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The legal framework for corporate governance: explaining the development of contract law in Germany and the United States

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The Legal Framework for Corporate Governance:

Explaining the Development of Contract Law in Germany and the United States

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The Legal Framework for Corporate Governance:
Explaining the Development of Contract Law in Germany and the United States

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Abstract

How are new forms of industrial organization accommodated into a country‘s legal frameworks, and what effect does this have on the ability of firms to innovate? Variations in the broad institutional organization of the German and US political economies result in different processes of contract law modernization in the two countries, with important implications for innovation trajectories. The German institutional infrastructure encourages firms to develop cooperative „diversified quality production“ (DQP) inter-firm strategies. This is promoted through highly regulative contract laws and the existence of strong trade associations that firms engage to create standardized industry frameworks. These contracting arrangements allow the diffusion of standardized governance structures showing firms how to create rules needed to manage complex new forms of organization. While strongly supporting DQP strategies and discouraging opportunistic product market strategies, German patterns of contract law regulation place important constraints against more innovative product market strategies. In the United States legal resources are decentralized across firms, trade associations have few law-making competencies, and courts do not regulate the distribution of risks across firms. Contractual frameworks are developed on a firm-by-firm basis and slowly accommodated within the legal system through the generation of court precedent. This system encourages radical innovation in the law, an important prerequisite for innovative product market strategies more generally. However, the paper shows that a necessary trade-off of legal innovation in the US is that courts cannot implement German-style contract law regulation to constrain opportunism, while the decentralization of legal resource inhibits the creation of standardized contractual frameworks needed for DQP strategies. Through an extensive game theory analysis of bargaining between courts and large firms, the paper explains why these equilibria are maintained, despite strong incentives in the German case for some large firms to deviate.

Zusammenfassung

Wie sind neue Formen industrieller Organisation an die rechtliche Verfaßtheit eines Landes angepaßt und welche Folgen hat dies für die Innovationsfähigkeit von Unternehmen ? Generelle Unterschiede in der institutionellen Organisation der jeweiligen politischen Ökonomie in Deutschland und in den USA führen zu unterschiedlichen Formen der Modernisierung des Vertragsrechts in beiden Ländern. Dies hat wichtige Auswirkungen auf den Typus der Innovations-Entwicklung.

Die spezifische Ausprägung des Institutionengefüges in Deutschland begünstigt vor allem eine kooperativ angelegte „diversifizierte Qualitätsproduktion (DQP)“, an der mehrere Unternehmen beteiligt sind. Dies wird gestützt durch ein hochreguliertes Vertragsrecht und starke Gewerkschaften; die Verbände nutzen dies, um für alle Unternehmen geltende Regelungen zu entwickeln. Diese Art, vertragliche Vereinbarungen zu entwickeln und zu gestalten, führt zu einer allmählichen Verbreitung allgemeingültiger Governance-Strukturen, durch die die Unternehmen erfahren, wie sie Regelungen entwickeln können, um neue, komplexe Formen der Zusammenarbeit zu managen. Das in Deutschland verbreitete Vertragsrecht erweist sich als vorteilhaft für DQP-Strategien und als hinderlich für kurzfristig orientierte Produktmarktstrategien; es führt aber auch zu schwerwiegenden Einschränkungen bei der Entwicklung innovationsorientierter Produktmarktstrategien.

In den USA ist die juristische Kompetenz, gerade auch, was die Klärung juristischer Grundsatzfragen angeht, auf viele Unternehmen verteilt. Gewerkschaften haben nur geringe Möglichkeiten, die Gesetzgebung zu beeinflussen und die Gerichte regulieren nicht, wie die Risiken aus der Zusammenarbeit von Unternehmen aufgeteilt werden. Die rechtlichen

„Rahmungen“ vertraglicher Vereinbarungen werden fallweise in Unternehmen entwickelt; gerichtliche Musterentscheidungen passen sie dann Schritt für Schritt an die bestehenden gesetzlichen Regeln an. Dies begünstigt radikalere Innovationen in der Gesetzgebung; sie wiederum sind generell eine wichtige Voraussetzung für innovative Produktmarktstrategien. In dem Papier wird gezeigt, daß der schnellen Innovationskraft des amerikanischen Gesetzgebungssystems als Nachteil gegenübersteht, daß die Gerichte keine Regulierungen einführen können, die dem in Deutschland entwickelten Vertragsrecht vergleichbar und durch das sehr schnelle, quasi opportunistische Marktorientierungen einzuschränken wären. Die Dezentralisierung juristischer Kompetenz in den USA verhindert die Schaffung eines allgemein gültigen rechtlichen Rahmens, der wiederum Voraussetzung für eine diversifizierte Qualitätsproduktion ist.

Durch eine ausführliche spieltheoretische Analyse von Aushandlungsprozessen zwischen Großunternehmen und Gerichten wird erklärt, warum sich die jeweils spezifischen Gleichgewichtssituationen erhalten, auch wenn es in Deutschland für einige Großunternehmen starke Anreize gibt, davon abzuweichen.

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1. Introduction

In recent years the analytical focus of the comparative political economy field has shifted. A new literature focusing on the role of employers, companies, unions, and other "social actors" has begun to supplant earlier, state-centered frameworks (Wood, 1997; Mares, 1996; Soskice, forthcoming; Thelen and Steinmo, 1992). In a more complex, decentralized economy traditional industrial policies are less effective (Kitschelt, 1991). Instead of orchestrating the economy, the state is now viewed as one actor among many. Special emphasis has been placed on business coordinated market economies, in which neocorporatist legal frameworks sanctioned by the state allow designated social actors to negotiate the terms of industrial adjustment directly. Within Europe, Germany quickly emerged as a star performer in this field, as virtually every domain within the economy contains "para-public institutions" (Katzenstein, 1989) in which social actors negotiate the terms of change (Thelen, 1991). Furthermore, thanks to widespread legal regulation under the guise of the social market economy, traditionally weak market participants (workers, unions, small firms) are delegated important bargaining rights within these institutions (Streeck, 1984). Because the costs of adjustment cannot easily be imposed on the weak, the German economy is often seen to engender long-term "high-road" solutions that are seldom possible in the more liberal, market-oriented US and UK economies (Turner, 1991, 1997).

The German response to the rapid rise of the Japanese model of production during the 1980s consolidated this consensus. While the US and UK at first seemed unable to mount a coherent response to the introduction of new production concepts, German institutions facilitated the creation of firm-level competencies needed to eagerly embrace them. The new forms of flexible production made good use of highly-skilled German labor and cooperative, long-term relationships between firms (see Streeck, 1989). The system of long-term finance and extensive diffusion of new technologies to small firms through trade associations, the apprenticeship program, and other programs allowed a rapid re-tooling of the industrial infrastructure. The result was the widespread adaptation in industry of a "diversified quality production" (DQP) product market strategy (Streeck, 1992). German firms excelled in a variety of high value-added export oriented industries, such as specialty chemicals, high-end automobiles, and a range of niche-market machine tool and industrial machinery markets. The success of this strategy can be seen most clearly in Germany's export performance during the 1970s and 1980s. During this period exports as a percentage of GDP increased from 21 to 32 percent, the balance of trade was negative in only one year (1980) and increased from an annual average of 2.4% in the 1970s to 3.2% in the 1980s (figures excerpted from Casper and Vitols, 1997: 1-2; see also Carlin and Soskice, 1997).

During the 1990s, however, growing pessimism surrounds the German model. Despite the initial economic boom provided by unification, the German economy has struggled throughout the 1990s. Economic growth has been low. During the sharp 1992/3 recession real GDP fell over 2 percent below the previous year's level. The recovery since then has been disappointing, with annual growth of about 2 percent in 1995 and 1996 after 3 percent growth in 1994. Business profitability reached a post-war low of 1.9 percent of sales before taxes in 1993 and has rose only to 2.4 in 1994 and 2.5 in 1995 (Deutsche Bundesbank figures, cited in Casper and Vitols, 1997: 2).

While the prolonged economic problems of the mid-1990s have many causes (Carlin and Soskice, 1997), much of the analysis, both scholarly and political, has focused on the continued viability of the German production model. Faced with American competition in high-technology industries and East Asian success in upgrading the quality of mass-produced consumer goods, many critics now see little room for traditional German product market strategies emphasizing incremental innovation in established technologies. In particular, institutions and policies promoting innovation have come under attack. Though adequate at diffusing existing innovations (Lütz, 1993), the German system seems unsuccessful in fostering more radical innovation (Soskice, 1997). This has lead to a chronic weakness in high-technology industries such as information technology and biotechnology. While German companies have long been leaders in established science based industries such as pharmaceuticals, chemicals, and mechanical engineering, German companies may be losing their competitive edge now that the pace of technological change has quickened. Critics argue that "imitate and improve" innovation strategies are no longer adequate given shorter product life cycles (Jürgens, 1994). Wolfgang Streeck, long a leading proponent of the German model, now sees the declining relative importance of high value-added niche markets in traditional industries as leading to an "exhaustion" of the German model (Streeck, 1996).

