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Proactive Provisions in Selective Distribution Contracts

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Abstract

A manufacturer within a selective distribution system is given the right to list demands to distributors regarding the store design, the assortment and product knowledge. In all, this contributes to the protection of the brand value that has been created, and contributes to the consumers experience – in harmony and accordance with the exclusive reputation. The law sets legal limitations to the distribution system, and the strategic aspects and rationale for deciding to use these systems are reasoned through three elements; prevention of free-riding by other distributors, maintenance of the brand value, and creation of distributor incentives. These reasons underline the conditions for finding that a selective distribution system is compatible with EU competition law.

Historically, in the conventional legal paradigm this distribution contract is primarily defensive and reactive, which is unsuitable for creating and optimizing distributor-relations and generating value trough the relationship, since it highly focuses on failure. Contracting parties enter contracts because they believe that there is mutual benefit to be achieved, and negotiators focus on the consequences of failure will undermine the probability of success. More importantly, it results in key areas of the contract content being overlooked or paid inadequate attention – specifically, clarity over scope and goals and over the on-going governance and management procedures for the relationship. The contractual conditions that are being negotiated should be more relation- and future-oriented and contracting parties should always have these goals in mind to learn from previous business to improve future business.

By applying proactive provisions the parties will generate relational rents through provisions on asset specificity, knowledge sharing routines, complementary resources and through effective governance. Specifically, the latter is of importance since the greater the parties in a selective distribution system are to employ effective governance mechanisms, the greater the potential will be for relational rent. These mechanisms generate relational rents by either lowering transaction costs, or providing incentives for value-creating initiatives. A solid dispute solution plan that focuses highly on self-enforcement will include elements of prevention and management in the proactive contract. Such a dispute solution plan is important since settling disputes in courtrooms are simply too costly.

The integration of law and economics is headed in a highly interesting direction, where the contract will hopefully be a tool and result of this integration. This shift away from failure presents itself through the proactive approach, where an integration of the legal and economic discipline appears to create an interdisciplinary management tool with a wide range of possibilities. With a proactive approach a paradigm shift emerges, from which the focus is on success rather than potential failure. Legal resources will help firms in achieving sustainable competitive advantages, by encouraging legally strategic thinking, and to extract competitive advantages in a legal environment.

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"You can settle any dispute if you keep the lawyers and accountants out of it. They just do not understand the give-and-take needed in business.", Stewart Macaulay

1.0 Introduction

1.1 Topic presentation

Since the early 90'ies there has been a growing body of literature contributing to the definition and further development of proactive law. Managers, lawyers and economists have become aware of the fact that settling disputes in courtrooms are simply too costly, as it was put by Brown et al. *It usually cost less to avoid getting into trouble than to pay for getting out of trouble.*[1] In today's business environment of increased inter-corporate dependency, complexity, and uncertainty companies must take good care of their relationships. They must detect and strengthen weak links in their supply chains, and manage their projects and transactions well.

In a selective distribution system (SDS) the manufacturer is *given* the right to list demands to counterparts, being it sellers and/or distributors. The manufacturer seeks an optimal number of places to perform sales and the distributor meets a minimum number of demands in regards to the store design, the assortment and product knowledge. This thereby contributes to the protection of the brand value that has been created and to the consumers experience in harmony and accordance with the exclusive reputation. As a distributor, you will in most cases be set inferior to the manufacturer, because the manufacturer will achieve a "dominating" position in the contract, while the distributor must meet the demands set by the manufacturer and might therefore be less liable in fulfilling the contract terms. This is due to the question of obtaining the brand value and reputation, is one of the most important elements of the trademark. I will in this thesis presume that manufacturers, who use SDS, are those with high-end-products and who use these systems for three main reasons: because of the achieved brand value, to create distributor incentives and to exclude price competition from potential free-riders.

The field of research of this thesis will focus on how to avoid contractual disputes in SDS from arising, by applying proactive provisions to the contract. Because, when disputes occur, business performance will suffer and will be at stake, including good-will, brand value and reputation. The cooperation between the two parties is essential, and it is therefore important to lead the manufacturer's attention towards the inter-relational matters, such that this can be strengthened and not result in a shut and close solution. If contracts fail, apart from the legal issues, business and relationships will be harmed.

Proactive contracts in this context are understood as self-made rules of the game, and as tools that can be used proactively to obtain business success and problem prevention. Business, law, and contracts are intertwined, and the latter two can increase or decrease business costs, liabilities, and risks.

[1] Brown (1956)

There can be many elements in the contract that can make it seem "complete", however, maintenance of the mutual relation must under no circumstances be underestimated, and here the proactive law will come in to play. Proactive law is based on the strong belief that legal knowledge is at its best when it is being applied *before* a dispute arises.[2]

In this thesis it is examined whether these relational circumstances can contribute proactively to a stronger relationship between the contracting parties and result in a stronger and more solid contract, which is more resistant to disputes and opportunistic behavior. The attention must be drawn towards the intersection between law and economics.

1.2 Research question

How can firms apply proactive provisions in selective distribution contracts in order to generate relational rent?

1.2.1 Research field

When a manufacturer uses selective distribution as a means of distribution strategy, it is interesting to enlighten how, the use of proactive provisions in the contract, can generate profit from an c point of view and give further advantage to the manufacturer and his/her distributor(s). Maintenance and strengthening of the contracting parties relationship is an important factor, as to avoid disputes from arising, this element to which the parties can gear profit from their relation is called relational rent (RR).[3] Furthermore, how the use of proactive provisions in the contract can contribute to safeguard the brand value created by the manufacturer, and how firms can generate RR through these proactive contracts.

Firms must try to *catch* these disputes in advance or before it has a negative impact on the business and the relationship, because, when law is used a dispute situation arises. The question in mind now is how will firms do this? Should business-partners continuously update each other, or should the lawyer be drawn into all the early processes, relating to the agreement to prevent one of the parties feeling neglected.

With this thesis it is examined how contracts can be, not only a legal tool but also a strategic management tool, and how contracts and alliances can be used proactively to enhance the competitive benefits. In addition to this, it is examined whether a proactive approach to the making of contracts will contribute to a value increase for both contracting parties.

[2] Haapio (2010a, p. 1)

[3] The term RR is being used, although, technically speaking, trading partners generate quasi-rents, which are: *returns that exceed a factor's short run opportunity cost, [and] are an excess over the returns to a factor in its next best use.* The term quasi-rents suggest that the rents are not permanent in nature - Peteraf (1994, p. 155)

1.3 Structure

This thesis is organized as follows; the first part of this thesis will seek to encircle the rationale and incentive for choosing to distribute through SDS, along with clarifying the legal areas juridical development, and objectives in legal and economical terms, while the second part will estimate the competitive contracting strategy more narrowly, in relation to SDS and RR. The progression is from a wide to a more narrow perspective, in the maneuver to encircle the significance of the issues relating to competition law, contracting duty and the conventional way of doing business, towards getting the most effective use of the resources in combination. Finally the third part of the thesis will use all of these tools and methods of both legal and economical issues and incorporate them into the designing of the rent generating selective distribution contract (SDC). Even though some chapters will be more legal or economic than others (e.g. chapter 3 and 5), there will be a slightly structural division between the two disciplines, with a continuous interdisciplinary integration, as the mindset is to link business strategies with legal strategies. The figure below sets the ground and mindset for its execution and process, though it does not explicitly illustrate the structure of this thesis.

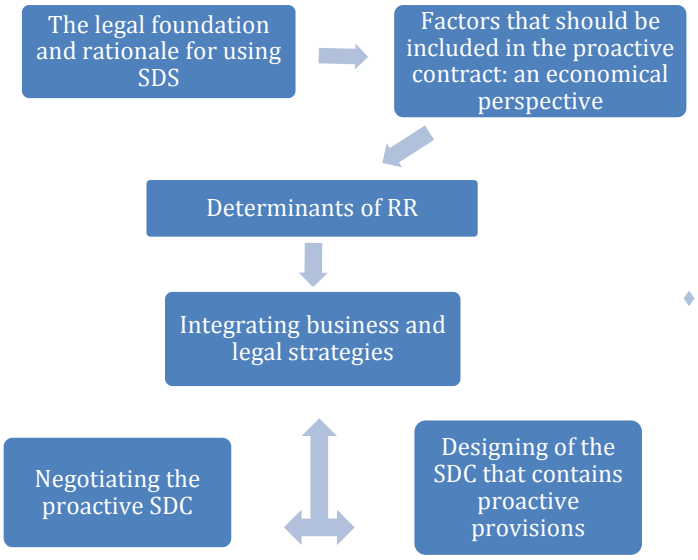

Figure 1.1 - Working structure

After the present introductory chapter, delimiting the research question and choice of research methodology and theory, comes *Chapter 2*, which clarifies the incentive for both manufacturers and distributors for choosing SDS. In *Chapter 3* the legal areas for SDS within the frames of European legislation, contract law and the exclusivity of the trademark law will be framed, furthermore how these laws can be used to achieve (sustainable) competitive advantages, whereas the understanding will be explicit.[4]

[4] The distinction is between competitive advantages and sustainable competitive advantages. Like a competitive advantage, a sustainable competitive advantage occurs when a firm's engages in a strategy that competitors cannot immediately copy.

In *Chapter 4*, the historical development of proactive law in Europe will be outlined, along with the tools given to proactive contracting, since the most important part of acting proactively is being able to manage disputes, and avoid litigation.

Chapter 5 will illuminate the object clauses in an economical perspective and terms, and provide a conclusion for a definition of the legal-economical framework, which will set the fundament for the further work in this thesis. Along with bringing an analysis of RR, and the sources and notions of interorganizational competitive advantages, and at the same time an analysis of opportunistic behavior in the pre-contractual and post-contractual stages.

Chapter 6, discussing strategic contracting, will help to achieve a better understanding of the fact that contracts should no longer be formally signed documents, but rather an integration of law and strategy, and thereby work as means of preventing disputes. Strategic contracting and contract design will be analyzed in helping to achieve these goals, along with a discussion of the use of contract law to achieve competitive advantages. The negotiation process prior to the formation of the contract has a great impact on the actual relationship and further business; this will be analyzed in *Chapter 7*.

In *Chapter* 8 the designing of the proactive contract will present a number of suggestions, for proactive provisions in the contract. *Chapter 9* addresses the possible ways forward, while concluding, this chapter will review main findings and objectively discuss any limitations of the thesis, also proposing avenues of further inquiry on the topic of SDS and proactive law.

1.4 Methodology and Theory

This thesis overall field of research will be treated, and discussed, mostly through the rules of law and economics, methodologies and theories. In answering the research question, the methods being used range from legal aspects to historical and relational analysis, furthermore, to relevant economical theory combined with strategic theory, to give various perspectives and further understanding of relations of causality, and presumable consequences of the actions under scrutiny. The sources used in the legal and the economical chapters are mostly secondary (research papers, academic Articles, etc.). The interdisciplinary methodology will be expressed in business legal context, and slightly through contract-economy. The legal and economical chapters are in relation with each other, and as such when doing the legal analyses, legal references will occur, and likewise with the economic approach.

The methodology, will in agreement with the structure of this thesis, embrace itself around the use of proactive law in SDS, and since proactive law is a relatively new breakthrough, it can lack clear contours. Newer research within the area of today's legal pioneers will be weighted greatly in striving towards answering the research question, and at the same time maintaining the connecting thread.

In regards to the EU-competitive regulative complex, the restrictive provisions in the Treaty for the Functioning of the European Union (TEUF) will set the ground for juridical unit of analysis in this thesis. The competition law and the trademark law counteracts each other, since competitive law namely has the purpose of ensuring workable competition and firms conduct on the market, whereas trademark law bestows the trademark owner with an exclusivity and thereby terminates the possibility for competition, like seen in most cases as a restriction of the competition. In most legal systems there is a principle of freedom of contract, which in coherence with SDS, implies that the parties of the contract, i.e. the manufacturer and the distributor, can enter the contract which serves their interest on their own terms. This methodology is formed by the mindset that the most efficient in business will set the fundament for the formation of the law, and therefore contract-law is declaratory, and can be dispensed with by agreement between the parties.

