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TranState Working Papers

TRANSNATIONAL
ECONOMIC GOVERNANCE

THOMAS DIETZ

No. 100

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Transnational Economic Governance

ABSTRACT

What role do contract enforcement institutions provided by the state play for economic development? This question has often been addressed. However, empirical research in this field looks predominantly at transactions that are conducted domestically. Less research exists regarding the enforceability of contracts in cross-border transactions. In other words, research that addresses the institutional foundations of international exchange processes is still in its infancy. The following case study investigates the contract enforcement institutions that enable German customers to purchase software in Asian and East European Countries. This paper's main argument is that nation states are not capable of providing a workable legal infrastructure for cross-border transactions. Instead, economic actors create their own informal mechanisms in order to enforce their contracts. Particularly important are relational contracts and reputational networks. Furthermore, the empirical evidence shows that German enterprises comprehensively use the opportunities offered by new developments in information and communication technology, when it comes to the initiation and control of their foreign business relations. Due to such technical innovation, it therefore seems that both reputational networks and relational contracts gain more and more efficiency compared to state private law.

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Transnational Economic Governance

INTRODUCTION

For a number of years now, there has been a lively debate in law, the social and economic sciences about those institutions that could provide a sufficient degree of contractual certainty in cross-border business transactions.¹ The common starting point for this debate is the observation that state private law cannot fulfill its function to safeguard the performance of contractual claims in today's globalized markets with the same reliability it achieves in domestic markets.² Every state has its own private law, which is in force within its territory. Therefore, the possibility exists that national legal systems collide once an economic transaction transcends national borders.³ From the perspective of actors interested in economic exchange, the territorial fragmentation of law leads to three main problems: *First*, uncertainty can emerge about the obligations of the contractual parties, as they can to be assessed differently according to the law applicable. *Second*, it is unclear where the place of jurisdiction is for the solution of conflicts. And *third* it is often doubtful, whether judgments of one state are actually enforced in another.⁴ In more abstract terms, economic globalization ends the congruency of economic and legal spaces.⁵ The far-reaching unity of state, law and economy is increasingly un-

¹ For a very good summary of this debate see: *Gessner, Volkmar*, Towards a Theoretical Framework for Contractual Certainty in Global Trade, in: Volkmar Gessner (Hrsg.), *Contractual Certainty in International Trade*, Oxford (UK) 2008, 3-27; see also: *Streit, Manfred E. und Mangels, Antje*, Privatautonomes Recht und grenzüberschreitende Transaktionen, in: 47 *ORDO* (1996), 73; *Rühl, Giesela*, "Effizienzprobleme bei grenzüberschreitenden Rechtsstreitigkeiten", German Working Papers in Law and Economics: Vol. 2008, Article 17, verfügbar unter: <http://www.bepress.com/gwp/default/vol2008/iss2/art17>, p. 3-5.

² *Gessner*, Towards a Theoretical Framework for Contractual Certainty in Global Trade, p. 3; *Rodrik, Dani*, How Far Will International Economic Integration Go?, in: 14 *The Journal of Economic Perspectives* (2000), 177, p. 179.

³ *Berman, Paul Schiff*, Global Legal Pluralism, in: 80 *Southern California Law Review* (2007), 1155, p. 1155; *Gopalan, Sandeep*, *Transnational Commercial law*, Oxford 2004; *Rühl, Giesela*, *Methods and Approaches in the Choice of Law: An Economic Perspective*, in: 24 *Berkeley Journal of International Law* (2006), 801, p. 801

⁴ See: *Schmidtchen, Dieter*, *International Contracting and Territorial Control: The Boundary Question*. Comment on B.V. Yarbrough and R.M. Yarbrough's article of the same name, *Journal of Institutional and Theoretical Economics* (1994), 272, p. 274.

⁵ *Sweet Stone, Alec*, *Islands of Transnational Governance*, in: Martin M. Shapiro/Alex Sweet Stone (Hrsg.), *On law, Politics and Judicialization*, Oxford 2002, 323-342, p 323

done by this process.⁶ In short, the uncertainty whether prospective contractual partners behave in an opportunistic or cooperative manner is far higher at global than at domestic markets, as in the transnational realm actors have no unitary, private law system at their disposal in order to enforce contracts effectively.⁷

Although there is a broad consensus about the specific problems of international economic transactions in the relevant literature, the proposed solutions vary significantly. Especially lawyers stress that those problems arising out of the plurality of law in cross-border economic intercourse are solved by dint of private international law (PIL). The PIL determines which law is applicable to a cross-border transaction. Concerning contractual certainty, cross-border transactions therefore approximate domestic business transactions.⁸ Ultimately, the argument here is that due to working collision norms economic actors can rely on state courts and enforcement authorities both in the domestic and transnational realm.⁹ Peter Behrens argues in this vein:

“It follows from the principles of modern private international law (collision law) that on the whole foreign legal norms can be used as the basis of a domestic judgment, while foreign judgments can be enforced domestically. In both cases one can argue that a sovereign action of another state, namely legislative acts (legal norms) and judicial decisions (judgments), are 'recognized' domestically, i.e. they are enforced by dint of the instruments of domestic sovereignty. As this is a universal phenomenon, it can be stated that in principle national legal norms and decisions can be taken out of their territorial confines and gain quasi-global validity.”¹⁰ (Translation Thomas Dietz)

However, this view, according to which the PIL is principally suitable to reduce the uncertainty of international business transactions, has met numerous objections. It is, for instance, a common assumption that the globalization of law cannot keep up with the

⁶ Zürn, Michael, Sovereignty and Law in a Denationalized World, in: Richard P. Appelbaum/William L. F. Felstiner/Volkmar Gessner (Hrsg.), Rules and Networks. The Legal Culture of Global Business Transactions, Oxford 2001, 39-71

⁷ Anderson, James E. und Marcouiller, Douglas, Insecurity and the pattern of trade: an empirical investigation, in: 84 The Review of Economics & Statistics (2002), 342, p.342; Belloc, Marianna, Institutions and International Trade: A Reconsideration of Comparative Advantage, in: 20 Journal of Economic Surveys (2006), 3, p. 7; Rodrik, How Far Will International Economic Integration Go?, , p 179.

