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CONTRACTUAL FORMALIZATION AND GOVERNANCE OF LONG-TERM RELATIONSHIPS

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Abstract

In this paper I discuss the relationship between contractual formalization, contractual incompleteness and the governance of long-term relationships. I analyze data on contracts for the production and distribution of goods collected between 2004 and 2009 in two research projects, one carried out in four industrial districts in north-east Italy in different manufacturing industries, and the other conducted at European level on the wine sector with seven case studies. The data show that purely oral contracts are rare, while formalization is significant even if the amount of litigation before courts is almost nil.

I first consider some factors affecting contract formalization. Then, I try to provide an explanation which relates to the governance of contractual relationships. I divide contractual relationships into market transactions, where parties rely mainly on detailed written contracts, and strategic relationships, which are partly regulated in writing – however vaguely – and partly not regulated at all. In this latter case, parties leave some issues unregulated because they may enter self-enforcing agreements or, if this is not the case, because they face radical uncertainty. In this situation, they prefer to resolve adaptation problems cooperatively instead of resorting to legal enforcement. I hold that for strategic relationships courts should adopt a mixed strategy: to adhere to written terms as much as possible and, for disputes arising on issues which are not regulated at all, to try to avoid filling the gaps and leave the determination to the parties.

Keywords

Inter-firm contracts, long-term relationships, governance, formalization, incompleteness

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Marco Gobbato
Max Weber Fellow, 2010-2011

1. Introduction

The problem of governance is strongly related to the setting in which transactions take place. Indeed, neoclassical economics explains just one type of transaction, namely those concluded in a perfect market. However, in perfect markets economic exchanges do not need to be properly governed. If markets are perfect all exchanges are instantaneous, there is free and complete information, there are no information asymmetries between parties (i.e. no private information), and all the investments parties commit to undertake are fully contractible. Finally, the institutional framework also encompasses third parties (judges) who may acquire all the significant information about the transaction between the parties without incurring any costs and who can perfectly enforce – without errors or misunderstanding – any contractual provision negotiated by them. In other words, as the transaction costs are very low, contracts are complete and the transaction becomes a simple exchange making it unnecessary to address the problem of governance.[1]

Thus, within perfect markets contracts play a very marginal role and, above all, are complete and fully enforceable. Parties may include provisions concerning any future state of the world in a contract. In the case of injury produced by the non performance of a party, the other may prove the breach in front of a court, which can obtain all the information concerning the content of the contract as well as the circumstances of the breach in order to settle the dispute and award damages to the aggrieved party.

Unfortunately, market imperfections are widespread in the real world. During the last century several analytical currents developed to explain the real economics of interactions in depth.[2] Many of them deal with (different degrees of) bounded rationality and contractual incompleteness.[3] Bounded rationality is already a concept which "cannot be precisely defined."[4] Nevertheless, some models consider that although parties are not able to predict an actual outcome, they may nonetheless know – with unlimited ability – all the possible outcomes and the probability of each one, and thus they may calculate the expected value.[5] Other streams of literature, such as transaction cost economics, accept the radical notion of bounded rationality inspired by Simon: since the abilities of parties are consistently restricted, they are unable to predict even possible outcomes and their relative probability.[6]

In consequence, as complexity and uncertainty increase, contracts become more and more incomplete. By complexity we mean a transaction which is difficult to describe, e.g. engineering design effort. Uncertainty also increases the difficulty of writing complete contracts: think of the problems involved in predicting a variation in sales or demand.[7] Uncertainty increases with long term contracts. If the relationship extends over a long period of time, it is hard for parties to even predict at

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[1] See ZINGALES, *Corporate Governance* , The Palgrave Dictionary of Economics and the Law, MacMillan, 1998.

[2] See, for a general overview, BROUSSEAU and GLACHANT, *The Economics of Contracts and the Renewal of Economics*, in BROUSSEAU and GLACHANT (eds.), *The Economics of Contracts: Theories and Application*, Oxford University Press, Oxford, 2002; for an overview of the empirical research conducted around the various models, see LAFONTAINE and SLADE, *Vertical Integration and Firm Boundaries*, Journal of Economic Literature, September 2007, pp. 629-685.

[3] See, LAFONTAINE and SLADE, previous note, p. 629 ss.

[4] See SELTEN, *What is Bounded Rationality?* in GIGERENZER and SELTEN (eds.), *Bounded Rationality*, Cambridge MA, MIT Press, 2001, pp. 13–36, p. 15.

[5] Properly, in these models rationality is bounded to the extent that part of the information possessed by one party is not available to the other. In such a case, problems of adverse selection and of moral hazard may emerge, depending on whether the asymmetries of information emerge in the phase of contract formation or once the contract has been concluded. See, for a general discussion, the classic contribution by AKERLOF, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, Quarterly Journal of Economics, 84, 3, 1970, pp. 488-500. For principal-agent models, see the classic contribution by ARROW, *Essays in the Theory of Risk Bearing*, Markham, Chicago, 1971.

[6] See SIMON, *Rationality as process and as product of thought*, American Economic Review, 68, 1978, pp. 1-16; SIMON, *Organizations and Markets*, Journal of Economic Perspectives, 5, 1991, 25-44.

[7] See WILLIAMSON, *The Economics of Governance*, American Economic Review, 95, 2, 2005, pp. 1-18.

time 1 what is going to happen at time 2. In such cases, the choices the parties make at time 1 may be inefficient, as they can only verify at a later stage which state of the world is actually realized.
Such cognitive problems also affect the institutional framework in which contracts are concluded. The authority in charge of ensuring the performance of the contract, the judge, is incapable of observing and assessing some of the relevant variables, such as the level of effort and of the investments made by the parties. Thus parties cannot rely on courts for enforcement and they must do their best to create their own bilateral or collective mechanisms for supporting troublesome exchanges – even if they are themselves bounded in their ability to do so. In transaction cost economics such a mechanism established by parties is called "private ordering."[8]

The cognitive problems facing parties even frustrate the possibility of contracting over the planning of specific investments. Such investments generate quasi-rents, i.e. returns that are higher than returns on a generic investment. As such, it is efficient for parties to undertake them. However, since the investment is specific to the relationship, as the level of investment increases so does the cost of exiting from the relationship.

Furthermore, it is problematic and costly to contract the level of commitment for specific investments in advance and it may not be possible to accord a credible plan for sharing the quasi-rents produced. Therefore, parties have to negotiate an initial, incomplete provisional plan (ex ante negotiation) and need to renegotiate the arrangement as the specific investments are undertaken and the outcomes are realized (ex post renegotiation). At this stage, the party which has made the smaller specific investment – and thus may exit the relationship at a lower cost – may behave in an opportunistic way by threatening to exit the relationship in order to appropriate a larger part of the rents produced by the other (hold-up).[9] Because of cognitive problems affecting the authorities, it may be very costly to demonstrate in front of a court that a party has behaved opportunistically, and, in consequence, each party has an incentive to cheat. Knowing this, each party has no incentive to fully invest ex ante, thus reducing the joint surplus and producing an inefficient outcome.

To summarize, a hold-up may arise (i) when, although each party can observe the behaviour of the other party, the costs of demonstrating the cheating behaviour of a party to a court are very high (or when it is impossible to demonstrate it at all), and (ii) when specific investments are made by one party or by both so that each party faces some costs for exiting the relationship.

According to transaction cost economics, in order to deal with coordination problems, parties may set up several "private orderings" according to the features of both the transaction and of the institutional framework. Apart from the market, which is not practical for the reasons explained, parties may use hybrids (contracts with the role of governing the relationship) or organizational solutions (i.e. vertical integration). Initially, transaction cost economics focused more on vertical integration, but recently it has given more credit to hybrid solutions. As Williamson states, "because added bureaucratic costs accrue upon taking a transaction out of the market and organizing it internally, internal organization is usefully thought of as the organization form of last resort: try markets, try hybrids, and have recourse to the firm only when all else fails."[10]

Thus, when the magnitude of complexity, uncertainty and specific investments is not too great, contractual (incomplete) safeguards may suffice. But how should the contractual arrangements be set up? It is a very difficult task. Parties need to balance the ex ante costs (costs of negotiation) against the ex post costs (costs of litigation). Ex ante costs entail all the expenditures parties incur for including a provision in the contract (basically, writing and negotiation costs). If an additional provision is negotiated, then the probability of litigating over the issue regulated decreases, thus saving legal costs ex post. However, ex ante and ex post efficiency may be in tension, since to protect the specific

[8] See WILLIAMSON, *The Economic Institutions of Capitalism*, 1985, New York, Free Press.

[9] See WILLIAMSON, *cit.*, 1985; HART – MOORE, *Incomplete Contracts and Renegotiation*, Econometrica, 1988, 56, 4, 755-785.

[10] See WILLIAMSON, *The Economics of Governance*, American Economic Review, 95, 2, 2005, p. 12.

investments which generate a higher contractual surplus parties may stiffen the agreement with a multitude of provisions, thus reducing the adaptability of the contract to uncertainty.[11]

In this respect, we need to take into account the fact that the institutional framework may affect the work of parties in writing contracts in two ways:

(i) The legal system may provide parties with default rules, thus permitting them to save the cost of explicitly regulating some issues. For example, contract law may facilitate maximizing the joint surplus for the contracting parties[12];

(ii) Theory assumes that judges are quite unable to address disputes between the parties. Although this may be the case, it does not happen all the times. Judges may in fact do this job quite efficiently. Thus, to some extent, parties may include (and actually do include) contractual provisions and rely on courts for their enforcement.

The issue described in (ii) divides the literature and, specifically, economists and legal scholars. Indeed, the notion of incompleteness has a different meaning for economists and lawyers. For a lawyer, a contract is complete if it provides the obligations for the parties in each state of the world ("obligational completeness"). For an economist, a contract is complete if it provides the *efficient* set of obligations for each state of the world. For instance, if the seller commits to deliver a certain good on a given date in consideration of a given price, the contract is obligationally complete even if it is not complete in an economic sense because, for instance, the production price for the sellers may increase in the meanwhile, thus producing an inefficient outcome.