While the majority of scholarly attention has focused on the industrial relations system (see Thelen, forthcoming), the problems facing German industry today is mirrored in other institutional domains. Through comparison with the United States, the chapter examines the development of German legal regulation in the area of inter-firm relationships and the influence of these laws on the competitive strategies of firms. How are new forms of industrial organization accommodated into a country’s institutional frameworks, and what effect does this have on the ability of firms to innovate?

Institutional architectures and patterns of public legal regulation are virtually identical in areas of corporate organization as they are in industrial relations. The German institutional infrastructure encourages companies to develop cooperative inter-firm strategies that directly parallel the DQP product market strategy as conceptualized in work organization, training, and other areas of industrial relations. Companies

engage a network of trade associations to create standardized contractual structures, which I call “industry frameworks.” These contracting arrangements allow the diffusion of standardized governance structures showing firms how to create rules needed to manage complex new forms of organization introduced by innovative firms. Industry frameworks also contain a number of important club goods that can dramatically lower the cost of contracting. Courts use industry frameworks as the basis with which to impose strong legal regulation punishing companies attempting to choose short-term, price-based strategies focused on delegating important legal and market risks to weaker contractual partners. Through bracketing distributive conflicts over the gains from cooperation, these regulations promote long-term supplier relations.

As a liberal market economy, the United States lacks the institutional arrangements needed to support DQP-style strategies in the area of inter-firm relationships. In the United States new contractual frameworks are developed on a firm-by-firm basis and slowly accommodated within the legal system through the generation of court precedent. Whereas German legal resources in Germany are concentrated within para-public institutions and a few large firms, in the US most firms have access to sophisticated legal talent. This, combined with the lack of legal regulation, encourages radical innovation in the area of law. The drawback is that it also necessarily condones the use of opportunistic contractual structures. No legal restrictions inhibit powerful firms from delegating legal and market risks to their weaker partners.

Facing US and other international competitors employing different product market strategies, many large German firms resist choosing DQP strategies and would prefer not to develop or use industry frameworks. Strong legal regulation of the terms and structure of contracts prevents the use of opportunistic strategies that delegate risks to weaker parties or innovative strategies that require the ability to create customized legal structures. How, then, is the German system of contracting sustained in the face of pressures via international competition for at least some firms to pursue alternative strategies? Because companies must engage nation-specific legal rules to manage complex inter-firm relationships, the form and regulatory content of these rules strongly influences the relative costs of pursuing different product market strategies. Through increasing the costs of choosing opportunistic strategies, courts can increase the relative advantage for companies of creating industry frameworks and competing with DQP product market strategies. German public policy does not intentionally punish innovation. However, legal regulation necessarily discourage companies attempting to develop innovative new contractual structures. This is the dilemma for German legal regulation: the same strategies fostering DQP and punishing opportunism also stifle innovation.

To examine these issues, the chapter must begin with a somewhat technical analysis of contract law regulation (section 2). Emerging institutions theories within the

law and economics literature identify the key problems facing courts, but cannot provide a sufficient comparative analysis. The different legal solutions adopted in the US and Germany can only be understood through locating legal institutions within the broader political economy. Through examining institutional networks between groups of companies and between companies and legal actors, it is explained why the structure of the German political economy creates a "coordination capacity" firms may use to create industry frameworks. Courts in Germany can then use these frameworks to impose very strong legal regulation (section 3). This is followed by a strategic analysis of bargaining between large firms, small firms, and legal actors over the content in the two laws within the varying US and German institutional structures (section 4). By combining institutional and strategic logics, we can understand why different equilibria have emerged and examine potential sources of instability within the two systems. These issues are addressed in the conclusion (section 5).

2. Contract law regulation in the US and Germany

German and US contract laws have developed diametrically different approaches to regulating inter-firm relationships. US contract law is constructed around classical principles. It assumes that all parties are sophisticated agents; through the enforcement of formal written agreements, courts protect their freedom to contract (Macneil, 1978). In the vast majority of cases, US courts take a conservative view of the contract by enforcing only the written provisions of the original contract. They usually do this even if contingencies not anticipated in the contract favor one party in ways that were probably not taken into account when the contract was designed. In adjudicating most breach of contract disputes between firms, US courts usually insist on the fulfillment of even flawed written contracts. (Schwartz, 1992). Though tort law creates important external liability risks, parties may contract them out as they see fit (Priest, 1985). This means that neither the final assembler nor supplier has preexisting legal entitlements protecting them from a variety of potential liability problems created by "just-in-time" logistical systems, collaborative product development projects, and other risky practices caused by modern supplier relationships (see Casper, 1997).

By contrast, the orientation of major portions of German contract law is far more regulatory in nature. In the standardized contracts that, we will see, dominate major portions of the economy, German law strictly regulates the distribution of legal entitlements between firms, prohibits large companies from delegating unspecified risks caused by contractual incompleteness to small companies, and limits the legal categories companies can adopt when designing governance structures. When adjudicating disputes, German courts have long used the norm of "good faith," Article 242 of the German Civil Code (BGB), as primary instrument to adjust contracts along fairness principles (Dawson1983; Goldberg 1985). However, even more striking is

widespread use by German courts of the Law Regulating Standardized Contracts (known in Germany as the AGB Gesetz). This 1976 law unified a large body of legal precedent applying Ar. 242 BGB to standardized contracts (Ulmer, 1984). The wide usage of standardized contracts, combined with the very wide scope the AGB-Gesetz gives courts to police contracts, has made the law the center of recent contract law developments in Germany.

The AGB-Gesetz allows courts to void or adjust any contract in which unspecified risks are delegated to the receiver of the contract (Ulmer, 1984, Martinek, 1991). The law severely limits the ability of large firms to design contracts granting control rights over incomplete contracting risks to themselves. Furthermore, the AGB-Gesetz prohibits the inclusion of clauses in standardized contracts that change the distribution of legal entitlements set out in the in either the Civil Code (BGB) or Commercial Code (HGB). Particularly in distributing liability for a range defects between suppliers and final assemblers, this law severely constrains the ability of final assemblers to delegate important liability risks to suppliers

In the United States, courts have attempted to impose regulatory contract laws, but failed (see Casper, 1997, Ch. 6). Why can German courts implement regulatory contract laws while US courts cannot? Legal scholars in the United States have linked the institutional organization of judicial processes with the ability of courts to implement different types of laws. Recent studies examining how US courts adjudicate cases involving complex, long-term contracts reveal that information asymmetries are the key problem thwarting more regulative strategies. US courts refrain from adjusting contracts over which they have incomplete information in order to protect their core role in society in the area of dispute resolution. Courts must apply laws in such a way as to protect judicial process. Decisions must be based on a consistent application of laws. Violation of judicial process norms prevents courts from creating a consistent body of precedent. Precedent serves as the “shadow of the law” (Mnookin and Kornhauser, 1979), structuring private dispute resolution among private actors. This is one of the most important functions of private law systems that courts must protect. Courts cannot always efficiently enforce all contracting laws. If courts do not have the information necessary to apply laws consistently, judicial process norms will be broken.

In a series of articles, Alan Schwartz has examined how the organization of courts and other law making institutions influence the content and implementation of US contract law (Schwartz, 1992). Key to all studies of long-term incomplete contracts is the idea that companies must create a series of norms and rules to deal with contingencies that are difficult to plan for in the written contract. Schwartz examines a number of reasons why contracts are typically incomplete (see also Hart, 1995). Simplifying a complex argument, this reduces down to two broad categories (Schwartz 1992: 278-281). First, contracts are often incomplete because the gain from having various contingencies planned for in the contract outweighs the transaction cost of

contracting those contingencies out. Second, contracts are sometimes incomplete because the information needed to complete the contract is distributed asymmetrically across the parties and judicial system. For example, only the producer of a good usually knows its cost function. In other cases, information, such as private norms used to settle some long-term contracting problems or the responsibility for decisions made informally, is known to the parties but not verifiable to courts when a dispute arises.

Following an analysis of judicial processes, Schwartz argues that US courts sometimes take an activist view of adjusting the first class of cases, but almost always adopt a passive view towards cases plagued by incomplete information. The reason the first class of contracts can be completed by courts is that the information needed to complete them is observable to the court. Courts often adjust contracts through granting relief when extraordinary events such as natural disaster or government intervention make contracts difficult to fulfill. In cases of physical inability information concerning the difficulty is verifiable to courts, making it possible to adjust the contract (Schwartz 1992: 293). However, courts usually do so only if explicit control rights over common classes of incomplete contracting contingencies are not delegated within the contract (Schwartz 1992: 293-294). When control rights covering the contingency do exist, courts almost always take a passive view, even if clauses granting discretion to one firm are vague or only partly apply to the disputed conditions.

