Contracting with Contracts:
How the Japanese Manage Organizational Transactions

Michael J. Smitka

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Michael J. Smitka
Associate Professor of Economics
Washington and Lee University
Lexington, VA 24450

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"...all legal systems must have a set of rules to govern the making and enforcement of agreements, and we hope that much of what we say about the English law of contract will have parallels in the law of contract in other legal systems." (Harris and Veljanovski 1986:109)

"...in negotiating the settlement...it is a waste of time and expense to investigate the precise legal position. .... It would clearly not make economic sense to settle all contractual disputes out-of-court...[but] An appreciation of this situation should lead contract lawyers to the conclusion that legal rules on remedies for breach of contract should be designed to take into account the fact that in the vast majority of cases the rules will be used to guide out-of-court settlements and to induce compromises." (ibid., pp. 116-117)

I. Introduction

This book seeks to pull together two approaches to institutions, those of law and organizational theory. As an economist, I stand somewhat apart from both of those approaches. Within economics, law on the one hand is presumed to provide an essential support for "market" transactions, but the nature of that support is seldom specified. On the other hand, organizational studies focus upon "hierarchy," the locus of most day-to-day economic activity in the U.S. Economics, however, typically treats organizations as a black box that is best left unopened. Here my focus is on the presumed centrality of contract law, drawing upon empirical work on the Japanese auto industry (Smitka, 1991).

My analysis draws upon the transactions cost approach of Coase (1992) and Williamson (1985), and recent work in game theory (various chapters in Gambetta, 1988). Ironically, in their work Coase and Williamson retreat to an analysis based on the formal structure of Law and of the organization of the Firm. While these provide a convenient starting point, one motivation for this book is the need to understand a world in which these pure structures cannot be empirically isolated. Indeed, neither law nor organization by themselves provide an adequate theoretical framework for understanding the base on which transactions are grounded. Thus economics as a field can benefit from -- and by providing another perspective, contribute to -- a richer research paradigm.

In the following I argue from my own empirical work, which highlights the pervasiveness of complex, deep-reaching interactions among firms that maintain many of the features of intraorganizational transactions. As such, they fall outside the realm of "hierarchy," but are also outside the scope of the "market" of neoclassical economics and the classical contract theory in law. However, I believe that the "relational" contracting and "network" organizational forms that are central to the Japanese auto industry are typical of economic transactions in general.

The central feature I see in such transactions is both the necessity for and the possibility of relying upon trust among parties, where legal remedies are too awkward and ineffective to be central. (See likewise Black, 1976:40, who as a sociologist argues that law will be comparatively dormant when interdependence is central.) But if trust is effective -- and by "trust" I mean a willingness to act in reliance on the other party, where circumstances do not compel them to be trustworthy -- then what constructive role can contract law play?

(Similarly, then in what way is formal organization -- the firm -- important?) These are clearly extreme positions, but taking them as a starting point will, I believe, lead both to better empirical work and to more precise theory. In the conclusion I briefly look at issues that my own and other recent studies of contracting raise for organizational studies. The bulk of this chapter, however, will focus upon the role of law.

Briefly, I posit that law -- or more precisely, contract law -- is unnecessary. In other words, *contracting* -- the framing of the environment for transactions -- is quite possible without *Contracts*, the potential for legal enforcement of the agreements that accompany transactions. Indeed, I argue that the Japanese economy is best characterized as functioning without Contract. (See Haley, 1991, for parallel arguments about the overall role of law in the Japanese polity.) At least when Japan's performance is viewed from afar, it is easy to presume that economic efficiency suffers little or may even be enhanced in such a "lawless" society. Let it suffice that Japan demonstrates that it is possible to have a complex, vigorous economy without contract law and associated legal institutions playing a central role.

