The Role of Institutions in the Contractual Process

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ABSTRACT

Human beings increase their productivity by specializing their resources and exchanging their products. The organization of exchange is costly, however, because specialized activities need coordination and incentives have to be aligned. This work first describes how these exchanges are organized in an institutional environment. It then focuses on the dual effect of this environment—as with any other specialized resource, institutions may be used for expropriation purposes. They enjoy specialization advantages in safeguarding exchange but they also make possible new forms of opportunism, causing new costs of exchange. Three perverse tendencies are identified: In the legal field, there is a surplus of mandatory rules and, at the same time, a deficit in default rules. Second, courts' activity is biased against the quasi-judicial role of the parties and the market. Third, Market enforcement is based on reputational assets that are badly exposed to opportunism.

Key Words: contracts, institutions, enforcement, safeguards.

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THE CONTRACTUAL PROCESS

In all contractual processes, exchanges have to be completed and enforced. Contractual completion involves ascertaining the efficient terms of the exchange. Enforcement means ensuring that these terms are complied with. Problems arise in contractual completion mostly because of lack of information, whilst the problem of enforcement is related to informational asymmetries between the parties, which makes them prone to opportunistic behavior.

Information scarcity explains the variety and complexity of mechanisms used to complete contracts, i.e. to accurately define the terms and conditions of the exchange or the commitments between the parties. This definition can occur ex ante or ex post—i.e. before or after the parties become committed to each other. It may be carried out by the parties themselves and/or by various social institutions, in particular the legal/court system, involvement of which to a large extent reduces the seriousness of the information problem.[1]

		INDIVIDUAL SOLUTIONS (internal to the parties)		INSTITUTIONAL SOLUTIONS (external to the parties)	
		Unilateral	Multilateral	Decentralized	Centralized
CONTRACTUAL COMPLETION	EX ANTE	EXPLICIT CONTRACTING		NORMS AND RULES	
		Contracts drawn up by one of the parties only (standard form contract)	Explicit contracts negotiated by both parties (joint contracts)	Usage and custom	Common Law Codified Law Statutory Law
	EX POST	RELATIONAL CONTRACTING		JUDGEMENT BY THIRD PARTIES	
		Authority (e.g. employment and franchise contracts)	Contractual definition of decision-making rules and bodies	Judgment of the parties' conduct by market participants	Litigation (by judicial judgments)
ENFORCEMENT		INTERNAL SANCTIONS		EXTERNAL SANCTIONS	
		Asymmetric sanctions in exercise of authority	No repetition of transactions; hostages	Loss of reputation in the market or in society (ostracism)	Police (enforcement of judgments)
		PRIVATE SOLUTIONS			PUBLIC SOLUTIONS

Four types of contractual completion result. In *explicit contracts*, the parties make express provision for a very limited set of the many possible situations which may arise and the steps to be taken in each of them. The *normative system* (customs, usage and laws—in essence, norms and rules in the terms used by North 1981) provides the parties with a detailed standard contract, filling in many of the gaps left out of their explicit contract and predetermining the contract when the legislator considers it necessary. Decision-making bodies and rules established by the parties constitute *relational contracts* capable of efficiently solving unforeseen situations. Lastly, the *judicial system* "closes" the contract, providing solutions for all remaining unforeseen situations and developing the standard contract through case law. The accompanying figure summarizes these possibilities, taking into account also the fact that either one or more parties may play a leading role in individual or internal contracting and that institutional contracting may be centralized or decentralized.

Whatever the content of the exchange, the proclivity of individuals to advance their interests requires enforcement to ensure they perform their contractual obligations. Different enforcement mechanisms require different degrees of observability with respect to performance: With *first-party* enforcement it is the individual in breach who will evaluate and sanction his own conduct. Evaluation takes place in relation to his own moral code and the sanction consists of a certain psychological suffering which takes different forms, related to religious conviction and self-esteem. *Second-party* enforcement is based on verification and sanction by the party suffering the consequences of breach, who may break off the relationship with the other party or appropriate some hostage or security. Lastly, *third-party enforcement* requires

verification by third parties. It comprises centralized systems, such as arbitrators and judges, and decentralized systems. The latter include the quasi-judicial activity of other participants in the market (breach harming reputation and hindering future contracting) and social mechanisms by which human groups ostracize non-performing members.

These contractual solutions may function as substitutes or complements, both horizontally and vertically, in terms of the previous figure.