Moreover, according to lawyers, contract theorists fail to assume a realistic vision of how contracts are used. Often parties include vague terms, such as "best efforts" or "reasonable care", to preserve the flexibility of the agreement, thus transferring costs from the negotiation phase (they avoid detailing their duties) to the back-end stages: the question of what is the content of vaguely specified obligations may turn into litigation, thus increasing ex post costs. Economists usually assume that such terms are not contractible at all, since they are not verifiable by courts. As already mentioned, however, this is not always the case.

But by dealing with a radical notion of incompleteness, some economic scholars do not pay full attention to the role and the degree of formalization of contracts or to the factors affecting them. On the contrary, especially in long-term relationships, where the level of uncertainty may be very high, "the choice of contract partner, and his or her inclination to cooperate, the tools or governance mechanism to deal with uncertainty and new contingencies, and to provide the adequate incentives are crucial."[13]

This paper adopts a legal perspective, and basically deals with:

1. Contract formalization and the substantive factors affecting it. Parties may adopt formal written agreements and/or increase the level of detail for many reasons not always related to governance issues – that it is to say to the problem of allocation of cost between the negotiation and the enforcement phase. Basically the level of contract formalization is significant, but to a different degree according to several factors: the level of public and private regulation, whether the contract regulates national or international relationships, and, particularly, whether it regulates market or strategic relationships;
2. The relationship between contract formalization, level of contract detail and contract completeness. I suggest that in dealing with formalism in business contracts the level of contract detail and the problem of contract completeness should be considered separately, even if they are related and both are relevant to the problem of governing long-term relationships.

As already seen, a trade-off between the level of contract detail and the costs of opportunistic behaviour and/or the costs of adaptation to future states of the world may arise. On the one hand, the higher the level of detail ex ante, the lower the possibility of expropriation of quasi rents ex post. On

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[11] See SCOTT – TRIANTIS, *Incomplete Contracts and the Theory of Contract Design*, University of Virginia Law School, The John M. Olin Program in Law and Economics Working Paper Series, 2005, 3.

[12] See SCOTT – TRIANTIS, *Contract Theory and the Limits of Contract Law*, Yale Law Journal, Vol. 113, Nov/Dec 2003.

[13] See GOMEZ, *Cooperation, Long-Term Relationships, and Open-Endedness in Contractual Networks*, mimeo, 2010.

the other hand, it is sometimes more efficient not to complete a contract ex ante because (i) uncertainty about future states of the world makes it much more attractive to leave the contract incomplete as this increases flexibility, making adaptation to lower costs possible[14]. Thus, the commitment necessary to protect the specific investments that generate the expected contractual surplus is antithetical to the flexibility needed to ensure ex post efficiency[15]. Therefore, parties face a trade-off between a detailed contract which regulates as many future contingencies as possible and a contract which is ("obligationally") incomplete but preserves a certain degree of flexibility. In deciding whether to express their obligations in precise or vague terms, parties also allocate the contracting and litigation costs[16]. Moreover, (ii) the enforcement of a detailed initial agreement itself may lead to opportunistic behaviours.[17]

However, while in market transactions parties rely mainly on detailed written contracts, collaborative and strategic relationships may exist outside of highly detailed contracts. In such relationships, parties can combine different formal and informal mechanisms allowing each party to respond cooperatively to unforeseen circumstances[18].

In other words, in strategic relationships parties adopt vague and not easily enforceable standards, thus shifting the enforcement costs to the back-end stage. Even when parties set up a certain level of detail for dealing with governance issues, they shift the costs to the ex post phase not because they intend to rely (to some extent) on courts, but because they wish to avoid higher litigation costs and settle disputes by themselves, adjusting adaptation problems cooperatively. They sometimes prefer to leave contracts ("obligationally") incomplete in order to preserve a certain degree of flexibility[19], rather than to draft detailed contracts which regulate as many future contingencies as possible.

In order to elaborate this suggestion, I concentrate only on contracts for production and for the distribution of goods. I analyze data collected between 2004 and 2009 in the two research projects mentioned above[20]. The first was carried out in four industrial districts in north-east Italy in different manufacturing and agri-food industries – one case study for each district. The second project was conducted at the European level in the wine sector with seven case studies – three in Italy, and the others in the Loire region in France, in the Port and Douro region in Portugal, in the Valencia region in Spain, and in selected areas of Hungary.

The paper is organized as follows. Section 2 frames the relevant economic and legal theory on contract form, contract detail and the governance of long-term agreements. Section 3 presents the evidence. Section 4 discusses the data collected and gives some comprehensive explanations concerning contract design and the governance of long-term relationships. Section 5 concludes and suggests further issues for future research.

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[14] See DIAMOND, *Seniority and Maturity of Debt Contracts*, Journal of Financial Economics, 1993, 33, 341-368; CHE – HAUSCH, *Cooperative Investments and the Value of Contracting*, The American Economic Review, 1999, 89, 1, 125-147; HART – MOORE, *Foundations of Incomplete Contracts*, Review of Economic Studies, 1999, 66, 115-138; SEGAL, *Complexity and Renegotiation: A Foundation for Incomplete Contracts*, Review of Economic Studies, 1999, 66, 57-82.

[15] See SCOTT – TRIANTIS, *Incomplete Contracts and the Theory of Contract Design*, University of Virginia Law School, The John M. Olin Program in Law and Economics Working Paper Series, 2005, 23.

[16] See SCOTT – TRIANTIS, *Anticipating Litigation in Contract Design*, 115 Yale L. J. 814, (2006).

[17] See the emblematic case of Alcoa / Essex and the debate stemming from it. Specifically, see GOLDBERG, *Price Adjustment in Long Term Contracts*, Wisconsin Law Review, 1985, 3, pp. 527-543; KLEIN, *Why Hold-Ups Occur: the Self Enforcing Range of Contractual Relationships*, Economic Inquiry, 1996, 34, 444-463.

[18] See GILSON – SABEL – SCOTT, *Contracting for Innovation: Vertical Disintegration and Inter-firm Collaboration*, 109 (3) Columbia L. R. 431, (2009). I consider "formal" in this paper to be synonymous with "written".

[19] See SCOTT – TRIANTIS, *Incomplete Contracts and the Theory of Contract Design*, University of Virginia Law School, The John M. Olin Program in Law and Economics Working Paper Series, 2005, 23.

[20] See note 2 above.

2. Contract form and contract design

To some extent, short-term and long-term contracts can play a similar role – i.e. both can be used for regulating a long-term relationship[21]. Both usually include basic features such as the definition of the price, the quantity and a description of the good or service required. However, according to the literature, long-term contracts can be expected to also include governance terms such as readjustment provisions, long-run remedies, and parameters affecting the parties' bargaining position over time[22]. If this is the case, specific obligations in long-term contracts should be articulated in much more detail.
In order to deal with the relationship between contract form and contract design in greater depth I will review the principal findings of four different streams of literature.

2.1 Macaulay's seminal contribution

Legal scholars have different opinions concerning the form and the level of contract detail of business contracts. The famous contribution by Macaulay tries to shed some light on the real use of contracts in business practice[23]. He understands contracts as being composed of two elements: (i) "rational planning of the transaction", with provision for as many future contingencies as it is possible to foresee and (ii) the "existence or use of actual or potential sanctions for inducing performance or for providing some compensation in case of non-performance"[24]. He further distinguishes among four different degrees of planning in business contracts. Parties may plan and make explicit all the relevant issues; they may have a "mutual but tacit understanding about an issue"; there could be a unilateral determination of responsibility for an unexpressed issue to the other party; an issue may not have been foreseen or considered[25].

Thus, even though Macaulay does not clarify the relationship between contract form and completeness (and the associated governance problems), he concludes, after a preliminary empirical study, that non-contractual relationships are very common in industry[26]. This is to say that firms engage in a contractual relationship without paying attention to the planning of their exchanges and without providing sanctions for the potential non performance of their obligations.

Two considerations should be made. Firstly, part of the literature does not properly explain the extent to which business contracts are formalized – i.e. which elements are defined and which are set aside from explicit regulation. In some cases even formalization itself is not well defined: to some extent formalization is related to – if not confused with – the codification of routines or practices. Such routines and practices are usually defined outside of contracts and even orally[27]. Therefore, codification of routines can coincide with non formalization. In our view, formalization is related to an increase in the written content of agreements, while codification concerns the definition of practices,

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[21] There is no general reason for regulating a long-term relationship with a long-term contract instead of a short-term one. The decision is affected by the interests of the parties and by the circumstances of contracting (the information available to parties, the potential asymmetries in its distribution, etc). See GOMEZ, *Cooperation, Long-Term Relationships, and Open-Endedness in Contractual Networks*, mimeo, 2010; FUDENBERG – HOLMSTROM – MILGROM, *Short-Term Contracts in Long-Term Agency Relations*, Journal of Economic Theory, 1990, 51, pp. 1–31. See also SALANIÉ – REY, *Long-Term, Short-term and Renegotiation: On the Value of Commitment in Contracting*, Econometrica 1990, 58, pp. 597–618.

[22] See GOMEZ, 2010, above.

[23] See MACAULAY, *The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules*, Modern Law Review, 66, 2003, p. 56.

[24] See MACAULAY, *The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules*, Modern Law Review, 66, 2003, p. 56. This paper deals with the legal conception of contract completeness.

[25] See MACAULAY (2003), p. 57.

[26] Cfr. MACAULAY, *Non-Contractual Relations in Business: A Preliminary Study*, American Sociological Review, Vol. 28, No. 1 (Feb., 1963), pp. 55-67.

[27] According to some scholars, the relationships governed by the codification of routines are regulated by simple contracts. See HELPER – MACDUFFIE – SABEL, P*ragmatic Collaborations: Advancing Knowledge while Controlling Opportunism*, Industrial and Corporate Change, 2000, 9, 5, 445 ss.

which can take either oral or written form and can also be agreed outside a contract. Of course, the way practices are codified affects their enforceability; for instance, if they are included in written agreements they are also much easier to enforce[28].

