

# Joint Venture Contracts as Strategic Tools

STEVEN R. SALBU\*

## INTRODUCTION

Joint venture activity has increased rapidly over the past twenty years,<sup>1</sup> and although research in the field is still incipient, the growing literature on joint ventures reflects both the proliferation of such business endeavors and the questions which are raised by them. Scholars have addressed the particular strategic nature of joint ventures,<sup>2</sup> and much of the existing research concentrates on understanding their success or failure. Studies done by McKinsey and Coopers & Lybrand report a seventy percent eventual break-up rate among joint venture partnerships.<sup>3</sup> This suggests either that joint ventures are inherently unstable and subject to failure or that they adapt to changing conditions by changing ownership, as has been suggested by Harrigan.<sup>4</sup>

International joint ventures have become a separate area of research. Papers have been written concerning the impact of international joint ventures on the American economy,<sup>5</sup> joint ventures in less developed countries (LDCs),<sup>6</sup> and technological cooperation across international

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\* Assistant Professor, Legal and Ethical Environment of Business, University of Texas at Austin. B.A., Hofstra University; M.A., Dartmouth College; J.D., The College of William and Mary; M.A., Ph.D., The Wharton School of the University of Pennsylvania. The author gratefully acknowledges the helpful comments and suggestions of Rich Brahm, Tom Dunfee, Peter Lorange, Howard Perlmutter, Tim Sullivan, and Paul Tiffany.

1. In the late 1980s and early 1990s strategic alliances were formed in industries such as television, electronics, aircraft, and automobiles. See Lazzareschi, *IBM to Develop 64-Megabit Chip With Siemens*, L.A. Times, Jan. 25, 1990, at D1, col. 5; Redburn, *Technology Competition: Time to Fight 'Em or Join 'Em?*, L.A. Times, Nov. 26, 1989, at D1, col. 2; Risen, *GM-Chrysler Project Sets Precedents*, L.A. Times, Feb. 7, 1990, at D2, col. 4; Sanger, *Industries in U.S. and Japan Form Alliance on New TV Technology*, N.Y. Times, Nov. 9, 1989, at 1, col. 1; Uchitelle, *A Japanese Strategy for Boeing*, N.Y. Times, Nov. 3, 1989, at D1, col. 3.

2. See D. HALL, *THE INTERNATIONAL JOINT VENTURE* (1984); K. HARRIGAN, *STRATEGIES FOR JOINT VENTURES* (1985).

3. See Levine & Byrne, *Corporate Odd Couples*, BUS. WEEK, July 21, 1986, at 101-05.

4. K. HARRIGAN, *MANAGING FOR JOINT VENTURE SUCCESS* (1986).

5. Reich & Manken, *Joint Ventures with Japan Give Away Our Future*, 64 HARV. BUS. REV. 78 (1986).

6. See Beamish, *Joint Ventures in LDCs: Partner Selection and Performance*, 27 MGMT. INT'L REV. 23 (1987); Beamish, *The Characteristics of Joint Ventures in Developed and Developing Countries*, 20 COLUM. J. WORLD BUS. 13 (1985).

borders<sup>7</sup>. Studies have examined joint venture stability using economic analysis,<sup>8</sup> and others have applied economic antitrust analysis to joint ventures.<sup>9</sup>

Much of the existing literature concerning both domestic and international joint ventures suggests that the contract used to establish the venture is of strategic importance. Norm Alster discusses five "dealbusters" which cause strategic alliances to fail: (1) uneven levels of commitment; (2) changing strategic objectives; (3) inadequate internal structures; (4) insufficient executive attention; and (5) lack of internal consensus.<sup>10</sup> Each of these strategic problems can be averted during the contracting process, at which time either the disparity can be addressed or the venture proposal can be rejected, saving effort and money. The process and substance of initial venture contracting are important strategic components of a successful collaboration.

In their article on international collaborative agreements, Morris and Hegert suggest that there are four constant attributes of collaborative agreements: (1) shared responsibility; (2) maintenance of individual identities; (3) continual transfer of resources; and (4) indivisibility of project.<sup>11</sup> All four characteristics of collaboration are inherently contractual, referring to mutual trust, ownership, and control. Because the basic components of a joint venture are themselves contractual, the instrument establishing the venture is an important strategic variable worthy of study.

In any collaborative effort, contracting choices are managerial as well as legal, affecting the strategic implementation of the venture. The following analysis examines different contracting approaches and develops propositions regarding their impact on joint venture strategy. The observations support a concept of contracts which goes beyond the status of legal instrument. Because the various approaches to contracting have implications for corporate planning as well as subsequent behavior within a venture, the process should be viewed holistically as a management tool in which lawyers play a vital strategic role.

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7. Roehl & Truitt, *Stormy Marriages are Better: Evidence from U.S., Japanese and French Cooperative Ventures in Commercial Aircraft*, 22 COLUM. J. WORLD BUS. 87 (1987).

8. Kogut, *The Stability of Joint Ventures: Reciprocity and Competitive Rivalry*, 38 J. INDUS. ECON. 183 (1989).

9. Blackman, *Joint Ventures and the Antitrust Laws*, 40 N.Y.U. L. REV. 651 (1965).

10. Alster, *Dealbusters: Why Partnerships Fail*, ELECTRONIC BUS., April 1, 1986, at 70.

11. Morris & Hegert, *Trends in Collaborative Agreements*, 22 COLUM. J. WORLD BUS. 15, 16 (1987).

## I. CONTRACT TYPOLOGY

Because an inevitable trade-off between stability and flexibility exists in formulating strategy,<sup>12</sup> the typology of contracts along this dichotomous dimension is helpful. The ideal types of contracts which Macneil calls classical, neoclassical, and relational<sup>13</sup> can be viewed on a continuum relative to the underlying transactions and the extent to which they are respectively discrete or relational. A discrete contract can probably never exist as purely defined. Rather, it is an ideal type representing a single transaction in which the parties have neither any past nor any future relationship with each other. In its purest sense, a discrete transaction allows for little planning because it is by definition a present exchange. No contractual arrangement can be entirely discrete because a contract presumes a future relationship following the exchange of promises.<sup>14</sup> Thus, although a present, noncontractual transaction comes closest to approaching discreteness, contracts can be spoken of as discrete depending on the relatively low level at which the parties are personally involved, the simplicity of social exchange, and the unlikelihood of future dealings.<sup>15</sup>

The discrete transaction itself yields no future stability, and Macneil notes that in classical, discrete contractual arrangements, planning must be done beyond the transaction's confines.<sup>16</sup> Whereas relational dealings tend to usurp the market mechanism by incorporating price and quantity into a series of long-range contractual arrangements, discrete dealings must be negotiated over and over from one transaction to another.<sup>17</sup>

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12. See, e.g., Quinn, *Managing Strategies Incrementally*, 10 INT'L J. MGMT. SCI. 613 (1982); Tushman, Newman, & Romanelli, *Convergence and Upheaval: Managing the Unsteady Pace of Organizational Evolution*, 29 CAL. MGMT. REV. 29 (1986).

13. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 NW. U.L. REV. 854 (1978) [hereinafter Macneil, *Contracts*].

14. See RESTATEMENT (SECOND) OF CONTRACTS § 1 (1978), which defines a contract as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." Under this definition a contract requires at least two necessary steps: promise and performance. A contract so defined cannot encompass an entirely discrete transaction which has no future element. The simplest contractual arrangement containing one promise rather than a series comes closest to the ideal type which Macneil calls "discrete." See Macneil, *Contracts*, *supra* note 13.

15. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 738 (1974) [hereinafter Macneil, *Futures*].

16. See Macneil, *Contracts*, *supra* note 13.

17. The use of planning to internalize market mechanisms has been frequently observed in respect to vertical integration and diversification strategies. See, e.g., R. CAVES, *AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE* (1982); R. RUMELT, *STRATEGY, STRUCTURE AND ECONOMIC PERFORMANCE IN LARGE AMERICAN INDUSTRIAL ORGANIZATIONS*

While the low level of commitment over time allows incremental decisionmaking from moment to moment, there exists neither the ability to shift risk to another party nor the ability to stabilize price or supply in ways which might support long-range planning.<sup>18</sup> Although planning occurs through classical contracting and relatively discrete transactions, the planning in such situations must be internal planning regarding a series of rapid and relatively unrelated contracts, rather than mutual planning as applied through relational contracts.<sup>19</sup>

### A. Classical Contract

Macneil's classical contract serves two essential functions: the enhancement of discreteness and the enhancement of presentiation.<sup>20</sup> Classical contracts enhance discreteness by reducing the importance of the identity of the parties (*i.e.*, normalizing the participating people or firms via the rules and norms which apply to all). The classical contract concerns transactions in the abstract. Individual identities and idiosyncracies are theoretically irrelevant. Procedures normalize the sources of contractual construction through a series of rules which explain which acts and statements take precedent over others.<sup>21</sup> Remedies for breach are relatively

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(1974). Contracting is a mechanism for stabilizing markets through quasi-internalization: short of consolidating forces with suppliers or buyers, a corporation can purchase products or services for the future through contracting, thereby stabilizing market mechanisms to the extent of the agreement.

18. Risk allocation is a fundamental object of contracting. The consensual commitment to supply resources stabilizes the risk to a seller that buyers at a given price will be in short demand; the analogous commitment to purchase resources mitigates the risk of shrinking supply. For a discussion of the risk allocation function of contracts, see Kinter v. Wolfe, 102 Ariz. 164, 426 P.2d 798 (1967). The importance of risk allocation in the contracting process is emphasized in the doctrines of impossibility, commercial impracticability, and frustration of purpose. See *Impracticability of Performance and Frustration of Purpose*, RESTATEMENT (SECOND) OF CONTRACTS Chap. 11 (1978); U.C.C. § 2-615 (1990). The contractual function of risk allocation is evinced as well in the "risk of loss" sections of the Uniform Commercial Code. See U.C.C. §§ 2-509, 2-510, 2-613 (1990).

19. There is evidence that the planning process in most firms occurs in an emergent, gradual fashion which is inconsistent with the traditional, classical discrete contracting process. See J. QUINN, STRATEGIES FOR CHANGE: LOGICAL INCREMENTALISM (1980), in which it is suggested that organizations which attempt to use formal planning mechanisms suggestive of the classical contracting mode in fact exercise a "power-behavioral approach" wherein plans and goals develop incrementally. Quinn's descriptive rather than normative account of planning processes suggests that the use of a series of discrete contracts is inconsistent with the prevailing tendency to develop emergent strategies.