As noted, the null hypothesis that law is irrelevant runs against the grain of legal scholarship. It does, however, serve a useful purpose by forcing careful arguments for how law actually matters. One role that I believe law should play is to suggest how transactions ought to be framed to encourage trust and avoid dispute-prone situations. In this normative and pedagogic role, drawing up a contract serves primarily as a check that each side has thought through the core business elements, to try to assure that both parties have an ex ante interest in carrying through their end of the deal. The training of lawyers in the U.S., however, stresses the importance of Contracts over contracting, that is, the need for protection

should things go wrong over the prevention of things going wrong. The emphasis on carefully drafting a document all too often diverts the parties' attention from the business at hand. Indeed lawyers, in a careful professional stance, will claim that their purview should be limited to narrow legal advice. I believe this combination produces unnecessary (if for lawyers fruitful) levels of dispute.

Second, the prevalence of complex transactions, and the often tenuous connection that Contracts bear to the real world of business contracting (a point long ago made by Macaulay, 1963), should serve as a cautionary tale for the ability of courts to resolve disputes. In one sense, this is what lies behind the death of classical contract law that Gilmore (1977) portrays as occurring through the accretion of exceptions to the classical doctrine, stemming from the willingness of courts to try to handle increasingly complex cases. Ironically, this may have made matters worse, because it creates pressures for more specialized and complex documents and hence a greater role for lawyers. Instead, a greater reticence by courts to attempt to resolve disputes would encourage parties to exercise more care up front.

However, restricting the role of the legal system makes sense only if it is indeed practical in most situations to rely upon trust and relational mechanisms to support contracting. There are situations -- fraud, incompetence -- that are appropriately recognized under current contract law (or shifted over to Torts). We may as a society wish to provide protection to "small" parties who find it hard to self-insure through numerous independent transactions, and who have neither the resources nor the experience to carefully craft transactions. (In fact, reforms to make available "small claims" procedures are now being discussed in Japan.) But I think that such situations should be viewed as exceptions to the

general rule, and that the granting of these exceptions should be grounded in careful theoretical and empirical work.

This argument is in accord in many ways with the findings of the Wisconsin school. Macaulay (1963) stresses the divergence between what contract law says and what businessmen do; Macneil (1985) argues that the contract law conception of a world of "spot" transactions is at variance with the pervasiveness of "relational" contracting. Both, however, start from the presumption that law matters or ought to matter, that the real world operates under the shadow of the law. Closer in spirit is the recent study of Ellickson (1991), who highlights how (in his case) neighbors settle disputes outside of the shadow of the law, and why non-neighbors in similar situations may have recourse to law.

With these themes in mind, let me now leave Contracts behind and turn my attention to the world of contracting. In the conclusion I will briefly turn my skeptical eye to studies of the Firm.

II. Transactions and Trust

The Larger Literature

Many fine studies of contracting and interfirm organization have appeared in the past five years; most of these are of manufacturing, and many were stimulated by an interest in reputedly distinctive Japanese practices. (Much of this work is also informed by if not inspired by Williamson, 1975, 1985.) Along with my study of the Japanese automotive industry, there is Helper's (1991) work on the U.S. auto industry, Sako's (1993) book on British printed circuit board makers, Nishiguchi's (1993) book on autos and consumer

electronics, Lorenz's paper (1988) on French machine builders, Dore's (1986) book on the Japanese textile industry, and Joskow's (1985) analysis of coal markets. In addition to these studies by economists and sociologists are a series of anthropological studies of wholesale food markets -- Acheson (1991) on Maine lobsters, Bestor (1993) on Tokyo's seafood market, and Silin (1972) on Hong Kong produce markets.[1]

Two common themes are found in these studies. One is an emphasis on the wider context of the relationship; the atomistic "spot" transactions envisioned in classical contract theory (and the atomistic, anonymous markets of introductory microeconomics) are not what one finds in the real world. (Again, note Macneil, 1985.) Another implicit and often explicit theme of these recent studies is the role of "trust" in contracting. Virtually any economic transaction requires that parties rely upon each other, that one or both sides place themselves at risk. Formal contracts can highlight where risks lie, and provide penalties for reneging. But contracts in themselves are inadequate to produce active compliance, and provide little guidance on how to adjust terms when problems arise but (as typically is the case) both sides still wish to carry through. Trust can help parties muddle through; contracts invite conflict. But these are only a few of the facets of trust; for other examples, see the Gambetta (1988) volume *Trust*; my own study (1991:Chapter 6), Sako (1991) and Sitkin and Roth (forthcoming).