In most cases involving asymmetric information, courts have no capacity to uncover and verify the facts needed to resolve the dispute; the information needed to correctly complete contracts is not verifiable to courts. US courts rarely take an activist role in such cases. For example, because production costs are generally known only to the company, courts rarely allow relief when a company cites unanticipated increases in production costs as a reason for breaking the contract (see Schwartz, 291-305 for examples). An additional problem is the inability of courts to verify the content of private norms. For example, because companies often work closely together to develop goods or maintain quality control systems used for JIT delivery, objective evidence assigning liability for damages is often difficult to produce. Minor problems are easily solved by the parties themselves through invoking private norms, often based on technical rules or indices developed by the parties. However, when major problems occur, such as serial errors during production or defective designs that cause product recalls, courts cannot rely on private norms because they will be disputed between the parties. Instead, they usually rely on broad control rights set out in the contract or assign liability on the company that can objectively be shown to be most culpable (such as, for example, the company that conducted product testing or was responsible for quality control).

While this analysis is not sufficient to explain the variance across US and German contract laws, it identifies important technical problems undermining effective

implementation of regulatory contract laws in the United States. How can German courts overcome information problems in incomplete contracts that have stymied regulatory attempts by American courts? To answer this question, we must analyze a different philosophy of regulating contracts - a philosophy that involves regulating both the distribution of risks and the forms of governance structures companies may adopt. Furthermore, to understand how this system can persist, we must widen our analysis, examining how legal institutions are embedded within the broader organization of the political economy.

3. The intersection between legal analysis and comparative political economy

While the court system is more centralized in Germany, with most precedent deriving from the High Court (BGH), the organization of judicial processes for private law in Germany is not fundamentally different than in the United States (see Langenfeld, 1991). German courts do not have substantially different information gathering or technical competencies than US courts. How, then, can German courts effectively develop and apply laws that cannot be successfully implemented within the US judicial system?

An important reason complex contracting structures are difficult for US courts to decipher (why information problems exist) is because the governance structures companies use to manage their relationships vary widely. Legal scholars tend to view this problem as universal, presumably driven by the micro-organization of business relationships. However, these business relationships are in part derived from product market strategies that are formed by companies to take advantage of a broader framework of institutional incentives and constraints within the political economy.

The institutional structure of the US political economy creates incentives for companies to choose a product market strategy based on competing on the basis of creating innovative governance structures. US corporate law has few restraints on not just the distribution of legal responsibilities, but also legal categories companies develop to manage inter-firm relationships. Firms have wide latitude in customizing their own governance structures. A few basic legal concepts can be combined in a myriad of ways to create new structures. If the needed legal concepts do not exist, companies can often successfully create new ones. New contracting structures are then incorporated into law through the precedent system.

The resulting forms of industrial organization used by US companies differ tremendously across the economy. Because subtle or major differences in legal categories may exist on a case by case basis, it is difficult for US courts to gain an

understanding of how particular governance structures are typically used to manage various technical contingencies. Such knowledge could inform courts how particular control structures for incomplete contracting actually function. Have bargaining imbalances between the parties influenced how control rights are organized? Are the circumstances causing the dispute common for the form of governance structure used? If so, courts could develop a more subtle understanding of the adequacy of the private rules or technical standards used. Because of the extreme customization of governance structures in the US, it is very difficult for courts to develop such knowledge. The passive reliance on even partially defined control rights exemplifies this difficulty.

One reason why German law can be more regulatory is that most contracts German courts adjudicate are standardized, conforming to a limited set of governance structures with well-known technical and legal properties that courts can understand and thus effectively regulate. Limiting the ability of firms to create a variety of governance structures makes legal regulation much easier for German courts. Complicated inter-firm practices are similar across companies. Courts can invest energy in understanding the consequences of these practices in terms of the distribution of legal and market risks across firms and create laws and precedent regulating them. This is often impossible in the United States because companies have more freedom to customize contracts. Practices differ substantially from case to case.

German private law is divided into two broad legal categories: association and exchange. These categories quickly translate into two basic forms of industrial organization in Germany: firm or contract (see Hueck, 1991). In the supplier relationship area, contract law then assumes that a very strict, hands-off relationship exists between fully autonomous companies, and then regulates important aspects of the technical division of labor between these companies in order to police the distribution of risks between companies. The German Commercial Code (HGB) in essence contains a late 19th century version of the technical and legal division of labor between companies in a supplier contract relationship. In more modern times German courts have used the AGB-Gesetz and other legal instruments deriving from the BGB to impose a similar, but more technically advanced, legal division of labor within the contracting structures used by companies.

The German economy has quite obviously progressed past a 19th century model of capitalism. German law supports governance structures suiting the product market strategies of not all, but most large companies in the decentralized economy of the 1980s and 1990s. While courts and other legal actors have played an important role in modernizing German contract law, it is large companies that have dominated the process. Compared to the immense freedom of action companies enjoy in the American legal environment, large German companies exist in a legal straightjacket. Yet, despite this, German companies have a tremendous collective law-making role.

They collectively create new contracting structures, then, in a prolonged legal exchange with courts, federal agencies, and sometimes the legislature, see their creations molded into forms that comply with the broader system of legal restraints. I refer to these structures as industry frameworks. They consist of interdependent legal and technical rules that are used to manage complex inter-firm relationships. Industry frameworks differ from governance structures only in that they are standardized structures commonly used by firms throughout industry and in that they are also often used as the basis by which courts develop strong legal regulations.

How does the institutional organization of the German political economy facilitate the modernization of German law? It is here that coordinating institutions become important. Within the strict principles regulating the division of risk between companies, the German legal system grants German companies a collective law making capability within trade associations and other institutions that does not exist in the United States. This allows German companies to collectively develop and use industry frameworks regulating important parts of both the legal and technical division of labor between companies. Courts have policy instruments helping them to understand these industry frameworks in detail, strongly regulate their content, and then use the result as precedent applied more generally.

In terms of facilitating the coordination of business activity, the German associational governance system can be broken into three distinct areas:

a) Capacities of individual social actors. In Germany social actors such as unions, employer federations, and, of most concern here, trade associations, have competencies in a variety of technical and legal areas that typically do not exist in the US. Trade associations in both countries engage in marketing and some types of research for companies, such as gathering industry sales data (see Scheiberg and Hollingsworth, 1990). German trade associations possess additional capabilities, such as the ability to create technical standards, help diffuse new technologies, or in some cases run common technology projects sponsored by the state (Lütz, 1993; Herrigel, 1993). In addition, they have strong law making capabilities, such as the ability to create legal frameworks governing trading relationships within or across industries and competency in adjudicating disputes between members. Each of these added competencies requires expertise about the industry, and thus intricate knowledge about company technologies, organizational structures, and product market strategies. This knowledge only develops through extensive engagement of trade associations by companies.

In Germany most specialized legal talent in the area of complex contracting law is concentrated in a small number of trade associations and a number of very large companies. Lawyers from these companies usually participate in working groups within trade associations to create new industry frameworks. The technical and legal

resources of German trade associations provide the resources needed to create sophisticated legal frameworks that large companies often adopt. However, the critical competency I want to stress is that trade associations can develop industry frameworks combining legal and technical rules. The capacity to provide comprehensive governance structures increases the attractiveness of industry frameworks, particularly to companies without the resources to develop them themselves. Furthermore, when companies use industry frameworks, both the legal and technical arrangements they adopt becomes transparent to third party observers. Through examining the standardized practices generated by industry frameworks, courts can effectively regulate their provisions.

b) Horizontal coordination: This refers to the ability of a trade association or other representative body to coordinate its activities with other social actors. In Germany horizontal coordination occurs at two levels. First, individual trade associations (or other social actors, such as unions) join a broader group of associations in the same sector of the economy and create a peak association. For example, individual trade associations in the industrial sector of the economy belong to the BDI (*Bundesverband der deutsche Industrie*). Peak associations have resources allowing individual associations to share information and coordinate their activities. The legal and technical staffs of the BDI often work with individual associations to insure that their industry frameworks are portable across the industry.