⁸ See: Rühl, "Effizienzprobleme bei grenzüberschreitenden Rechtsstreitigkeiten", German Working Papers in Law and Economics: Vol. 2008, Article 17, p. 9.

⁹ See also to this point: Berkowitz, Daniel, Moenius, Johannes und Pistor, Katharina, Legal Institutions and International Trade Flows, in: 26 Michigan Journal of International Law (2004), 163.

¹⁰ Behrens, Peter, Weltwirtschaftsverfassung, Jahrbuch für Neue Politische Ökonomie, 2000, 5- 27, p 17.

globalization of the economy.¹¹ It is even argued that the nationally caused legal fragmentation (PIL is also national law) as well as the fact that different norm systems meet and block each other in cross-border transactions lead to significant regulatory gaps, norm collisions and enforcement deficits—resulting even in growing problems of cross-border business. The legal context of cross-border trade resembles rather an anarchic state of nature than an area structured by law. In any case, contractual certainty is not provided by the PIL. In fact a *constitutional uncertainty* exists, which rather hampers than enables cross-border exchange.¹²

A way out of this constitutional uncertainty is often seen in the possibility to embed cross-border transactions into the institutions of *transnational law*.¹³ Stressing the significance of the so-called *transnational law of the new Lex Mercatoria*¹⁴ for the safeguard of cross-border transactions, pundits free the concept of law from its close link to the state:

“The new Lex Mercatoria (New Law Merchant) is conceptualized as an autonomous legal system beyond the nation-state, which is based on common legal principles, i.e. on basic rules generated through functional legal comparison between the common core of national private legal systems (such as the UNIDROIT principles) and on trade customs and habits of the international merchant class (such as standardized contractual conditions, like the Incoterms of the ICC or model contracts); while its application, interpretation and development rest with international arbitral jurisdiction.”¹⁵(Translation Thomas Dietz)

According to the transnationalists, the categorical equation of law and state obscures the view of the emergence of new, privately generated, legal regimes. So, private law on the

¹¹ See: Rodrik, How Far Will International Economic Integration Go? , p 179-180.

¹² Schmidt-Trenz, Hans-Jörg, Außenhandel und Territorialität des Recht, Baden-Baden 1990 Schmidt-Trenz, Hans-Jörg und Schmidtchen, Dieter, Private International Trade in the Shadow of the Territoriality of Law: Why Does It Work?, in: 58 Southern Economic Journal (1991), 329, p. 241-244.

¹³ As far as known the term “transnational law” was first used by Phillip C. Jessup, Judge at the International Court of Justice. Jessup, Philip, Transnational Law, New Haven 1956. See: Slaughter, Anne-Marie, Breaking Out: The Proliferation of Actors in the International System, in: Yves Dezalay/Bryant G. Garth (Hrsg.), Global Prescriptions 2002, 12.

¹⁴ Berger, Klaus Peter, The Creeping Codification of the Lex Mercatoria, The Hague, London, Boston 1999;

¹⁵ Calliess, Gralf Peter, Grenzüberschreitende Verbraucherverträge. Rechtssicherheit und Gerechtigkeit auf dem elektronischen Weltmarktplatz, Tübingen 2006, p. 198

global level is not created by state intervention, but by private actors who belong to specific socioeconomic networks.¹⁶ Alex Sweet Stone, for example, argues in this vein that

„ sovereignty and control are detaching from another rapidly, at least with respect to transnational commercial activity. In the past three decades, a growing and increasingly cohesive community of actors—including firms, their lawyers, and arbitration houses—have successfully created a transnational space. The space is comprised of a patchwork of private jurisdictions, of rules and organizations without territory, an offshore yet virtual space. These are islands of private, transnational governance.”¹⁷

In the theory of transnational law, *private arbitration courts* play an important role. They apply those norms that emerged autonomously in the social context of the global mercantile community and gradually specify through their judgments the legal framework of cross-border transactions.¹⁸ Finally, the community of market participants safeguards the enforcement of arbitration judgments with the help of reputation¹⁹, so that the enforcement of law by third parties functions on the basis of private arrangements without the use of state coercive power.

According to the transnationalists' theory, the easing of uncertainty occurs within an institutional framework that functions without any state support. Hence, this theory is diametrically opposed to those approaches that emphasize the significance of state PIL with regard to safeguarding the contractual fulfillment of international exchange processes. However, both approaches have in common that they refer to an institutional mechanism, in which the performance of contractual agreements is safeguarded by the organizing activity of a higher third party.

From these points of view, a third approach can be distinguished according to which cross-border transactions can manage even without a regulatory framework organized

¹⁶ Berger, *The Creeping Codification of the Lex Mercatoria*, p. 40, 42; Gaillard, *Emmanuel*, *Transnational Law: A legal system or a method for decision-making*, in: Klaus Peter Berger (Hrsg.), *The Practice of Transnational Law*, The Hague 2001, 53

¹⁷ Sweet Stone, *Islands of Transnational Governance*, p. 323

¹⁸ See; Berman, *Harold*, *The Role of International Law in the Twenty-First Century*, in: 43 *Fordham International Law Journal* (1995), 1617; Berger, *Klaus Peter*, *The New Law Merchant and the Global Marketplace, A 21st Century View of Transnational Commercial Law*, *International Arbitration Law Review* (2000), 91; Calliess, *Graf Peter, Dietz, Thomas, Konradi, Wioletta, Nieswandt, Holger und Sosa, Fabian*, *Transformation of Commercial Law: New Forms of Legal Certainty for Globalized Exchange Processes*, in: Achim Hurrelmann/Stephan Leibfried/Kerstin Martens/Peter Mayer (Hrsg.), *Transforming the Golden-Age Nation State*, Basingstoke 2007, 83-108.

¹⁹ *Streit und Mangels*, *Privatautonomes Recht und grenzüberschreitende Transaktionen*, p. 88.

by third parties.²⁰ Rather, the actors create themselves an institutional environment (*informal and spontaneous self-organization*), which allows them to conduct international transactions. On the basis of game-theoretical assumptions, it is argued here that self-interested actors do not cooperate in isolated games, but that cooperation becomes of more interest once actors interact repeatedly. As long as contractual parties expect that the value of continued business transactions is higher in the future than the profit that can be achieved by the non-performance of a contract in the present, they follow their contractual obligations even without safeguarding the transaction by additional superordinate institutions.