To reiterate, the thrust of these studies is that contracts are neither sufficient nor even necessary to provide assurance of performance. Indeed, below I make two simple, primarily empirical, claims. The first is that trust is not primarily a cultural phenomenon. It is certainly true that goodwill is widespread in Japanese and American society -- as stressed by

(respectively) Dore (1983, 1986) and Macaulay (1963) -- while a cultural legacy of distrust of others is similarly a barrier to development in many ethnically diverse societies. Clearly, without trust there is no civilization. But in business mere goodwill is insufficient; for example, the village and ethnic ties in Silin's (1977) Hong Kong wholesale market, and the familial ties in Bestor's (1993) Tokyo fish market, provided at most a common starting point. Whatever the social or cultural foundation, parties invest much time and energy to develop trust, as a conscious part of their business strategy.

Indeed, the ability to deliberately foster trust leads to my second point, that trust offers an effective substitute to law as a basis of contracting. Parties require a concrete reason to trust each other, to risk non-performance by the other party. Such trust can be, and in Japan is, deliberately fostered through appropriate contracting strategies, which I sketch below. I believe, furthermore, that similar strategies can be employed in the U.S. Trust then in general offers a viable alternative to Contracts -- indeed, trust is necessary even with Contracts. But in that event the Hobbesian specter of chaos in the absence of law reduces to a ghostly mist. The opposite problem may be more important: law imposes an artificial structure upon contracting that all too often blinds parties to the need and the potential for crafting transactions in a manner that facilitates trust, as Sitkin and Roth (forthcoming) also argue.

Contracting in Japan

As is reasonably well known, lawyers play a small role in Japanese society. The Bar is kept small; only about 600 individuals a year pass the written exam and go on to the mandatory legal apprenticeship. As a result, Japan with a population of 125 million has approximately

14,000 lawyers, or fewer than Manhattan. Furthermore, from this group are drawn not only the nation's 3500 judges -- again a small number relative to the population -- but also public prosecutors, private practitioners, and the elite of the law school faculties.[2] The result is long dockets -- an average of a year even for simple civil cases -- and, relative to the U.S., a small body of case law.[3] In short, whatever the theoretical possibilities are for using courts and other quasi-legal fora to resolve contract disputes, the remedies they provide in Japan are almost always too little and too late. (Indeed, I am only aware of only one instance in the auto industry in which a dispute was taken to court.[4]) The legal system well-nigh forces parties to rely upon their own devices. Upham (1987) eloquently argues that this reflects a deliberate choice by the government during the post-WWII era, and he and Haley (1991) provide other examples besides Contracts where formal law plays a minor role relative to the U.S.[5] In any event, formal contracts tend to be brief -- one typewritten page -- and leave many details to be specified elsewhere.[6] As a result, except for international transactions and the occasional real estate case, lawyers are not involved in drafting contracts.[7]

Of course, a sophisticated commercial economy is symptomatic of an environment of interfirm specialization and the routine reliance upon transactions with other legal entities. There is clearly a need for some sort of framework for governing these everyday transactions. The standard assumption has been that, absent a Hobbesian legal order, anarchy reigns. But the Japanese example makes this claim suspect, though even in the best of circumstances there is seldom time to wait for a court to act in the real world. Still, whatever the framework, these independent parties must reach an accord on price and other transaction terms, and so contracting (though not Contracts) remains important. For less complex

transactions, parties may insure themselves against problems by dividing business up into small units with different parties.[8] But another alternative is to try to do all business on the basis of "relational" contracts. What I outline here is the manner in which the auto industry structures transactions, contracting on the basis of trust rather than on the basis of Contracts.