In principle, legislation defines facilitating rules under which the intention of the parties overrides the provisions of the legal text, which only prevails in the absence of relevant private provisions. To this extent, private solutions dominate legal solutions in ex ante completion. This situation is most typical in 19th century codification and also in Anglo-Saxon common law.[2] This priority, however, has been inverted in much subsequent legislation, particularly in that passed during the second half of the 20th century, in which the proportion of mandatory rules is considerable, even within the ambit of commercial transactions. On the other hand, virtually all private ex post completion is subordinated to the judicial system, so that it is generally impossible for the parties to deprive themselves ex ante of the (not always desirable) possibility of appealing against their decisions ex post. For these reasons, rather than complementarity among solutions, there is now interference, with institutional solutions reducing the scope of individual solutions.

With respect to substitutions between ex ante and ex post solutions, these are highly varied. Firstly, in the private field it may be thought that the more the contract is completed ex ante, the less it is necessary to complete it ex post. However, the functioning of ex post decision-making bodies and rules makes it more necessary to devote resources to ex ante completion, at least to provide for the basic elements of

such bodies and rules. In the institutional field, there is a particular interaction: to the extent that litigation leads to case law, ex ante completion is developed to a greater extent and can be expected to reduce recourse to litigation.

In summary, parties contract within a sophisticated environment made up of the market, the law, and social and moral constraints. This institutional dimension is not a complement but the main feature of the contractual process and there are substantial substitutions and complementarities between most elements of the contractual process.[3]

The rest of the chapter will set aside moral and social solutions and focus on those mechanisms for which political actions are more important. This abstraction of moral and social mechanisms makes more sense now than at earlier stages of development because, throughout history, institutional solutions have become increasingly specialized. For example, the separation of Church and State required differentiation between moral and legal solutions. The same happened later with the separation of the legislative, judicial and executive powers of the State.

EX ANTE LEGAL COMPLETION

Irrespective of the degree of detail that the parties introduce when contracting, the content and terms of the exchange are further defined by the series of rules and norms in force in the field in which the contracting occurs. When it takes place in an institutional environment of a legal nature, exchanges are carried out in accordance with a very extensive contract, even though the parties themselves only expressly agree on the most basic elements of the exchange. Thanks to this legal support, the parties do not need to define separate sets of contingencies and compensation. All they need to do is

adapt the standard contract, of great complexity and scope, which the institutional environment both explicitly (by legislation and case law) and implicitly (by conflict solution mechanisms, including litigation) provides for them. These institutional tools enable most exchanges to be completed effectively. The cost of contracting is thus considerably reduced and the parties use highly detailed contracts without having to write them down or even being aware of them. In other words, the cost of writing contracts defining the content of the exchange is reduced because contracts are written in an institutional framework established by the law and ancillary institutions, not in a direct one-to-one relationship between the parties.

Legal completion can thus be seen as a rationalization mechanism. The rationality of the parties is *bounded* when contracting since the contract is not usually of sufficient scope and the parties are not usually in a position where it is worthwhile devoting the necessary resources to completing it, not even to the extent of defining the content of the exchange in a series of likely contingencies. This limitation relates to the *intellectual* rationality of the parties and is a direct consequence of individual mental activity. By settling for the law, the parties opt to base completion of the contract on rationality of an *evolutionary* type, which has generated the greater and more durable part of the law.[4] The parties can thus contract in ignorance, without knowing details of the content of their rights and obligations, trusting in the efficiency and good sense of their legal definition. (This analysis justifies in efficiency terms the objective of legal security so dear to the law, by stressing the necessity that the law and its consequences must be easy to predict).

Certainly, consideration of law as the outcome of evolutionary rationality and, even more, of the efficient nature of norms and rules must be interpreted in relative and not

absolute terms. The reason lies in the systematic survival, at least in the short term, of inefficient norms originating in the application of an intellectually defective rationality or, certainly more frequently, an inefficient collective decision motivated by rent-seeking activities in the legislative field. In short, although intellectual rationality and problems of collective action are important in the genesis of legal rules, their survival in the long term constituting a stable legal *corpus* is, at least in the final instance, governed by a logic of competitive adaptation. To the extent that this occurs, we can rely on this legal corpus being generally efficient.

More precisely, two main sources need to be considered in legal completion: customary law, including judicial precedent, which is more important in the common law tradition, and statutory law, which is more important in the civil law tradition. Both sources are closely connected and differences have probably been exaggerated. First, all statutory law is a mixture in variable proportions of evolutionary and intellectual rationality, with 19th century codified law being mainly the distillation of customary law. Second, codified systems of law also benefit from customary law prospectively—the existence of a code does not eliminate the normative capacity of the courts. In the words of Savigny, "codes are not more than geometric dots—jurisprudence draws the lines". It is not even clear to what extent statutory law is more prone to fall prey of inefficient rent seeking than confrontational litigation. The balance probably hangs on whether the political market or the litigation process is closer to perfect competition.