20. See Macneil, *Contracts*, *supra* note 13, at 862.

21. See 3 A. CORBIN, CORBIN ON CONTRACTS § 534 (1960 & Supp. 1991); 4 S. WILLISTON, WILLISTON ON CONTRACTS § 602 (3d ed. 1961). The classical approach to contract interpretation resolves ambiguities by applying rules of construction. When the intention

standard and encourage predictability.<sup>22</sup> Relatively clearly marked standards of offer, acceptance, and consideration separate the realms of being within and without a contractual relationship.<sup>23</sup>

The goal of presentation, or the restriction of future effects through definition and stipulation in the present, is achieved as a by-product of the discreteness discussed above.<sup>24</sup> Presentation, like discreteness, creates stability. Precision and predictability aid in the accurate calculation of the present value of future transactions so that the risk-reduction function of classical contracting is highly specified and reliable. This function has some negative implications, however. Because humans tend to be risk averse,<sup>25</sup> they tend toward conservative strategy. Risk aversion has been blamed for portfolio management of corporations as well as a consequent failure to innovate and operate effectively in competitive markets.<sup>26</sup> Classical contracting and its orientation toward stability may provide a disservice in today's volatile markets.

### B. Neoclassical Contract

Neoclassical contract law lies on a continuum between classical and relational contract. If the classical extreme represents a single, isolated transaction, the relational end represents relationships which approach the creation of an organization.<sup>27</sup> The neoclassical approach to contracts is a compromise between the classical and relational extremes seeking to enhance flexibility in long-term contractual relations while maintaining a significant degree of stability and commitment. The neoclassical contract approach to planning for flexibility incorporates the use of standards,

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of the parties is not clearly manifest in the agreement itself, rules of construction attempt to guess the intent by extrapolating from standard or objective intentions under a given set of circumstances. This provides consistency of results from one instance of contractual ambiguity to another, regardless of the parties. The U.C.C. approach attempts to discern the actual intent of the contracting parties by examining their "course of dealing" in the past or "course of performance" after the contract was made. U.C.C. § 1-205 (1990). The U.C.C. approach is more neoclassical in its attempt to tailor construction to the individual parties' needs rather than to standardize construction in the interest of future generic contractual stability.

22. For a discussion of damages, the normal remedy for breach of contract, see C. McCORMICK, *DAMAGES* (1935).

23. *Cessna Fin. Corp. v. Mesilla Valley Flying Serv., Inc.*, 81 N.M. 10, 13, 462 P.2d 144, 147 (1969), *cert. denied*, 397 U.S. 1076 (1970).

24. See Macneil, *Contracts*, *supra* note 13, at 863.

25. Hayes, *Incorporating Risk Aversion into Risk Analysis*, 20 ENG. ECON. 99 (1975).

26. Hill, Hitt, & Hoskisson, *Declining U.S. Competitiveness: Reflections on a Crisis*, 2 ACAD. MGMT. EXECUTIVE 51 (1988).

27. I. MACNEIL, *CASES & MATERIALS ON CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONSHIPS* 70 (1971).

direct third-party determination of performance, one-party control of terms, and "agreements to agree."<sup>28</sup>

"Standards" refer to the use of criteria extrinsic to a contract which are incorporated by reference into the contract.<sup>29</sup> For example, adjustment of contractual wages based on the consumer price index gives flexibility to long-term contracts while maintaining much of the stability inherent in that medium. In fact, standards comprise an indirect third-party determination of performance.<sup>30</sup>

Direct third-party determination of performance<sup>31</sup> can consist of any contractually arranged mechanism for nonjudiciary settlement of disputes, but in its most common form it consists simply of arbitration procedures.<sup>32</sup> Third-party determination can be used both to settle disputes under the terms of the contract and to fill in gaps when the contract has failed to anticipate a dispute.<sup>33</sup> Commonly used in joint venture contracting, third-party determination brings security and rationality to areas of the relationship which might best be left open in deference to the need for flexibility.

One-party control of terms<sup>34</sup> allows a party to the contract the flexibility of a purchased option either to continue or to discontinue the

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28. Macneil, *A Primer of Contract Planning*, 48 S. CAL. L. REV. 627, 657-63 (1975).

29. See Macneil, *Contracts*, *supra* note 13, at 866.

30. The utilization of standards in contract terms ties performance criteria to the unforeseen threats and opportunities in the future environment. This departure from the classical goal of presentiation provides an opportunity for improved objective setting in the strategic process. Because the external standards applied in neoclassical contracting often fluctuate on the basis of changes in the environment, the contractual terms have a built-in modulator of unforeseen risk. Accounting for future exigencies in this manner serves both to lessen the risk at the time of contracting and to strengthen the likelihood that the contractual relationship will continue to serve the needs of both parties as originally intended. Although the precise goal of presentiation is not served thereby, it is served by a proxy of reasonableness: the standard applied will help ensure that unrepresented results come within the original intent of the parties. Inherent in this neoclassical approach is a strong contention that unrepresented but reasonable results are better than represented results which become both unreasonable and undesirable given the unforeseeable development of contingencies. For a discussion of the role of opportunity and threat assessment in this context, see F. AGUILAR, *SCANNING THE BUSINESS ENVIRONMENT* (1967).

31. See Macneil, *Contracts*, *supra* note 13, at 866.

32. The progress of contract jurisprudence away from the classical mode and toward the neoclassical and relational modes is reflected in the growing acceptance of arbitration and other forms of alternative dispute resolution in both contract and labor contexts. See, e.g., *Boys Markets Inc. v. Retail Clerks Local 770*, 398 U.S. 235 (1970).

33. See Macneil, *Contracts*, *supra* note 13, at 865. See Aksen, *Legal Considerations in Using Arbitration Clauses to Resolve Future Problems Which May Arise During Long-Term Business Agreements*, 28 BUS. LAW. 595, 599 (1973).

34. See Macneil, *Contracts*, *supra* note 13, at 868.

deal.<sup>35</sup> One party buys from the other the luxury of both the stability of a solid contractual claim and the flexibility of opting for a “no-deal” release.<sup>36</sup>

Use of particular cost terms is another neoclassical approach to achieving compromise between stability and flexibility.<sup>37</sup> Typically, the contract clause gives the seller cost plus some stable percentage above cost for profit.<sup>38</sup> These “cost-plus” provisions are similar to the standard setting technique in that they ensure a stable margin while normalizing the cost beneath that margin over time by tying it into the flexible standard of fluctuating costs.

Flexibility is built into neoclassical contracts using “agreements to agree,”<sup>39</sup> which are slippery provisions of questionable binding validity because they lack real substance. When contracting parties want to leave particular terms completely open, but wish to evince their good faith commitment to resolve the gap at a later and more appropriate time, they may include a provision agreeing to do so.<sup>40</sup> The concept is of limited legal value because it is difficult to enforce and likely to be invalidated in court.<sup>41</sup> The value of agreements to agree is more behavioral than legal because the manifestation of any commitment is likely to encourage continued dealings and the future determination of specific terms.

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35. *Id.*

36. Under classical contract law, unilateral options to discontinue a deal under certain conditions often invalidated the contract on the theory that the ostensible consideration was illusory because the agreement lacked mutuality of obligation. *G. Loewus & Co. v. Vischia*, 2 N.J. 54, 57, 65 A.2d 604, 606 (1949). The neoclassical approach of the U.C.C. tends to uphold such contracts based on an assertion that a conditional obligation coupled with a good faith obligation comprises real legal detriment. U.C.C. § 2-316 (1990).

37. See Macneil, *Contracts*, *supra* note 13, at 869.

38. The cost-plus approach has traditionally been employed in the government contracting procurement sector. It has also been developed as a mechanism for inferring price when no price term is explicitly stated. *Kuss Machine Tool & Die Co. v. El-Tronics, Inc.*, 393 Pa. 353, 355, 143 A.2d 38, 40-41 (1958); U.C.C. § 2-305 (1990). The cost-plus approach as a method of upholding agreements through inference of price is a neoclassical departure from the classical notion that a price term was necessary to establish minimal contractual specificity.

39. See Macneil, *Contracts*, *supra* note 13, at 870.

40. Under classical contract law, agreements are unenforceable if their content is uncertain or indefinite. *Parks v. Atlanta News Agency, Inc.*, 115 Ga. App. 842, 156 S.E.2d 137 (1967); *Hill v. McGregor Mfg. Corp.*, 23 Mich. App. 342, 178 N.W.2d 553 (1970); RESTATEMENT (SECOND) OF CONTRACTS § 32(1) (1978). Although agreements to agree may be invalid as contracts for omission of price, time, subject matter, and location terms, they serve the strategic function of developing open and flexible relationships within the context of some psychological commitment.

41. “Agreements to agree” are, *inter alia*, vague and imprecise in regard to the setting of contractual terms, and potentially lacking in consideration. See *supra* note 36 (illusory contracts and mutuality of obligation).

Taken together, these flexibility enhancing devices typify the neo-classical approach to contracting. Although flexibility is gained, an increment of presentiation is lost as some degree of total predictability at the time of contracting is sacrificed to future contingencies. The neo-classical genre of contracts makes concessions to planning needs by accommodating a more behaviorally realistic long-term relationship than is foreseen in classical contract theory as applied to wholly discrete transactions. In essence, neoclassical contracts are amenable to gap filling, and they recognize the reality of contractual omissions in all but the most isolated, discrete transactions.<sup>42</sup>

Neoclassical doctrine differs from classical doctrine in regard to consequences of dispute settlement in a manner which may be crucial to strategy, particularly joint venture strategy. Under the classical approach, breach of contract immediately terminates further performance expectations between parties.<sup>43</sup> The classical emphasis on legal remedies in general and monetary compensation in particular is impersonal, rendering the transaction a commodity, the breach of which is easily and predictably compensated.<sup>44</sup> The liberal application of a variety of legal remedies under the Uniform Commercial Code tends to support continued relations and the need for flexibility.<sup>45</sup>

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42. Neoclassical legal doctrines which have developed to increase flexibility of the contractual relationship include impossibility of performance and frustration of purpose. Under either of these defenses, clear and unambiguous agreement of terms can be superseded because performance has become impossible or commercially impracticable due to unforeseen circumstances or because an essential, mutually known purpose of performance has been thwarted by unforeseen forces. *See, e.g., Mineral Park Land Co. v. Howard*, 172 Cal. 269, 156 P. 458 (1916). These common-law principles admit the value of undermining a firm agreement for fairness reasons given unforeseen changes of circumstance. The Second Restatement of Contracts generates similar flexibility, potentially at the cost of contractual stability. For example, to avoid an injustice, a court may supply contractual terms omitted from the document which are "reasonable under the circumstances." *RESTATEMENT (SECOND) OF CONTRACTS* § 292(2) (1978).