The Auto Industry

Whatever the legal and institutional environment, auto makers face a complex problem in contracting for production parts. First, they require up to 20,000 different parts for a single vehicle (and more when engine, trim and color variations are included). These parts, furthermore, must be produced for the four or more years that a car remains in production. Second, many of these parts are unique to a given model: a windshield wiper motor will be specific to a single car of one manufacturer. But because the manufacture of a part often requires costly tools and dies, the assemblers face strong pressures to purchase from a single supplier. Similarly, from the supplier's standpoint such assets can only be used to service one customer. There is thus a strong degree of interdependence among parts firms and their automotive customers, as transactions are neither "spot" nor short in duration. This is of course true whether the supplier is an internal division of the company, the pattern at the U.S. Big 3 and particularly at GM and Ford, or an independent firm, the prevalent pattern in Japan, where firms are not as vertically integrated. Because of such complexity and interdependence, automotive parts purchasing is thus *not* a typical business transaction, though I believe that the use of this non-representative example is not fatal to my larger argument.

In any event, a little thought experiment provides the clearest way to understand the methods that are actually used in the Japanese auto industry. Let us assume that Contracts have absolutely no legal standing, so that the parties to a transaction cannot rely on courts or other outsiders to enforce a bargain. How, then, can one go about initiating a transaction, and then maintaining and reinforcing it over time?

Commencing Transactions: Conceptual Aspects[9]

Choose partners carefully. As a first step, firms must obviously be very careful in choosing their partners. Even though in certain aspects Japanese are unusually honest, there are plenty of businessmen ready to fleece the presumptuous newcomer. Thus firms ought to and do expend energy up front searching among possible suppliers or customers before commencing a business relationship. Even in the U.S. it is common sense to run a credit check and, for a smaller firm, to check with the Better Business Bureau and similar sources. More generally, if a contract is worth only the paper it is written upon, firms ask questions such as: Is senior management committed? Will they be interested in doing business next year, too? Do both sides get along together personally? Do both sides have a good reputation? And so on. This courtship is time-consuming and expensive, and helps explain why business entertainment accounts for 1% of Japanese GNP. It is the antithesis of the quick handshake of a go-go American businessman.

Begin gradually. However careful the initial search, the telling is in the making, to twist an aphorism. Both parties reduce their risks when the first transactions are small in scale, and

are restricted to unimportant items. This serves other functions as well in the automotive industry, because the contracting environment is complex and each firm has its idiosyncracies. Competence is hard to measure in advance, while terms are complex and most readily learned through experience. Can the firm actually deliver quality parts on time as promised? (And how does the customer measure quality?) Does deliver in the morning mean by 7 AM or by noon? With whom does one communicate regarding a minor hitch? -- remembering that a minor problem, if not resolved quickly, can stop the assembly line and turn into a major disaster. In short, actual transactions are needed to provide a meaningful test of good faith and competence. And since minor mistakes are inevitable in the process of learning the ropes, it is best to start small. When successful, this process locks parties into closer ties, since the costs of first finding new partners and then teaching them the ropes make it desirable to continue doing business. When unsuccessful, a small and gradual start facilitates damage control.

Commencing Transactions: Empirical Aspects

The above advice fits what is observed in the Japanese auto industry. The major of automotive suppliers have been dealing with their major customer continuously from day one, sometimes for over 50 years. For most auto companies turnover of suppliers is under 5% per year. Of course, new entry is similarly rare, to the discomfit of outsiders, both Japanese and foreign.[10] Even when a new supplier can gain a foothold, the buildup in volume is slow. The resulting frustration for firms unused to that environment has helped turn auto parts into an ongoing source of US-Japan bilateral tension.

Popular culture reinforces that success is gradual. From early in life Japanese are taught that it is necessary to persevere in the face of challenges, whether it be at school, work, family or riding the subways. One is taught that hierarchy cannot be defeated, and indeed must be respected. At the same time no one need, or in fact will, stay forever on the bottom rung. Even sports reflect this: while victory in an individual sumo match is decided in a momentary struggle, the result is interpreted as reflecting the outcome of years of practice that add strength, weight and mental stamina. Furthermore, even the successful wrestler can advance but one or two rungs at a time, and so reaching the top takes years of effort and (at the last rung) repeated triumphs.

