

Leaving Money On the Table: Contract Practice in a Low-Trust Environment

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Abstract

Social capital – the level of trust inherent in a society – will affect the contracting practices that are considered standard, practical or fair. These practices in turn will help determine the parties' positions as they approach their negotiation, how they will communicate, and what terms they will agree in any particular transaction. This is true not only for the small transaction, but also for large and complex deals. As a result, when operating in a low-trust environment, even sophisticated parties (who can bear the costs of tailoring an agreement to their particular case), will be prone to relinquish or to sacrifice value – leaving money “on the table”. The paper illustrates this point by contrasting alternative practices in merger & acquisition transactions, comparing the “standard” model that is generally encountered in the United States with an alternative model often encountered in the developing world, most particularly in transactions done among sophisticated parties throughout Latin America. The relationship between trust, social capital and contract is then outlined. Finally, some preliminary observations are made comparing the normative and behavioral presuppositions of different legal traditions and how they may reinforce or help rationalize alternative contract practices, as described earlier in the paper.

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Every society is a moral society ... [I]t is wrong to oppose a society that derives from community of beliefs to one whose foundation is cooperation, by granting only the first a moral character and seeing in the latter only an economic grouping. In reality, cooperation has also its intrinsic morality.

Emile Durkheim, The Division of Labor in Society²

[A] nation's well-being, as well as its ability to compete, is conditioned by a single, pervasive cultural characteristic: the level of trust inherent in the society.

Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity³

Part 1. Overview

We often think of contract as reflecting the very *opposite* of trust. Indeed, in much of the academic literature, the contracting process is modeled as a “prisoners’ dilemma,”⁴ where trust and trustworthiness, at least in a one-shot encounter, are virtually ruled out. According to this line of thinking, contract is the device each party uses to protect against the other’s opportunistic behaviors. The parties to a contract will negotiate their agreement, and rely on it being legally binding and enforceable, *precisely* in order not to have to trust each other to perform.⁵ Limited – but effective – cooperation results from actual or threatened

² Emile Durkheim, The Division of Labor in Society (W.D. Halls, transl.), 173-174 (1984).

³ Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity, 7 (1995).

⁴ For a helpful discussion of this basic concept, see David D. Friedman, Law’s Order: What Economics Has To Do With Law And Why It Matters (2000) at 89-92.

⁵ See Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 35 J. L. & Econ. 453, 469 (1993):

[How] is trust implicated if parties to an exchange are farsighted and reflect the relevant hazards in the terms of [their] exchange? [T]rust is irrelevant to commercial exchange and ... reference to trust in this connection promotes confusion.

A similar bias *against* the introduction of trust is apparent in related fields, to the extent they are seen as derivative of contract. Scholars who argue for the centrality of trust in explaining concepts such as fiduciary duty (in the corporate law area) or disclosure (in securities regulation) will, in many instances, draw a sharp distinction

coercion between adversary parties. Conversely, It is common to think of trust as a device that reduces or eliminates the costs of transacting business – avoiding, at the limit, any recourse to contract.⁶

between “contractarian” analyses for those fields and analyses based on trust. The *contractarians* are those, like Easterbrook and Fischel, who will “speak of the corporation as a ‘nexus of contracts’ or a set of implicit and explicit contracts.” Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 12 (1991). They will analyze fiduciary principles as substituting for contract only because the cost of actually agreeing to each and every one of the relevant commitments would involve excessive cost in negotiation and monitoring (as well as the difficulty of anticipating future circumstances). If well designed, fiduciary rules will therefore “approximate the bargain that investors and managers would have reached if they could have bargained (and enforced their agreements) at no cost.” *Id.*, at 92. The *anticontractarian* critics will argue that “it is misleading and fundamentally mistaken to apply the rhetoric of contract” to certain key corporate law concepts (such as fiduciary duties), maintaining a fundamental opposition between contract and trust – except in the very narrow sense of “trust in the system itself, that is, in relatively free and open markets, and relatively efficient and unbiased methods of dispute resolution”. Lawrence E. Mitchell, *Trust, Contract, Process*, in Lawrence E. Mitchell (ed.), *Progressive Corporate Law* 185 (1995), at 196. They too will describe contractual relationships as “start[ing] from the assumption that the contracting parties are purely self-interested actors whose behavior must be channeled by external constraints ... Describing a relationship as a contract both assumes and legitimates the adoption of a purely self-interested preference function by both parties.” Margaret M. Blair and Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. Pa. L. Rev. 1735, 1784 (2001).

⁶ See, e.g., Larry E. Ribstein, *Law v. Trust*, 81 B. U. L. Rev. 553 (2001), at 553 (citing Fukuyama, at 151): “Trust is a kind of social glue that allows people to interact at low transaction costs.” Ribstein argues that legal change of one sort or another is not likely to promote what he, following a classification developed by Barney and Hansen (see Jay B. Barney and Mark H. Hansen, *Trustworthiness As a Source of Competitive Advantage*, 15 Strat. Mgt. J. 175 (1994)), calls “strong-form trust” – namely, the willingness of a person to expose herself to a certain vulnerability to another, “even where the trustor is technically free to breach but ‘opportunistic behavior would violate rules, principles, and standards of behavior that have been internalized by parties to an exchange’” (Ribstein, *op cit*, at 557 (citing Barney and Hansen, above)). This strong-form trust, as opposed to “semi-strong” or “weak” forms of trust, as Ribstein defines them, is possibly closer to my own definition. Ribstein’s focus, however, is “on the effects of mandatory rules rather than on the enforcement of private contracts.” *Id.*, at n3. And his principal argument is that mandatory rules (which supersede contract) are less likely to be “conducive to the development of trust” than the legal enforcement of contracts as such. *Id.* But neither that enforcement, nor the entering of contracts as such, is credited by Ribstein as creating trust – again, in the strong-form, as he defines it. In this, I would disagree: the contracting process, as I indicate below, is itself a trust-building exercise, even in the sense of “principled” or “non-calculative” trust.

No doubt this is a fair description of why commercial agreements are made: partly as a defense, partly as a means to coerce performance. But in many instances the aim of the contracting process, however much it displays the dynamics of a *cooperation* game (a prisoners' dilemma situation), is to develop a basis for *coordination*.⁷ The purpose of the agreement is in large part to determine a procedure (or a series of procedures) that will allow both parties to achieve a common goal by acting *in concert*. Moreover, the very process of negotiation has its own rules – and those rules are not tailored to any one party's interests. Designing the contracting process is itself, in other words, an exercise in coordination.

I argue in this paper that social capital – what Fukuyama calls “the level of trust inherent in [a] society” – will affect the contracting practices that are considered standard, practical or fair in any legal or business culture. These practices in turn will help determine the parties' positions as they approach their negotiation, how

⁷ This refers to a situation where neither party has anything to gain from its own (or anyone else's) failure to perform. Instead, it is preferable for the parties to agree on a set of behaviors that, if adhered to by all, will make every one of them better off than if he (or she) had defected. A common illustration is this: You and I are driving in opposite directions on the same road. If we can agree on a simple convention (e.g., for each of us to drive on the right side of the road) or if we both know to do so by custom or decree – or because a sign on the road says “drive on the right”– we will avoid a collision. If we are not out to kill one another, neither of us has anything to gain from defecting: the whole idea is to agree on the convention and then to implement it. Of course, this is a particularly simple case: the choice is obvious and binary (to drive on one or the other side). But many coordination problems, though more complex, can be analyzed in essentially the same way. To state it differently, there are many possible points of equilibrium (there are “multiple equilibria”) which, once agreed, would provide a satisfactory resolution to the challenge. Not all, however, are equally efficient, nor will they all optimize value. But they will be stable: none of the relevant players will have an incentive to depart from the rules (i.e., defect). And even if they all concede that an alternative equilibrium might produce better (even optimal) results, there may be a reason, outside of the control of any one of them, why they are stuck at some particular point of equilibrium. For an important discussion of coordination games generally, and the effect of legal principles and norms on the creation of “focal points” that serve to identify an equilibrium position, see Richard H. McAdams, The Legal Construction of Norms: A Focal Point Theory of Expressive Law, 86 Va. L. Rev. 1649 (2000).

they will communicate, and what terms they will agree in any particular transaction. Indeed, depending on how those practices are shaped, the parties to the transaction may or may not be able to reach an efficient result, even if (a) they are free from other bargaining constraints, and (b) they are able to assume that there is an effective mechanism in place for the *enforcement* of contracts. I argue that this is true not only for the small transaction, but also for large and complex deals.⁸ When operating in a low-trust environment, even sophisticated parties (who can bear the costs of tailoring an agreement to their particular case), will be prone to relinquish or to sacrifice value – leaving money, as the expression goes, on the table.⁹

⁸ Scholars have written on the significance of trust to the proper functioning of capital markets, corporations, the judiciary, and government bureaucracies generally. See, e.g., Robert D. Putnam, Robert Leonardi and Raffaella Y. Nanetti, *Making Democracy Work: Civic Traditions in Modern Italy* (1994). See also La Porta et al, note ___ below. There is an academic literature also on the role of trust in allowing for the relatively small transaction, as in banking by individual households, or retail investors going into the capital markets (See, e.g., Luigi Guiso, Paolo Sapienza and Luigi Zingales, The Role of Social Capital in Financial Development, Working Paper No. 551, The Center for Research in Security Prices (available on-line at <http://papers.ssrn.com/sol3/delivery.cfm/000214650.pdf?abstractid=209610>). Others have written on how trust appears in a particular business sub-culture (See, e.g., Lisa Bernstein, Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions, 99 Mich. L. Rev. 1724 (2001); Lisa Bernstein, Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms, 144 U. Pa. L. Rev. 1765 (1996); Lisa Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 J. Legal Stud. 115, 132-33 (1992)), and on people's behavior in experimental, "social dilemma" situations (See, e.g., Colin Camerer and Richard A. Thaler, Anomalies: Ultimatums, Dictators, and Manners, J. Econ. Persp., Summer 1995, at 209; Colin F. Camerer and Ernst Fehr, Measuring Social Norms and Preferences using Experimental Games: A Guide for Social Scientists, Working Paper No. 97, Institute for Empirical Research in Economics, University of Zurich (2002) (http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID229143/delivery.cfm/SSRN_ID299143_code020201670.pdf?abstractid=299143.) Less has been written on the effect of trust in large transactions. That is my focus here.

⁹ Much as, in Mancur Olson's phrase, "bills are left on the sidewalk[s]" – and for similar reasons – in countries without the necessary institutional arrangements for cooperation. See Mancur Olson, Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor, 10 J. Econ. Persp. 3 (1996).