43. *See, e.g., Jacob & Youngs v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921). Substantial performance is considered a constructive condition to a second party's duty to perform under common law. This means that a material breach of contract excuses performance of the nonbreaching party. The effect of this classical approach is to terminate expectations, duties, and relations between parties when a breach occurs.

44. The classic remedy for breach of contract favors discreteness rather than continuous relationships and consequently awards damages rather than specific performance. Thus, under ordinary circumstances, the aggrieved party is entitled to the "benefit of the bargain" in the form of monetary compensation as required to make him whole in new, unrelated market transactions calculated at replacing the lost object or service. Only under extraordinary circumstances, typically when goods or services are considered unique and irreplaceable in the marketplace, is the aggrieved party entitled to specific performance of the promised task. *See Farnsworth, Legal Remedies for Breach of Promise*, 70 *COLUM. L. REV.* 1145 (1970).

45. The neoclassical approach of the U.C.C. broadened the potential application

Neoclassical contracting attempts to empower a party to force relations to continue during conflict. Grievance and arbitration clauses improve the likelihood of dispute resolution and continuing relations between parties. Clauses are regularly employed prohibiting walkout during resolution of a dispute. Although the binding nature of these clauses is questionable, contractual provisions may encourage continued relations by stipulating compelling damages in the event that a party disrupts performance.

These neoclassical modifications of contracting reflect the classical mode's self-confining, often unresponsive approach to real-life situations. The classic goals of discreteness and presentiation are unattainable, most significantly because all eventualities cannot possibly be foreseen between contracting parties. A contract cannot be discrete because it exists in an open system of environmental change,<sup>46</sup> and it cannot attain presentiation because the parties are neither prescient nor in full control over a wide array of potential future contingencies. Given the inevitability of these limitations, neoclassical law trades a measure of both discreteness and presentiation in order to improve the legal environment in which real parties develop continuing relationships and contracts, the needs of which change over time and cannot be considered either discrete or presentiated. The gain in flexibility is achieved by inhibiting rigidity of both the terms of contracts themselves and the legal construction of these terms by courts.

### C. *Relational Contract*

As noted earlier, the classical contract was driven by two ideals, discreteness and presentiation, which do not exist in the real world, but instead represent the desire for order, stability, and predictability in business relations. Whereas neoclassical contract theory developed as the natural response to the realities of unpredictability, changing circumstances, and environmental instability, relational contract law is a conscious response to the true nature of business relations.<sup>47</sup> Agreements,

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of specific performance, implicitly emphasizing flexibility and legal support of ongoing contractual arrangements. U.C.C. § 2-716 (1990).

46. The open systems approach is well accepted in the discipline of organization theory. Organizations operate within dynamic and often volatile environments which are crucial to the planning process. For a detailed discussion of the necessity to view organizations as open systems, see D. KATZ & R. KAHN, *THE SOCIAL PSYCHOLOGY OF ORGANIZATIONS* (1978).

47. The management literature reflects a growing recognition that strategies are, and to a large extent must be, emergent and incremental rather than formal and post hoc. For the classic statement of this tendency, see D. BRAYBROOKE & C. LINDBLOM, *A STRATEGY OF DECISION: POLICY EVALUATION AS A SOCIAL PROCESS* (1963); Lindblom, *The Science of "Muddling Through,"* 19 *PUB. ADMIN. REV.* 79 (1959).

far from being neatly packaged and discrete, vary widely and approach, at the relational extreme, the creation of new organizational boundaries. Just as contracts exist creating relationships between separate firms over long periods of time, contractual relationships exist both within functionally structured companies and between the business units of multi-divisional companies. Under these circumstances, discreteness and presentation, still desirable contractual characteristics for reliable planning purposes, become extraordinarily difficult to achieve.<sup>48</sup> These two classic contract goals become ultimately less compelling than flexibility and responsiveness to change as the parties become less discrete (and therefore more relational) and as the environment becomes more turbulent and volatile.<sup>49</sup> Although classical contract theory sacrifices flexibility in favor of stability, relational contract law seeks to accommodate relational priorities.

Relational contract concepts are largely incipient ideals rather than a reflection of significant judiciary trends.<sup>50</sup> Relational notions differ from neoclassical concepts in their ultimate reference to the current and shifting relationship between parties, rather than the original agreement. This is in part the creation of scholars seeking to alter the common law of contracts to meet the current strategic needs of modern firms.<sup>51</sup> Although contractual language is not jettisoned in the process of dispute resolution, it is interpreted loosely and with wide discretion to adapt to a holistic view of the altering relationship. Whereas the neoclassical approach to

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48. There is, however, a trade-off between discreteness and presentation benefits of classical contracting and other types of stability achieved by creating a complex system of relations. Relatively relational contracting has been viewed as a cooperative mechanism for coopting potentially threatening organizations, thereby enhancing stability. J. THOMPSON, *ORGANIZATIONS IN ACTION* 35-38 (1967).

49. The relationship between volatility/turbulence and flexibility is intuitively compelling: the more unpredictable the threats and opportunities in the business environment, the greater the demand for flexible rather than stabilized response mechanisms. Strategic tools for uncertain environments are discussed in O'Connor, *Planning Under Uncertainty: Multiple Scenarios and Contingency Planning*, THE CONFERENCE BOARD REPORT NO. 741 (1978).

50. Classical contract ideology can be viewed roughly as comprising the common law of contract, whereas neoclassical contract approaches are embodied in some of the more flexible reforms contained in the Uniform Commercial Code. Relational contracting in its ideal form trades rigid enforcement of legal doctrines and commitment under classical contract law for the adjustment of relations which best manifests the original and developing needs of the parties. This conception of contract is an ideal type rather than a description of the bulk of extant legal doctrine. Relational contract is nonetheless of vital importance in terms of both its descriptiveness of actual classically nonlegalistic behavior of contracting parties as well as its normative value in shaping the future of legal contract doctrine.

51. See, e.g., Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005, 2030 (1987) (discussing the need for adjustment in long-term contracts).

contractual disagreement seeks to end the dispute,<sup>52</sup> relational techniques are less concerned with clear, expedient, unambiguous results. Instead, the techniques sacrifice ultimate dispute resolution in favor of continuing the relationship.<sup>53</sup>

The relational approach to contracts recognizes that although contract terms are finite and circumscribed, the disputes which arise between parties usually do not conform to these pre-existing confines. Instead, they change within a natural context of organic change and development.<sup>54</sup> As a result, disputes are often immune to any effective quick fix based solely on the language of the contract document. Negotiation and mediation, considering both the document and the continuously unraveling pattern of relationships between the parties, may be the most effective mode of resolution.

Macneil's conception of relational analysis admits the continued importance of restitution, reliance, and expectation interests in the process of contracting.<sup>55</sup> Whereas neoclassical scrutiny seeks to protect these three objects by referring to language of promise, relational examination views the realistic expectations of the parties as the product of promises and the development of relational behavior patterns.<sup>56</sup> In seeking to fashion restitution to support a party's reasonable expectations and to support justifiable reliance, reference is made to intent as evinced by contract language and subsequent acts, statements, and overall behavior. As relations become closer, the parties approach a blurring of organizational boundaries. As the relationship develops a culture and set of norms, they also become part of the context in which dispute resolution occurs.<sup>57</sup>

## II. THE ROLE OF LAWYERS AND MANAGERS

Relational contracting seeks to mitigate dysfunction in contracting systems at two levels: the judicial approach to interpreting contracts and

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52. Even the neoclassic invention of arbitration seeks to achieve this relatively discrete end.

53. The relatively discrete and inflexible nature of neoclassical dispute resolution is apparent in the characteristics of traditional litigation. Lawsuits circumscribe, in often unrealistic and unnatural ways, the elements of a disputed transaction. There is typically a winner and a loser, based on a finite set of past events contained in an isolated incident. See, e.g., Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1283-88 (1976).

54. For a discussion of the inherently organic nature of organizations, see von Bertalanffy, *The History and Status of General Systems Theory*, 15 ACAD. MGMT. J. 411 (1972).

55. See Macneil, *Contracts*, *supra* note 13, at 887-95.

56. *Id.*

57. The application of the extracontractual, idiosyncratic expectations of the parties as well as the norms and culture which arise from the developing relationship to contractual construction is somewhat evident in the U.C.C.'s use of "course of dealing" and "course of performance." See *supra* note 20.

developing common law or U.C.C. doctrines and the strategies utilized by particular parties in drafting contracts.<sup>58</sup>

The planning process can be confounded during the contracting stage when people who are traditionally nonstrategists have influence and control. The fact that lawyers control the contracting process may affect strategy as discussed in the following propositions.

*Proposition 1:* Lawyers think differently than strategists. Specifically, lawyers are trained in contracting to avoid conflict, avoid ambiguity, reduce risk, and foster stability and predictability.<sup>59</sup> Strategists focus instead on adaptation of strengths and weaknesses of the firm to the vicissitudes of the environment.<sup>60</sup> They continually survey the world for new threats and opportunities, and on-going monitoring for changes is considered essential.<sup>61</sup> Flexibility is crucial, and a sustained, continued effort at fashioning new, innovative solutions in unforeseen ways is highly valued. In short, lawyers are likely to be inclined to encourage discreteness and presentation in contracts, whereas strategists tend to value, through their training and experience, ad hoc, flexible responses to environmental shifts.