Because of the recent success of Hawaiian wrestlers, this sports image is now familiar to non-Japanese readers. But the same images pervade descriptions of business life. The young salesman will carefully cultivate potential clients, perhaps for years, until he (seldom she!) is a well-known and even trusted figure. Then, one day, a new need arises, and by dint of constant effort he is on hand to serve -- while, implicitly, the invisible rival who thus far had dominated the business has grown complacent. The result: a token order, but with the obvious message that further inroads will follow with continued effort.[11]

Never in these stories do we see the jubilant man in the concluding moments waving a piece of paper in front of his boss (much less springing the news to his wife!) that "I got the contract." First, the news wouldn't be broken to her because, by the time our Dagwood Tanaka got home from socializing with customers new and old, his wife would have long since been asleep in her room, next to the kids. Second, we do not see the scene in the boss' office, either -- and when we do, there is no piece of paper. Third, what he would have is

not "the" business, but one portion of the business. Indeed, these three scenes are a piece of the same cloth, of contracting without Contracts.

Supporting Ongoing Transactions

In the Japanese auto industry, firms find it important to maintain ongoing ties. As noted, even when the initial courting of two firms goes smoothly, it consumes significant managerial resources. For administrative efficiency, it is thus important that relationships be kept on a steady and smooth course. Yet as time passes, the complexity of the auto industry makes disputes inevitable, in part because initial conditions will not remain in effect as the years pass. Furthermore, firms are interdependent across many facets. For example, independent parts suppliers account for up to half the engineering hours required to develop a new car, including testing designs and drafting final blueprints. Quite literally, a car cannot be designed without supplier assistance. (In the U.S., the Big 3 historically undertook this work themselves.) Overall, then, it is important to maintain more than a mere facade of cooperation. Strategies to maintain and strengthen trust are thus at least as important over the long run as exerting care at the start.

Making credible commitments. Firms strive to make their mutual commitment to the transaction tangible, to provide assurance to each other that they have a vested interest in continuing the relationship. In Japan, the auto assemblers have avoided vertical integration into parts manufacture, and do not maintain production facilities for items such as small metal stampings. Unlike GM in the US, which often invested in parts production in competition

with outside suppliers, Japanese firms made a clear commitment to purchase from someone. This lack of internal capacity in Japan even extends into engineering, as noted above. In turn, suppliers have often specialized in the automotive market, and in many cases built dedicated production facilities near their prime customers' plants. Both sides are thus visibly interdependent, with a clear separation of roles. Furthermore, a supplier typically has overlapping contracts for different types of parts with different time horizons. This makes it virtually certain that both sides will be interacting into the foreseeable future. In the short term it is simply impossible for either side to walk away from the other. Indeed, the auto companies have repeatedly bailed out suppliers that suffered large losses due to financial speculation, because of the difficulty of finding alternative capacity at other firms. An additional reason, of course, is what potential supplier would want to make a substantial commitment of resources to a firm that has just let its previous supplier go bankrupt? Indeed, it is partly the fact that purchasers entail such costs that makes their commitment credible.

Establishing rules and norms. Written contracts are exceedingly simple, but the overall transaction is not. The timing of delivery, containers, lot sizes and payment methods obviously must be fixed, along with myriad other details. But in practice the only enforceable contract for parts is normally the monthly purchase order, where a concrete order for a specified quantity at a stated price is made for the first time. However, even that contracted quantity seldom matches actual deliveries, since under just-in-time production controls the actual production schedule is set on the factory floor in response to sales to dealerships, while the purchase order reflects planned production based on projected sales.