Secondly, contracts can provide a plan for some issues even if they are not concluded in written form. Therefore, contract form and contract completeness (even legal completeness) are related but are different concepts. A contract can be legally complete even it has oral form – since, for instance, parties may rely upon default rules. Nonetheless, the contract remains incomplete from an economic perspective because the initial set-up can turn out to be inefficient in the execution phase.

When agreements are not expressed in written form or in detail, contracts may still be enforceable if:

- There is the possibility of constraining the room for ex post negotiations in order to provide parties with incentives for ex ante investments (see par. 2.2);
- A self-enforcing mechanism can be set up (see par. 2.3);
- Cooperation is possible for other reasons, such as a disposition of the parties to commit to cooperation, and/or the inclusion of provisions within the initial contract for the (imperfect) governance of the relationship (see par. 2.4).

2.2 Constraining ex post re-negotiation

As previously noted, making the terms enforceable and increasing the (legal) completeness of contracts reduces, even though it does not eliminate, the incentives to breach[29]. A legally complete contract can, of course, be economically incomplete and so the problem of enforcement is by no means eliminated – and this is the main concern of economics scholars, who deal with a more radical concept of incompleteness.

Two families of models suggested by scholars encompass the possibility of assigning the entire contractual power to one party and selecting default options to protect the investments of the other party[30]. The first group states that it is possible to assign the entire contractual power to one party – the residual rights of control, that is to say the right to take decisions on non-contractible issues in the relationship[31]. The right should be assigned to the party whose investment determines the production of the larger proportion of the final surplus. As the counterparty is not incentivized to the same extent, the final outcome is not the best possible. Nonetheless it is better than the market solution (without any assignment of property rights or with wrong entitlement).

The second family of models also contemplates that one party can be endowed with the entire contractual power – even the power of choosing whether to conclude the contract. Thus, as such a party is the residual claimant, it is incentivized to invest efficiently (or not to conclude the contract at all)[32]. To incentivize the counterparty a combination of a given price and quantity is determined at the time of contracting. This outcome, called the status quo, is the worst result the counterparty may obtain even in the case of failure of renegotiation – i.e. if the party invested with contractual power

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[28] Such inclusion is costly and may even not be feasible (problem of verifiability). GOETZ - SCOTT, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092-95 (1981); See also HART, *Incomplete Contracts and the Theory of the Firm*, 4 J.L. ECON. & ORG. 119 (1988); HART – MOORE, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115 (1999).

[29] See SCOTT, *The Case for Formalism in Relational Contracts*, 94 Nw. U. L. Rev. 847 1999-2000. Some studies show that in the presence of specific investments contract completeness increases.

[30] See the overview provided by BROUSSEAU – GLACHANT, 2002, cit.

[31] See HART – MOORE, *Incomplete Contracts and Renegotiation*, Econometrica, 1988, 56, 4, 755-785.

[32] Cfr. CHUNG, *Incomplete Contracts, Specific Investments and Risk Sharing*, Review of Economic Studies, 1991, 58, 5, 1031-1042; AGHION – DEWATRIPONT – REY, *Renegotiation Design with Unverifiable Information*, Econometrica, 1994, 62, 2, 257-282; NOLDËKE – SCHMIDT, *Option Contracts and Renegotiation: A Solution to the Hold-Up Problem*, RAND Journal of Economics, 1995, 62, 2, 163-179.

decides not to renegotiate the contract. If the status quo is determined appropriately, even the party without the contractual power is provided with an incentive to invest[33].

Some criticisms of this second array of models have arisen. It is unrealistic to contract ex ante over the allocation of contractual power[34]. Therefore, other models consider contractual power as an exogenous variable[35]. Parties agree a combination of price and quantity in the initial contract. Once a surplus is realized, they may negotiate over its division according to the given contractual power. In any case, judges have to be able to enforce the default options, even if they are of great complexity. But this is not always the case.

In sum, these models suggest that, in certain cases, even simple contracts may play a role in dealing with uncertainty and in improving the efficiency of the exchange. They have been appreciated because they link the degree of ex ante contractual completeness and the design of renegotiation[36]. Nevertheless, they have proven unrealistic, mainly because of the restrictions concerning the assignment of the contractual power to only one party[37]. It can be added that it is still to be proven that parties currently use such sophistications in drafting their contracts.

Moreover, from an economic point of view, the models are built on the hypothesis that each party engages in selfish investments – i.e. investments benefitting only the investing party. However, in transactions involving a high degree of interdependence, investment made by one party can benefit both (cooperative investments). For instance, consider the case of an investment realized by a supplier which increases the welfare both of the supplier and the manufacturer itself. Or, in distributorship, teams can be formed in order to invest in providing the upper levels of the supply chain with information useful for the production of a specified good[38]. Some models show that renegotiation schemes do not work when cooperative investments are involved. As usual, if parties cannot credibly commit to invest to an agreed level and if investments are to some degree cooperative, then an efficient outcome cannot be achieved.

2.3 Self-enforcing contracts

Another economic theory which is very interesting in this respect states that parties may set up self-enforcing arrangements. Indeed, and more interestingly for us, the theory predicts a combination of non-judicial governance devices and enforceable terms, thus explaining the level of formalization in business contracts.

A contract is self enforcing if the sole threat of withdrawal is enough to induce the counterparty to perform according to the initial agreement and to its best effort. So parties can arrange

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[33] See AGHION ET AL., (1994), above. The only enforceable variable in other models is the quantity of the good required: see NOLDËKE – SCHMIDT (1995), above.

[34] For instance, in the model by Chung the initial contract sets out that one party has the possibility of making a "take it-or-leave-it" offer in the renegotiation phase. The counterparty may accept or refuse the offer. But parties may not engage in an ex ante agreement preventing them from continuing with the game in the case of a refusal of the offer. See CHE – HAUSCH, *Cooperative Investments and the Value of Contracting*, The American Economic Review, 1999, 89, 1, 125-147

[35] Cfr. EDLIN – RECHELSTEIN, *Specific Investments Under Negotiated Transfer Pricing: An Efficiency Result*, Accounting Review, 1996a, 70, 2, 275-291; ID, *Holdups, Standard Breach Remedies, and Optimal Investments,* American Economic Review, 1996b, 86, 3, 478-501.

[36] Cfr. SCOTT – TRIANTIS, *Incomplete Contracts and the Theory of Contract Design*, University of Virginia Law School, The John M. Olin Program in Law and Economics Working Paper Series, 2005, 23. In particular, see p. 8: *"From the perspective of lawyers and legal scholars, therefore, the most important contribution of economic contract theory is arguably this systematic incorporation of renegotiation and its feedback effects into the analysis of contracting".*

[37] Cfr. SCHWARTZ, *Relational Contracts in the Courts: an Analysis of Incomplete Agreements and Judicial Strategies*, in Journal of Legal Studies, 1992, p. 271 ss.

[38] See the examples included in CHE – HAUSCH, 1999, above.

two different types of complementary governance devices. They can include some clauses which are court-enforceable at low cost in the contract, while avoiding specifying non contractible terms[39].

Such intentional gaps do not lead to a failure of the relationship, as non-judicial governance mechanisms are activated. A credible threat of withdrawing from the contract is enough, under certain conditions, to induce the best effort, because each party is aware of the losses it can incur in the case of cheating[40]. The private sanction is composed of two parts: the first is the future loss imposed on a party if the relationship ends – given the presence of specific investments the loss is equal to the discounted value of the quasi-rents from such investments. The second part is the reputational loss suffered in the marketplace[41]. Each party compares the potential gain from breaching the contract with the capital loss from the private sanction. If the former gains are less than the latter losses, then a party cannot credibly commit to breach the contract. Thus, even though not all aspects of the contractual understanding are specified in the written contract, a party cannot take advantage by breaching and, instead, will perform according to the initial agreement.

Theory also predicts that not only can the contractual terms be enforced by courts but that they also may affect both the range of gains and losses from breaching. The self-enforcing part of the contractual relationship is the difference between gains and losses. Its range is, however, limited. For example, if the gains from breaching surpass the losses, a rational party will breach the initial understanding. Negotiation over contractual clauses aims to increase the self-enforcing range of the contractual relationship – because it raises the losses and/or it reduces the gains from cheating – thus increasing the potential of the private enforcement mechanism and the flexibility of the contract. Therefore, parties may intentionally avoid putting some terms into writing in order to allowing private enforcement to work. In such a case, the courts should not try to complete the contract with default rules[42].

Our evidence is consistent with this theory. As we will see, parties include some enforceable terms in contracts in order to improve their reciprocal reliance on the fulfilment of the contractual understandings. Consider, for example, exclusive dealing arrangements or even agreements on the distribution of risk, such as the obligations of a buyer purchasing a given amount of a product, who thus assures the seller of the amortization of his investments undertaken for performance.

2.4 Relaxing some assumption of the economic models: the relational contract theory

The problem of contract incompleteness has also been acknowledged by the theory of relational contracts, which, unlike the other models presented, has been proposed by legal scholars. The theory is grounded on the works of Ian Macneil[43]. Relational contracts are contrasted with discrete contracts, in

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[39] Cfr. KLEIN, 1996, *op. cit.* and, more recently, ID., *The Role of Incomplete Contracts in Self-enforcing Relationships*, in BROUSSEAU – GLACHANT (eds.), *The Economics of Contracts: Theories and Application*, Oxford University Press, Oxford, 2002.

[40] Parties must have the possibility of monitoring each other (action must be observable). Moreover, it is also necessary that cognitive misunderstandings concerning the outcomes do not arise.

[41] See KLEIN, 1996, cit., 449.