In addition, particular forms of legal completion may serve other purposes. For instance, codification has been used to prevent judicial opportunism by restricting the discretion of the courts. As far as a judiciary is needed for enforcement purposes, a crucial issue is then to contain opportunistic litigation that expands the functions of the

courts in an inefficient way. This allows the parties to be relatively free of the risk of opportunistic litigation, which seems to be more prevalent in common law legal systems, especially when courts are allowed to decide on the basis of equity. Certainly, civil law codes contain seemingly flexible concepts such as "good faith", but their meaning is usually unambiguously defined in informational or intentional terms.

Facilitating and Mandatory Rules

Before discussing the failures of the legislative process, a distinction should be made between the roles of the two main types of legal rule, facilitating and mandatory, since they often respond to very different logic. Firstly, *facilitating* or enabling rules can be modified at the will of the parties when they state as much in the contract. They thus fit fully into the efficient argument, since their purpose is to reduce the cost of contracting, providing the parties with a standardized solution to the most typical or common problems that arise with different types of contract. On the other hand, *mandatory* rules are binding on the parties who cannot modify or exclude them. Their existence can be justified by failings in free contracting, whether such failings lie in the presence of external effects or in the irrationality of the contracting parties.

Although important, the distinction between facilitating and mandatory rules becomes blurred and a question of degree when taking into account the implicit coercive capacity of facilitating rules. When agreeing on terms, in a situation of informational asymmetry between the contracting parties, the latter are not entirely free to depart from the facilitating framework since, when trying to do so, they run the risk of being misinterpreted and endangering their negotiating position and, therefore, the

contract itself. A function of the law is to prevent the parties from having to manifest their desire to include a particular clause in the formal contract. Such a manifestation can often generate mistrust in the party receiving the proposal, because it indicates that the person suggesting it has some potentially conflictive characteristics (mistrust, informational advantage and, in particular, little disposition to perform). Likewise, proposing a clause that varies from the provisions of the enabling legal rule could be interpreted as a sign of the problematical contractual characteristics presented by the proposer. In these conditions, the facilitating rule to some extent operates as mandatory in cases in which it is costly for one of the parties to depart from it. In these cases, and to the extent that a substantial proportion of contracting parties are faced with this problem, it can nonetheless be expected that contractual usages which avoid the problem will develop. The matter is thus of some short-term importance during the adaptation period following promulgation of facilitating rules that depart from the customary pattern previously established in the corresponding market.

Excess of Mandatory Rules

Human creations rarely respond completely to a logic of efficiency, and legislation is no exception. Although it is arguable whether the inefficiencies and failings are more or less long-lasting, imperfections in the collective decision-making process which legislation generates convert it into a useful instrument for rent seeking, and it matters little to the beneficiaries that its facilitating purpose is thereby undermined, thus converting it into an obstacle to private contracting, exchanges and productive specialization.[5]

In the field of private law, two general types of defect are possible, which translate into an excess or deficit of legislation. It will be argued here that excesses and deficits tend to affect mandatory and facilitating rules respectively . In both cases, social optimization is sacrificed to individual private interests. In the first case, to those of contracting parties and, in the second, to those of intermediaries.

A large number of mandatory rules that govern private contracting are not the result of a logic of external effects or imperfect rationality. They respond, rather, to a desire to achieve advantages or redistribution of wealth. The most important origin of inefficiencies in the legal system surely occurs when some parties to a pre-existing contract or series of contracts manage to legalize breach of their obligations by passage of a new mandatory rule or Act applied with retrospective effect.

Assume, for example, that the parties to a lease were completely free to agree on any terms as to price and period such as, for example, a fixed rent, long term and freedom for the tenant to terminate the lease. These terms are onerous on the lessor and therefore, when he asks for higher rent as compensation, the lessee may prefer to omit them, agreeing on a variable rent, shorter period and/or payment of compensation if he terminates the lease early. It is understandable, however, that after signing leases of this type, lessees have an interest in seeing an Act passed which freezes rents or introduces a system of minimum periods and will support political intermediaries who achieve this, however much such rules may damage future lessees.