I will focus here on what I call complex commercial agreements or “CCA’s”.¹⁰ Although rare in the literature, a focus on CCA’s may help refine the standard law and economics model of contract and exchange.¹¹ In particular, it may help us understand why the parties to a transaction may not, in actual fact, arrive at an optimally efficient result – choosing instead a process that *increases* the transaction and the opportunity costs involved.¹² An analysis of differences in how CCA’s are negotiated, and of the contract rules that apply in different environments, suggests that an inefficient result may not be attributable to cost considerations, to “bounded rationality,”¹³ to the insufficiency or absence of

¹⁰ By this I mean the sorts of contracts that lawyers produce for sophisticated business clients, doing large transactions with a variety of “deal points” or constituent parts. A large transaction is one where the value involved is enough to incent the parties to retain the legal and other advisory resources needed – and to invest their own time and effort – to negotiate an agreement tailored specifically to their deal. By “a variety of constituent parts”, I mean that these complex deals typically involve a number of reasonably well-defined (but closely related) issues, negotiated more or less in parallel. For example, in an acquisition agreement there may need to be provisions dealing with the management of the business before the transaction closes, the actual purchase and sale, and the relationship between the parties afterwards (e.g., not to compete with each other, or to furnish services to one another, etc.), each raising separate negotiating postures and issues.

¹¹ The model I am referring to is based on Coase’s seminal analysis of transaction costs (see Ronald H. Coase, The Problem of Social Cost, 3 J. Law & Econ. 1 (1960)), and is described in many standard law and economics texts. See, e.g., Richard Posner, Economic Analysis of Law (5th. ed.), ____ - ____ (1998).

¹² There is a point here that is, I think, intriguing theoretically: While the transaction costs of negotiating these agreements are (by definition) significant, they are also not (or not necessarily) material from the parties’ standpoint. So CCA’s might help us answer the following question: where transaction costs, while not in any proper sense zero, are (in another perfectly relevant sense) not material, and where the parties cannot avoid but plan for a continuing relationship or other (at least potential) interaction, do they in fact exhibit the behaviors – do they “act out” the preferences – that our accepted (law and economics) contract theories would predict? Recall that, in many of the schematic scenarios that are typically used, the explanation that is often given by scholars for why parties accept or adopt a sub-optimal / standard form solution is precisely that the transactions costs involved in negotiating a tailored – and more efficient – solution are simply excessive.

¹³ My preferred definition of this term is Herbert Simon’s classic observation, that economic agents may be “*intendedly* rational, but only *limitedly* so”. Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 35 J. L. & Econ. 453, 458 (1993) (citing Herbert A. Simon, Administrative Behavior, at xxiv (2d ed.

enforcement mechanisms, or to the application of mandatory contract rules.¹⁴ Other factors are also at play, and my argument here is that those factors are irreducibly social: namely, what are actors' expectations of one another's behaviors, and whether the baseline practice in their legal and business cultures is one of compliance and trust – or *non-compliance* and *distrust*.¹⁵ Contracting

1957)). See also Christine Jolls, Cass R. Sunstein, and Richard H. Thaler, A Behavioral Approach to Law and Economics, reprinted in *Behavioral Law & Economics* (Cass R. Sunstein, ed., 2000), at 14: “Bounded rationality ... refers to the obvious fact that human cognitive abilities are not infinite.” These definitions could readily encompass virtually any deviation from purely self-interested, calculative rationality. They may not only include cognitive biases (e.g., the observed “endowment effect”, “optimistic bias” or “status quo bias”), or the heuristic devices that people use to simplify their decision-making (these are helpfully summarized in Cass R. Sunstein, Introduction, in *Behavioral Law & Economics* (Cass R. Sunstein, ed., 2000), at 3-7), but extend also to *normative* preferences. So bounded rationality may be read to include “bounded self-interest” (defined as the fact that “[i]n many market and bargaining settings ... people care about being treated fairly and want to treat others fairly if those others are themselves behaving fairly”.) Christine Jolls, Cass R. Sunstein, and Richard H. Thaler, A Behavioral Approach to Law and Economics, reprinted in *Behavioral Law & Economics* (Cass R. Sunstein, ed., 2000), at 16. In that case, many of the behaviors I describe in this paper *could* conceivably fall within the broad definition of “bounded rationality”. My inclination, however, is to separate the limitations on our cognitive abilities, on the one hand, from the nuanced and sophisticated judgments people make – which of course *do* shape their preferences – on a normative basis.

¹⁴ Two other reasons come to mind why CCA's may well be interesting in their own right. First, because they provide the context in which lawyers are most often called upon to interpret contract law – and present the hardest issues for an impartial arbitrator or a judge. This is the world in which most practicing commercial lawyers are engaged in some fashion. Second, and returning to the Latin American context, clearly these agreements are important to the introduction of direct foreign investment and other foreign capital on a long-term basis – the transactions that are critical to development: a major merger or acquisition transaction, a private equity partnership or joint venture, or a complex (e.g., infrastructure) financing.

¹⁵ What I am saying about trust and contracts is of course related to (and draws from) what a number of scholars have suggested in the extensive “law and social norms” literature. See, e.g., Robert C. Ellickson, *Order Without Law: How Neighbors Settle Disputes* (1991); Eric A. Posner, *Law and Social Norms* (2000). Much of that literature, to the extent it deals with contract, focuses either on extra-contractual sanctions or on interpretive/enforcement questions. Although there has been some considerable debate on whether “default rules” should be designed by reference to social norms (see, e.g., Lisa Bernstein, Social Norms and Default Rule Analysis, 3 S. Cal. Interdis. L. 59 (1993); Todd D. Rakoff, Social Structure, Legal Structure, and Default Rules: A Comment, 3 S. Cal. Interdisc. L. J. 19 (1993) (noting that “[p]eople

practices that develop naturally in a low-trust environment are often *destructive* of value (at least as compared with alternatives that are theoretically available), and the reason why they are *stable*, even among sophisticated parties involved in large transactions, has everything to do with that low level of trust.

I will illustrate these points by describing alternative structures for buying a business: the “bread-and-butter” of corporate dealmaking. In Part 2, I describe a “standard” acquisition model: one typically seen in United States mergers & acquisitions practice, and in certain international transactions. What I want to elicit from this description are the *behavioral* (one might say, *normative*) presuppositions of the standard model: how it assumes certain levels of trust and

in fact contract in a cultural setting; people in fact meet each other in good part as type characters in social roles; and in law, at least as the law is now stated, those facts are relevant” Id., at 24-25), the literature does not generally focus on how the contracting process itself is shaped by social norms – except as the parties may be concerned with the reputational effects of violating those norms (which *is* an important constraint on the parties’ behaviors). This, I believe, misses an important dimension – namely, the internalization of certain constraints and their use as ground-rules for communication. In this context I am attracted especially to the work on reciprocity (a component, obviously, of just about every contract relationship) that Dan Kahan and others have done, as in the following passage from Kahan’s critique of Eric Posner’s “signaling theory”:

[T]he reciprocity theory holds that individuals in collective action settings behave not like rational wealth maximizers but rather like moral and emotional reciprocators When they perceive that other individuals are voluntarily contributing to public goods, most individuals are moved by honor, generosity, and like dispositions to do the same. When, in contrast, they perceive that others are shirking or otherwise taking advantage of them, individuals are moved by resentment and pride to withhold their own contributions and even to retaliate if possible. . . . [B]ecause individuals behave in this fashion, the most effective means to promote cooperative behavior in collective action settings is to promote trust – the shared belief that others can in fact be counted on to contribute their fair share to public goods, whether or not doing so is in their material self-interest.

Dan M. Kahan, Commentaries on Eric Posner’s Law and Social Norms: Signaling or Reciprocating? A Response to Eric Posner’s Law and Social Norms, 36 U. Rich. L. Rev. 367, 368 (2002). See also Dan M. Kahan, The Logic of Reciprocity: Trust, Collective Action, and Law (available from the Social Science Research Network Paper Collection at http://ssrn.com/abstract_id=361400), and sources cited therein.

social capital in the corresponding legal and business cultures. In Part 3, I describe an *alternative* model: one that is quite common in a variety of developing countries, and is found particularly in Latin America (where I happen to concentrate as a practitioner). My point is that the first of these two models is more likely to produce efficient outcomes, and yet the less efficient practice – the alternative I describe in Part 3 – is often the option of choice, perhaps the only choice available, for parties operating in a relatively low-trust environment.

In Part 4, I outline the relationship between trust social capital and contract, in a manner that departs significantly from standard contract theory – especially as it has been shaped in recent years by the law and economics scholarship. I am trying to call attention to certain features of the business and legal cultures in which the contracting parties are operating. Those features will help define, I believe, the *communicative* process that is involved in contract formation, allowing certain pathways – and closing certain others – that the parties can travel in order to reach an eventual agreement. They will constrain the possibilities for negotiation, and will shape (as much as they will be shaped by) the parties' own definitions of "self-interest", "optimization" or "utility". Because these are features of a legal and business culture, the question naturally arises: How will they respond to "transplanted" legal practices? I explore this question in Part 5, where I also describe the dysfunctionalities that often occur when we overlook the differences among legal and business cultures – and, specifically, the effect of different levels of trust or social capital – when exporting our familiar contract practices. Finally, in Part 6 I draw some very preliminary connections between my comparative observations in the rest of the paper and what I believe are certain *ideological* preferences of the common law and the civil law traditions.

Part 2. The “International” Acquisition Model: Deal Structure and Efficiency Gains.

If asked to describe the normal procedure for buying a company, an experienced advisor in an “international” law firm – or in the mergers & acquisitions department of a major investment bank – would typically provide an answer along the following lines:

(i) The prospective Buyer will first sign a confidentiality or non-disclosure agreement. The Seller then will provide information on the assets, liabilities, properties and business of the target. Much of this information is competitively sensitive (which is why the Seller requires a non-disclosure agreement). In many cases, management of the target will share with the Buyer its current business plan(s) and projections as to the future performance of the target. These plans and projections may be critical for valuation – but again, they are extremely sensitive. The fact that negotiations are underway may itself be confidential, and will be treated as such. For its part, the prospective Buyer may require, before incurring costs (and in order not to be exploited as a “stalking horse” by the Seller), an exclusivity undertaking: i.e., a commitment by the Seller not to solicit or pursue any competitive transaction.

(ii) Based on the information provided (including, if applicable, management’s business plans and projections, interviews with executives of the target and possibly some inspection of the company’s facilities (this entire exercise being referred to typically as the Buyer’s “due diligence”)), the Buyer will make a proposal to buy the company for a specific price. This proposal will be subject to conditions precedent, including the negotiation of definitive documents, the receipt of regulatory and other third-party approvals and satisfactory completion of “confirmatory” due diligence.