Actual production thus will vary from the forecast reflected in the purchase order, with discrepancies reconciled after the fact. In any event, both parties over time learn what each expects from the other for these and countless other details. The ongoing nature of the relationship permits this to be done, and in a more informal and flexible manner than provided by formal Contracts, since the pretence of keeping to the letter of the agreement need not be maintained, nor need energy be spent constantly rewriting contracts.

More important for trust, elaborate norms have been worked out to cover such potentially fractious issues as initial pricing, compensation for deviations from projected volume, defective parts and engineering changes. In the case of pricing, firms seldom employ American-style competitive bidding. Instead, prices are set by adding a pre-specified margin to costs, where costs are broken down so as to separate out such objective items as material costs. (The supplier must use this fixed margin to cover overhead and provide a profit.) In addition, the continuity of transactions in most cases permits the use of previous costs as a starting point, with corrections made for the targeted productivity increase for the period, which is announced publicly by the auto maker. As many elements of price as possible are therefore removed from the bargaining table, either by basing them on historic data or currently observable market prices, or by making them a common element to all suppliers. And when a contract is lost against a rival, the auto company can provide a concrete reason, such as that costs for process X were out of line with that at rival firms. Norms for pricing thus provide a wealth of information that both parties can use for future transactions, and more important, limit the ability of one or the other side to employ hardball tactics that impinge upon trust.

The gradual buildup of a contracting relationship provides an opportunity for new suppliers to learn the ropes. But the auto companies have also instituted formal means of communicating with suppliers as a whole. Each firm has a formal supplier association, with newsletters, working committees for technical issues, and regular meetings with senior management. In addition, purchasing departments are responsible for monitoring the overall flow of information, including that from engineering, marketing and other functions, to try to see that wires do not get crossed or issues fall through the cracks. The purchasing department thus fulfills a strategic management role, in sharp contrast to the clerical roles that purchasing staff played until recently in Detroit. In turn, suppliers maintain a "gatekeeper" who plays a similar coordinating function.

Investing in information and reputation. Even with shared norms and expectations, how can one feel confident that they will be honored? The presence of the credible commitments outlined above is clearly important. In addition, both suppliers and particularly the auto firms invest heavily in reputation. Even if they cannot provide ironclad assurances of future performance, they can at least make clear past behavior. Part of this information is obtained automatically, in the course of the extensive interactions that take place at the individual level between supplier and assembler. But the range of experience of any given firm with the treatment of exceptional circumstances will (by definition!) be limited. What will happen if the advent of plastics or other new materials makes current production capabilities obsolete? Who will bear the costs of an after-the-fact discovery of a major design error? If a customer encourages a firm to expand its capacity to produce parts for a new model, but the car flops

when it hits the market, are suppliers then left holding the bag? While an individual firm may not have faced such issues, at least a few firms in the supplier universe will have done so. In addition, a single firm cannot be sure it is being treated fairly when its customer demands a price decrease during hard times. Suppliers will want reassurance on these and other such what-if scenarios.

In fact, the auto makers are acutely aware of the need for suppliers to trust them on such issues, since the sheer number of parts transactions makes it a practical necessity that as the general rule each side accept the other's word without challenge. But most possible contingencies will in fact have been faced by at least a few of an auto company's suppliers. Here the supplier associations are again important for creating and maintaining trust. The occasional meetings of the association as a whole provide a forum for top management at the auto companies to present market projections and policy changes to all suppliers equally and consistently. The associations are also the organizational nexus through which joint technical issues are addressed and new management methods are taught (including in the past cost accounting, engineering management, quality control and management information systems). Suppliers also interact with each other through these associations on many different levels, and not just with their customer. They know a lot about each other, and can readily learn how exceptional circumstances were handled, and whether they are receiving equal treatment. In addition, the associations provide a route for suppliers to voice their concerns, as the directors, typically the CEOs of a cross-section of suppliers, meet regularly with the executives of their "parent" company.[12]

Avoid threats, provide positive incentives. If the legal system (or a hierarchical analog) does not provide glue to hold parties together, then threats are highly dangerous: unless both sides want to continue to do business, there is ultimately nothing to bind them. Threats are antithetical to the credibility of commitments, and can rapidly extinguish any trust that has been built up over time. Furthermore, as repeatedly stressed above, complexity and interdependence make willing cooperation crucial; both sides in general must be willing to go the extra kilometer.