The economic methodology will illuminate the theories and models being used, and how they are interdependent, e.g. whether they are complementary and how they can be sources of competitive advantages through an inter-cooperative relationship. Economic theories such as, transaction cost economics, opportunistic behavior, asymmetric information, are relevant in manufacturer-distributor relationships and embody the principal-agent model and meet Eisenhardt's requirements for a useful application of agency theory. The two parties are interdependent and cooperative, yet rationally may pursue different, even contradictory, goals.[5] Furthermore, the theoretical background in Dyer and Singh's research on RR is the leading theory of, which the proactive provisions will encircle. At its core, the RR posits that firms in combination may reach sustainable competitive advantage by focusing on strategies that leverage their internal resources to take advantage of environmental opportunities.[6]

The RR's can help firms and business partners reach sustainable competitive advantages by i.a. strengthening the relation specific assets, having knowledge sharing routines, complimentary resources and having effective governance mechanisms. These four points are key points, as it is believed that the relationship among firms is a rising unit for analyzing supernormal returns. Dyer & Singh relates to effective knowledge sharing routines, which indicates bounded rationality and not just opportunistic behavior. I will use the term opportunism in cases where either the manufacturer or the distributor takes a competitive position that is contrary to the interest of the other parties to the contract or to their common agreement.

The significance of trust is emphasized; a factor that is not prominent in the transaction cost theory, and might therefore indicate that Dyer & Singh theoretical frame is more comprehensive than contractual economics, from which the business legal theory differentiates. The RR will be analyzed

[5] Eisenhardt's (1989)
[6] Bird (2011, p. 6)

and used in interaction with the proactive approach to the SDS, and thereby contribute to an interdisciplinary use of the economic and legal theoretical knowledge.

1.4.4 Methodology and Source Criticism

The legal literature as an interface question is very limited. Therefore this thesis will be strongly drawn towards using the scholarly literature of the legal field, where the thesis in most cases will handle them indirectly.

That this thesis not so thoroughly refers to case law, is because freedom of contract mostly makes national case law inadequate as a source of law, because of the standard terms and conditions of i.a. arbitration. Furthermore it is more relevant in this thesis to look at the parties' interests to avoid that disputes are taken to courts and instead find present self and co-regulation.

The leading economical theory of RR does not focus on product and market strategy, which is important in a SDS, nor is a view on objective criteria's on how they should be interpreted and dealt with, included in the theory. Therefore the theory has been supplemented with relevant theory, where it is found needed.

1.5 Delimitation

Firm disputes have a major impact on the socio-economic costs, and it would in this thesis therefore be quite relevant to do calculations on these costs, to point out how crucial it is that the contractual fundament is solid. However, since this thesis has a business economical approach, a socio-economic point of view will not be illustrated.

To be able to maintain a solid analytical approach, there will be a narrowing down to one type of contracts, namely long-term SDC's, whereas mass distribution contracts and exclusive distribution in addition to the linkage between the interdisciplinary generic strategies within law and economics will be excluded.[7] The costs by making this type of contracts, indeed, will in many cases exceed the actual worth of the agreement. In addition, the rising globalization and the negotiation across borders will not be narrowed down to only concerning nationally agreed contracts but rather, as much as possible, be drawn into international provisions for formation of contract

The increase of value, as mentioned earlier will not be measured as a function of the economical increase, but instead there will be argumentations as to how it could be measured, and to what extend the proactive provisions that can contribute to a value increase.

The contractual-legal perspective will not be fundamental in a certain national legal-system, since most legal system is governed by the principle of freedom of contract. In the competition law perspective it is assumed that the contract in question is implacable in the EU, and that the law is

[7] Michael E. Porters generic strategies (1980)

consistent. If one was to have something bullet-proof, all countries rules on competition must be scrutinized, and in the case of some countries, laws governing competition do not exist.[8]

Since there are no proactive legislations that can lead to a proactive use of provisions and approaches, the use of CISG and other laws will be very limited. When selling through selected distributors, the contracts involving intermediaries bring together people with diverging requirements. A series of contracts made by the ICC are available to balance these conflicting interests, and represents all those involved, - principals and agents, the manufacturer and distributors, sellers and buyers - without favoring any - though these will not be drawn into the thesis.

Williamson's neo-classical contract law a hybrid form, *in which the parties to the transaction maintain autonomy but are bilaterally dependent to a nontrivial degree*.[9] This type of contract has a built-in flexibility, so that significant disturbances already have been seized and therefore does not demand re-negotiation of the contract-relationship. These contract laws will not be analyzed in comparison with Macneils, classical contracts, neo-classical and relational contract law. Neither will the *new institutional economics* (NIE) coined by Williamson,[10] with its roots in Ronald Coase's, *The Nature of the Firm*.[11]

2.0 Why Selective Distribution Systems? – The Economic Reason for Selective Distribution

Why do some firms form strategic alliances, such as selective distribution? One reason for this can be strategic aspects of co-operation, the central premise that those who engage in co-operation do this because of payoff structures, which is that people corporate when the payoff exceeds that of proceedings alone.[12] SDS are the degree to which, a manufacturer restricts the number of distributor outlets, in a trade area allowed to carry its brand.[13] These restrictions are proposed to be beneficial, when manufacturers want to encourage distributors to provide higher levels of customer service, provide incentives for distributors to promote new products, develop new markets, or provide incentives for distributors to increase market coverage, and penetration for the manufacturer's products.[14]

The law sets legal limitations (these limitations will be outlined in the next chapter), to distribution systems, but what is the rationale behind deciding to use SDS? For this three reasons have been

[8] Countries with existing competition law are available on http://www.oecd.org/gov/regulatory-policy/bycountry.htm
[9] Willamson (1996, p. 95)
[10] Williamson (1975)
[11] Coase (1937)
[12] Eisenhardt & Schoonhoven (1996, p. 137)
[13] Ashurts (2011, p. 4)
[14] Dutta, Bergen & John (1994, p. 84)

identified as the rationale to use these systems, reasons that underline the conditions for finding that a SDS is compatible with EU competition law:

1. Prevention of free-riding by other distributors (sec. 2.1),
2. Maintenance of the brand value (sec. 2.2) and
3. Creation of distributor incentives (sec. 2.3)[15]

2.1 Preventing Free-riding by other Distributors

Where a distributor invests in its premises and in training to provide customer services in order to promote the manufacturer's products and brand value, there is a risk that other distributors that have not made any such investment might *free-ride* on these investments. The concern is essentially that customers may visit a premium distributor, in order to benefit from the high quality of service offered, but then carry out their actual purchase at a discount distributor who does not provide such services but can offer a lower price. Should this become a pattern, the result would be a move towards discount distributors with a lower level of service and a less attractive distributor experience.[16] Some manufacturers have a strong incentive to coordinate the activities of their distributors. Failure to do so will perhaps lead to decrease in sales efforts by their distributors.

Further, without distributor's coordination, distributors may shirk in their efforts to promote and sell the manufacturer's brand, this damages the brand's overall image, which in turn would lead to a decrease in the distributor incentive. These distributors might free-ride on the marketing efforts of other distributors.[17] SDS may prevent price competition on the brand, but consequently, distributors may be tempted to raise prices above competitive levels, which reduce the number of units sold and the manufacturer's revenue.[18]

2.2 Maintenance of the Brand Value

Manufacturer's who chose selective distribution as a distribution channel, base the competitive advantage on product performance, associated service and the brand image. Selective distribution is a strategy that aims at creating distinct value or image for a product or service. With regards to selective distribution of high-end-brands, the image of a product as a luxury item is; firstly a key input into the demand for these goods, secondly an input that is provided to some degree at the retail level when a manufacturer distributes through high-class luxury retail stores; and thirdly an input that economic theory shows will be fundamentally under-supplied by distributors.[19] Furthermore, these users of selective distribution channels with high-end-products perceive their products as being unique and justify the higher product prices, by educating the distributors to the advantages of their

[15] Ashurts (2011, p. 5)
[16] Id.
[17] Lassar (1998, p. 67)
[18] Posner (1975, p. 807)
[19] Ashurts (2011, p. 5)

unique qualities. Since, both parties share the goal of maximizing sales and profits it cannot be achieved at the expense of the products differentiated position.

Economic theory predicts that for luxury goods, if the style of the retail distribution outlets is an input into the image of a product, then manufacturers will respond with selective distribution. From an efficiency point of view, consumers are evidently willing to pay high prices for goods with a strong luxury image. [20]Since high-end products normally require greater levels of expertise on the part of distributor personnel, as customers must clearly understand why the brand is worth a higher price.[21] Moreover, distributor service standards and policies (product returns) can have a significant impact on the brands image.

The economical perspective is if consumers are willing to pay for image, then this dimension of luxury products should be regarded as valuable to consumers.[22] To the extent that a manufacturer uses a SDS to enhance the retail sector's input into the image of a product, then the manufacturer is adding to a valuable dimension. Prohibiting a manufacturer of luxury goods from engaging in selective distribution is a restriction of the manufacturer's choice of inputs – image versus lower prices – into its final offer of a product-price package.[23]

A luxurious environment and sense of exclusivity enhances the image and desirability of certain products, thereby promoting the brands stocked in such an environment. Likewise if the brands were to be sold in a less well presented outlet, this could damage the brand and lead to reduced demand.

2.3 Creating Distributor Incentives

Distributors are often primarily interested in competing on price, with the aim of attracting a greater number of customers through lower prices. Manufacturers, on the other hand, may have different incentives, such as competing on customer service and experience, to attract new customers to their products, and to enhance their brand image. From a manufacturers perspective, it may be necessary to impose quality standards to achieve these goals.[24]

Manufacturer support refers to the assistance a manufacturer makes available to distributors in its channel system, such as promotional material, consumer hot-lines, etc. Research has shown that distributor's commitment to a brand is heightened by the manufacturer's willingness and ability to

[20] Catry (2003, p. 11)

[21] Davidson, Sweeney, and Stampfl (1988) in Lassar & Kerr (1996, p. 620)

[22] The principle of consumer sovereignty takes consumer welfare as the values that are revealed by their choices.

[23] This assumes that the manufacturer can fully prevent internet distribution. Analytically the results also extend to limitations imposed to the distributors in the network with regard to their internet sales (monitoring of the quality of the internet sites and a requirement that significant investment is also made on brick-and-mortar outlets).

[24] Ashurts (2011, p. 5)

provide support. A strong manufacturer support program reduces the distributor's cost and risk of carrying a brand and promotes satisfaction with the channel relationship.

Support is used to motivate distributors to present the competitive advantages of their more expensive products, and convert consumers to their respective brands. Weak support imposes greater costs and risks on the distributor and signals the manufacturer's unwillingness to make significant investments in the channel.[25]

Lassar & Kerr define selective distribution as a differentiation strategy that aims at creating distinct value or image for a product or service.[26] To justify the higher product prices, they must educate the distributors to the advantages of these unique qualities. This strategy may be achieved through innovative technology or design, and the firms who pursue a differentiation strategy aim to create a distinct value or image for a product or service. In SDS the product is perceived as being unique and thus both parties share the goal of maximizing sales and profits, it cannot be achieved at the expense of the products differentiated position. Lack of distributor commitment to the brand is especially threatening to differentiators, given the strategy's dependence on distributor selling and service activities. Therefore, differentiators are expected to engage in relatively high levels of support and coordination efforts in their management of distribution channels.[27] These efforts help enforce distributor's contractual obligations as well as provide incentives for high service levels and commitment to the brand.

2.4 Summary

The rationale for choosing a SDS is determined for three reasons; prevention of free-riding by other distributors, maintenance of the brand value, and creation of distributor incentives. These three reasons have been identified as the rationale to use these systems, reasons that underline the conditions for finding that a SDS is compatible with EU competition law. The SDS is a subject to advantages and disadvantages for both the manufacturers and distributors who engages in a distribution system. The nature of the advantages obtained by the manufacturer or distributor from qualitative criteria depends on the terms of the criteria applied or the obligations imposed.

The manufacturer bears the cost of control, coordination and monitoring, while the distributor incentives consists of reduced competition, higher margins and manufacturer support payments. All these behavioral and monitoring costs will be reduced if a strong relational contract is present.

[25] Rosenblom (2004, p. 257)
[26] Lassar & Kerr (1996, p. 619)
[27] Id., p. 620

3.0 The Legal Framework for Selective Distribution Contracts

Typically, when manufacturers use selective distribution as a distribution channel to sell their product assortment, it will be to maintain greater control over the resale of their products. The rationale for choosing such a system is determined by the fact that the manufacturer is highly focused on how the product is being marketed and sold by the distributor.[28] In such a system, the manufacturer agrees to supply only those distributors who meet certain minimum criteria's. The distributors, in return, agree to supply only other distributors who are within the approved SDS or to end-users.[29] The selection criteria used will typically require that the products are sold only through distributors who convey a particular image or that the distributor undertakes specific obligations such as training of the employees or after-sales services such as:

- The location and organization of the point of sale
- The range of a product line
- The respect of certain requirements relating to the qualifications of the sales personal.

