The New Institutionalism in Contract Scholarship

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Matthew Jennejohn, *The Private Order of Innovation Networks*, 68 **Stan. L. Rev.** 281 (2016), available at SSRN.

Relational contract scholarship is at a pivot point. On the one hand, the relationalist revival that has dominated contracts scholarship for almost half a century may be on the wane. Relational contract scholarship has evolved during this period into separate, and often dueling, intellectual traditions. One camp consists of scholars who are typically associated with the "law and economics" movement; in the other camp are scholars who more readily identify with the "law and society" tradition.[1] While relationalists have been quarreling with each other, a younger cohort of law and economics scholars, armed with impressive technical skills, have abandoned relational questions in favor of projects that are capable of being analyzed through formal models or sophisticated empirical techniques. In turn, many other of the brightest stars in contract are formally trained in analytic philosophy and focus their energies on classical contract doctrine and the extent to which it adheres to deontological principles grounded in Kantian notions of autonomy. At its best, this new contracts scholarship is analytically elegant and generates counter-intuitive insights. But its analytical rigor requires strong simplifying assumptions. As a consequence, the bulk of this work is a far remove from the complex environment of relational contracting.

This pessimistic view of the legacy of relational scholarship is tempered, however, by the rise of a new institutionalist school of contract scholarship that offers the promise of an accommodation between the dueling branches of relational theory and a counterweight to the elegant but abstract analysis of the philosophers and economists.[2] The new institutionalists reflect the older relationalists in their commitment to the belief that the institution of contract can only be understood by observing the law "in action," but they go beyond relational theory to explore both the potential and the limitations of contract design in a world of uncertainty: how can we understand the circumstances in which different contractual patterns are used to organize different kinds and speeds of innovative activity? A particularly noteworthy example of this new institutionalist school is a recent article by Matthew Jennejohn, *The Private Order of Innovation Networks*, published recently in the Stanford Law Review.

Jennehohn's project is to deepen our understanding of the "collaborative methods of innovation that have become a centerpiece of modern economic organization." (P. 281.) In a number of industries characterized by rapid technological development, conditions of high uncertainty have led to collaborations where both parties' skills and commitment to cooperate are necessary to achieve success.[3] In settings as diverse as the pharmaceutical industry and manufacturing supply chains, parties have come to realize that the feasibility of many projects can only be determined by joint investment in the production of information to evaluate whether a project is profitable to pursue. A particularly salient example is the research collaboration between a large pharmaceutical company with expertise in bringing new drugs to market and a smaller biotech firm with innovative technology. The collaborative agreement seeks to discover, design and develop a novel pharmaceutical product, and then take that product through the FDA approval process and through commercialization. The common feature of all these regimes is a commitment to joint exploration without imposing legal consequences on the outcome of the parties' collaborative activity other than in conditions of "bare-faced cheating."[4] Thus, neither party has a right to demand the performance that the parties imagine may result from a successful collaboration. If the parties cannot ultimately agree on a final objective, they may abandon the collaboration.

Jennejohn's starting point is a critique of the "braiding theory" developed by me and my co-authors, Ron Gilson and Chuck Sabel, that offers an explanation for the peculiar features of these collaborations. Braiding theory argues that the collaboration rests on a governance structure that, over time, creates confidence in the capabilities and trust in the character of the counterparty. Viewed through this lens the governance of these commercial collaborations shares

several common elements. The first is a commitment to an ongoing mutual exchange of private information designed to determine if a project is feasible, and if so, how best to implement the parties' joint objectives. The second is a procedure for resolving disputes. Its key feature is a requirement that the collaborators reach unanimous agreement on crucial decisions, with persistent disagreement resolved by unanimous agreement at higher levels of management from each firm.[5] Together, my co-authors and I argue, these two mechanisms make each party's character traits and substantive capabilities observable and forestall misunderstandings. Working under conditions of uncertainty, the parties can expect to encounter unanticipated problems that can only be solved jointly and that may generate occasions of disagreement. Their increasing knowledge of each other's capacities and willingness to share private information in service of their collective goals facilitates the resolution of problems and constrains opportunistic behavior.[6]

Jennejohn's principal critique is that braiding theory's exclusive focus on opportunism is too narrow. Rather, he argues, these collaborations must also respond to two other problems that can cause these alliances to fail. The first is the risk of "spillovers": the costs that arise when property rights in these innovative activities are not sufficiently defined and thus can bleed out of the effective control of the relevant commercial actors. The second problem is "entropy": the need to coordinate the routines that translate inputs into the successful team production of outputs. Collaborators under this framework must trade off the governance mechanisms that constrain opportunism with mechanisms that limit spillovers and reduce entropy. His analysis of prototypical collaborations together with the preliminary results of an ongoing empirical project suggests that this *multivalent* approach better explains observed variations in design strategies in many alliance agreements. The result is a richer but more complex (and thus less clean) conception of the factors that undergird the design of collaborative contracts.

