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STRATEGIC CONTRACTING: CONTRACT LAW AS A SOURCE OF COMPETITIVE ADVANTAGE

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"[Law remains] the last great untapped source of competitive advantage."[1]

"Companies that agree on a clear strategy and management structure before they tie the knot stand a better chance of living happily ever after."[2]

"[B]usiness lawyers serve as transaction cost engineers and this function has the potential for creating value."[3]

I. INTRODUCTION

Any comprehensive, value-maximizing business strategy incorporates the legal function into the planning process.[4] The management literature has recognized the importance of law in business planning and in achieving business ends: "[L]awyers and corporate leaders who understand the law and the structures of power in the United States have a unique capacity to

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[1] Larry Downes, "First, Empower All the Lawyers," HARV. BUS. REV., Dec. 2004, at 19, 19.

[2] Rachelle C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. 909 (2003), quoting, "How to Make Mergers Work," THE ECONOMIST, Jan. 9, 1999, at 15, 16.

[3] Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 293 (1984).

[4] Robert C. Bird, *Pathways of Legal Strategy*, 14 STAN. J.L. BUS. & FIN. 1 (2008) (hereafter, Bird, *Pathways*), citing Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378 (2008) ("Bagley's holistic approach perceives legal problems as business problems that require business solutions through the partnering of corporate counsel and management to achieve strategic goals.").

achieve business ends."[5] Law provides numerous sources, both facilitative and adversarial, to gain and sustain strategic advantages. In the area of litigation and government prosecution, law can provide means of limiting damages by informing compliance programs and litigation strategies.[6] In the transactional realm, law provides the means to gain and sustain competitive advantages. Its use ranges from value creation to the use of law as a weapon to maintain advantages. In certain areas, such as strategic alliances with competitors, law can be used to enhance collaborative effort and to deter opportunistic behavior. The primary law in many of these areas is the law of contracts. Alternatively stated, the strategic use of contracting and contract law is an important subset of the use of law as a source of strategic advantage.[7] This article will examine some of the many uses of contracts as a source of strategic advantage.

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[5] Tom Hinthorne, *Predatory Capitalism, Pragmatism, and Legal Positivism in the Airlines Industry*, 17 STRAT. MGMT. J. 251, 251 (1996) (Hinthorne, *Predatory Capitalism*).

[6] A stark description of the strategic use of the law in a litigation setting would state: "A corporate leader can use the adversary system to destroy or weaken an opposing stakeholder or to protect the corporation from the predatory actions of an opposing stakeholder." Hinthorne, *Predatory Capitalism* at 261.

[7] In a way the strategic use of contracting or strategic contract are misnomers because contracts are inherently strategic. One commentator notes that:

> Contracting is a potentially strategic process as well as a legal process aimed at forming a binding document. Contracting forces parties to think in advance about important questions which are likely to arise well into the future of the venture. This kind of thinking is strategic in nature, as both business strategy and contract formulation are concerned with long-range development of relations and expectations between parties.

Steven R. Salbu, *Parental Coordination and Conflict in International Joint Ventures: The Use of Contract to Address Legal, Linguistic, and Cultural Concerns*, 43 CASE W. RES. L. REV. 1221, 1252 (1993) (Salbu, *Parental Coordination*).

The strategic uses of contracts and the contract paradigm to gain or sustain competitive advantages are numerous.[8] This article intends to survey the strategic uses that contracts play in the creation of value and as a source of competitive advantage.[9] Since contracts pervade most of what we do at a consumer or commercial level, this article's main purpose is the provide a survey of areas where contract law is used to obtain a strategic advantage. Often contracts can be designed to advance one party's competitive advantage at the expense of the other contracting party. At times, the strategic design of the contract is a mutual undertaking. Both parties realize the possibility or likelihood of post-contract formation advantage taking so they undertake to provide incentives or penalties to prevent purely self-interested advantage taking. This article will often use the term "opportunism" in cases where one party to a contract takes a competitive advantage that is contrary to the interest of the other parties to the contract or contrary to their common enterprise, such as joint ventures, strategic alliances, and franchising. In the end, contracts can be a strategic tool in obtaining a competitive advantage or be used as a tool to

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[8] Competitive advantage will be used here in two dimensions. First, the designation of resources that are rare or unique, valuable, and difficult to imitate. Second, the notion of sustainable competitive advantage in which the resource is inherently sustainable or where continuous measures need to be undertaken to extend its sustainability. For the purpose of this article the different dimensions will not be of great importance since, it will focus on both the use of law to create a competitive advantage and its use in sustaining a competitive advantage.

[9] This article focuses on transactional law in which contracts provide the core mechanism for interaction. There is, of course, a major role for legal strategy in the area of dispute resolution. It has been strongly argued that legal strategy often determines legal outcome in the area of litigation. Lynn M. LoPucki & Walter O. Weyrauch, *A Theory of Legal Strategy*, 49 DUKE L.J. 1405 (2000) (note that legal strategy that directly impacts legal outcomes include: "rampant forum shopping in major business bankruptcies, the nullification of securities class action reform by the simple expedient of moving the litigation to another set of courts, and the lack of relationship between formal circuit rules governing the rules for publication of opinions and actual publication practices") .

support collaboration by minimizing the opportunities for advantage-taking. This article will often use the term "strategic contracting" as an overarching term that covers many forms of how contract law can be a source of competitive advantage.

Part II of the article differentiates two frames of the contract paradigm. One is the internal frame in which contract law's inherent flexibility allows for its use as a source of strategic advantage. The second frame is external since it focuses on the use of the contract paradigm in non-contractual contexts. The first, is most relevant for the current undertaking. It asserts that the inherent flexibility of a privately created body of law (the contract itself) provides a source of strategic advantage. In fact, it asserts that that flexibility can be viewed as part and parcel to a business method. Contract law provides a core of rules of private ordering that can be used to develop new methods of doing business or contracting. The novel use of the rules of contract law continue to result in new types of contracting,[10] new methods of doing business based upon contracts,[11] and newer ways of creating value.[12]

The second part of Part II examines the use of the contract paradigm or construct to explain phenomena that have traditionally been considered as non-contractual in nature.[13] The idea of

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[10] Over the past few decades there has been seismic change in the types of contracts used in carrying out a business. From a purchase-dominated economy contract law we supplemented that with the leasing of goods or services, and more recently the growth of licensing has elevated it to a core contract type.

[11] The birth of limited liability companies is one example of a contract-centered method of doing business.

[12] The explosion in the creation of intellectual property resulted ever-evolving types of licensing contracts to increase the value of such rights.

[13] It is important to bear in mind that paradigms or constructs are never perfectly, self-contained models. One commentator notes this in discussing contract as construct: "[T]he fact that contract law is a human construct that is neither perfect nor all-inclusive. It is and must be augmented in real life by other areas of law that serve values other than individualism because people and their problems extend beyond the

contract as construct will be briefly explored in this Part. However, Part VII will explore three examples of the use of contract as construct: (1) theory of the psychological contract in the human resource management area, (2) the nexus of contract theory of the corporation, and (3) the potential abuse of the construct in the area of limited liability companies. This external use of the contract construct attests to the flexibility of contracts as emphasized by the internal frame discussed above.

Part III explores the creation of value through contracts. The specific area to be analyzed is the commodification or creation of new products through contracts. In a sense, the contract becomes the product. Three areas will be reviewed including, the commodification of information, the use of licensing to create a limited use product, and the creation of the franchise method of doing business. Part IV explores the use of contracts to sustain a competitive advantage and to create shared competitive advantages. This Part covers the notions of strategic contracting and strategic collaboration. The creation of patent pools will be used to illustrate both types of strategic uses of contracts. Part V notes that no matter how sophisticated the parties and how well thought out a strategy a degree of uncertainty remains. It examines ways contracts can mitigate uncertainty in a business transactions. The areas covered in this Part include: the strategic use of existing contract doctrines, the use contracts to insure performance and to deter opportunistic behavior, and the use of contracts to develop a preventive legal strategy.

Part VI focuses on the use of contract as a source of strategic decision-making. This Part examines two uses of contract as a strategic source for business deals. Examples to be reviewed include contracting for innovation and joint venture agreements. Part VII provides a respite from

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individualist paradigm." William J. Woodward, Jr., *Contractarians, Community, and the Tort of Interference with Contract*, 80 MINN. L. REV. 1103, 1182 (1996).

the strategic use of contract law to briefly explore the idea of contractarianism[14] or what some label as "contract as metaphor."[15] This Part looks at the theoretical use of the contract construct to explain other areas of law. The areas chosen for discussion include employment, corporations, and limited liability companies. Finally, Part VIII offers some thoughts on how the strategic use of contracts and the contract construct may impact the law of contracts. The final section of this Part concludes the article by asking: Does the novel or strategic use of contract law feedback and change contract law? I conclude that the answer is an emphatic yes!

II. CONTRACTS AS BUSINESS METHOD AND AS CONSTRUCT

Contracts as business method relates to two potentially long-term consequences and ultimately the success of an enterprise. The obvious example is the choice of business organization to conduct business. This, at first, seems to be the domain of business organization law. Although true, the role of contract law is profound in the choice and construction of a business organization. The corporation has been characterized as a nexus-of-contracts. The limited liability company is almost completely contractual in nature with the operating agreement acting as foundational document and as governance structure. These two examples of contracts as business method will be explored in Part VII. Contract law has also been the vehicle

[14] Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990) (Braucher, *Contractarianism*).

[15] Timothy L. Fort & James J. Noone, *Banded Contracts, Mediating Institutions, and Corporate Governance: A Naturalists Analysis of Contractual Theories of the Firm*, 62 LAW & CONTEMP. PROB. 163, 165 (1999) (hereinafter, Fort, *Banded Contracts*).

for the creation of hybrid methods of conducting business including joint ventures,[16] franchising,[17] and collaborative alliances.[18]

A more non-obvious role of contract law in relation to the creation of a business is not only how it can be used strategically in choosing a method of business or in creating hybrid methods and governance structures, but its role in how a business is created. This is most clear when a private company elects to go public. A company may elect to craft the contractual offering differently than the traditional sale of stock through an initial public offering. Alternatively stated, the company may ignore the more efficient or traditional methods of selling their stock for a less efficient means. Such a decision seems irrational unless there is a strategic reason that is likely to produce long-term benefits.

One commentator offers two examples of strategic offering plans—the initial public offerings of Google and Ben and Jerry's.[19] He also offers the employment contract of Steve Job's at Apple as another example of "unusual legal structures."[20] Google ignored the traditional investment banking path by selling its shares via an internet auction. Auction law is a part of the law of contracts. Ben and Jerry's limited the sale of its stock to residence of the State of Vermont. Such a limitation, much like a disclaimer, is based in contract law. Finally, the initial public offering of Apple stock included an employment contract with founder Steve Job that limited his compensation to one-dollar per year. The employment relationship is a specialized

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[16] *Infra* Part III.C.

[17] *Infra* Part VI.B.

[18] *Infra* Part IV.B.1. & VI.A.

[19] Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581 (2006).

[20] *Id.* at 1582, 1615-21.

area of contract law and an express employment contract is treated no differently than any other type of contract with a few exceptions.

Why did these companies use such unusual and relatively inefficient means of setting up public companies? Internet auctions are inefficient in that they open the market to large numbers of people at the initial offering price and possibly limit the escalation of share values that commonly occur immediately after the offering. Limiting the sale of shares to residents of a sparsely populated state closes the market to a less than optimal number of prospective purchasers. Finally, the restricting of CEO compensation to one dollar undercuts the incentive structure that is common to all CEO compensation schemes. The answer is that these companies traded off short-term inefficiency for long-term financial gain.[21] In short, they were acting strategically. They believed that the notoriety of using such unusual legal maneuvers would produce a positive "branding effect."[22] The branding effect is premised on the use of "contract design [to] contribute to the atmospherics of the brand."[23] The contract design in these cases enhanced the brand name by enforcing certain core values that the company wants to be associated with its products. Google's internet auction reinforced "Google's identity as an innovative, egalitarian, playful, trustworthy company."[24] By selling to Vermonters, Ben and Jerry's was attempting to reinforce the notion of a wholesome, mom and pop operation. The one-dollar compensation scheme for Steve Jobs reinforces the idea that Apple is a company that

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[21]"An innovative deal structure may cost the company something in short-term efficiency, but it may pay dividends in the form of increased demand from consumers in the long run." *Id.* at 1583.

[22] Professor Fleischer explains the phenomena of creating a branding effect in this way as follows: "[T]he legal infrastructure of the deal had a *branding effect:* the design of the deal altered the brand image of the company." *Id.* at 1582.

[23] *Id.* at 1583.

[24] *Id.* at 1584.

thrives on creating innovative, user-friendly products. The one-dollar compensation scheme reinforces Apple's brand as a company committed to integrity.[25]

The importance of contract as a source of competitive advantage has grown over the years for numerous reasons. The most obvious include the increases in globalization, technology, and entrepreneurship.[26] The increase in globalization presents coordination problems that are not presented by solely domestic transactions and relationships. At the opposite end of the global-local spectrum is the rise of entrepreneurship. Globalization and entrepreneurship are not exclusive phenomenon, but for our purposes entrepreneurship refers to the grassroots development of business ideas which may or may not have immediate global implications. The fundamental goal of an entrepreneur is the search for a competitive advantage.[27] Technology has and will continue to bring into "play a wide variety of legal topics in unique and innovative settings."[28] A combination of these phenomenon—rapid globalization, rapid technological change, and entrepreneurial innovation—increases the importance of strategic contracting and strategic collaboration in order to create and sustain competitive advantages.[29] As firms

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[25] *Id.* at 1618.

[26] George J. Siedel, *Six Forces and the Legal Environment of Business: The Relative Value of Business Law among Business School Core Courses*, 37 AM. BUS. L.J. 717, 735 (2000) (Siedel, *Six Forces*).

[27] The Harvard Business School, for instance, "emphasizes a behavioral model of entrepreneurship, defining it as the pursuit of opportunity beyond the resources currently controlled," Siedel, *Six Forces* at 736, *quoting*, Harvard Business School web site "Entrepreneurship" at http://www.hbs.edu/mba/entrepreneurship.html (visited July 22,1999).

[28] Siedel, *Six Forces* at 737.

[29] "[I]ncreases in the complexity of the technology and in the rate of change have made it difficult for a single firm to sustain state-of-the-art capacity across all the technologies necessary for successful product development." Gilson, *Contracting for Innovation* at 448.

recognize their limitations, through vertical integration (expansion),[30] in maintaining competitive advantages in an environment of rapid change, they have increasingly sought to build networks of contracts or collaborations with other firms.[31]

A. *Contract's Flexibility as Source of Strategic Advantage*

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[30] Of course, the choice is not limited to vertical integration versus collaborative alliances. However, the trend towards contracting for innovation has been toward increase collaborative alliances, especially when the goal is to expand into a new product line or to pursue non-core activities. The management literature has generally shown that the choice of market entry between internal development or acquisition is largely the product the degree of relatedness between a firms existing products and the new product. Professor Yip argues that the greater the relatedness the more efficient choice is internal development since the firm's core competencies can be leveraged to overcome barriers to entry. G.S. Yip, *Diversification entry: internal development versus acquisition*. 3 STRATEGIC MGMT. J. 331 (1982). In a recent study, Lee and Lieberman show, however, that relatedness has a number of dimensions and that even where the products are closely aligned acquisition may still be a rational mode of entry. This is due to the fact that core competency acquisitions serve not only the purpose of expansion, but are also used for the purpose of exploitation. For example, "acquisitions [may be] used to fill persistent gaps in the firm's product portfolio." Gwendolyn K. Lee & Marv B. Lieberman, "Acquisitions vs. Internal Development as Modes of Market Entry," at 32, 33 (Unpublished paper on file with author) forthcoming in 31 STRATEGIC MGMT. J. 140 (2010). It is important to note that their study did not look at other market entry strategies, such as joint ventures, franchising, collaborative alliances, and licensing. They note that in the area of entry into foreign markets that: "Foreign entrants often bring technological or marketing skills but lack key resources relating to the foreign market. This can make partnering options such as joint ventures and licensing arrangements more attractive than the direct establishment of a fully-owned subsidiary." *Id.* at 34. The subject of the current undertaking is the use of strategic contracting in joint ventures (Part VI.B.), licensing (Parts III.B., IV.A.2. & VI.B.2.), franchising (III.C.), and collaborative alliances (Parts IV.B.1. & VI.A.) between competitors.