In this chapter the legal areas for SDS within the competition law, contract law and the exclusivity of the trademark law, furthermore how these laws affect SDS and to which extend they can be used to achieve competitive advantages, whereas the understanding will be explicit. Furthermore, analyzing previous case-law, and the Block Exemption Regulation (BER).

3.1 Closed Distribution Channel - SDS

Selective distribution is primarily characterized by a qualitative selection of distributors that in some cases may be very strict. The distributor has to meet certain criteria's in order to become an authorized distributor, within the SDS, such criteria's are typically related to the complexity and/or the brand value of the product which the manufacturer has already achieved, or wish to achieve.[30] This qualitative selection may come with an indirect quantitative selection without any exclusivity granted to the authorized distributors. The manufacturer's primary objectives are to protect the quality of the distribution, and to preserve the achieved brand value. SDS are most often used by manufacturers of products in one of these two categories:

- Complex or technical products that require a high level of pre-sale advices, and post-sale services.[31]

[28] Østergaard in Berger-walliser & Østergaard (2012, p. 251)

[29] Ashurst (2011, p. 1)

[30] Østergaard in Berger-walliser & Østergaard (2012, p. 252)

[31] The specialization of the distributor is technical, and not only related to the product image even if one does not exclude the other. Setting up an automobile dealership also requires significant investments, which in turn require a quantitative selection of distributors. These distributors enjoy an exclusive territorial mandate in the trading area defined in the contract, and will then be protected from any direct competition. The need to set up an efficient marketing and sales system suited to the product is even more important when other related services, such as technical advice, and mainly subsequent services (installation, maintenance, and after-sales services) must be offered. This is especially the case for automobiles, a complex, costly, and durable consumption good.

- High-end products sold under prestigious brand names which are heavily promoted to create an exclusive brand value. Manufacturers of luxury products choose selective distribution in order to protect and promote the brand image.[32]

Specifically, the manufacturer can demand from authorized distributors that the status, store design, and environment of their points of sale match the prestige and brand image of the products. Manufacturers can also ask distributors to offer advice proportional to the size of the store and the volume of products offered.[33]

3.1.1 Legal Areas that Affect SDS

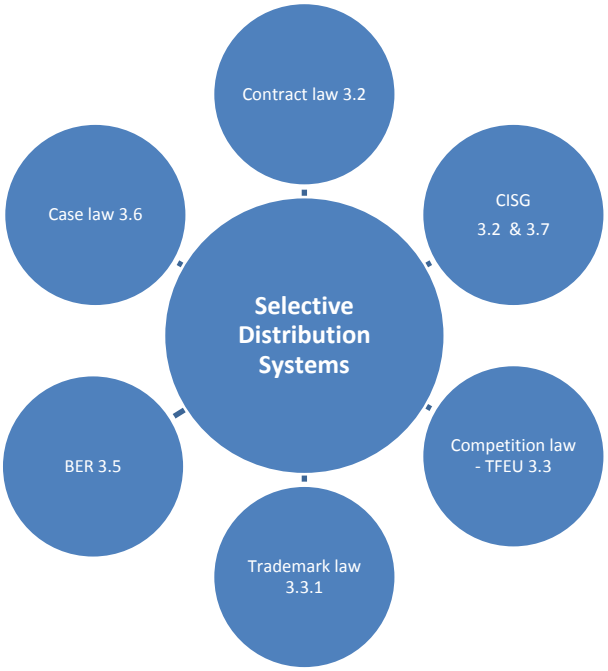

Figure3.2 - Legal areas that affect SDS

Figure 3.2 shows an overview of the most central laws and legal areas that affect the SDS, along with creating a structure for the following sections. The sections will frame the legal areas for SDS within the contract, competition and the exclusivity of the trademark law; in addition how these laws affect SDS along with the impact of relevant Articles in TEUF, BER and by analyzing previous case-law.

3.2 Principles of European Contract Law (PECL)

Most legal systems have a principle of freedom of contract. In Europe this is regulated in the PECL, which implies that the parties to a SDC can enter into a contract which serves both of their interests. The first chapter of PECL, Article 102 defines freedom of contract as follows;

(1) Parties are free to enter into a contract and to determine its contents, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles.

[32] Østergaard in Berger-walliser & Østergaard (2012, p. 252)
[33] Commission's regulation no. 330/2010, Article 1 (e)

(2) The parties may exclude the application of any of the Principles or derogate from or vary their effects, except as otherwise provided by these Principles.

The two principles explicitly outline the freedom of contract regulated within the EU, and that the parties to the contract are free to determine its contents and rules. Furthermore, that PECL is a model law, which requires the parties to actively opting it into the contract for it to be applicable. The principle of freedom to contract is widely acknowledged throughout the world, which turns contracts into important transactional tools in fine-tuning the legal framework regulating the transactions.[34]

Contract literacy obviously requires an understanding of basic contract law principles, which addresses matters relating to the formation of the contract, and whether the agreement should be in writing. Therefore it should be understood that there are two key variables that determine the sources of contract law, the freedom of the contract philosophy and its limitations, and the role of the invisible implied terms. These fundamental elements are important, and should be known by contracting parties.[35] The first variable as mentioned above - determines whether the contract is governed by civil law or common law. This variable can result in differences in the form and substance of the contract. One example of these differences is that, civil law contracts have traditionally been shorter than common law contracts because of the greater reliance in placed or implied law.[36]

The other variable relates to the subject of the contract, if it is a sales of good it will be governed by a national or international convention (law), for example the Sales of Goods act in the Nordic countries, the Uniform commercial code in the United States or if the Convention on Contracts for the International Sales of Goods (CISG) might apply depending on whether or not the parties are in business, from different countries and how the contract, which the parties have entered into is governed by a different law and whether the countries have adopted CISG.[37]

There are several legal doctrines that limit unimpeded freedom of contract and provide guidelines for ethical behavior in negotiating contracts, including principles relating to fraud, fiduciary-duty and unconscionability.[38] These legal doctrines might limit the ability of the parties to use their bargaining power unfairly.

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[34] Lando (1983, p. 654)

[35] Siedel & Haapio (2010, p. 671)

[36] http://ppp.worldbank.org/public-private-partnership/legislation-regulation/framework-assessment/legal-systems/common-vs-civil-law

[37] Sorsa (2011, p. 166), Seeing that freedom of contract is at its broadest in the B2B and B2G related transactions, the management aspect of contracting is more attractive to these two mentioned categories, and legal scholars must therefore be able to understand business as much as managers must be able to understand the law (Keskitalo, 2009).

[38] In contract law an unconscionable contract is one that is unjust or extremely one-sided in favour of the person who has the superior bargaining power. An unconscionable contract is one that no person who is mentally competent would enter into and that no fair and honest person would accept. (Source: legal dictionary).

3.3 Selective distribution and European Competition Law (TEUF)

European competition law might limit the freedom of contract, even though the parties can chose which law that governs the contract, national as well as international, the contract must not violate the competition law, since consumer benefits, not firm profits, are at the heart of European Competition law. The legal framework set forth by SDC and freedom of contract, is by nature, likely to clash with the rules of competition law.

A SDS is considered to be a vertical agreement within the European Union and is therefore regulated by Article 101(1) of the Treaty on the Functioning of the European Union (TEUF), which prohibits agreements or decisions of undertakings and concerted practices that have as their object or has the effect of prevention, restriction or distortion of competition. Under Article 101(2) TEUF all such anti-competitive restrictions are void. The conditions listed under Article 101(3), are at first sight anti-competitive restrictions that may be exempted from the prohibition, where it is shown that, on balance, the consumer benefits and efficiencies flowing from the restriction outweigh the anti-competitive effects.[39] In particular, Article 101(3) will apply where the agreement:
Contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not: (a) Impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; b) Afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question

These cumulative conditions listed in TEUF Article 101(3) must be fulfilled in order to have a valid vertical agreement. In general, parties are required to make their own analysis of whether their agreements benefit from Article 101(3), but the Commission has also issued the BER in relation to certain common types of commercial agreements, which set out clear rules as to the conditions, which must be met, and the terms and conditions which can be included in an agreement for Article 101(3) to be applicable.[40] The BER is dealing with distribution and is known as the regulation for vertical agreements, one of the most significant of the European competition law, and in terms of the number of agreements to which it applies (see sec. 3.5).

The element, which is relevant to the competition law, is that the manufacturer typically (presumably) chooses the best suitable distributors to sell and deal with his/her line of products, while others will be excluded from the opportunity, and might typically be imposed with education. These obligations can be very thorough and detailed, and will in many cases remind one of

[39] Guidelines on the application of Article 101(3) TEUF, http://europa.eu/legislation_summaries/competition/firms/l26114_en.htm
[40] *Vertical Agreements* - Global Competition Review http://globalcompetitionreview.com/reviews/47/sections/162/chapters/1822/

franchise. But selective distribution differs from franchising by typically rebuilding through selection of main-distributors of approved under-distributors.[41]

A SDC typically has no element of territorial exclusivity, but is instead characterized by a restriction on the resale of the contracted goods to third party distributors who are not a part of the SDS. The manufacturer in practice limits resale to a selected group of distributors who meet a set of objective criteria. This group is then free to sell to all end-users, wherever they are situated. The number of selected distributors in SDS will in most cases make it less exclusive, than exclusive distribution.[42] Namely an obligation on the manufacturer to exclusively deliver to the selected distributor is not approved from a competitive law point of view.

3.3.1 Competition Law contra Trademark Law

As mentioned earlier the exclusivity of trademark law and competition law counteracts each other, the former limits competition the latter prevents limitation of competition. Trademark law, like all unfair competition laws, is sought to protect manufacturers from illegitimate diversions of their trade by competitors.[43] Most countries' laws provide legal protection for intellectual property rights in the form of trademarks, patents, copyrights and so on, to individuals and companies. A lot of those rights require some form of registration, in order to be protected. Therefore trademark infringement must be dealt with in accordance with national legislation.

The value of a high-end brand could immediately be affected if the manufacturers trademark was associated with, for example, discount stores or other distribution outlets inferior to the quality of distribution premises normally used in the distribution of the trademarked products. Considering this, a question in mind might be what would then be the effect of selling specialized or luxury goods over the Internet? The exclusive rights conferred by a trademark provide a trademark owner an incentive to develop, promote, and invest in the brand and the products sold under it and trademark laws protect the achieved brand value created by manufacturers in SDS.[44] The fear of

[41] Selective distribution should not be confused with franchising, although these two modes of distribution do have some characteristics in common and are both governed by the BER. In general, a franchise requires an entrepreneur to sell specific products under a specific concept in which product brand plays a central role. In selective distribution, a distributor is not obliged to follow a particular concept to the same extent as in franchising. Products from different manufacturers might often be sold side by side and the trademarks of all these manufacturers may be used in advertising, as the requirements for selective distribution are limited to the suitability of sales premises, qualifications of personnel, and so forth.

[42] Under an exclusive distribution agreement, the distributor will have an exclusive sales territory within which it is protected from competing sales by the manufacturer and/or distributors appointed in other territories. Slightly less commonly, and either alone or in combination with an exclusive sales territory, the distributor may enjoy the allocation of an exclusive category of customers, again with protection from competing sales by the manufacturer/other distributors.

[43] McKenna (2007, p. 1841)

[44] McKenna (2007, p. 1916)

undermining efforts made to build brand and trademark image, namely goodwill, are eager to control the way in which their products are presented and sold to customers.[45]

3.4 Constructing a Selective Distribution System that Avoids Competition Law Issues

Competition law distinguishes between SDS that are either *quantitative*, based on criteria which directly limits the number of distributors in an area, a requirement to order a minimum amount of stock or to achieve a particular level of sales of the manufacturer's product or *qualitative* based on purely qualitative criteria which are laid down uniformly for all distributors, applied in a non-discriminatory manner, and do not directly limit the number of distributors.

Previous case law has confirmed that Article 101(1) prohibition on anti-competitive agreements will generally not apply to a SDS if these four conditions are fulfilled; [46]

First, the nature of the goods in question means that such a system is a legitimate requirement: the Commission generally accepts that manufacturers might require distributors to have appropriate premises, adequately trained employees and other service related requirements in respect of the two categories of products, complex consumer products and high-end luxury products, where such requirements are necessary to preserve quality of service around the products and/or ensure their proper use of it. Second, the distributors should be selected only on the basis of non-discriminatory qualitative criteria's, which are applied consistently, relating to their technical ability to handle the goods and the suitability of their premises. Quantitative criteria, on the other hand, will be subject to Article 101(1). Third, the selection criteria do not go beyond what is necessary; and forth, the aim of the SDS should be to improve other forms of competition and off-set the distortion of price competition caused by the use of a SDS; for instance, the system should enhance non-price competition, in relation to customer service levels, as a compensation for any loss of price competition between the products. Any refusal to approve distributors which meet the qualitative criteria would be considered prohibited.

