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COMMENT: NON-LEGAL SANCTIONS
AND STRATEGIC ALLIANCES:

THE USE OF THE MARRIAGE
CONTRACT AS A MODEL FOR
STRATEGIC ALLIANCES

Edward A. Bernstein[†]

The term “strategic alliance” is of relatively recent vintage but the type of transaction that it describes has been around at least since 1920 when Fisher Body contracted to be the exclusive manufacturer of automobile bodies for General Motors.¹ The literature makes much of the GM-Fisher Body transaction as an example of the difficulties presented by the transactions costs inherent in long-term contracts, including the cost and uncertainty of enforcement in the courts and the inability of the parties to predict their needs and costs in various future states of the world.² Although, in theory, such transactions costs should be high, the use of long term contractual arrangements between parties that contribute critical inputs on a continuous basis to a common enterprise – that we now call strategic alliances – has become commonplace. I suggest that this disconnect between theory and practice results from an underappreciation of the power of non-legal sanctions and how they work in a commercial context.

The centerpiece of most strategic alliances is usually a contract that includes promises by each party to provide critical inputs on a continuous basis at its own expense and share revenues. The contract also contains an expiration date and/or a provision permitting termination at the unconditional option of a party or upon the occurrence of certain circumstances, and provisions relating to the division or use of the assets of the enterprise after expiration or

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¹ The contract continued until 1926 when GM acquired Fisher in a negotiated transaction.

² See R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* (n.s.), Nov. 1937, at 386, reprinted in *THE NATURE OF THE FIRM* 18 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

termination of the contract. The transaction is similar to a partnership, except that the primary capital contribution by the parties is their promise to provide inputs.

The contract may employ "Legal Promises," that is promises that can be effectively enforced by a court and/or "Extra-Legal Promises," that is promises that cannot be enforced in a court. Extra-Legal Promises often include non-verifiable but observable conditions – that is conditions that are such that performance cannot be effectively demonstrated in court although each of the parties will know whether it has been performed.³ This Comment suggests that in general a contract governing a strategic alliance should: (1) permit termination of the contract at will by any party and (2) employ Extra Legal Promises to provide critical inputs and Legal Promises to govern events following termination or expiration of the term.

If these suggestions seem counterintuitive, consider what is perhaps the oldest known example of a strategic alliance, the institution of marriage, which is usually governed by a contract, whether by application of law or a prenuptial agreement. The typical marriage contract contains a few verifiable promises concerning inputs, or what the parties will do for each other during the marriage, such as a promise of fidelity or a promise of financial support during the term. However each of the parties expects a great deal more of each other throughout the marriage as the result of a series of express or implied Extra-Legal Promises, such as those relating to "love, honor, and cherish," the production of children, the type of life style to be pursued, or the geographical location of the marital domicile. The term is for life but is subject to early termination, either at will, as in many in states, or with few restrictions. The marital contract also provides how property will be divided if the marriage terminates, and what, if any obligations survive termination such as the obligation to support a spouse or child. Religious motivations aside, marriages survive so long as each party believes it is better off if the marriage continues. Even when a spouse might prefer not to perform a promise it may nevertheless perform it in order to obtain counter performance or to avoid termination. This Comment suggests that this is precisely how most strategic alliances should be and are usually structured and seeks to explain why they are so ubiquitous despite the high transaction costs associated with Legal Promises.

³ See Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 278-80 (1992).

Brides, grooms, and businesspeople contemplating a strategic alliance elect to leave most of the important promises to provide critical inputs to the Extra-Legal realm because the details of how the obligation is to be met are often indefinite and dependent upon future developments that are difficult, if not impossible, to anticipate. As a result of this uncertainty, the value of any Legal Promise will tend to be low and its cost to the promisor will tend to be high, whereas a structure based on the right to terminate at will enables the parties to exchange Extra-Legal Promises to provide critical inputs that will have substantial value and can be given at a reasonable cost. This conclusion is based upon an analysis of the elements that define the value of a promise to the promisee and its cost to the promisor.⁴

The value of a promise is equal to:

- (a) the benefit of performance to the promisee multiplied by the probability that the promise will be performed,

plus

- (b) what the promisee will get if the promise is not performed (the settlement value of the claim) multiplied by the probability that the promise will not be performed,

less

- (c) Monitoring Costs.