[31] "This ongoing process of vertical disintegration has stimulated the development of networks of explicit contracts among collaborating firms." Gilson, *Contracting for Innovation* at 448.

Contracts is the most flexible, strategic tool that the law offers to the business community.[32] There are many ways contracts and contract law can be a source of strategic advantage. By contracts or contract law it is important to note that most of business is founded upon a web of contracts. Even in areas that are governed by specialized bodies of law, such as government procurement, employment, franchising, and patent pooling, the area-specific law is essentially a body of specialized contract law.

The Court in *Combined Energies v. CCI, Inc.*[33] provides a description of a bundle of contracts used by two firms in collaborating to procure government contracts. A prime contractor and a subcontractor crafted a number of related agreements—to obtain a government procurement contract and to build an ongoing relationship to develop and build projects for the

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[32] It is important to note that flexibility does not mean simplicity. In theoretical terms, due to the "richness" or deep texture of contract law, a uniform theory or single normative framework, such as "contract as promise," is doomed to failure due to the complexity of contract law. But, it is in that complexity lies flexibility and adaptability, and their lies contract as a source of strategic advantage. See, ROBERT A. HILLMAN, THE RICHNESS OF CONTRACT LAW: AN ANALYSIS AND CRITIQUE OF CONTEMPORARY THEORIES OF CONTRACT LAW (1997), CHARLES FRIED, CONTRACT AS PROMISE (1981); Peter A. Alces, *Unintelligent Design in Contract*, 2008 U. ILL. L. REV. 505 (2008) ("the necessary plasticity of contract doctrine"). Professor Alces explains the complexity of contract law as follows:

> Contract is an amalgam; it defies simple reduction, heuristic reduction, into accessible theoretical terms. The reason for that is largely because of the nature of contract doctrine and because theoretical analysis cannot yield the results we would have it yield. . . . Contract has a rich texture, too rich a texture to reduce as extant theories would have it reduce.

Id. at 554-55. A management scholar refers to the elasticity of law in general as a means to gaining strategic advantage: "In complex, high-stake situations, the law is potentially elastic." Hinthorne, *Predatory Capitalism* at 262. He, however, pessimistically argues that that elasticity is highly dependent upon a "client's stature and ability to pay." *Id.*

[33] 514 F.3d 168 (1st Cir. 2008).

United States Navy. The first agreement, entitled "Teaming Agreement," established the one party as the prime contractor and the other as a subcontractor for a specific Navy project. After obtaining the first contract, the two parties executed a "Purchase Order Agreement" that set the terms and conditions allocating each parties' responsibilities for the performance of the procured contract. Soon thereafter, they entered into a "Strategic Alliance Agreement." The stated purpose of the Agreement was "to strategically align themselves with one another in order to promote and utilize their respective expertise for the purpose of developing and performing projects . . . ."[34] This is an example of the strategic bundling of contracts or the aligning of a number of serial contracts. In this way, the companies may gradually build a strategic alliance through the sequencing of a number of discrete contracts followed by a an agreement for continuing collaboration. The strategic beauty of such a preconceived scheme is that the contracting parties can test each other's capabilities and reliability before agreeing to a long-term arrangement.

In many instances the parties will make a number of agreements, along with an umbrella agreement that acts as the overarching contract. The issue that strategic contracting would need to address is whether a breach of one of the side or ancillary agreements is a breach of the overarching contract or other side agreements. This is the issue of the independency of related contracts. Are the contracts to be viewed as completely independent obligations or parts of a network of obligations. The law's response is likely to be that contracts are interdependent where they "clearly indicate that as between the immediate parties they were intended to constitute an entire and not a divisible undertaking [and where it] was the evident purpose to

[34] *Id.* at 170.

make the two agreements interdependent."[35] The courts' task is to determine whether the parties intended that the different agreements to act independently or interdependently.[36] If more than one contract is considered relevant to the case, then the court will attempt to harmonize or "give effect to all of their provisions, if it is possible to do so."[37] The issue of interdependency should be expressly addressed by the strategic drafting of the individual agreements. If one contract is intended to be the governing agreement, then its relationship to the side agreements should be expressly stated, such as through incorporation by reference. If the agreements are meant to stand alone or are intended to be sequential as described in the previous paragraph, then their independence should be explicitly stated. Explicit statements of independency is vital since even if considered independent courts will be tempted to look at the prior or contemporaneous contracts as evidence of prior dealings[38] in resolving a dispute involving one of the contracts.

B. Contract as Construct

The contract as construct concept, sometimes referred to as contractarianism or contract as metaphor, is the application of the contract framework to areas outside of contract law. The construct is often used in theoretic ways to understand legal-business relationships. Examples

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[35] *Guar. Sec. Co. v. Equitable Trust Co.*, 136 Md. 417, 110 A. 860, 861 (Md. 1920). See also,

[36] Final Analysis Commun. Servs. v. General Dynamics Corp., 253 Fed. Appx. 307 (4th Cir.

[37] Rothman v. Silver, 245 Md. 292, 226 A.2d 308, 310 (Md. 1967)

[38] The use of prior dealings or course of performance evidence in the interpretation of contracts is expressly authorized in the Restatement (Second) of contracts and the Uniform Commercial Code. See *Restatement (Second) of Contracts* §§ 203 (b), 202 (5), & 223 (1) ("A course of dealing is a sequence of previous conduct between the parties to an agreement which is fairly to be regarded as establishing a common basis of understanding for interpreting their expression and conduct."; Section of the UCC §§ 1-303 (b) & 2-208.

include the nexus of contracts theory of the corporation and the psychological contract approach to the employment relationship. The broad use of the contractarian framework can be attributed to contract law's inherent flexibility and expandability as a legal concept. Contract, like other core legal concepts, such as agency and trust law, is used by legal practitioners, in response to the needs of business, to provide creative solutions to real world problems. Flexible legal concepts are also used by scholars in creative ways to explain other legal phenomena. These uses of contract law will be more fully explored in Part VII.

C. Creating Value

Many, if not most companies, see law as a hindrance to value creation. Few companies see the law as a device to create value and strategic advantages in the marketplace. More astute companies see the facilitative nature of law and its potential to create value. Law like marketing, product development, development of human capital, and strategic alliances can be a source of strategic advantage. Law can be used for value creation, both positive value creation and to reduce the effects that produce value reduction, such as reducing costs. It can be used as a value-adding strategy to sustain or prolong a firms competitive advantage. The value adding use of law includes the prevention of easy replication by a competitor or as a facilitative means to fully expand the value of a competitive advantage. Recognition of the strategic advantage capabilities of law allows a company to include law as a resource in the development of its overall business strategy. The next Part examines the use of contracts to create value.

III. CONTRACTS AS VALUE CREATORS

Technology brings into play a wide variety of legal topics in unique and innovative settings. A review of syllabi for courses on cyberspace-internet law illustrates the range of legal concerns relating to technology including, communications (electronic records, information security, and trans-border data flows), competition law, consumer protection law, criminal law, employment law (harassment and privacy), financing (electronic payments, off-shore banking, secured transactions, and securities regulation), intellectual property (copyrights, digital property rights, domain name usage, licensing, patents, trade secrets, and trademarks), litigation and alternative dispute resolution (dispute resolution in cyberspace, conflicts of law, and jurisdiction), marketing law, on-line contracts, and tort law (defamation and product liability). Just as technology touches every aspect of commerce, these ubiquitous legal issues envelop technology with a seamless web that requires the attention and understanding of every business and law school graduate.[39] Contract law can be used to manage these concerns and will be addressed throughout the article. But, the issue of this Part is: In the managing of these concerns can contract law also create value?

A. *The Commodification of Information*

The modern information age, including the development of new technologies, electronic products, easily available compilations of information, has blurred the lines between property and contract. At times, the difference between viewing an item as property or as a bundle of contract rights has become problematic. Contract is used as a mechanism to create new forms of

[39] Siedel, *Six Forces* at 737.

property. It is possible in some areas to view the contract as property, and not just a transfer of property rights. In the area of licensing the license itself can be viewed as the product.[40] A number of metaphors have been used to describe this phenomena, such as "commodification,"[41] "propertization,"[42] or an earlier theoretical variation: "contract as thing."[43]

Because traditional intellectual property regimes, as well as schemes like trade secret law and appropriation of image, fail to provide sufficient protection for information products, creators of these works often turn to other legal means, like contract, to limit the use (or misuse) of these products. Databases and software in particular have often found protection via contract and have been subject to both negotiated and shrink-wrap licenses.[44] Many of the objections to the protection of information are based on the idea that we do not want 'information' itself to be

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[40] See John J. A. Burke, *Contract as Commodity: A Nonfiction Approach*, 24 SETON HALL LEGIS. J. 286 (2000) (need to regulate online transactions).

[41] The metaphor of commodification refers to things not previously thought of as saleable property. The term has been sued in numerous areas such as the sale of information, human organs, and even the human genome. *See, e.g.*, THE COMMODIFICATION OF INFORMATION (Niva Elkin-Koren & Neil Weinstock Netanel, eds. 2002) (reviews the numerous issues dealing with the commodification of information); Margaret Jane Radin, Market-Inalienability, 100 HARV. L. REV. 1849 (1987) (concluding that organ commodification should be avoided); Guido Calabresi, *An Introduction to Legal Thought: Four Approaches to Law and to the Allocation of Body Parts*, 55 STAN. L. REV. 2113, 2114 (2003) (predicting that "whether we own our bodies and their parts or whether, instead, they belong, at least in some instances, to those who need them" will become an increasingly pressing issue). Meghan M. Overgaard, Note, *Balancing the Interests of Researchers and Donors in the Commercial Scientific Research Marketplace*, 74 BROOKLYN L. REV. 1473 (2009) (commercialization of science; issue of gene patents).

[42] Daniel D. Barnhizer, *Propertization Metaphors for Bargaining Power and Control of the Self in the Information Age*, 54 CLEV. ST. L. REV. 69 (2006) (Barnhizer, *Propertization*).

[43] See Arthur A. Leff, *Contract as Thing*, 19 AM. U. L. REV. 131 (1970). See *infra* note ____

[44] Kristen Osenga, *Information May Want to be Free, But Information Products Do Not: Protecting and Facilitating Transactions in Information Products*, 30 CARDOZO L. REV. 2099, 2116 (2009).

protected; that is, we are against the protection of the information as 'thing,' but as free and openly accessible. This is the essence of the propertization or commodification of information.[45]

In the consumer contract area, the view of personal information as owned by the person has become obsolete—given new information gathering technologies. Often consumers' contracting with legitimate retailers leads to a loss of control over their personal information either through the retailer retaining the information and consolidating numerous sets of personal information and selling them to others. In addition, data miners create databases of personal information, such as contact information, purchasing histories, and profiles of personal choices and interests.

On the contract side of personal data consolidation, browse-wrap and click-wrap contracts often contain provisions that personal information may be retained by the seller and can be shared with others.[46] The contract of sale or license provides the means to create a new product—information. The ownership in the database or compilation is in the consolidator of that information.

As firms increasingly seek access to personal information, the concept of information as a commodity that firms can buy and sell has led legal theorists to rethink the way law understands privacy.[47] The release of private information initially in relationship to a specific transaction

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[45] *Id.* 2129-30.

[46] This is aided by the fact that "the nature of online contracting permits producers to hide their boilerplate terms for more effectively than even the finest of fine print [written forms]." Barnhizer, *Propertization* at 72.

[47] Julie Manning Magid, Mohan V. Tatikonda, & Philip L. Cochran, *Radio Frequency Identification and Privacy Law: An Integrative Approach*, 46 AM. BUS. L.J. 1, 24 (2009). See Simon G. Davies, "Re-Engineering the Right to Privacy: How Technology Has Been Transformed from a Right to a Commodity," *in* TECHNOLOGY AND PRIVACY: THE NEW LANDSCAPE 143 (Philip E. Agre & Marc Rotenberg eds., 1997); Symposium, *Cyberpersons, Propertization, and Contract in the Information Culture: Propertization, Contract, Competition and Communication*, 54 CLEV. ST. L. REV. 1 (2006).

allows for the consolidation of that information in the creation of large databases that can be reused and sold to others.[48] With the creation of the Internet, and rapid growth of innovative uses of it, more and more of people's lives are spent in cyberspace shopping, socializing, learning, and being entertained. The Internet has accelerated the collection of personal information and with the assistance of contract law has created various, highly marketable information products.[49]

B. Licensing and IT Outsourcing

In recent decades, there has been a trend away from vertical integration or expanding firm capabilities in the production chain and towards alternative means of acquiring inputs, such as licensing and outsourcing. One commentator has dubbed this trend as "deverticalization" which he describes as firms enmeshing "themselves in a webs of collaboration—joint ventures, strategic alliances, just in time production arrangements …."[50] These contract-based alternatives are aimed at cutting the costs of production and to secure "competitive advantage through innovation."[51]

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[48] "[A] significant threat to personal privacy arises not from the initial disclosure of personal information but more problematically from the subsequent reuse, transfer to third parties, and aggregation of that information." *Id.* at 51. "[F]irms engage in buying and selling on a vast secondary market with no regard for the personal privacy implications." *Id.*

[49] Ken D. Kumayama, Note, *A Right to Pseudonymity*, 51 ARIZ. L. REV. 427, 427 (2009).

[50] Matthew C. Jennejohn, *Collaboration, Innovation, and Contract Design*, 14 STAN. J.L. BUS. & FIN. 83, 84 (2008) (Jennejohn, *Collaboration*).

[51] *Id.*

The licensing contract as a paradigm presents issues involving freedom of contract. Recently, in *Vernor v. Autodesk, Inc.*,[52] the court held that a license of a software product was a sale of that particular copy and therefore, could be resold despite the transfer prohibition in the license. The developers of software use the license form of contracting to incorporate resale or copying restrictions not available if the transaction is structured as a sale. However, some courts, as noted above, and commentators, have argued that the license of software is best governed as a sale under Article 2 of the Uniform Commercial Code.[53]

In the licensing of software, license contracts generally mimic the Copyright Act and place the licensee on notice that copying of the software violates the Act.[54] However, the Copyright Act does not completely prohibit the decompilation of software in order to uncover its underlying source code.[55] The question becomes: Why would licensors incorporate more restrictive provisions in their licenses than is allowed under the Copyright Act? The logical explanation is the licensor is attempting to obtain additional protections through contract law that are not expressly provided under copyright law. An overly broad anti-decompilation term would prohibit appropriate purposes for obtaining the source code, such as debugging and repair, or to produce a compatible product.[56] These acts of decompilation would not be a basis for an infringement action under the Copyright Act.

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[52] 555 F. Supp. 2d 1164 (W.D. Wash. 2008).

[53] See Jean Braucher, *Contracting Out of Article 2 Using a "License" Label: A Strategy That Should Not Work for Software Products*, 40 LOY. L.A. L. REV. 261 (2005) (explaining that software product transactions should be treated as "sales" under Article 2 because doing so works "well enough").

