-in-time inventories, political change, technological innovation, and government regulation.
- That means that response times are shrinking, even while basic background conditions in business are becoming more volatile.

When to Use the Relational/Alliance Approaches

- As a consequence, drafting costs may generally be going up rather than down. Unknown contingencies continue to multiply and become more pressing, even while sophistication and experience increase.
- Further, the opportunity costs of inflexibility are rising. Firms must remain nimble in their allocation of resources, and their ability to form new combinations with strategic partners, as unknown contingencies bring positive new prospects.

When to Use the Relational/Alliance Approaches

- Finally, legal enforcement costs (the primary form of enforcement for discrete contracts) continues to rise even while courts and contract rules attempt to supply contract law default rules and gap fillers.

When to Use the Relational/Alliance Approaches

- All in all, the economic case for relational rather than discrete contracts is good. Especially is this so where, as Kobayashi suggests, the higher enforcement costs of relational contracts can be met through stronger inter-firm trust, mutual accommodation, and strong reputations for both honesty and reliability.

Possible Contract Provisions

- If one is to move toward more flexible, relational bilateral contracts and the stronger use of strategic alliances, what sorts of contract clauses might one use?
- A variety have been suggested by Salbu, Kobayashi, and Smythe.

Possible Contract Provisions

- Salbu first postulates a “neoclassical” contract that fits between the traditional discrete contract and a full relational contract. This compromise attempts to “enhance flexibility in long-term contractual relations while maintaining a significant degree of stability and commitment.” 25 Ind. L. Rev. at 401--05.

Possible Contract Provisions

- Among the devices recommended in a neoclassical contract are:
 - incorporation of standards, i.e. extrinsic, objective criteria incorporated by reference;
 - Third-party determination of performance, i.e. figures like a contract referee (or a “standing neutral” as James Groton discusses);
 - “cost-plus” agreements calling for a fixed return above provable costs; and

Possible Contract Provisions

- Forced continued relations devices in the event of a dispute: mediation and other grievance procedures.
- Kobayashi agrees, recommending a “confer in good faith” clause when a dispute arises.

Possible Contract Provisions

- Under conditions of high volatility, the parties may employ devices that are recognized as not legally binding, but that operate as important reputation markers:
 - Salbu discusses “agreements to agree” which are commitments to negotiate in good faith toward some end
 - Kobayashi similarly advocates creating “letters of intent” or “memos of understanding” rather than binding agreements under conditions of high uncertainty.

Possible Contract Provisions

- In his article in the American Journal of Business Law, Salbu also suggests:
 - “Contingent sets of commitments” (pp. 405-07). This is the liberal use of explicit conditions and options that work to limit duties, or triggering of rights or duties. These conditions can be used in incremental layers to introduce flexibility that both reduces risks and can permit taking advantage of opportunities. Options can be held by either an obligor or an obligee.
- Donald Smythe similarly suggests the stronger use of the idea of “impracticability” to prompt re-negotiation of duties where needed.

Possible Contract Provisions

- In probably his most bold suggestions, Salbu advocates constructing strategic networks. This would be a web of companies with similar interests and capabilities that could band together to share information and reduce risks.
- These alliances would have some rough similarity to the keiretsu system in Japan. Note that alliances among possible competitors could raise antitrust difficulties in the U.S.

Possible Contract Provisions

- Nonetheless, Salbu envisions advantages for such alliances. Within the alliance, the partners could agree to have broader powers to assign contract rights and delegate contract duties. Thus, when one firm encountered difficulties fulfilling a project, an alliance partner could assist.
- As a group, the “coupling, uncoupling, and re-coupling” behaviors would promote efficiency while also reducing risks.

Possible Contract Provisions

- Furthermore, to make the alliances work well, firms would be required to share information, avoiding “dysfunctional secrecy.”
- There also would be an incentive for alliance firms to move toward standardized contract provisions, which would make contract rights more easily transferable. In time, Salbu envisages a full-blown market emerging in contract rights.

Possible Contract Provisions

- Finally, an idea of my own in the bilateral contract setting: why not require significant contracting partners to appoint permanent experts within each firm, whose job it is to learn as much as possible about the business goals and capabilities of the other contracting partner?

Possible Contract Provisions

- Within any large firm ("A"), therefore, one or more persons ("Partner Specialists") would have the ongoing assignment of being the institutional reservoir of information and memories about all of the firms ("B," "C," and "D") significant trading partners.
- Assigning these permanent persons would provide continuity across specific contracts, and across minor changes in job descriptions.

Possible Contract Provisions

- The tasks of these persons could be many:
 - They could consult periodically with their counterparts: i.e., those persons in firms B, C, and D who know about Firm A. This would advance understanding and trust.
 - They could be charged with brainstorming new contracting opportunities between the two firms.

Possible Contract Provisions

- They could prompt honesty in dealing and the sharing of information because of their long-standing familiarity.
- As “insiders” in Firm A, for example, they could readily gather information at Firm A. This would put people together who are both well-informed and whose job it is to be forthcoming with contracting partner firms.
- In the event of a dispute about a particular contract, the firm specialists could be called upon to confer and attempt a quick solution.