[42] See, SCOTT, *A Theory of Self – Enforcing Indefinite Agreements*, Col. L. Rev., vol. 103, n. 7, 2003, p. 1641 ff. Further extensions of the model propose combining the self-enforcing theory with principal agent theory. LAFONTAINE - RAYNAUD, *Residual claims and self-enforcement as incentive mechanisms in franchise contracts: substitutes or complements?*, in BROUSSEAU – GLACHANT (eds.), *The Economics of Contracts: Theories and Applications*, Oxford University Press, Oxford, 2002. The main conclusion for franchising contracts is the following: *"Residual claims are a particularly appropriate incentive tool […] when output measures (here sales and profits) are good proxies for effort and effort is difficult to monitor [...] By contrast, a franchisee's decision to implement or not new production procedures or new product offerings, or to participate in various system-level activities, and more generally to comply with explicit contract clauses such as those that govern supplier choices and minimum advertising levels, are all fairly easy (low cost) to monitor. The correlation between an individual outlet's sales and compliance by the franchisee with all these policies, however, need not be high at all. If sales and or profits do not provide a good measure of such effort, residual claims will not give franchisees the right incentives to implement them. Franchisors will therefore do better using a self-enforcement mechanism to get the franchisee to participate in these"*.

[43] Cfr. Campbell (ed.), *The Relational Theory of Contract: Selected Works of Ian MacNeil*, Sweet and Maxwell, 2001.

the sense that relational contracts have all the features that discrete contracts do not have. Thus, scholars tend to define relational contracts by defining discrete ones. Unfortunately however, not even the definition of discrete contracts has yet been totally addressed[44].

It is noteworthy that, albeit indirectly, relational contract theory deals with the incompleteness of contracts by trying to overcome the trade-off between completion of the contract ex ante and adaptation ex post. Even if relational contracts do not necessarily extend over a long period, they are nonetheless incomplete[45].

Relational contract theory contributes to our specific issue – the relationship between contract form, contract (in)completeness and the governance of long-term relationships – in two basic ways.
Some legal scholars question the assumptions of economic theory (and of transaction cost economics in particular), by holding that individual utility maximization does not drive economic actors in long-term relationships. Thus parties are more prone to "flexibility strategies", that is to say that "the plausibility of writing contracts in an open-ended fashion turns on assuming a co-operative attitude to the resolution at the appropriate time of the problems initially left open-ended. If there is no shift in attitude, formal provision for flexibility is pointless, for one cannot create a co-operative attitude by writing down that such an attitude will be taken as contingencies arise"[46]. When unforeseen circumstances arise, parties adopt extra-legal strategies to maintain long-term relationships: they abstain from enforcing some terms included in contracts and agree to adjust their relationships cooperatively in a different manner, reallocating both tasks and risks. This implies that the contract terms play the role of coordinating the behaviours of the parties rather than strictly obligating them to perform specific tasks[47]. As will be seen, our findings are consistent with this approach. However, in addition, we will try to much better address which issues play such a role (see section 4).

The legal approach tries to bridge the gap between McNeil's explanations for the emergence of cooperation and the economic assumption concerning individual utility maximization. According to Campbell and Harris, in MacNeil's theory "the self-interest of the individual utility-maximizer must bring about a certain element of co-operation between the parties if their separate goals are to be realized through mutual performances. However, such co-operation does not require commitment to the goal of the other party and indeed may, within prudential limits, be inimical to it"[48].
The weak point is that, in order to explain the rise of cooperation, some assumptions of economic theory (and of transaction cost theory in particular) need to be relaxed. Therefore, some economists subsume the theory of relational contracts to the theory of self-enforcing contracts in order to understand under which conditions long-term collaboration can be sustained without relaxing the assumption concerning selfishness and bounded rationality[49].

Relational contract theory tries to deal with the flexibility problem by assuming that parties often use vague terms to try to approximate an efficient set of obligations, thus shifting to courts the

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[44] It is possible to define discrete contracts as contracts in which (i) there is a clear definition concerning the beginning, the duration and the expiration of the contract; (ii) there is a clear and precise definition of the object of transaction, of the quantity required and of its price; (iii) the contents of the exchange are planned at the time of the formation of the contract; (iv) the rights and the duties of the parties are well defined and allocated at the time of the formation of the contract; (v) little attention is paid to interdependencies and to cooperation between the parties; (vi) the personal relationship between the parties is very limited and the contract is created instantaneously. See MCKENDRIK, *The Regulation of Long-term Contracts in English Law*, in BEATSON – FRIEDMAN, *Good Faith and Fault in Contract Law*, OUP, 1997, pp. 308 – 309.

[45] See GOETZ – SCOTT, *Principles of Relational Contracts*, Virginia Law Review, 67, 1981, p. 1091: *"A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangements to well-defined obligations"*.

[46] See CAMPBELL – HARRIS, *Flexibility in Long-Term Contractual Relationships: The Role of Co-Operation*, Journal of Law and Society, Vol. 20, No. 2 (Summer, 1993), pp. 166-19, part. p. 173.

[47] Cfr. DEAKIN – LANE – WILKINSON, *Contract law, trust relations, and incentives for cooperation: A comparative study*, in DEAKIN - MICHIE, *Contracts, cooperation and competition*, Oxford, Oxford University Press, 1997.

[48] See CAMPBELL – HARRIS, 1993, p. 181.

[49] See GIBBONS – BAKER – MURPHY, *Relational Contracts and The Theory of the Firm*, The Quarterly Journal of Economics, 2002, p. 39-84.

task of enforcing incomplete contracts[50]. Where it is impossible or too costly to specify obligations at the time of contracting, parties compensate for contractual incompleteness through incentive mechanisms. Therefore, parties can specify a general performance standard, such as a "best efforts" clause, for each party. Unfortunately, courts are not always able to properly enforce such clauses. As a result, when recourse to courts is not desirable, parties can opt to introduce other means of controlling the standard of performance. They therefore include in the contract monitoring and/or bonding mechanisms that police the parties' efforts to meet performance standards[51].

In the next sections, I suggest that parties rely on written agreements more than some of the theories presented predict. However, formalization is driven not only by governance considerations, but also by several factors which are not even related to the will of the parties.

The degree of contractual detail and completion mechanisms depends on whether the parties contract in a spot transaction setting or within a long-term relationship involving a high degree of party commitment (strategic relationship). While in market transactions parties rely mainly on detailed written contracts, collaborative and strategic relationships may exist outside of written and highly detailed contracts. In such relationships formal and informal mechanisms are combined allowing each of the parties to respond cooperatively to unforeseen circumstances[52].

On the one hand, parties include in the initial contract specific terms which are easily verifiable and useful for controlling the other party's reliability. A credible treaty for the enforcement of these terms suffices to deter opportunism and to induce compliance. Nonetheless, they also include vague and not easily enforceable standards, thus shifting the enforcement costs to the back-end stage. Since parties rarely rely on courts to resolve disputes – our data are straightforward in this respect – they are inclined to manage them cooperatively[53].

3. Evidence

In order to support our suggestions we analyse data collected in two research projects conducted by an inter-disciplinary research group coordinated by the EUI of Florence and the Department of Legal Studies of the University of Trento (Italy) between 2004 and 2009. The first study was carried out in three industrial districts and one province in the north-east of Italy in different manufacturing and agri-food industries – one case study for each district plus an analysis of the wine sector in the province of Verona[54]. The data were collected by a questionnaire with multiple choice questions.

As reported in Table 1, firms performing different tasks along the supply chain were interviewed. Only in the wine sector are there vertically integrated firms – i.e. which perform all the phases internally (grape growing, vinification, bottling and distribution).

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[50] See GOETZ – SCOTT, *Principles of Relational Contracts*, Virginia Law Review, 67, 1981, p. 1091; JENNEJOHN, *Collaboration, Innovation, and Contract Design*, 2007, SSRN Electronic Papers Collection.

[51] See GOETZ – SCOTT, *Principles of Relational Contracts*, cit., note above.

[52] See GILSON – SABEL – SCOTT, *Contracting for Innovation: Vertical Disintegration and Inter-firm Collaboration*, 109 (3) Columbia L. R. 431, (2009).

[53] See KAPLOW, *Rules versus Standards: An Economic Analysis*, 42 Duke L. J. 557 (1993).

[54] For a comprehensive and detailed presentation and discussion of the results of this research see CAFAGGI – IAMICELI (eds.), 2007, *Reti di imprese tra crescita e innovazione organizzativa: riflessioni da una ricerca sul campo*, Il Mulino, Bologna, 2007.

Table 1 – Number of enterprises interviewed according to the function carried out

	Sportsystem district of Montebelluna	Wine sector in Verona province	Gold district of Vicenza	Furniture district of Treviso and Pordenone	***Tot. N. enterprises interviewed***
Sellers of raw materials	0	11	4	1	**16**
Suppliers of goods or services produced under specific requirements of the buyer	13	0	9	9	**31**
Designers	4	0	0	0	**4**
Final producers	13	17	15	16	**61**
Distributors	3	0	5	4	**12**
Vertically integrated firms	0	3	0	0	**3**
Tot. N. enterprises interviewed	**33**	**31**	**33**	**30**	**127**

Firms are in prevalence small and medium-sized (see Table 2 below)

Table 2 – Number of enterprises interviewed according to size

	Sportsystem district of Montebelluna	Wine sector in Verona province	Gold district of Vicenza	Furniture district of Treviso and Pordenone	***Tot. N. enterprises interviewed***
Firms with less than 50 employees	16	26	19	7	**68**
Firms with 50 employees or more	17	5	14	23	**59**
Tot. N. enterprises interviewed	33	31	33	30	**127**
Firms with revenues of less than 10 million euros in 2004	8	23	13	9	**53**
Firms with revenues of 10 million euros or more in	25	8	20	21	**74**

2004					
Tot. N. enterprises interviewed	**33**	**31**	**33**	**30**	**127**

The data concerning contract form was collected from the enterprises by separately considering sales contracts for the supply of raw materials, subcontracting (contracts for the production of goods produced under the requirements of the buyer) and contracts for the distribution of final goods.

Tab. 3 – Contract form according to the function performed by the contractual relationship (all firms considered)

	Sales contracts for the supply of raw materials	Contracts for the production of goods produced under the requirements of the buyer (subcontracting)*	Distribution contracts
Contracts in writing drafted ad hoc	**46,25%**	39,7%	**67,3%**
Standard contracts (provided by one of the parties or by local institutions – i.e. trade associations, chambers of commerce)	23,75%	4,1%	15,4%
Total contracts in writing	**70%**	**43,8%**	**82,7%**
Oral agreements followed by purchase orders	17,5%	**45,2%**	-
Totally oral contracts	12,5%	11%	17,3%
Total	100%	100%	100%

* = strategic relationships
Higher percentages in bold.