*“The emergence of cooperation is enabled by the fact that players can interact over and over again. This implies that present decisions do not only determine the outcome of the current exchange, but they also impact on the players' future decisions. Hence, the future can cast a shadow over the present and thereby affect the current strategic situation.”*²¹

Factually, economic transactions that are safeguarded by repeated interaction are either guaranteed by stable bilateral contractual relations²² (*relational contracts*) or by *reputational networks* consisting of several parties. The enforcement of contractual claims with the help of the mechanism of repeated interaction implies therefore that past, present and future relations are of importance.²³ Only this way allows the contractual par-

²⁰ See: *Belloc*, Institutions and International Trade: A Reconsideration of Comparative Advantage, 3. Belloc writes on page 6: “Transaction costs affect international trade dynamics in two ways. First, they shape interactions among traders and encourage relation-based exchange. Social networks enhance cooperation and trust in inter-community trade, and cross-border ties help to overcome information and imperfect contract enforcement problems stemming from long distance between partners.” Note that Steward Macaulay has shown that even within national markets businesses often manage their business relationships with no or little and highly selective resort to state provided rules and dispute resolution mechanisms. See: *Macaulay, Stewart*, Non-Contractual Relations in Business: A Preliminary Story, in: 28 *American Sociological Review* (1963), 55.

²¹ *Axelrod, Robert*, The Evolution of Co-operation, Harmondsworth 1990, p. 12

²² For a socio-legal view of relational contracts see: *Macneil, Ian R.*, Contracts: Exchange Transactions and Relationships, Mineola 1971; *Macneil, Ian R.*, Reflections on Relational Contract, in: 141 *Journal of Institutional and Theoretical Economics* (1985), 541.

²³ The following authors in particular highlight the meaning of ethnic relations and networks for international trade: *Appelbaum, Richard P.*, The Future of Law in a global Economy, in: 7 *Social & Legal Studies* (1998), 171 *Casella, Alessandra und Rauch, James*, Anonymous Market and Group Ties in International Trade, *Journal of International Economics* (2002), 19; *Gould, David M.*, Immigrant Links to the Home Country: Empirical Implications for U.S. Bilateral Trade Flows, in: 76 *The Review of Economics and Statistics* (1994), 302; *Rauch, James und Trinade, Vitor*, Ethnic Chinese Networks in International Trade, in: 84 *Review of Economics and Statistics*

ties to agree on rules implicitly or explicitly, with which they intend to solve future interaction problems (*relational norms*), to control rule compliance and to sanction rule breaches with the termination of business relations or with the exclusion from the reputational network.²⁴

In sum, it can be stated that the relevant literature offers highly diverse approaches concerning the institutional foundations of cross-border economic exchange processes. Despite the numerous contributions to this issue, hitherto there exist hardly any comparative empirical studies that analyze the relative importance of those contract enforcement institutions in cross-border business stressed by the individual approaches. Whether state private law really loses its working capability at the global level and is replaced by private institutions, this is a question not yet sufficiently addressed by current research.²⁵ Therefore, in the following, the argument draws on a concrete empirical example in order to illustrate, which institutions actors really rely on in order to safeguard contractual performance in cross-border exchange processes.

THE EMPIRICAL STUDY

The focus of the empirical study²⁶ is on cross-border transactions in the software industry. This concerns exchange processes by which an enterprise asks another enterprise across borders to develop a software application designed to its very own requirements (*individual software*). In the following, these exchange processes are termed cross-border software transactions. In detail, 32 qualitative interviews with German, Bulgarian, Rumanian and Indian experts in the software industry were conducted in 2005 and 2006. They all concerned the question of how German enterprises safeguard the per-

(2002), 116; *Rauch, James* Business and Social Networks in International Trade, in: 39 *Journal of Economic Literature* (2001), 1177.

²⁴ For the theoretical foundations of relational contracts see: *Axelrod, Robert*, *The Evolution of Co-operation*, Harmondsworth 1990; *Abreu, Dilip, Pearce, David G. und Stacchetti, Ennio*, *Optimal Cartel Equilibria with Imperfect Monitoring* in: 39 *Journal of Economic Theory* (1991), 251; *Dixit, Avinash K.*, *Lawlessness and Economics, Alternative Modes of Governance*, Princeton and Oxford 2004; *Townsent, Robert M.*, *Optimal Contracts and Competitive Markets with Costly State Verification*, in: 21 *Journal of Economic Theory* (1979), p. 265.

²⁵ *Trebilcock, Michael J. und Leng, Jing*, *The Role of Formal Contract Law and Enforcement in Economic Development*, in: 92 *Virginia Law Journal* (2006), 1517, pp 1540-41; *Gessner*, *Towards a Theoretical Framework for Contractual Certainty in Global Trade*, p. 10

²⁶ The empirical study was conceptualized, organized and conducted in collaboration with the economist Holger Nieswandt in the context of the research project 'New Forms of Legal Certainty in Globalized Exchange Processes' within the The Collaborative Research Center 597 'Transformations of the State' at the University of Bremen.

formance of contractual obligations, when they order software applications in Asia or Eastern Europe. The software industry was chosen as object of research, as it is one of the most globalized industries in the world economy and offers therefore optimal conditions for the analysis of the institutional foundations of international exchange processes. In order to achieve the most comprehensive picture possible, the selection of enterprises and interviewees paid attention to deliberately include small (under 100 employees), medium (100 to 1,000 employees) and larger (over 1,000 employees) enterprises into the sample. Furthermore, employees with different expertise and in different positions were interviewed.

Interviews were conducted as non-standardized expert interviews. In detail, the following subjects were addressed in all interviews and complemented by additional questions:

The risks of transaction: This subject area includes questions about those risks enterprises face when they are involved in cross-border software transactions.

Private law provided by the state: This subject area includes questions about the significance of private law provided by the state for the emergence of cross-border software transactions.

Private order contract enforcement institutions: This subject area includes questions about the significance of the above-mentioned private institutions for cross-border software transactions.