*Proposition 2:* Incremental strategy, to the extent that it is necessitated by volatility and the need to forestall important strategic decisions to the last possible moment,<sup>62</sup> is more compatible with strategic thinking than with legalistic thinking. Proponents of formal strategic planning give significant attention to continual adjustment, monitoring, steering, contingency planning and the like.<sup>63</sup> Lawyers' work can undermine incremental

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58. See Macneil, *Contracts*, *supra* note 13, at 855. Macneil discusses adjustment of long-term economic relations both in terms of "legal response to planning" and preservation of contractual relationships.

59. See H. BERMAN & W. GREINER, *THE NATURE AND FUNCTIONS OF LAW* 6 (1980). The authors discuss "the proper purposes of law study" as "understanding the legal order as a vital part of the social order." *Id.* The emphasis on "order" is carried throughout the law curriculum and is particularly salient in procedural doctrines such as stare decisis and due process.

60. For a detailed discussion of this particular orientation, see K. OHMAE, *THE MIND OF THE STRATEGIST* (1982).

61. See P. LORANGE, *CORPORATE PLANNING: AN EXECUTIVE VIEWPOINT* 120 (1980). Lorange discusses strategic planning systems as a five-stage process during which monitoring for change through effective environmental surveillance is essential, particularly under conditions of volatility. This process of strategic development and evolution does not fit neatly in the classical contracting mode characterized by discreteness and presentation.

62. For a discussion of the disadvantages of formal strategic planning systems, many of which foster presentation by utilizing an annual planning process which is classical in its attempt to solidify strategic commitments in advance in a formal manner, see Hall, *Strategic Planning Models: Are Top Managers Really Finding Them Useful?*, 8 J. BUS. POL. 33 (1972).

63. See P. LORANGE, *supra* note 61, at 196-99.

thinking to the extent that attorneys emphasize early and complete commitment to clearly specified terms, often with precisely delineated remedies that are more concerned with quick and expedient resolution than continuance of strategic alliance.

*Proposition 3:* Strategic input in the contracting process will tend to be more relational, whereas legal input will tend to be more classical. This follows logically from the first two propositions. Strategists are usually concerned with fashioning workable solutions and continuing desirable ventures, particularly in the instance of joint venture contracting which presumes a close relationship between parent parties. In particular, they will want commitments to be flexible in the event that environmental changes suggest strategic alteration. Attorneys are more likely to approach contracting with one eye looking ahead to disputes, resultant lawsuits, and often a terminal resolution containing a clearly defined issue, an ultimate winner and loser, and a reference to an aging contract which may bear little resemblance to the business relations as they have evolved in a rapidly changing environment.<sup>64</sup>

*Proposition 4:* Lawyers usually have significantly greater input in the joint venture contracting process than do strategists. This phenomenon is a function of two factors: the traditional temerity of laypersons in regard to legal issues and the bifurcation of strategy and law/contracts in the minds of business people.<sup>65</sup>

Taken together, these propositions bear several important implications. Although lawyers tend to be less strategic than strategists and are more likely to err in favor of the more rigid classical form, they may also usurp the joint venture contracting phase because contracts are generally viewed as legal safeguards that no one understands or reads.<sup>66</sup> Several potentially damaging consequences result.

First, in the event of dispute and subsequent litigation, any reference to the contract will tend to reveal discrete, classical contract thinking

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64. For a discussion of the socialization of attorneys in the process of professional legal education in the United States, see L. FORER, *MONEY AND JUSTICE* 208-211 (1984). Forer observes that much of the training which occurs in law school attempts to teach students to think like lawyers. Given that the traditional case method which conserves traditional and classical approaches to law is still the dominant method of American legal education, it is not surprising that lawyers are socialized to value clear resolution over adaptation.

65. Extensive interviews with strategists for joint ventures have supported these assertions. See S. SALBU, *STRATEGIC IMPACT OF THE JOINT VENTURE CONTRACTING PROCESS* (1990).

66. The law as it has become relational has begun to recognize the fact that persons routinely sign contracts which they have not read. This phenomenon is in part the basis for such legal doctrines as construction of contracts against the drafter, particularly when the contract is detailed boilerplate and there is a disparity of power between parties. See, e.g., *Comprehensive Health Ins. Ass'n v. Dye*, 531 N.E.2d 505 (Ind. Ct. App. 1988).

which may impair the possibility of compromise and continuance of a potentially beneficial alliance.

Second, even if no dispute arises, the bifurcation of contracting and strategy as separate spheres of operation can deny the parent companies an invaluable opportunity to use the contracting process strategically: for recognition of threats and opportunities, for optimal negotiating between parties, and for the early and clear creation of workable objectives, goals, programs, and budgets.<sup>67</sup> The labor and capital invested in the creation of the joint venture contract are strategically diminished if done solely by attorneys. The type of thinking that is done in the contracting stage will often approximate scenario building techniques,<sup>68</sup> which attempt to foresee a variety of contingencies and provide for each. This is the kind of activity that is a vital part of the planning process, and significant contracting participation by planners can be an invaluable strategic exercise that yields a contract that is both more strategic and relational.

Third, bifurcation of the contracting and planning functions is a manifestation of the kind of classical thinking that views agreements as discrete rather than relational. The tone set for the entire enterprise may be ideologically regressive, reinforcing a culture wherein clear demarcations are expected and irrational boundaries are supported in the quest for the finite and the discrete. Just when a fluid and organic conception of the relationship is in order, artificial bounds are encouraged.

These propositions and their consequences bear implications concerning the training of lawyers and the allocation of tasks. Attorneys should have less absolute input in drafting the joint venture contract, and strategists should work closely with them to maximize the desired ends of flexibility, responsiveness to environmental change, and the encouragement of any desired relational support.

An alternative view suggests that while strategists should bear greater responsibility in the contracting process, the socialization of attorneys is deficient in its failure to educate lawyers who understand the needs of their clients for mediation, compromise, flexibility, and a tolerable level

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67. While the world of legal commentary has given substantial recognition to the idea of alternative dispute resolution, less emphasis has been placed on preventive legal practices. The unification of legal and strategic aspects of the contracting process should result in more realistic and germane documents that lessen the likelihood of any dispute arising.

68. The literature on scenario building provides an excellent normative framework for lawyers engaged in contract development who attempt to tailor the document to the idiosyncracies of the particular parties. For a discussion of this strategic technique, see W. ROTHSCHILD, *STRATEGIC ALTERNATIVES: SELECTION, DEVELOPMENT AND IMPLEMENTATION* (1979). Scenario techniques have been used extensively by the Royal Dutch Shell Company. These tools are discussed in ROYAL DUTCH SHELL COMPANY, *THE DIRECTIONAL POLICY MATRIX: A NEW AID TO CORPORATE PLANNING* (1975).

of strategically advantageous ambiguity. If lawyers are trained only to ensure the classic goals of stability and discreteness of transactions, then they are in large part unresponsive to the needs of their business clients as they have evolved.

### III. CONTRACT TYPOLOGY AND TRANSACTION COST ANALYSIS

Joint ventures can be viewed as attempts by parent parties to rationalize and internalize markets by redesigning existing organization configurations.<sup>69</sup> From the perspective of transaction cost analysis, contracts establishing joint ventures should be evaluated based on economies relative to other options. What follows is a summary of the basic markets and hierarchies perspective<sup>70</sup> and a discussion of the relationship between transaction cost concepts and Macneil's contract typologies.

Transaction cost theory is a branch of economics that reduces the level of analysis from the more typical market analysis to the single transaction.<sup>71</sup> The earliest work in the area examined the vertical integration decision and determined that integration is indicated when the cost of a flexible employment agreement is less than the cost of negotiating and executing the contracts used in dealing with an intermediate product market.<sup>72</sup> Under this new economic approach, decisions concerning organizational design were attributed to differential transaction costs.<sup>73</sup>

Markets and hierarchies analysis has been broadened beyond its original scope of contract versus vertical integration issues. This analysis is applied to determine the suitability of three main models for the governance of transactions: (1) markets; (2) quasi-markets, including

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69. A desire to make markets more rational often directs organizations to make an integration versus contracting decision in regard to suppliers and buyers. See Klein, Crawford, & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. LAW & ECON. 297 (1978).

70. See, e.g., O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975) [hereinafter O. WILLIAMSON, *MARKETS*].

71. See O. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985).

72. Coase, *The Nature of the Firm*, 4 *ECONOMICA* N.S. 386 (1937).

73. See Williamson, *The Vertical Integration of Production: Market Failures Considerations*, 61 *AM. ECON. REV.* 112 (1971). Williamson operationalized this theoretical foundation by modeling the vertical integration decision. He applied transaction costs rather than aggregate measures as the decisionmaking unit of analysis and determined differential costs for various modes of contracts and transactions. In the process, he departed significantly from traditional microeconomic theory, which would examine vertical integration in terms of production functions and the theory of the firm. Williamson's model begins not with what he calls "hyperrational" production functions, but with a more fundamental question which precedes it: given assumptions of bounded rationality, what is the least expensive means of organizing transactions?

“obligational market contracting”<sup>74</sup>; and (3) internal organization.<sup>74</sup> Williamson identified critical criteria for the choice of governance model: the degree of uncertainty, the frequency of transactions, and the degree of idiosyncratic transaction.<sup>75</sup>

The markets and hierarchies literature is not limited to viewing economic decisions from a transaction cost perspective. As make-or-buy is determined to be a function of mitigating transaction costs, the broader question of organizational design is also seen as a transaction cost issue.<sup>76</sup> In particular, the joint venture form may be chosen as a means of minimizing transaction costs.<sup>77</sup>

Overlap exists between the markets and hierarchies approach to economics and Macneil's contract typology. Perhaps because Macneil's three categories are somewhat arbitrary denominations along a continuum, Williamson prefers to refer to the contracts as relatively “hard” or “soft.”<sup>78</sup> Hard contracting occurs when autonomous parties express obligations with specificity and under more classic adversarial assumptions. Hard contracts are powerful by virtue of the legal and economic sanctions which are incurred in the event of breach. Soft contracts are made between related, less autonomous parties and lack the specificity of classical contracting. Their power is derived not from legal and economic sanctions, but from social controls and cultural pressure. Soft contracting, or relational contracting in the vernacular of Macneil, relies much more

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74. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. LAW & ECON. 233, 247-54 (1979) [hereinafter Williamson, *Governance*].