The psychology literature supports the importance of socialization and of a gradual buildup to a relationship, and the strength of positive incentives over threats.[13] Of course, when outside sanctions are unavailable, a threat to terminate a Contract (or a promise not to) holds no force in and of itself. But the entire contracting environment seeks to minimize the role of threats, from the use of rules that keep gross margins sacrosanct in the price-setting process, to the explicit policy of not dropping a supplier without strong cause, and even then not doing so suddenly. A troubled firm in fact often turns to its customer (and/or suppliers) for assistance to overcome difficulties in remaining competitive, or for help in recovering from gross management mistakes. At the same time, the auto makers seek to steer new business to existing suppliers when possible, and strive to keep profits high enough for their suppliers to be willing and able to keep investing in new production equipment. Another aid to limiting conflict is that suppliers simultaneously are making several hundred or even thousand different parts. The multiplicity of contracts of different value, complexity and duration allows both sides to balance a loss in one potential dispute with a profit on another transaction. As Ellickson (1991) noted, and the mathematical theory of repeated games

shows, it is far easier to bury the hatchet and maintain cooperation when the books do not have to be closed at the end of each transaction.

Summary

Automotive contracting in Japan relies upon trust; both parties put themselves at the risk of loss, without assurance of long-term gain, out of the belief that the other party would not take unfair advantage of them. But in a business environment blind trust is foolish, and reliance upon personal trust among individual members of larger organizations is equally untenable. Nor can either side systematically structure the relationship so that the other party is effectively compelled by commercial considerations or legal threat to always carry through even to the bitter end.

Ultimately, then, contracting in Japan is governed neither by recourse to legal authority nor by reliance upon command within an organizational hierarchy.[14] Instead both sides invest substantial resources to obtain information and generate reputation about past behavior and future expectations. This is buttressed by the establishment of norms, the fostering of communication channels and the adoption of measures to reduce risk by a search process and the structuring of initial transactions. There is nothing in these methods, of course, that limits their applicability to the auto industry or to Japan. Indeed, I am convinced that even cursory empirical research will show that such techniques are widely employed (if poorly conceptualized) in the U.S.

III. Concluding Thoughts

In the introduction I argued that contract law is not a prerequisite of a commercial economy; the above description of contracting parties in the Japanese auto industry has given a sense of how contracting without Contracts can operate. Few transactions in Japan lead to disputes, and most disputes are resolved amicably outside the shadow of the law -- as in the U.S. While readers ought to be skeptical of my academic revisionism, it is surely both disingenuous and a disservice for lawyers to claim that documenting Contracts is their job, and contracting is solely that of their customers. Surely the specialization and breadth of exposure of lawyers ought to leave them ideally equipped to provide the latter, invaluable service. It is ultimately a legal fiction that contract law governs business transactions. The profession should not permit an unwarranted faith in both the importance and necessity of law to turn lawyers into mere clerks. As Macaulay (1985:480) phrased it, "Students must understand a game to learn to play it well."

At the same time, organizational theorists need to avoid making the similar error of focusing on the form of an organization and ignoring the actual workings of individuals and the means through which transactions are carried out. In the Japanese auto industry, many highly complex interactions occur on an ongoing basis across organizational boundaries. The day-to-day partner of an automotive engineer may be a supplier engineer seconded to the next desk, or attached to the same computer network. Pfeffer and Baron (1988) argue that such blurring of organizational membership is widespread in the U.S. as well. More generally, as Powell (1990) argues, it strains both received concepts and commonsense language to classify such interactions as an admixture of "market" and "hierarchy" rather than as something

qualitatively distinct. But while organizational theory may be better aware of the gap between form and function, caution remains in order. Even Coase (1992), assuredly an astute student of transactions, finds it difficult to move away from the assumption of the centrality of formal institutions. To me it is ironic that he is currently involved is an effort to assemble a large collection of formal contracts of large corporations.