(iii) If the proposal is accepted, this implies (at least in principle) that the price has been established. If outside lawyers are involved at all, they will certainly be included at this stage.¹⁶ A definitive purchase agreement will be now negotiated, containing:

¹⁶ It is interesting that, in major transactions involving considerable legal costs and effort, the lawyers’ involvement – and the actual contracting work – may well begin only after the transaction price has been agreed (at least in principle). This highlights the fact that, contrary to the simplest economic model of contract, price may not be

- (a) a detailed description of the mechanics of closing and the payment of consideration,
- (b) provision for the post-closing adjustment of the purchase price based on a balance-sheet review (e.g., net worth, or net working capital) or other audit occurring as soon as practicable after the closing (but with no right of the parties to “back out” depending on the size of the adjustment),
- (c) extensive representations and warranties, giving in effect a snapshot of the assets, properties, business and condition of the target (and including, typically, a full-disclosure representation – effectively a catch-all that incorporates a securities anti-fraud standard (10b-5))¹⁷,
- (d) conditions to closing and a certain number of limited “outs” (e.g., the occurrence of a material adverse change affecting the target company in the period prior to the scheduled closing),
- (e) indemnities that would be owed by the Seller post-closing if any fact or circumstance that contravenes (i.e., represents a breach

agreed at the same time that the parties identify “hazards” (i.e., risks associated with the proposed exchange, at least as they derive from the terms of the contract) and the negotiation of the corresponding “contract safeguards” (i.e., protections against opportunism by one or more of the parties). Cf. Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 35 J. L. & Econ. 453, 467 (1993):

The simple contractual schema to which transaction cost economics makes repeated reference describes exchange as a triple (p, k, s) , where p refers to the price at which the trade takes place, k refers to the hazards that are associated with the exchange, and s denotes the safeguards within which the exchange is embedded. The argument is that price, hazards, and safeguards are determined simultaneously.

¹⁷

In the model most often seen in the US, these representations and warranties will range from (a) the most “objective” (e.g., that the company was organized on a specific date under the law of a particular state, or that it has so many issued and authorized shares of capital stock) to (b) those that incorporate terms with some conventional meaning but requiring a degree of professional judgment (e.g., that financial statements “fairly present” the financial condition and results of the target company in accordance with “generally accepted accounting principles”) and (c) those that require a business judgment that is more “subjective” (e.g., that relationships with major customers of the target company are satisfactory, and that there is not any indication those relationships would be “materially and adversely affected” by the proposed transaction).

of) the representations and warranties of the Seller results in a loss within some specified “survival” period (with a “cap” that will often represent a substantial percentage of the amount of the purchase price), and

(f) dispute resolution, governing law and other similar provisions.¹⁸

(iv) When and if the conditions are satisfied (and if none of the “outs” are triggered), the closing will take place.¹⁹

¹⁸ One can easily see that the combined effect of the representations, warranties and indemnities described above is for the parties to (at least partially) *contract out* of what would otherwise be the default legal rule: namely, that a legal entity (the target company, in this case) will have the same liabilities before and after it is sold. A change of control will not release or transfer those liabilities (unless the parties to the transaction agree otherwise). So, for example, if a company has incurred an environmental liability (say, because of a toxic release from its premises that was known to and condoned by its then management and owners), the acquisition of the company by a new owner will not release the company from that liability. The liability is not discharged because the prior owner is “cashed out”. But if the prior owner (the Seller, in a transaction involving the company) agrees to indemnify the company (and the Buyer, its new owner) for losses arising from any such liability, then operationally the liability follows the Seller – and, subject to the Seller’s credit (i.e., its ability to make payments if required), the company is released from the financial burden of the liability. So one can see the negotiation of these provisions as a voluntary incurrence by the parties of a certain transaction cost, aimed at allocating risks in the most efficient manner between them. This is precisely a Coasian bargain. The question arises, why does it *not* get made in the alternative structure that I describe in part 6 below? Is it because the transaction costs are simply too high? In a sense, yes: the difficulty in (i) obtaining and verifying information, and (ii) collecting for any actual loss will be much greater in the relevant environments. So are the parties there behaving in a conventional Coasian fashion? In a sense, again, yes. But this begs the question why the transaction costs are so high in one legal or business culture and not in another. Why is this a transaction cost that is manageable and acceptable in one contracting environment (in this case, the United States) and viewed as effectively infinite in another? My interest is in identifying *that* decisive factor, which I characterize here as trust (or the lack of it) in a given legal and business culture.

¹⁹ In this process, it is assumed that the principals’ representatives and advisors (who typically conduct the negotiation) have authority to make concessions and commitments on their principals’ behalf. It may be they, and not the principals themselves, who engage in what I describe below as a *normative* discussion. But their authority as agents is a given: the principals are subscribing to the concessions and commitments that their representatives are making.

What is especially interesting about this structure – and similar observations can be made about alternative structures – is how the parties' adherence to it will shape their discussion. By approaching the deal-making exercise with a view to produce an agreement in the “standard” form, and by agreeing to a particular sequence of contracting *steps*, the parties will be drawn more or less inevitably to a set of *normative* references – references that will in turn result in a fairly robust conversation between the parties.

The parties will approach each representation and warranty, for example, from the standpoint of requiring *full disclosure* – qualified by such things as *materiality* or *reasonableness*, and backed-up by indemnities that are *effective, binding* and *enforceable*. They will define, in considerable detail, the conditions to their respective obligations – preserving, all along, a strict *equivalency* that must be assured in order to justify a maximally efficient price.

Now this style of doing business – characterized, often, by endless deliberation and discussion, massive and confusing documentation, and a negotiating etiquette (or the lack of it) that can easily bruise and offend participants – is not in any sense ideal. Certainly this is not a “feel good” exercise, driven by the desire to establish meaningful and trusting connections with one's fellows. But there are clear *efficiency* advantages to the overall procedure, and the *behavioral* presuppositions (the normative demands that the parties will make of each other) will tend to direct the parties towards those advantages:

(i) Until the Buyer has made its investigation of the business (its due diligence review), neither party incurs the costs of negotiating a transaction. At worst, the Seller incurs an opportunity cost (by complying with its exclusivity undertaking) and the prospective Buyer bears the advisory and other costs of allocating resources to a deal that, in the end, it may decide not to pursue (or to which the prospective Seller may not ultimately agree).

(ii) By the time the definitive agreement is “put on the table”, an acquisition price will have been agreed (subject only to the limited post-

closing adjustment procedure that may have been agreed as well). Therefore, there is less risk that the transaction will not ultimately be consummated: neither party will have the ability to walk away from the transaction because of a disagreement in price. Certainly they won't have that right once the contract is signed (that is, not over a "pricing" issue).

(iii) The ability of the Buyer to rely upon the Seller's representations and warranties – and to invoke the corresponding indemnities – allows the Buyer to place the highest possible value on the target company (that is, without having to discount the price by the risk that various undisclosed contingencies will develop).²⁰

Our normal (i.e., Coasian) modeling assumptions would tell us that contracting parties will tend towards this (more efficient) procedure in negotiating acquisition agreements. At a minimum, they would develop *alternative* contracting practices that achieve comparable efficiencies – i.e., they will not consistently sacrifice value when engaging in whatever contracting practices they consider appropriate or fair. But is this so? The answer, interestingly, is often "no": either the parties perceive that an efficient procedure is unavailable to them (for reasons they do not control), or an alternative procedure is preferred that sacrifices economic value but preserves some other (often unexpressed or covert) preference. This is so in the cross-border context and, at times (for example, in a number of Latin American countries), for *both* cross-border *and* domestic deals.

Part 3. Valuing Certainty over Efficiency in an Environment of Distrust.

The structure of a complex acquisition may differ significantly from the one I just described, when the surrounding legal and business cultures are characterized

²⁰ The Seller is more likely to be able to manage/determine/value the contingencies that do exist, and is a more efficient insurer for those contingencies: it is less likely to over-estimate the premium it should demand, in effect as part of the purchase price, to insure the risk. The Buyer is more likely to over-estimate the risk (because it knows less and is more likely to be conservative with respect to information that it does not have) and would therefore over-discount the price – thus extracting, in effect, an oversized insurance premium.

by a deep *distrust*, communicated to and shared by the contracting parties, with respect to all or some combination of the following:

- (i) First, the likelihood of compliance with – or the ability to enforce or obtain an effective remedy under – agreements where performance is difficult to define and/or monitor (e.g., a confidentiality or non-disclosure agreement as it pertains to the Buyer, or an exclusivity undertaking as it might bind the prospective Seller).²¹ In effect, neither side believes it is realistic, given the base-line behaviors and the existing risk of non-compliance, to expect the full or unequivocal performance of the parties' respective promises;²²

²¹ By referring here to enforcement – and to the availability of effective remedies for an actionable breach – it might seem that I am shifting away from trust (or other intangibles as to the character of the parties' relationship) and moving into the more familiar territory of institutional efficiency and legal predictability: something entirely external to the parties, having nothing to do with their (or their societies') levels of trust or distrust, compliance or non-compliance, and always assumed as a boundary condition in the traditional law and economics analysis of contract. In part, of course, this is true: I *am* straddling two rather different concepts. It is simply impossible to understand the internal dynamic of a contract negotiation without factoring in the level of confidence that the parties have in the surrounding legal infrastructure: the existence (or the lack) of competent and unbiased courts, of reasonably clear and consistent legal rules and of reliably effective tools for coercing compliance with a court's eventual contract interpretation and its enforcement order. But it is important to understand that each of these factors may be present – and *still* there may be a real question as to enforceability and the availability of effective remedies. Different legal systems and legal cultures, even if they are all efficiently administered and none of them is corrupt or biased, can provide quite different levels of comfort: standards of proof, or basic conceptions as to what are the *elements* of actionable breach, can be radically different. For example, can there be an actionable breach in the absence of *fault*? This is a fundamental question on which the Common Law and Civil Law traditions generally differ. See Section __, below. I would maintain that these differences are responsive to – or at a minimum will tend to reinforce – certain characteristics of the social environment in which a contract is negotiated.

²² From the Seller's standpoint, the fear here is that the due diligence exercise will be exploited by the Buyer (that it will turn into a "fishing expedition"), or that information will be "leaked" to competitors (e.g., by the advisors or intermediaries involved, who are not trusted to respect conflicts of interest or similar policies), or that the process of investigation will itself uncover practices or policies that should simply not be allowed to see the light of day – unless the Buyer already has a vested interest in protecting the confidentiality of the information. So the Seller will conclude that the prospective Buyer cannot be allowed access to confidential information, unless and until it has already committed to the deal (which obviously presents a problem of circularity). Conversely, from the Buyer's standpoint, the fear is that the Seller won't suspend its sales efforts unless and until it is itself bound to actually close the transaction, and that the time, effort and expense of conducting a thorough

(ii) Second, the reliability of information that predates the transaction, either because of “aggressive” accounting practices, or because the existing corporate structure *on the surface of it* may simply not reflect the real economics of the business,²³

(iii) Third, the credibility of business plans, projections or other forward-looking information, which are likely to have been “reverse engineered” to provide a desired result – or are perceived by local players, given the uncertainty in the business climate overall, as simply too speculative to be meaningful;

(iii) Fourth, the ability or willingness of the Seller meaningfully and truthfully to describe in a (discoverable) contract, other than in the narrowest accounting sense, the assets, liabilities, business or condition of the target company – let alone its prospects or the contingencies to which it is subject. Is there really a baseline of tax compliance, for example, against which the Buyer could truthfully represent that it has not engaged in any tax evasion or other unlawful conduct?²⁴ How, in other words, could the parties possibly correct for their lack of trust in the relevant institutions – not only the courts that would enforce the contract itself, but the many other agencies that are continually shaping the environment in which the transaction is made?