The analysis of the interviews applies *Philipp Mayring's* method of *qualitative contents analysis*. Accordingly, the empirical data is first reduced systematically so that only the essential elements of conversation remain. Then the content of conversation is condensed into general statements at a more abstract level.²⁷ The following account includes only the condensed summary of a wider research process.²⁸

The risks of transaction

The analysis of the expert interviews established four main risks German enterprises encounter when they order software applications in Eastern Europe or Asia: *First*, there is the risk that the software application ordered is not delivered at the agreed date or,

²⁷ Cf. *Mayring*, *Qualitative Inhaltsanalyse. Grundlagen und Techniken*, p. 42ff.

²⁸ From a methodical point of view, it should be added that the findings of this study allow no representative statements about the institutional foundations of cross-border business in its entirety. The software industry certainly provides a particularly suitable research object, in order to analyze the issue of contractual certainty in globalized exchange processes. The picture drawn here could look very different for alternative industries and country constellations. It requires therefore further research to determine to what extent the results of the empirical study are actually generalizable.

second, that it does not meet the expected quality standards. Both these risks are particularly serious, if the customer has a contractual agreement with a third party, whose fulfillment requires him to deliver the ordered software application in advance. In order to avoid falling behind, the German enterprise has to make sure that the ordered software application is delivered punctually and works faultlessly. *Third*, there is due to the almost cost-free reproducibility of software products a high risk that the software supplier resells the same or an only slightly amended version to another enterprise—in the worst case to a competitor. From the perspective of the German customer, the question arises how the intellectual property rights to the developed software can be secured. Fourth, for the buyer of a software application there is the risk that the software producer obtains sensitive corporate data during software development, whose use or distribution could jeopardize the business of the customer. Hence, the German enterprise needs a strategy with which it can be as reliable as possible and prevent the passing on of confidential information to third parties.

State private law does not provide contractual certainty

It has to be asked, then, what significance do German enterprises attribute to the state protection of private law in the reduction of these risks. Therefore, the typical structure of a software contract has to be outlined.

Regarding the structure of a software contract, it should at first be said that in general, an entire project cannot be covered in a single contract due to the complexity of the underlying transactions. Therefore, software transactions usually consist of a number of contracts. These are, *first*, a *non-disclosure agreement*, which is meant to guarantee that confidential information is not passed on to third parties even before a business transaction; *second*, a framework contract which establishes the fundamental rights and obligations of the contractual parties for the duration of the business relationship; and, *third*, individual service level agreements, which define the exact extent of work required.

The empirical findings indicate that the involved actors usually prepare this contractual edifice with great care. Especially, the work required is comprehensively fixed through the creation of so-called requirement or performance specifications; furthermore, the framework contract defines an exact catalogue of sanctions for the case that foreign enterprises fall behind with the development of software or fall short of agreed quality standards. Moreover, in most cases it is arranged in detail what procedures have to be observed, if during a business relationship incidents occur not foreseen by the parties at the moment the contract was concluded (*change request, project and executive committee, escalation procedures*). Additionally, the patterns of conflict resolution are exactly pre-determined, in case the parties cannot agree on them once a dispute occurs (*arbitrator, applicable law, place of jurisdiction*).

From the perspective of legal sociology, the fact that the global software industry usually works with very elaborate contracts suggests at first that the involved parties indeed rely heavily on state enforcement authorities, in order to safeguard the performance of contracts by their foreign business partners.²⁹ State private law would therefore be of high significance for the generation of contractual certainty in cross-border business transactions. However, as the following will indicate, this provisional conclusion cannot be confirmed before the backdrop of the further empirical findings of this study.

The experts draw an unambiguous picture: There are clear statements in almost all interviews according to which the state enforcement of contracts is insignificant for generating contractual certainty in cross-border software transactions. This assessment refers to all the four mentioned risks facing customers who purchase software applications in Eastern Europe and Asia. With the help of state private law, it cannot be guaranteed that delivery deadlines are met; that the ordered software is of the required quality; that there is an exclusive transfer of intellectual property rights; and, finally, that confidential information is kept secret. In the words of an expert interviewed, the software contract is "not worth the paper it is written on."³⁰ It can hence be argued that the possibility of enforcing contractual agreements with the help of state enforcement bodies is of no importance for German enterprises, when they purchase software applications in typical offshore countries like India, Bulgaria or Rumania.

If one inquires further into the reasons for this far-reaching insignificance of state private law, the following picture can be drawn: *First*, there is deep distrust towards the legal systems of offshore states on the part of German enterprises. The interviewed German experts therefore refrain from making their contractual relations subject to a foreign jurisdiction and contracts are usually concluded according to German law.

German courts have jurisdiction. The fact that German law is in effect does, however, not mean that state private law can indeed fulfill its function of enforcing contracts and enabling economic cooperation. In principle, it is indeed possible to successfully sue a foreign company for the performance of a contract in Germany, yet according to the interviewed experts the title cannot be enforced reliably in offshore countries. This

²⁹ In his seminal 1963 article, Steward Macaulay introduced the degree of contractual planning as indicator for the significance of state private law for the occurrence and conduct of economic transactions. In contrast to the empirical findings of this study, Macaulay, however, argued that (1) "many business exchanges reflect a high degree of planning about the four categories—description, contingencies, defective performances and legal sanctions—but (2) many, if not most, exchanges reflect no planning or only a minimal amount of it, especially concerning legal sanctions and the effect of defective performances." *Macaulay, Non-Contractual Relations in Business: A Preliminary Story*, p. 9.

³⁰ Interview D-VII, p. 3

means that even if the contractual parties have agreed that German law applies, it cannot be guaranteed that foreign business partners are effectively sanctioned in case of a breach of contract. In the end, state private law remains without effect from the perspective of a German enterprise, because the territorial confinement of law prevents a reliable enforcement of German judgments in Eastern Europe and Asia. *Second*, the interviewed experts stress that state courts are hardly able to contribute to conflict resolution in the area of software development due to the technical complexities of the relevant subject matters. In order to gain an overview of the situation in a case, the responsible judges have to rely on expert reports, which increase the costs of proceedings enormously. Moreover, expert reports do not always bring more clarity; rather they often intensify the conflict, when a conflict among experts ensues. Before this backdrop, it is hardly astonishing that judges tend to "push" cases "towards settlement"³¹. The result is that it becomes hardly worthwhile to involve state courts, even for a party that thinks it is in the right. The outcome of proceedings is too uncertain; the costs for the involved experts are too high. In short, entirely independent from the territorial confines of state law, the insignificance of state private law can also be attributed to the lack of contractual certainty in the area of software development.