The problem affects not only leases but all types of contract, with examples as varied and bountiful as contracts themselves: debtors will want to make it more difficult for creditors to collect, minority shareholders will have an interest in increasing the rights of minorities in shareholder companies, employees who have contracted work without

the right to compensation for dismissal will fight for it to be provided by law, etc. In all these cases, the private and social effects are similar. From the private point of view, there is a transfer of wealth: one of the parties to the contract obtains a benefit at the cost of the other. The most harmful effect, however, is of a collective nature. The parties to new contracts will be obliged to use inefficient terms, their inefficient nature (absent external effects or a failure in individual rationality) being shown by the fact that they were not previously included in contracts. Alternatively, they will devote resources to circumventing laws, all of which reduces the value of contracting to both parties and ends up by wasting possibilities for productive specialization. It is not surprising, therefore, that many dwellings tend to stay empty, the worst risks find it difficult to obtain credit, minority shareholders are dispensed with in new companies and numerous potential employees remain unemployed.

The general consequence of inefficient mandatory rules is to raise contractual costs. This makes specialization impossible or forces parties to use suboptimal arrangements. Most European labor law probably has this effect, forcing firms to disintegrate and contract labor through all kinds of commercial law contracts.[6]

Deficit in Facilitating Legislation

Failings also occur in the legal system as a result of insufficient introduction of laws. The origin of the problem is found not so much in the search by contracting participants for rents as in the activities of contractual intermediaries, taken in the broad sense.

The fact that the experts who draw up laws also often provide the services necessary to contract in the context of such laws gives rise to a potential conflict of interest. These

services include those aimed at reducing the interpretative rigor of regulatory agencies. There may be a radical asymmetry in the incentives of the experts, depending on whether the rules are of a facilitating or mandatory nature, since both excess of mandatory laws as well as shortfall in facilitating laws could benefit experts and intermediaries. This is because both shortcomings increase demand for their services to the extent that they facilitate ex ante contracting, which is complementary to mandatory laws and substitutive of facilitating laws. An example of this argument is provided by some European corporation laws, which have undergone substantial change with a proliferation of mandatory rules. This mandatory nature has even entered areas in which it is scarcely justified, such as that of private companies. Since this legislation is aimed at "closed" companies, which do not sell securities to the public, even the arguments based on external effects that are occasionally used to justify the application of mandatory rules to "open" companies hold little water. Despite the fact that facilitating laws have simultaneously been expanded, the growth in their extent of the latter is far removed from that of mandatory legislation. More importantly, there is even further removal from the evolution of facilitating laws in those jurisdictions that are characterized by a relative lack of mandatory provisions such as, in particular, US company law, especially in the State of Delaware.

Without suggesting a causal relationship, it is worthwhile considering the benefits that this normative imbalance between mandatory and facilitating rules can give rise to. The surplus of mandatory rules tends to increase the demand for legal services to circumvent the letter and even the spirit of the law. Two simple examples are provided by the prohibition on multiple voting shares (in force, for instance, in Spain since the 1950 Companies Act). This can be avoided by having a pyramid of companies, but this

requires greater outlay on legal services, not just to create the pyramid but also recurrent maintenance of the companies that make it up. Also in the field of company legislation, rules regarding legal capital maintenance are not only pointless but in many jurisdictions are very costly.[7] The relative lack of facilitating laws generates several less visible, but perhaps equally important, effects which are based on the fact that the parties need to use other solutions to complete their contracts. The demand for legal services will therefore tend to increase as such solutions make greater use of explicit contracts ex ante or litigation ex post.

INSTITUTIONAL ENFORCEMENT AND EX POST COMPLETION

Parties do not contract in a vacuum, but within a legal system which provides them ex ante with standardized provisions. It is also possible for them to have recourse to a third party to settle their conflicts ex post. This third party takes two forms: either decentralized market judgment, whose force lies in the loss of future contractual opportunities, or a judicial system whose power comes from the political monopoly of power.[8] Both the market and judges certainly have inseparable completion and enforcement functions. Market participants who turn against a seller or a judge who issues a judgment firstly define the content of the exchange when there is a dispute between the parties and, secondly, act as ultimate enforcers of the contractual obligations so defined. Depending on the features of each case, the relative importance in their work of the completion function in relation to the enforcement function varies. For example, if a lender sues a recalcitrant debtor, enforcement is probably more important than completion in the judicial task of solving the matter. On the other hand,

challenging an agreement to distribute the profits obtained by a company, or a dispute regarding dismissal of an employee or termination of a franchise agreement will probably involve considerably more completion, as in these cases the actual content of the exchange as agreed by the parties is less obvious.