At the second level, peak associations coordinate their activities with other peak associations. Of particular importance here is the practice of peak associations bargaining with each other to make their individual legal frameworks compatible through using common terms, legal concepts, and rules distributing risks. As a result, modern commercial codes in Germany have an interlocking quality not seen in the United States. The possibility to create interlocking laws is important because it results in yet more standardization of contractual practice, again simplifying the judicial regulation of contracts. Furthermore, interlocking legal frameworks create substantial collective goods for companies and are thus a major reason why large companies participate in projects to create industry frameworks.

c) Para-public links between industry and the state (vertical coordination): While in the US trade associations or other societal actors routine lobby legislative and administrative officials over prospective regulation, their status is no different than any other interest group (see Streeck and Schmitter, 1985). In Germany there exist numerous formal and informal linkages between social actors and the state (Katzenstein, 1989). Particularly in labor law, unions and employers association are explicitly recognized within law and encouraged to create private agreements, which are then legitimized by the state (Keller, 1991). Though the policy process is not so explicit within corporate law areas, it is similar. The primary linkage between trade associations and the state is through the *Bundeskartellam*t (Cartel Office), which has

the official task of evaluating and then legalizing industry frameworks to ensure that they do not violate Germany's strict postwar cartel laws. In addition to examining the impact of all industry frameworks on market structure, the Cartel Office also must assure that frameworks are voluntary in nature. However, in the context of these official inquiries, the Cartel Office has set up a much broader, informal review. Legal experts at other trade associations, private law firms, and university law departments are asked to scrutinize the broader legal status of the proposed agreement, in particular to see if would violate the AGB-Gesetz and other contract laws.

This review process has two important implications. First, it internalizes contract law considerations that could be brought up in eventual court reviews from an early stage. This ensures that AGB-Gesetz and other related regulations on contracts are of primary consideration when constructing industry frameworks. This has the further effect that trade associations representing one particular class of companies, such as final assemblers, cannot easily legalize industry frameworks that would violate contract laws and then use the legitimacy of the agreement combined with bargaining power to impose it on companies in another sector. Second, when companies use industry frameworks, they will be highly confident that they are legally permissible. When introducing new technical practices that impinge upon existing legal rules, the risk of using industry frameworks (or private contracts explicitly modeled after them) is less than private arrangements.

By comparison, the US institutional environment is different in each of these three respects. Trade associations and other social actors are weak, and particularly in corporate law areas, do not have strong law-making capacities. There exist tremendous legal resources in the US, but these are decentralized throughout the private economy. Except in some legislative lobbying domains, trade associations do not horizontally coordinate their activities. Finally, trade associations, unions, and other collective actors do not have privileged access to the government or legal system. They must engage the political and legal systems through formal channels that any other interest group can use.

Differences in the distribution of law-making institutions and resources across the US and Germany clarify why the two contracting systems can differ. However, it would be mistaken to simply "read off" legal outcomes from these differences in law-making capacities. It is also necessary to examine the range of circumstances in which it is in the interest of the actors involved to choose strategies that will lead to these outcomes. In both countries institutional structures can be used to effectively modernize legal frameworks, but only if they are engaged by companies and legal actors who are interested in doing so. This is something that cannot be taken for granted in either case. The next two sections examine more carefully the implicit strategic bargaining between large firms and courts in Germany and the United States.

4. Courts, large companies, and legal modernization

National institutional frameworks influence the governance costs of embarking on particular product market strategies. My argument differs from the "embededness" approach often found in sociological studies (Grannoveter, 1985). In its simplest form, this position holds that company organizational structures are shaped directly by the orientation of national institutional frameworks. Rather, I assume that company management, faced with international competition, can survey the spectrum of possible organizational arrangements prevalent within their industry, and attempt to shape a coherent strategy. National institutional frameworks play a strong role through influencing the relative cost of building the organizational competencies needed to pursue each strategy.

The orientation of national institutional frameworks is dependent on the actions of large companies and courts. Large companies decide whether to engage the associational governance system to create industry frameworks. Courts chose the form of legal regulation to impose on the new organizational forms. Should courts attempt to regulate the distribution of risks entailed by new practices, or leave it up to the firms involved? The cumulative strategies chosen by large firms and courts create the framework conditions faced by firms within the country.

To examine the process of strategic bargaining between courts and large firms, this section first examines three generic types of product market strategy companies might adopt to compete on international markets. I then examine the logic of strategic bargaining over legal modernization in Germany and the United States. Each case begins by examining the how different constellation of national institutional frameworks advantage each product market strategy, in terms of the likely governance costs incurred. This analysis helps identify the rank ordering of institutional framework preferences for each product market strategy. Finally, we can uses these preferences, together with an analysis of court preferences, to examine the logic of strategic bargaining over legal modernization. The outcome of this bargaining produces the actual institutional framework conditions in the country.

4.1 Product market strategy possibilities

Innovation-based product market strategies

Innovative companies attempt to create new forms of "best practice" within an industry. Best practice can be defined through advances in product technology itself or through advances in the technical organization of the production process. While

product advances often result from radical innovation within the company, inter-firm links are increasingly used to promote innovation. Within the automobile and most other complex manufacturing industries, the increased technological complexity of different components within the final product has created an incentive for final assemblers to decentralize operations by allowing suppliers to design important subassemblies. In the area of inter-firm relationships, product advances are often achieved through highly collaborative design relationships (See Sabel, 1993; Ulrich, 1995). Advances in simultaneous engineering, benchmarking, and other collaborative design techniques allow companies to achieve a market advantage through the introduction of products with more sophisticated systems integration than competitors. A parallel strategy is to focus on process enhancements. For example, the introduction of "just-in-time" delivery systems has allowed innovative companies to radically reduce inventory costs, while allowing consumers more flexibility in customizing product specifications (Schonberger, 1982; Asanuma, 1993). Heightened quality control risks created by JIT delivery have also created competition across companies to introduce "quality management systems" with their suppliers. Companies compete on the overall effectiveness and efficiency of quality management regimes. In this case, the innovative strategy is characterized by on-going quality dialogues designed to continuously reduce quality control costs while simultaneously creating quality management systems with close to zero defect rates and an ability to rapidly incorporate changes in the production process.

Emulation-based product market strategies

Innovative companies attempt to appropriate their discoveries through patents, tacit-knowledge, the introduction of standards, or other devices. However, most innovations eventually diffuse to other companies within an industry (see Teece, 1986). Non-innovative companies attempt to keep abreast with broad industry trends through emulating standardized forms of innovations created elsewhere, but then supplementing or linking them with other competitive assets to achieve market success. Both the German "diversified quality production" (DQP) approach and more opportunistic price-based product market strategies rely on this approach to appropriating technology. Opportunistic strategies link standardized forms of innovations with the delegation of market risks to non-essential workers or suppliers while the DQP embeds them with club-goods created through the German associational governance system.

Price-competition (opportunism). This is a general term for all strategies that create market advantages through the delegation of risks to weaker market participants, whether these are internal employees or, of more relevance here, suppliers. Particularly when there exists a large pool of potential suppliers for each subcontracted component, final assemblers have substantial bargaining advantages over suppliers that may be used to develop opportunistic governance structures. The

control rights contained in these structures allow the final assembler to externalize costs of industrial adjustment to suppliers. Legal clauses do this through delegating to the final assembler unilateral control rights over incomplete contracting contingencies. These typically include rights to change the price of parts or quantity ordered when market conditions change or the delegation of various liability risks to the supplier (see Popp, 1993).

Within Germany and other countries with regulatory contract law systems, the introduction of new supplier network concepts often creates an opportunity to redistribute legal and market risks to suppliers under the pretense of innovation. For example, many German companies have created minimal versions of JIT delivery systems in order to reduce inventory costs and improve product variety while simultaneously delegating important legal liability risks to suppliers. German private law obligates final assemblers in most subcontracting relationships to conduct "entry inspections" of all goods upon delivery. These inspections force final assemblers to assume important legal liability risks. If inspections are not completed and defective goods subsequently damage machine tools, create work delays, or escape unnoticed into final products and eventually harm customers, the final assembler must assume partial liability. German final assemblers have used the introduction of minimal forms of JIT delivery as a mechanism to improve the technical efficiency of their supplier networks, but also transfer these legal liability risks fully to suppliers. They argue that the technical organization of JIT delivery, by definition, precludes the performance of "entry inspections." New contracts designed by large auto assemblers replace "entry inspections" with "exit inspections" to be performed by suppliers and contain clauses abrogating standard German liability laws in favor of customized clauses transferring legal liability risks normally assumed by final assemblers to suppliers (see Casper, 1997, chapter 3).

Diversified Quality Production (DQP): This product market strategy augments standardized forms of innovations with club goods created collectively by firms. In the area of inter-firm relationships companies choosing DQP strategies design collectively design industry frameworks. I assume that, at least in the short term, these club goods are crucially dependent on the existence of national institutions facilitating business-coordination, such as the German associational governance system. Thus, DQP strategies are only sustainable in business-coordinated market economies. Furthermore, while the innovative and price competition strategies can be implemented by individual companies, DQP requires substantial coordination across companies in the sector. Thus, the majority of companies within any sector must choose the strategy if industry frameworks are to be developed.