In closing, however, let me pose a parallel conjecture about organizations: that trust will prove equally central to the smooth handling of transactions among members of the same firm, and not merely to those between firms. Trust, I posit, is not only the substance of contracting, but the substance of bureaucracy. I have for now few insights as to how formal rules and structures within organizations support trust, and the extent to which they are essential. (But see, for example, Sitkin and Roth, forthcoming.) However, I believe the same null hypothesis -- that formal structures are unnecessary -- will provide a fruitful starting point for clarifying the essential elements of formal organization, just as I believe it will clarify the role of contract law.

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ENDNOTES

1. Other studies use organizational theory as a framework. See Moorman et al. (1992).

2. Tamiya (1992:19, 56-57). There are however several types of paralegals specializing in tax, patent and administrative filings, tasks that are largely clerical in nature. There is also a mediation (chotei) system that mobilizes community leaders and other lay individuals to attempt to resolve disputes brought into courts. Bureaucrats and police also play such roles. In addition, Japanese law schools admit about 30,000 undergraduates a year. Business newspapers carry regular "how-to" columns, and bookstores all contain sections on law for businessmen. Even if the knowledge of law school graduates is modest, it is thus wrong to automatically conclude that businessmen are totally ignorant of the law. Whether they make use of this knowledge is of course a separate issue.

3. Uchida (1990). Japan is a civil law jurisdiction, so that in principle the discretion of judges is more narrowly restricted to applying statutes. These, however, are phrased in general terms and courts do not have a high reputation for consistency. Furthermore, judges try to force disputants to privately mediate their differences, and final judgments exhibit a strong tendency to split down the middle rather than to find fully for one or the other party. For a brief overview of current issues, see Choy (1992).

4. Ueda (1987). This case was filed by the union of a company that went bankrupt after an automotive customer abruptly canceled its contracts. I am told that ultimately a modest settlement was reached out of court.

5. I did not come across Haley's work until after this article was in process, and so do not fully integrate his study here.

6. Even then, many agreements are oral and may not specify price or other variables that would be needed for a proper Contract. Written documentation is most prevalent in response to specific government guidance, as with the Subcontractor Law that seeks to regularize the terms of subcontracting arrangements (my own research) or to satisfy regulators in the Tokyo fish market (discussion with Theodore Bestor).

7. Many Japanese businessmen are graduates of law faculties, as noted. Furthermore, large firms often maintain legal departments. However, virtually no firms in Japan employ a full-time lawyer. In addition, I am told that legal department staff are not always graduates of law faculties, and are in any case rotated to other functional positions in 2-3 years, so that the depth of expertise is not great.

8. As an example of self-insurance, most stores in the small town in which I reside readily accept personal checks for small amounts. Indeed, one store no longer accepts credit cards, having found that losses from the occasional bad check were in the aggregate less that the 3%-5% fee that card companies levy on small stores.

9. The following discussion draws heavily on Smitka (1991:Chapter 6).

10. Structural shift in the Japanese auto industry is now producing greater opportunities for new entry. Technologies are evolving rapidly, permitting new firms to break in, while the rapid rise in labor costs has hurt the competitiveness of many domestic auto parts firms. This is providing a window of opportunity for exports from the U.S. and elsewhere. See Smitka (1992).

11. Iwata (1982) offers such anecdotes in English; see, too, the several "business novels" now available in translation, e.g., Arai (1991).

12. See Helper (1990) on "voice" versus "exit" in auto parts contracting in the U.S.

13. See the essays in Gambetta (1988) and Sitkin & Roth (forthcoming).

14. Despite much discussion of "keiretsu," in the automotive industry the assemblers in general do not have equity ties or other means of potential control over their suppliers. The "keiretsu" are thus a reflection of the desired continuity of transactions, and are not a "hierarchy" to which the auto companies can issue commands.