[54] Copyright Act of 1976, 17 U.S.C. §§ 101-810, 1001-1010 (1994).

[55] Maureen O'Rourke, *Drawing the Boundary Between Copyright and Contract: Copyright Preemption of Software License Terms*, 45 DUKE L.J. 479 (1995).

[56] *Id.* at 498.

One commentator distinguishes between negotiated and standard from terms that contain more restrictive provisions greater than the protections provided by the Copyright Act. She argues that negotiated terms should be enforced,[57] but that such terms in standard form contracts should be preempted by the Copyright Act. A related question is whether two parties can agree to create a private copyright?[58] In the area of licensed databases, the parties could conceivably negotiate copyright-like protections to prevent the further dissemination of information of the database.

The licensing of intellectual property rights presents interesting issues for strategic contracting. There is a general issue and more specific issues that need to be addressed. The general issue is common to most contracts and involves the trade-off between brevity, flexibility, and trust provided by open terms and the certainty, but distrusting, nature of detailed, inflexible, terms. How long and detailed should a contract be in order to serve its intended purpose? Transaction costs aside, can a contract be too long and too detailed from the perspective of strategy? The main function of the license is to provide a framework for the relationship and to strike a balance between trust (open or vague terms) and providing for future possible contingencies (closed, detailed terms).

The area of information technology (IT) outsourcing provides an example.[59] An open, vague terms approach may provide undue discretion to the IT provider.[60] This discretion

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[57] *Id.* at 523-534.

[58] *Id.* at 555-57.

[59] It should be noted that IT outsourcing here assumes that IT is not a core competency of the outsourcer. Outsourcing strategy theory holds that a firm's best strategy is to develop and focus on core competency where it has a competitive advantages; they then can benefit by outsourcing non-core activities. See James Brian Quinn, *Strategic Outsourcing: Leveraging Knowledge Capabilities*, 40 SLOAN MGMT. REV 9, 12 (1999).

could be utilized to charge additional fees for anything not specifically required under the contract and may also prevent the upgrading of equipment that the IT company is to service. At the other extreme, a contract that is overly detailed may breed relational rigidity and anti-collaborative behavior. Such contracts, especially those coupled with detailed default or penalty clauses for poor performance, is likely to deter innovative problem-solving or cooperation. Somewhere in between, is a contract that frames the contract to balance detailed goals and objectives with flexibility and openness. In this scenario a set fee structure is provided for the IT service plus a budget for system upgrades, and the IT provider is allowed to determine the best use of those funds to meet the contract objectives. The process of actually providing the services and deciding on what upgrades are needed could be done jointly by forming an inter-firm group. Such a system is likely to breed a greater deal of trust and cooperation that benefits both parties.[61]

C. Franchising

A classic example of the use of contract law to create an entirely new means of value creation is the evolution of the franchise method of doing business.[62] The franchise vehicle of

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[60] See Arturs Kalnins & Kyle J. Mayer, *Relationships and Hybrid Contracts: An Analysis of Contract Choice in Information Technology*, 20 J.L. ECON. & ORG. 207 (2004).

[61] This IT outsourcing scenario was inspired by the following article: Jérome Barthélemy, "Outsourcing: The Goldilocks Strategy," OUTSOURCING, December 14, 2008.

[62] "[A] franchise agreement is most often understood to be a contractual arrangement between two legally independent firms in which one firm, the franchisee, pays the other firm, the franchisor, for the right to sell the franchisor's product, the right to use its trademarks and business format in a certain location for a certain period of time, or both." THOMAS S. DICKE, FRANCHISING IN AMERICA: THE DEVELOPMENT OF A BUSINESS METHOD, 1840-1980 2 (1992).

value creation was an entirely American fabrication. It has now become a global phenomenon, but for many years it was not a recognized legal entity in many countries of the world. The evolution of the franchise method of doing business also provides an example of how innovations in contract law has resulted in the creation of new bodies of specialized laws, including enunciation of immutable rules often through government regulatory intervention.

The franchise model is an example of contract law's incredible flexibility. It is an example of strategic contracting in setting the parameters for a long-term contractual relationship. It is also an example of a privately-created governance structure. The use of contracts to establish hybrid governance structures will be discussed later in this article.[63] This section focuses on the franchise contract as a strategic device used by the franchisor to protect its interests and the interests of its franchisees from the perspective of a single enterprise. The franchisor perspective of protecting the franchise enterprise as a whole may conflict with a purely franchisee perspective.

Professor Hadfield notes that franchising is a unique organizational form.[64] The uniqueness of franchising is seen in the terms that are commonly found in franchise contracts. Hadfield surveyed franchise contracts and found the following terms to be commonly used: termination, royalty fees, insurance, duration, franchise fees, transfer, training, standards, inspection, trademark, audit, enforcement, separability, noncompetition, trade secret, agency status, operating manual, territory, advertising, supply, management consultation, performance deposit, and renewal fee clauses.[65]

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[63] *Infra* Part VI.B.2.

[64] Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990).

[65] *Id.* at 940-43.

Many of these clauses are what make possible the uniqueness and creativity of the franchising method of doing business. Clauses that provide trademark and trade secret protection to the franchisor and those that ensure uniformity of product across all franchises, such as training, standards, inspection, management consultation, and operating manual clauses, help insure the quality of the brand to the benefit of all parties. The welfare-maximizing potential of franchising as a business model are generally realized through fair allocation of risks and benefits. Many of the terms can provide the proper allocation of risks and benefits, such as insurance, audit, agency, noncompetition, duration, and fairly drafted royalty, franchise, performance deposit, and renewal fee clauses. In this way, the possibility of *pareto* optimal gains are enhanced. This may be the case initially when the franchise begins operations, but problems appear subsequently if the franchisor attempts to capture greater amounts of the surplus being generated by the franchise. This is done by exercising embedded contractual rights in what can be deemed as a bad faith manner. This is accomplished through the opportunistic use of territorial, termination, renewal, performance, supply, transfer, and advertising clauses. These clauses generally provide the franchisor with a great deal of discretion in exercising their rights. This fact underlies the franchising dilemma presented by the "separation between the ownership of the franchise assets and the control over those assets."[66] The franchisee invests substantial amounts of capital, owns most of the assets, and is liable for the debts of the franchise.[67] However, control over the use of those assets are contractually given to the franchisor. This allows the franchisor to act opportunistically though actions including, franchise encroachment,

[66] *Id.* at 991.

[67] As in corporation, limited liability, and limited partnership law the franchise relationship shields the franchisor from liability to third parties who contract with the franchisee. In this way, the franchisor is like a limited party whose only liability is for any investments made in the particular franchise and the franchise is the general partner liable for any and all debt of the franchise operation.

franchise nonrenewal, use of performance and termination rights to prematurely re-capture the franchise, and manipulation of the supply, advertising, and transfer clauses to capture more of the operational surplus.

Strategic contracting in franchise contracts focus on a number of financial and non-financial terms. The financial terms center on franchise fees, royalty rates, advertising fees where payment of advertising fees by the franchisees for overall promotion of the franchise name by the franchisor. One means by which a franchisor increases its value is through mandatory purchase requirements. Such tying agreements are subject to challenge under the antitrust laws but, are often held to be enforceable.[68] To defend itself against such a claim, the franchisor should show that the mandatory purchase requirements are tied to the uniqueness of the item being supplied, or to issues of cleanliness, safety, or brand name protection.

The key strategic non-financial terms include territorial rights[69] and the problem of franchise encroachment. This problem occurs when the value of an established franchise operation is diminished by the establishment of a competing franchise within its territorial domain. This varies from the intentional predatory move into a lucrative market area or the non-intentional creation of market saturation through the overestimating by the franchisor of the depth of a given market area. Contract terms may provide a right of the franchisor to develop

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[68] For a discussion of the arguments for (quality control) and against (anti-competitive) such tying clauses see, Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. L. & ECON 345 (1985).

[69] "Disputes over territorial rights in the quick-service restaurant sector and in hotel chains have led many of the firms in these industries to include much more detailed territory definitions in their contracts." Francine LaFontaine & Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States*, 3 ENTREPRENEURIAL BUS. L.J. 381, 433 (2009) (reviews the common financial and non-financial terms found in most franchise contracts).

institutional locations, to develop franchises under different trade names, or the right to sell their products through alternative channels.[70] The issues regarding territorial exclusivity involve the franchisor created problem of franchise encroachment, where a franchisee is undercut by its own franchisor, and the franchisee created problem of underdevelopment, where a franchisee is given a large territorial domain and fails to properly develop a reasonable number of franchise locations.[71]

The common use of territorial exclusivity provisions to signal to the franchisee that it will be protected from "encroachment and cannibalization"[72] is becoming less common.[73] Franchisors have increasingly not provided territorial guarantees in the franchise contract, and some have incorporated express provisions denying all territorial rights to the franchisee. Isn't this an example of negative signaling which should ultimately cause reputational costs to the franchisor, especially when it subsequently encroaches on the franchisee's market area? In the world of law and economics this would be answered in the affirmative and would be internalized in a lower price for the franchise. In reality, the contract is probably one of adhesion whereby the

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[70] [T]he data show that franchise contracts usually are quite long term, with a very high tendency for the relationship to continue beyond the original term. When they do not continue beyond that point, it is often at the request of the franchisee that the relationship is terminated. Evidence suggests further that contract termination by franchisors serves a disciplining, or enforcement, role in these relationships, rather than being a manifestation of opportunistic behavior on the part of the franchisors. LaFontaine & Blair, at 432.

[71] "The desire to maintain flexibility in developing a franchised system is the main reason franchisors give for not granting exclusive territories to franchisees. . . . the main concern of franchisors that did not offer exclusive territories was that 'exclusivity would allow franchisees to hold them up through underdevelopment.'" LaFontaine & Blair, at 397, quoting, Pierre Azoulay & Scott Shane, *Entrepreneurs, Contracts, and the Failure of Young Firms,* 47 MGMT. SCI. 337, 353 (2001).

[72] Burger King Corp. v. Weaver, 798 F. Supp. 684, 689-90 (S.D. Fla. 1992).

[73] Robert W. Emerson, *Franchise Contracts and Territoriality: A French Comparison*, 3 ENTREPRENEURSHIP BUS. L.J. 315 (2009).

importance of territorial protections are not made aware to an unsophisticated franchisee or where a sophisticated franchisee views the lack of territorial exclusivity as a case of strategic ambiguity. Another question is when a territorial dispute results in litigation will the court imply such protections? The answer is a most definite maybe! In cases, of express declaimers of territorial exclusivity, the courts have shown a propensity to not recognize an implied protection.[74] In cases where there is a gap in the contract on the issue of exclusivity, some courts have implied territorial protections through the duty of good faith and fair dealing.[75]

Two recommendations can be taken from this analysis. First, strategic contract terms need to be carefully calibrated to provide incentives for expansion, but not to the point of oversaturation. The terms should aim for the creation of a maximum value or revenue streams for the franchisor, but not at the cost of diminished value creation of individual franchisees. A properly drafted franchise contract should lead to the maximization of value for both the franchisor and its franchisees. This strategic calibration of terms leads to a second recommendation. Such calibration is unlikely to be ensured through the use of a standard or uniform franchise agreement, even one carefully drafted by the franchisor.[76] The degree of customization of terms will depend on the type of product or service being provided, the nature of a given market, the amount of existing or expected competitors, and the experience and

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[74] *Id.* at 340, *citing*, Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 139 F.3d 1396 (11th Cir. 1997) (the implied covenant will not override express terms in a written franchise agreement).

[75] *Id.* at 339-40. Emerson states that some courts have used the standard of good faith and fair dealing in areas of termination and exclusivity. *Id.*, *citing*, Dayan v. McDonald Corp., 466 N.E.2d 958, 994 (Ill. App.Ct.1984); Scheck v. Burger King Corp, 798 F. Supp. 684, (S.D. Fla. 1992); Vylene v. Naugles, 90 F.3d 1472, 1477 (9th Cir. 1996)

[76] "The chain's inability to deal with special circumstances, and the resulting lost franchise sales, was the main disadvantage of uniform financial contract terms cited by franchisors." LaFontaine & Blair, at 397.

characteristics of the franchisor and the franchisee. In the end, the key determination will be the level of exclusivity and territorial size provided in the franchise agreement.[77]

IV. CONTRACTS AS MEANS TO SUSTAINABLE COMPETITIVE ADVANTAGE

This Part explores the use of contracts to protect competitive advantages and to create shared competitive advantages. The first use introduces the concept of strategic contract; the second use introduces the concept of strategic collaboration. The creation and use of patent pools are used to illustrate both uses. Patent pooling can be used to create and protect competitive advantages, as well as being a source of value creation.

A. Protecting Competitive Advantages

This section analyzes the concept of strategic contracting both in the negotiation of a contract and in the post-formation stage. It uses the illustration of the use of patent pools by companies who use the patents in the producing of goods, services, or technology. These pools are used to protect competitive advantages and act as a barrier to entry from prospective competitors.

1. Strategic Contracting: Taking Advantage in One to One Relationships

[77] See Arturs Kalnins, *Overestimation and Venture Survival: An Empirical Analysis of Development Commitments in International Master Franchising Ventures,* 14 J. ECON & MGMT STRATEGY 933, (2005) (attributing the frequency of failure of master franchise agreements in international markets to development schedules that are too aggressive).

Strategic contracting necessarily begins in the negotiation and drafting of a contract. Despite the use of opportunism during the pre-contract stage, the common law rarely provides a remedy[78] despite evidence of damages caused by such opportunistic acts as breaking off negotiation in bad faith.[79] There are a number of scenarios where the possibility of pre-contractual opportunism or advantage-taking is especially strong. First, one of the parties incurs significant sunk costs in the pre-contract stage that are contract-specific and not recoverable through re-use in a subsequent contract. In such a scenario, that fact can be used to the strategically to negotiate or re-negotiate more favorable contract terms.[80] The second scenario presents itself when one of the parties discloses confidential and proprietary information.[81] This allows the other party to use the threat of further disclosure to other parties, or the threat of breaking of negotiations while retaining the proprietary information, in order to negotiate more favorable terms.

Such opportunism, as discussed above, continues into the post-contract formation phase, especially if one of the parties succeeds in its opportunistic quest for more favorably terms. This may occur when one party invests in significant post-formation sunk costs. With that knowledge, the other party may use the threat of breach to renegotiate the contract to its favor.[82]

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[78] The doctrine of promissory estoppel is rarely used in the area of pre-contract opportunism or bad faith negotiations.

[79] See, e.g., UCC § 1-203 (the obligation of good faith extends only to the performance or enforcement of a contract).

[80] See G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221 (1991).

[81] Shell at 236-39.

[82] Shell at 231. See Narisimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 CAL. L. REV. 1123 (1986); Graham & Pierce, *Contract Modification : An Economic Analysis of the Hold-Up Game*, 52 L. & CONTEMP. PROBS. 9 (1989)

The same concern for opportunistic behavior can appear in a relationship that consists of a series of discrete, independent contracts.[83] The expectation of the continuing relationship may cause one party to incur significant sunk costs. A variation of this phenomenon is when the stability and growth of a relationship causes one party to re-structure or re-focus its business to accommodate a single party. This produces a dependency effect in which the termination of the relationship would prove to be catastrophic to that dependent party's business.[84] This knowledge can be used opportunistically to negotiate better terms in future contracts.