Lawyers often have difficulty accepting the idea of employing Extra-Legal Promises to provide critical inputs because the inputs are the heart of the contract and legal sanctions at least provide for

⁴ Lawyers often resist the suggestion that the most important promises in a contract be left to the Extra-Legal realm because of their own agency problems – they fear ex post criticism from the client if they do not raise and fight vigorously for detailed enforceable promises. This behavior imposes a subtle, but important cost upon the client, namely Attitudinal Negotiation Costs. The value of a promise is in large part a function of the promisee's estimate of the probability that the promisor will perform, and the promisor's cost is partially a function of his estimate of the probability that an invalid claim of breach will be asserted by the promisee. At the time a contract is executed, the parties base their determination of the value of a transaction on their perceptions of the relevant probabilities. An Attitudinal Negotiation Cost is a decrease in value or increase in cost that results from an attitudinal change that causes either party to revise his expectation of the probability of performance or the assertion of invalid claims. These attitudinal changes often result from lawyer behavior.

Attitudinal Negotiating Costs may have an impact either during negotiations in the form of transaction breakdown or after a contract is signed. In a Strategic Alliance the impact may be much greater than in other transactions because, as just noted, one motivation to perform at a high level is to induce similar behavior by the other party. If one party expects a minimal level of performance by the other party, he may well limit the level of his own performance.

some compensation to mitigate the damage caused by a breach, whereas non-legal sanctions usually do not. Another reason is that their law school education emphasizes the function of a contract as the basis for a lawsuit and to a large extent ignores the function of Extra-Legal Promises. In fact the value of a potential judgment for damages (usually the settlement value of the claim) is often quite modest (and often illusory) after taking into account enforcement costs, uncertainty (including the probability of error), and the time it takes to obtain a judgment. These factors also impair the *in terrorem* effect of legal sanctions in inducing performance. However, even without the right to sue for breach, a promise will have substantial value if there is a high probability that it will be performed. That probability depends upon the context of the transaction as well as the terms of the contract. The value of an Extra-Legal Promise is based solely upon the probability that it will be performed.

The cost of making a promise is equal to:

- (a) The expected cost of performing the promise including a contingency reserve to deal with unanticipated expenses that may be incurred; and
- (b) The probability that the promisee will assert an invalid claim of breach multiplied by the anticipated cost of defending and the expected cost of losing in the case of error. I call these costs the promisor's "Legal System Costs."

The reserve for unanticipated expenses will be significantly lower with respect to an Extra-Legal Promise than with respect to a Legal Promise since the former need not be performed if the costs exceed the benefits to the promisor. If in the future, unanticipated expenses arise, the promisor may refuse to perform and either renegotiate or terminate the contract. Neither of these actions are cost-free, but the cost will probably be lower than a contingency reserve that would have been taken into account in evaluating the cost of a Legal Promise made at the time the contract was executed. Moreover, since an Extra-Legal Promise cannot be enforced in court, it will not impose Legal System Costs on the promisee.

Since an Extra-Legal Promise will have value only to the extent that there is a probability that it will be performed, it is important for the parties to a strategic alliance to focus upon the probabilities relating to the promises they receive. A promise will be performed until such time (a "Breach Point") as the promisor is

unable to perform or concludes that its well-being will no longer be served by performing. The probability that a Breach Point will occur depends upon the benefits the promisor will lose and the costs he will avoid if he breaches. With respect to Extra-Legal Promises, the loss a breaching promisor will suffer depends exclusively upon non-legal sanctions. These sanctions are usually characterized as “bonds” or “hostages” – things of value to the promisor that will be lost if he does not perform. Most non-legal sanctions increase the value of a promise by deterring breach, but do not compensate the promisee for his loss if the deterrent fails.

There are various types of non-legal sanctions. This Comment will address the two that I think most often power Strategic Alliances:

- The loss by the non-performing promisor of reputation in the market in which it operates.
- The sacrifice of a “relationship-specific prospective advantage.” That is to say that the non-performing promisor will forego any benefit he would have derived from future transactions with the promisee.

The reputation bond cannot often be created by the contract, but lawyers must nevertheless understand its power in order to determine the extent to which other sanctions will add value to the promise he is receiving or, indeed, whether other sanctions are appropriate. A contract between two Japanese corporations that are concerned about their reputation among other Japanese firms may present such a high probability of performance that a legal sanction will not add much to the value of promises made by the parties. As the merger trend in the United States accelerates and companies enter into multiple strategic alliances, often with competitors, the reputation bond is increasing in importance in the United States. When this bond is operating, an attempt to negotiate detailed Legal Promises, by implying distrust, might induce reciprocal distrust. This in effect reduces the value of the promise given by the promisor and may contribute to transaction breakdown or a change in pricing.