To give an illustrative example, firms in the German electronics industry have recently developed an industry framework for JIT delivery (see Casper, 1997 ch. 3). The agreement integrates technical provisions over quality control with legal clauses

distributing legal liability risks across companies. It necessitates that final assemblers maintain a less stringent form of the "entry inspections" mandated under German commercial law while also requiring suppliers to introduce a systematic quality management system, certified by accredited auditors on a regular bases, that meets the quality demands created by JIT delivery. On the advice of the industry association, firms usually implement the ISO 9000 quality system. Though not as efficient as the more customized quality systems introduced by innovators, most firms using ISO 9000 can adequately perform as JIT supplier firms. However, because this industry agreement has undergone a thorough judicial review under the Cartel Office and other industry associations, the legal implications of using this agreement are clear. Companies preserve normal liability rights that protect suppliers. The association has negotiated agreements with the insurance industry to maintain normal, standardized, insurance rates for companies using the industry framework.

Overall, firms choosing DQP product market strategies to fully take advantage of the incentives and constraints produced by the German associational governance system. Firms attempt to maximize gains offered by industry frameworks and minimize the costs of probable legal regulation. This usually requires creating cooperative supplier relationships that use legal entitlements set forth in German commercial codes. In addition, when companies cooperate to create industry frameworks they often expose private company information to competitors. As a result, companies most inclined to adopt this approach are those situated within sectors with a highly differentiated domestic market structure. Companies in industries where domestic competition is limited, such as electronics or machine tools, have the maximum incentive to collectively engage the associational governance system in order to create industry frameworks. These frameworks help companies compete abroad, where competition over governance structures does exist. Table 1 summarizes this discussion of product market stategies and related supplier network practices.

Table 1: Product market strategies and supplier network practices

Product market strategy	Competitive strategy	Supplier network practices
Innovate	Create new forms of "best practice."	Create new governance structure arrangements (usually highly collaborative supplier relationships)
"**Diversified quality production**"	Emulate existing forms of best practice, but enhance them with club goods generated by associational governance system.	Rely on standardized industry frameworks for governance structures
Price competition	Emulate existing forms of best practice but externalize risks/costs to suppliers and workers.	Opportunism: distribute market and legal risks to supplier companies.

4.2 Legal modernization in Germany

Why do German companies participate in associational governance projects, given that courts use the resulting industry frameworks to impose regulatory contract laws? Central to the following analysis is the ability of German courts to make a credible commitment towards legal regulation in all cases in which they know that large companies would prefer industry frameworks with legal regulation rather than no industry framework with no legal regulation. The problem for courts is that the gains created for companies by coordinating institutions vary depending on each company's particular product market strategy. While for many companies the gains from creating industry frameworks outweigh the costs of legal regulation, for companies with other product market strategies this is not true. We must examine implicit bargaining between courts and companies for each of the three product market strategies.

The implicit bargaining game played between courts and companies is diagramed in figure 1. I will not attempt to solve this game in any formal sense, but only use it to illustrate the trade-offs created by different strategies of legal regulation, in terms of the product market strategies adopted by companies. The game assumes that legal modernization occurs through the following process: Bargaining is between large companies and courts. Companies first choose one of the three product market strategies described earlier. They may attempt to innovate (I), to compete on the basis of price by externalizing costs to suppliers whenever possible (P), or to compete on the basis of engaging standardized governance structures that are produced as part of industry frameworks (S). When disputed contracts are adjudicated before courts, I assume that the courts can judge the type of product market strategy chosen only if it is the standardized governance structure choice (S). Courts cannot differentiate between companies choosing to compete on price (P) or on innovative governance structures (I). Courts adopt a legal strategy (R, NR), where R denotes a strategy of regulating the distribution of legal entitlements within a contract while NR refers to no regulation. Companies decide whether or not to create industry frameworks (IF, NF), where IF denotes a strategy of engaging the associational governance system to create industry frameworks and NF refers to a strategy of not creating industry frameworks. This produces four general framework possibilities:

IFNR -industry framework, no legal regulation
IFR - industry framework, legal regulation
NFR - no industry framework, legal regulation
NFNR - no industry framework, no legal regulation

Framework preferences of courts and large firms

Courts have a fixed ordering of preferences, but those of large companies depend on the product market strategy they choose to adopt.

Framework Preferences of Public Actors (Courts)

Courts play the key role in determining the regulatory structure of contract law. Will they attempt to police the distribution of legal and market risks across companies through strong legal regulation, or will courts pursue an "enabling" strategy concerned with enforcing the letter of contract, no matter how it distributes risks? A core point of the earlier section on contract law regulation is that courts cannot always efficiently enforce all contracting laws. Efficiency can be defined as the ability to implement laws effectively; courts can obtain all information about the relationship that is presupposed within the contract law doctrine that they are enforcing. If courts do not have the information necessary to apply laws consistently, judicial process norms will be broken. There are thus three possible outcomes for courts:

- regulatory laws plus efficiency
- efficiency alone
- regulatory laws without efficiency

These general preferences can be translated into regulatory framework preferences as follows. In Germany broad social norms underlying the idea of the "social market economy" have combined with specific "fair trading" laws such as the AGB-Gesetz to provide a clear public mandate for courts to apply regulatory contract laws whenever possible. Courts prefer legal regulation over no legal regulation (R>NR). However, courts can only efficiently implement regulatory laws if companies create industry frameworks. Industry frameworks reveal standardized information about technical practices that is often hidden in private contracts. If courts impose inefficient legal regulation but companies decide not to develop industry frameworks, then the resulting laws will be inefficient. Courts will fail in the core purspoe of dispute resolution, as companies cannot effectively use the "shadow of the law" to privately settle disputes. As a result, the IFR framework outcome is the best outcome for courts, while NFR must be the least preferred outcome. In between these two outcomes are the IFNR and NFNR outcomes. Courts can always implement "enabling" contract laws, in which they merely enforce the written rules of contracts. Thus, either the NRIF or NRNF outcomes produce efficient legal outcomes. As industry frameworks have diffuse public policy benefits (lower transaction costs to industry and small firm competitivness), I will assume that as agents of the state courts prefer NFIF over NFNF, but this is inconsequential to the logic of implicit bargaining that occurs. The regulatory preferences of courts are thus RIF > NRIF > NRNF > RNF.

Framework preferences of large companies

The legal preferences of large companies depend on the particular product market strategy that they choose to adopt. For each of the three possible product market strategies, there exists a different constellation of possible benefits and costs that may be produced by national institutional frameworks. I will first examine the spectrum of benefits and constraints generated by these institutions, and then explain how they generate particular regulatory preference orderings for each product market strategy.

Benefits of industry frameworks:

1. Large firms obtain viable governance structures to organize inter-firm relationships at a much lower cost than that of developing them privately. The institutional capacities of trade associations combined with horizontal linkages with other associational bodies and public actors make the cost of creating industry frameworks low. Trade associations use membership fees to create specialized legal and technical competencies, in effect socializing the cost of creating new technical and legal frameworks. Because legal expertise and services are concentrated in trade associations, most firms do not need to develop sophisticated legal competencies or hire private law firms. In addition, there are also important bargaining cost savings. Companies using industry frameworks with their suppliers largely avoid distributional conflict over the distribution of various legal entitlements (Knight, 1992, Goldberg, 1985).

2. Transaction cost savings are sometimes created through using horizontal coordination links with other associational bodies to create interlocking legal codes. If general patterns of economic organization are based around a standard set of legal categories and obligations, this allows different commercial frameworks to easily coexist and build upon one another. Commercial codes regulating how lenders, insurers and other "third-party service providers" in an economy may organize their businesses with firms may be structured around the assumption that standard legal rules are followed. The risk assessment of particular business deals and the costs of setting up transactions is correlated with whether or not the firms involved follow standard legal form in designing their dealings with one another. When structured in an inter-locking way, standardized contracts can result in considerable transaction cost savings. In most German manufacturing industries, customized contracts, for example, between industrial liability insurers and manufacturing firms do not need to be negotiated if industry agreements are used. And because industry agreements also reveal considerable information about the technical organization of firms, in many cases insurers also waive expensive customized risk assessments (see Migge, 1992).

3. Industry frameworks also create important information externalities. The process of developing industry frameworks, even if they are not subsequently adopted by many firms, helps develop and diffuse information about complex interlinkages between contract laws, liability laws, and different technical interlinkages between companies. Trade associations have the competency to gather expertise needed to propose different models of cooperation and examine the likely effects they will have on different types of companies. Because trade associations have expertise in both technical and legal areas, the often complex interlinkages between different parts of governance structures can be gauged. This knowledge is costly for companies to develop privately (see Eichengreen and Ghironi, 1996).