2. The Case of Patent Pools

Contract law, due to its inherent flexibility as private law, is a tool that companies can use to achieve strategic goals within the legal environment, and more creatively as a tool to frame its business activities outside a prescribed set of rules that make up the legal environment. Alternatively stated, contract law can be used in business to create a more favorable legal environment. It can be used to avoid obstacles presented by immutable rules of law. As private law, it is also used to create customized ways of using law to strategic advantage and to create entirely new means of conducting business. An example of the former is the building of patent

[83] See Narisimhan, *Relationship or Boundary? Handling Successive Contracts* , 77 CAL. L. REV. 1077 (1986);

[84] This type of strategic advantage is seen in the area of output contracts where one company's business is entirely tiled to the fortunes of the output-buyer. A classic is a smaller company who sells all of its output to a larger company. The larger company has multiple suppliers and can gain strategic advantage through the threat of reallocating it's purchases to another supplier. The same can be said of requirement contracts where one party agrees to supply all the requirements of the other party. In the case of non-fungible goods the threat of non-supply may allow the supplier to gain strategic advantage.

pools, sometimes by a process of cross-licensing. Patent pools is a phenomenon that has evolved out of the realization that competitive advantages can only be sustained by the continuous development of next generation, innovative products. Value is enhanced as larger patent pools produce synergistic effects. The value of a sum of pooled patents is very often greater than the value of stand-alone patents.

Patent pooling can be divided into two different types—the first type is focused on the competitive advantage function of patent pools and the second type focuses purely on the revenue generating function of patent pools. The first function involves patent pool owners whose primary source of revenue is through the sale of products. This type is the focus of the current section. The second function uses patent pools as the product itself and the patent pool owner's major or only source of income is generated though the licensing of its patents. This purpose in of itself may be an efficient and fair means of disseminating information, especially when the patent pool owner was the creator of the patented innovations. An innovator, is able to obtained a number of needed patents from a patent pool instead of having to obtain licenses from numerous patent owners.

Those who assemble patent pools through purchase for the sole purpose of bringing infringement claims have been described as "patent trolls" who actually inhibit innovation.[85]

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[85] "A patent troll is a person or entity who acquires ownership of a patent without the intention of actually using it to produce a product. Instead, the patent troll buys the patent and either licenses the technology to a person or entity that will incorporate the patent into a product, or it sues a person believed to already have incorporated the technology in a product without permission." James F. McDonough III, Comment, *The Myth of the Patent Troll: An Alternative View of the Function of Patent Dealers in an Idea Economy*, 56 EMORY L.J. 189, 189 (2006); Robert E. Thomas, *Vanquishing Copyright Pirates and Patent Trolls: The Divergent Evolution of Copyright and Patent Laws*, 43 AM. BUS. L. J. 689, 692 (2006). Thomas states that "patent reforms are designed to address the interests of large information technology (info-tech) companies seeking to reduce their exposure to patent trolls--nonproductive patent consolidators who

One prevalent definition of the term is that a patent troll is a company that holds a patent not to produce a product but to extort royalties from others. In fact, non-producing patent holders are common.[86] From a purely strategic point of view, patent consolidation or hoarding is a business method that provides the pool owner a strategic advantage over those needing patents.

Patent pools are also be used to block innovation and to hold-up other users of intellectual property through infringement claims. In the later use, the infringement claim can be merely a nuisance suit in which a party pays a fee or royalties even in cases where the claim is without merit. In a more predatory way, patent pools can be used to coop an entire area of technology or innovation as the very size of the pool allows the pool owner to raise the threshold of entry for would-be competitors. This threshold can be raised by the aggressive use of patent infringement litigation. This is the essence of achieving a strategic competitive advantage through law. The offensive strategy of patent pooling can be further compounded by strategic alliances of owners of ancillary patent pools.

These predatory uses of patent pools raise antitrust issues. The building of a patent pool and how it is used needs to be done strategically to avoid antitrust claims. Guidelines drafted by the

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acquire patents allegedly for the purpose of extorting a substantial settlement or judgment from productive companies." *Id.* at

[86] "Until an inventor finds an investor to provide capital, she remains a non-producing patent holder." Ben Klemens, *The Rise of the Information Processing Patent*, 14 B.U. J. SCI. & TECH. L. 1, 28 (2008). See generally, Robert E. Thomas, *Vanquishing Copyright Pirates and Patent Trolls: The Divergent Evolution of Copyright and Patent Laws*, 43 AM. BUS. L.J. 689 (2006) (analysis of possible reforms to deal with the issue of patent trolls). For a review of the problems with business method problems and their strategic use see, Robert E. Thomas & Larry A. DiMatteo, *Harmonizing the International Law of Business Method and Software Patents: Following Europe's Lead*, 16 TEXAS INTELL. PROP. L. J. 1 (2007) (comparative analysis of United States, European, and Japanese intellectual property systems response to the idea of business method patents).

Justice Department and Federal Trade Commission (*IP Guidelines*) provide the parameters for such a strategic construction.[87] The *IP Guidelines* state that intellectual property pooling is pro-competitive when it integrates complementary technologies, reduces transaction costs, clears blocking positions, avoids costly infringement litigation, and promotes the dissemination of technology.[88] In contrast, the *IP Guidelines* state that excluding firms from an intellectual property pool may be anticompetitive if the excluded firms cannot effectively compete in the relevant market without incorporating the licensed technologies, the pool participants collectively possess market power in the relevant market, and the limitations on participation are not reasonably related to the efficient development and exploitation of the pooled technologies.[89] These factors need to be considered in the construction and utilization of patent pools. In the end, a patent pool that generates easily licensable packages of patents and provide additional royalties to the creators of the invention, process, or method can be profitable to the patent pool owner, facilitate innovation, and not violate the antitrust laws.

A recent dispute between Nokia and Apple Computer illustrates how patent pools, especially in patent-dependent industries or in industries where innovation is incremental in nature, especially in industries where the patent landscape is dense and closely aligned, serve both strategically offensive and defensive purposes. The offensive purpose aims at the generation of new revenue sources; the defensive purpose is aimed at defending of competitive

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[87] *See* U.S. DEP'T OF JUSTICE & FED. TRADE COMMISSION, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY ("IP Guidelines"), *reprinted at* http://www.usdoj.gov/atr/public/guidelines/ipguide.htm.

[88] IP Guidelines, § 5.5.

[89] *Id.*

advantages. In the ongoing lawsuit, Nokia is claiming that Apple is infringing on its patents.[90] Nokia is the world's largest manufacturer of cell phones. However, its market share has been on the decline in the United states since the introduction of Apple's iPhone. It asserts that the iPhone free rides on the back of innovations developed by Nokia.

The strategic solution would seem to be to enter into a licensing agreement. In this way, Nokia could offset some its revenue losses due to declining market share with royalties from Apple. Apple would then be able, without threat of infringement claims, to continue increasing its market share. Apple, however, has rejected overtures from Nokia to this effect. One reason is that even though royalty rates are relatively low (1-5%) that percentage is likely to increase due to the fact that the market for new customers continue to shrink since most people already own cell phones.[91] Therefore, the value of patent portfolios is likely to be seen as a major source of revenue generation. This is evident in the Nokia case since, Nokia is not seeking an injunction to prevent Apple from using its patented innovations (sustaining a competitive advantage), but is solely seeking damages for past and future uses of those patents (revenue generating). This is most understandable from a strategic perspective. Due to the fast pace of innovation and product development in this area, Nokia understands that sustaining its competitive advantage is short-sighted.[92] Thus, obtaining royalties from Apple recognizes that sustaining a market advantage is not cost effective.

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[90] See Saul Hansell & Kevin O'Brien, "In Lawsuit, Nokia Says iPhone Infringes its Patents," Wall Street J. (October 23, 2009); Ian Edmonson & Yukari Iwatani Kane, "Nokia Accuses Apple of Patent Infringement," WALL STREET J. (October 23, 2009).

[91] *Id.*

[92] Ian Edmonson & Yukari Iwatani Kane, "Nokia Accuses Apple of Patent Infringement," WALL STREET J. (October 23, 2009).

B. Creating Shared Competitive Advantages

This section analyzes the use of strategic alliances as a more efficient substitute to vertical integration. Patent pools are used here to illustrate contract law as a value creator.

1. Strategic Collaboration

The traditional vertical integration model[93] of corporate expansion is more and more being replaced by strategic collaboration or alliances as a means to expansion.[94] Strategic collaboration involves a number of areas of law including, contract law and the law of business organizations. Strategic contracting and alliances may be used in place of vertical integration to obtain needed supplies and services.[95]

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[93] "Conventional industrial organization theory predicts that when parties in a supply chain have to make transaction-specific investments, the heightened risk of opportunistic behavior by their counterparties will drive them away from contractual relationships and toward vertical integration." [93] Gilson, *Contracting for Innovation* at 434-35.

[94] Gilson, *Contracting for Innovation* at 433. For a discussion of transaction cost theory, see Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979). Another commentator notes that there are "[t]hree types of contracts in organizational theory: (1) creating vertical integration (intra-firm contracts), firm to firm contracts, and hybrid contracts, such as joint ventures, research and development contracts, and alliances." D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 1 (2009).

[95] Rachelle Sampson explains that:

> Firms have a myriad of forms to choose from in organizing their alliance activities, ranging from simple licensing arrangements to more complex forms, such as the equity joint venture, where firms incorporate a separate entity for their collaborative efforts. These forms can be loosely grouped into two categories: purely contractual and institutional (i.e., the equity joint venture).

Collaborative strategic alliances are also used to obtain knowledge, obtain and create innovation, and produce new product lines.[96] It is a way of pooling resources from a number of firms, as well as sharing costs and risks of the new undertaking. In a typical scenario two parent companies form an alliance. The alliance may take numerous forms, such as a joint venture, a subsidiary of one of the parent companies, or an independent corporation. The entity may be conceived as having a narrow or targeted purpose, such as the importation of products or the construction of a manufacturing plant in a foreign country. The collaborative entity could be conceived as a longstanding undertaking involving research and development of new product lines. The parent companies may invest money, intellectual property rights, know-how, and key employees.[97]

The strategic issues in such collaborations is minimizing conflicts of interest, continuing to align interests and the prevention of opportunistic behavior by one of the collaborating partners. These issues become especially pronounced when the collaborating partners are also

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Rachelle C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. 909, 913 (2003).

[96] The role of strategic alliances has grown in importance as globalization and technology have accelerated. Rachelle C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. 909 (2003) ("the frequency of firms participating in inter-firm collaborations has increased dramatically") (Sampson, *Strategic Alliances*). See also, David C. Mowery et al., *Strategic Alliances and Interfirm Knowledge Transfer*, 17 STRATEGIC MGMT. J. 77 (1996) (examining the effect international collaborative agreements have on the transfer of interfirm knowledge); Ranjay Gulati & Harbir Singh, *The Architecture of Cooperation: Managing Coordination Costs and Appropriation Concerns in Strategic Alliances*, 43 ADMIN. SCI. Q. 781 (1998) (providing a review of the alliance literature): Laura Poppo & Todd Zenger, *Do Formal Contracts and Relational Governance Function as Substitutes or Complements?*, 23 STRATEGIC MGMT. J. 707 (2002) (discussing how formal contracts and relational governance complement each other rather than work against each other).

[97] "Firms may transfer technologies, achieve economies of scale in manufacturing, marketing or R&D, and access capabilities that may be difficult to develop in-house." Sampson, *Strategic Alliances* at 909.

competitors. It is not uncommon for competitors to collaborate in new endeavors that may be cost prohibitive or creatively-difficult for either company to undertake by themselves.[98] As competitors, they will be sensitive to the turning over of competitive advantages to assist the alliance for fear of usurpation by the other partner. In a similar way, the partners will be tempted to use the innovations developed within the alliance to create competitive advantages outside of the alliance.

Rachelle Sampson notes that there are two possible purposes for detailed alliance contracts—to guide the courts in case of dispute or to provide guidance, at times legally unenforceable guidance, to the organizational alliance to align interests and to coordinate future activities.[99] She argues that such detailed alliance agreements primarily serve the second purpose. In support, Sampson notes that firms often waive their rights to litigation in their alliance contracts.[100]

Contract law can be sued to align interests and to deter opportunistic behavior. This is essential in order to maintain the necessary collaboration to ensure success and achieve longer-term mutual benefits. One theory asserts that the alliance should create a mutual hostage scenario. The scenario not only deters opportunistic behavior it also reduces the costs of ensuring or monitoring compliance with the mutually targeted goals of the enterprise.[101] One means of creating a mutual hostage situation is the incorporation of *reciprocal penalties* into the alliance agreement. One commentator explains the role of penalties in aligning interests: "[P]enalties essentially execute the golden rule: If you do damage unto another it will be done

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[98]Firms may even ally with competitors to set standards in an industry or to meet difficult time goals for development of new technologies. Sampson, *Strategic Alliances* at 910..

[99] Sampson, *Strategic Alliances* at 918-19.

[100] *Id.*

[101] Salbu, *Joint Venture* at 303.

unto you. . . . it might, [however,] be necessary to create 'more-than-reciprocal' punishments, which would, like treble damages in the case of antitrust violations, more than reciprocate for a wrong."[102] The mutual hostage scenario, whether created through reciprocal penalties, reciprocal benefits, or by the strategic investment of mutual sunk costs, reduces the risk of opportunism and acts to maintain the alignment of the parties' interests.

At times, strategic contracting focuses on a discrete transaction, other times on strategic collaboration aimed a developing a long-term, evolving relationship. Sometimes both types of contracts are used to link the parties to achieve numerous strategic goals. Gilson, Sabel, and Gilson give an example of expanding contract design to include a number of interlocking transactions.[103] They discuss the technique of interlocking contracts by using a series of transactions executed by Apple and SCI. Essentially, Apple wanted to sell a manufacturing plant to SCI. In order, to make the sale more attractive it agreed to purchase products from the plant through a long-term purchase contract. The problem with the scheme is that in the electronics industry products are being constantly changed. So in order for the supply contract to work, the parties entered into a design and a corroboration agreement to oversee creation and production of new product lines. In addition, to more closely align their interests, the new owner agreed to pass on all discounts given by material suppliers to Apple. This was done in order to reduce the temptation to act opportunistically by capturing the additional surplus that the discounts represented. By entering into an interlocking series of contracts the parties where able to achieve numerous strategic purposes—the sale of a manufacturing plant, guaranteeing sales to the new

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[102] Salbu, *Joint Venture* at 300. See also, Steve Salbu, *Parental Coordination and Conflict in International Joint Ventures: The Use of Contract to Address Legal, Linguistic, and Cultural Concerns*, 43 CASE W. RES. 1221 (1993).

[103] Gilson, *Contracting for Innovation* at 464-67.

owner and a supply to the original seller, as well as creating a collaborative alliance to innovate new products.

2. The Case of Patent Pools

Under one scenario, patent pool licenses can be used when two or more patent owners agree to license one or more of their patents to one another or to third parties.[104] As discussed earlier,[105] patent pools are used to create value by allowing the pool owner to bundle and license different rights which make up the pool, to encourage collaboration among competitors to cross-license the rights in their respective pools, and serves the market as an efficient disseminator of intellectual property rights.

A hybrid function of patent pools is best described as collaborative. This is where two, generally large, patent pool owners cross license with each other for mutual benefits. In addition, cross-licensing between two large patent pools may create an overlapping or a number of overlapping pools. Such permutations can lead to the development of new product lines or entirely new specialized pools for revenue generating purposes. Such hybrids is an example where a company's business and legal strategies become one and the same

[104] Alternatively, a patent pool may also be defined as "the aggregation of intellectual property rights which are the subject of cross-licensing, whether they are transferred directly by patentee to licensee or through some medium, such as a joint venture, set up specifically to administer the patent pool." U.S. PATENT AND TRADEMARK OFFICE, PATENT POOLS: A SOLUTION TO THE PROBLEM OF ACCESS TO BIOTECHNOLOGY PATENTS OFFICE 4 (2000), available at www.uspto.gov/web/offices/pac/dapp/opla/patentpool.pdf (last visited Nov. 17, 2009).

[105] *Supra*, Part IV.A.2.