3.5 Regulation no. 330/2010 and Case-Law

Selective distribution is regulated by the Commissions regulation 330/2010, cf. BER Article 1(e), previously regulated by commission's regulation 2790/1999, prior to this there was not any BER, but courts had earlier engaged with selective distribution and defined some guidelines which primary concerned the applicability of TEUF Article 101 (1).

[45] This concern might warrant the view suggesting that the quality of distribution channels forms an important component in brand goodwill protection. Trademark proprietors, having made heavy investments in the creation of goodwill, have strong reasons to protect the acquired reputation of a brand.

[46] YSL-Case

The BER automatically exempts from the general Article 101 prohibition of vertical agreements: between a manufacturer and a distributor each with a market share under 30%, that does not contain any so-called *hardcore restrictions*.

The 30% *safe harbor* applies both to the manufacturer and the distributor.[47] Normal market definition principles apply to establishing market shares. It will be necessary to determine:

- The relevant product market[48] and the relevant geographic market[49];
- The manufacturer's share of the market in which he sells the contract goods; and
- The distributor's share of the market in which he buys the contract goods: where possible, market shares should be calculated on the basis of value rather than volume of sales.[50]

A vertical agreement may fall outside, and therefore not benefit from, the BER because; one or both market share thresholds is exceeded; or the agreement contains hardcore restrictions (see sec. 3.5.1). In such cases, the parties will need to assess whether the agreement falls within Article 101(1) and, if so, whether it meets the criteria for exemption under Article 101(3). The BER does not generally apply to distribution arrangements entered into by actual or potential competitors.

There is one qualification to the exclusion of competing parties under the block exemption, where the BER will apply:

- Competitors enter into a non-reciprocal distribution arrangement (i.e. only one party distributes for the other) and;
- The manufacturer is both a manufacturer and a distributor of the contract goods, and the distributor is just a distributor of the contract goods, and not a manufacturer, – i.e. they are competitors at the retail level but not the wholesale/supply level.[51]

3.5.1 Hardcore Restrictions

In the BER there is a list of serious hardcore restrictions of competition in which if they exist, removes the benefit from the BER from the agreement. The provisions to the SDC must show that they are in balance, pro-competitive and benefits consumers, to avoid the agreement being unenforceable under Article 101(2).

There are three restrictions that are most relevant to a SDC these include:

- Resale price maintenance
- Territorial restrictions
- Restrictions of online sales

[47] A change from the previous BER from 1999, where the 30% rule applied only to the manufacturer.
[48] A group containing the contract products and those similar products with which they compete.
[49] The territorial area within, which conditions of competition are essentially the same.
[50] It's share of purchases on the upstream wholesale market and not its share of sales on the downstream retail market.
[51] Ashurts (2011, p. 4)

3.5.1.1 Resale Price Maintenance

Resale price maintenance - restricts the distributor's freedom to determine its resale price; even though the manufacturer can impose high standards to quality and service, he cannot put restrictions on the retail prices, that the distributors of the network charges, by imposing minimum or fixed prices.[52] Paragraph 225 in The Commission's guidelines to the BER from 2010 shows some softening on the traditional strict stance on this subject.[53] Recognizing that resale price maintenance may, in some circumstances, lead to economic efficiencies and therefore meet the test for clearance under Article 101(3). Of particular interest in the selective distribution context, given the free-riding concern discussed above, are comments that resale price maintenance may be justifiable to eliminate free-riding, on the basis that distributors who invest in additional customer services may cut back on such services if they are undercut on price by distributors who do not provide such services. However, there will be a high burden of proof to justify these tentative exceptions under Article 101(3) and caution is essential.

3.5.1.2 Territorial Restrictions

Article 4 (b) (iii), regulates the territory restriction of a SDS, and of sales to unauthorized distributors; *The restriction of sales by the members of a selective distribution system to unauthorized distributors within the territory reserved by the manufacturer to operate that system.* The directive allows restrictions on the acting parties of SDS, to authorized distributors. This limitation is the core in a SDS. Distributors receive the products when they have been approved as a selected distributor in a SDS, but the unapproved will not. This way the internet as a distribution-channel will be excluded through the contracts, so that only approved distributors have access to the products, in accordance with the agreement of the system. A contractual restriction on sales to unapproved distributors, in the distribution system is thereby instituted, even though parallel import via unauthorized distributors gets cut out of the agreements.

Hence this provision there cannot be any further limitation on the export to approved distributors in the system. The prohibitions on limitation of areas or clientele that can accord the last pile in Article 4 (b) are derogated by a limitation of the buyer's access to selling components. This limitation is kind of narrow since: *the restriction of the buyer's ability to sell components, supplied for the purposes of incorporation, to customers who would use them to manufacture the same type of goods*

[52] The Danish design company Georg Jensen A/S has recently paid a fine for acting in violation to the Danish competition law regarding resale price maintenance, the fine was trimmed because Georg Jensen contacted the authorities and helped in the clearing up of the case

[53] The guidelines comment that resale price maintenance may be justifiable during an initial product launch period or for short-run coordinated promotions across a franchise or distribution network. Paragraph 225) However, retail price maintenance may not only restrict competition but may also, in particular where it is supplier driven, lead to efficiencies, which will be assessed under Article 101(3). Most notably, where a manufacturer introduces a new product, RPM may be helpful during the introductory period of expanding demand to induce distributors to better take into account the manufacturer's interest to promote the product. RPM may provide the distributors with the means to increase sales efforts and if the distributors in this market are under competitive pressure this may induce them to expand overall demand for the product and make the launch of the product a success, also for the benefit of consumers.

as those produced by the manufacturer.[54] The accepted limitation affects the regulation since the manufacturer of components contractually will safeguard him against competitors, who produce on a derivate market, to get access to these components. However, the provision only applicable, if the manufacturer of the components partly deliver these to a buyer with the intention that the components are being worked into the buyers production, and that the manufacturer produces the components himself on the basis of such components. This provision makes it possible for a manufacturer who produces components, which he himself uses in his/her, line of production to make use of this, by selling to non-competitive buyers who use the components to another kind of production.

3.5.1.3 Restriction on Sales to End-users

This provision excludes the group exemption for agreements between the manufacturer and the distributor, who have cf. BER Article 4 (c) the following aim: *the restriction of active or passive sales to end users by members of a selective distribution system operating at the retail level of trade, without prejudice to the possibility of prohibiting a member of the system from operating out of an unauthorized place of establishment.* This means that members of a SDS cannot be restricted active or passive sales on customers to whom they sell, or wish to sell to. The last part of Article 4 (c), reserves the access of forbidding a member of the system to do business from an unauthorized place of establishment.[55] This reservation has coherence with the fact that it results in an acceptable bound on the distributor in a SDS, and that this prevents him from freely deciding, where the products are being sold. By doing this the manufacturer ensures that no exploitation of the build-up goodwill will occur cf**.** Pronuptia de Paris,[56] and is thereby the fundamental point of view on acceptable restrictions in accordance with Article 101(1) TEUF, which seeks to protect goodwill and knowhow rules in this judgment.

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[54] BER Article 4 (b) (iv).

[55] In active sales the distributor takes steps to attract customers, for example through advertising or sales promotions; in passive sales the distributor has not taken any such steps but the buyer has found the distributor and requested the products - a consumer from a different area unsolicited addresses the selected distributor and asks for deliverance of a product.

[56] In the *Pronuptia case,* the Commission found that in a system of distribution franchises of that kind an undertaking which has established itself as a distributor on a given market and thus developed certain business methods grants independent traders, for a fee, the right to establish themselves in other markets using its business name and the business methods which have made it successful. Rather than a method of distribution, it is a way for an undertaking to derive financial benefit from its expertise without investing its own capital. Moreover, the system gives traders who do not have the necessary experience access to methods which they could not have learned without considerable effort and allows them to benefit from the reputation of the franchisor's business name (Paragraph 15) which incorporate approved retailers into a selective distribution system, which do not involve the use of a single business name, the application of uniform business methods or the payment of royalties in return for the benefits granted. Such a system, which allows the franchisor to profit from his success, does not in itself interfere with competition. In order for the system to work two conditions must be met. The franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in order to enable them to apply his methods, without running the risk that that know-how and assistance might benefit competitors, even indirectly. It follows that provisions which are essential in order to avoid that risk do not constitute restrictions on competition for the purposes of Article 85 (1) (Paragraph 16).

If a selected distributor operates in the retail trade he must then sell to all end-users, which means consumers in the designated country or in other countries. There is thereby an indispensable obligation to making it possible, so that passive sales are not limited, and active sales for the distributor outside his/her area to the consumers can be limited. This provision is therefore more committing for the manufacturer to the selected distributor of the retail, than the commitment where there is not a SDS, since a distributor in the latter case even though he delivers to the consumers, can be ordered limitation in the agreement with his/her manufacturer in regards to active sale in the territory of the manufacturer or another distributors area or his/her reserved clientele.

3.5.1.3.1 Using the Internet as a Sales-channel

Developments of the Internet and electronic commerce upset the traditional marketing schemes. This disruption is moderately appreciated by the manufacturers who have built selective distribution channels. The manufacturers are particularly attentive to potential free-rider offences. In other terms, they do not wish their products be resold outside the network (parallel import). This legally framed marketing model is underpinned with contracts that define the terms and conditions for sale.

Manufacturers have the opportunity to take legal action against the (authorized) distributors who do not respect these conditions, especially the ones concerning resale of the product. Proceedings against the free-riders can also be held responsible, arguing that their behavior provoke unfair competition and is a violation of their trademark.

Whether the Internet should be used only as a communication medium, including helping people locate the nearest available source for products, or as both a communication medium and a sales-distribution channel needs attention. In certain situations, use of the Internet as only a communication medium is likely to be appropriate. Manufacturers using an exclusive or highly selective distribution intensity approach where local distributor investments are crucial should likely stay away from using the Internet as a sales-distribution channel, since a product's price varies considerably across global markets, and therefore limiting the Internet's scope would appear wise Cf. Pierre Fabre.[57] This statement is not harmonized with the BER guidelines: *In principle, every distributor must be allowed to use the internet to sell products.*[58] Paragraph 52 in the BER guidelines, elaborates on this in the context of e-commerce, stating that, any requirement on a distributor to prevent customers located in another territory from viewing its website and purchasing its good-will be considered a hardcore restriction.[59] The Commission also indicates that any criteria

[57] Paragraph 19 in Pierre-Fabre case, will be analyzed further in sec. 3.6.

[58] BER guidelines, paragraph 52

[59] Examples of such hardcore restrictions of passive selling, identified in the guidelines, are requirements as follows:

- To automatically redirect customers to another distributor's or the manufacturer's website, where the website in question is located in a different territory that the customers;"

imposed on an authorized distributor in relation to online sales which are not equivalent to the criteria imposed on sales through a *bricks and mortar-shop*[60], constitute a hardcore restriction, as they are likely to prevent distributors from using the internet to reach more customers.[61]

Internet sales have been the subject to much discussion in relation to distribution agreements, as they threaten the notion of exclusive territories and allow for the possibility of free-riding. Furthermore, concerning luxury goods in particular, there is a fear amongst manufacturers that the prestige of the brand may be lost if it is not accompanied by personal customer service and care in an appropriate environment, which add to the essence of exclusivity.
The revised BER and new guidelines have attempted to address concerns in this area. The BER does not refer specifically to internet sales; however, the guidelines do attempt to provide some clarification on the Commission's approach to internet sales with specific reference to SDS.[62]

Before the development of the internet, when an exclusive distribution system had been put in place, with active sales prohibited but passive sales not prevented, search costs were very high for consumers.[63] Since, it was unlikely that consumers would drive long distances to compare prices in different geographical markets. In this setting passive sales were unlikely to be a very important issue for distributors, and territorial clauses solved the free-riding issues even if passive sales could not be prevented. The internet eliminates any search costs for consumers: consumers can check prices on different websites within minute, and shopping costs are often not much higher for international sales. The internet reduces effective distances between outlets.