In general, it can therefore be established that state private law is of no significance for German customers purchasing software applications in offshore countries, because on the one hand the outcome of proceedings in state courts is highly uncertain but causes high costs. While, on the other hand, the title of a German court, if acquired, cannot reliably be enforced in typical offshore countries.

The alternative meaning of contracts

At this point, one issue remains open. Why do German enterprises conclude detailed contracts, as outlined above, in order to purchase software abroad, although these contracts generate no contractual certainty? From an economic perspective, it is hardly sensible to use resources for the design and negotiation of contracts, if they remain ultimately without effect on transactions. Which purpose do contracts fulfill, if they do not generate contractual certainty?

Although this aspect is not at the center of this study, some interesting insights can be won from the expert interviews: Accordingly, enterprises need contracts in order to define their legal relationship with third parties not directly involved in the transaction. This can concern insurance companies, banks and tax authorities. More concretely, contracts are the basis for the conclusion of an insurance, the granting of a credit or the determination of a tax liability. Contracts are therefore necessary documents for the par-

³¹ Interview D-VII, p. 5

ticipation in modern business life, independent of their actual function—the generation of contractual certainty. The empirical findings furthermore demonstrate that contracts can also be used to legitimize the actions of a company's management vis-à-vis its owners. No corporate management would like to be accused of acting without a valid contract in case a transaction with a foreign company fails. On the part of the owner, this would be seen as flawed behavior and would have negative career effects. Contracts are therefore concluded because the members of the corporate management "have to guard their back"³² for the case that things go awry. However, the most important function of the contract is the one as communication document. In cross-border intercultural business relationships, no common socio-cultural norms exist that could implicitly govern the exchange beyond the contract itself. There (still) exists no transnational business culture. At the transnational level, enterprises are far more than in the domestic context dependent on the detailed explication of the behavior they expect from their business partners and on turning their expectations into the written form of a contract. In this sense, an expert stresses that although contracts do not generate contractual certainty

*"[...] one still needs a contract as the basis of cooperation so that everyone knows what one talks about and what is expected."*³³ (Translation Thomas Dietz)

Contracts and the private law applicable to them are hence means of communication, which can be easier universalized than social norms reproduced in exclusive ethnic or social contexts. Contracts serve mutual communication but not the enforcement of legal claims.

Private contract enforcement institutions establish contractual certainty

The account above indicates that contracts and state private law take on numerous alternative meanings, but they do not create contractual certainty for German enterprises ordering software applications in Eastern Europe or Asia. But if German enterprises cannot resort to state enforcement authorities, in order to safeguard their transactions against opportunist behavior, how do they manage to safeguard the performance of contracts by their foreign offshore providers? This question has to be answered in the following.

Relational contracts

The initiation of relational contractual relationships: At first, it can be said that German enterprises subject their potential business partners to a comprehensive evaluation proc-

³² Interview D-X, p. 3

³³ Interview D-IX, p. 1

ess in the run-up to a transaction. In addition to the competence of a potential transaction partner, also their reliability is checked. In other words, before a transaction starts German enterprises pay particular attention to choose only enterprises that show a low risk of defaulting behavior.³⁴ In this test, German enterprises evaluate three aspects in particular. *First*, it is checked, how much the enterprise invests into the quality of its employees. In this context, the German enterprise is interested in the number but also the exact qualification of the staff of the foreign provider. Concerning employee qualifications, German actors attribute particular importance, apart from university degrees, to fee and examination-based training certificates from multinational corporations, like, for instance, Microsoft, SAP or IBM. *Second*, it is checked, how much a potential business partner invests into the quality of its production processes. This evaluation is conducted based on quality standards but also on test projects. Concerning the quality standards, there is a distinction to be made between certificates issued by professional standardization bodies (like ISO, SEI³⁵) and certificates issued by well-known multinational enterprises (like Microsoft Gold Partner, IBM Certified Partner). In this context, it is interesting that the certificates of big multinational corporations are apparently given more importance than the quality standards of professional standardization bodies. The reason for this difference in significance is especially the fact that although standardization bodies establish global unitary norms, national offices, which apply different standards of accuracy in the certification process, supervise them.

“Sure, I trust the certificates of globally active enterprises more than those based on globally valid norm, as individual monitoring bodies in individual countries supervise the latter. A certificate under the ISO 9.000 standard is, for

³⁴ The following interview passage illustrates in exemplary manner, what is meant by reliability test: "If someone invests a certain amount of money to build up a business, he shows that he will be serious. It is the same with the companies in Rumania. Usually after I am contracting them, who are you, how many employees do you have, 70, ok. You have an office? 'Yes'. That is why we have such a nice office; we have video cameras outside, all kinds of good networks. This is an investment of two million Euros. If I put so much money in the environment that means that I have the capability to do such a good job. Nobody is investing two million Dollars into nothing." Interview BR-III, p. 11

³⁵ The ISO (International Organization for Standardization) is a network of national standardization institutions in 147 countries with its headquarters in Geneva, Switzerland. For the software industry decisive is certification according to ISO 9,000. The SEI (Software Engineering Institute) is a state financed research and development center, which is supported by the US ministry of defense and situated at the Carnegie Mellon University. Regarding cross-border software development, the CMM (Capability Maturity Model) has become the best-known quality certification. See, for further information, *Amberg, Michael*, IT-Offshoring. Management Internationaler IT-Outsourcing Projekte, Heidelberg 2005, Chap 5.

*instance, in Germany monitored by a certification center, accredited in Germany. In Italy, it is monitored by an Italian body, etc. I wouldn't like to compare a German body with an Egyptian or Sudanese one—to take it to the extreme.”³⁶
(Translation Thomas Dietz)*

Third, it is examined to what extent the enterprise has invested in its production facilities. To do this, production sites are usually visited in person, in order to review the quality of the business premises and of the technical infrastructure as well as the investments into the physical and virtual security arrangements. A potential foreign business partner, who has made significant investments in all three areas, signals the German company credibly that he is interested in long-term business success and will therefore behave cooperatively. From the perspective of the German enterprise, with these points a fundamental precondition is met for further cooperation on the basis of private institutions.