V. CONTRACTS AS MITIGATING STRATEGIC UNCERTAINTY

This Part analyzes specific contract doctrines to illustrate the strategic uses of contract law. This includes an analysis of pre-contractual negotiation, excuse doctrines, no penalty rule, infancy law doctrine, rules related to covenants not-to-compete, and the doctrine of unconscionability. It also examines the use of contract terms strategically by focusing on the strategic use of standard terms or boilerplate. It concludes with an examination of how contracts can be used to insure performance and as part of a preventive legal strategy.

A. Strategic Use of Existing Contract Doctrine

This section will provide examples of the strategic use of existing contract doctrines.[106] Since there are many contract doctrines and rules, and many of them can be used strategically, this section will provide a sampling of the strategic use of the doctrines of contract law.

1. Pre-contractual Negotiations

[106] Contract doctrine is to be broadly construed to include not only the rules of contract law, but also principles and standards enunciated in contract law.

The negotiation of contracts is a fertile area of strategic posturing.[107] I will divide the strategic negotiation of a contract into positive and negative strategic posturing. Both types of posturing are supported by contract doctrine, namely, the common law's rule that there is no good faith duty to negotiate. A party is not liable under contract law for bad faith negotiating or breaking off of prolonged negotiations without providing a viable reason for the termination. Negative strategic posturing relates to the scenario where a party to the negotiations has no intent to consummate a contract. The negotiations are used as a pretext to advance interests outside of the prospective contract. The negotiations may be used strategically to influence a party not privy to the negotiations or to strategically obtain information from the other party.

The negotiations can be used as a rue to influence another party to enter into negotiations with the party taking the negative posture or as a way of deterring another firm from opportunistic behavior, such as entering the territory or product line of the one taking the negative posture. The second motive for strategic negative posturing is the procurement of information from the other party. A surprising amount of confidential information may need to be provided in order to form a contract. This is likely in cases of strategic alliances, whether involving competitors or innovative start-up companies, licensing contracts, joint ventures, and distribution contracts. In order, to minimize such risks the information provider should require a "negotiations contract" requiring that the information remain confidential. Although such

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[107] One commentator has noted that such strategic posturing may prevent the consummation of a deal: "[T]ransaction costs, information asymmetries, and strategic behavior may keep parties from consummating deals." "Is there a role for a different kind of player in transactions-a player who could help parties, including business lawyers, to overcome these various market imperfections as they negotiate the terms and conditions of a deal?" Scott R. Peppet, *Contract Formation in Imperfect Markets: Should We Use Mediators in Deals?*, 19 OHIO ST. J. ON DISP. RESOL. 283, 286 (2004) He recommends the use of non-lawyer, transactional mediators.

agreements allow the aggrieved party to monitor breach of the confidentially agreement when the other party conveys the information to a third party, it will be difficult for the non-breaching party to prevent the information from being used internally by the breaching party. In these types of cases, strategic negotiation becomes an imperative. Techniques to be considered include the deposit of funds in escrow to be released if a party breaches the confidentiality contract or automatically if the negotiations are not successful and the confidential information is irretrievable. In cases where both parties hold confidential information, the gradual release of one party's information can be linked to the release of information by the other party.

Positive strategic posturing is the negotiation of a contract on the most favorable terms possible for either party. Both parties intend to consummate a contract based on reaching a minimal standard of benchmarked terms. One or both parties act strategically in terms of negotiating style and purposes for including certain terms. This does not mean there is an open process characterized by the free flow of information. In fact, negotiations are generally characterized by opportunistic behavior including, the withholding of information.[108] Opportunism includes the misrepresentations of positions, withholding information, superior knowledge of the law as it relates to the enforceability of particular terms, and the strategic use of vague or ambiguous language.[109]

A more aggressive opportunism is the strategic use of information. The opportunistic party partially and serially provides information to entice the other party to incur transaction-specific costs. The opportunistic party then exploits the knowledge of the other party's sunk costs to

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[108] Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621, 642-63 (1993) (examines the risk of opportunism or strategic behavior by contracting).

[109] *Id.* at 642.

obtain a more favorable deal.[110] Professor Kostritsky concludes that the result of opportunism and information asymmetries is a less complete contracts.[111] The problems of incomplete contracts are two-fold. First, the gaps and ambiguity of the contract allows for an increased likelihood of opportunistic behavior in the performance of the contact than would occur in a more formalized contract.[112] Second, in case of dispute, the parties are less likely to come to an amicable resolution. The incompleteness of the contract is, in essence, a deferral to courts to solve the dispute. This deferral comes at a price including, the high cost of litigation and the likely elimination of a relationship-saving resolution.

2. Excuse Doctrines

Contract law provides a number of excuse doctrines to relieve a contracting party of liability for a technical breach of contract. These include the doctrines of impossibility and commercial frustration in the common law, the doctrine of impracticability in Article 2 of the

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[110] *Id.* at 643.

[111] *Id.*

[112] Formal or informal contract language always retains a certain amount of ambiguity. This is especially true when language, whether orally or in written form, is used strategically. This produces some costs and benefits. "The lack of certainty leaves certain content hanging in the air, as it were, leaving each party to the conversation with an option of understanding the full communicated content somewhat differently." Andrei Marmor, "Can the Law Imply More than it Says?—on some Pragmatic Aspects of Strategic Speech," U. So. Cal. Legal Studies Working Paper Series, Paper %% (2009), available at http://law.bepress.com/usclwps/lss/art55. The benefit is that it may allow the deal to be made in the first place, provides flexibility in the development of a long-term contractual relationship which implies that strategic or ambiguous language may case a greater deal of cooperation. The cost or risk is that the parties settle on mutually exclusive interpretations which stifles cooperation and leads to dispute.

Uniform Commercial Code,[113] and the doctrine of impediment in the Convention for the International Sale of Goods.[114] The excuse doctrines rest on three fundamental premises: (1) the event that prevented performance was unforeseeable at the time of contract formation, (2) the breaching party had no means or control to prevent the event from occurring, and (3) overcoming the superseding event would be an undue burden. These rather onerous requirements make obtaining an excuse from liability difficult. In response, a well worded force majeure or hardship clause can bring a degree of certainty to downstream liability.[115] Such a clause, tailored to the risks unique to a particular industry or type of transaction, assuage a court away from a finding of allocated risk.

A force majeure clause may provide an excuse for any eventuality expressly designated in the clause, such as transportation problems, governmental interference, currency fluctuations, and increases in the costs of production. The force majeure clause should be customized for the particulars of the specific parties and the specific type of contract. It can be expanded to events that are not considered to produce undue hardship. These clauses, often called hardship clauses, provide an excuse for mere hardship or inconvenience. The clause can require the parties to

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[113] U.C.C. § 2-615 states in part that a party is not in breach of a contract "if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made . . . ."

[114] United Nations Convention on Contracts for the International Sale of Goods, Apr. 11 1980, U.N. Doc. A/CONF.97/18, Annex I, *reprinted in* 19 I.L.M. 668 (CISG). CISG Article 79 states: "A party is not liable for a failure to perform . . . if he proves that the failure was due to an impediment and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences."

[115] See generally, International Chamber of Commerce, Publication No. 650, "*Force Majeure* and Hardship Clauses" (2003) (provides examples and language for tailoring customized clauses).

negotiate alternative terms in good faith. If that fails, then the parties have the right to terminate the contract.

3. No Penalty Rule

The law of liquidated damages provide fertile ground for strategic contracting. Most contracts possess liquidated damages clauses that serve numerous purposes, such as a strategic tool in retaining deposits, as a tool to deter opportunistic breach, and to signal good faith or reliability. Unfortunately, these rational purposes are often undercut by the common law rule that penalties, which are supra-compensatory liquidated damage clauses, are unenforceable.[116] Civil law systems have recognized the legitimate uses of penalty clauses.[117] They are generally enforced under civil law unless they are deemed to be manifestly excessive. This could be easily be done in the common law by eliminating the law of liquidated damages and allow overly punitive clauses to be policed under the doctrine of unconscionability.[118]

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[116] See U.C.C. § 2-718 (1) (2009). It states: "A term fixing unreasonably large liquidated damages is void as a penalty." *Id.*

[117] *See, e.g.* Pembroke v. Gulf Oil Corp., 454 F.2d 606 (1971) (the civil law still is the law of sales in Louisiana, therefore, courts do not inquire whether the liquidated damages amount approximates actual damages). *See also*, Council of Europe, Resolution 78 (3), "Penal Clauses in the Civil Law (1978).

[118] See Larry A. DiMatteo, *Penalties as Rational Response to Bargaining Irrationality*, 2006 MICH. ST. L. REV. 883 (argues that penalty clauses serves many rational purposes including, incentivizing performance, providing performance insurance, compensating for under-compensatory nature of common law damages, reducing transaction costs in the negotiation stage and reducing dispute resolution costs); Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633 (2001) (advances a theory of efficient penalty and the elimination of the no penalty rule;

Penalty clauses can be an efficient device to insure performance and to deter opportunistic breach. It can also act as insurance by allocating the risk of non-performance to the most efficient insurer. In a construction contract, the most efficient insurer is generally the contractor. The payment of a premium (increase in contract price) in exchange for the payment of penalties for delayed performance should not be viewed as a penalty, but as the acquisition of insurance. The parties could enhance the non-punitive nature of such a clause by tailoring a force majeure clause that provides reasonable excuses for the contractor to avoid payment of the penalties. In addition, penalty clauses can act as a signaling device.[119] The performing party's willingness to agree to pay penalties for untimely performance signals to the other party that the performing party is confident in performing in the allotted time. Unfortunately, common law does not recognize the notion of efficient penalty clauses since it holds all penalties to be unenforceable.

This brief review leads to a number of questions and conclusions. If penalties were enforceable under the common law, then they could serve numerous strategic purposes. That said, given the threat of being voided by a court, why do liquidated damages clauses remain so common in all types of contracts? The answer is that unenforceable penalty provisions still have strategic value. This is largely due to the uncertainty of whether a court will determine that the pre-agreed damages are reasonable liquidated damages or unenforceable penalties and the parties' behavior during the performance stage may be influenced by the clause due to the

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advocating the use of the doctrine of unconscionability and the remedy of reformation to police penalty clauses).

[119] Another commentator gives example of signaling in the area of franchise contract law. She asserts that signaling may explain the franchisors' choice of royalty rates, franchise fees, as well as their tendency to operate outlets directly." Francine LaFontaine, *Contractual Arrangements as Signaling Devices: Evidence from Franchising*, 9 J. L. ECON & ORG. 256, 257 (1993).

uncertainty of a judicial finding. Alternatively stated, the no penalty rule masks the possibility that liquidated damages clauses serve the strategic purposes discussed above. There are also other plausible justifications for the use of penalty clauses to encourage performance or to deter opportunistic breach. The non-performing party may decide that paying the penalties will serve a number of benefits, such as reputational effects, relationship preservation, and as a payment for extended time to complete the project. Finally, in international transactions, such as foreign construction projects, penalties are enforceable under most national law regimes.

4. Passing Thoughts: Other Contract Doctrines

This section will discuss the infancy law doctrine, enforceability of covenants-not-to compete, and the doctrine of unconscionability as further examples of the strategic uses of contract doctrine. The infancy law doctrine entered the common law of contract at a time when the protection of minors was needed.[120] Despite the changing characteristics of many minors, especially in the fifteen to eighteen year old age group—such as higher levels of sophistication, greater access to information, higher levels of education, and greater amounts of financial resources—the infancy law doctrine persists to the present. Even though intended to act as a shield to protect minors, the sophisticated minor may attempt to strategically use it to take advantage of the adult or company party.

[120] For a review of the history of the infancy law doctrine and its major tenets see, Larry A. DiMatteo, *Deconstructing The Myth Of The "Infancy Law Doctrine:" From Capacity To Accountability,* 21, OHIO N. U. L. REV. 482 (1995).

The often litigated covenant not-to-compete in the employment setting serves two strategic purposes: proprietary protection and strategic coercion. The first relates to the proprietary property that the employer seeks to protect. The second purpose seeks to deter employee movement to a competitor. The first purpose is best served by drafting a covenant that is likely to be enforced by the courts. The employer shows that there is some proprietary interest—trade secrets, know-how, client contacts, access to key employees, specialized training, databases, compilations—that are susceptible to being harmed if used or disclosed by an ex-employer to her new employer. Most courts will enforce this covenants unless their restrictions regarding geographical scope, duration, and scope of prohibited activities are deemed to be unreasonable. To ensure enforceability, legal counsel can ensure reasonableness by drafting the covenant, or any other contract term, using reasonable person theory. This theory limits the use of superior bargaining power in favor of drafting a covenant that protects the employer without creating an unnecessary burden on the ex-employee.[121] The drafter would look to the specific state's case law and relevant state statute to ensure enforceability.[122]

Covenants not-to-compete used as strategic coercion is not constrained by the legality or enforceability of the covenant's restrictions. What, then, is the strategic value of drafting an unenforceable covenant—in a word, to *terrorize* an employee to stay or to terrorize an ex-employee not to violate the covenant. First, many cases are not litigated, therefore, the employer receives the benefit of broader restrictions through submission by the employee. This benefit is enhanced by the use of threatening letters and the costs of litigation. Second, if litigation is

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[121] Larry A. DiMatteo, *Contracts and Precedents*, 2009 TRANSACTIONS: THE TENN. J. BUS. L. 262, 268.

[122] One exception would be California whose statute voids all covenants not-to-compete. Cal. Bus & Prof Code § 16600. Under California legal regime, confidentiality and non-solicitation gain strategic importance.

pursued, the employee's defense, likely paid by the new employer, will result in a court reforming the covenant by redrafting the restrictions in order to make them reasonable. So, at worse, the employer retains the less broad restrictions of reasonable person theory.[123]

Unconscionability is generally regarded as a substantive fairness doctrine where terms in a contract are so one-sided that they shock the conscience of the court. The doctrine of unconscionability, which previously existed in the law of equity, was codified in Section 2-302 of the Uniform Commercial Code and is generally used to police unconscionable terms in consumer contracts. Most courts require a finding of procedural (bargaining naughtiness) and substantive (one-sidedness) forms of unconscionability before voiding a clause or contract.

Is there a strategic method of buttressing a defense to a claim of unconscionability? An empirical study involving the coding of unconscionability cases offers a method of defending against unconscionability claim.[124] The project shows that the most predictive factors relating to a finding of unconscionability related to procedural and not substantive unconscionability. Alternatively stated, consent factors and not substantive unfairness factors controlled most court's finding of unconscionability. Therefore, a party can enhance the enforceability of one-sided terms by enhancing the appearance of consent. The appearance of consent is enhanced if the other party is represented by a lawyer, the term is conspicuously presented in the contract, the parties negotiate over the one-sided term, the term is brought to the attention of the other party before the execution of the contract, the other party is given a reasonable amount of time and is

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[123] An exception would be Georgia where its statute prohibits the reformations of covenants not-to-compete. Thus, covenants that contain overly broad restrictions are void under Georgia law. Georgia Statutes § 13-8-2.1.

[124] See Larry A. DiMatteo & Bruce Louis Rich, *A Consent Theory of Unconscionability: An Empirical Study of Law in Action*, 33 FLA. ST. U. L. REV. 1067 (2008).

encouraged to read the contract in its entirety, and/or the form receiving party initials the term in question.