75. *Id.* at 239. The movement from markets to hierarchies is encouraged when the degree of uncertainty is nontrivial and transactions are frequent and idiosyncratic. A significant degree of uncertainty, threatening the availability of either suppliers or end users, is needed to justify the expense of integration. The number of market transactions must also be frequent enough to amortize efficiently the cost of developing the governance structure. The “idiosyncratic transaction” requirement means that the product is relatively specialized for the use of the buyer. When products are custom made and not for general usage, excess production is wasted and cannot be channeled to other buyers in the marketplace. The threat of waste combined with a need to plan carefully and precisely the number of units needed suggest internal organization as a means of achieving stability.

76. The decision to enter into a joint venture would be attributed in this analysis to reduction of transaction costs. Because the transactions are simply an economic designation of the contracting process, joint venture contracting can be evaluated from the standpoint of transaction cost efficiency.

77. See Hennart, *A Transaction Cost Theory of Equity Joint Ventures*, 9 STRATEGIC MGMT. J. 361 (1988).

78. O. WILLIAMSON, *MARKETS*, *supra* note 70. See Ouchi, *Markets, Bureaucracies, and Clans*, 25 ADMIN. SCI. Q. 129 (1980). The concept of soft contracting is derived from Williamson's concept of the “economics of atmosphere” and Ouchi's discussion of bureaucratic versus clan-type styles of management. Soft contracting is similar to relational contracting in its less formalistic approach to organizational challenges, which is typical of clan-type arrangements.

crucially on a good fit between the contract itself and the culture into which it is introduced.<sup>79</sup>

Transaction cost theory applied to contract choices suggests that the decision between soft and hard contract style should be a function of the relative cost economies associated with each. Applying transaction cost theory to Macneil's contract typology, the following propositions emerge.<sup>80</sup>

*Proposition 5:* The more a joint venture is steeped in overall conditions of uncertainty,<sup>81</sup> the more appropriate relational contracting will be.<sup>82</sup> This proposition is a function of an underlying assumption: when the environment is predictable, transaction costs of classical contracting, accompanied by discrete, clear distinction between the two parent companies, will be minimized. Conversely, when the environment becomes sufficiently unpredictable and uncertain, transaction costs will be minimized by relational contracting and the development of an ongoing, organic relationship.

Areas in which levels of uncertainty might be relevant in joint venturing include: (1) the speed and nature of technological change; (2) the changing requirements of parent companies for the use of the venture to stabilize supply or market distribution; and (3) the evolving nature of competition in the industry in which the venture operates. When technological change is relatively slow and predictable, hard contracting reduces transaction costs by stabilizing the expectations of the parties in a way that will require little alteration or modification over time. One relatively inexpensive contract iteration fixes technological decisions so that other obligations and opportunities can be fixed at an optimal level of efficiency. Essentially, a single, clearly outlined agreement can be used to delineate technological specifications over a long planning horizon.<sup>83</sup>

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79. Macneil, *Futures*, *supra* note 15, at 738-44.

80. These three propositions directly apply the dimensions of transactions identified by Williamson to the case of joint venture contracting. Williamson states that these critical dimensions are uncertainty, transaction specificity, and frequency. See Williamson, *Governance*, *supra* note 74, at 239.

81. See *id.*

82. By their nature, joint ventures are likely to be characterized by uncertainty to a greater degree than organizations of noncollaborative origin. Although most of the literature regarding the unsettling effects of clashes in culture concern mergers, the principles apply analogously to joint venture situations in which the degree of collaboration can be significant. See, e.g., A. BUONO & J. BOWDITCH, *THE HUMAN SIDE OF MERGERS AND ACQUISITIONS: MANAGING COLLISIONS BETWEEN PEOPLE, CULTURES AND ORGANIZATIONS* (1989); BUONO, Bowditch, & Lewis, *When Cultures Collide: The Anatomy of a Merger*, 38 *HUM. REL.* 477 (1985).

83. Although highly specific, long-term contracts are more viable under stable rather than volatile conditions. Long-run agreements are more likely to involve informal under-

Relational contracting that fails to fix technological decisions firmly and completely from the beginning leaves room for unnecessary revision and renegotiation of what is essentially a stable variable. In a relational contracting process, the natural pattern of behaviors unharnessed by hard contracting will tend toward wasteful reassessment and repetition of the basic transaction between venturing parties under assumptions of technological stability.<sup>84</sup>

Conversely, if the technology is volatile, classical contracting will be inappropriate because the specificity entailed in this process will need continuous revamping at great transaction cost because lawyers and planners constantly draft new formal agreements. When relational contracting is used in volatile technology cases, the behavioral variation of requirements necessitated by rapidly changing assumptions will be less costly than creating a series of rigid contracts.<sup>85</sup>

The scope of the joint venture contract can also be handled using a relatively classical or relational contracting procedure. If the competitive environment is stable, perhaps by virtue of high barriers to entry and technological limitations to the potential threat of substitutes,<sup>86</sup> classical contracting should minimize transaction costs. Specificity will render the usual advantages of stability, although any loss of flexibility will have minimal impact in an environment which is unlikely to change. When an industry is susceptible to both new entrants and substitute products or technologies, flexibility will be of crucial importance. The ability to maneuver quickly, easily, and with little notice, increases the cost of inflexible, rigid contract terms: A more efficient option in this instance is relational contracting, under which a monitored competitive environment

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standings than short-run agreements because an increased span of time reduces foreseeability by its very nature. The study of informal institutions of contracting is thus especially concerned with longer contracts. See Williamson, *Assessing Contract*, 1 J.L. ECON. & ORG. 177 (1985).

84. For a more elaborate discussion of the nature of fixed bargains in contract law, see Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741 (1982).

85. Likewise, hard contracting will be cost efficient in rationalizing supply or distribution markets only if such markets are fairly stable to begin with. Hard commitment to purchase X units from the venture per year for five years is efficient only under the assumption that the quantity will be adequate over the life of the contract. As often as unstable conditions render the committed amount inadequate, another formal contracting transaction will add to the overall transaction costs. If the quantity specified in a hard contract proves appropriate over the life of the contract, then the important objective of rationalizing supply has been obtained at the bargain rate of one detailed contract.

86. The competitive environment of industries has been addressed in great detail by Michael Porter. Volatility is created by competitive forces which are a product of power of buyers, power of suppliers, barriers to entry, threat of substitute products, and jockeying for position within the industry itself. See M. PORTER, *COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS* (1980).

is unshackled by unnecessary and unduly burdensome degrees of commitment. Relational contracting can create a culture and framework for more natural responses to change. An increment of transaction cost efficiency is gained in both reduced legal fees and increased speed of decisionmaking.<sup>87</sup>

*Proposition 6:* The more idiosyncratic the transactions between the parent companies and the joint venture, the more appropriate relational contracting techniques will be.<sup>88</sup> Idiosyncratic transactions are those that involve a product or service which cannot readily be diverted to the marketplace in the event that the needs of either party change.<sup>89</sup> The crucial consideration regarding costs for idiosyncratic transactions is high risk. Idiosyncratic products or services have no value if they cannot be used by the particular contracting parties. This phenomenon magnifies the expense of overproduction. The resulting "waste leverage" does not recommend classical contracting, particularly when such leverage exists in a volatile marketplace. Early and specific commitment for the sale and purchase of idiosyncratic products or services augments the likelihood of error in calculating an appropriate target quantity. If the venture is to supply each parent with idiosyncratic products in contractually fixed quantities and is non-negotiable, environmental changes that alter supply needs cannot be accommodated. Production is likely to exceed or to fall short of actual need, and in the former instance, the parents' contractual assumption of risk of oversupply will be extremely costly. A soft contracting process which tends to informalize relationships and internalize market mechanisms avoids such an early overcommitment. Quantity orders can be determined on a rolling basis, resulting in greater accuracy of supply-needs predictions. A concomitant reduction of supply error will reduce the number of idiosyncratic units over which leveraged loss occurs.

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87. See P. LORANGE, *supra* note 61, at 196-99. The logic behind this proposition is supported by Lorange's discussion of the environmental predictability and the optimal degree of delegation. When the environment is stable and predictable, delegation is effective, and when the environment is unstable and unpredictable, a lower level of delegation is recommended. Delegation is a nonrelational analogue of hard contracting. Because future developments are predictable, quantifiable, and stable, one initial contractual transaction is cost efficient. Nondelegation is a relational analogue of soft contracting. Rather than use one legalistic and specific contractual delegation, the decisionmaker is advised to retain discretionary control in order to address decisions at the last possible moment. In this situation, the decisionmaker emphasizes a continuing relationship with key actors so that decisions can be made more idiosyncratically and incrementally, and therefore, more responsively to the volatile environment.

88. See Williamson, *Governance*, *supra* note 74, at 247-60.

89. For a discussion of the nature of idiosyncratic services and products and their relationship to transaction cost economics, see Williamson, *Franchise Bidding for Natural Monopolies — in General and with Respect to CATV*, 7 BELL J. ECON. 73 (1976).

In this way, the soft contracting mechanism should be the more efficient choice under conditions of idiosyncratic transaction.

*Proposition 7:* The more frequent the transactions under the joint venture business, the more appropriate relational contracting will be.<sup>90</sup> Classical contracting is premised on insularity of transactions and the absence of significant ongoing relations. As quantity and frequency of transactions increase, the relational nature of the transactions is strengthened. Patterns of behavior replace rigidly defined contractual arrangements as the more cost efficient option, and parent companies learn to coexist under cultural norms. Although the creation of a strong culture undoubtedly incurs expense, there will be a point at which this expense is exceeded by the cost of enforcing individual classical contract provisions. The expense is likely to be an incidental by-product of the frequently occurring transactions and therefore will be subsumed therein and reduced over time.

The adoption of relational contracting and an appropriate culture of clan-type management should be a natural process.<sup>91</sup> As the frequency of transactions approaches infinity, the market relationship between two completely independent parties should approach synthesis. The joint venture, lying somewhere between these two extremes, should evince transaction cost efficiency by using relational contracting as a function of the frequency of transactions.

#### IV. THE IMPACT OF CONTRACTING CHOICES ON JOINT VENTURE STRATEGY

The discussion to this point has focused on different approaches to joint venture contracting, the tendencies of lawyers and strategy makers in employing these approaches, and the effect of these choices in terms of transaction cost theory. The propositions and observations in the preceding sections play a significant role in improving the use of joint venture contracting in the strategic planning process.