The Courts

Institutional Optimum

A large proportion of contractual disputes can be litigated in the courts.[9] These use two main mechanisms for completing contracts:

First, in order to make up for the lack of explicit agreement between the parties, use is made of the general provisions laid down by legislation, case law and commercial custom through the process of "contractual integration" (Larentz 1958: 112-121). By virtue of this process, "contracts…make it obligatory not only to comply with what is expressly agreed but also with all the consequences which, based on their nature, conform to good faith, usage and the law" (Section 1258 of the Spanish Civil Code, taking it as an example of a typical civil law legal system).[10]

Second, a pattern of judicial decision-making tends to be used to fill in gaps in the contract. This pattern consists of an implicit inquiry as to the hypothetical will of the parties in the case that, under conditions of zero transaction costs, the parties had made express provision ex ante, thus filling ex ante the specific gap that the court has now to fill ex post. As it is likely that the parties had come to an agreement generating efficient incentives, it suffices to discover the efficient solution in order also to ascertain the

hypothetical will of the parties. It is especially in this field that economic analysis can help, both in preparing judgments and in interpreting case law.[11]

The fact that the majority of contracts or conflicts never reach the courts does not diminish the role of the judicial system. The mere possibility of judicial intervention prevents breach: if the parties anticipate the outcome of a judicial decision they will tend to come to an agreement or avoid the conflict. In other words, the judicial system carries out an enforcement task, not only explicitly, by implementing its decisions or judgments, but also implicitly, by encouraging voluntary compliance in anticipation of an even more costly judicial decision.

Inefficient Sentencing

In principle, the possibility of having recourse to a judge facilitates contracting: by resolving conflicts, the judge will ex post fill the gaps which the parties have not specified, such that if the judge's independence is guaranteed and he has coercive power (or the judge's function is allocated to someone with such power), the costly ex ante stipulation of terms for the exchange and/or enforcement of its obligations by the parties themselves is less necessary. Nevertheless, the efficiency of judicial decisions can also be affected by the interests of the participants, including those of the judges themselves. When this occurs, the judicial solution may be inefficient and it is possible that the parties could more easily contract without the presence of the judicial system. Nevertheless, this presence is usually inevitable since the parties are frequently not in a position to choose the jurisdiction in which they wish to settle their disputes, and legal systems do not usually respect provisions by the parties eliminating ex ante the possibility of litigating ex post, with the exception of arbitration acts.

On this point it is worthwhile pointing out three specific types of failure in the judicial system. These are associated with: (a) deficient identification of judicial opportunism by the parties; (b) defective consideration of criteria of "material justice"; (c) the presence of a possible bias against quasi-judicial action by the parties.

a) Judicial and arbitration solutions, by which society or the parties authorize a third party (judge or arbitrator) to resolve conflicts which arise in exchanges, provide a further possibility for non-compliance if the parties are able to manipulate the judge to decide in their favor after incorrectly appreciating the merits of the case. A common example consists of considering the merits of the dispute and, in particular, the balance of compensation between the parties, based solely on the ex post situation, but without taking into account that this is often only the outcome of a random event which could have led to different outcomes in which the net balance of compensation would have been different. The existence of the judge thus motivates the parties to devote resources to both bringing about and preventing this manipulation. In many cases the contracts themselves are structured to avoid this type of opportunism. Judicial systems also tend to incorporate mechanisms aimed at protecting the judge from manipulation and ensuring his independence. Whether they achieve this or not is an empirical matter but some systematic biases are frequently present.

b) It is often considered that implementing the ideal of material justice by means of judicial decisions comes into conflict with legal certainty and economic efficiency. In reality, the consequences are worse. These closely-related principles of certainty and efficiency are often not only affected but justice itself is harmed. This often happens because, in order to implement individual solutions which are considered just, the very objectives of justice at an overall level are damaged. The most common case is perhaps

when the solution believed just in an individual case favors the weaker party to a contract and, as a result, weak parties to future contracts suffer from a reduction and worsening of their contractual possibilities and conditions. A case brought by a rich creditor against a poor debtor for non-payment serves as an example. If the judgment in this type of case takes into account the insolvency or poverty of the debtor, it is perhaps resolving an individual problem (at root that of providing the latter with an insurance that he perhaps could or could not, depending on the circumstances, have voluntarily contracted). Nevertheless, to the extent that it prevents the creditor from collecting his debt, it places obstacles in the path of all loan contracts that may be subject to similar judgments in the future. As a result, the judgment also harms potential debtors of a similar type to the beneficiary of the judgment, who are deprived of access to credit or will have to pay additional interest. In this respect, the conduct of the judge is inconsistent, since he is acting unfairly, albeit in a general manner, in relation to the type of party to whom on an individual basis he is attempting to dispense justice. Moreover, this type of judgment motivates judicial opportunism by the parties, who will try and place themselves in a position in which justice will favor them. In this way, what is described as justice can even conceal simple contractual expropriation.