In the case of subcontracting, the data only concern strategic relationships – that is to say relationships satisfying both the following criteria:

a) the contractual relationship must have been in course for three years or more (or less than three years but expected to last more than three years[55]) and one party can be replaced only at high cost to the other party;
b) the parties must have included one of the following devices in the contract: an exclusivity clause; frequent inspection of the other party's premises; the possibility of one party involving the other in making strategic decisions within the firm.

Thus, the data concerning the contract form for subcontracting reveal a different set of relationships – long-term and strategic – because they involve contractual devices for improving commitment and collaboration.

Sale contracts and distribution contracts can formalize long-term relationships, strategic relationships and short-term non-strategic exchanges. Further qualitative interviews clarify that such

[55] Subcontracting relationships last on average 5 years according to the answers from manufacturers and 8 years according to the answers from suppliers. See CAFAGGI – IAMICELI, *Le reti produttive: spunti ricostruttivi da una indagine empirica*, in CAFAGGI – IAMICELI, 2007, p. 333 ss.

relationships are mainly market ones (with a lower level of commitment by the parties), and that in distribution asymmetrical relationships tend to prevail[56].

It is worth noting that disputes are very rare and are almost never taken to court because they are normally settled informally[57]. For instance, in the Montebelluna district 86.6% of disputes are settled cooperatively by the parties. A further study was conducted on the use of an alternative method of dispute resolution in the same district, processed by a committee called the *Curia Mercatorum*, which was specifically set up by the Chamber of Commerce of Treviso[58]. Between 2001 and 2006, 347 alternative dispute resolution procedures were examined by the committee: just one dispute arose concerning a firm in the Montebelluna district and it was finally settled before the intervention of the mediators.

The second research project was conducted at the European level on the wine sector, with seven case studies (three in Italy, and the others in the Loire region in France, the Port and Douro region in Portugal, the Valencian Community in Spain, and selected areas in Hungary)[59]. This study also employed a questionnaire, which was completed by a group of 193 enterprises (Table 4), in prevalence micro and medium-sized (Table 5).

Table 4 – Number of enterprises interviewed according to function

	Italy			Loire	Douro	Valencia	Hungary*	***Tot. N. enterprises interviewed***
	Trento	Verona	Catania - Ragusa					
N. grape-growers	5	5	2	3	1	1	2	**19**
N. final producers	24	21	28	22	23	15	16	**149**
N. distributors	5	4	3	5	6	1	1	**25**
Tot. N. enterprises interviewed	**34**	**30**	**33**	**30**	**30**	**17**	**19**	**193**

**= 10 enterprises were interviewed with a reduced version of the questionnaire, while the others were interviewed using a grid of open questions*

[56] This does not imply that the relationships are short-term. Indeed, sales relationships last on average 13 years according to the answers from sellers and 12 years according to the answers from buyers. See CAFAGGI – IAMICELI, *Le reti produttive: spunti ricostruttivi da una indagine empirica*, in CAFAGGI – IAMICELI, 2007, p. 333 ff.

[57] See CAFAGGI – IAMICELI, 2007, p. 333 ff.

[58] See AZZOLINA – BOSI – GOBBATO, *Le reti di imprese nel distretto dello Sportsystem di Montebelluna*, in CAFAGGI – IAMICELI, 2007, above, 85 ff.

[59] See CAFAGGI – IAMICELI (eds.), *Inter-firm Networks in the European Wine Industry*, 2010, forthcoming as EUI working paper.

Table 5 – Number of enterprises interviewed according to size (see Reg. 2003/361/CE; Reg. CE 363/2004; Reg. CE 264/2004)

	Italy			**Loire**	**Douro**	**Valencia**	**Hungary***	***Tot. N. enterprises interviewed***
	Trento	**Verona**	**Catania - Ragusa**					
Micro	12	12	15	0	11	9	0	**59**
Small	8	3	16	20	9	6	6	**68**
Medium	6	9	1	4	6	2	8	**36**
Large	8	6	1	6	4	0	1	**26**
Tot. N. enterprises interviewed	**34**	**30**	**33**	**30**	**30**	**17**	**15 (4 n.a.)**	**193**

**= 10 enterprises were interviewed with a reduced version of the questionnaire, while the others were interviewed using a grid of open questions. For 4 enterprises the data concerning this dimension are not available.*

The legal form of contracts was analyzed only with regard to sales of grapes and bulk wine, and only for strategic relationships, which were defined with only very slight differences from the definition given above[60]. The evidence shows that written contracts were largely prevalent in Italy (more than 75% of relationships were regulated by written contracts in all three Italian cases) and Loire, while in the Douro region and in Valencia the oral form prevailed. It is notable that in Loire all the contracts were written. In more detail, of the three cases investigated in Italy, in Verona and Catania-Ragusa the strategic relationships for the sale of grapes or bulk wine were regulated by general terms provided by the seller (61.1% and 50% respectively) while in Trento ad hoc drafted contracts prevailed (52.6%), and in France the majority of strategic relationships were regulated by general terms provided by the buyer (50%).

Further analysis of the data collected in the three Italian case studies allows some conclusions to be drawn concerning the relationship between contract form and the object of the contract in sales contracts (distinguishing between grapes and wine). Even though the written form prevails, in the case of the sale of grapes there is a higher percentage of relationships regulated by oral contracts than in that of bulk wine. Qualitative interviews revealed that grapes are much more the subject of long-term

[60] Strategic relationships are those that have a duration of more than three years, regardless of whether they are fragmented in several "contractual periods" each governed by a new contract, and regardless of the legal commitment made by the parties to continue the relationship for a long period (this circumstance does influence the nature of the relationship, but it is not considered a necessary element for defining a strategic relationship) or the possible use of termination clauses. Moreover, the relationships must possess one of the following features: difficulty in substituting one or both of the parties, related to asset specificity or the structure of the market or the quality of product supplied; the use of collaborative tools (co-design of process or product characteristics, monitoring procedures, consulting and information exchange); the use of exclusivity clauses (one or both of the parties commit to not having competitive relations with other partners for the same type of transaction); the use of covenants not to compete.

strategic relationships, as the sale of grapes (often of high quality) calls for deeper coordination between the growth and vinification processes.

Before proceeding with the discussion of data, it should be mentioned that in this study too disputes were very rare and almost none were processed by the courts.

4. **Discussion: explaining the level of contract detail**

The main result of the data concerns the general level of formalization. Regardless of the object of the contract and the length of the relationship, formalization is significant (see Table 3 and the data collected in the study on the wine sector) even though the degree of it depends on whether the relationships are strategic or non-strategic and even though, in the wine sector, remarkable differences among countries emerge.

Purely oral contracts are rare. This is particularly true for industrial districts. It is often held that within industrial districts social ties are substitutes for legal formalization[61]. As the economic actors have reputations to defend, there is no need to increase the enforceability of agreements by detailing duties and rights in written contracts.

Contractual relationships within industrial districts are changing and the use of written undertakings – and specifically of written contracts negotiated *ad hoc* – has been increasing over recent years. The written form works as a safeguard against possible opportunistic behaviour by the parties[62]. This is consistent with the traditional theory according to which trust and formalization are substitutes for each other, which turns out to be true – at least to some extent – if we consider that, according to our qualitative interviews with entrepreneurs, formalization has increased in recent years as bigger final producers (their buyers) have internationalized production to an ever greater degree[63].
On the other hand, contract form and contract detail are both affected by several factors other than concern for increasing contractual safeguards. I focus on this different role of written terms in section 4.1, while in section 4.2 I deal with governance issues in long-term strategic relationships.

4.1 Factors affecting contract formalization

Some drivers which are not directly related to governance concerns can explain the high level of formalization. For instance, parties may have to comply with binding provisions set up by the legislator or with standards set by one of the contracting parties in a supply chain; formalization can also be the outcome of codification of knowledge and its inclusion in the contract. In such cases, written terms perform a function other than governing long-term relationships – for instance they improve coordination. I consider the main factors in depth below.

Regulation

Parties may use written terms to comply with regulatory provisions set up in contract law. In some cases the regulation concerns particular types of contracts and may vary across jurisdictions. For instance, in the Italian law concerning subcontracting (l. 192/1998) a written form is required for a valid contract – even for orders followed by a formal acceptance or for a supplier which starts to perform without formal acceptance. Note that the contracts in Table 3 for the production of goods under the requirements of the buyer are regulated by these mandatory provisions. As can be seen from the table, oral contracts are very few (11%).

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[61] See BRUSCO, *The rules of the game in industrial districts*, in GRANDORI (ed.), *Interfirm Networks*, Routledge, 1999, p. 17 ff.

[62] Cfr. CAFAGGI – IAMICELI, *Reti di imprese e modelli di governo interimprenditoriale: analisi comparativa prospettive di approfondimento*, in CAFAGGI – IAMICELI (eds.), 2007, cit., p. 284 ff.

[63] See also CORÒ – MICELLI, *I nuovi distretti produttivi*, Marsilio, 2009.

However, such an explanation is not consistent with the fact that the written form is also quite common in sales and distribution contracts[64]. Moreover, in subcontracting a significant proportion of agreements are concluded orally and are followed by written orders. Even if written orders can be considered as single subcontracting contracts – and thus valid in accordance with the provisions included in law 192/1998 – courts do not acknowledge that a unique, long-term contract exists when annual (or even seasonal) orders in writing are concluded under a framework oral agreement[65]. This also impedes the provision of the supplier with an adequate safeguard against opportunistic behaviour by the main contractor[66]. Therefore, as suggested in section 2, since the oral form reduces the room for court enforcement, further explanations are needed. I basically deal with the nature of the relationship – market vs strategic relationships – in section 4.2.

There are other rationales for the adoption of the written form for specific industries. In the wine sector – and the food sector in general – specific rules concerning 'rural' law may call for written contracts. This explains the differences among countries in the wine sector. In France, for instance, both grape and bulk wine sales have to be signed in writing and registered; registration is linked to the payment of a tax calculated on the basis of the volume of grapes and bulk wine sold[67]. In fact, in the Loire case study all contracts were concluded in writing.