(iv) Fifth, the Buyer’s ability or disposition to abuse the provisions of the agreement to undermine the economics of the deal *ex post*: is the Buyer asking for representations, warranties or indemnities as a back-door way

evaluation of the business will be wasted – or worse, that the Seller may engage in the process merely to “create interest” in a potential transaction.

²³ For example, if a variety of service companies and other apparently independent entities have been used to direct value away from the primary business, be it for the direct personal benefit of the existing owners or to avoid some layer of corporate tax or other liability (e.g., the obligation to fund benefits mandated by law but generally not provided as a practical matter). This is very typically the case in Mexico, where there is widespread avoidance of a profit-sharing requirement technically on the books.

²⁴ Suppose even that the Seller has in fact paid its taxes in accordance with whatever practices are generally observed. Can it comfortably assess – and insure the Buyer against – the risk that the company will not become subject to a politically-motivated tax audit, or that the results of that audit will not be subject to manipulation by the government? During due diligence, I was once advised by a prominent accounting firm in Mexico that the risks associated with a particular corporate structure would depend on *who* was sent to do the auditing work by the Finance Ministry: a “normal team” or the “A team”. The “A team”, they said, would be dispatched only if there is a political motive to the audit. In that case, all bets were off.

to re-negotiate or recover the price, setting liability traps that will lead to spurious claims for reimbursement? Will it demand an insurance against risks (e.g., that third parties will default in respect of *their* obligations to the target) that “everyone would understand” are simply part of the business as a going concern?²⁵

(v) Finally, there is doubt as to the extent that the relevant principals understand (and have an internalized sense of being bound by) the detailed terms and conditions of their agreement – the concessions and commitments made on their behalf by the armies of advisors and representatives engaged in the transaction (who do not necessarily carry the full weight of patriarchal authority).

What are the consequences of this? Very simply, a considerably stilted²⁶ conversation as between the parties. There is a natural move away from the focus on transparency and disclosure, predictability and accountability, flexibility and completeness²⁷ in the drafting of the contract – the very elements I described as directing the parties’ conversation under the ground-rules of an alternative transaction structure. Instead,

- (i) the emphasis on disclosure gives way to a *caveat emptor* principle (“you go in and look, and then tell me if we have a deal”);
- (ii) the environment is simply *assumed* to be unpredictable (perhaps even malevolent), and any prospective risks are expected simply to be

²⁵ Conversely, the Buyer is often aware that the proceeds of sale will vanish into the personal accounts of the Seller (and related parties), so they would not be recoverable if there were a legitimate claim for indemnification. And *both* sides worry about the likely inability of a court or an arbitrator under local law to apply any standard such as “material adverse change”, “reasonable” or “best knowledge” – let alone “loss” or “value”.

²⁶ A senior Venezuelan lawyer once described to me the negotiation process, and the drafting style in particular, as “laconic”. That is a more fair – and certainly more elegant – term than “stilted.” My point is only that important subjects, which normally consume hours of negotiation in a U.S. transaction, are simply off the table. (In contrast, endless discussions may be had on questions of authority, mechanics of closing (delivery of certificates, resolutions, powers of attorney) and governance procedures (shareholder or board approvals, administrative filings and so forth)).

²⁷ Or, as the extended literature on default rule and transaction cost analysis might see it, *manageable* incompleteness.

factored into price – so no discussion of warranties or indemnities, except possibly as to the most formal characteristics of the asset; and

(iii) there is a distinct preference for saying as little as possible of any substance – certainly nothing that might provide inadvertent disclosure to third parties or to the government – with a view instead that whatever provisions are applicable to the deal will be incorporated by reference from the law.

I should emphasize that these rhetorical moves do not imply that the parties perceive one another – at least not those who are accustomed to doing business in the relevant legal and business culture – as dishonorable or untrustworthy. As I will discuss in more detail below, it is precisely because certain qualities or duties (e.g., to provide full and fair disclosure of all material facts) are assumed not to extend beyond an intimate circle of family and friends, and because certain assumptions are made by all parties about the environment at large (e.g., that it is unpredictable in certain regards, and that one simply cannot insure against a variety of external shocks), that a sophisticated, seasoned businessperson has no choice but to adhere to a particular strategy of negotiation. It is not that she would presume bad faith: she simply knows what are the parameters of good faith, and in what environment it is (or is not) being exercised.

The key point here is that the parties will move towards a transaction structure that is significantly less efficient – one that is often found (not always, and not in every sector or country, but with a regularity that surprises an American-trained lawyer) in transactions done in many parts of the developing world – and, in my own experience, particularly throughout Latin America.²⁸ One finds, specifically, that:

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I do not want to suggest that this is the only transaction structure that one finds. There are many instances where parties will adopt (with some reservations, perhaps) the transaction structure that is customary in the US – largely as a result of the influence of financial and legal advisors, and the perception that there is a developing “international market practice”. But it is well worth looking underneath the

(a) The Seller will demand (and the Buyer may well agree) that a definitive agreement be negotiated and signed before any due diligence is done (or based on very limited due diligence). Moreover, the opportunity for due diligence will be limited even after the agreement is signed – with corresponding uncertainties and information asymmetries for which the Buyer will need to discount its price. This will discourage a “fishing expedition” by the Buyer (whom the Seller may suspect of not having any serious interest in doing a deal). It will give some comfort as well to the Seller that the Buyer will not acquire any knowledge of information that is potentially damaging to the Seller – e.g., the extent to which it has run its business “at the edges” of the law – at least not until it is legally bound to the transaction.

(b) The Buyer will then demand certain (extensive) “outs”, based in part – but not exclusively – on its eventual due diligence review of the target company. So it is entirely possible that the negotiation of a definitive agreement, and all that goes with it, will have been a waste of the parties’ resources – a decidedly inefficient result, from the standpoint of transaction and, more importantly, opportunity costs, as compared with the procedure that allows for due diligence (and a corresponding decision to move ahead or to abandon the transaction) before a definitive agreement is actually signed.

(c) The Parties will establish a price for the transaction, to be reflected in whatever definitive agreement is signed, based solely on the review of financial statements. This will require a proviso that the price may be adjusted, when the results of (limited) due diligence are in, on the basis of specific (typically, accounting) criteria. This, again, builds in a number of inefficiencies. The Buyer has an incentive to discount the price well beyond what it would do if it had received prior access to full (or reasonably full) information. And the parties will need to agree on a percentage adjustment to the agreed purchase price, once due diligence has been done, that is the maximum allowed (again, an incentive to the Buyer to “lowball” the price) – or will have to permit either side to abandon the transaction if the adjustment exceeds that percentage. This again creates the possibility that the effort and resources used will have been spent for no purpose and other opportunities will be lost for efficiently pricing the asset.

(d) The Buyer will have to accept limited representations and warranties from the Seller (with correspondingly limited rights of

surface of this apparent convergence. See my discussion of transplants in Part 5, below.

indemnification in favor of the Buyer), and possibly even to represent to the Seller – as a constraint on the Buyer’s own ability to assert future claims – that it does not have any information that is inconsistent with (or that leads it to believe there is a breach of) the Seller’s representations or warranties in respect of the business. This devolves into something of a cat-and-mouse game (who knew what when), and will force the Buyer to self-insure, by reducing the price of the asset, against risks that should be, and very possibly are, better managed and more accurately estimated by the Seller.²⁹

The aim of this extended illustration should be clear: There is a built-in inefficiency to this transaction structure. It is attributable, in very large part, to the existence of pervasive distrust – of the parties with respect to one another, and of people at large with respect to the institutions for enforcement, oversight and dispute resolution – that is hard to remove or to counter in any individual case. These are attitudes that the parties bring with them to their negotiation, based on perceptions of what can or cannot reasonably be expected from others in terms of reciprocity, fairness, transparency and so forth. So the particular equilibrium that results – the way the parties themselves towards the common goal of closing a transaction – is remarkably stable, even if it is inefficient.

The conclusion I draw from these examples (admittedly anecdotal, and subject to more systematic empirical studies) would be this: that the prevalence of distrust is consistently destructive of value. Stated differently, the aggregate welfare of the parties, on giving effect to their bargain, may well be less – by a quite substantial margin – than if they had been willing (and able) to follow an alternative contracting *practice*.³⁰ The fact that this happens is interesting as a

²⁹ This “anti-sandbagging” provision, like many other features of the transaction structure, is not unique to these jurisdictions – and may be encountered as well in the “American model”. But it is significantly less standard – and isn’t nearly as entrenched from the standpoint of responding to a deeply held (and firmly rooted) intuition of what makes *normative* sense.

³⁰ It interests me as well that, contrary to our intuition that the parties to a proposed exchange would want to limit or avoid transaction costs, what the parties are doing is voluntarily to assume, even create, additional costs. Stated differently, they apparently perceive that certain transaction and opportunity costs are unavoidable,

matter of contract theory, because it highlights certain factors that (a) affect the parties' ability to achieve an optimal result, and (b) may be thrown in generally into the broad category of "transaction costs" but appear to have a character of their own. For the lack of a better term, I would describe those factors as *environmental* – and suggest that the extent of social capital that the parties can "draw down" for purposes of their transaction (as in the use of a public good) is one of them.

Quite apart from whatever theoretical interest this may have, one could ask the question: So what? Aren't the inefficiencies absorbed here by the parties themselves: in effect, isn't there simply more wealth left in one or the other pocket – as opposed to there being, as I suggested, money "left on the table"? There are three relevant answers to this:

First, a clarification: given the constraints under which they are operating, the parties that apply these sub-optimal contracting practices are still doing, as the expression goes, the best that they can. I am not suggesting that any one of them is somehow acting against its own interest – only that they would both do better if they had recourse to more efficient contracting practices.