The guidelines have sought to update the definitions of active and passive sales in the light of the growth of e-commerce. They state that the use of the internet is generally considered to constitute passive sales. More specifically, the guidelines state that the use of a website is considered passive sales as long as it is not targeted at certain customers through the use, of online advertising banners and unsolicited emails to customers in other territories - these practices will be considered to be active sales.[64] This distinction is less relevant in the context of SDS's, as both active and passive sales to end-users (and other authorized distributors) must be permitted. While, as noted above,

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- Terminate the customer's order once the credit card details reveal an address which is outside the distributor's home territory; a requirement that the distributor will *pay higher prices* for goods which are intended for resale online, than for those intended for sale offline
- And a requirement that the distributor limit the proportion of its overall sales made online.

[60] A traditional street-side business that deals with its customers face to face in an office or store that the business owns or rents. The local grocery store and the corner bank are examples of "brick and mortar" companies. Brick and mortar businesses can find it difficult to compete with web-based businesses because the latter usually have lower operating costs and greater flexibility. (source: http://www.investopedia.com)
[61] BER guidelines, paragraph 56
[62] BER guidelines, paragraph 51
[63] Id., paragraph 65
[64] Id., paragraphs 52 and 53

many restrictions on the use of the internet will constitute hardcore restrictions, a manufacturer may impose quality standards:

- Requiring distributors to have one or more shops in order to be a member of the distribution system, (i.e. the distributor may be prevented from selling solely via the internet);[65]
- Requiring that third-party platforms on the internet may only be used in accordance with the quality standards agreed between the manufacturer and its distributors.[66]

The guidelines also recognize that certain quality requirements may need to be tailored specifically to reflect the characteristics of distribution online. This is illustrated by reference to the possibility of a requirement upon an authorized distributor to limit the quantity of goods sold to each end user in order to prevent sales to unauthorized distributors. If internet platforms make it easier for unauthorized distributors to obtain large quantities of products, the quality standards for online sales may need to be stricter to take this into account.

There is a clear efficiency rationale for manufacturers to restrict active sales by distributors operating in different territories wishing to free-ride on the effort of distributors operating in the territory. The rationale applies with equal force to passive sales. In short, economic analysis suggests that manufacturers should be free to restrict passive sales as well.[67]

3.5.2 Restriction of Cross Supplies between Distributors within a Selective Distribution System

The second restriction on sales in selective distribution is found in Article 4 (d) of the BER, which prohibits: *Restriction of cross supplies between distributors within a selective distribution system, including between distributors operating at different levels of trade.*

This provision requires that all authorized distributors in a SDS - including wholesalers - be free to sell to, and purchase from each other, including on a cross-border basis. This provision is meant to promote trade between authorized distributors (i.e. intra-brand competition), so that if, for example, a distributor in one country faces higher prices than a distributor in another country, there will be scope for the distributor facing higher prices to purchase cross-border at lower prices – parallel import. Moreover, appointed wholesalers cannot be restricted as to the authorized distributors they can supply, and similarly authorized distributors cannot be restricted in relation to the authorized wholesalers from whom they buy. Yet again, in theory there is potential for arbitrage between low and high cost territories/wholesalers. For example, an appointed distributor in one EU-country cannot be prevented from actively selling to authorized distributors elsewhere in the EU.[68]

[65] Id., paragraph 54

[66] Id., paragraph 54 - The guidelines give one example of a permitted restriction, namely a requirement that customers do not visit the distributor's online shop through a third party platform carrying a name or logo from a third party platform

[67] Cleary, Gottlieb, Steen & Hamilton (2008), paragraph 64

[68] Ashurts (2011, p. 6)

3.6 Case law

European Court of Justice (ECJ) rulings in cases of selective distribution have drawn a lot of attention towards criteria's for approval in a distribution system, which the distributor or the seller can make use of. The ECJ stated its openness towards SDS in the *Metro-case,* where the commission had accepted SABA's SDS, which the Metro business-chain was unsatisfied with, because they had not been approved by the SABA-distributor. Even though Metro filed for annulment, the commission did not rule in their favor. On the other hand it led to a general statement from the commission saying that, the Article in the treaty on competition cannot be distorted, since it presumes the demand for workable competition on the market cf. Paragraph 20.[69] The ECJ added that it is particularly so when, as in the present case, access to the distribution network is subject to conditions exceeding the requirements of an appropriate distribution of the products, however, although price competition is so important that it can never be eliminated, it does not constitute the only effective form of competition or that to which absolute priority must in all circumstances be in accordance with Article 101 (1).[70] The same statement[71] was applied by the court to the *Lancôme-case* and *l'Oréal-case*.

In the l'Oréal judgment the court stated that: the agreements laying down a SDS based on criteria's for admission, which go beyond a mere objective selection of a qualitative nature, exhibit features making them incompatible with Article 101(1) where such agreements, either individually or together with others, may, in the economic and legal context in which they occur and on the basis of a set of objective factors of law or of fact, affect trade between member states and have either as their object or effect the prevention, restriction or distortion of competition. It is for the commission alone, subject to review by the court, to grant an exemption in respect of such agreements pursuant to Article 101 (3).[72]

In the *Pierre Fabre-case* - a judgment that came after the introduction of the new BER 330/2010, which emphasizes the distributors' ability in any type of distribution systems use of the Internet - the ECJ ruled that, in the context of selective distribution, Article 101(1) TEUF must be interpreted as meaning that a contractual clause requiring the presence of a qualified pharmacist for selling cosmetics/personal care products within a physical space resulting in a ban on using the Internet for such sales, amounts in *a restriction by object* according to Article 101(1) TEUF. It furthermore stated that, following an individual and specific examination of the content and objective of such contractual clause as well as the legal and economic context of which the clause forms part of, as

[69] The requirement contained in Article 101 of the TEUF treaty that competition shall not be distorted implies the existence on the market of workable competition, that is to say the degree of competition necessary to ensure the observance of the basic requirement and the attainment of the objectives of the treaty, in particular the creation of a single market achieving conditions similar to those of a domestic market.

[70] See also AEG-telefunken-case.

[71] Metro-case, Paragraph 20

[72] l'Oréal-case, Paragraph 21

well as taking into consideration the *properties of the products at issue*,[73] this contractual clause cannot be objectively justified.[74] Moreover, in paragraph 58 the ECJ ruled that Article 4 (c) BER,[75] on active or passive sale to end-users operating from an unauthorized place of establishment, must be interpreted as meaning that the BER does not apply to a SDC containing a clause prohibiting de facto the internet as a method of marketing contractual products. Nevertheless, such contracts may benefit from an individual assessment under the conditions of Article 101(3) TEUF. The Pierre fabre-case does not include the jurisprudence point of view on whether it would be a problem that the internet is only used as a marketing-channel and not as a sales-channel. This would be an interesting discussion to include in regards to internet-sales.

From a competition policy perspective, the treatment of dissimilar environments - physical/virtual - under the same instruments BER actually demonstrates a deficient approach which minimizes and restricts the positive dynamic elements created by internet technology.[76] This approach can also act against the process of competition within virtual and dynamic markets; market evolution itself and certainly, consumer demand and preferences.[77]

3.7 Summary

The legal areas that affect the SDS have now been established through this chapter, and selective distribution is found to be a closed distribution channel, where a manufacturer's primary objective is to protect the quality of the distribution, and to preserve the achieved brand value. Users of SDS are manufacturers with either complex/technical products or prestigious high-end products.

A SDC, which eliminates intra-brand competition, can only address free-riding - should such problem exist- if markets can be rigorously segmented. This means that the markets in which exclusive distributors operate are effectively isolated from one another. Investment by one distributor, in local advertisement, promotion or in-store service, must not benefit other distributors. Apart from the fact that such a SDC – provides territorial exclusivity to the appointed distributors – goes against the very essence of the European ideal of the single market and violates the BER. But selective distribution is a means for the manufacturer to reduce intra-brand competition for the purpose of enhancing distributors' incentive to invest in image, although not necessarily at the level that would be best suitable for the manufacturer. Without the ability to limit internet sales, the incentive for such investments would be severely curtailed.

[73] BER guidelines, Paragraph 47

[74] Id., at Paragraph 34 citing Case 56/65 LTM [1966] ECR 235 and paragraph 35 citing Joined Cases C-501/06P, C-513/06P, C-515/06P and C-519/06P GlaxoSmithKline v Commission [2009] ECR I-9291, paragraph 58.

[75] Article 4(c) BER 2790/99 prohibited the restriction of active or passive sales to end users by members of a SDS. The guidelines of BER 2790/99, paragraph 53, emphasized that*: in a selective distribution system the distributor should be free to advertise and sell with the help of the Internet.*

[76] Themelis (2012, p. 2)

[77] Id., p. 2

4.0 Proactive law - Historical Insights

In this chapter the gradual historical development of proactive law will be outlined, from conventional law to preventive law, outlining factors that have driven the traditional legal paradigm towards preventive law and later to proactive law.

4.1 Conventional (reactive) Law

When dealing with proactive law it is essential to briefly go through some of those conditions that characterize the conventional legal paradigm. Basically, the nature of law seems to be a set of rules made up to guide human conduct, imposed upon, and enforced among people in a given society or state.[78]

In the vocabulary of many managers, the word law implies that legal disputes must be solved by legal means, and they appear to think about the law only when approached - or threatened - by lawyers. In other words, lawyers are expected to get one out of trouble.[79] This is a reactive approach to legal matters that contains many pitfalls. Siedel and colleagues have discussed, that too often, legal concerns are treated as problems to be resolved as quickly as possible so that attention can be focused on business goals.[80] The problem with this approach is that even though legal matters are viewed as problems to be solved rather abruptly, the inevitable fact is the unpleasant effect it has on the business goals.

The traditional legal system is mainly backwards oriented. Even if governments or industries develop laws and regulations in order to influence the future, often these changes or new legal developments take place in reaction to negative developments in society and evolve around shortcomings and failures of the existing legal systems. The legislator must at his/her best try to manage the society's interests and realize that the legislation can ensure prohibition of inacceptable actions.[81]

Court decisions sanction failures, responds to deficits, disputes, missed deadlines and breaches, and the contract has traditionally been a final sealing of a given agreement, with focus on ensuring and enforcing ones rights in litigation, rather than enhancing a co-operation between the parties. The contract and contracting parties were not prepared for changes that might occur along the way. Instead of developing a system that was able to manage and prepare for changes, the focus had been

[78] Gerlinde in Sorsa (2011, p. 113)
[79] Siedel & Haapio (2011, p. 4-5)
[80] Id., p. 4.
The ratification of CISG by the remaining EU member states would be a significant step in simplification of the cross-border trade in the EU. It should also be noted that the UNIDROIT principles already provide an *optional instrument* for B2B contracts, and that the freedom to choose the applicable law also means that all available national laws can be seen as optional instruments. - ICC (2011, p. 2)
[81] Sorsa (2011, p. 115)

mainly on formal and tense formulations, with the opportunity to hold the counterpart liable to breach of contract.[82]

Not only do those in lawmaking suffer, the judiciary, private legal relationships, and contracts suffer as well from this failure and orientation of litigation.

Instead of promoting good behavior, penalties, liquidated damages, dispute resolution clauses are being provided, almost assuming that something will go wrong. Ultimately this approach leads to litigation, loss of or broken relationships and even costs, but also loss of opportunities, which cannot be measured in money alone.

4.2 Preventive Law

The idea of preventive law was first introduced by law professor Louis M. Brown, the founder of The National Centre for Preventive Law[83] also known as the father of preventive law, a pioneer within the field of preventive law, and who marked a movement in the mid 50'ies in USA.[84] Preventive law is about avoiding various independencies' from occurring, by acting in prevention. This way of thinking arose in business surroundings characterized by legal assistance that was purchased from house councils.[85] The lawyer was seen as the central and driving force and the client the primary source of information.[86]

It usually costs less to avoid getting into trouble than to pay for getting out of trouble.[87] This quote by Brown illustrates the whole mindset behind preventive law and is *a truth that hasn't lost its value.*[88] The idea of an ex-ante view or proactivity of law is not new itself. It is difficult to point out one originator of the preventive way of thinking law. In addition to that, this form of law has been practiced for years, to varying degrees, but it still does not change the importance of the summarized principles along with the verbalization and distribution of the knowledge that exists within the field. For years it has been known that the earlier a dispute or a potential dispute is addressed, the better the chances for a fair and prompt solution.[89]

Awareness has been created which is necessary to be able to change people's mindsets, in order to use the law in accordance with business goals, and to become more creative, preventive, and even

[82] Pohjonen (2009, p. 5)

[83] The NCPL website at http://www.preventivelawyer.org/ offers a general introduction to the theory of Preventive Law and how it applies to particular areas of practice.