5. Use of Contract Terms Strategically

The use of contract terms strategically is partially a misnomer. Most contract terms serve a strategic purpose. Many terms have been standardized in the modern era of form contracts and terms that may not be considered strategic in nature are, in reality, duplications of terms that were initially formulated to serve strategic purposes. For example, terms related to dispute resolution—choice of law, forum selection, and arbitration clauses, are found in most contracts. These terms are strategically important in cases of dispute. In the area of choice of law, the United States as two sale of goods laws—Article 2 of the Uniform Commercial Code (UCC) and the Convention on Contracts for the International Sale of Goods (CISG). Although similar in nature, there are significant differences between these two laws.[125] These differences can be used strategically in drafting a choice of law clause. A manufacturer-seller who is concerned that the deadline provided in the contract may not be attainable may want to select the CISG since it provides the right for a seller to ask for time extensions for performing under the contract.[126] No such concept exists in the UCC.

One of the longstanding debates in contract law is the regulation of standard or boilerplate terms. The challenge to contract law is that standard forms and standard terms rarely reflect any true consent or meeting of the minds. The unconscionability doctrine has been used primarily to

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[125] For a chart showing the major differences between the UCC and CISG see LARRY A. DIMATTEO & LUCIEN DHOOGE, INTERNATIONAL BUSINESS LAW: A TRANSACTIONAL APPROACH 260 (2d ed. 2006).
[126] CISG, *infra* note 114, at Articles 47, 48 & 63.

regulate overly one-sided terms in consumer contracts.[127] The issue here is not whether they are fair, but whether they are used to gain a strategic advantage. It is important to note that standard terms are commonly found in many types of contracts—whether those between a merchant and consumer or in merchant to merchant transactions. In the consumer context, the strategic purposes of forum selection, choice of law, arbitration, or short notice times to report defects in goods are readily apparent.

The more perplexing issue is why would such terms persist in contracts between equally sophisticated parties? Professor Ahdieh has offered "a 'strategic' theory of boilerplate."[128] He argues that standard terms between sophisticated parties serve a coordination function. Even though parties bargain for preferred terms, standard terms narrow the potential for conflict and increases the chances of the parties reaching an agreement. If a term is considered as standard and not customized by one of the parties, then it anchors the bargaining by signaling that the terms are reasonable. Alternatively, if the terms are significantly different than what is considered standard, then the other party may feel the need to bargain, possible due to status quo

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[127] See Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827, 828 (2006) (noting that a company's "expectation of doing business with other consumers in the future may dissuade it from enforcing a one-sided contract to the hilt"); Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857, 858 (2006) ("[F]irms . . . have given their managerial employees the discretion to grant exceptions from the standard-form terms on a case-by-case basis.").

[128] Robert B. Ahdieh, *The Strategy of Boilerplate*, 104 MICH. L. REV. 1033 (2006). See also, Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or the 'Economics of Boilerplate')*, 83 VA. L. REV. 713 (1997) (networks effects in the choice of terms favor reliance on widespread norms).

bias,[129] over the divergent standard.[130] This broadens the field of conflict needed to be resolved through negotiations and decreases the chances that the parties will ultimately reach agreement.

In the end, the use of standard terms serve a number of functions, In the consumer context, the merchant places favorable terms in the boilerplate to achieve strategic advantages regarding dispute resolution, notice of defect, and other terms impacting on its liability to the purchaser. In the area of contracts between sophisticated parties, standard terms can strategically signal the reliability and trustworthiness of a party, as well as to alert a party of potential risks. This signaling function seems most relevant when the standard terms are those promoted by a trade association or group. In cases where there are no "standard" standard terms, then the parties are likely to bring different sets of standard terms to the bargaining table. This is where strategic negotiations determine if the parties will reach an agreement. To do that, the parties need to work toward a basket of terms that at least meet each parties' minimal threshold of acceptability.

B. Contracts as Insurers of Performance

Contracts offer numerous was of insuring performance, such as the use of letters of credit to insure payment in documentary credit transactions. The entire area of secured transactions attempts to assure a lender that the borrower is likely to perform or lose the collateral made to secure the loan. One incentive for encouraging performance is the allocation of risk between the parties, but this is more an allocation of liability than an insurer of performance. The use of

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[129] See Russell B. Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1999) (the framing of a term as the norm influences a party's preferences).

[130] Adhieh notes that even if the term is more favorable to the other party it still may send a negative signal: "[E]ven a favorable deviation from boilerplate could constitute an adverse signal. This may simply be an issue of raising suspicions regarding the reason for the deviation." *Id.* at 1045.

performance bonds or standby letters of credit to insure performance of a non-monetary obligations, such as the construction of a building or the delivery of goods. However, only guarantees from reputable third parties, such as commercial banks or insurance companies, can truly insure performance when the obligation is merely to pay money. In fact, many of these devices are perform or pay devices. There are few means to absolutely insure the performance of a non-monetary obligation. Legal devices, such as performance bonds, standby letters of credit, are essential contractual remedy provisions. They serve two important purposes: (1) the beneficiary party (non-breaching party) is provided damages through a third party immediately hopefully allowing the party to avoid protracted litigation and (2) the third party payment (guarantor) provides an immediate pool of money to hire another supplier or builder to complete the performance and thus, limiting further delays.

There are numerous contractual terms that if not fully insuring performance at least create intrinsic value to a company mostly by providing safeguards against economic loss. One example, is the use of moral clauses in entertainment and sports contracts. A product or company's reputation are often tied to the celebrities that they hire to act as their representatives. If, for example, a company's reputation focuses upon integrity and trust it is especially important that they select persons that exemplify those traits. A morals clause in personal services or endorsement contracts allow for termination in the event of a violation of the clause. It serves not only the function of terminating the relationship without paying damages, but also serves to "encourage socially responsible behavior."[131]

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[131] Amanda Harmon Cooley, Marka B. Flemming & Gwendolyn McFadden-Wade, *Morality and Money: Contractual Morals Clauses as Fiscal and Reputational Safeguards*, 14 J. LEGAL STUD. BUS. 1, 29 (2008).

C. Formative or Preventive Legal Strategy

The notion of law as business method is understood within a "legal-managerial framework."[132] Such a framework requires that legal and public policy tools and issues be used as inputs in pre-decisional analysis leading to the making of a business decision.[133] This approach looks to bridge the gap between business and legal methodologies. The normal path to the use of legal methodology by business is by way of the presentation of a problem to legal counsel. The lawyer than attempts to use legal sources to propose a solution or path for dealing with the business problem. The strategic use of law requires a different approach. This approach would entail the use of legal sources in the initial decision-making process. This way law is being used strategically not to solve a problem but to prevent or minimize the occurrence or severity of the problem in the future.

The most common example of the intersection of legal and business strategy is the area of business planning. This is especially true in start-up or small business enterprises. A thoughtful process involving the recognition of the intersection of business purpose and goals and legal strategy at the formation of a new enterprise is predictive of the long-term longevity or viability of that enterprise. A truly well-thought out business plan needs to be coupled with an equally well thought out legal strategy. Success is often dependent on the early coupling of a business purpose and a legal strategy aimed at achieving that purpose. This linking should begin at the very beginning of the development of the business idea, the business plan, and culminating with

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[132] James E. Holloway, *The Practical Entry and Utility of a Legal-Managerial Framework without the Economic Analysis of Law*, 24 CAMPBELL L. REV. 131, 133 (2002);

[133] Professor Holloway explains that "[t]he framework relies on pre-decisional evaluation of laws and policies, utilizing business theories and principles to ascertain the effects of these laws and policies on business methodology and thinking." *Id.*

the formation of the enterprise or the execution of a contract. Examples are almost unlimited since many of the issues may or may not become relevant in the future. But, proper legal planning follows an "anticipatory thinking approach" to provide the means of problem-solving for future eventualities.[134] It is true that not all eventualities are foreseeable, but it is also true that many are foreseeable and yet poorly planned for.[135]

VI. CONTRACT AS SOURCE FOR STRATEGIC DECISION-MAKING

Gilson, Sabel, and Gilson notes that there has been a trend away from vertical integration to strategic contracting and strategic alliances: "Producers today recognize that they cannot themselves maintain cutting-edge technology in every field required for the success of their products. Accordingly, companies are increasingly electing to acquire by contract components that in the past they would have made themselves."[136] This Part will examine two examples of this phenomena: (1) contracting for innovation and (2) the use of hybrid organizations, namely joint ventures, to create customized governance structures through contracts.

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[134] See also, MARTIN E. SEGAL, PREVENTIVE LAW FOR BUSINESS PROFESSIONALS (2005). Professor Segal notes that most legal problems, and many business problems, could be prevented if the parties had used an "anticipatory thinking approach" at the onset of the enterprise or transaction.

[135] One preventive law text describes the essence of the concept as "how legal problems may be prevented; how lawyers may proactively assist clients in identifying and reaching their goals; the impacts of legal methods on the people involved in a dispute; and how law can be understood as one part of an elaborately intertwined system comprised of the problems that people bring to law." THOMAS D. BARTON, PREVENTIVE LAW AND PROBLEM SOLVING: LAWYERING FOR THE FUTURE (2009).

[136] Ronald J. Gilson, Charles F. Sabel & Robert E. Scott Gilson, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431 (2009) (hereinafter Gilson, *Contracting for Innovation*). "Despite conventional industrial organization theory, however, contemporary practice is moving away from vertical integration." *Id.* at 434.

A. Contracting for Innovation

Corporate strategy that fails to take in account of the strategic use of law is likely to waste opportunities of gaining competitive advantages. A corporate legal strategy can be used to gain competitive advantages both internally and externally. Internally, research and development in some companies are often specialized into different areas of research. Failure to monitor the different areas can result in the loss of synergistic-related advantages. An example is the division of research and development along different product lines or along different intellectual property regimes. The problem is that a detached view or more holistic coordination could lead to the procurement of additional rights, such as a design patent developed by connecting the innovations produced in the different areas of research.[137] Companies often fail to recognize product shapes as innovative enough to obtain trademark protection despite the positive impact trademarks have of shareholder wealth.[138]

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[137] David Orozco, *Rational Design Rights Ignorance*, 46 AM BUS. L.J. 573 (2009) ("various departments routinely forfeit the ability to exploit coordinated design-related intellectual property rights"). failure to recognize existing intra-company innovations results in the generation of "suboptimal legal rights, particularly product design rights" *Id.* at 574. *See also*, Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378 (2008) (the importance of firm decision-makers having or obtaining legal knowledge in order to coordinate their firm's various innovation-creating activities).

[138] Companies fail to recognize and obtain trademarks that have been "found to positively impact shareholder value." *Id.*

The external use of contract law to create a competitive advantage is through its use in crafting strategic alliances with other firms. Such alliance-making has been called *contracting for innovation*.[139] Because of the fluidity and uncertainty of innovation, alliance agreements in this area need to blend hard, fixed terms with more open, flexible terms or standards. Hard and express terms provide firm protections and boundaries for each firm's investments and obligations.[140] Open and implicit terms and standards allow for greater flexibility of operation needed to fully exploit the collaborative effort and to generate the most innovation-related benefits. Striking a proper balance between such terms requires "a new form of contracting . . . [one that] supports iterative collaboration between firms by interweaving explicit and implicit terms that respond to the uncertainty inherent in the innovation process."[141] The difficulty of drafting sufficiently hard and soft; explicit and implicit terms creates problems for strategic contracting. Both sets of terms create potential for problem-making. Hard and express terms provide a degree of certainty, but may stifle innovation and collaboration later in the relationship. Soft and implicit terms provide discretion to one of the parties and thus, creates a moral hazard problem in which it selects a term favoring its own self-interest and not one that provides joint benefits for both parties.[142]

One commentator argues that contracts for collaboration, especially in the area of innovation, is not a thing but a process. Because of the uncertainty that is inherent in

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[139] See, Gilson, *Contracting for Innovation*.

[140] "Explicit contracts can protect, and thereby encourage, specific investments, which are often critical to transactions that contemplate more than a single simultaneous exchange." Gilson, *Contracting for Innovation* at 451-52.

[141] Gilson, *Contracting for Innovation* at 435.

[142] Gilson, *Contracting for Innovation* at 458.

collaborative innovation, contracts main function "is to institutionalize [a] learning process."[143] The contract provides a process conducive to innovative collaboration by avoiding hierarchical management structures and replacing them with "peer-reviewed systems of unilateral decision-making coupled with open information sharing."[144] Contract design in collaborative alliances for innovation need to continue to provide a certain level of certainty through standard terms that allocate risk, but also need to be strategically designed to provide a learning process or governance structure flexible enough to deal with the uncertainty of innovation and at the same time deter opportunistic behavior. A strategic contract balances the need to minimize the uncertainties inherent in innovation, while providing the flexibility so as not to inhibit the creative process. It does this by creating a customized governance structure able to deal with future uncertainties.[145] The next section will explore the concept of contracts as governance structures.

B. Contracts as Governance Structures

Governance structures are generally associated with the selection of a type of organization to conduct business. Business organizational structures are formed within a legal framework. In the area of statutorily-created entities the framework is pre-formed and ready for internalization in the resultant business organization. Whether founding parties select the partnership, corporate or limited liability form of doing business, this is only the first level in the

[143] Jennejohn, *Collaboration* at 88.

[144] *Id.* at 87.

[145] "The inability of the parties to specify ex ante the nature of the product to be produced or its performance characteristics means that the terms of performance will be determined by the very governance process the contract creates." Gilson, *Contracting for Innovation* at 435.

analysis of governance structures. Robert Bird explains that the second level of governance is internal to the organization-type selected.[146] Thus, the use of law as a source of strategic advantage is often fragmented within the operation of the chosen business organization. In order to better manage this fragmentation and to foster a more holistic strategic approach to corporate legal strategy, some business ventures use hybrid organizations so that they may create customized internal governance structures.

Privately-constructed governance structures and hybrid entities are created through contract.[147] As noted in the previous section, contractually-built governance structures are especially important in alliances between companies.[148] Coordination problems often develop, especially when the alliance partners are competitors in other areas. Coordination problems include the usurpation of alliance assets and the development of purely self-interested governance. One of the means of deterring such behavior is by building a formal-contractual governance structure That "can reduce some of the uncertainty in collaboration and give the

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[146] Bird, *Pathways* at 12.

[147] See Bryan Borys & David B. Jemison, *Hybrid Arrangements as Strategic Alliances: Theoretical Issues in Organizational Combinations,* 14 ACAD. MGMT. REV. 234 (1989).

[148] Gilson, Sabel & Gilson state:

> In [such an uncertain and fluid] environment, we observe contracts in which parties create elaborate governance mechanisms in lieu of the more familiar risk-allocation provisions of conventional contracts. The contracts can be arrayed along a continuum, ranging from contractual relationships that impose no formally enforceable obligations on the parties but that contemplate ongoing relationships of unlimited duration, to collaborative research agreements that look to the development of a particular product and a consequent end game. In each case, there is an iterated process of continuous collaboration and innovation that functionally substitutes for ex ante specification of the desired product.

Gilson, *Contracting for Innovation* at 449.

partners some confidence that the spirit of the agreement will be upheld, ultimately improving chances for alliance success."[149] The next section uses the strategic joint venture to illustrate the use of contract—the joint venture agreement—to create a private governance structure responsive to the particular concerns of the joint venture members.

1. Strategic Joint Venturing

Joint venture agreements should, and are often, highly customized contracts. The structure and content of such contracts are especially susceptible to one partner gaining a strategic advantage over another partner. This is especially true when the joint venture involves otherwise competing companies. The inter-firm collaboration anticipated by the partners in a joint venture can be threatened when one of the partners attempts to gain additional benefits, often not in the interest of the other partners or the joint venture. These strategic advantage gains by an opportunistic partner are used to conduct business outside of the joint venture.