Second, many potential transactions simply do not occur – the parties simply cannot reach an agreement – because of the application of these sub-optimal contracting practices. In other words, there are deals that

when a more efficient procedure is at least theoretically available. Why might the parties do that? One simple answer is that they have no choice: this is the world in which they live, and the transaction costs of negotiating a more efficient structure are simply too large. To "contract out" of the default legal rules regarding liability is just prohibitively expensive. The Buyer has no choice but to acquire the company "lock-stock-and-barrel" – with no hope of recovering any indemnification from the Seller – because the transaction costs of negotiating a full set of representations, warranties and indemnities would be unacceptably high. But this simply begs the question: why is this so in one legal or business culture and not in another? Alternatively, we could attribute the patterns observed entirely to trade-offs among "expressed" preferences: in favor of certainty, of nailing things down in the short term – as opposed to optimizing value in the long term – while "keeping one's options open", not divulging too much too soon, and guarding certain secrets at all costs. But this is precisely how people behave who are insecure or distrustful. And rarely does it go with a sense that one could meaningfully have done things differently.

don't get done precisely because the parties do not have access (or do not believe that they have access) to more efficient contracting practices. In those instances, money *does* get left on the table.

Third, and I think most importantly, the contracting practices I have described as sub-optimal will tend, systematically, to favor those individual players who have access to informal dispute resolution mechanisms (e.g., through family or social ties) that are not otherwise generally available, or who have privileged access to information. Stated differently, the persistence of these structures, driven as they are by a low level of social capital, will tend only to reinforce the very same oligarchic arrangements that are the source of the problem in the first place. This, I believe, is visibly the case in the context particularly of Latin American business.

4. Defining Trust and its Place in Contract

Trust is “an elusive notion,”³¹ and simply invoking it (by saying that in certain context people are “distrustful” of each other) does not tell us how exactly it is it relevant to the analysis of contract practices. To answer this question, I will suggest some definitions, and then tie those definitions back to the analyses in the previous two sections of this paper.

³¹ Diego Gambetta, Can We Trust Trust?, in *Trust: Making and Breaking Cooperative Relations*, at ix (Diego Gambetta ed. 1988). Some authors see trust as coextensive with “social capital”, and define it operation-ally as “[the] propensity of people in a society to cooperate to produce socially efficient outcomes and to avoid inefficient non-cooperative traps such as that in the prisoners’ dilemma.” See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishni (hereinafter, La Porta et al), Trust in Large Organizations, Working Paper 5864, National Bureau of Economic Research (1996) (available online through http://papers.ssrn.com/sol3/papers.cfm?abstract_id=10378#PaperDownload), at 1. But this does not tell us much about what trust actually *means*, or why it is conducive to cooperative behaviors that are socially efficient. One alternative approach is Russell Hardin’s (see note __, below). He defines trustworthiness (the quality of a person in whom I trust) as that other person’s “encapsulating” my interest in his/her own. See Russell Hardin, *Trust and Trustworthiness*, __ (2002). I agree with those who say that this “encapsulated interest” definition reduces trust to a quality that is calculative and instrumental, perhaps to the point that it “destroys the concept in the process.” Lawrence E. Mitchell, The Importance of Being Trusted, 81 B. U. L. Rev. 591, 596 (2001). See also Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 35 J. L. & Econ. 453, 472, n.79 (1993).

If you and I trust each other (in the more common, colloquial sense of the term, as in “A trust B to do X”), we can each of us “take a chance” somehow on the disposition, ability or character of the other. Trust is at play when (i) I cannot maintain (or make) a desired connection with you, unless each of us is thereby exposed to the other’s exercise of discretion, judgment and skill,³² (ii) there is not (or not necessarily) a complete alignment or identity of interests, and (iii) neither of us is entitled to demand, or can reasonably expect, that the other will behave altruistically (i.e., that you will advance my interests, simply out of love or concern for me, to the exclusion of your own).

Under those conditions, my trust in you means I am confident you will exhibit certain qualities, and observe certain norms, as those qualities or norms would apply to our *relationship*. Trustworthiness consists of a person having those qualities that would provide a reasonable basis for my confidence in the first place. The relevant norms, in the context of a *business* relationship, may define – and instruct an individual to exhibit – qualities such as honesty, judgment, fidelity (keeping one’s promises) and truthfulness. As a participant within an institution, a trustworthy person would act in such manner as to validate the institution’s

³² See Margaret M. Blair and Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. Pa. L. Rev. 1735, 1739 (2001) (describing trust as “[the] willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one’s vulnerability (that is, will behave trustworthily)” and trustworthiness as “[the] unwillingness to exploit a trusting person’s vulnerability even when external rewards favor doing so”). This “behavioral” definition of trust is, I think, fair so far as it goes. But its emphasis on one’s “willingness [to trust]” overlooks the fact that I often have no alternative *but* to “make myself vulnerable” to another – at least if I wish to establish a particular *relationship* with that other. Moreover, trust is an *explanatory* – not only a *descriptive* – concept. In other words, part of the reason why I am prepared to “make myself vulnerable to another” is precisely that I am confident of that other person having certain qualities or virtues (and that they have a particular meaning for her): the use of the term is not meant only to refer to “trusting behavior”, but to a cognitive or affective state. The definitions I am using in this paper are some help at least in describing that cognitive or affective state. I believe they are generally consistent as well with our common-sense use (see, e.g., The American Heritage Dictionary of the English Language 1919 (3rd ed., 1996) (defining trust as “[f]irm reliance on the integrity, ability or character of a person or thing”)), and with our everyday moral intuitions.

claim of transparency, fairness, integrity and competence. Those are the claims that entitle the institution's judgments or procedures to be respected.³³

Take now a more technical, social scientific use of "trust", often equated in the literature with "social capital". In a high-trust culture, it is easier for relative strangers to establish a trusting relationship (in the first, more colloquial sense of the term), particularly in a business context. Trust, in this sense (borrowing, once again, from Fukuyama's work), is an indicator of "spontaneous sociability": loyalty, solidarity, fellowship and so forth that will spring, to all appearances naturally – and with a realistic expectation of mutual benefit – as among relative strangers. As so defined, trust allows people to form bonds and associations at an intermediary level between the family and the state. Why is that?

First, because prevailing norms – defining those trustworthy qualities that I referred to earlier – are less often framed in terms of inherited *status*, and are not normally restricted in their application to a favored class of individuals. A duty and expectation of truthfulness, for example, would be understood as applying to one's communications generally, and not only to those communications that occur "inside the family".

Second, because adherence to those norms will not generally conflict with (or imperil) other basic *loyalties*. I can be reasonably confident that my being truthful to you isn't bound to betray family confidences, or unfairly to expose my associates to harm or other sanction (because they are not generally engaged in practices that "shouldn't see the light of day"); *and*

Third, because it is possible for each of us to embark in a trusting relationship without having thereby to assume an *unfair burden*. I can be reasonably comfortable that like cases are generally treated alike – and that I am not being forced into a position to which my counterpart would never agree if our roles were reversed

In other words, a culture of high trust is one where trustworthy qualities are defined *expansively*, one can act upon those qualities without being disloyal to

³³ Stated differently, those are the claims that legitimate the institution's right that others defer to it. See Philip Soper, *The Ethics of Deference* (2002). I am grateful to Carlos Rosenkrantz for directing me to this source.

one's intimates, and one is able to do so with a reasonable expectation of *reciprocity*.³⁴ In a high-trust society, it generally pays to exhibit trustworthy behavior.³⁵

So how is trust, as I have defined it, connected with contract? My claim here is that trust is not the opposite of (or superfluous to) contract, but is instead its pre-condition.³⁶ In the movement "from status to contract",³⁷ trust is the underlying

³⁴ I should hasten to add that in a low-trust environment (where the conditions I have just described are not in fact satisfied) there may well be broad adherence to a strict honor code. Family members will be loyal and true and behave towards one another in an exemplary way, even in business. Confidences among longtime associates will be protected. Commitments by authority – if made at the right level and to those who are "in the right circles" – will be fulfilled, whatever the costs or the risks involved. Institutions may behave paternalistically towards their members, and be protective of insiders, even if they have little internal accountability or transparency to the outside world. Conversely, a high-trust culture may exhibit and condone behaviors among families (or family members) that would appear dishonorable to a more traditional observer. The use of objective standards of transparency, compliance or accountability may appear disloyal – a betrayal of trust. Government may be criticized as bureaucratic, lacking vision or discernment. In other words, what I describe as a "high-trust" environment may well appear to an outsider (and from a certain angle, rightly so) as devoid of core values: a desiccated, over-objectified, depersonalized culture. I want, therefore, to avoid – and here disclaim – any implication that a high-trust society is necessarily more advanced, or better *overall*. My point is narrower, and is focused only on the effect of this one variable (the level of trust in a given culture) on the contracting process generally and the likelihood that certain economic results will be achieved.

³⁵ Am I merely circling back to an instrumental view of trust: that people will behave in a trustworthy manner, or comply with a given set of social norms, simply for fear of incurring reputational or other social sanctions? In some sense, yes. There *is* a "signaling" component to one's behavior, independently of one has or has not internalized the relevant norm. See Eric Posner, *Law and Social Norms* (2000). But, as I indicated earlier, I believe that focusing solely on this "signaling" component is in fact much too artificial: it simply misses the *actual* dynamic of contract communication, the fact that in negotiating their agreement the parties are trying to make or to elicit a determination of one another's character, reliability, integrity, etc. See my discussion of the literature on law and social norms, at footnote ___, above.

³⁶ Trust is a pre-condition in the relatively trivial sense that generally I would not negotiate a contract with you unless I essentially trusted you to perform your obligations. Even though we will generally negotiate *as if* the contract were going to be interpreted and enforced effectively by an impartial and omniscient third party, the last thing I want to do is to "see you in court". Indeed, it is interesting that parties often quite consciously and deliberately negotiate agreements – or provisions within

variable. Even between parties who are not intimates, and have not had any experience dealing with one another, the existence or the lack of “social capital” defines the contracting options that are available. It shapes the rhetoric to which the parties will resort in negotiating their transaction,³⁸ and it sets the boundary, in a sense, of their legal and their business imagination.³⁹

agreements – that are most likely unenforceable (or which would involve an extraordinary expenditure of effort to enforce). This is true, for example, of certain non-compete or non-solicitation agreements, or of contracts that contain “best efforts” provisions that are essentially aspirational, or of provisions that purport to establish evidentiary standards (or allow any one party to make decisions, in its sole and complete discretion, that are somehow binding on the other). Many such provisions are routinely “carved out” when lawyers provide enforceability opinions, and yet their inclusion is very often agreed – and not infrequently it is the subject of intense negotiations among the parties. The common sense observation, stated quite elegantly by Ian Macneil, bears repeating: “While law may be an integral part of virtually all contract relations, one not to be ignored, law is not what contracts are all about. Contracts are about getting things done in the real world – building things, selling things, cooperating in enterprise, achieving power and prestige, sharing and competing in a family structure.” Ian R. Macneil, *The New Social Contract: An Inquiry Into Modern Contractual Relations*, 5 (1980). Here I am using the reference to “pre-condition” in the sense that trust, as a feature of the legal or business environment, will establish the premises and procedures for negotiation.

³⁷ The phrase is Henry Sumner Maine’s, and was used by him to describe “the movement of ... progressive societies.” Sir Henry Maine, *Ancient Law* 100 (1861).