An actual transaction illustrates how the reputation bond operates in the context of a strategic alliance. A client manufactured a product for a major national retailer (the “Retailer”) pursuant to a short letter agreement executed annually that contained only Extra-Legal Promises as to probable quantity pricing, delivery schedules, and other important matters. Although the client used counsel for

most significant contracts, an executive explained, "We never retain counsel to work on the contract with the Retailer. They represent 40% of our production so what the Retailer wants, The Retailer gets" Despite this vulnerability, the client did not feel threatened, concluding that Sears believed that if it exploited the situation, other manufacturers would not be willing to invest funds in manufacturing facilities and devote large portions of their production to meet the Retailers' needs. The client was confident that absent dishonest behavior on its part, the Retailer would only terminate the relationship over a period of years during which the client would have an opportunity to replace the business. Despite the form of the transaction, both parties had the benefit of high-value long-term promises because of a high probability of performance, and low cost because of the absence of Legal System Costs and a reduced reserve for the unexpected.

The most ubiquitous bond securing performance of Extra-Legal Promises in contracts creating strategic alliances is the benefit of the deal itself. As with the marital contract, the value of the deal as a bond tends to increase over time as the value of the enterprise increases and each party develops transaction specific capital in the form of knowledge of each other and increased trust.⁵ Contract structure can affect the value of the deal as a bond by increasing the loss that a breaching party will suffer as a result of his own breach or if the contract is terminated. For instance, marital contracts typically specify what each party will get financially if there is a divorce. The value of the bond in the GM/Fisher transaction was increased when GM made an investment in Fisher that would be lost if Fisher failed, even if GM could obtain automobile bodies elsewhere.

In a strategic alliance, as in all partnerships in which the parties contribute services, each participant as a promisor is faced with a decision matrix with respect to Extra-Legal Promises that is similar to the matrix presented by a prisoner's dilemma. This is because each participant must bear the entire cost of his own performance but must share the resulting benefits with the promisee and will, at no cost, share in the benefits resulting from performance by the other participant of its promises.⁶ Thus, the best result for either participant as a promisor is to perform only to the extent that the cost of performance is less than his share of the resulting

⁵ The same process operates during the term of a marriage as the parties have children, acquire a home, and develop other types of jointly owed assets.

⁶ See Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 958-60 (1984).

value added to the enterprise while obtaining a share of the benefits provided by full performance by the other party. However, if both participants perform at minimum levels, they will usually both be worse off than if they had both fully performed at anticipated levels.

The deal as a bond is self-enforcing, in the sense that a Breach Point will not occur, so long as the cost of performing a promise is less than that of the promisor's share of the resulting increase in the value of the enterprise. The enforcement mechanism for the deal as a bond, at times when it is not self-enforcing, is a right on the part of the promisee to terminate the contract, which can be exercisable at will or upon the occurrence of specified circumstances. An attempt to specify the circumstance permitting termination (other than non-payment) presents the same problems as an attempt to structure a detailed Legal Promise. It is unlikely that the circumstances under which termination would be appropriate can be predicted reliably or would be verifiable. As a result, any attempt to terminate would be subject to challenge in the courts and will subject the parties to the expense, delay, and uncertainty of litigation. During the litigation, the contract would probably remain in effect, forfeit of the bond will be delayed, and the power of the right of termination would thus be substantially diminished. The right to terminate at will avoids the cost and uncertainty of litigation and is an effective mechanism to present each party with a continuing option to either perform or lose the deal.

The right to terminate as an enforcement mechanism has limitations in that it motivates the promisor to perform only to the extent necessary to avoid termination, and this may be a low level of performance if the promisee is willing to settle for a lesser profit than he would have received had the promisor performed as originally anticipated in order to avoid termination. As noted above, if both parties adopt the strategy of performing only up to minimum levels, they would both be worse off than if they both had fully performed at anticipated levels. However, so long as performance by the parties is continuous, the decision matrix is in fact a repeat play prisoner's dilemma in which traditional negotiation strategies, such as tit-for-tat, can be employed to induce full performance by both parties. If, at the end of the day these strategies do not produce cooperation, the promisee can elect either to accept minimum performance (and minimum return) or terminate the contract.

The structure of a contract governing a strategic alliance is significantly different than the structure contemplated by the typical law school view of a contract – i.e., a promise and a potential

judgment for damages if it is not performed. In fact the right to sue is probably the least important factor in inducing performance by the parties. Instead, a complex matrix of reputation bonds, the prospect of future performance by others, the right of termination and related termination provisions, and various strategies aimed at inducing cooperation in a repeat play prisoner's dilemma situation imports value to the transaction. The structure seems at odds with the conventional view of a contract until we recognize that a very similar matrix has for decades imported value to one of our most important institutions – marriage.