[84] Dauer (1999, p. 801)

[85] Brown (1956, p. 949)

[86] Haapio (2010a, p. 6)

[87] Sorsa (2011, p. 118). Dauer (1986, forewords) - Brown has been criticized for using the term preventive law among others; by the legal Austrian theorist Hans Kelsen, who pointed out that the term Preventive law is incorrect, since it is not the law that is preventive, but rather the competences of using the law by a legal professional, who is acting preventive. Yet another critic of the Browns manual is Charles E. Corker, whom has been cited for nothing less than: *But a book which acquaints laymen with "the law" at the level of Mr. Brown's manual is worse than useless.*

[88] Id., p. 119

[89] Id. - Even though Brown is called the father of preventive law, he is, not the inventor of preventive law.

be better lawyers.[90] To prevent and preclude, you relate to effects and consequences of a firms behavior, and by doing so you are able to manage risks and avoid disputes and trials. One of Browns fundamental premises is that in traditional law the focus is in mainly on predicting what courts might do, while in the preventive law one predicts what people might do, according to Edward Dauer one important thing we have been taught by Brown.[91]

Dauers presents four core principles of preventive law; *prediction of human behavior*, *components of conflict management*, *embracing risks*, and *making preventive legal services available to clients*.[92] The first principle refers to the lawyer who practices preventive law and tries to predict human behavior, and will search for a legal solution, which takes into account what people might do, by doing so anticipating and preventing litigation. Conventional law tries to predict what a court will decide, it remains backwards oriented and does not improve business relationships, which is essential for preventive law. The second principle has components of conflict management: preventive law is based on the assumption that the most successful medical treatment is prevention, and seeks to transfer this assumption from the medical to the legal context.[93] Conflict management is a keyword in preventive law, and is built on the assumption that prevention is the most *effective* way to deal with conflicts. Preventive law shares many similarities with preventive medicine, a branch of medical science dealing with methods such as vaccination in preventing the occurrence of disease.[94] The third principle is the embrace of risk.[95] For sure, his/her contributions lies in identifying preventive law by its own name and organize it into a distinctive way of thinking law and developing concepts, rather in forming a comprehensive theory of preventive law.[96] The fourth and last principle is to make preventive legal services available to clients. Lawyers must participate with others in multi-disciplinary teams in the planning of clients' concerns. This principle is aimed towards the client - the business or a private person, while the first three principles principally focus on a change in the mind-sets of lawyers. Since, it is not solely the lawyers who need to become more prevention-oriented, but clients need to bring in lawyers early enough, to detect legal risks and prevent harm from occurring and engage in interdisciplinary collaboration, otherwise even the best preventive lawyer may not be of any help.

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[90] Berger-walliser in Berger-walliser & Østergaard, (2012, p. 21)

[91] Dauer, E. (1999, p. 802) - *In litigation it is important to predict what a court will do. In Preventive Law, it is important to predict what people will do.* Brown (1956, p. 942) see also Siedel & Haapio (2010, p. 14).

[92] Berger-Walliser in Sorsa(2011, p. 119)

[93] Dauer (2008, p. 25)

[94] Haapio (2010a, p. 22). The focus is aimed at the reality and not at paragraphs of law, meaning that one must relate to circumstances, which combined constitutes the reality before problems emerge. In this process the lawyer must be included early enough for it to be possible.

[95] This principle, is unusual for lawyers, but is nothing surprising for managers, which means to intentionally embrace some risk as a way of reducing overall risk, rather than try to drive one element of risk to zero. - Berger-Walliser in Sorsa(2011, p. 119)

[96] Dauer (2008): Four principles for a Theory of preventive law. In: Happio (2010, p. 24), an introduction to proactive law.

According to Brown, the source of disputes is caused in most cases by people getting unnecessarily ill treated, rather than a violation of any law.[97] By being so jurisprudence is added with an element of pragmatism, because it is not the law or the technicalities, but it is more the practical reality that is the key element. An interesting example to enlighten this statement is a research made on why people sue doctors. This was based on research from the University of Toronto and a study from St. Mary's hospital in UK.[98] In this study, hundreds of conversations were recorded between a group of physicians and their patients. They were divided into two groups, where the first half of this group had never been sued; the other half had been sued at least twice. The findings of this research based on the conversations showed a clear difference between the two observed groups. The doctors in the first group, who had never been sued spent more than three minutes longer with each patient than those in the second group. Similarly, these doctors were more likely to engage in active listening, laugh or be funny during the patients visit. There was no difference between the quality or quantity of the information given to their patients. The difference was in how they spoke and those additional three minutes the doctors in group 1 devoted to their patients.[99] Another angle to the very same study was made by Gladwell, who writes: *Patients don't file lawsuits because they've been harmed by shoddy medical care. Patients file lawsuits because they've been harmed by shoddy medical care - and something else happens to them.*[100]

4.3 Proactive Law with take-off in Preventive Law

Proactive law has its origins in preventive law and comprises legal and practical principles for anticipating and avoiding legal problems, why it now is appealing to understand preventive law in first. This section will describe the development of the proactive approach to law, its history and origins in preventive law.

In the progressing from preventive law to proactive law, a quote by Helena Haapio on medical science shall lead the discussion: *Proactive law practice has its origins in preventive law. Both approaches have many similarities with preventive medicine: a branch of medical science dealing with methods (such as vaccination) of preventing the occurrence of disease. Along the same line, it*

[97] Siedel & Haapio(2010, p. 14)

[98] The University of Toronto's Dr. Wendy Levinson is considered among the world's foremost researchers on physician-patient communication. In a landmark 1997 study, she recorded hundreds of conversations between a group of physicians and their patients. Half of the doctors had never been sued, and the other half had been sued at least twice. Levinson found that just on the basis of those recorded conversations alone, she could find clear differences between the two groups: The doctors who had never been sued spent more than three minutes longer with each patient than those who had been sued did (18.3 minutes versus 15 minutes). Levinson reported no difference in the amount or quality of information doctors gave their patients. The difference was entirely in how they talked to their patients. A UK study from St. Mary's Hospital in London that also investigated patients who had taken legal action against their doctors came to similar conclusions. Research published in *Lancet* identified four main themes that emerged from their analysis of the reasons patients sue: Overall, the London researchers found that the decision to take legal action was determined not only by the original injury, but also by i**nsensitive handling and poor communication** after the original incident. (Source: Why do people sue doctors? A study of patients and relatives taking legal action: http://www.ncbi.nlm.nih.gov/pubmed/7911925)

[99] Medical Negligence: The Role of America's Civil Justice System in Protecting Patients' Rights February 2011, American association for justice.

[100] Gladwell(2005)

can be stated that proactive law aims at "vaccinating" business people against the "disease" of legal trouble, disputes, and litigation.[101]

In particular, our attention is drawn to how Haapio points out the *leap* from preventive to proactive lawmaking. It is clear that proactive law has its origin in preventive law, since it consists of many of the same elements, but it is built on various points. These points are not exclusively the reason for the differences, but the differences of preventive law and proactive law is also affected, by the fact that they have their origin in different environments and legal systems.

Proactive Law in Europe emerged by the Proactive Law movement in Finland in the end of the 90'ies. [102] The Proactive Law Movement is a future-oriented approach to law that anticipates legal problems and takes steps to prevent such problems from arising.[103] The movement has been popular among scholars in Europe. Interestingly, it has been skilfully applied not just toward improving competitiveness of private entities, but also toward facilitating the responsiveness and legislative development of government agencies.[104]

The Nordic School of Proactive Law defines proactive law as; *a future-oriented approach to law placing an emphasis on legal knowledge to be applied* ***before*** *things go wrong. It comprises a way of legal thinking and a set of skills, practices and procedures that help to identify opportunities in time to take advantage of them – and to spot potential problems while preventive action is still possible. In addition to avoiding disputes, litigation and other hazards, Proactive Law seeks ways to use the law to create value, strengthen relationships and manage risk.*[105]

Proactive Law has two dimensions both, which emphasize an ex-ante forward-looking action view – with a preventive dimension and a promotive dimension. The two dimensions have been processed further in section 8.2.1. Though all four of Dauers principles to preventive law (discussed in sec. 4.2) are relevant and of significance, apart from the second principle, the others will not be discussed in relation to proactive law.

[101] Haapio (2010a, p. 22)
[102] Haapio & Varjonen (1998)
[103] Siedel & Haapio (2010, p. 651-56)
[104] The Nordic School has been instrumental in the creation of the ProActive ThinkTank, which is led by a core team from Denmark, Finland, France, the Netherlands, and the United Kingdom. The mission of the ThinkTank is to provide a forum for business leaders, lawyers, academics, and other professionals to discuss, develop, and promote the proactive management of relationships, contracts, and risks and the prevention of legal uncertainties and disputes
(Source: http://www.juridicum.su.se/proactivelaw/main/thinktank/missionstatement.pdf.)
[105] http://www.proactivelaw.org/

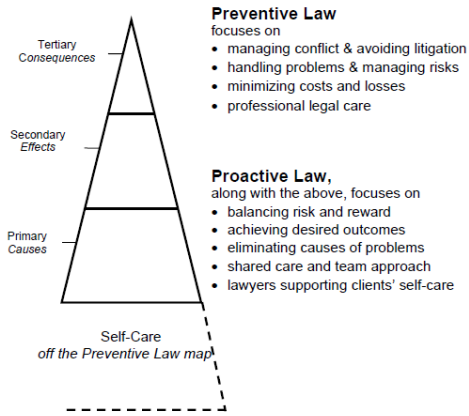

Figure 4.3 - Preventive Law and Proactive Law: Similar Approach - Different Focus[106]

From the components of conflict management Haapio has set forth in figure 4.3, which illustrates the differences between proactive law and preventive law. The figure illustrates the difference between the two legal approaches, adapted from preventive medicine, with three different levels; primary, secondary, and tertiary. [107]Just like preventive medicine, preventive law and proactive law underlines the importance of working at all three levels. So far, preventive law has worked predominantly in the domains of secondary and tertiary prevention. Proactive law, again, has focused on the primary and secondary levels and, in particular, on supporting clients' self-care, which is considered fundamental at all levels.[108] The components of conflict management; preventive law is based on the assumption that the most important medical treatment is prevention, and seeks to transfer this assumption from the medical to the legal context.[109]

Preventive law is a spin-off from the intellectual environments encircled by American Business Schools. In addition USA has a legal system based on common law, which historically is influenced by a bigger focus on trials. On the other hand the proactive movement has its roots in a more interdisciplinary co-operation between, lawyers, practitioners, economist, etc. In addition to this, the European legal systems are based on a tradition of civil law, which is less focused on

[106] Haapio (2010a, p. 25)
[107] http://www.britannica.com/EBchecked/topic/475636/preventive-medicine
[108] Haapio (2010a, p. 25)
[109]Sorsa (2011, p. 120); Mahler (2010) se also Dauer (1998): *"Work in the primary domain keeps the causes of illness from arising. Mosquitoes carry malaria, so to avoid malaria; we drain swamps to prevent mosquitoes. Work in the secondary domain keeps unavoidable causes from having effects. We can't drain every swamp, so we develop netting. And work in the tertiary domain keeps unavoidable consequences from being harmful. We get out the quinine. The beginning of the process is locating the cause. The core of the process is determining how it can be managed. And the objective is not avoiding losses, but avoiding causes first and results second, and losses only third. Applied to what we do, this approach takes lawyers into somewhat unfamiliar terrain. … 'That's not the law,' we might say. 'That's the client's business.' And therein lays the problem. Trained by our law schools only accidentally if at all in the arts of transactions, and trained nowhere in the systematic application of preventive lawyering, we see the boundary between us and our client right here. The client designs the widgets, the corporate culture, and the environmental integrity. We practice the law. That, however, is not a boundary preventive law respects".*

litigation.[110] These difference indicates that one must not see proactive law as a directly improvement of preventive law. Juridical frames of various countries are of course determent for the legal way of thinking. In other words, the proactive law uses the way of thinking that was formatted with the preventive law, and in addition adds components influenced by European traditions.

4.4 Summary

Deducted from the, above it is concluded that the conventional legal paradigm is viewed as a defensive and reactive paradigm. The conventional contract appears to be a legal tool, which anticipates failure and is primarily applied to protect firms and finds use in cases where a conflict or a dispute arises. The insufficient approach to the law and contracts has resulted in preventive approach to contracts in the USA and further to the proactive law movement in Europe. Differences indicates that proactive law is not a directly improvement of preventive law. Legal environments determines the legal way of thinking, and proactive law uses the way of thinking, that was formatted with the preventive law, and in addition adds components influenced by European traditions. The proactive approach is found to be an integration of the legal and economical discipline and becomes an interdisciplinary management tool, which arises through proactive contracting.