Lorange provides a useful framework for this analysis by describing both symptoms of organizational joint venture dysfunction and strategies for approaching a win-win posture.<sup>92</sup> Symptoms of venture dysfunction include: (1) conflict-ridden internal communication; (2) energy spent on stressful interactions; (3) the static state of a relationship which is ill-

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90. See *supra* note 80.

91. Ouchi distinguished between bureaucratic and clan-style management, reflecting from an organizational standpoint differences which legal scholars characterize as classical and relational contract. See Ouchi, *The Transmission of Control Through Organizational Hierarchy*, 21 *ACAD. MGMT. J.* 248 (1978).

92. Lorange, *Creating Win-Win Strategies for Joint Ventures* (Wharton working paper 88-103, July 1988) [hereinafter Lorange, *Win-Win Strategies*].

equipped for adaptation; and (4) disparity between partners over time.<sup>93</sup> Conflict in communications can result from a failure of the parties to participate in the setting of procedures and ground rules during the contracting stage and leads to wasted energy which weakens, rather than strengthens interactions because the contracting process does not take the natural development of the relationship between the parties seriously. Likewise, poor adaptation potential is a central weakness of contract processes which attempt to fix terms with greater precision than is necessary strategically.<sup>94</sup> The creation of disparity between partners over time is a natural symptom not only of venture dysfunction but of a failure to address the need for the venture to develop over time within a contractual framework which enhances, rather than impedes the process.<sup>95</sup>

Lorange suggests that a win-win posture can be attained through the process of "putting together and managing the joint venture."<sup>96</sup> The vernacular chosen here is crucial. The creation and management of the venture are viewed as connected functions, implying the importance of structuring the venture through the contracting process. Creation and development are not conceptualized as isolated or insular projects, and in a sense, the importance of relational ideology is thus assumed.<sup>97</sup> In particular, the prescription includes: (1) explicit and realistic understanding of competitive realities when the venture is created; (2) assurance of continued productive contribution by both parents, utilizing the dynamic change of roles if necessary; (3) planning and control routines for easier

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93. *Id.* at 2.

94. For a discussion of the importance of relinquishing control in favor of adaptability within the context of corporate volatility, see J. KIMBERLY & R. QUINN, *NEW FUTURES: THE CHALLENGE OF MANAGING CORPORATE TRANSITIONS* 308-09 (1984).

95. Organizational development has become a function of loosely structured decision processes as technological advances and change occur more rapidly in a highly competitive environment. For a discussion of the strategic foundations for change, see Mintzberg, Raisinghani, & Theoret, *The Structure of "Unstructured" Decision Processes*, 21 *ADMIN. SCI. Q.* 246 (1976); Van de Ven, *Central Problems in the Management of Innovation*, 32 *MGMT. SCI.* 590 (1986).

96. See Lorange, *Win-Win Strategies*, *supra* note 92, at 3.

97. The dichotomy in the strategy literature which usually presumes that creation and development are separate and unrelated processes, consists of "formulation" versus "implementation." See, e.g., Cohen & Cyert, *Strategy: Formulation, Implementation, and Monitoring*, 46 *J. BUS.* 349 (1973). The development of a literature of "management control" likewise distinguishes itself implicitly from creation or formulation of the strategy. See, e.g., Vancil, *What Kind of Management Control Do You Need?*, 51 *HARV. BUS. REV.* 75 (1973). Implicit in the work of those suggesting incremental or emergent rather than formal strategy is an assumption that the dichotomy between formulation and implementation is false or arbitrary. See Quinn, *Managing Strategies Incrementally*, in *COMPETITIVE STRATEGIC MANAGEMENT* 35-61 (Lamb, ed. 1984). Relational approaches to contracting are consistent with this philosophy.

adaptation; (4) effective human resource management modes which aid rather than impede managerial motivation; and (5) enhancement of learning in the venture process.<sup>98</sup>

These win-win vehicles and the contracting process are related. The contracting process is crucial to the manner in which understandings are evinced and constructed by the parties. Likewise, the creation of a system which supports dynamic change and assures commitment to and continuing benefit from the venture by both parents is the goal of successful relational contracting. At the center of relational techniques is the recognition that dynamic change can be a more important criterion for success than specificity, presentation, and predictability of terms.<sup>99</sup> Planning and control routines for easier adaptation are essentially relational as well. Managerial motivation in complex and rapidly changing environments will be subsumed in the ability of the venture to react flexibly to volatile environmental signals.<sup>100</sup> For these reasons, relational contracting appears to be more compatible with the development of joint ventures than the more traditional classical and neoclassical modes. A number of propositions follow from this observation as well as the preceding propositions. *Proposition 8.* Understanding of competitive realities at the time the venture is created can be significantly enhanced if venture parents become more involved in the joint venture contracting process. The connection between contracting and the competitive environment is not immediately evident, and in fact, the two may appear to be unrelated. Contracting is traditionally viewed as a manifestation of the agreements between two parties,<sup>101</sup> although the competitive environment is seen as a relatively immutable given which simply provides structure to the framework in which strategy occurs.<sup>102</sup> Only when the tendency to view the contracting and strategic processes in isolation is transcended can we begin to witness the potential usefulness of contracting in understanding competitive realities.<sup>103</sup>

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98. See Lorange, *Win-Win Strategies*, *supra* note 92, at 3-4.

99. Macneil, *Futures*, *supra* note 15, at 738-44.

100. These fundamental win-win components are reflected in Lorange's final emphasis: enhancement of learning in the venture process. Such learning applies to all the other four criteria and would not be important if it did not yield the possibility of strategic shifts, reordering of priorities and processes, and in rethinking every central element of the venture in general. In other words, implicit in this emphasis on learning is the assumption that win-win strategies must certainly contain a mechanism for change and development at a minimum. This mechanism is really the central thrust of relational contracting and the ends it seeks to support.

101. See, e.g., *Russell v. Union Oil Co.*, 7 Cal. App. 3d 110, 86 Cal. Rptr. 424 (1970); *Cessna Fin. Corp. v. Mesilla Valley Flying Services, Inc.*, 81 N.M. 10, 462 P.2d 144 (1969), *cert. denied*, 397 U.S. 1076 (1970).

102. See *supra* note 86.

103. For example, the parents of a joint venture should not enter an agreement

*Proposition 9.* Continued, good faith contribution by both parents can be supported by real parent participation in a relational contracting process. Lorange suggests that different underlying agendas can impede the functioning of the joint venture, often resulting in a lack of openness and honesty.<sup>104</sup> Under these conditions, a discrepancy is likely to develop between a parent company's stated goals and its actions.<sup>105</sup> This type of inconsistency can endanger the continued success of the venture and lead to disagreement, hostility, and additional subterfuge. When the parent companies participate in the contracting process instead of delegating contracting to lawyers, they obtain psychological ownership of the arrangement and are more likely to discover and negotiate differences in underlying agendas before the implementation stage.<sup>106</sup>

Meaningful participation in an ongoing, relational contracting process thus serves to strengthen commitment and understanding between parties, enhancing the likelihood of sound implementation of the venture's programs. To the extent that this function cannot be perfect, relational contracting can provide economic incentives for compliance in the event of conflicting interests. Examples of these incentives include reciprocal

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concerning the legal and strategic scope of the venture without examining the competitive environment. Among other things, competitive analysis will help reveal the difficulty of competing in a particular industry, the likelihood and magnitude of potential profitability in that industry, and the degree of industry infighting which can be anticipated by the level of competition therein. See *supra* note 86. The contracting stage is an ideal time for the strategic collaboration of partners in this regard because contracting must occur for legal reasons independent of strategy and because the partners will be the authors of the contractual results.

104. See Lorange, *Win-Win Strategies*, *supra* note 92, at 13.

105. Even when they operate in a forthright manner, organizations are subject to epiphenomenal discrepancy between stated goals and actual results. This occurs because the process of role-sending, crucial to the implementation of goals, can be flawed by role conflict (wherein a number of legitimate expectations of an individual are mutually inconsistent) and role ambiguity (wherein individuals experience uncertainty simply because of cognitive limitations). See R. KAHN, E. WOLFE, R. QUINN, J. SNOEK, & R. ROSENTHAL, *ORGANIZATIONAL STRESS STUDIES IN ROLE CONFLICT AND AMBIGUITY* (1964); Lieberman, *The Effects of Changes in Roles on the Attitudes of Role Incumbents*, 9 *HUM. REL.* 385 (1956). Although implementation of strategy is always potentially confounded by these naturally occurring phenomena, the venture can seek to avoid adding an additional layer of dishonesty by encouraging good faith commitment during the contracting process.

106. Organization theory has long recognized the value of co-optation in the creation of commitment which might not occur naturally. Co-optation occurs when an organization brings another person or organization into the decisionmaking process. This inclusion tends to help ensure commitment to the decisions reached. This is particularly relevant in regard to joint ventures, in which two potentially conflicting organizations seek to cooperate on some level. Organizational boundary spanning can rationalize relationships between parent companies and the contracting process serves this function when it creates real bridges. For discussion of boundary spanning, see Leifer & Delbecq, *Organizational/Environmental Interchange: A Model of Boundary Spanning Activity*, 3 *ACAD. MGMT. REV.* 40 (1978).

penalties,<sup>107</sup> bundling of commitments,<sup>108</sup> and rewards for altruism.<sup>109</sup>

Incentive schemes, both in and apart from the contract terms, are essentially either neoclassical or relational in their nature. They tie the continued behavior and support of parent companies to a loosely connected web of rewards and penalties which are often triggered by mechanisms other than litigation or grievance. As such, they benefit from being automatically tied to the unpredictable development of the relationship between the parties as they pursue venture goals.

There is, however, a proviso: the quality of behavior is only as effective as the structurally incorporated mechanism for self-regulation of compliance and the commitment of the parties. When the parties are establishing procedures into which behavior-altering terms are built, it is essential that the quality be high and the parents be sold on their validity. Parent companies in reality often divorce themselves from the legal processes in which these procedures can be crafted, leaving a vacuum in which they are copied from the prior boilerplate of other ventures.<sup>110</sup> If the parties abdicate responsibility for the terms of commitment by viewing them as legal, rather than strategic, they lose an opportunity to improve the chances that the joint venture will succeed and operate smoothly.