³⁸ In the use of this term, I am influenced by the writings of Professor John Boyd White. See, e.g., John Boyd White, *Heracles’ Bow: Essays on the Rhetoric and Poetics of the Law* (Wisconsin, 1985). White’s essential insight, for my purposes, is that the lawyer operates in a world of *communicative* action, a world in which deep normative precepts are continually at play in an ongoing conversation. The aim of that conversation, in contract no less than in policy or scholarly debate, is to find common ground, to create a basis for shared endeavor.

³⁹ For parties in the same culture, this may not impair their ability finally to reach an agreement – it may simply detract from their ability to achieve an efficient (or otherwise optimal) result. Among parties from cultures that differ materially in the prevailing indices of trust, this alone may be the cause of a failure ultimately to agree on *any* deal (or any deal that is actually functional in the eventual implementation), even if both parties would prefer to have concluded a complete (or manageably incomplete) and enforceable contract.

Contracts are often – nearly always – negotiated under non-ideal constraints,⁴⁰ in conditions of real (and unavoidable) uncertainty,⁴¹ and where there is at least *some* opposition of interests between the parties. So of course there are strategic elements to a negotiation. In much of what they do, the parties *will* think as rational utility-maximizers, competing for every last advantage. But the parties to a sophisticated transaction will generally understand that some degree of trust (in the first, more colloquial sense) must be created and maintained not only as a threshold matter – i.e., whether one goes into the negotiation in the first place⁴² –

⁴⁰ There is time pressure, often used strategically by one side or the other. There may be relevant information that is concealed or unknown (again, often for strategic reasons). And there may be limits, perceived or real, on what the parties are willing or able to say to one another. It is not helpful, however, to group all of these various constraints on the negotiation under the general label of “transaction costs”. In a complex transaction between sophisticated parties negotiating a CCA, the parties may have concluded that no amount of professional or other resources should be spared (where cost “is no object”). Within the required time constraints, if it is necessary for an army of professionals to work night and day, at an otherwise exorbitant cost to the parties, they will be encouraged (indeed, required) to do so. And while the parties may avoid settling certain issues that are simply “too complicated” – and therefore end up with a (manageably) incomplete agreement – they may well be equally inclined to focus on at least certain key bargaining issues and to address them, in effect, irrespective of the costs incurred. The “too complicated” label may in fact be a proxy for relational issues that the parties want to exclude at a particular stage of their conversation.

⁴¹ In a real-world context, the expected risks or rewards of a transaction are often so hard to assess, the unknowns are so large, that neither party can possibly come to the table with a worked-out model that disaggregates each and every one of the relevant outcomes and assigns a price to it. Under these conditions, “intuitive” or “behavioral” models of thinking are often called for, and emotions (fear, respect, anger, confidence) are central. See Herbert A. Simon, *Reason in Human Affairs*, 17-35 (1983). The ability to “reason” under these circumstances is, in many respects, precisely what we understand as “good judgment” in a seasoned, competent professional.

⁴² “Never do business with someone who is dishonest, even if the other side offers you an airtight contract.” In my experience, this is the advice of any seasoned lawyer: much as we do not need a contract if I trust you absolutely, I cannot rely on contract if I trust you not at all. But now assume that I *am* negotiating with a person who (I believe) is *not* a crook. Do I approach our discussion as an arm’s length process, where each of us is seeking the best possible deal? Of course I do. Does that mean that trust is no longer a factor in our conversation (beyond that minimal threshold that you are not out to steal from me, or that our contract is enforceable)? Certainly not, at least not in any transaction that goes beyond the immediate and discrete

but on an ongoing basis throughout the deal.⁴³ A contract is the result of a conversation between the parties, aimed at allocating rights and responsibilities, risks and rewards, in a manner that is perceived by them as being *normatively* plausible. And what will (or will not) qualify as such – i.e., as a reasonable or fair, or what the parties will concede is a “market”⁴⁴ allocation of costs and benefits –

exchange of a market commodity. What if I set aside the question entirely of whether I trust you, and negotiate on the basis of what I believe is a “standard” contract. In that case, have I made trust irrelevant to the discussion? I have not. The form itself that I am negotiating, the way it is organized and what assumptions it makes – the language we will use to negotiate – will reflect whatever level of trust exists in our legal and our business cultures.

⁴³ The dynamic has an element, as some authors have said, of “courtship.” See, e.g., Jason Scott Johnston, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, 85 Va. L. Rev. 385 (1999). But there is more going on than seductive sales-talk. The contracting process is the parties’ effort jointly to bridge the gap between divergent interests, and to contrive some measure of effective and ongoing solidarity. The point is nicely made by Lawrence Mitchell, who critiques Oliver Williamson’s analysis of “calculative” reasoning (and Williamson’s claim that such reasoning pervades commercial relationships – to the exclusion, effectively, of trust or empathy in any meaningful sense of the term). Mitchell argues against this view, particularly when applied in the context of “institutional trust”:

All [human relationships in an institutional setting], including the narratives in which [Williamson] describes calculative behavior, involve human beings interacting – communicating – on an individual level. And where humans interact on an individual level it is impossible for all but the most pathological of us to avoid the development of some minimal affective sentiments . . . For the same reasons that Williamson cannot escape calculativeness even in the most intimate relationships, I will suggest that there is a thread of human empathy even in the most calculating relationships.

Lawrence E. Mitchell, The Importance of Being Trusted, 81 B.U.L. Rev. 591, 608 (2001).

⁴⁴ There are, of course, many reasons for this particular preference (i.e., for “market terms”). One such reason is that the parties know that there are “network effects” – advantages that derive simply from the fact that the terms are commonly used (e.g., that courts are familiar with their interpretation, that there is less uncertainty as to their application and a smaller risk that the parties (or their advisors) will be embarrassed by an unforeseen or aberrational result. See Marcel Kahan and Michael Klausner, Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”), 83 Va. L. Rev. 713 (1997). A further (or related) reason is that the parties have a sense that whatever terms have been agreed by other players in the ordinary course are a reasonable indicator of where the appropriate

depends much on the level of trust in the surrounding legal and business cultures (in the second, social scientific sense of the term).

Where trusting business relationships can be created among relative strangers, irrespective of their pre-existing place in the social or familial structure, there is room (the more the openness, the greater the room) for *efficient* contract. The reason for that is very simple: contract practices that are comparatively efficient (e.g., the first acquisition structure that I described) are predicated on certain behavioral expectations, and can only be followed if the parties can actually engage in a *normative* conversation of a particular kind.

The parties to a negotiation will assume, in most cases rightly so, that if they conform to the prevailing contracting practices in their business and their legal cultures (how transactions are structured, what is the precise sequencing of steps, what expectations are legitimate and what tactics are acceptable, etc.) they will get to an agreement that the each party *can* in fact be trusted to perform,⁴⁵ and one where the relevant allocations are, as I suggested earlier,

balance of interests can be struck, given the degree of trust (or trustworthiness) in the relevant business or legal environment. In other words, parties read some *normativity* into the market term. Interestingly, this would help explain the fact that parties manifest such a notable preference for placing a premium on the retention of terms that reflect the applicable “default rules”, irrespective of what they understand to be “market practice”. See Russell Korobkin, Behavioral Economics, Contract Formation, and Contract Law, in Cass R. Sunstein (ed.), Behavioral Law and Economics (2000) at 117, 127-129; Russell Korobkin, Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms, 51 Vanderbilt L. Rev. 1583 (1998). Is it merely a “preference for inaction” or a sense that the default rules have some *expressive* function: that somehow they signal to the parties what is the more *normatively plausible* result? For a thoughtful discussion of the “expressive effects of bargaining”, see Richard H. McAdams, The Legal Construction of Norms: A Focal Point Theory of Expressive Law, 86 Va. L. Rev. 1649, 1686-1690 (2000).

⁴⁵

I would distinguish this from the observation, supported by empirical studies, that in repeated instances of bargaining situations, each modeled on a prisoners’ dilemma, the parties may develop an interest in continuing or repeating their interactions – and thus a disposition voluntarily to cooperate with one another. See Robert Axelrod, The Evolution of Cooperation (1984). The spread of these “cooperative strategies” will, in

normatively plausible. By so doing, the parties will establish an *expressive* dynamic: each will expect the other to justify its negotiating positions, or to evaluate a suggested compromise, by reference to certain *normative* ideas (disclosure, reasonableness, equivalency, etc.) The failure by any one of them to maintain this dynamic will be perceived by the other party as a sign that there *cannot* be a meeting of the minds – or, as one of them may see it, as evidence that the other party “just doesn’t get it”.

In describing two alternative acquisition structures, I suggested how in one case the negotiation process could be shaped by certain assumptions:

- (i) that providing information will not compromise the interests of either party – at least not to the point that it would be unreasonable to ask for it to be disclosed;
- (ii) that information, when disclosed, will be reliable (there is only one set of books);
- (iii) that information will not be put to a use that somehow betrays the purposes of the deal (trumped-up indemnity claims);

effect, foster trust – and this will impact the individual contract negotiation, as I have suggested. But my argument is that trust (or the absence of it) will make itself felt even among parties engaged in a one-shot interaction, as is often the case in the negotiation of complex commercial agreements for a single deal. In the context of those agreements, the distinction often made in the literature between “discrete” and “relational” contracts is unhelpful. In practice, often the “discrete” transaction (say, the one-time acquisition of 100% of a business) must be documented in an agreement that requires performance over time: *before* the actual exchange (or “closing”), to fulfill conditions, obtain consents, maintain the business substantially in the ordinary course and so forth; *after* the exchange, to share and help resolve the risks or contingencies that are associated with the business, to limit one’s competitive activities in one form or another. So even when engaged in a one-time interaction, the parties to a commercial agreement have to plan for a period of time when they will be living together, in effect, with the risks, the demands and the consequences of their interaction. (In this connection, there is interesting evidence that when presented with “social dilemma” situations, given certain instructions or conditions subjects will display more cooperative behaviors in one-shot interactions than in an iterative process over time. See Robyn W. Dawes & Richard H. Thaler, Anomalies: Cooperation, J. Econ. Persp., Summer 1998, at 187, 188-189.)

(iv) that the assertion of legitimate claims will be met with a meaningful response; and

(v) that like cases will be treated alike and there is some predictability as to the contingencies that might arise.

Most importantly, it is believed that the relationship between the parties, both before *and* after closing, can be managed consistently with those assumptions, while preserving *other* privileged relationships and continuing to pursue one's own worldly objectives: you needn't be a traitor or a saint to fulfill those assumptions. This more than anything else, as I have suggested, is what characterizes a high-trust legal and business culture.

Part 5. CCA's in a Comparative Context: Organic Innovations or Transplants.