Furthermore, the wine sector is covered by a specific regulatory system concerning quality and safety. An increased level of regulatory requirements concerning food safety has imposed a shift from oral to written contracts even when the general contract law does not require a specific form[68].

Technological innovation

The impact of technological innovations on contract detail is a relevant and subtle phenomenon. In recent decades the technology for the production of goods has developed greatly. For instance, the production of a sports shoe, of a chair, or even of a bottle of wine is no longer in the hands of skilled craftsmen but of very powerful and complex machines interacting with computers. According to the suggestions of some of the entrepreneurs interviewed, contract detail has been positively affected by the process of codification of knowledge[69].

A very technical description is needed to produce a good according to the requirements of a buyer or a manufacturer. Sometimes the specification of the object is useful for other purposes. For example, in the wine sector the features of the wine sold are described very specifically: the type of grapes, the vinification process, the area of production, the colour, the level of alcohol and other features are indicated. In the past it would have been impossible to specify such requirements so precisely. But the possibility of differentiating the final product by changing even one of the variables may allow the buyer to set up private standards and to impose them on the supplier, thus improving a private regulatory system[70].

This increase in contract detail solves a problem of coordination other than a governance issue. Buyers do not specify the requirements in order to prevent opportunistic behaviour by suppliers but

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[64] In sales contracts, formalization is also explained by an increase in the standardization of contracts (see Table 3). This is not true for distribution, where contracts drafted ad hoc prevail.

[65] See, in Italian case law, Trib. Bari, 11/10/2004.

[66] For instance, if the main contractor does not renew a written order, the supplier cannot invoke the protection of art. 9 of law 192/1998 for abuse of economic dependence as he cannot prove that the orders are part of a long-term valid contract and the missed renewal is actually a withdrawal from a multi-year – even though oral – agreement.

[67] See CAFAGGI – IAMICELI (eds.), *Inter-firm Networks in the European Wine Industry*, 2010, forthcoming as EUI working paper.

[68] See GOBBATO – CASAROSA, *Food Quality Through Networks: Data from a European Research on Wine*, mimeo, 2010.

[69] Note that this is not always the case according to the suggestions by HELPER – MACDUFFIE – SABEL, P*ragmatic Collaborations: Advancing Knowledge while Controlling Opportunism*, Industrial and Corporate Change, 2000, 9, 5, 445 ss., who consider the codification of routines compatible with the use of oral contracts.

[70] See CAFAGGI – IAMICELI, *Private Regulation and Industrial Organisation: the Network Approach*, presented at ELSNIT conference, Paris 2010.

simply to prevent misunderstandings. Thus the shift toward an increase in contractual detail may be driven by issues other than governance.

National vs. international relationships

In order to explain the formalization of relationships we should distinguish between national and international relationships – i.e. those linking national firms vs. those arising between a national firm and a firm from another country[71].

The data show that contracts regulating international relationships are much more detailed than national contracts[72]. They include explicit trade secret agreements and, with higher frequency, exclusivity clauses. Frequently, any innovations developed by suppliers during the production process are allocated to customers.

These contracts approximate the level of completeness in a legal sense. As it is much more difficult to rely on private punishment – based mainly on reputation – the number of contractual safeguards increases. Moreover, although we have little evidence for this, the level of detail increases according to the value of the transaction involved. For instance, joint venture agreements with big Far East suppliers in the Montebelluna district are very detailed[73].

The formalization of such relationships is also connected with the formation of transnational networks[74]. In such cases parties may enter several contracts performing different but interdependent tasks directed to a common purpose. Even if a single contract is not highly detailed, interaction with the contracts connected to it may increase the complexity of the private regulation of the overall economic operation. In other cases, a single contract reaches a higher level of complexity by being combined with agreements concerning modes of production, quality monitoring, use of machinery, trademarks, and, again, safety standards associated with private and public regulation.

Contrary to the other factors mentioned above, this issue is directly linked to governance. International relationships call for further safeguards against opportunistic behaviours by the foreign partners. This occurs for basically three reasons:

Firstly, parties describe reciprocal obligations more accurately because they may rely to a lower extent upon default rules, because of coordination problems among the rules of different legal orders. At the same time, they introduce arbitration clauses to reduce litigation costs.

Secondly, parties may no longer put their trust in reputation mechanisms for non-legal enforcement of the contract; although reputation is a valuable commodity within a local economic community (such as industrial districts); this is not the case in the international context.

Finally, since the value of the transactions involved can be very high, parties may be much more prone to enforce contracts through the courts. Thus, they include written and enforceable terms.
However, in some cases we observe that transnational contracts are also concluded with a combination of both oral and written terms. While the latter regulate single orders, the former usually concern the planning of an uncertain, long-term activity. For instance, in the wine sector some entrepreneurs report that if contracts with international distributors entail complex projects spread over a long period – such as the production of relevant quantities of specific new wines requiring the common definition of

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[71] We draw such conclusions mainly from the research on industrial districts. The internationalization of production and distribution is widespread in some industrial districts, such as the Montebelluna sportswear and shoes district. See AZZOLINA – BOSI – GOBBATO, 2007, above, 85 ff.; CORÒ – MICELLI, 2009, above.

[72] See CAFAGGI – IAMICELI, *Le reti produttive: spunti ricostruttivi da un'indagine empirica*, in CAFAGGI – IAMICELI, 2007, above, p. 333 ff.

[73] See CAFAGGI – IAMICELI, 2007, above.

[74] See CAFAGGI, *Contractual Networks and the Small Business Act: Towards European Principles?*, 4 European Review of Contract Law 49 (2008), 495; CAFAGGI, *Contractual Networks, Inter-firm Cooperation and Economic Growth*, Cheltenham Glos, Edward Elgar, forthcoming (2010b); DI MARIA – MICELLI, *District Leaders as Open Networks: Emerging Business Strategies in Italian Industrial Districts*, Padova University, Marco Fanno wp. N. 38.

standards for the product – the written contracts set aside many issues concerning the regulation of the relationship.

In other cases distributors rely on an intermediate enterprise for the coordination of the production of one or several wines by many small-sized producers according to the requirements of the distributor. Each year, a few months before the harvest, the intermediary spends resources on looking for appropriate producers according to an oral agreement with the distributor and before entering into the final distribution contract.

Therefore, the drivers for contract formalization trace a general outline which needs to be addressed by also taking into account other relevant issues such as the level of commitment of the parties and the uncertainty they face in setting up a collaborative process. The next paragraph will take some steps forward in this direction.

4.2 The governance of long-term relationships and the role of courts

The overview presented in section 2 illustrates the different views of the literature on the relationship between contract form and governance. One of these views is that parties try to complete contracts as much as possible in order to avoid legal enforcement, which can be too costly and even unfeasible when the contractual terms are non verifiable by courts.

Before examining this issue, our data suggest taking a step back and first examining more carefully the absence of formal settlement though courts. I think that, principally, litigation costs matter: this seems to be strongly linked to the non verifiable argument. But this is not always the case. Here I am not referring to the ability of the courts to address disputes or to enforce terms set by parties at the beginning of their relationship, but to the mere costs connected to access to justice in terms of the length of legal suits and related expenditures. The problem is straightforward both for legally complete contracts and for incomplete contracts.

This issue operates as a limitation which forces parties to settle disputes by themselves, with the exception of high-value transactions which are worth formal settlement. Theory also predicts that the choice of whether to bring a dispute before a court or to adopt other enforcement mechanisms, such as arbitration, may affect the initial design of contracts[75]. Our results show that no substantial differences emerge between courts and arbitration: parties seldom rely either on arbitration or on courts.

Apart from this, a tension with our main evidence (the formalization of contracts) seems to emerge. If parties resolve disputes without relying upon courts, why write contracts? Some explanations have been provided in the previous subsection, but governance issues also matter.

One option for better linking the level of contractual detail to contractual governance is to distinguish between market relationships and strategic relationships. Apart from a detailed description of the object, contracts regulating market relationships usually specify the quantity, the price, the time of delivery and of payment. More generally, parties specify the content of an obligation ex ante rather than draft standards which leave a large portion of the content of the obligation to be determined after the regulated issue has occurred[76]. Thus market contracts are consistently complete in a legal sense as no relevant issue remains unexpressed[77].

Enforcement is basically carried out in two ways. To a large extent, since such contracts do not entail specific investments or a specific commitment, the party aggrieved by the breach may exit the relationship at a very low cost. This is usually done by not renewing the contract (or, more simply, the order) anymore.

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[75] See SCOTT – TRIANTIS, 2005, above, cit.

[76] On the difference between rules and standards in contract law see SCOTT – TRIANTIS, 2005, above, cit. and KAPLOW, *Rules versus Standards: An Economic Analysis*, 42 DUKE L. J. 557 (1993).

[77] One problem remains is that of which law is applicable when parties do not include any reference to default rules – and this is usually the case. In the food sector Italian courts have applied both the law of sale contracts for the production of a not yet existent good and the discipline of "contratto di appalto" (tender contracts). See JANNARELLI, *I contratti dall'impresa agricola all'industria*, Rivista di Diritto Alimentare, 2, 2008, p. 5 ff.

To a lesser extent, enforcement is realized by threatening to sue the breaching party before a court – at least for transactions of some value, as otherwise the threat would not be credible. The terms can be checked and proven at low cost even by resorting to default rules. In this case, the role of courts is quite clear: since there are no implicit understandings between the parties, it does not make sense to wonder whether courts should interpret an agreement by paying as much attention as possible to the written text and to the ordinary meanings of the words it uses or whether they should adopt a contextualist approach also considering the practices adopted by the parties and memoranda, letters, etc.[78]. The written text includes all the relevant issues and the cost of interpretation is low. Moreover, enforcement by the usual sanctions – expectation damages – may induce efficient performance at the first stage.

Our explanations are consistent with economic theory: in the case of low transaction costs – low complexity, low uncertainty, and low specific investments – parties use standard safeguards. Since there is a common understanding of the fact that contracts are formally enforceable, the mere threat of bringing a lawsuit to court suffices to reach compliance.