A partner may provide confidential information to assure joint venture success. The fear is that contributed information and the information or ideas produced in the joint venture operation will be taken by another partner to gain a competitive advantage against other competitors, including partners to the joint venture.[150] If the purpose of the joint venture is the promotion of

[149] Rachelle C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. 909, 909 (2003).
[150] Allan W. Vestal, *"Ask Me No Questions and I'll Tell You No Lies:" Statutory and Common-Law Disclosure Requirements Within High-Tech Joint Ventures,* 65 TUL. L. REV. 705 (1991) (problems of high-technology international joint ventures regarding the exchange and use of proprietary information).

mutual interests through the joint venture enterprise, then it is vital that the joint venture agreement provides means to deter such strategic advantage-taking.[151]

Salbu and Braham note that strategic contract design to deter opportunistic advantage-taking will vary depending on the purpose of the joint venture. The purpose may be simply to share costs if expanding into new markets, whether geographically or in the development of new products.[152] They assert that the drafting of a purpose clause, which defines the scope of the venture, is a key strategic undertaking. Whether the clause should be tightly or narrowly drawn or whether it should be open and flexible in its mandate depends on the nature of the enterprise. A single purpose or single project venture may dictate a narrow clause. But, the strategic issue is how narrow should the clause be drafted? If the clause is too narrowly drawn or detailed it may be used opportunistically by one of the parties to prematurely terminate the venture.[153]

Salbu and Braham conclude that the strategic design of a joint venture should include "incentive schemes" to encourage altruistic or venture-enhancing conduct by individual partners

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[151] It is important to note that there are costs of using the equity joint venture as a means of coordination through internal governance structures:

> [T]he equity joint ventures permit firms to adapt to unforeseen contingencies that arise over the course of the alliance, [but] the mechanisms that facilitate greater coordination and control in an alliance also introduce bureaucratic costs. . . . Given these costs, firms should use equity joint ventures only where alliance activities require more substantial coordination and control.

Rachelle C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. 909, 917 (2003). See also, Rachelle C. Sampson, *The Cost of Misaligned Governance in R&D Alliances*, 20 J.L. ECON. & ORG. 484 (2004).

[152] Steven R. Salbu & Richard Braham, *Strategic Considerations in Designing Joint Venture Contracts*, 1992 COLUM. BUS. L. REV. 253, 255 (hereinafter Salbu, *Joint Venture*). *See also*, Steven R. Salbu, *Joint Venture Contracts as Strategic Tools,* 25 IND. L. REV. 397 (1991).

[153] Salbu, *Joint Venture* at 261.

and to deter self-interested opportunistic behavior by a partner at the expense of the venture. In the case of incentivizing altruistic behavior they suggest structuring rewards for partner conduct that confers benefits on the joint venture, especially when the benefit-conferring partner incurs costs.[154] The joint venture contract may provide any number of incentives including, "extending licensing privileges for the joint venture's products to a [partner] who makes a critical contribution to the development of that product.[155]

In the area of deterrence of opportunistic behavior by one of the partners, the creation of "reciprocal penalties" is suggested to punish and hopefully, deter a party from pursuing a self-interested, venture or partner-harming activity. In order to be successive in deterring such conduct the penalties in some cases will need to be severe. In such cases, they will likely serve a punitive purpose.[156] The problem is that penalties are unenforceable in the common law. Although, as earlier stated, the rule that penalties are not enforceable prevents the strategic use of penalties, it remains the law.[157]

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[154]Salbu, *Joint Venture* at 300.

[155] Salbu, *Joint Venture* at 301.

[156] The strategic rationale for the use of enforceable terms is to "terrorize" through supracompensatory damages to deter from the targeted misconduct. This poly can be seen in the employment area where many employers continue to use overly restrictive covenant not-to-compete. For a brief review of the complexities in designing an enforceable covenant not-to-compete see, Larry A. DiMatteo, *Contracts and Precedents*, 2009 TRANSACTIONS: THE TENN. J. BUS. L 262.

[157] See generally, Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633 (2001) (argues that penalty clauses serve appropriate purposes and our efficient in some contexts). *See also*, Ann Morales Olazábal, *Formal and Operative Rules in Overliquidation Per Se Cases*, 41 AM. BUS. L. J 503 (2004) (recommending judges avoid using actual damages arising from a contract breach as an indicator of whether the parties pre-breach estimate was reasonable, and instead adopt a prospective-only view of the reasonableness of damage stipulations).

Other devices to increase collaboration and deter opportunistic behavior iclude "significant mutual investment,"[158] establishment of an "indirect interlocking directorate,"[159] establishing 'shared ongoing risk,"[160] and "strategic ambiguity."[161] Significant mutual risk incentivizes the parties to the joint venture to collaborate in the goal of making the venture a success at least in order to recover their sunk costs. The benefits of a board of directors made up of representatives or managers from the parent companies is that it may lead to trust-building and greater cooperation. Much like the device of substantial mutual investment to align interests during the early stages of the venture, continued shared risk acts to keep those interests aligned. Finally, strategic ambiguity in the joint venture agreement may provide incentive for greater cooperation and, at the same time amplify the perception of shared risks. The shared risk effect is due to the uncertainty of risk produced by the strategic ambiguity.

Finally, a strategically drafted joint venture agreement addresses the issue of dispute resolution. A well-worded dispute resolution clause provides "a problem-solving framework prior to the development of disagreements."[162] If this fails, then it provides for an amicable

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[158] Michael A. Rabkin, *Tactical Interdependence and Institutionalized Trust: The Unrecognized Risk of Joint Ventures Among Competitors,* 7 DEPAUL BUS. & COMM. L.J. 63, 84 (2008).

[159] *Id.* at 88.

[160] *Id.* at 90.

[161] See George S. Geis, *An Embedded Theory of Indefinite Contracts*, 90 MINN. L. REV. 1664, 1680-82 (2006); B. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 AM. ECON. REV. 902 (1998).

[162] Salbu, *Parental Coordination* at 1228. See also, D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315 (2005).

method of terminating and unwinding the business through good faith negotiation, mediation and arbitration.[163]

The above review indicates the importance of managers and their lawyers working together in drafting a strategic joint agreement contract through the use of a variety of contract clauses ranging from highly specific terms to broader, more open ones.[164] In the end, the flexibility of contract law and the nuanced nature of joint venturing allow for, if not require, the strategic design of a governance structure in the joint venture agreement to enhance the chances of success.[165]

VII. CONTRACTARIANISM: THE STRATEGIC USE OF CONTRACT AS METAPHOR

The use of the contract construct, based primarily on the principles of private autonomy and freedom of contract rationales, have increasingly been used to explain all sorts of phenomena including legal, economic and political ones.[166] Contract itself has been used as a

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[163] See, e.g., D. Gordon Smith, *Uncorporation A New Age?: The Exist Structure of Strategic Alliances*, 2005 U. ILL. L. REV. 303 (contractual boards are "an important vehicle for discovering and disseminating information about the activities of the alliance, [but] also play a somewhat surprising role in the exit structure of many alliances: They serve as a means of exit without breach."

[164] Salbu, *Joint Venture* at 306.

[165] For a general review of contract drafting techniques, see generally, Symposium: *Teaching Drafting and Transactional Skills: The Basics and Beyond*, 2009 TRANSACTIONS: THE TENN. J. BUS. L. 3.

[166] "The 1980s and 1990s have witnessed perhaps an unprecedented growth of legal, political, and economic analysis based on a . . .'contractarian' model, which in turn, is built on an individualist, largely objectivist model. William J. Woodward, Jr., *Clearing the Underbrush for Real-Life Contracting*, 24 LAW & SOC. INQUIRY 97, 101 (1999). The problem with fabrication of contractarian models of areas outside of contract, especially by those will limited knowledge of contract law or contract theory, is they may have a simplified view of contract law. A simplified view rationalizes the institution of contract law

metaphor. Arthur Leff's seminal article *Contract as Thing*[167]analyzed the consumer from contract or contracts of adhesion. He argued that since there is not any real bargaining over standard form contract terms, classical contract's model of consent serves no useful purpose in explaining these types of transactions. Instead he proposed "a new way of thinking, a new metaphoric framework for thinking, about consumer 'contracts.'"[168] His metaphor was to view such contracts as "things"—that is, as part of the product being sold. And, such as the government regulates things like automobiles from a minimal level of quality and safety it could regulate the contract for minimal levels of quality. Finally, he notes that actual governmental regulation may be minimized since the threat of government regulation should lead to greater disclosure and thereby "increase the power of the market to control the price-quality mix."[169]

The contract as thing analysis was taken from an internal perspective of contract law. In more recent times, contract has been used as a metaphor and applied to areas external to contract law. The construct as metaphor is applied by constructing idealized, hypothetical contracts. Jean Braucher has labeled such theoretical applications as "contractarianism."[170] The problem with such uses of the contract construct is that users of the construct do not appreciate the important distinction between the theoretical use of the contract construct and the actual nature

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as representing a single or a cluster of related purposes or theories. A common cluster is the purpose of contract law is to advance personal freedom or private autonomy, and thereby it is purely characterized as a privately controlled, individualistic domain. For an argument against the uselessness of such an understanding f contract law see, Peter A. Alces, *Unintelligent Design in Contract*, 2008 U. ILL. L. REV. 505. Professor Alces states that any theory of contract is at best a heuristic and heuristics are "necessarily over-and under-inclusive, much like all rules." *Id.* at 558.

[167]See Arthur A. Leff, *Contract as Thing*, 19 AM. U. L. REV. 131 (1970).

[168] *Id.* at 131.

[169] *Id.* at 157.

[170] Braucher, *Contractarianism*.

of contract law.[171] The application of the construct is usually premised on an iconic view of contracts as a bastion of private autonomy when, in fact, contract law is an amalgamation of private and public inputs—it is both facilitative (freedom-enhancing) and regulatory (freedom limiting).[172] Despite these shortcomings, the contract construct is being used strategically to develop theories to explain other legal and non legal phenomena. [173] The next three sub-sections provide three examples of this phenomenon: psychological contract theory in employment law, nexus of contracts theory in corporate law, and the limited liability company as contract.

A. Employment Law and the Psychological Contract

A deep literature has developed around the idea that the employment relationship creates a psychological contract. This view sees the employment at-will relationship which allows for termination without cause to be nonetheless controlled by a psychological contract.[174] This psychological contract, taken from the perspective of the employee, creates employer "obligations." Alternatively stated, the employees reasonable perceptions and beliefs of the

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[171] "Legal theorists in recent years have developed 'contract as a central concept to explain more and more topics." Braucher, *Contractarianism* at 697.

[172] Because of this, Braucher asserts that "contract [law] . . . is not contractarian." Braucher, *Contractarianism* at 699.

[173] See Kim L. Scheppele & Jeremy Waldron, *Contractarian Methods in Political and Legal Evaluation*, 3 YALE J.L. & HUMAN.. 195 (1991); T. M. Scanlon, "Contractualism and Utilitarianism", *in* UTILITARIANISM AND BEYOND, 110-15 (Amartya Sen & Bernard Williams eds., 1982); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 566-67 (1993);

[174] See generally, Denise M. Rousseau, *New Hire Perceptions of Their Own and Their Employer's Obligations: A Study of Psychological Contracts*, 11 J. ORG. BEHAV. 389 (1990).

nature of her employment relationship establishes a psychological contract. What is this purpose or goal of the psychological contract? What does it have to do with the law of contracts? What are the contract rationale or rationales that underpin this theory of employment? An answer to the first question is that it is a theory which may lead to the legal recognition of employer obligations, but under the present employment at-will regime it has little relevance.

An answer to the second question is that it has nothing to do with the law of contracts. The law of contracts states that, unless there is an express employment contract, a collective bargaining agreement, or a court recognizes the implied-in-fact or good faith duty exceptions to employment at-will, the employer owes no obligations to the employee in relation to termination. It can be argued that the psychological contract is akin to the implied-in-fact or good faith duty exceptions to the employer's right to discharge an employee without cause. Some of the same contextual factors used to build a case for one of the exceptions are also prominent in psychological contract theory. However, the fact that a majority of states do not recognize these exceptions render the idea of a psychological contract a poor use of the contract construct.

An answer to the third question is that contract law traditionally is premised upon a promissory rationale. In psychological contract theory, the implication is that the employer by word or conduct implicitly promised that the employee was entitled to certain protections greater than employment at-will.[175] Contract law also recognizes the notions of reliance and reasonable expectations as a source of obligation. Transferred to psychological contract theory it would be

[175] See, S. M Framer & & D.B. Fedor, *Volunteer Participation and Withdrawal: A Psychological Contract Perspective on the Role of Expectations and Support*, 9 NONPROFIT MGMT. & LEADERSHIP 349 (1999).

argued that the employer has an obligation to meet the reasonable expectations of its employees.[176]

From a strategic perspective, there is much the employer can due to prevent the formation of an implied contract in law or the so-called psychological contract. The wide use of disclaimers on employment materials that nothing in the materials changes the at-will nature of the employment can be supplemented by a thorough review of the materials to modify language that would cause an employee to believe that she would only be discharged with cause. Any policies related to employer obligations and termination rights should be applied consistently to all employees. The at-will nature of the employment should be reaffirmed from time to time to defeat the claim that an implied contract was formed subsequent to the beginning of employment. Finally, the employer could consider providing various severance packages to be provided based on length of employment in order to contractually confirm the at-will nature of the employment. It also provides a means of placating discharged employees.

B. Corporation as Nexus of Contracts

The nexus of contract theory is an example of the inherent flexibility of contracts and the contract construct. In a market-based system, flexibility and adaptability are the basis for efficiency in business and transactions. The corporation, seen as the engine of capitalism, can be explained as based on a series of contracts (corporation-shareholder, corporation-employees, corporation-suppliers, and so forth). To support this thesis, the argument must be that the nexus of contracts view provides a theoretically efficient way to organize corporations.

[176] D. M. Rousseau, *Psychological and Implied Contracts in Organizations*, 2 EMPLOYEE RESPONSIBILITIES & RIGHTS J. 121 (1998).

Corporation as a nexus of contracts rejects the traditional view of the corporation as an entity created by the state and thereby consents to be regulated by the state.[177] Since it is a creature of the state, whatever rights and powers bestowed on it are not proprietary per se, but can be taken back at the whim of the state. The view of the corporation as a contingent entity whose existence is due to a privilege given by the state sees the corporation as a quasi-public institution subject to broader regulatory control. As such, it has a greater duty than shareholder wealth maximization. It also has a duty of corporate responsibility to the greater community of stakeholders.[178] In contrast, nexus of contracts theory "views the corporation as founded in private contract, where the role of the state is limited to enforcing contracts. In this regard, a state charter merely recognizes the existence of a 'nexus of contracts' called a corporation."[179] And, like any other contract, the parties that form the corporation and the relationships created within the corporation can be freely structured under the freedom of contract rationale.

The difference between the nexus of contract of corporations and the corporation as a quasi-state entity is immense for purposes of the strategic engineering of the corporate contract (corporate charter, bylaws, shareholder agreements). The nexus view provides a greater mandate to create a corporation solely to benefit controlling shareholders and their alter egos—the officers and directors. The nexus view also asserts that the government's role in regulating

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[177] One commentator reviews contemporary theory of the corporation and concludes that the "nexus-of-contracts theory is the predominant theory of today's modern corporation." Fort, *Banded Contracts*.

[178] See, John Boatright, *What's So Special About Shareholders?*, 4 BUS. ETHICS Q. 393 (1994). Compare, Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

[179] Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 100 (1989). *See also*, Bratton, *The 'Nexus of Contracts' Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1986) (reviews the different conceptions of nexus of contract theory of the corporation); Michael Klausner, *Corporation, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

corporations should be kept to the minimum. A nexus view treats the corporation as a series of *private* contracts. Therefore, the corporation is free to reject any ethical duty to contribute to the common good through acts of social corporate responsibility.[180] However, Fort and Noone assert that if a corporation is a series of contracts, then that implicitly rejects the paradigm that the shareholders are the sole stakeholder. The other contracts in the nexus, such as corporation-employee, corporation-supplier, and corporation-community.[181] These contracts expand the number of stakeholders that the corporation owes duties. Since the relationships are contractual in nature, it can be argued that those dealing with the corporation obtain stakeholder status because the corporation has an obligation to keep its promises, express or implied, with its contracting parties and to act in good faith.[182]

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[180] "[T]he notion of contracts within corporate legal theory because contracts are used as a model both by those who advocate minimalist, agency business duties and by others who propound a broad business ethic." Fort, *Banded Contracts* at 154.