*Proposition 10.* Planning and control routines that facilitate adaptation<sup>111</sup> are essentially relational in nature. Thus, contracts which are loosely

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107. Kogut, *supra* note 8, at 195-97. Reciprocal penalties exact a charge upon the violating party equivalent to its transgression. They help to mitigate opportunistic behavior which arises naturally when competitors enter into a cooperative situation such as a joint venture. The value of reciprocal penalties depends on two factors: the likelihood that a prospective violator will be caught and the magnitude of detriment experienced by a violator in the event that the penalty is charged. If the penalty is only as detrimental as the violation was beneficial, and the violation is unlikely to be discovered, the risk involved in opportunism may be economically justified. Because of this effect, "more than reciprocal" penalties might be more effective.

108. Bundling provisions in a joint venture contract tie various commitments into an interrelated web of contingency. Duties of parent A become triggered by the occurrence of an act by parent B, or parent A is relieved of a duty by virtue of nonperformance of parent B. In either case, the bundling provision is a self-policing method of implementing reward and punishment systems. Bundling serves as a mutual hostage situation which can stabilize the transactions in a relationship. For a discussion of the use of mutual hostages, see Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

109. Rewards for altruism mitigate opportunistic behavior by creating countervailing incentives. In this manner they help balance the scales which naturally favor opportunism.

110. S. SALBU, *supra* note 65, at 38-43.

111. The importance of adaptation is well established in the strategy literature. See, e.g., H. MINTZBERG, *MINTZBERG ON MANAGEMENT: INSIDE OUR STRANGE WORLD OF ORGANIZATIONS* (1989); Alexander, *Adaptive Change in Corporate Control Practices*, 34 ACAD. MGMT. J. 162 (1991); Zajac & Shortell, *Changing Generic Strategies: Likelihood, Direction and Performance Implications*, 10 STRAT. MGMT. J. 413 (1989).

structured and which allow the relationship between venturing parties to develop in unanticipated ways are most likely to ensure the survival<sup>112</sup> and the effectiveness of the venture.<sup>113</sup>

Lorange suggests a paradox which underlies the success of venture development: the venture must be controlled, but not overcontrolled, so that control exists "along clearly set dimensions, allowing sufficient autonomy."<sup>114</sup> Among the implications here are: (1) that the parents should not smother the venture with attempts to get involved in its management and (2) that notwithstanding this warning, there must be enough control to support rather than inhibit the freedom and autonomy of the venture to surpass presentiated expectations under classical contract modes.<sup>115</sup>

The degree of control within a contract can be classified alternatively as: (1) procedural or substantive; (2) insufficient or excessive; (3) appropriate or inappropriate; or (4) internalized or noninternalized. The propositions which follow suggest that these choices are strategically and legally important.

*Proposition 11.* Procedural control is more likely to be relational in character, whereas substantive fixation of agreements is more likely to be classical.<sup>116</sup> Whereas procedures are content nonspecific and serve simply to clear a pathway for the natural development of the venture, substantive clauses are by definition specific and yield discrete and presentiated obligations. The relative strength of procedures consists of their value in

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112. Success in survival of joint ventures can be a problem because of failure to adapt successfully to unforeseeable contingencies. See Levine & Byrne, *supra* note 3, at 101-05.

113. The relational conception of organizational effectiveness in the strategy literature is usually termed "proactiveness," which is a means of changing the strategy process in an adaptive and anticipatory manner rather than a reactive manner. See B. CHAKRAVARTHY & P. LORANGE, *MANAGING THE STRATEGY PROCESS: A FRAMEWORK FOR A MULTIBUSINESS FIRM* 302 (1991).

114. See Lorange, *Win-Win Strategies*, *supra* note 92, at 22.

115. This balance is poorly served by classical contracting philosophy. The classical mode errs entirely on the side of control in its efforts toward both discreteness and presentiation. The conceptual opposite of control in the organization literature is contained in the relatively novel idea of "empowerment" of both individuals and institutions. The literature regarding empowerment often focuses on the relational concepts of risk-taking and innovation. See, e.g., Thomas & Velthouse, *Cognitive Elements of Empowerment: An "Interpretive" Model of Intrinsic Task Motivation*, 15 *ACAD. MGMT. REV.* 666 (1990); Walton, *From Control to Commitment in the Workplace*, 63 *HARV. BUS. REV.* 77 (1985).

116. Procedural control can be defined as "embracing the systems and methods available to enforce the rights specified" substantively. T. MCADAMS, *LAW, BUSINESS AND SOCIETY* 107 (1986). Because such procedures must refer back to some substantive form of control, procedural control cannot exist in a pure and insular form. When we speak of procedural and substantive control, we therefore refer to a general emphasis, force, or impact, rather than the actualization of ideal types.

enhancing flexibility,<sup>117</sup> while the relative strength of substantive clauses reflects the pinning down of specific terms in a way that fixes obligations so that the parties can rely on the risks they willingly assume. In terms of Lorange's delicate balance between functional and dysfunctional control, the procedural-relational types of control are more likely to bring the flexibility associated with free and autonomous management.<sup>118</sup>

*Proposition 12.* Emphasis on relational contracting is likely to create a self-regulating mechanism which negotiates the balance between over-control and under-control.<sup>119</sup> As long as the allocation of overall power and responsibility is addressed and procedures and structures are established for the changes the venture will face, there is little risk of over-control. The intentional omission of many fixed, substantive terms reflects the postponement of commitment<sup>120</sup> which, if made too early, will be a form of excessive control that binds the venture management to conditions established by contracting parents. This is precisely the type of impediment to autonomy which impairs the likelihood of a win-win venture. At the same time, the frameworks and procedures of relational contracting help ensure that the venture will not be undercontrolled. By creating clear lines of authority, mechanisms for dispute resolution, and channels for development, the opportunities to exercise a reasonable degree of control are assured.

*Proposition 13.* Relational contracting is more likely than classical contracting to result in internalization of control mechanisms.<sup>121</sup> Parents of

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117. Examples of flexibility enhancement through the emphasis of procedure over substance are agreements to agree and forums for alternative dispute resolution which are more neoclassical or relational than classical in nature. Emphasis on procedures for change in the absence of clearly specified substantive provisions provides flexibility at the expense of clearly delineated obligations on which both parties can rely.

118. A movement from substantive to procedural emphasis within contracts serves to make the development of the contract more idiosyncratic and less an objective reflection of the biases which have developed under the common law of contract. For a discussion of this bias, see Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law*, 41 MD. L. REV. 563 (1982).

119. See Lorange, *Win-Win Strategies*, *supra* note 92, at 15-25. A venture must be controlled enough to create an independent, meaningful managerial life, but not so controlled that it impairs freedom of response to environmental cues. Lorange recognizes the need to clearly identify management teams and responsibilities and clearly delineate authority and limits to responsibility.

120. Timing of commitment has been viewed as an important control issue in both traditional budgeting theory and more current strategic monitoring theory. The essence in each case reflects an advantage in postponing commitments until the last possible moment in order to gain increments of information and thereby improve the quality of decisions, particularly under conditions of uncertainty. See, e.g., J. BOWER, *MANAGING THE RESOURCE ALLOCATION PROCESS: A STUDY OF CORPORATE PLANNING AND INVESTMENT* (1970); W. NEWMAN, *CONSTRUCTIVE CONTROL* (1975); Schiff & Lewin, *Where Traditional Budgeting Fails*, in *BEHAVIORAL ASPECTS OF ACCOUNTING* 132 (M. Schiff & A. Lewin eds. 1974).

121. Control mechanisms become internalized to the extent that they are incorporated

joint ventures often regard the contract creating the venture as a device to consult only upon the reaching of irreconcilable differences.<sup>122</sup> Agreements are seen as irrelevant unless and until there is a problem. Yet variables will often fail to manifest themselves as important concerns if lawyers operate in isolation from parent company representatives. The contract as classically conceptualized is unlikely to be consulted until a sense of discomfort or failure escalates to the status of a legal problem. As such, the contract cannot serve to facilitate an ongoing negotiation of terms which can be internalized into a commitment and a shared sense of venture purpose.

Participation in the decisionmaking process has long been recognized as a significant component of internalization of the decision and future commitment thereto.<sup>123</sup> If good relational contracting is likely to improve the quality of control and encourage moderation therein, it will be beneficial to encourage managers to accept, understand, and use the mechanisms and procedures created in the process. Yet, in practice, the participation in the contracting process which is likely to foster this goal is notably missing.<sup>124</sup> In their failure to participate in the joint venture contracting process, parents sacrifice an opportunity to help select more effective terms, which they are then more likely to understand and employ in the actual operation of the venture. Thus, even if the formulation process by which contractual terms are selected stumbles upon acceptable choices, there is a reduced likelihood that they will be implemented unless the venture managers know they exist and are committed to them.<sup>125</sup>

*Proposition 14.* The processes of learning and reconciling new information with existing strategies are fundamental to relational contracting. Rela-

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into the value systems or behavior systems of the parties. This internalization process occurs naturally as a result of group activity, such as real participation in an iterative and continually developing contracting process. For some classic discussions of the effect of group activity on cohesiveness and norm internalization, see I. JANIS, *VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN POLICY DECISIONS AND FIASCOS* (1972); T. NEWCOMB, *PERSONALITY AND SOCIAL CHANGE: ATTITUDE FORMATION IN A STUDENT COMMUNITY* (1943); Asch, *Studies of Independence and Conformity: A Minority of One against a Unanimous Majority*, 70 *PSYCHOLOGY MONOGRAPHS* 9 (1955).

122. S. SALBU, *supra* note 65, at 181.

123. *See supra* note 121.

124. *See* S. SALBU, *supra* note 65, at 178.

125. Implementation of well formulated strategy can fail because the individuals expected to carry out its goals have not participated sufficiently in the formulation process, including the establishment of contractual expectations. Quinn emphasizes the usefulness of "highly adaptive learning interactions" in the creation of strategies characterized by acceptance and commitment. *See* J. QUINN, *supra* note 19, at 24. Highly adaptive learning interactions are relational in their development under conditions of meaningful participation of those who will implement the strategy. These interactions are unlikely to occur under classical contracting conditions typically characterized as lawyer-intensive.

tional contracting is in large part defined by its openness to learning and to the processing and incorporating of new information.<sup>126</sup> This is best explained by returning to the fundamental differences between classical and relational contracting.