c) Finally, centralized judicial systems frequently exhibit a certain bias against ex post quasi-judicial activities by the parties, even in cases in which these quasi-judicial activities are the result of an ex ante contractual agreement. The parties' interests lie in allocating judicial functions or rights to the party who has the best information and incentives to carry out this judicial task. Two sets of motivation are thus configured: firstly, with respect to information, the contracting parties who are in a central position compared with other parties will have a comparative advantage in this task since their

central position provides them with information as a free by-product of their transactions and enables them to make specialist use of all types of resources in these informative and judicial tasks. Secondly, with regard to incentives, those parties who have a better reputation or who are in a position to provide further guarantees have an advantage. In this respect, the size of the undertaking is usually important since it is often associated with greater reputational capital. This quasi-judicial action of the large undertaking is usually attacked in the strictly judicial field when judges often interpret the subject matter of litigation as deriving from greater bargaining power on the part of the larger party and not from the ex post exercise of judicial functions contractually allocated ex ante. We have found, for example, that car manufacturers are assigned rights in relation to their dealers to complete the contract, defining obligations, assessing their performance and, as the case may be, penalizing them if they consider that they are in breach of their obligations (Arruñada, Garicano and Vázquez 2001). This quasi-judicial activity, which is common amongst many franchiser companies in relation to their franchisee networks, is essential to control the proclivity of the latter to exploit other members, enabling them to provide their customers with uniform service quality in disparate locations. This does not mean, however, that size is the only relevant variable in terms of asymmetric allocation of quasi-judicial functions, even though it is the most problematical in terms of judicial treatment. Informational advantages may outweigh an eventual advantage in incentives. This helps in explaining why many retailers carry out these quasi-judicial functions, even in their relations with much larger, and supposedly better motivated, suppliers (Arruñada 2000). Nevertheless, the ex post contractual asymmetry tends to be perceived by some judges as unfair (at least this is their justification, although it may also be thought that their real objective is

to monopolize completion and external enforcement activities ex post) and they therefore tend to correct it, thus inefficiently restricting the quasi-judicial powers which the private contract itself allocates to one of the parties.[12] (Ex ante competition can be safely assumed because judicial proceedings rarely refer to lack of competition *ex ante*).

To the extent that legislation and judges restrict the parties' possibilities for establishing efficient ex post decision-making mechanisms the contracting parties must implement strategies aimed at protecting self-enforcement mechanisms from the possibility of judicial intervention. A large part of ex ante contracting serves this purpose. This is probably the case with the inclusion of burdensome terms in contracts—for example, that repairs shall be to the account of the lessee, using the famous United Shoes case (Masten and Snyder 1993). Despite the fact that these terms are not normally enforced (en the United Shoes example, the lessor in fact carried out the repairs), their inclusion by assigning to one the parties (the lessor) the right to evaluate and penalize the degree of performance by the other party of his obligations (which allegedly, amongst other variables, included proper use and care of equipment) makes them relatively safe from judicial intervention which the latter party may have an interesting in seeking ex post.

The foregoing refers to what is conventionally understood by judicial system. If, on the other hand, we use a broader concept, including market activity aimed at punishing what is perceived as contractual breach, the parties will also generally be unable to avoid judgment of their activities by third parties. For this reason, it is also important to take account of the biases that the market may suffer when judging the activities of its participants, particularly when property rights in relation to reputation are poorly protected against opportunistic attack.

The Judicial Activity of the Market

We have taken "judicial" enforcement to mean all those enforcement activities in which the person assessing the degree of compliance and implementing the possible sanction is one or more third parties other than parties to the contract. In this broad sense, not only the courts but also the activity implicitly carried out by the market can be categorized as judge as a result of the fact that the contracting is almost always observed by other participants in the market, who thus obtain useful information for their future contracts. When making this assessment they in fact act as judges in conflicts which previous contracts have given rise to. This is a decentralized system in the sense that the overall decision, equivalent to a judgment, is the result of a cumulative series of individual decisions taken independently and generally not at the same time by market participants.