At this point, it remains to note that the German companies make extensive use of modern information and communication technologies (ICT) during the above described reliability test of potential transaction partners. Initial information on the number of employees or the certifications a company holds are obtained directly by German companies through a thorough search of the websites of the foreign potential transaction partners. In a further step, the German company receives additional information, such as the detailed qualifications of each employee, by sending a detailed questionnaire to foreign providers, which are completed and returned to the German companies. Only when these Internet-based pre-examinations have been completed successfully, staff members of the German enterprise will visit the production sites of the foreign provider in person, in order to gain a final impression about the latter's willingness to cooperate. The following interview passage illustrates this point in exemplary fashion again:

“At the moment, many first contacts are established via the Web. It plays a very prominent role. They do research on the Internet, and in this way learn to know each other somewhat. Then, they will exchange information at first. Sure, at some point these people have to meet.”³⁷ (Translation Thomas Dietz)

The implementation of relational contractual relationships: The phase of initiation is finally followed by the implementation of the transaction. Here, it turns out that software development contracts are usually divided into different stages (*milestones*). This means that the final product is not delivered in one piece at the end of the transaction; rather it is spread gradually throughout the entire development process. At the end of each milestone phase, a comprehensive test is conducted, in which the German client

³⁶ Interview D-III, p. 9

³⁷ Interview D-II, p. 16-17

reviews with the help of predefined quality criteria; whether the delivered intermediate product meets the agreed specifications. The German company then pays according to the progress of the project, either a fixed agreed milestone payment (*fix-contracts*) or the working hours spent by the foreign software producer to reach the milestone (*time and material contracts*). Only with the last milestone payment, the transaction is then completed entirely.

However, if the foreign supplier cannot fulfill the milestone-related quality criteria as agreed or exceeds the delivery time, the German company can then suspend payments after a short grace period and, finally, even end the business relationship with low costs involved (*exit clause*). For suppliers, this means that they have to endeavor to meet the contractual requirements in every milestone phase, as this is the only way to reach the next level of payment. However, if he behaves opportunistically, the prospect of future earnings are lost with the German enterprise terminating the business relationship. Obviously, by this structuring of the contractual relationship into various milestone phases bound to testing, the German companies establish a simple but highly effective means for controlling the actions of their providers. In this sense, German companies perceive "payment arrangements"³⁸ as more important than "legal terms"³⁹ and the option to refuse to pay bills is deemed to be a "massive lever"⁴⁰ to enforce contractual claims.

In short, by structuring the business relationship in milestone phases, the transaction turned from a simple prisoner's dilemma into a repeated game. In other words, the consciously created shadow of the future⁴¹ gives the foreign supplier an incentive to reliably fulfill contractual agreements.

The monitoring of relational contractual relationships: Modern economic exchange processes can be conducted both as market transactions as well as within the hierarchical structure of an enterprise. It is the central concern of transaction cost theory (*make or buy* decision) to specify the conditions under which it is more efficient to choose one or the other governance mode; but this needs not to be of detailed concern in the following. In the context of this study, it is however important to note that the governance structures of these two transaction types, market and hierarchy, differ among other things fundamentally in the way they arrange the monitoring of the involved parties. If a transaction is handled via the market, the contract serves as the basis for monitoring: The contract determines the required services and products as well as the time when the contractual performance is due. When this point in time has come, it can be verified on

³⁸ Interview D-II, p. 4

³⁹ Ibid.

⁴⁰ Ibid., p. 12

⁴¹ *Axelrod*, The Evolution of Co-operation, S.25.

the basis of the contract whether the transaction partner has met the contractual obligations. In other words, the monitoring is done with regard to the achieved result and works therefore indirectly and impersonally, as the transaction partner is not directly monitored during the provision of services. In the case of a company, however, different units cooperate on the basis of plans, which are set by the corporate management and controlled bureaucratically. Here, individual employees are supervised directly and personally at their work place during their performance by their superiors.

A particularly interesting finding of the empirical study is that especially major German companies safeguard the monitoring of their foreign transaction partners not only indirectly with the help of the contractual obligations and specifications—as would be typical for a transaction between independent enterprises—but they rely also on other control systems, which structurally correspond more to the governance mode of hierarchy than of a market transaction.

The expert interviews show in detail that the foreign providers allow their German clients direct access to their company-internal project management systems, so that German enterprises can monitor and control the process of software development directly. Although legally separate entities are formally concerned in this process, the companies involved create in this way a common relational structure, which transcends a merely contractual relationship. From the level of project managers up to senior management, a system of monitoring and reporting is established between the involved corporate units, which is based on monthly or weekly reports and includes in extreme cases even the real-time monitoring of foreign providers—when the German client can watch "live" what happens on the computers of the foreign provider (*real-time controlling*).

“One uncertainty of the customer is losing control. Usually he has a customer and a contract with that customer, with deadlines. He has to deliver good quality. Then there is a problem in the project management: You ask the project manager: Have you started the project? He says: Yes, and he did not. How much have you completed? 50 Percent and so on. You lose control of deadlines. So, in the sales process you have to show him that you have a project management system. He can get in, you give him a password, and he can get in to check.”⁴²

In this context, the expert interviews indicate very clearly that this comprehensive and direct supervision of the foreign transaction partner would not be possible without the precondition created in recent years by technological advances in the information and communication technologies. According to the interviewed experts, this is reflected, for example, by the fact that the above described system of monitoring and reporting is usually web-based. This means that the provider sets up an Internet portal, where he

⁴² Interview BR-I, p. 9

deposits those documents required for monitoring purposes; these password protected documents can then be accessed by the client from any point in the earth, given that an Internet connection is available. In addition, information that serves the control of the transaction partner can, if necessary, be sent cheaply and quickly via the Internet or be acquired by oral reports via telephone and videoconference.

In short, the comprehensive technological interlink of the transaction partners increases the transparency on the side of the customer significantly. With this the German company is able to immediately identify opportunistic behavior of the foreign provider in the course of the relational contractual relationships and to react with the appropriate sanctions, even before. At the end of the respective milestone stage it turns out that the foreign partner was not able to perform the contractual arrangements reliably. The uncertainty related to software transactions is again significantly reduced.