A shift in the paradigm has seen the light of day, and the proactive mindset offers a fundamental change in the perception of and to the law. As opposed to the conventional legal paradigm a proactive approach prevents what is unwanted and promotes what is wanted; especially the promoting element is viewed as having a determining significance. Proactive law looks towards the future rather than past experiences and requires the ability to develop new ideas and concepts from all actors in order to respond to needs, problems or challenges, by means of an original and previously non-existing result.

5.0 RR - Sources of Competitive Advantages

In economics, it is reasonable to assume that all firms have the aim of creating value through the contracts they enter and that manufacturers and distributors enter into SDC's to benefit from them.
The term *value* is wide, so before continuing with the legal-economical frame, the term value will be defined. Value can be financially based, i.e. monetary, high stock prices etc. or based on immaterial assets like a firm's performance, innovation, competitive position on the global market and the value of the brand. The values and agreed-upon processes found in social relationships may minimize transaction costs of contracting as compared with formal contracts.[111]

The following chapter, will in continuation from the previous chapters, concretize and extend the economical understanding and the economical contents of the legal aim on the proactive provisions

[110] Id., p. 121
[111] Mayer & Argyres (2004, p. 395) se also Dyer (1996)

in a SDS, and whether or not RR will lead the parties to sustainable competitive advantages that cannot be copied and implemented by others.[112] SDC's have both legal and economical value. When contracting parties to a SDS enter into a contract, there are different factors to be considered. For one, when individuals suffer from imperfect information, and imperfect rationality they tend to make mistakes, and consequently might fail to make choices that maximize their preferences, profit and value.[113] The reality of incomplete and asymmetric information and transaction cost economics that can be narrowed down to being informational costs caused by the former.[114]

Regarding the sources of RR, two prominent views have emerged. The first is Porters *industry structure view*, which suggests that supernormal returns are primarily a function of the members of a firm in an industry with favorable structural characteristics.[115] Consequently, many researchers have focused on the industry as the relevant unit of analysis. The second is the *Resource-Based View* of the firm, which argues that differential firm performance is fundamentally due to firm heterogeneity rather than industry structure, Since Porter is known as one of the leading scholars and writers within the field of research for competitive advantages and value creation and the RBV is looked upon as a further supplement to Porter's value-chain, with a focus on firm's own use of resources to generate profit, as to the assets and processes. Both activities and resources are of significance as both are drawn in as complementarities.[116] In fact, RR is a third view to look at the firms use of resources, namely as a profit, firms in combination can generate.[117] Further, this chapter will analyze RR in combination with relevant economical theory to deduce how these can be implemented as proactive provisions in the SDC, such as RR - as a way for the contracting parties to generate value and profits, with focus on the relation.

5.1 Porters Five Forces Model

This section will make explicit the legal aspects inherent in Porters five forces model. The five forces model is a framework for industry analysis and business strategy development. It is a strategic management research tool that focuses on isolating and addressing a firm's external opportunities, and threats.[118] Porter identified five forces that determine the attractiveness of an industry: buyer power, supplier power, the competitive threat posed by current rivals, the availability of substitutes, and the threat of new entrants.[119] He then outlined strategies firms could use to change the firm's position in the industry face-to-face with its competitors, suppliers, and buyers in order to find a

[112] Bharadwaj & Varadarajan (1993)
[113] Bar-Gil & Epstein (2007)
[114] Coase (1960, p 15)
[115] Porter (1980)
[116] Barney, (1991, p. 101)
[117] Dyer & Singh (1998)
[118] The five forces derive upon industrial organization economics, to determine the competitive intensity, and therefore attractiveness of a market. This attractiveness refers to the overall industry profitability that will lead the parties to an above-normal profit.
[119] Porter (1980)

position from, which it could best defend itself against these competitive forces or influence them to its own advantage. These five forces can be affected by the law. The law can create barriers to entry by giving an immaterial right to a good. Like in a zero–sum game where one parties gain (or loss) of utility is exactly balanced by the losses (or gains) of the utility of the other so that the sum will be zero. In contrast, non-zero–sum describes a situation in which the interacting parties' aggregated gains and losses are either less than or more than zero.[120]

5.2 Resource Based View

The RBV is considered to be a further development of Porters five forces model and value-chain theory - the focus is on firm's resources. According to Barney, it is about how firms can achieve competitive advantages and continuous competitive advantages from a firms intern resources, when the firm implements a value-creating strategy that is not implemented by its competitors.[121]

The RBV posits that, firms may obtain sustainable competitive advantage by focusing on strategies that leverage their internal resources to take advantage of environmental opportunities.[122] A sustained competitive advantage is a competitive advantage, where there is no opportunity for competitors to copy these strategic advantages. [123] Firms that are able to accumulate resources and capabilities that are rare, valuable, non-substitutable, and difficult to imitate will achieve a competitive advantage over competing firms.

Thus, extant RBV theory views the firm as the primary unit of analysis. Consequently, the search for competitive advantage has focused on those resources that are housed *within the firm.*[124]

Whether a contract can be viewed as a resource in the shape of an asset, competence or something similar can be difficult to determine. If the SDC is used in a special way to achieve advantages, the argument will be that the contract is viewed as a resource. On the other hand, the contract and especially the dealing with it, consist of different resources and especially competencies. An example can be employees and their competences to the formation of a contract. Hence, the contract is a tool that, if used optimally, can be used by the firm to work effectively. As mentioned above, a great deal of the firm's activities is within the frames of a contract, therefore its significance in the firm's daily operations should not be denied. Since the contract has importance for a firms operations and ability to function efficiently, it is assumed that the contract is a resource.[125]

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[120] http://www.investopedia.com/terms/z/zero-sumgame.asp

[121] Barney (1991)

[122] Id., p. 99

[123] Id., p. 102

[124] These resources include elements such as assets, capabilities, organizational processes, competencies, information knowledge etc. Resources can hereby have a material as well as immaterial shape and is defined as: *a stock or supply of money, materials, staff, and other assets that can be drawn on by a person or organization in order to function effectively (source:* http://oxforddictionaries.com/definition/resource)

[125] The contract must likewise be a link between the manufacturer and its distributors. If the contract is applied in a way that supports a relation between these, the contract makes way for an opportunity for firms to access and make use of manufacturer resources and hereby enhances the chance for value creation. The value creation in

5.3 Generating Profit through the Relationship

When entering into a SDC a RR has already been created, since you have *committed* to a co-operation. So catching the early warning signals is important, as to prevent value destruction that eliminates the RR, which in an economical point of view must be prevented.

So, how do you do this? How do you catch warning signals from business partners with matching expectations? The main purpose is to examine how RR's are earned and preserved, offering a *relational view* of competitive advantages that focuses on dyad/network routines and processes as an important unit of analysis for understanding competitive advantage. Dyer & Singh distinguishes between the two types of relations; namely the arms-length market relationships - where the parties are incapable of generating RR and is a relationship that is not rare or difficult to imitate - and the interfirm relationship.[126] The latter relationship is characterized by the four determinants of interfirm competitive advantages, which allows the parties to achieve a strategic fit. The figure below shows the determinants of interorganizational competitive advantages and will give an overview of the following sections, by seeking to identify and relate the various sources of rents at the interfirm unit of analysis in relation to the application of proactive provisions in SDC.

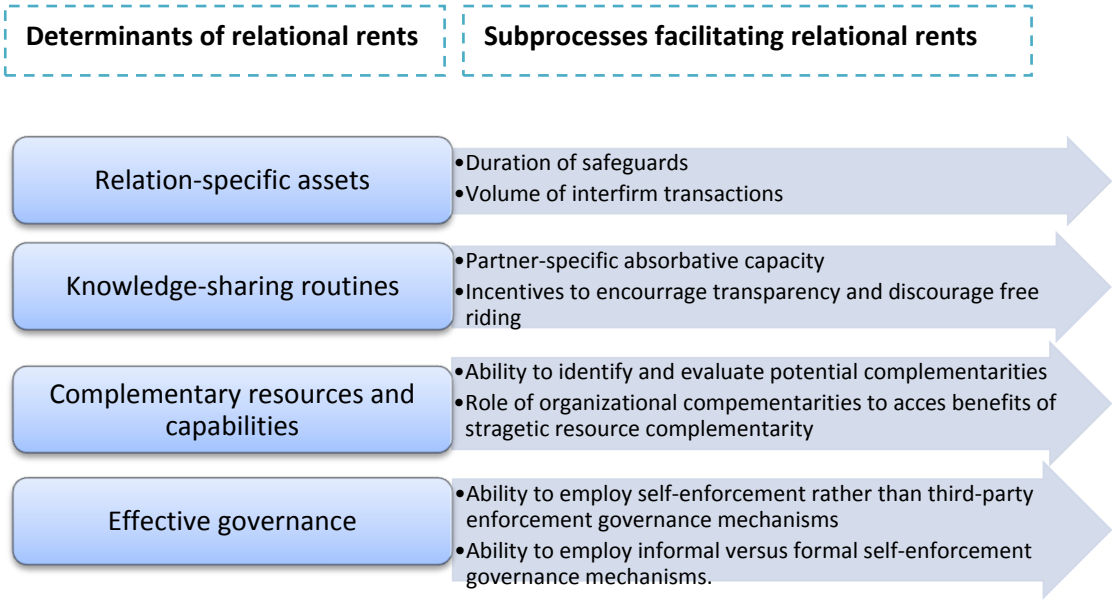

Figure 5.4 - Determinants of interorganizational Competitive Advantage[127]

5.3.1 Relation Specific Assets

One of the first to document the effects of relation specific assets was Asanuma. He documented how these skills between Japanese suppliers and their automakers generated profits and competitive

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the RBV view must consist in a better use of the firm's resources, especially the contract. A better use of the contract as the resource it is sought to be, likewise as being a tool for achieving access to extern distributors resources, where value-creation can be achieved.

[126] Dyer & Singh (1998, p. 662)

[127] Dyer & Singh (1998, p. 663)

advantages for collaborating firms.[128] His study followed by other studies on the positive effect from the surplus gained from collaborating firms indicated that RR's generated through relation specific assets/investments are realized through lower total value-chain costs, greater product differentiation, fewer defects, and faster product development cycles. [129]

In figure 5.5 the key sub-processes that affect the relation specific assets are the duration (length in years) of the safeguards and the volume of interfirm transactions. These influence the ability of alliance partners to generate rents through relation-specific assets. In selective distribution the contract is long-term and since it is differentiated products that the distributors buy from the manufacturer the level of transactions must be high.

According to Amit and Schoemaker, a necessary condition for rent is specialization of assets and *strategic assets by their very nature are specialized*.[130] The investment the parties put in the relation specific assets determines the potential for greater rent. According to Oliver Williamson productivity gains in the value-chain are possible when firms are willing to make relation/transaction-specific investments.[131] He identifies three types of asset specificity that are relevant relation specific assets in SDS: site specificity, physical asset specificity, and human asset specificity. These are worked into Fig. 5.5. Generally, when asset specificity is low, by definition resources can be readily deployed to other relationships or businesses, and partner identity and continuity therefore is not important.[132] In addition, brand value has been added to the asset specificity since the protection of the brand and the differentiating factor is important in the selective distribution process, and the brand value becomes an important relation-specific asset, which generates rent through the product differentiation.

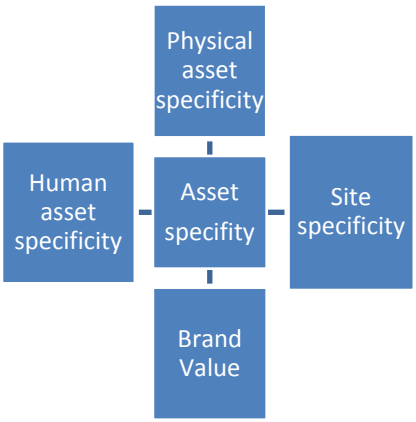

Figure 5.5 - Four types of asset specificity

[128] Asanuma (1989)
[129] Dyer and Singh (1998, p. 663)
[130] Amit & Schoemaker (1993, p. 39)
[131] Williamson (1985)
[132] Klein, Crawford, and Alchian (1978)

Site specificity refers to the situation where successive production stages, which in nature are immobile and located close to one another. Previous studies suggest that site-specific investments can substantially reduce inventory and transportation costs and can lower the costs of coordinating activities.[133] The distributors in SDS are located on different markets and in most cases they have a physical location from where they sell the goods, so there is a site-specific investment that contributes to the asset specificity. In SDS the distributors do not lose their rights to a site if the contract has been terminated, it can still be used as a store that sells other goods, so this asset specificity is not that essential in SDS.[134]

Physical asset specificity refers to transaction-specific capital investments (in customized machinery, tools, dies, etc.), which tailor processes to particular exchange partners. Physical asset specialization has been found to allow for product differentiation and may improve quality by increasing product integrity or fit.[135] Proprietary distribution requires the distributor to invest in physical assets (warehouses, retail stores etc.), hire and train specialized personnel, and bear the full cost of product inventory.[136] SDS is a differentiation strategy concerning high-end products, and in SDS there is a high level of investments in the physical assets, therefore the manufacturer and distributors ability to generate rent through the specialized physical assets is an important point.