Cross-cultural comparisons bring us naturally to an issue that has attracted much attention in the literature (and is often encountered in practice): namely, the good or bad effects of legal transplants. Arguably the practice of transplantation (or legal borrowing) has been pervasive – not only recently in the emerging markets or economies “in transition”, but historically going back as far as the Roman roots of civilian legal systems.⁴⁶ One must admit, however, that many such transplants simply do not “take”. For whatever reason, they do not mesh with the underlying or pre-existing structures.⁴⁷ There is either widespread non-compliance or, at

⁴⁶ The prevalence of transplantation is the theme of Alan Watson's work and informs a great deal of historical literature. Watson's view is also that much of this “borrowing” is mediated by elites – and may be quite significantly “out of touch” with the host environment/culture, and quite possibly dysfunctional. See, e.g., Alan Watson, *The Evolution of Law* (1985).

⁴⁷ For a critical view of transplantation and borrowing generally, see Katharina Pistor, *The Standardization of Law and its Effects on Developing Economies* (cite) (2003), Uriel Procaccia and Uzi Segal, *Thou Shalt Not Sow Thy Vineyard With Divers Seeds: The Case Against the Harmonization of Private Law* (cite) (2003); and Carlos F. Rosenkrantz, *Against Borrowings and Other Nonauthoritative Uses of Foreign Law*, 1 *International Journal of Constitutional Law*, 269 (2003).

some level, compliance is a sham: a regulation, statute, principle or standard simply isn't implemented as intended. The form is there, but the meaning was lost in translation.⁴⁸ Moreover, the "transplant" may have a range of unintended consequences, good or bad. It may turn out to be an irritant, with effects that are unique to the context in which it is introduced.⁴⁹

Certain types of business deals, and certain forms of organization – as well as how those deals or organizations are structured, and the process through which they are documented – are also, in a sense, transplants. Stated differently, the negotiation of a complex business contract may be quite similar, in form and substance, to the process of introducing, by legislative innovation, a "foreign" legal principle or regulatory scheme. This is so especially when the relevant contracting parties are speaking from the perspective of (and have been formed by) different legal traditions.

From the standpoint, say, of a person doing business in the United States, a certain process or business logic for pricing or negotiating an acquisition, or for

⁴⁸ Consider, in the public sphere, the effort to install meaningful democratization by merely introducing the trappings and the outward procedures of elections (while the selection of candidates and the relative strengths of their campaign organizations continues to be a function of power or political dynamics that are entirely outside the view of the electorate). While the formal features of democracy may appear recognizably to be in place, the ability of the electorate effectively to form or to express a preference with respect to the principal political issues presented (or the allocation of power and responsibility) may be minimal. Or, in the regulatory/securities area, consider the attempts, commonly seen in many of the world's emerging markets, to insure accountability by creating endless checklists of disclosure materials that are ultimately filed with a regulator who is not expected (or, for that matter, qualified) to exercise or implement any critical judgment of their content. While the prospectus formally on file with a national securities commission may have all the appearance of a complete and carefully nuanced disclosure document, the fact may be that neither the regulator nor the investing public has had any material benefit from the disclosure provided (or could have formed an informed opinion as to the sufficiency or the adequacy of such disclosure).

⁴⁹ Indeed, it is almost always so – whether or not the effects are positive or negative. See Gunther Teubner, Legal Irritants: How Unifying Law Ends up in New Divergences, 61 *Modern Law Review* 11 (1998). I am grateful to Katharina Pistor for directing me to this source.

organizing a partnership or other venture, may seem “natural”. To her counterpart elsewhere (e.g., in much of Latin America and in various other civil law jurisdictions), those basic assumptions may appear distinctly unnatural, impractical – even morally objectionable. The result is often a dysfunctionality in cross-border contracting and cross-border business. The parties may simply be unable, because of their different approaches to the negotiation, to agree on a mutually beneficial transaction. Even if they do succeed, and the deal has the external features of a fully thought-through, enforceable transaction, the parties may seem never to get to the heart of it in actual implementation.

This dysfunctionality (a pathology, almost) is not unlike what I described in the public or the regulatory areas: The procedures that are supposed to underlie the “conventional” structure (e.g., due diligence), may be subverted by a residual discomfort, a continuing sense that this is an alien and unnatural procedure in which the Seller is being forced to “bargain against [her]self”. Or perhaps the pieces will be put together differently, defeating the overall purpose. For example, the Buyer may have a fuller opportunity for due diligence, but no meaningful recovery under the proposed indemnification provisions. Once again, the Buyer will have to assume a risk that it cannot control or quantify. The point is that somehow the intent of the exercise is lost, as I indicated before, “in translation”.

A convergence in practice (orchestrated, frequently, by international advisory firms) may only conceal the underlying differences. At times an agreement will be signed in the “standard” (i.e., American) form, but claiming to be governed by the law of the host state. The problem is that the applicable law may have no plausible reading of the contract. The parties may not be able to make sense of the transaction as documented: terms contained in the agreement may have literally no meaning under domestic law (e.g., references to “reasonableness”, “full disclosure”, “best knowledge”, “due inquiry”, “best efforts”, “reasonable efforts” or “materiality” may be swept generally under the definition of good faith,

which does not – and is not intended to – encompass all these meanings). Or the terms may be simply unenforceable.⁵⁰

Alternatively, a “U.S. style” document may be signed under New York law – with the principals having only the most superficial understanding of the implications of that choice (or of the content of the agreement in the first place). In an eventual controversy, the parties may be surprised by what the contract says and may disclaim ownership of (or obligation under) the deal as documented.

In each of these scenarios, there will often be a growing perception of bad faith, an increased disenchantment (coupled, often, with accusations of “lawlessness”, directed somewhat vaguely at the overall environment of the transaction). Where we see these dysfunctionalities, we are likely to find, I would argue, a difference in “where the parties are coming from”: namely, the presence (or the lack) of trust in their respective business and legal cultures, and the

⁵⁰ See Ruben Kraiem and Christian Neira, Latin Law Supplement: Mexico (Latin Finance, October 1999), at 19:

Article 198 of the general companies law [of Mexico] - *Ley General de Sociedades Mercantiles* (the 'Companies Law') - is a deceptively simple, one-line provision. It states, in its entirety, that 'any agreement restricting a shareholder's freedom to vote is null'. Intended, presumably, to ensure that shareholders can freely exercise their judgment and their right to representation in corporate management, Article 198 has a perverse effect when it comes to ensuring, among other things, certain minority protections, exit rights and other provisions typically on the list of 'must haves' for investors. Investors who blithely rely on the execution of conventional agreements (for example, those providing for registration rights) could be in for an unpleasant surprise if this effect is not anticipated and addressed as the transaction is documented. Combined with the principle that certain corporate actions must be approved by the company's shareholders - and with the practical mechanics for the adoption and recordation of resolutions - Article 198 of the Companies Law provides, at least arguably, a complete defense to any shareholder who breaches his contractual commitment to vote in a particular manner (for example, to authorize a company's public sale of securities), and thus a legal bar to the enforcement of certain shareholders' or third parties' rights (for example, an investor's registration rights with respect to the securities he owns in a Mexican company).

corresponding presence (or the lack) of transactional or business structures that make normative sense within those contexts.⁵¹ The challenge for practitioners or legal scholars is to devise the means to effect a meaningful and authentic convergence: enhancing and building (the right sort of) trust or social capital, while respecting the integrity of our varying legal and business cultures.

6. So What Does Law Have to Do With It?

In this section, I want to draw some connections between my comparative observations – focusing, as I have, on the different processes for contract negotiation – and what I believe are the ideological preferences of the common law and civil law traditions: what the law *is*, and how the principles, standards or rules that it contains are *communicated* to (or understood by) the parties to commercial transactions. The relationship, needless to say, is dauntingly complex, and here I can only make some tentative proposals for further study.

More often than not, legal *and* business policies or practices are likely to have co-evolved, largely in response to a social reality that is itself impacted by a vast variety of factors – many having nothing to do with those particular policies or practices. They will reinforce and rationalize one another. Or, in the face of selective pressures (be they from within the relevant environment or from the outside), one may force the other to adjust from time to time, or both may need to change simultaneously. So I do not want to say – however tempting it is to offer a reform prescription of one kind or another – that a “tweaking” of those legal principles, standards or rules is either necessary or sufficient, or that any one of the two major Western legal systems is somehow more efficient or better placed

⁵¹ I am making a separate point here than in the rest of the paper – namely, that the cross-border contracting process is affected by these normative differences. I am arguing elsewhere that in each of the relevant legal and/or business environments, the contracting process will manifest different tendencies, and have a better or worse

to “deliver the goods”, be they narrowly economic or more broadly social or political.

My only claim here – realizing that this is a wildly over-broad generalization, and with the caveat that it requires far more focus and detail than I am able to provide at this stage – is simply that *certain* features of the Civil Law tradition, as embedded in the laws and in the business practices that prevail throughout Latin America (and most other emerging markets), seem to resonate quite naturally with the more distrustful attitudes generally (centered on hierarchy, authority, loyalty, and so forth) that one finds in the region and that inform the contract and transaction structures that I described. Again, I am not suggesting that any one set of practices is optimal – certainly not that it is universally applicable. Nor am I claiming that the characteristics I have described are everywhere apparent. But the correlations are there, and they are not accidental.⁵² I outline them below in

likelihood of arriving at an optimal (or optimally efficient) result, even if it involves a transaction that is entirely domestic (i.e., local to that environment).