4. The competitiveness of small firms is increased. They receive modern governance structures in both legal and technical areas at no cost to themselves. The technical norms integrated in some industry frameworks are designed to help small companies upgrade areas of company organization that affect their exposure to liability risks. Recent industry frameworks have included technical norms helping suppliers create management systems to better implement quality and environmental controls in their production processes (see Casper, 1997). Large companies appropriate these benefits through improved supplier performance and adaptive capacity (see generally Herrigel and Sabel 1995; Teece and Pisano, 1994).

Constraints imposed by legal regulation:

Legal regulation primarily benefits small companies. Laws prevent large firms from pushing the costs of industrial adjustment to changes in international competition onto small firms. By forcing large companies to take the "high road" of adapting to international competition through increasing the productivity and value-added created within supplier networks, these laws might also enhance the overall competitiveness of industry in the country. Large firms often oppose regulation, since it is their flexibility that it impinged upon. There are four particular constraints on large firms created by legal regulation:

1. Large firms have reduced flexibility in distributing legal entitlements with suppliers. For example, during the 1980s German courts created legal regulation preventing large firms from using contracts with incomplete price clauses. Final assemblers faced limitations on the content of legal clauses allowing price clauses to be adjusted if market demand changes or the price of input goods fluctuate. They might have to include price indices or other information detailing to suppliers the circumstances, processes, and range by which prices can change due to changed market conditions (see Casper, 1997, chapter 5).

2. Inefficient laws could emerge if courts impose regulation, but firms create no industry framework. Because all industry frameworks emerge out of a consensual decision-making process, if large firms within an industry are strongly divided over their content, no industry framework will be created. Companies may also fail to develop an industry framework because of difficulties in creating standardized solutions in technically complex areas. Companies have to bear the cost of inefficient laws or, if they are extreme, circumvent public law through creating private governance structures.

3. Courts often impose legal regulation through impinging upon the technical organization of inter-firm relationships. For example, in order to minimize the liability risks small firms must accept, German law forces final assemblers to conduct "entry inspections" of all goods purchased as soon as they are delivered by the supplier to the final assembler. These inspections limit the liability risks suppliers must accept, but in doing so create technical rigidities firms face when designing new forms of industrial organization.

4. Legal regulation limits the type of legal categories available to firms. German law places limits on the legal categories private actors may use to structure their relationships. It channels all private relationships into one of two broad legal categories: association or exchange. By restricting the use of other basic legal categories the complexity of legal regulation is reduced. This limits the ability of companies to customize incentive structures through creating novel legal categories. For example, in Germany the lack of legal categories recognizing network forms of organization limits the ability of companies to pool some types of legal risks.

Based on these benefits and constraints, we can examine the regulatory framework preferences for companies, momentarily assuming they have already chosen one of the three available product market strategies.

1. Diversified Quality Production. For companies using DQP product market strategies the benefits gained from industry frameworks outweighs the costs of legal regulation. The preferred outcome is no legal regulation with industry framework (NRIF). Since the cost of legal regulation is small, the regulation with industry framework outcome (RIF) is preferred over the no regulation and no industry framework outcome (NRNF). Regulation with no industry framework (RNF) is the least favored outcome, since here legal regulation will be both costly and inefficient, creating additional governance costs in addition to the lack of associational governance benefits. The resulting regulatory preference ordering of companies with this product market strategy is NRIF > RIF > NRNF > RNF.

2. Price-competition. For companies concerned with the ability to retain control rights over legal and market risks, the threat of legal regulation strongly influences the

decision to participate in industry framework projects. Companies choosing cost based product market strategies are usually not innovative in creating their own supplier network structures, and thus could appropriate most of the benefits created by industry structures. Such firms often participate in technical standardization projects and also benefit from the creation of interlocking legal frameworks. However, they are likely to oppose any industry framework that include legal provisions that fall under existing areas of regulatory contract law or are likely to provoke new regulation from courts. Even with the ability to opt out of industry frameworks (which is protected under German law), the legalization and use by other companies of legally unfavorable clauses in industry frameworks decreases the ability of large companies to impose illegal contractual structures on weaker partners. Case law and public information concerning the governance structures regulated in industry frameworks will better inform supplier companies about their legal rights in complex areas of the law. While raw bargaining power might allow large companies to include illegal or quasi-legal contract clauses in some domains, in other areas supplier companies will know what their rights are and can insist on maintaining normal practice.

For companies choosing to compete on costs, the NR > R legal preference strongly outweighs the IF > NF associational governance preference. While the NRIF outcome is most preferred, the second most favored outcome is the neutral NRNF framework, which also preserves freedom to delegate contractual control rights. If legal regulation is nevertheless imposed, then these firms still prefer legal regulation with industry frameworks (RIF) over legal regulation without industry frameworks (RNF). The resulting regulatory framework preference ordering is NRIF > NRNF > RIF > RNF.

3. Innovation. For innovators legal regulation is often costly. Innovative governance structures usually formulate customized contractual structures to create frameworks of incentives needed to sustain volatile and risky new forms of collaboration. Fair trading laws themselves are usually not the problem, since innovative companies usually design cooperative relationships with suppliers and often adopt strategies of sharing most legal risks in order to align incentives. However, limits on legal categories or attempts by courts to standardize some technical aspects of the division of labor between firms are often very costly. If courts will not recognize the legal categories or underlying division of technical labor between highly innovative large firms and its suppliers, these companies must then opt out of the normal system of legal entitlements and remedies governing inter-firm relationships and create private contracting rules to manage relationships. Innovators thus have a strong preference for an “enabling” system of contract law (NR > R)

Innovators also have little to gain from the associational governance system. Innovators do benefit from the improved competitiveness of smaller supplier firms. However, the primary goal of industry frameworks is to create tool-kits showing other large firms how to emulate new forms of industrial organization. Why should an

innovative company directly help other large firms appropriate its inventions? Innovators thus have a preference for no industry frameworks (NF > IF).

Overall, innovators have a strong first preference for NFNR and their least desired framework preference is RIF. The second and third preferences could be argued either way. However, for most innovators the legal preference should outweigh the associational governance preferences (NRIF > RNF). Innovators are dependent on an enabling system of contract law to create customized governance structures. While appropriability is a core concern to all innovative companies, industry frameworks will only be used by companies operating in Germany, and therefore do not influence the innovator's position against competitors in other countries. The framework preference ordering for innovators is thus: NRNF > NRIF > RNF > RIF

Table 2 summarizes the framework preferences for German courts and large firms:

Table 2: Framework preferences for German courts and large firms

Actor	Framework Preferences
Courts	RIF > NRIF > NRNF > RNF
Large firms by Product Market Strategy:	
DQP	NRIF > RIF > NRNF > RNF
Price-based (opportunism)	NRIF > NRNF > RIF > RNF
Innovation	NRNF > NRIF > RNF > RIF

Bargaining outcomes in Germany

We can now examine implicit bargaining between courts and large firms. I will start by examining the legal strategies courts would develop for companies competing in each product market strategy, if they had perfect information as to the type of company they were dealing with. From this analysis, we can then examine whether dominant strategies emerge for courts in situations where they do not always know the product market strategy type of the large company.

Court strategies with perfect information as to the type of product market strategy

Court regulatory strategies for competing on the basis of industry frameworks (S): DQP firms have a dominant strategy to always choose to create industry frameworks. Thus, courts can always credibly commit to legal regulation, knowing that companies will choose to create industry frameworks and that the resulting legal regulation will be efficient. This regulatory outcome (S,R,IF) produces the second most favored outcome for companies, and the first preference for courts.

Court regulatory strategies for companies attempting to compete on the basis of cost (P): Here implicit bargaining becomes more complex. Because price competitors value no legal regulation much more than the gains from industry frameworks, companies have an incentive to commit to a no framework policy, since they must assume that courts will always regulate any industry frameworks created. Even though legal regulation could then lead to their least preferred outcome (P,R,NF), companies know that this is an inefficient outcome for courts as well. If courts believed this threat, they might not adopt legal regulation, creating the second most favored outcome for companies (P,NR,NF), which must be seen as far superior than any outcome that includes legal regulation.

Nevertheless, if courts are certain that the company is competing on price, they might still choose a strategy of legal regulation. From a German public policy perspective, courts have a strong mandate to punish companies adopting the price competition strategy. This might be interpreted to mean that the cost to courts of arriving at the (P,R,NF) outcome is not as high as in the other cases, since inefficient legal decisions in effect adds to the "punishment" imposed upon companies adopting industrial practices socially defined as illegitimate. But besides this point, if courts consistently adopt a policy of legal regulation across all cases, companies must realize that their threat not to create industry frameworks is not credible. Faced with legal regulation in any case, companies will then create industry frameworks, since then they receive their third most preferred outcome (P,R,IF) instead of their least preferred outcome (P,R,NF). Of course, once firms adopt this strategy, courts achieve their preferred regulatory outcome.