The limits of relational contracts: As the following interview passage illustrates, relational contracts meet the limits of their effectiveness, despite all the extensive technological surveillance, if a business relationship comes close to its end.

“Specifically, there is a critical risk in paying the last milestone, because it may turn out that the product is still faulty after it ran some time in practice.”⁴³

(Translation Thomas Dietz)

To avoid this risk, the contract contains a clause that obligates the provider to offer corrections to the software free of charge for a certain time (in this case one year) after delivery. The difficulty now is to enforce this agreement, as the customer has lost effective means of sanctioning and therefore control after the payment of the last milestone.

As a solution to this problem, the experts mention, on the one hand, the possibility of delaying the payment of the last milestone as long as possible, in order to retain a means of sanctioning, or on the other hand to continue the repeated game by further future orders. In the following section, however, it will turn out that for the enforcement of this rectification agreement the mechanism of reputational networks can be of crucial importance, transcending the bilateral level.

Reputational networks

Before beginning a business relationship, German enterprises usually consult a list of references, which shows those businesses as a potential transaction partner cooperated with in the past. These reference lists are an integral part of the web presence of foreign providers and are therefore directly available to German companies. In general, these reference lists are used as a starting point by German enterprises in order to do further research into the exchange history of a potential foreign business partner. In this it is

⁴³ Interview, D-IV, p. 11

common to phone or email the reference providers directly, in order to find out how a potential transaction partner actually behaved in past exchange situations. The exchange of information can here be so intense that not only the management exchanges information on potential foreign business partners, but also the personnel that was directly involved in the technical implementation of a project. What is striking is that in this context the experts interviewed attribute particularly high significance to the references of large multinational corporations. The reason is that in the case of large companies the perceived risk is smaller that two players agree strategically to draw the picture of a foreign potential transaction partner in an all too positive light.

It is questionable at this point, however, why German customers trust the information given by other companies at all. Ultimately, on the part of the reference provider there is no incentive to help a company in finding a suitable foreign partner. The solution to this matter is that, first, it is usually avoided to inquire with direct competitors, and, second, experts would immediately lose their status if they disseminated false information within their industry:

“If you are asked as an expert by another expert, then you even tell a competitor: this company is really excellent. If you give false information, you can forget about your status as an expert. Things like this spread quickly.”⁴⁴ (Translation Thomas Dietz)

In other words, the reference providers are themselves embedded in reputational networks, which safeguard the reliability of their information.

Yet, the crucial factor here is that foreign providers know that their potential customers are in touch with each other and exchange information about them:

“We think that if we try to give a commitment to the customer and the chances are that we may not be able to meet, then in the long term this causes big problems. It is a network society and word will easily go around.”⁴⁵

In this way, German enterprises generate another trilateral means in order to safeguard contract performance by the foreign provider, in addition to the above-mentioned possibility to end the business relationship (*bilateral governance*). For the case of a breach of contract, the foreign supplier must not only fear to lose its direct business partner, but against the backdrop of communicating reference networks, there is also the danger that it will find no more alternative transaction partners in future. Once the past behavior of a foreign supplier is not only known by its direct opposite, but also by any other potential customer, the breach of contract leads to a loss of reputation of the foreign provider

⁴⁴ Interview D-II, p. 14

⁴⁵ Interview IND-III, p. 4

within the "business community", which ultimately renders unlikely its survival at the market.

As the following passage illustrates, the loss of reputation is seen as such a strong threat to business success that foreign providers only engage into a transaction, if they actually believe that they can meet the expectations of their customer with some certainty. The high importance of the reputational mechanism for the creation of contractual certainty is here again emphasized:

“It is a very competitive work. So, delivery, commitments that are made by companies like us, if you don’t do this, it is not just a question of losing that half-million Dollars or Euros. It is a total incredibility in the business. It’s a small world. If I work with Audi tomorrow, they will say: can you give me a reference of another large German company? Now, if I have done a bad job, how can I request a reference? So, I know the repercussions of not delivering. Sometimes I leave it because I cannot deliver.”⁴⁶

The empirical results indicate further that German companies are supported, on the one hand, by foreign trade chambers and, on the other hand, by various trade associations in their quest for a suitable offshore provider.

Foreign trade chambers: Foreign trade chambers mainly support German companies by passing on their order requests to foreign members at a cost and by returning offers to the German companies. In this context, it should be noted, however, that foreign trade chambers have formally no other ordering function beyond this mere brokering activity: They do neither publish black lists, in which the misconduct of foreign companies were documented, nor do they exclude companies systematically from their organization when they have breached a contract in the course of a business relationship. The generation of contractual certainty is therefore not among the official duties of foreign trade chambers.

At the informal level, a different picture emerges. It indicates that the employees of foreign trade chambers collect informally important information about the transaction behavior of their members and pass them on to German companies, in order to warn them about business partners with a bad reputation:

“Reputation is our strong point. We do not publish information about companies, this is not allowed. But we have this knowledge already. And the Indian companies know that we are also very close to the consultants. We are also very close to the German community, on a one to one basis. But this is nothing official, because you asked me if there is a process in place, we cannot have this. We cannot say: here, there is a blacklist. This is not allowed. We cannot do that.

⁴⁶ Interview IND-IV, p. 7

But, the Indian companies know already that in different forums we can discuss this issue. And if a German company should come to us saying: Ok, I am going to do business with such and such a company, do you think that is safe, do you have a background, we may not even write it down in correct words because then it comes to defamation. But we could always pick up the phone and tell them: no, they have done wrong sometimes, so please watch out. That we would still do. And we are very well knit with the chamber of commerce in Germany, so there is a forum where we can talk about these things.”⁴⁷

In short, the foreign trade chambers become an important part of the above described informal reference networks through which German companies control their foreign transaction partners.

Trade associations: In addition to the foreign trade chambers, various trade associations, such as the BITKOM⁴⁸, support German enterprises in their quest for foreign software suppliers. A widespread means for promoting cross-border cooperation is the organization of contact forums, so-called match-making events, to which the trade associations invite both targeted German and foreign companies, in order to facilitate business contacts for both sides. As the foreign trade chambers, trade associations refrain, however, in the run-up to these events from systematically reviewing the transaction histories of the participants, in order to ensure that only reliable companies participate in match-making events. This means that trade associations also focus primarily on the initiation of business contacts; but they do not create marketplaces with their own rules and arbitration, as would be characteristic for a private legal system based on the principles of *Lex Mercatoria*.