Classical contracting is characterized by its adherence to the fundamental goals of discreteness and presentation. These two ends are in direct conflict with the incorporation of new information.<sup>127</sup> Discreteness is the quality in contracts wherein transactions are isolated, insular, and independent. No future relationship beyond the immediate, bounded transaction is assumed or anticipated. The purity of this sense of discreteness exists because the transaction is fixed and clearly bounded from other transactions or other information which may affect later transactions, but which cannot, under the definition, affect the stability effected by classical contract commitment. Likewise, presentation pins down the present and future values of promises so that planning and action can proceed within a context of risks which, in the ideal form, have been perfectly fixed and allocated. The role of learning is certainly limited within this context. Although information may be incorporated in the pursuit of other transactions and their contracting processes, new information is technically irrelevant to the present transaction under classical contracting assumptions.

Conversely, relational contracting can be defined in terms of learning as a mode of contract ideology which values the ability of parties to utilize new knowledge as it arises, and it alters the nature of the relationship between parties so as to utilize information and exploit learning opportunities. When Lorange emphasizes the importance of information, learning, and "knowledge packages,"<sup>128</sup> he emphasizes implicitly the need for relational forms of contracting and a more open conceptualization of the process.

#### V. MODIFYING THE JOINT VENTURE CONTRACTING PROCESS

Together, the preceding propositions suggest a model for altering the manner in which joint venture contracting occurs, particularly under

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126. See Macneil, *Contracts*, *supra* note 13, at 895. Macneil notes in regard to learning and adaptation in relational contracting that a "great deal of change in ongoing contractual relations comes about glacially, though small-scale, day-to-day adjustments resulting from an interplay of horizontally arranged exchange—e.g., workers creating new ways of cooperatively defining their work."

127. Cognitive theory regarding the assimilation of new information suggests that there are five basic stages of information processing: selective attention, encoding, storage and retention, retrieval, and judgment. Lord, *An Information Processing Approach to Social Perceptions, Leadership, and Behavioral Measurements in Organizations*, in 7 RESEARCH IN ORGANIZATIONAL BEHAVIOR 87 (L. Cummings & B. Staw eds. 1985). This model of processing information is more likely to be effective when discreteness and presentation of contract are minimized and the model is reiterative and developmental over time.

128. See Lorange, *Win-Win Strategies*, *supra* note 92, at 29.

conditions of volatility and environmental unpredictability.<sup>129</sup> The model organizes the fourteen propositions into three categories: (1) threshold venture conditions; (2) prescribed contracting modifications; and (3) subsequent strategic benefits. The model, discussed in detail in this section, can be visualized as follows:<sup>130</sup>

#### Threshold Venture Conditions

Environmental Uncertainty (P5)	or	Transactional Idiosyncrasy (P6)	or	Transactional Frequency (P7)
require contracting modifications, including				
(a) strategic thinking by lawyers (P1)				
(b) incrementalism (P2)				
(c) relational orientation of contract (P3)				
(d) increased managerial input (P4)				
resulting in subsequent strategic benefits, including				
(a) improved understanding of competitive realities (P8)				
(b) increased likelihood of continued, good faith participation of venture parents (P9)				
(c) facilitation of adaptation, venture survival, and venture effectiveness (P10)				
(d) more flexible, procedural control (P11)				
(e) a self-regulating mechanism to ensure a reasonable balance between over- and under-control (P12)				
(f) internalization of control mechanisms (P13)				
(g) enhancing learning and assimilation of new information (P14)				

The threshold venture conditions are the primary, but not the exclusive, triggering situations for the prescribed contracting modifications. In accordance with Williamson's observations regarding transaction cost analysis,<sup>131</sup> these are the conditions under which classical contracting and concomitant traditions are least likely to be effective. Environmental uncertainty, transactional idiosyncrasy, and transactional frequency are

129. Turbulent conditions are a possibility in any contractual situation; they are particularly relevant in the instance of joint venture contracting. The potential for conflict is increased in the venture form because the majority of these arrangements are "related" joint ventures in which the collaborating parent companies are competitors in extra-venture situations. See Pate, *Joint Venture Activity, 1960-1968*, 23 *ECON. REV.* 16 (1969), in which 520 joint ventures were studied and four-fifths were found to be horizontally or vertically related. The tension between cooperative and competitive roles makes the joint venture form of business particularly precarious.

130. "P" designations in the visual diagram of the model relate back to propositions as they are numbered in the text.

131. See Williamson, *Governance*, *supra* note 74, at 238-45.

venture conditions likely to be correlated with volatility and stochastic variation of assumptions.<sup>132</sup> The rigorous presentation of variables typical of classical contracting will exact high transaction costs as frequent and idiosyncratic modification of expectations is continually renegotiated.

Because the classical mode is suboptimal under these threshold conditions, contracting modifications are prescribed. Specifically, lawyers must think strategically, rather than in the classically legalistic fashion typically found in law school contract curricula. They must focus on adaptation and accept reasonable levels of uncertainty, ambiguity, and risk in drafting documents that will enhance relational development. To do this, they must understand the businesses they support<sup>133</sup> as well as the emergent strategies which occur naturally and are particularly desirable under the threshold conditions.<sup>134</sup> The effort to support emergent, incremental strategy will naturally entail a movement toward relational contracting because the two are analogous: the former managerial,<sup>135</sup> and the latter legal<sup>136</sup> in origin.

Hoping that lawyers will think strategically and support emergent strategy by employing relational contracting is idealistic and unrealistic unless assistance comes from the managerial ranks. Lawyers are not trained in relational contracting and are unaccustomed to viewing the nature of contracts except from a classical perspective,<sup>137</sup> but professionally trained managers are well versed in strategic theory.<sup>138</sup> In order to utilize lawyers strategically in the contracting process, managers must be significant participants whose frameworks of analysis can be shared with and assimilated by attorneys. This participation enhances the business-oriented quality of lawyers' work and brings managers into the process of contracting at a crucial point in the strategy formulation cycle.

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132. See Macneil, *Contracts*, *supra* note 13, at 886-99; Williamson, *Governance*, *supra* note 74, at 238-46.

133. The need for lawyers whose training and perspective are more relational than classical is supported by the trend toward utilization of in-house counsel whose knowledge of actual business practices is vital to the many nonlegalistic functions which lawyers serve.

134. See *supra* note 47.

135. See, e.g., Wrapp, *Good Managers Don't Make Policy Decisions*, 45 HARV. BUS. REV. 91 (1967).

136. See Macneil, *Futures*, *supra* note 15, at 691.

137. A typical textbook or treatise on contracts includes discussions of offer, acceptance, consideration, capacity to contract, mistake, conditions, breach, impossibility, remedies, third party rights, discharge, and illegality. Virtually all such treatises limit their analysis to classical (typically common law) and neoclassical (typically U.C.C.) concepts. See, e.g., E. FARNSWORTH & W. YOUNG, *CONTRACTS* (3d ed. 1980).

138. L. PORTER & L. MCKIBBIN, *MANAGEMENT EDUCATION AND DEVELOPMENT: DRIFT OR THRUST INTO THE 21ST CENTURY?* 47-87 (1988) (discussing in detail curricular requirements for accreditation of business programs by the American Association of Collegiate Schools of Business).

Adoption of these contracting modifications under conditions of environmental uncertainty, transactional idiosyncrasy, and transactional frequency, can yield strategic benefits<sup>139</sup> by which lawyers operate to strengthen planning. The by-products of the recommended changes include development of advantage within a given industry,<sup>140</sup> enhancement of effectiveness,<sup>141</sup> efficiency,<sup>142</sup> job satisfaction,<sup>143</sup> and likelihood of survival.<sup>144</sup> Given that conditions of uncertainty and idiosyncrasy characterize increasingly complex markets, the movement toward the proposed contracting modifications will be crucial. The resulting strategic benefits will help ensure the prosperity of the developing venture form as a mechanism of organizational adaptation for the future.<sup>145</sup>

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139. See *supra* note 130 (these benefits are listed as a-g, with referrals to relevant propositions throughout the text).

140. Understanding of competitive realities, a strategic benefit under Proposition 8, is vitally important in the process of jockeying for position within industries according to industrial organization literature. See M. PORTER, *supra* note 86, at 4.

141. Organizational effectiveness is usually defined in terms of goal achievement. For a discussion of this concept, see Cunningham, *A Systems-Resource Approach to Organizational Effectiveness*, 31 HUM. REL. 631 (1978); Perrow, *The Analysis of Goals in Complex Organizations*, 26 AM. SOC. REV. 854 (1961). The strategic benefits of contracting modifications are essential elements of organizational effectiveness.

142. Efficiency is generally conceived to be an economic concept wherein the production function is characterized by reduction of input and augmentation of output. See W. SCOTT, T. MITCHELL, & P. BIRNBAUM, *ORGANIZATION THEORY: A STRUCTURAL AND BEHAVIORAL ANALYSIS* 4 (1981). Efficiency can be effected by competitive environment, flexibility, control, and quality of information as enhanced by the prescribed contracting modifications.

143. Propositions 12 through 14 suggest that the prescribed contracting modifications help modulate levels of control while assisting in the internalization of norms and enhancing learning and assimilation of information. For discussions regarding the positive effects of mitigated control and enhanced autonomy and self-determination on worker satisfaction, see R. FORD, *MOTIVATION THROUGH THE WORK ITSELF* (1969); F. HERZBERG, B. MAUSER, & B. SNYDERMAN, *THE MOTIVATION TO WORK* (1959); R. MAHER, *NEW PERSPECTIVES IN JOB ENRICHMENT* (1971).

144. See Levine & Byrne, *supra* note 3, at 101-05 (joint venture survival is both a direct result of contracting modification under Proposition 10 and a natural result of increased industry advantage, effectiveness, efficiency, and job satisfaction).

145. See H. MINTZBERG & J. QUINN, *THE STRATEGY PROCESS* 735 (2d ed. 1991). Mintzberg & Quinn note that organizational design under increasing complexity should move from the traditional multidivisional form to "adhocracy," which is a less bureaucratically rigid form capable of incorporating emergent strategy more effectively than traditional structures. Organizational innovation which allows for more flexible systems of control can be incorporated into nontraditional arrangements like joint ventures and are more conducive to relational contracting and its benefits than more bureaucratic structure.