Court legal regulation strategies for innovative firms (I): Innovators face a similar dilemma as price competitors. Even though innovative companies prefer NRIF to RNF, they have a strong rationale to always choose NF. Doing so ensures that the least favored RIF outcome is avoided, and creates a possibility that courts, fearing the creation of inefficient law, will help innovators achieve their most favored outcome through choosing NR. The difference between this and the price competitor case, however, is that there exists no social legitimacy for a punishment strategy against innovators. While courts are encouraged to punish price competitors through various fair trading laws, why should courts attempt to punish known innovators? So long as courts know they are dealing with innovators, they should understand that enabling laws are needed to facilitate the creation of customized contractual structures needed to support new forms of organization, not to opportunistically redistribute risks to weaker suppliers. In other words, the payoff courts receive for the most favored (I,R,IF) framework must be lower than that for (P,R,IF). Similarly, since fair trading laws empower courts to punish opportunists but not innovators, the court payoff for the least preferred outcome in the innovation case (I, R,NF) must be much lower than that for the (P,R,NF). Thus, if courts want to create national institutional frameworks hospitable to

innovation, they must chose NR. Doing so preserves a large role for law in promoting innovation, and avoids the possibility that courts will obtain their least preferred RNF framework outcome.

Court strategies when they do not know the type of product market strategy chosen

If courts could discriminate between different product market strategies when receiving cases, then the problem of legal regulation would be simple. Courts could customize legal regulation to promote innovative firms and those competing with industry frameworks, while punishing cost competitors through strong legal sanctions. This, however, is seldom possible. As a practical matter, courts develop laws for the economy as a whole and can rarely customize precedent to suit the needs of particular sectors or product market strategies. If courts could tailor the law to suit particular product market strategy types, they would still face important information asymmetries. It is difficult for courts to distinguish between innovative contractual structures and the contractual structures used by companies attempting to compete on price.

To illustrate this problem, consider again the importation of a new form of industrial organization from abroad, such as JIT delivery. Some companies in Germany have decided not simply to emulate standard forms of JIT delivery and related quality control systems, but to compete with Japanese and US firms directly on the basis of creating new legal and technical innovations in managing quality control and logistical relationships with suppliers. These are the innovators. Other companies merely want to emulate standard forms of "best practice" developed by international competitors into their operations. However, new logistical and quality control concepts necessitate the reorganization of important legal liability entitlements. This modernization of legal clauses often may occur in a variety of ways. Companies may attempt to preserve the content, if not form, of existing legal entitlements as they have been developed through German legislation or case law, while introducing standard forms of the new industrial arrangements into their operations. Companies choosing this strategy have every incentive to develop an industry framework, as this minimizes the costs of obtaining viable new governance structures. Other companies might choose to create contractual frameworks that support minimal forms of the new industrial organization, but at the same time redistribute legal and market risks between final assemblers and suppliers in favor of the final assembler. In the JIT case, many German final assemblers have used this opportunity to redistribute important liability risks away from final assemblers and to suppliers. This is in essence the price competition strategy.

In this example, firms choosing innovative and opportunistic strategies will alter standard contractual clauses: in one case because they have to be in order to support the innovative form of industrial organization and in the other because doing so

opportunistically benefits the large firm. Companies competing on price have every incentive to claim both to courts and their contractual partners that changes in standard practice are being adopted to facilitate "best practice". Not understanding the underlying technical practices until industry frameworks have been developed, courts only see incomplete contracting structures and altered versions of standard contractual clauses, both of which in many cases clearly violate the AGB-Gesetz and other regulatory contract laws. The assumption that courts cannot discriminate between product market strategies is usually warranted.

Let's now assume that a large company has not yet chosen a product market strategy. From the court's point of view, legal regulation has the positive effect of raising the cost of opportunism, in effect creating incentives for companies contemplating the S or P strategies to choose the DQP strategy. However, this threat is only viable when large firms know that choosing P will <u>always</u> lead to a punishment outcome. A court strategy of rewarding innovators through choosing NR all or most of the time would lead many non-innovating firms to choose P over S. It creates an incentive for price competitors to disguise themselves as innovators. In game theory terminology, this is a "signaling strategy" designed to achieve a "pooling equilibrium" (Gibbons, 1992, chapter 4). They can do this by choosing P and then NF. The (P,NR,NF) outcome is likely to outweigh the (S,R,IF) outcome for many firms. This is particularly true for companies experiencing substantial competition from low-cost foreign producers. The problem, however, is that a fixed strategy of legal regulation punishes innovation companies as well as companies attempting to compete on the basis of costs. This is the basic dilemma of legal regulation in Germany.

By eliminating the possibility of a strongly preferred outcome within the P strategy, courts may interpret legal regulation as promoting the associational governance system through giving companies an incentive to choose S and create industry frameworks. Companies competing on the basis of DQP strategies know that they are very likely to encounter legal regulation. However, because they organize the supplier network to maximize gains from industry framework and minimize the potential costs of legal regulation, they can obtain a better regulatory framework outcome, in terms of preference orderings, than companies competing on costs. They also have an incentive to minimize the potential costs of courts regulating their governance structures. They can do this through creating cooperative, long-term relationships with suppliers. From both a court perspective and a broader public policy viewpoint, this is clearly a superior outcome.

Potential innovators, however, must also cope with legal regulation designed to sway potential price competitors to adopt the DQP strategy. Whenever the RIF equilibrium prevails, national institutional frameworks become a constraint on innovation. Innovators must circumvent legal regulation by create private governance structures to support new forms of organization. Furthermore, most other firms in the

sector will chose to compete on the DQP strategy, meaning they will be emulators much more than potential partners interested in cooperating to create new innovations. Given this decision calculus, it should not be surprising if potential innovators decide to choose the DQP strategy too.

Courts also have private incentives to create a general pooling equilibrium around S. Because companies choosing S will always create industry frameworks, only this outcome assures that courts will always be in a position to efficiently regulate contracts. Remember that industry frameworks can only be created when there is a consensus among large firms within particular industry associations. For different reasons, both innovators and price competitors are opposed to legal regulation, and thus have an incentive to undermine associational governance projects. Since, for cartel law reasons, the associational governance system is organized on consensus principles, a small coalition of large firms can easily thwart any industry framework project. As long as there is no way for courts to prevent price competitors from attempting to pool with innovators, courts have a strong incentive to develop a signaling strategy of always adopting legal regulation, since this promotes a pooling equilibrium around diversified quality production (S). The broad public policy problem is that the cost of this strategy – punishing innovative companies – is borne by the public and not courts.

4.3 Legal modernization in the United States

Because the institutional infrastructure in the United States lacks coordinating institutions, large companies cannot cheaply collaborate to create industry frameworks. This eliminates DQP as a viable product market strategy, at least in terms of creating supporting institutional frameworks. This simplifies the possible regulatory frameworks available to firms and also creates dominant strategies for both courts and large firms, in effect eliminating the complex strategic bargaining made possible within Germany's coordinated political economy.

Regulatory Preferences

In the absence of a possibility for companies to use business coordination institutions to create industry frameworks, there are only two possible regulatory outcomes:

NR - no legal regulation
R - legal regulation

Large companies: For all large companies, the preferred outcome is NR>R. The reasoning is identical to that in Germany. Companies choosing the innovative product market strategy need "enabling" laws that allow them to customize legal categories in

order to create sophisticated new legal frameworks to support new forms of cooperation. Companies preferring to compete on the basis of price oppose legal regulation that prohibits the creation of contractual structures that delegate market and legal risks to suppliers.

Courts: The general preferences of US courts are similar to German courts. In areas where information asymmetries do not exist, such as product liability, US courts have not hesitated to implement highly regulatory legal doctrines when public policy and legal philosophy shifted in support of these laws. We have already seen that US courts have refused to implement regulatory contract laws in cases in which they lack private information about industrial practices. The reason again is that these laws would violate judicial process norms, undermining the consistency of legal reasoning within the precedent system. We may assume that US courts have a preference ordering of NR>R when dealing with innovative companies. When dealing with companies competing on the basis of price, courts probably would prefer effective regulatory laws, but since industry coordination is not possible in the United States, this outcome is eliminated, so courts must again prefer NR>R.