Strategic relationships instead are formed when a higher level of collaboration is needed. Here problems of the non-contractibility of some issues may emerge. This usually happens when one party has specific capabilities or specific resources. Think of a skilled specialized supplier or of a producer of a specific good not easily recoverable in the market (e.g. a grower of high quality grapes). Such relationships usually entail a high level of commitment. They are usually formed to produce a (final or intermediate) good under the requirements of the buyer[79].

Contracts regulating strategic relationships specify certain issues such as the price, the quantity, the time of delivery and of payment. They also include further agreements concerning exclusive dealing arrangements, trade secret agreements, and covenants not to compete. However, many contractual issues may not be defined in the written text. This is the case of subcontracting in Table 3, where a significant proportion of relationships are regulated by oral agreements followed by written orders. This explains the higher level of oral contracts in the relationships concerning grapes, which are usually considered more strategic than bulk wine as they are usually provided for the production of high quality wines. As mentioned above, some entrepreneurs in the wine sector report that if contracts with international distributors entail complex projects – like the production of relevant quantities of specific new wines requiring a common definition of standards for the product – the contracts set aside many issues concerning the regulation of the long-term relationships. This is not to say that contracts regulating strategic relationships are concluded totally in oral form: instead, our data show a general formalization. More simply, the focus is not so much on form as on the degree of formalization.

Some written issues are included to increase the parties' commitment. For instance, consider trade secret agreements and exclusive dealing arrangements. These terms are included in contracts because:

- They are easy to enforce, at least to some extent. Parties may rely on the low costs of proving a cheating behaviour. For instance, consider a violation of an exclusive dealing arrangement or of a covenant not to compete by one of the parties[80]. This is consistent with the theory of

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[78] See SCHWARTZ – SCOTT, *Contract Theory and the Limits of Contract Law, Yale Law Journal, Vol. 113, Nov/Dec* 2003.

[79] The empirical evidence concerning industrial districts shows that collaboration between final producers and suppliers has recently increased. Cfr. GARGIULO – MARIOTTI, *natura e ruolo degli accordi di collaborazione tra pmi: un'indagine esplorativa nel settore legno-arredo*, in TRAÙ (a cura di), *La «questione meridionale» nell'industria italiana*, Bologna, Il Mulino, 1999.

[80] It is not so costly to prove the violation of such agreements. However, this is not always the case when a trade secrets agreement is signed. In such a case it can be difficult to prove that the third party has received the information from the cheating party or to contest a claim according to which the information was produced by the third party itself. Therefore, "*a covenant not to compete or an exclusive dealing arrangement may provide better protection than trade secret agreements, since these do not simply prohibit the disclosure or use of knowledge, but they also establish some restrictions on the mechanism through which the spillover occurs*". See GOBBATO, *Long-term relationships, networks and exchange of knowledge in production and distribution contracts*, in A.A.V.V., "*From Exchange to Cooperation - Networks and Long-Term Relationships in European Contract Law*", SECOLA Conference proceedings, forthcoming;

self-enforcing contracts in which some variables are defined to increase the promisor's costs of cheating. The low rate of litigation is consistent with such explanations because the threat of appealing to a court is credible given the low costs of verifying cheating.

- They may perform other functions such as risk sharing. For instance, the promisor assumes the duty of producing a certain product only for a specific promisee under a requirement set up by the latter. But in return the promisee may commit to buy all the production – or a certain (and relevant) part of it. Thus the promisor has the assurance of selling a planned quantity. This is very important in some industries like wine, where the supplier has to know in advance to whom he is going to sell the grapes or bulk wine at the time of harvest. Such clauses were also found in contracts between high tech suppliers and large buyers in the Montebelluna district.

It should be noted that, according to our results, there is a remarkable level of formalization and so purely oral contracts are rare. Thus, in a large proportion of cases the parties operate in the shadow of legal enforcement, even if contracts include open term agreements or they do not regulate some issues at all.

Here, the theoretical problem is whether we are examining unenforceable incomplete agreements or enforceable open-term agreements. Note that parties may ignore the distinction[81]. Indeed, the threshold between the two may sometimes be hard to define. Nonetheless, theoretically speaking, the task of the courts changes: in the first case they should intervene by filling the gaps in the contract; in the second case they should interpret an existing – but unclear – agreement. We consider here the more radical perspective – parties enter some unenforceable incomplete agreement – but we suppose that they deliberately opt for this choice.

In fact, if we consider that contractual disputes are settled informally by parties themselves, we should conclude that parties take care more of the flexibility of contracts than of the possible litigation costs arising by the possible (and probable) disputes once the contract is concluded and so that they design contracts with the awareness that the terms will not be enforced by the courts. The role of courts is therefore marginal and it will be examined below.

So, why in our setting do parties conclude incomplete contracts rather than spending more resources on trying to complete them in the first stage? There are basically two explanations: the possibility of concluding cheaper self-enforcing agreements (see section 2.3) or the problem of uncertainty, which induces the parties to save contracting costs and shift the decision about the allocation of results to when the uncertainty is resolved[82].

In the first case, losses in reputation and the possibility of being excluded from future transactions may induce each party to cooperate (see subsection 2.3) – remember that strategic relationships usually last for many years (see section 3) and parties may face high exit costs. Moreover, in social-economic communities unwritten rules may play the role of filling the consequent gaps, even if they are frequently contingent to the community which has produced them[83].

Even if this is not the case, possible cheating may be reduced by the uncertainty concerning the object of the contract as well as the future state of the world. Because of this, on the one hand some terms are written but will be changed during the relationship as new information becomes available. This is the case of technical features or blueprints. In strategic relationships the goods exchanged are seldom standard commodities. Even if the promisee determines the requirements for the good it is very common for the supplier to contribute by defining them further. For instance, an initial project provided by the final producer may call for adaptation of the material used for the final production. The content of the duties of the parties may therefore change, regardless of what they have planned in the contract.

(Contd.)

GILSON, *The legal infrastructure of high technology industrial districts: Silicon Valley, Route 128 and covenants not to compete*, 74(3) New York Univ. L. R. 575, (1999).

[81] See SCOTT, 2003, above, p. 1644.

[82] See GILSON – SABEL – SCOTT, 2009, above.

[83] See BRUSCO, *The rules of the game in industrial districts*, in GRANDORI (ed.), *Interfirm networks. Organization and industrial competitiveness***,** Routledge, London, 1999, p. 1 ff.

On the other hand, no safeguard against the appropriation of quasi rents may be specified in the contract because these issues are not contractible. However, this does not result in a failure of negotiations – i.e. the parties refuse to undertake specific investments, as institutional cost economics predicts – nor in the assignment of the residual right of control to one of the parties – as predicted by other models presented above (see section 2). In fact, because of uncertainty, they adopt a more practical approach, thus overcoming the problems related to specific investments. For instance, if the supplier is very specialized and he is asked to specifically invest, the manufacturer (the promisee) has no incentive to cheat because he needs the capabilities of the supplier. This could even be the outcome of a process of increasing reciprocal complementarities. The manufacturer may gradually externalize some specific production tasks – and save the costs of performing them internally – as he can rely on the technical capabilities of third firms. Moreover, specialization changes the range of specific investments: the supplier reduces his specific investments in the single relationship because they become network-specific, or even industry-specific, thus reducing the danger of cheating by the promisor.

The statement that coordination between specific investments is not possible, as found in the literature, is not always true. When uncertainty is very high, parties are unable to foresee the amount of investment they will make in the final stages. Thus they may adopt a strategy of investing progressively in the relationship by raising the switching costs for both, and at the same time of acquiring knowledge about the collaborative attitude and the technical skills of the other party[84].

As the final stages draw near, opportunistic behaviour may arise. However, (i) at such time both parties have already undertaken specific investments in the project, and (ii) even if at the end the investments are asymmetrical so that one party has more incentive to cheat than the other, no possibility of predicting such an outcome may arise. Consider again the case of a shoe designer. Suppose that an innovative project for a sports shoe has already been carried out. The manufacturer may refuse to pay the designer by claiming that he is not satisfied with the product. However, he has probably engaged some of his own laboratories and spent resources on the innovation process. He may thus be more interested in resolving technical problems than in raising spurious claims. Moreover, it is common for the designer to be required to also be involved in setting up the final model – after athletes having tested the product – and in following the final production[85]. Therefore, the execution stages are interdependent and all call for the collaboration of the designer.

We also observe clauses which postpone disputes on risk management in order to manage them cooperatively ex post without relying on courts. For instance, consider the following clause: "If, during production, the promisee (manufacturer) requires the promisor (supplier) to make any modifications to the original project, the explicit consent of the promisor is required; the latter should be informed immediately of the modifications and also of the motivations which force the promisee to ask for the modifications, providing that the modifications do not radically alter the initial product required"[86]. It is hard to define well what radical modifications are. At the same time, the requirement concerning motivation is consistent with the principle of collaborative risk sharing as the supplier may accept sharing the risk if the motivation turns out to be justifiable; furthermore, this is also consistent with the willingness of the parties to not regulate the relationship by relying on costly legal remedies when unverifiable variables are at stake[87]. Clauses like this are common in long-term contracts (for example, renegotiation clauses).

This explanation does not apply when the uncertainty is not so high as to impede the parties from predicting the outcome. In fact, there are some cases in which the strategy proposed by Gilson, Sabel and Scott is not fully convincing. They assume that the constraints set up by parties (stemming from a rise in bilateral switching costs) result only from the interaction between them. In fact, the

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[84] See GILSON – SABEL – SCOTT, 2009, cit. and GILSON – SABEL – SCOTT, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, Columbia Law Review, 110, 6, 2010, p. 1377 ff.

[85] Consider the following clause: "The promisor (designer) commits to design the good and to also to assist in the realization of the models, in collaboration with trustworthy employees of the promisee (manufacturer)".

[86] Translation provided by us.