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Going even further on a speculative limb, I might venture what I think is a broad explanatory/historical hypothesis. For this, I would look to the Roman law roots of the civilian systems, where the importance of family relationship or other status cannot be overstated. A classic statement of this, and its relationship to the Roman law of contract, is of course Sir Henry Maine, *Ancient Law* (1861). The extent to which family ties also pervade the original Roman notion of *business* is also remarkable. It is, I believe, deeply interesting that the Roman origins of partnership (*societas*) are found not only (or even principally) in the commercial practices or praetorial doctrines with respect to commerce, but rather in the laws of *inheritance*. Upon the death of a *pater familias*, his heirs became partners in all of their worldly goods (*societas omnium bonorum*). See Reinhard Zimmermann, *The Law of Obligations; Roman Foundations of the Civilian Tradition* (1996) (hereinafter, “Zimmermann, Roman Foundations”), at 452. See also Alan Watson, *Roman Law & Comparative Law* (1991), at 65: “Partnership (*societas*) has a long history and can be traced as a legal concept far back beyond the introduction of the consensual contract. The earliest form was called *ercto non cito*, ‘when an inheritance has not been divided’.” This makes ample sense when we consider that the “dependents” of a *pater familias* had no property of their own. (They were not precluded from employment (e.g., as advocates in the courts, or as elected magistrates) or from commercial activities; the point is that whatever engagement or property they had, except in very particular circumstances (e.g., earnings or booty acquired in military service) was effectively the property of the family estate – owned, right up to his dying day, by the head of the family. And it was he, the *pater familias*, who had the

the hope of stimulating discussion and as a guide to more extensive research than I have thus far been able to do.

a. *Classification.* As in other civilian systems, the Latin American civil and commercial codes contain extended provisions on the actual effect and content of specific types of contracts (leases, employment contracts, contracts for purchase and sale, and so forth), thus pre-empting – at least to the mindset of the civilian lawyer – a more free-wheeling and particularized discussion of terms. While not all such codified terms are *prescribed*,⁵³ the notion of “contracting out”

ability (delegable, but to a limited degree) to make commitments on behalf of, or binding upon, the estate. See David Johnston, *Roman Law in Context* (1999), at 30-32. The formation of a commercial partnership (i.e., as among persons who were not related and not common heirs to an estate) was originally described as an act of quasi-familial character: “[A]d exemplum fratrum societatem coierint”, is how Gaius describes what these partners did: they contracted a partnership on the model of the (natural) brothers of an undivided familia.” Zimmermann, *Roman Foundations*, at 452 (citations omitted). It is interesting as well that, except as to contracts the content and effect of which was thoroughly and carefully understood through application of the praetorian edicts (i.e., contracts such as *mutuum* (loan), *pignus* (pledge), *locatio conductio rei* (lease) and so forth), and which were not really open to negotiation (but were subject to an overall requirement of performance and interpretation in good faith (*bona fides*)), a *pater familias* under early Roman law would only enter into a contractual obligation by actual *stipulatio*: a formulaic recitation made by him personally before the promisee. (Only later did the Roman jurists recognize the possibility of free-form agreements entered into by means other than *stipulatio* – and binding by virtue of the parties’ formal or informal consent). See Zimmermann, *Roman Foundations*, at 537. See also David Johnston, *Roman Law in Context* (1999), at 77-78. My purpose in reviewing these points – on which I do not claim to be an expert, having suffered from the flaws and general incompleteness of common law training (as I will admit to my civilian colleagues) – is simply to highlight the extent to which the Roman roots of the civil law are so profoundly identified with respect and support for the family structure as the basic unit of social life (on the one hand), and so clearly resonant with the concepts and practices of a business world that is organized around powerful families (and family heads).

⁵³ Consider, for example, the distinction under French contract law between *lois supplétives* (corresponding generally to “default rules” in the American scheme) and *lois impératives* (closer to “mandatory rules”). See Barry Nicholas, *French Law of Contract*, 33 (1982).

is simply not particularly current.⁵⁴ So the parties to a negotiation will naturally have less of a sense that the contacting process is itself going to shape and define their relationship. They will be comfortable, on the other hand, with what I have described above as a somewhat stilted conversation – focused on the formalities of contracting and the mechanics of execution. Hence a certain lack of nuance in the actual contract.

b. *Contract Right as Property.* Traditionally the Civil Law is emphatic as to the *absolute* obligatoriness of a contractual obligation once incurred,⁵⁵ and far less sympathetic – whatever the consequences – to the debtor’s plea for a fresh start (consider the rather more draconian bankruptcy principles, when compared with United States reorganization practice, that prevailed until quite recently in much of Latin America and other parts of the Civil Law world) or for a more “businesslike” interpretation of the parties’ agreement. My right to require your

⁵⁴ If anything, there is a strong preference for what I would call “contracting *around*,” using complex contracting devices to obscure the substance of a transaction and thus claim that it should be subject to a different set of interpretive norms.

⁵⁵ Consider how unintuitive it is – one might even say offensive – for a good many lawyers and legal scholars in the civil law world, to speak of “efficient breach” when a contract “[has the force of] law between the parties”. This is the formula used in Article 1134 of the French *Code Civil* (*les conventions légalement formées tiennent lieu de loi à ceux qui les ont faites*). Similar provisions are contained in Article 1372 of the Italian *Codice Civile* (*Il contratto ha forza di legge tra le parti*) and Article 1091 of the Spanish *Código Civil* (*Las obligaciones que nacen de los contratos tienen fuerza de ley entre las partes contratantes, y deben cumplirse al tenor de los mismos*). The implication is that actual performance is required, that the good faith performance of a contract has the same moral authority, the same *obligatoriness*, as law. For a marvelously erudite and reflective essay linking these provisions with the *pacta sunt servanda* maxim (originating, interestingly, not in the Roman law but in the canonists’ reinterpretation and revision of the Roman precedents), see Richard Hyland, *Pacta Sunt Servanda: A Meditation*, 34 Va. J. Int’l L. 405 (1994). (Seen from this perspective, a contracts course that begins with, and focuses quite consistently on, the issue of remedies and breach is quite peculiar (as if a course on the legal protection of public health were taught essentially from the standpoint of what criminal penalties attach to particular infractions of the applicable law – with no sense that any one or the other possibility is more or less *permissible*). Lawyers trained in the civil law who then enroll in U.S. law schools for a graduate degree often react in precisely this way to their first exposure to the standard American contracts course.)

performance is as much a part of my property (*patrimoine* or *patrimonio*) as a tangible item that you actively transferred to me and is now *mine*: to deny it to me would be theft. There is an important *normative* element here, focused not on the maximization of welfare or the promotion of commerce, but on the defense of property and acquired rights (derived, in turn, from freely acquired obligations). Consider how alien this is to relational contract as an ongoing, dynamic, trusting connection where we “work things out as we go along.”

c. *Disclosure and Reliance: the Pervasiveness of Fault.* That said, the civilian lawyer is far less willing than her Common Law counterpart to divorce the concept of *contractual liability* from the notion of *fault*. For the civilian, the requirement of *fault* is a common factor in the incurrence of delictual (or “quasi-delictual”) and contractual (or “quasi-contractual”) obligations: it is necessary to prove that there was some element of concealment by the Seller, for example, in order for the Buyer to have an actionable claim for breach of a representation or warranty. So the civilian lawyer will focus her analysis of post-closing indemnity on *latent* or *concealed* defects: defects in the thing sold that were not known to the Buyer (despite the Buyer’s own inquiry, and assuming the Buyer was indeed diligent and aware of “how things are done”) at the time of closing. To the common lawyer (e.g., New York), the concept is that the contract is itself an insurance policy against any circumstance or event that contradicts the Seller’s representations and warranties – regardless of what the Buyer knew or did not know (or what it could or could not have known).⁵⁶ This position may well offend the civilian, who perceives it as bad faith, in effect, to claim recovery under these circumstances – and will suspect that the common lawyer is trying to “sandbag” her.⁵⁷

⁵⁶ The doctrine is reflected in the case law. See, e.g., CBS, Inc. v. Ziff-Davis Pub. Co., 75 N.Y.2d 496 (1990).

⁵⁷ See Nicholas, note ___ above, at 30. Consider how this plays out when there is an overlay, as there is typically in Latin America, of insecurity in predicting the policies of government or the resiliency or efficacy of an institution. Where it would be folly to

d. *Finality.* Latin American lawyers, and the contract rules they will apply, will also strongly encourage finality in a sale transaction. Indeed, there is much textbook discussion – and considerable differences for purposes of classification – as to whether property actually passes when price and object are agreed (i.e., even before actual delivery and payment) in certain types of contract relationships. So the civilian lawyer will be more inclined to see the risk shifting to the buyer when the deal is actually agreed – and to be suspicious of provisions that allow the buyer to reduce or to recover the price (or to back out of the transaction entirely if, for example, the representations and warranties of the seller do not turn out to be correct).⁵⁸ There is a question, conversely, whether certain other contracts can even be said to *exist* until one party has actually delivered to the other the asset (the *res*) in question – i.e., until it has actually performed *its* side of the bargain. The common lawyer, I would submit, is more accustomed to thinking of a purchase and sale agreement as executory and to focus not on the sequence of performance but on the element of reciprocity or consideration.

e. *Methods and Styles of Adjudication.* While the civil and commercial codes may contain detailed provisions on the contents of any particular *type* of contract (a lease of real property, or an agency contract), in approaching a question generally of contract interpretation the civilian lawyer is accustomed to invoke relatively broad principles as the applicable rules of law (e.g., that contracts should be performed in good faith), treating much of what is considered open for determination as a question of *fact*. The result is that the courts will

offer any projection of future performance, how could anyone reasonably ask for an *insurance* policy?

⁵⁸

I am not suggesting that in Latin America (or in any other civil law context) the parties could not design an *executory* purchase contract – I would argue, however, that how far they can go in doing so is very meaningfully constrained by the starting point in the law, and that the law helps to rationalize and support their intuitions of what makes *normative* sense.

approach matters of interpretation as though the required determination were unique to the case at hand. This approach, compounded by the absence of a *stare decisis* principle and a style in the rendering of opinions that is often remarkably laconic, creates an impression in the common lawyer of unpredictability (lack of “legal certainty”). Indeed, results may vary considerably as between cases that a common lawyer would not normally be able to distinguish – and civilian lawyers will be especially hesitant to offer a prediction of how courts will interpret agreements with broad American-style terms (“material adverse effect”, “reasonable best efforts” and the like). The civilian will prefer – and recommend to her client – agreements that are drafted quite specifically, and she will demand a certainty of meaning where the common lawyer would be more confident leaving the interpretation to the courts (or to market practice). This, again, reinforces the tendency towards a drafting style that is more “present tense”, less relational, more laconic.

f. *Formalities and Limited Powers of Agency.* Last, but decidedly not least, is the legal system’s insistence (and the emphasis placed by lawyers, notaries and others involved in a transaction) on the precise mechanics of authorization, of personalty and agency. The converse of this is the emphasis on what the principal *personally* agreed to – quite apart from what a detailed contract, negotiated through agents of various types, might or might not contain. To the common lawyer, this is all a rather peculiar mix: an emphasis on *subjective* intent combined with endless *objective* formalities (initializing every page, notarizing every signature, appending documents of authorization, etc.) In the actual contracting process, this only reinforces a tendency to personalize authority, so that nothing of any material consequence can be agreed if it is not cleared with and understood by the individual principal. It creates as well a strong incentive to contract within forms that are familiar to the many “pairs of eyes” that have to complete the formalization process (e.g., the notary public, who is charged with certifying as to legality).

One can see, from this very rough sketch, how legal principles or practices reflect, and how might reinforce, the transaction structures I described earlier. Law might, in this sense, organize itself around whatever trading or business practices are feasible/reasonable in a given environment, depending (among other things) on the level and definition of trust and trustworthiness in that environment. Indeed, perhaps the characteristics of a legal system, and the guiding principles of its contract law in particular – how it defines good faith,⁵⁹ or what behaviors it encourages in terms of formality, disclosure, standardization and so on – will co-evolve with the trusting or trustworthy behaviors that we seek to influence. What the direction might be of this evolution, or what pressures might bear on the process, are deeper questions to which I am not as yet prepared to suggest an answer.

⁵⁹ See generally, *Good Faith and Fault in Contract Law* (Jack Beatson and Daniel Friedmann, eds.) (1995).

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