When, for example, a dissatisfied customer reveals his dissatisfaction to someone who wants to listen to him, those who listen to him also act as "judge" in the "dispute" thus presented since, after accumulating a variable amount of information, they end up forming an opinion and making a resulting decision. Their "judgments" take the form of comments to other individuals and, in particular, end up turning into purchase decisions, both their own and of third parties. On the one hand, the judgment involves failing to acquire the product in question from the particular supplier and often commenting on the matter in turn, after which the cycle again begins with a new potential buyer. On the other hand, a judgment which acquits the producer also, although often implicitly, involves a judgment against the litigant, whose reputation is thus damaged. In both cases, these gains and losses associated with future transactions represent changes in the value of reputation. The importance of all these reputational

assessment processes makes it necessary to stress one of the essential functions of the institution we call the "market", that of acting as judge, rewarding and punishing the conduct of those involved in it.

Contractual Enforcement by Organizations and Markets

In the judicial activity of the market, it is potential contractual partners who in the final instance decide on judgments. Nevertheless, a large proportion of the information used to make a decision is often produced by organizations more or less specialized in this task. It is thus seen how entire sectors of economic activity have the basic function of providing information on the situation and degree of past, current and future performance of contractual obligations.[13] This is the case with specialists, such as auditing firms and those that rate debt securities. Furthermore, this information is constantly produced as a by-product of other activities. The most notable example is perhaps banks who, even though not specialists, carry out a function of this type when they report on the solvency of their customers.

The role of the market in solving contractual problems does not end with this quasi-judicial activity. More generally, when the benefits of productive specialization are sufficiently high, the market itself generates all types of external enforcement mechanisms whose activity, on occasions free of cost to the parties, protects this productive specialization in a more or less direct manner. These external mechanisms tend either to facilitate internal contractual structuring and monitoring processes or in themselves constitute monitoring or guarantee instruments. For example, in the relationship between shareholders and the management of a public company with specialized ownership and control, these roles are played respectively by the Stock

Exchange, which provides a low exit cost for dissenters and an indicator of management performance, and external competition for corporate control, manifested by public take-over bids and other means for gaining control from outside the company. In other contractual relationships, not only information producers appear, as mentioned, but also intermediaries who specialize in resolving specific problems which arise in third party contracts. This is the case with an essential function of banking activity, which is to reduce the cost of the relationship between savers and investors. And also with expert buyers, who select products and guarantee their quality, from department stores to doctors. Or with specialists in enforcing contractual compliance, such as debt collection agencies. These examples show that in some cases the person monitoring or bonding third party activities is a specialist, generally a firm, which charges for its services. In other cases, it is the market itself, as in the case of the market for corporate control, whose activities protect the relationship between shareholders and directors of *all* companies with specialized ownership and control, not only those directly affected.

Assessment of the Market as Judge

The fact that decision-makers are market participants ensures that they have powerful incentives to inform themselves adequately when taking their decisions. For example, the buyer of a car has incentives to be informed and, by means of his purchase decision, correctly "judge" the prior conduct of manufacturers. There are also substantial differences in the type of information which different types of third party responsible for completing or enforcing contracts can handle. It is possible that the market is more competent than the judicial system when *verifying* qualitative information.[14] Firstly, the market is not restricted to the use of a particular type of evidence, as are the courts,

particularly in countries with codified law in which the modern judicial apparatus is intended to enforce laws rather than facilitate contracts. Secondly, by acting through cumulative individual decisions, possible personal biases and variables are less pronounced.

These purely informative aspects are not the only relevant ones, however. The production and transmission of reputational information is not free of incentive problems, mainly the supply of false information. As a consequence, reputational assets may be subject to a certain degree of expropriation through "reputational blackmail". Certainly, this type of opportunistic conduct is automatically limited in that economic subjects also have a reputation as informers on the reputation of others and it is not in their interests to lose their reputation as informers. If this were to happen, not only would their threats no longer be credible but they would also find it increasingly difficult to safeguard the quality they receive in their future transactions.[15]

The greatest risk in this area often comes from the misuse or incorrect functioning of institutional mechanisms that increase potential damage without any sort of compensation. This might arise with certain consumer regulations which allow frivolous accusations to be published without any thought for the consequences, and with judicial decisions that on appeal are shown to be inadmissible but do not provide compensation. Here it is of interest to note that, because of their very size, large companies may be at risk from small enemies. This is because they never win their cases even if they are in the right. The guilty party is not able to pay compensation and the innocence of the large company is likely to be placed in doubt by the mass media.