Jennejohn's substantive critiques and his careful consideration of spillovers and entropy add importantly to our understanding of how collaborative alliances function. But more significant is the way his work melds the formerly disparate strains of relational scholarship. While his analytical techniques are clearly in the law and economics tradition, his methodology borrows importantly from the work of Ian Macneil.[7] Like Macneil, Jennejohn offers a rich and complex story of contracting practices that is not amenable (at least not yet) to an elegant theory. Like Macneil (and others working in the law and society tradition) his methodology is "bottom up" empiricism, using both qualitative and quantitative techniques to build understanding over time. This stands in opposition to the economic relationalist approach of "top down" theorizing—using a widely accepted theory to isolate the salient elements that influence commercial parties' behavior. Thus, like others working in this new institutionalist tradition, Jennejohn uses the analytic tools of law and economics to offer a rich descriptive account in the spirit of the law and society approach in order to describe how collaborative contractual arrangements function in a complex economic environment.

The accommodation between the law and economics and law and society methodologies reflected in Jennejohn's work offers hope that we might free the relational enterprise from its current peril: those who believe that contract law scholarship requires attention to the 'law in action' need to concentrate their energies on developing unifying themes that will permit the relational project to be as vibrant and influential in this new century as it has been in the last one. Jennejohn's work looks to just such a unification. What we need now are the voices of other "institutionalists" who will continue to examine the complex environment of contracting and propose principles that best explain how real world institutions maintain and support the ideal of human engagement through cooperative endeavor.

1. For discussion, *see* Robert E. Scott, *The Promise and the Peril of Relational Contract Theory in* **Revisiting the Contracts Scholarship of Stewart Macaulay: On the empirical and the Lyrical** 105 (J. Braucher et al. eds. 2013). [?]
2. For examples of work in the new institutionalist school, *see* Stephen J. Choi, Mitu Gulati & Robert E. Scott, *Contractual Arbitrage*, **Oxford Handbook of Global Governance** (forthcoming 2016); Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, Geo. **Wash, L. Rev.** (forthcoming 2016); Christopher C. French, *The Illusion of Insurance Contracts*, 89 **Temp. L. Rev.** (forthcoming 2016); Lisa Bernstein, *Private Ordering, Social Capital, and Network Governance in Procurement Contracts: A Preliminary*

Exploration, (**mimeo** 2015); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, 110 **Colum. L. Rev.** 1377 (2010); Ronald G. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration,*108 **Colum. L. Rev.** 431 (2009). [?]

3. In previous work, my co-authors and I have identified what is loosely called "the information revolution" as the exogenous shock that marked the emergence of collaborative contracting. Gilson, Sabel & Scott, *Contracting for Innovation*, supra note 2 at 441-2. [?]
4. *See, e.g.*, *Eli Lilly & Co. v. Emisphere Technologies Inc.*, 408 F. Supp. 2d 668, 696–97 (S.D. Ind. 2006) (holding that the contractual remedy for breach of a collaborative agreement is limited to the right to terminate and retain accrued scientific information). [?]
5. *See, e.g.*, Research, Development, and License Agreement by and between Warner Lambart Co. and Ligand Pharmaceuticals Inc. (Sept. 1, 1999), which provides that all decisions are by unanimous vote (Art. 3.1.4) and disagreements are resolved by the CEO of Ligand and the President of Warner-Lambert's Pharmaceutical division (or their designees). Requiring unanimity for project decisions makes it easy for reasonable skeptics to require more information from enthusiasts; bumping disagreements up to impatient superiors discourages obstinacy. Gilson, Sabel & Scott, *Contracting for Innovation*, supra note 2 at 479-81. [?]
6. The information regime characteristic of these collaborative agreements is designed to make it easy for each party to request clarification from the other. Thus, the regime allows for the joint interpretation of ambiguity, and makes observable to the parties' actions that would be opaque in an unstructured, informal exchange. This heightened, mutual observability allows the parties to learn about their respective capabilities as well as their disposition to cooperate. Under these conditions, continuing cooperation builds trust and protects each party's reliance on that trust in its substantive performance by increasing the costs of finding an alternative partner capable of reliably doing, and learning, as much as the current one. *Id.* at 1476-88. [?]
7. Ian R. Macneil, *The Many Futures of Contracts*, 47 **S. Cal. L. Rev.** 1018 (1974); Ian R. Macneil, *Restatement (Second) of Contracts and Presentiation*, 60 **Va. L. Rev.** 589 (1974); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 **Nw. U. L. Rev.** 85 (1978). [?]

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