[87] See GOMEZ, cit., 2010, p. 11.

specific investments they refer to are related to their (specific) knowledge of their counterparty's attitude to collaboration[88]. When the relationship does not entail any interaction concerning the definition of the object of the contract, Gilson et al.'s explanations are not fully persuasive. For instance, if a party produces a certain type of good, the counterparty may raise spurious claims about an alleged breach of the blueprint purely to reduce the price, knowing that it would not be easy to find an alternative seller. In this case there is no investment in reciprocal knowledge, while there are unilateral physical assets tied up. The threat of the other party thus becomes credible. However, in this case the cost of writing legally complete contracts decreases; for instance, parties may introduce parameters to define the quality of the product supplied thus reducing the room for the buyer to cheat by claiming that the product does not meet the quality standards[89].

The courts would not seem to play any role in this framework. But this is not totally true. As the literature reviewed above acknowledges, it is generally true that courts face cognitive problems, basically stemming from the costs to the parties of getting information. Moreover, as courts are usually incapable of dealing with the sophistication of business contracts[90], firms prefer their agreements to be enforced as written and courts to use a formalistic interpretation approach[91].

This might be the case when parties include enforceable terms in their contracts, such as exclusive dealing arrangements and covenants not to compete. By enforcing them, courts contribute to creating the basic rules of collaboration as set up by the parties. The unexpected level of formalization resulting from our data may also be interpreted as a willingness of parties to produce enforceable terms. Thus they expect, at least as a last resort, to rely on the courts for enforcement and, consequently, to use such a contract as a compliance enforcing mechanism.

This may not be true for the task of filling gaps. In this respect, especially in civil law regimes, general default rules or applicable mandatory rules may be unsuitable for acknowledging the complexity of real interactions such as idiosyncratic exchanges or even long-term relationships[92]. And this may hinder the ability of courts to acknowledge informal understandings between parties.

In consequence, the solution proposed by relational contract scholars of taking the context in which the relation is embedded into account may not be feasible[93]. In the US, lawyers have sought legal principles suitable only for relational contracts in vain [94]. In Italy, some lawyers try to

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[88] See GILSON – SABEL – SCOTT, 2010, cit., p. 1403: "*[…] The parties' increasing knowledge of their counterparty's capacities and problem-solving type, a direct result of the processes specified in the formal contract, creates switching costs—the costs to each party of replacing its counterparty with another—that constrain subsequent opportunistic behavior*".

[89] For instance, in the agri-food sector, the vagueness of the production standards communicated to suppliers may result in an increase in discretion for the buyer to refuse to receive the goods with the pretext of nonconformity to quality specifications.

[90] See SCOTT, 2000, cit., p. 875 "*At bottom the case for formalism in relational contracts turns on the relative implausibility of the empirical conditions necessary for activist incorporation: competent courts and incompetent parties. The evidence from the cases adjudicating contract disputes under both the Code and the common law is that the more likely empirical condition is competent parties and incompetent courts*".

[91] See SCOTT, *The Case for Formalism in Relational Contracts*, 94 Nw. U. L. Rev. 847 1999-2000. Other formalistic approaches hold that courts should enforce express contract terms literally without filling any gaps at all. See POSNER, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 Nw. U.L. REV. 749 (2000).

[92] This problem has been questioned in Italian law with regard to default civil code rules concerning the allocation of risk. See MACARIO, *Relational contracts e Allgemeiner Teil: il problema e il sistema*, cit., p. 123 ss. MAZZAMUTO – PLAIA, *I rimedi*, in CASTRONOVO - MAZZAMUTO (a cura di), *Manuale di Diritto Privato Europeo (vol II)*, 2007, Cedam, Padova, p. 739 ss.

[93] See MACNEIL, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. REV. 854 (1978); See also HADFIELD, *Problematic Relationships: Franchising and the Law of Incomplete Contracts*, Stanford Law Review, Vol. 42, No. 4 (Apr., 1990), pp. 927-992. and, as quoted by SCOTT AND TRIANTIS, 2006, p. 832, note 42.

[94] Cfr. EISENBERG, *Relational Contracts*, Pal. Dic. Of Ec. and the Law.

acknowledge certain principles for long-term contracts[95] or, more broadly, for business contracts[96]. Some of the results reached by legal scholars, also based on the explicit regulation of some contracts by the Italian legislator, are noteworthy, but not enough to identify a *corpus* of norms that courts may rely on in addressing disputes for long-term business contracts.

If parties bring a dispute before the courts, one possible (but costly) solution is to try to force them to re-negotiate the agreement under *bona fide*[97]. But the feasibility of this solution is dependent on the principles prevailing in each individual jurisdiction. For instance, in Italy parties may intentionally leave a gap in a contract and include an obligation to determine the issue afterwards. If they have not clearly excluded the possibility of judicial intervention, a judge may fill the gap, but he cannot oblige the parties to negotiate[98]. In some cases parties may prefer to fill the gaps by themselves rather than leave the task to a judge. Alternatively, one party might strategically refuse to renegotiate to induce the judge to apply default principles when they are favourable. However, the outcome of such an interpretation process is not easily predictable as the judge is required to apply general principles to a specific context.

Finally, it is worth observing that sometimes courts may intervene more effectively; as scholars of relational contract theory acknowledge, economists have approached the problem of non-verifiability somewhat radically and unrealistically[99]. Moreover, as transaction cost economics itself suggests, the institutional background matters[100]: the rules of commerce established by chambers of commerce and by local institutions may contribute significantly to improving knowledge of common practices in commercial relationships. Unfortunately, such rules are contingent to the community which has produced them. In other cases, they reflect a specific piece of legislation or common practices widespread in a specific sector[101]. Thus more research is needed to explore idiosyncratic rules more deeply, carefully investigating the extent to which they are comparable[102].

5. Conclusion and suggestions for future research

This paper has tried to contribute to the debate concerning contract form, contract detail and their interplay with governance issues by discussing some empirical data obtained from two research projects. Although the data were collected in very different industries and the group of enterprises

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[95] See MACARIO, *Relational contracts e Allgemeiner Teil: il problema e il sistema*, in NAVARRETTA (ed.), *Il diritto europeo dei contratti fra parte generale e norme di settore*, Milano, Giuffrè, 2007, p. 123 ff.; Granieri, I contratti di durata, 2008.

[96] Cfr. GITTI – VILLA (eds.), *Il terzo contratto*, Giuffrè, Milano, 2007.

[97] In common law regimes see GILSON – SABEL – SCOTT, 2010, cit., p. 1427: "*The courts are only deploying low-powered incentives; that is, courts sanction only cheating on the parties' mutual commitment to iterative collaboration, but do not attempt to regulate the course or the outcome of the collaboration. Put differently, the court should require a party who breaches its promise to invest collaboratively to repay the price the counterparty paid for the option—the amount spent on the preliminary investment—however, it should not require even a breaching party to exercise the option either by completing the transaction or by imposing expectation damages*".

[98] See FICI, *Contratto incompleto*, Dig. Disc. Priv. Sez. Civ., Agg., 2007, p. 275 ff.

[99] See HADFIELD, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159, 162 (1994), which states that: "*For the most part, competence has been treated as an either/or proposition: courts either can or cannot verify a potential contracting variable. ... [But] verifiability is a matter of degree not dichotomy; judicial competence is more or less limited because courts make errors more or less frequently in "observing" a contract variable or translating an observation into a conclusion about efficiency. ... The dichotomous verifiability approach to contract enforcement is somewhat surprising in light of the extensive literature examining the implications of varying degrees of imperfection in the enforcement of tort and criminal law*".

[100] See WILLIAMSON, 2005, above.

[101] See BERNSTEIN, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, Chicago Law School, John M. Olin Law & Economics Working Paper No. 133, 2001.

[102] For a consistent comparative approach on these issues see DEAKIN – LANE – WILKINSON, above, 1997.

involved do not have the features of a statistical sample[103], we are also aware of the scarcity of research projects concerning the concrete use of contracts in business and so we are confident about the utility of the analysis.

The most important and unexpected result is the high level of contract formalization. The paper has described the factors affecting the formalization of contracts. We have seen that some of these factors, disregarded by the literature, are unrelated to governance.

As regards governance, we face an apparent tension. The degree of formalization is high, so according to the literature we expect parties to rely on courts for enforcement. But this rarely happens. Our basic explanation is the following: parties operate in the shadow of court enforcement. They complete contracts to increase the abilities of courts to enforce their obligations and at the same time they may use the counterparty's awareness of this to obtain compliance. We have seen that parties only actually resort to formal enforcement to a limited extent because of the costs involved.

However, in long-term strategic relationships parties may also rely on unwritten terms or may even decide not to complete the contract in order to preserve flexibility as uncertainty increases. Instead, they may activate a process of reciprocal interaction to solve practical problems while increasing their reciprocal knowledge and the switching costs of exiting the relationship. Nevertheless, parties sometimes leave terms unwritten because they rely on informal rules, widespread in cohesive local communities, or on common rules of commerce.

In other cases they insert clauses which open "renegotiation room" during performance. When a dispute emerges, courts are required to enforce the written terms, while they are incapable of dealing with informal undertakings because of both cognitive problems and of interpretation problems stemming from the unsuitability of default rules for idiosyncratic exchanges. One possible solution is to force parties to renegotiate and, in the case of failure, to apply default rules.

I wish to make some suggestions for future research. The research carried out suggests that other elements should be considered in addressing the analysis of contract formalization. Among other things, contract formalization can be affected by the hierarchy in the relationships, by the value of the transactions, and by the standardization of contracts. We have collected some reports according to which the higher the level of hierarchy in contractual relationships, the more formalization; and the higher the value of the transaction, the greater the degree of contractual detail. Unfortunately, we have no strong evidence supporting either of these hypotheses. Moreover, theoretical counter-claims can be raised. For instance, within hierarchical relationships the main contractor is sometimes reluctant to enter a written contract since the oral form may hinder access to remedies for the weaker party[104].

Finally, the standardization of contracts does seem to positively affect formalization, although we sometimes observe a widespread use of the written form even in the absence of a high level of standardization (e.g. see distribution contracts in Table 3). Thus a deeper understanding of the interplay among such factors is required.

[103] See CAFAGGI – IAMICELI, 2007, above, p. 3 ff.

[104] See, in Italian case law, Trib. Bari, 11/10/2004.


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