The account of the importance of trade associations for the generation of contractual certainty would, however, be incomplete, if it remained limited to the organization of match-making events. Before the backdrop of the question about the institutional foundation for cross-border software transactions, much more important than the organization of these contact forums is the fact that the association links their members extensively. The BITKOM, for example, represents according to its self-description

“[...] a big, powerful network and brings together the best minds and companies in the digital world. BITKOM organizes an ongoing exchange between professionals and managers and provides its members with platforms for cooperation among themselves and for the contact with key customers.”⁴⁹ (Translation Thomas Dietz)

⁴⁷ Interview IND-VIII, p. 5

⁴⁸ http://www.bitkom.org/de/wir_ueber_uns/99.aspx, last visited 2 June 2008

⁴⁹ http://www.bitkom.org/de/wir_ueber_uns/99.aspx, last visited 2 June 2008

In BITKOM's nearly 100 professional working groups about 6,000 experts of the German IT industry are organized, and even if only few working groups address the issue of cross-border software transactions directly, this tight network still implies that German companies are constantly in touch with each other. Regarding the problem of contractual certainty, this means: Via the networks of the association, German companies learn "very quickly"⁵⁰ in an informal way "who behaves badly and where."⁵¹ Like the foreign trade chambers, the trade associations also encourage to a considerable extent the informal exchange of information between German companies. Thus, they also become an important part of the above mentioned informal reference networks, but without reaching the organizational degree of a transnational private legal system.

CONCLUSION

The starting point for the empirical analysis was the question of whether state private law loses its function to enforce contracts effectively and to enable economic cooperation in the wake of economic globalization, and whether it becomes therefore replaced by non-state private institutions at the global level. To inquire into this question, the software industry was chosen as a particularly suitable research example due to its high degree of internationalization. In concrete terms, it was examined which institutions offer a sufficient degree of contractual certainty when German enterprises purchase software in India and Eastern Europe. The findings of the empirical study can be summarized and theoretically categorized as follows:

Despite the fact that the enterprises involved usually settle on very detailed contracts, from the perspective of German companies state private law is of no significance for safeguarding contractual performance in cross-border software transactions. Contracts are necessary documents in order to participate in modern business life. For the management of an enterprise, they serve as a means of legitimation vis-à-vis its owners, and they ease communication in intercultural contexts. Furthermore, they are in need due to tax reasons, but they provide no contractual certainty for German customers purchasing software in Eastern Europe or Asia. As illustrated above, the view mainly advocated by lawyers can therefore not be confirmed, according to which cross-border transactions at least approximate national transactions with regard to the problem of contractual certainty due to working collision law norms. The empirical findings clearly prove that actors do not rely on state courts and enforcement authorities, in order to enforce contractual agreements in cross-border transactions. Mainly, two reasons are decisive for the insignificance of state private law: First, the outcome of costly proceedings in state

⁵⁰ Interview D-II, p. 19

⁵¹ Ibid.

courts is highly uncertain due to the high complexity of software development. Second, even if a state court has come to a verdict, claims cannot reliably be enforced across borders. This means that for German enterprises the use of state private law as an institution of contractual enforcement turns out to be both costly and ineffective and is hence avoided.

However, if German businesses cannot rely on state private law, how do they ensure the contractual performance of their foreign offshore providers? The empirical findings concerning this question can be summarized as follows:

First, German costumers check the reliability of a potential foreign business partner on the basis of specific investments before a business transaction even takes place. Then, they divide transactions into different milestone phases and thereby transform the transaction from a simple prisoner's dilemma into a repeated game. At the end of every milestone phase, the German enterprise can decide whether it wants to continue or to end business dealings (bilateral sanction). Thereby, the looming loss of future business opportunities keeps foreign suppliers cooperative and from turning opportunist. In short, the businesses involved create the institutional context themselves, which enables them to conduct cross-border software transactions. They design the exchange in a way so that contracts are fulfilled without outside intervention.

German enterprises control the activities of their foreign business partners not only with the help of *bilateral sanctions* but also additionally, cross-border software transactions are embedded into overarching reputational networks, which consist of companies, foreign trade chambers and trade associations. Hence, there is a further mechanism with which German customers can safeguard the contractual performance of foreign providers. For the case of a breach of contract, foreign providers have not only to fear that they lose their direct business partner, but there is the additional risk that they lose their reputation and become excluded from the business community due to the informal but intensive information exchange between German enterprises, foreign trade chambers and trade associations (*trilateral sanction*). In addition to *relational contracts*, for German enterprises the mechanism of *reputational networks* is of particular significance in order to safeguard the contractual performance of cross-border software-transactions. In contrast, formally organized, private systems of law, which are based on norms of the *New Law Merchant*, play no role in the provision of contractual certainty.

It should further be noted that German enterprises comprehensively use the opportunities offered by new developments in information and communication technology, when it comes to the initiation or control of their foreign business relations. Due to such technical innovation, it therefore seems that these two informal and spontaneous institu-

tions of contractual enforcement—*reputational networks and relational contracts*—gain more and more efficiency compared to state private law.⁵²

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⁵² Ronald J. Mann writes on this point: “If we believe that commercial enterprises in the longer run generally design their transactions so as to minimize the cost of such information problems, then the parties to those transactions generally should select the mechanisms that best resolve the information problems at the lowest cost. Thus, two features of the current environment suggest that the current set of institutions is unstable. The first of those is a general rise in the cost of legal sanctions, reflecting in the increasing pecuniary cost of litigation as well as slowing rates of resolution of civil disputes to the courts. The second is the general decrease in the cost of acquiring, processing and analyzing information. Taken together those two effects presage a significant shift in the balance of institutions away from legal sanctions – which are becoming more expensive and less effective – to non legal sanctions – which become more and more effective as information related cost continue to fall.” *Mann, Ronald J.*, Information Technology and the Increasing Efficacy of Non-Legal Sanctions in Financing Transactions, in: 54 *Vanderbilt Law Review* (2001), 1627

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