Table 3: Framework preferences for courts and Large firms in the United States

Actor	Framework preference
Courts	NR>R
Large Firms	NR>R

Bargaining Outcome

Figure 2 diagrams the legal regulation game for the United States. Implicit bargaining between courts and large companies is simple, since companies can always credibly commit to their preferred product market strategy. Courts might prefer the stricter regulation of contracts. However, they lack the ability to implement regulatory contracting doctrines in all areas where the governance structures used by firms are complex and embedded with information not available to courts. Furthermore, the institutions facilitating the creation of industry frameworks lie outside the legal system and, due to a combination of both America's historical development and the current strategies of companies, do not exist. Legal actors thus lack the necessarily policy instruments to promote their favored strategies. Thus they will chose to maximize efficiency. This can be promoted through "enabling" laws that promote flexibility by companies in creating a wide variety of governance structures and then enforcing the formal rules companies chose to create. The resulting regulatory climate for inter-firm relations fully supports both the innovative and price-based product market strategies.

To summarize, US legal regulation can influence the external risk structure faced by firms, but cannot mandate how firms distribute the new risks among themselves.

Important changes in legal risks may occur through legislation or broad changes in legal philosophy, so long as these new laws do not require the adjudication of incomplete contracting structures.

5. Conclusion

The chapter has examined why differences in institutional structures in the US and Germany lead to different capacities for public regulation of inter-firm relationships, and the influence this regulation has on the product market strategies of firms. Due to differences in historical development, German companies are embedded within complex networks of coordinated institutions that they may engage to create industry frameworks. However, we also saw that courts can use these frameworks to successfully implement regulatory legal doctrines. The chapter then examined the process of legal modernization, showing how legal actors and companies are likely to bargain over the creation of new laws in the two countries. From this analysis stylized descriptions of different trajectories of legal modernization in the US and Germany were created. The chapter concludes by considering the stability of these two trajectories of legal development.

In the United States courts and firms have dominant strategies that depend on no implicit bargaining. Lacking fundamental institutional change, the US seems locked in a very stable regulatory outcome. An industrial dualism exists in the United States. National institutional frameworks do not support DQP product market strategies, but allow companies to pursue radical innovation in law or adopt predatory practices designed to compete through delegating the costs of industrial adjustment to others.

Most large American companies are not interested in copying German style industrial arrangements. This is because most large American companies obtain their preferred outcome under the present institutional arrangements: few regulations on their freedom to contract. This is particularly true for companies relying on innovative product market structures that depend on sophisticated relationships with other companies. In terms of the product market strategies supported, this freedom is much more than the ability to adopt product market strategies based on delegating risks to weaker partners. The US institutional infrastructure has pushed American companies towards fundamentally different product market strategies than in Germany. US contract law, as one aspect of a broader body of corporate law that is broadly "enabling" in character (see Easterbrook and Fischel, 1991), allows American firms to compete over the organization and thus effectiveness of governance structures. Particularly in the 1980s and 1990s, the flexibility that American companies have shown in creating highly innovative forms of industrial organization is a key factor

allowing American companies to create product market innovations. The vast decentralization of legal resources in the United States is direct result of the companies demanding the ability to create complex governance structures.

Because legal resources are decentralized, it is very hard to imagine the underlying logic of American corporate legal development changing. Legal innovation is driven by thousands of private decisions by companies and courts. Individual companies create new contracting structures which, if successful, other companies might mimic. No collective action is necessary, and innovation usually occurs through competition. Furthermore, once companies embark on the product market strategies encouraged by these institutional arrangements, they develop private legal competencies and other resources allowing them to adopt product market strategies designed around competing on the basis of governance structures. These sunk costs create an additional source of stability. Even if changes to the US institutional infrastructure radically lowered the costs of creating industry frameworks, many large US firms are unlikely to engage these institutions to create industry frameworks. This is because most large firms already have the competencies needed to create and compete on the basis of complex private governance structures. Unless the gains from coordination are high enough to motivate companies to adopt new product market strategies and different internal resources to support them, large US firms would be unlikely to engage coordinating institutions.

By contrast, the German system of legal development is volatile. The creation of industry frameworks requires collective action by large companies. Institutions supporting business coordination lower the cost of cooperating to develop industry frameworks. The possibility of strong legal regulation will continue to create incentives for companies choose DQP strategies, while the associational governance system will allow DQP firms to continue to create important club that are not available to international competitors. While these factors lend stability to the system, they will also continue to produce framework continues inhospitable to innovators.

However, as the bargaining analysis made clear, even “typical” German DQP companies do not get their preferred outcome: the development of industry frameworks without strong legal regulation. As international product market competition continues to increase, firms may feel compelled to develop product market strategies that are not advantaged by German national institutional frameworks. German companies may increasingly be willing to pay the governance costs of opting out of German institutional frameworks in order to choose innovative or price competition strategies. Even if cooperation is cheap and rewarding, if enough important companies are not interested for other reasons, the German associational governance system could weaken.

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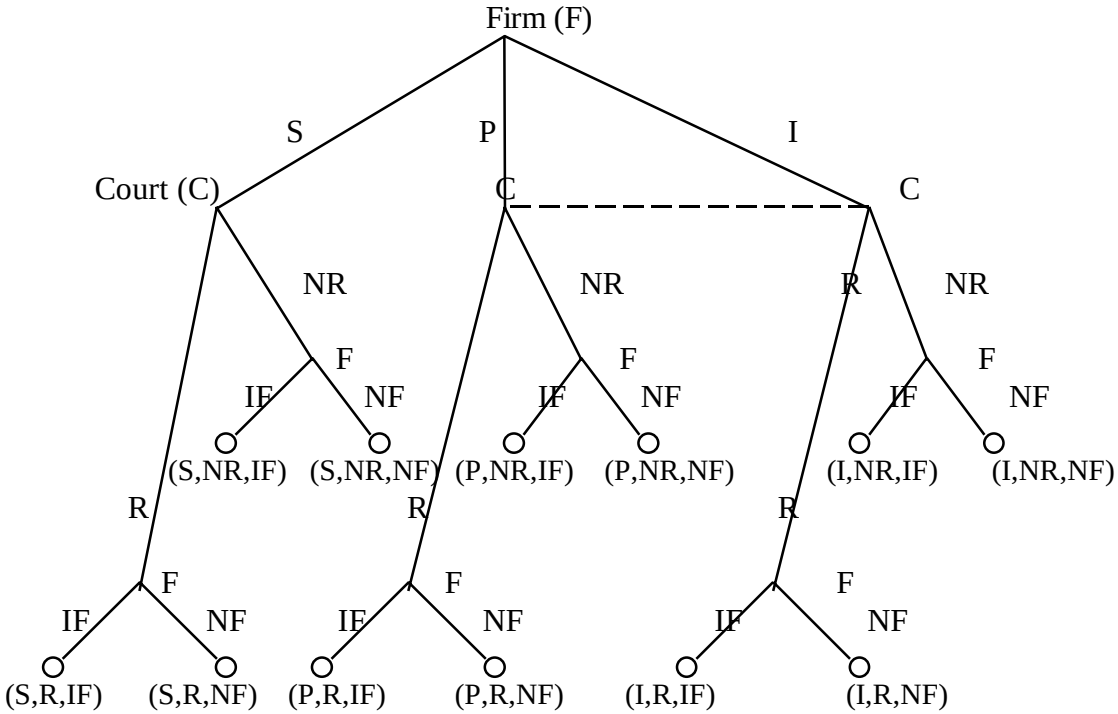
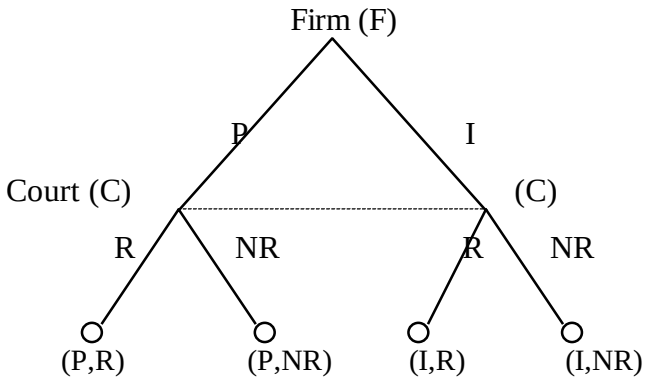
Figure 1: Legal regulation Game in Germany



Firm choices:
S: Adopt product market strategy using industry frameworks as governance structures
P: Adopt a product market strategy based on shifting legal and market risks to suppliers
I: Adopt a product market strategy based on creating innovative inter-firm governance structures
IF = Create industry framework
NF = do not create industry framework

Court choices:
R = create regulatory contract laws
NR = create no regulatory contract laws

Figure 2: Legal regulation game in the United States



Firm choices:
P: Adopt a product market strategy using industry frameworks as governance structures.
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Court Choices:
R: Create regulatory contract laws
NR: Create no regulatory contract laws.