CONCLUSION

The interactions between different contractual solutions have been described, considering that parties contract within an institutional environment with laws, courts and markets. Laws improve individual parties' rationality, courts complete and enforce contracts, and markets motivate contractual performance. Public intervention is decisive in making these institutions more or less effective in their facilitating roles. Several perverse tendencies are present, however. In the legal field, there is a surplus of mandatory rules and, at the same time, a deficit in default rules. Courts' activity is also unduly biased, mainly against the quasi-judicial role of the parties and the market. Finally, market enforcement is based on reputational assets that are exposed to opportunism. The presence of these failings is not surprising. Institutional solutions are also part of the specialization and exchange process. They enjoy the advantages of specialization in safeguarding exchange but they themselves also incur new costs of exchange because the added specialization in laws, courts and reputational resources gives rise to new forms of opportunistic behavior.

NOTES

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[1] This taxonomy is aimed at coping with the variety of solutions and "types of law" usually employed, sometimes even simultaneously, in most economic exchanges and also the variety of functions of explicit formulation of contract term, along lines similar to Masten (2000). It therefore varies from other conceptions aimed at establishing a correspondence between modes of organization (markets, hybrids and hierarchies, for

example) and modes of contracting (traditional contract law, neo-classic law with exception following the "excuse doctrine", and *forbearance* of law), particularly Williamson (1991). It also varies from the formulations which emphasize the role of the type of applicable law (labor, company) in defining the type of contract and, as a result, of economic organization (e.g. Masten 2000).

[2] We refer to "common law" not in the technical sense but as case law, law made by judges. It actually constitutes a hybrid in terms of degree of centralization: it has evolved through an accumulation of decisions which are decentralized but taken by judicial bodies.

[3] In the analysis of contracts, economic theory and part of current law and economics tend often to exclude the institutional environment to make problems easily tractable, with a substantial loss in relevance. For instance, the literature on incomplete contracts pioneered by Grossman and Hart (1986) tends to consider that enforcement of various dimensions of the exchange is fully guaranteed by a judge who simply implements the letter of contractual agreements with no intervention in other dimensions. A similar criticism can be raised on those approaches which emphasize activities of the parties aimed at developing self-enforcement mechanisms (particularly Klein and Leffler 1981; Klein 1992, 1996; and Klein and Murphy 1988 and 1997), which tend to exclude the role of the institutional environment.

[4] The contemporaneous version of this concept of law was basically developed by Hayek (mainly 1960 and 1973, and for a review and summary, 1988).

[5] On the ambiguity of institutional solutions, see North (1990: 59-60).

[6] González, Arruñada and Fernández (1998, 2000) analyzed this issue in construction and Fernández, Arruñada and González (1998, 2000) in trucking.

[7] For the case of the USA, Mannig (1990).

[8] On the economies of joining political power, arbitration and enforcement, see, for instance, North y Thomas (1971: 788).

[9] Similarly, the parties may opt to submit these disputes to an arbitration mechanism, generally led by more or less impartial experts. In both cases, with either judges or arbitrators, the decision-makers are centralized, although arbitration constitutes a hybrid formula: its appearance and survival are governed by market criteria, but it functions in accordance with centralized decision-making patterns. In the field of contractual completion, the private production of contractual forms is also located midway between market and centralized solutions.

[10] The role of good faith as a general or default provision varies widely in different legal systems. It is minor in Anglo-Saxon countries—although in some of them, such as Scotland, it had greater importance in the past but is now in decline—and very important in Civil Law countries. It is not by chance that this lesser role of contractual integration corresponds to the empirical fact that contracts tend to be much shorter in Europe than in Anglo-Saxon countries.

[11] The hypothesis of efficiency in rules of judicial origin was advanced in the first edition of *Economic Analysis of Law* (1973). Posner (1998: 271-275, 565-653) and Cooter and Ulen (1988: 492-499) contain separate inconsistent introductions regarding the efficiency of Anglo-Saxon common law and introduce the main bibliographic references on the matter. Regarding the efficiency of continental civil or codified legal systems, see *International Review of Law and Economics* 11(3).

[12] The promulgation of mandatory rules with retrospective effect is also generally related to asymmetric contracts, whose asymmetry is often used as an argument to justify consideration of free contracting as unfair.

[13] Their role could be seen recently in the sudden growth of "infomediaries" who grade the quality of electronic commerce operating through the Internet (Peet 2000: 319)

[14] For an application to the auditing industry, see Arruñada (1999).

[15] Some very "organized" markets are careful in managing the production of parties' reputation. For example, the American Information Exchange used very formal evaluation processes to ensure quality ("Information Industries: New Ideas on the Block," *The Economist*, 14 March 1992: 79-80). More recently, auction web sites, such as Ebay, have taken a similar approach to ensure compliance in payments and deliveries.

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