[181] A basis for of a corporation-community contract would be that by obtaining tax abatements the corporation is entering into an implied contract that creates a corporate obligation to give back to the community.

[182] The picture gets a little more complicated when one considers that there are multiple nexus of contract approaches. The two main schools of nexus of contracts theory are the agency theory of contracts and social contract theory. The former view is premised on a limited view of human nature. Under agency theory, human interaction and contracting is solely characterized as adversarial and opportunistic in nature. Social contract theory takes a broader communitarian view of human relationships. See OLIVER WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975) (agency theory); Thomas Donaldson & Thomas W. Dunfee, *Toward a Unified Conception of Business Ethics: Integrative Social Contracts Theory*, 19 ACAD. MGMT. REV. 252 (1994)
(social contract theory).

Fort and Noone than use the contract construct to develop a business ethics as social contracting model based initially on social contractarianism.[183] They argue that contracts in the corporate setting are not merely creatures of private autonomy, but are also influenced by social context. Their theory of banded contracts sees corporate contracts are products of private autonomy within the limits imposed by social context.

All of the above models provide a greater or lesser opportunity for strategic planning. Under the pure freedom of contract approach within nexus of contract theory, the corporate founders have the opportunity to create governance structures most advantageous to their interests. The modified freedom of contract approach of Fort and Noone uses the notion of multiple contracts as a recognition of the existence of multiple stakeholders. This approach requires the corporation to take into account the concerns of these other stakeholders. This suggests that the freedom of contract possessed at the inception of the corporation is diminished once the corporation creates additional stakeholders through subsequent contracts. Nonetheless, strategic contracting allows the corporation to frame their obligations under the subsequent contracts. Finally, the development of smaller groups within the corporation that act as mediating institutions[184] can be encouraged or discouraged by corporate management. That decision is strategically important.

C. Limited Liability Companies: A Case of Abusive Strategic Planning?

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[183] Fort, *Branded Contracts* at 191-202. *See also*, Janet McCracken & Bill Shaw, *Virtue Ethics and Contractarianism: Towards a Reconciliation*, 5 BUS. ETHICS Q. 297 (1995); Timothy L. Fort, *The Corporation as Mediating Institution: An Efficacious Synthesis of Stakeholder Theory and Corporate Constituency Statutes*, 73 NOTRE DAME L. REV. 173 (1997).

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A recent use of the contract construct is in the governance of limited liability companies (LLC). Business organization governance is a mix of private autonomy (customizing company bylaws and policies) and government regulation. The LLC model pushes the mix towards the private autonomy end of the continuum. Founding members, under most state statutes, have freedom to create an operating agreement to serve their strategic interests even if those interests are not aligned with the interests of the non-management members of the LLC. In essence, freedom of contract in drafting the operating agreement allows managing or controlling members to escape the template regulatory regime and create their own private legal regime.[185]

The freedom of contract paradigm that underlies limited liability companies allows for broad flexibility in strategically drafting the operating agreement. I will make a distinction here between proper and improper strategic drafting. This distinction is used because a distinction based on legality is insufficient—that is, improper terms may be perfectly legal under some states' LLC statutes. The argument here is the freedom of contract construct can lead to contractual abuse albeit, a legal sanctioned abuse.

Most state business organization laws, such as corporation, limited partnership, and general partnership law, limit the ability of those entities to construct there won governance structures. These limitations range from specific rights, such as rights to information, accounting, preemptive and dissolution rights, and broad fiduciary duties to those that manage the company. It is believed that these devices are needed to protect the owners, regulate conflicts of interest, and to align owner and management interests. In contrast, to the long history of immutable

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[185] See William J. Woodward, Jr., *Clearing the Underbrush for Real-Life Contracting*, 24 LAW & SOC. INQUIRY 97 (1999). Woodward states that "[i]n scholarship, [some have] deployed economic analysis to assert that businesses should be able to 'choose' their law by contract and thereby transport themselves to a different (and presumably less regulatory) legal regime." *Id.* at 101.

fiduciary duty law, the Delaware LLC statute allows for an elimination of those obligations.[186] The elimination of the duty of loyalty (duty to act in the best interest of the company) and the duty of care (to make good faith, informed decisions on behalf of the company) gives the member manager almost unlimited power and allows for self-interested decision-making, self-dealing, usurpation of company opportunities, and to act in a grossly negligent manner in supervising the affairs of the company. Delaware's complete embrace of the freedom of contract paradigm for LLCs allows for a great deal of strategic planning possibilities in establishing the LLC. The downside, as noted above, is that freedom can lead to abuse due to the elimination of fiduciary duties.

The middle and more prudent model is to maintain the contractual flexibility that underlies the very existence of LLCs, but to manage strategic opportunities for abuse through the recognition of a "mandatory core" of duties.[187] Sandra Miller challenges the "contractarian theory" that the LLC is merely a private contract. Instead, she asserts that the LLC, like other business organizations, is a social entity requiring mandatory fiduciary duties that require the

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[186] Delaware General Corporation Law (DGCL), Del. Code Ann. Tit. 6, §§ 17-1101(d) & 18-1101(c). See generally, Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L. REV. 221 (2009) (argues that an operating agreement that eliminates fiduciary duties should be honored and that no default fiduciary duties should be implied). Compare, Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 AM. BUS. L. REV. 243 (2009) (supports Miller's mandatory core approach , but argues that there are numerous contract law doctrines that can be used to police LLC governance).

[187] The mandatory core approach is advocated and discussed in Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L. REV. 243 (2009).

managing member to act in the best interest of the company in order to not only protect non-controlling members, but also other stakeholders like employees and creditors.[188]

VIII. CONTRACTS, ETHICS, AND OTHER AREAS OF MAYHEM

This Part briefly reviews regulation and strategic responses to regulatory interventions. Although not related directly to contract law, it focuses on the social contract between society as represented by regulators and the regulated. It examines whether strategic decision-making should include a legal strategy of non-compliance and regulatory avoidance. The second section analyzes the impact of strategic contracting on existing contract law.

A. Strategic Responses to Regulation

Immanuel Kant's most famous categorical imperative is the duty to obey law.[189] As a moral proposition it is difficult to argue with a general obligation to obey the law. One may venture a general exception for the appropriate use of civil disobedience in the face of a morally

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[188] *Id.* at 278.

[189] "A moral imperative is unconditional, i.e., categorical . . . A moral imperative commands unconditional conformity of our subjective maxim to a law . . . if moral, it should contain no condition which would prevent it from being *itself* a law." Kant further states that "[d]uty is the necessity of an action executed from respect for law." IMMANUEL KANT, FOUNDATIONS OF THE METAPHYSICS OF MORALS xii, 16 (trans. & intro Lewis White Beck 1985). For an analysis of the application of Kantian ethics to contract law see, LARRY A. DIMATTEO, EQUITABLE LAW OF CONTRACTS: STANDARDS AND PRINCIPLES 38-41, 233-237 (2001).

reprehensible law.[190] However, in the era of the administrative state, corporations often face ethical dilemmas between strict observance of the vast federal and state regulatory regimes and strategic decisions to ignore or circumvent certain regulations. Kant's overarching imperative that we all owe a duty to not harm[191] others mandates strict adherence to regulations that directly impact issues of safety, privacy, and environmental harm. But, when such harm is not directly implicated, a utilitarian analysis may be used to justify less than strict compliance. Under this view, law and regulation are seen as obstructions and costs to be avoided. One implementation of this view is the idea of "legal arbitrage" where a firm takes advantages of difference in laws between states, between state and federal, and between countries.[192]

A decision to strategically manage compliance or non-compliance may be plausible under a number of scenarios: (1) the regulation is merely serves revenue-generating purpose, (2) a regulation may be underenforced, (3) regulations provide loopholes or exceptions that can be exploited, (4) the penalties assessed do not adequately deter noncompliance, and (5) mechanisms in the regulation such as defenses or the recognition of mitigating factors allow a strategic approach of noncompliance to be cost-effective.[193]

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[190] For a modern application of natural law theory, and the inherent morality of disobedience to manmade laws in conflict with the higher law, see Blake D. Morant, *The Teachings of Dr. Martin Luther King, Jr..and Contract Theory: An Intriguing Comparison*, 50 ALA L. REV. 63 (1998).

[191] The duty not to harm is related to Kant's maxim that a human being can never be a means to an end: "[E]very rational being exists as an end in himself and not merely as a means to be arbitrarily used by this or that will." *Id.* at 46.

[192] Bird, *Pathways* at 15.

[193] Daniel T. Ostas, *Legal Loopholes and Underenforced Laws: Examining the Ethical Dimensions of Corporate Legal Strategy*, 46 AM. BUS. L.J. 487 (2009) (discusses the issues of breach and pay, strategic contracting, concealment and compliance). See also, Daniel T. Ostas, *Cooperate, Comply, or Evade? A Corporate Executive's Social Responsibilities with Regard to Law*, 41 AM. BUS. L.J. 559 (2004); GEORGE

The first category of strategic regulatory avoidance targets regulations whose focus is not on issues of safety or public health, but are merely meant to generate revenues. In cases where the cost of compliance outweighs any fine to be paid, and there are no issues of loss of certifications, permits, or licenses, a firm may elect avoidance. In under-enforced regulations, the compliance-avoidance decision is likely based on a probability calculation in which the likelihood of detection is multiplied by the expected fine or punishment. If the cost of detection is less than the cost of compliance, then noncompliance would be a strategically appropriate decision. However, like any utilitarian analysis, a utility calculation too narrowly construed may lead to an inappropriate decision. Indirect costs in the above scenario would include costs to reputation as a law-abiding company, increased likelihood of detection due to increased regulatory scrutiny, and the probability of escalating fines for future acts of noncompliance. These costs may be managed through the strategic use of mitigating factors, such as due diligence, as provided by the regulations or ancillary law.[194]

Professor Ostas emphasizes that the management of legal processes and institutions is an important component in any firm's overall corporate or business strategy.[195] An example can be

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J. SIEDEL, USING THE LAW FOR COMPETITIVE ADVANTAGE (2002) (due to the explosion of laws and regulations pertaining to businesses companies need high quality legal counsel to obtain competitive advantages within such a dense regulatory network).

[194] An example would be the recognition in the Federal Sentencing Guidelines of mitigating factors, such as due diligence (compliance programs), self-reporting, and cooperation with the investigation. U.S. SENTENCING GUIDELINES MANUAL (2008); 18 U.S.C. §§ 3553 (2009).

[195] "Managing the legal process efficiently provides firms with a competitive advantage. It is not surprising . . . that firms routinely bring law and lawyers into the strategic planning mix." Ostas at 487. Ostas notes that what may be good corporate legal strategy may present the attorney with an ethical dilemma: "The lawyer has an ethical duty to provide information about the law to the client, but the lawyer also has a societal duty to help support respect for substantive law." *Id.* at 495, citing, Stephen L.

taken from securities laws. The popularity of the use of the limited liability company business organization and exemptions provided in the securities laws allow promoters to limit their liability and to avoid a great deal of regulation. The strategic decision, given the amount of money needed to be raised and the number of investors needed, may be to make limited offerings, such as a private placement[196] or one of the other exemptions to the securities laws.[197]

B. Feedback Loop: How Does Strategic Contracting Impact Contract Law?

Sociological theory notes the circularity of the social order (including, the legal order) and real world activities. Anthony Giddons once proclaimed that "people's actions are enabled and constrained by the social order. … [But,] it is also affected by the action that it enables and constrains."[198] A contract example of this circularity is the evolution of franchise law. The freedom of contract paradigm allowed the franchisor to strategically control the franchisor-franchisee relationship. This strategic control is ultimately based upon the threat to terminate or to not renew the franchise despite the fact that the franchisee had invested substantially into the

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Pepper, *Counseling at the Limits of the Law: An Exercise in Jurisprudence and the Ethics of Lawyering*, 104 YALE L.J. 1545 (1995).

[196] Securities Act of 1933, 48 Stat. 4, codified at 15 U.S.C. § 77a et seq., Rule 506.

[197] *See, e.g., Id.*, Rules 504, 505, & § 4(6).

[198] Hinthorne, *Predatory Capitalism* at 252, *citing*, ANTHONY GIDDONS, THE CONSTITUTION OF SOCIETY: OUTLINE OF THE THEORY OF STRUCTURATION (1984).

franchise operation. Eventually, this threat and strategic imbalance was partially offset by changes in contract law, some through doctrinal change and some through legislative intervention, to provide safeguards against arbitrary terminations or bad faith non-renewals.

Given the fact that contract law is private common law, there is a feedback loop that channels real world developments back to the law that helped facilitate those developments. Current contract law is much more flexible than the contract law of the early part of the 20th Century. The creative use of strategic contracting will ultimately be recognized by the courts and result in adjustments to contract law. The modern law of contract of the first decade of the 21st Century will be different from the contract law of middle part of the 21st Century due to this feedback loop. This is due to the natural, organic development of contract law as it responds to changes in business practice. This organic growth is largely due to the needs for greater or more flexible means of coordination required by new ways of conducting business, such as contracts for innovation and collaborative alliances.[199] Strategic contracting is based on contract law's inherently flexible nature as private law created by the contracting parties. The inherent flexibility of contract law is apparent given the variety of contracts types that are in its domain—from contracts for the purchase of fungible goods to contracts for the construction of a turnkey manufacturing plant. It is in contract law's flexibility, as well as contracts blending of precise and open terms, that opportunities for strategic contracting exist.[200]

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[199] Salbu, *Joint Venture* at 255, citing Ian Macneil. *See* Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law,* 72 NW. U. L. REV. 854 (1978); Ian R. Macneil, *A Primer in Contract Planning,* 48 S. CAL. L. REV. 627 (1975).

[200] The strategic use of contracting has less power for those that argue that formal contracts serve a minimal level of importance in most business relationships. See generally, *Stewart Macaulay*, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963) (noting that, in

CONCLUSION

Too often managers and executives view lawyers and the law as necessary evils—obtrusive and costly ones at that. The sophisticated business-person sees the lawyer and her command of the law as a source of strategic advantage. They are incorporated as an important player in the management team whose advice is solicited throughout the process of business decision-making. This article surveyed one component of law—the law of contracts—as a source of competitive advantage. Contracts is broadly construed to include not only strategic contracting, but also the strategic use of contract doctrines, regulation, licensing of intellectual property, creation of patent pools, and to establish private governance structures.

As a survey, it provides illustrations of some of the many ways that contracts can be used strategically. It analyzes the use of contracts as value creators by looking at its use in the comodification of information, outsourcing, franchising, and in creating collaborative alliances. It also examine the contract construct's use in other areas of law including, nexus of contract theory in corporation law, the psychological contract in employment law, and the freedom of contract paradigm in limited liability company law.

The ultimate conclusion is that law and strategic management are intricately connected. A good corporate strategy is incomplete without a good legal strategy. The firms that best assess and incorporate the legal environment of their business are the ones more likely to gain competitive advantages. In the era of technology, information, and innovation, law plays an ever

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the business world, planning of exchange relations and use of legal sanctions to settle disputes are seen as unnecessary and undesirable).

important role in obtaining and sustaining competitive advantages. This article asserts that contract law plays a pivotal role in fostering such advantages and in the creation of value.