Human asset specificity refers to transaction-specific know-how accumulated by transactors through longstanding relationships; it is an investment in education that can create an extremely important asset. [137] Human co-specialization increases as alliance partners develop experience by working together and accumulate specialized information, language, and know-how. The requirement on the distributors for the training of the personal is an investment in the human assets specificities that allows them to communicate more efficiently and effectively, and result in a reduction of communication errors, thereby enhancing quality and increasing speed to market.[138] These human assets specificities in SDS are very specialized and are value generating assets that should be preserved and maintained. The two latter asset specificities are at most relevant, since selective distribution is a long-term differentiation strategy that requires the manufacturer and the distributors to invest in physical assets specificities and human asset specificities, where the contracting parties develop co-experience through information sharing and know-how (more on this in the following sections).

The element of *Brand Value* as a relation specific asset is important when dealing with higher prices, since it justifies the higher prices, and manufacturers seek to educate the distributors personal to the advantages of these unique qualities. It is important, therefore, that the distributors convey to the

[133] Dyer and Singh (1998, p. 662)

[134] An example where this would be essential is the MacDonald's restaurants that are located out in "nowhere" since it is difficult to use the site of these restaurants for alternative uses.

[135] (Clark & Fujimoto, 1991 & Nishiguchi, 1994) In Dyer & Singh (1998, p. 662)

[136] It can be likely that the manufacturer accepts to bear some of the inventory cost to help the distributor in start-up, but this is a special cases.

[137] Milgrom & Roberts (1992, p. 135)

[138] Dyer and Singh (1998, p. 662)

customer an image of quality and prestige that is congruent with overall product strategy.[139] While sales volume is the goal, it cannot be achieved at the expense of the product's differentiated position; therefore the brand value is an important asset, and firms who pursue selective distribution as a strategy aim to create value and image for a product.[140]

Formation of *relation-specific skills* requires learning through repeated interactions between the manufacturer and distributors, be added to the basic technological capability which the manufacturer has accumulated.[141] These strategic assets are according to Amit and Schoemaker defined as *the set of difficult to trade and imitate, scarce, appropriable and specialized resources and capabilities that bestow the firm's competitive advantage.*[142] A strategic asset is difficult to buy, sell, imitate or substitute; such an asset could be trust or knowledge between manufacturers and distributors, it cannot easily be replicated by competitors, since it is deeply rooted between the parties.[143] The challenge with these assets is that even though the manufacturer and the distributors can generate RR's through investments in relation-specific assets, their incentive to make specialized investments is affected by the fact that the more specialized a resource becomes, the lower its value is in alternative uses.[144] These specific assets are most valuable in one specific setting or relationship, and the specificity is measured as the percentage of investment value that is lost when the asset is used outside of the SDS.[145]

5.3.2 Safeguarding Against Opportunistic Behavior

When a firm invests assets in a partnership that cannot be deployed for other uses, their partner has the opportunity to take advantage of the situation and maximize his/her own benefits at the expense of the firm. As a result, firms have to deal with risks that arise from both an uncertain environment and potentially opportunistic partner.[146]

One of the key behavioral variables that drive transaction cost analysis is opportunism, which Williamson defines as *self-interest seeking with guile.*[147] The essence of opportunism is the element of deceit involved, examples of opportunistic behavior are such acts as withholding or distorting information or shirking or failing to fulfill promises or obligations. However, opportunism does not

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[139] Lassar & Kerr (1996, p. 619)

[140] Id., According to Williamson, *Rather than reply to opportunism in kind, the wise [bargaining party] is one who seeks both to give and receive 'credible commitments.' Incentives may be realized and/or superior governance structures within which to organize transactions may be devised* (1985, p. 48-49) and a way for firms to break their promises of an agreed-upon exchange, is the occurrence of opportunism. These credible commitments area type of investment in dedicated assets, which the parties make to signal accountability and commitment.

[141] Asanuma (1989, p. 21) - Accordingly, the skill always consists of two layers - on one hand the surface layer which corresponds to accumulated learning acquired through transactions with a given core firm, and on the other hand the basic layer which corresponds to general technological capabilities. The skills require the manufacturer to respond efficiently to the specific needs of the core firm

[142] Amit & Schoemaker (1993, p. 36)

[143] Id., p. 39

[144] Dyer & Singh (1998, p. 669)

[145] Milgrom & Roberts (1992, p. 135)

[146] Parkhe (1998)

[147] Williamson (1975, p. 6)

include other forms of self-interest-seeking, and similar conflictual behaviors do not constitute opportunism.

In transaction cost analysis, Williamson and others hold that human being will behave opportunistically whenever such behavior is feasible and profitable.[148] Thus, structural variation is viewed as a consequence of the human tendency to behave opportunistically whenever one can profit from such behavior and is not prevented from doing so, hence the quote. *Well, then say I, what's the use you learning to do right when it's troublesome to do right and ain't no trouble to do wrong, and the wages is just the same.*[149]

In this way the opportunistic parties will drive out the honest, therefore opportunistic behavior must be a fundamental behavioral assumption. Opportunism is a central concept and is a variety of self-interest seeking but extends simple self-interest seeking to include self-interest seeking with guile, a deceive behavior. It is not necessary that all be regarded as opportunistic in identical degree. It suffices that those who are less opportunistic than others are difficult to ascertain ex-ante.[150] Opportunism is especially important for economic activity that involves transaction-specific investments in human and physical capital.[151] The joining of opportunism with transaction-specific investments or *appropriable quasi rents* is a leading factor in explaining decisions to vertically integrate.[152] Recognizing that the world is complex that agreements are incomplete, and that some contracts will never be reached unless both parties have confidence in the settlement machinery thus characterizes neoclassical contract law.

The duration of the governance arrangement designed to safeguard against opportunism influences the ability of alliance partners to invest in relation-specific assets. Since relation-specific investments create appropriable rents, transactors need to safeguard those investments.[153] Partners are more likely to make investments in relation-specific assets when they have crafted effective safeguards.[154]

With regards to asset specificity, evidence shown by Anderson and Dekker supports the positive relationship, because specific investments encourage the integration of provisions dealing with both *rights assignment* and *legal recourse* which are - seen as a bundle - largely consistent with the provisions shown above and serve the safeguarding function.[155]

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[148] Williamson (1975), Coase (1960), Arrow (1963)

[149] Huckleberry Finn, The adventures of Huckleberry Finn, Mark Twain (1884)

[150] Williamson (1975, pp. 7-10 & 26-30) See also Klein, Crawford & Alchian (1978)

[151] The efficient processing of information is an important and related concept and the assessment of transaction costs is a comparative institutional undertaking. A way for firms to break their promises of an agreed-upon exchange is the occurrence of opportunism.

[152] Willamson (1971, p. 112), see also also Klein, Crawford & Alchian (1978)

[153] Klein, Crawford & Alchian (1978)

[154] Williamson (1985)

[155] Anderson and Dekker (2005, p. 1743)

Safeguards and controls on behavior may not necessarily be utilized for three reasons. First, if a manufacturer believes that the distributor's goals are compatible with its own, there is no need for behavioral controls. Second, many manufacturers cannot afford the information systems necessary for behavioral controls. Third, while manufacturers may be interested in distributor behavior, distributors may be unwilling to let manufacturers influence their activities. Given that the installation of behavioral control systems in channel relationships requires manufacturer's effort and investment, the impact of such behavioral control systems on distributor effectiveness should be a major concern to the channel partners. The overall relationships between the manufacturer and the distributors can be classified as a behavioral control system and that distinct control systems have an influence on brand performance at the distributor level.[156]

Selective distribution is examined as a means of economizing on the costs of avoiding risks of appropriation of RR's in specialized assets by opportunistic individuals. Once a specific asset has been achieved, it might be too expensive to remove or so specialized to a party that if the price were somehow reduced the asset's services to that user would not be reduced. Thus, even if there were free and open competition for entry to the market, the specialization of the installed asset creates a RR.[157] Therefore a certain level of trust and confidence is needed for an alliance to work. Only a certain degree of perceived risk can be tolerated in any particular alliance. The perceived risk of opportunistic behavior by partners can therefore reduce the potential benefits of cooperation.[158]

5.3.2.1 Trust

Trust (or safeguarding) and control (i.e. monitoring) are two fundamental managerial issues for inter-firm alliances.[159] Environmental uncertainties, the potential of opportunistic behavior from distributors make trust and control particularly important in sustaining cooperative relationships. At the same time, both trust and control have been difficult to define, while trust has been viewed as a substitute for control.

The relation-based approach emphasizes trust as an important factor and the contractual-based approach highlights that control are two different orientations for SDS-management.[160] The aim is to generate rents through a relation-based approach, so the element of trust in the relationships will be emphasized, since it is an important element as to minimizing opportunistic behavior in SDS.

The volume of the interfirm transactions also has an impact on the element of trust and opportunism, hence, a high volume of transaction must mean a higher communication level, which assumable results in stronger relation specific assets, such as trust. According to Williamson, in making relation

[156] Lassar (1998, p. 66)
[157] Klein, Crawford & Alchian (1978, p. 299)
[158] Parkhe(1998, p. 224)
[159] Lui & Ngo (2004, p. 474)
[160] Madhok (1995)

specific investments without the risk of hold-up, safeguards will not be a guarantee for elimination opportunism, since economical trust not always is personal.[161]

5.3.2 Knowledge Sharing Routines

Interfirm knowledge sharing routines are defined as the following*: a regular pattern of interfirm interactions that permits the transfer, recombination, or creation of specialized knowledge*.[162] This type of specialized knowledge has by many scholars been divided into two types: *information* and *know-how*.[163] It is not just important to know what knowledge sharing routines are, but it is also important to understand how partners create knowledge sharing routines that result in competitive advantages and the ability to incorporate these proactive provisions into the contract.

The interfirm processes designed in the contract to facilitate the exchanges between the manufacturer and the distributor will help in gaining and sustaining competitive advantages through the strengthening of the relation and thereby generating RR. These knowledge sharing routines play a great role in the communication between the manufacturer and its distributors, since it feeds the entire relationship and promotes interaction for dispute resolution and cooperation for creative development of the relationship. Now, this is human-asset specificity.

These knowledge sharing routines are a sort of give-and-take element in the relationship, and it can be wrongfully used when there is power asymmetry in the relationship. Power in the contract is by Macneil defined as the following: *the ability to impose one's will on others irrespective of their wishes*.[164] According to many scholars, the parties who show cooperative attitude, corroborate it by communicating openness and wide information exchange since this is one of the main tools to improve collaboration.[165] On the other hand, when the parties are on opposing sides, communication is managed more carefully and it becomes the way to dissimulate the parties' real hidden strategies.

Value through these connections must be created by dealing and optimizing firm's intern processes, and the sharing of information and know-how amongst manufacturers and distributors will therefore be a value-creating competitive advantage.

5.3.2.1 Information as a Source of Value

Information is defined as knowledge that can be easily transmitted *without loss of integrity once the syntactical rules required for deciphering it are known. Information includes facts, axiomatic propositions, and symbols.*[166] Information is relevant both in the pre-contractual and the post-

[161] Williamson(1985)
[162] Grant, (1996) in Dyer and Singh (1998, p. 665)
[163] Id., Kogut & Zander, (1992) Ryle, (1984) in Dyar & Singh (1998, p. 665)
[164] Here, two kinds of power may usefully be distinguished when analyzing communication in contracts and the economic model: unilateral or bilateral power. Communication management can depict two main approaches starting from the centrality position of the manufacturer in a distribution network, the distinguishing between unilateral or bilateral communication strategies. As the two terms suggest, the choice is strictly related to the relationship strategy conducted by the manufacturer in the case of its power asymmetry. - Macneil (1980, p. 909)
[165] Johnson (1989)
[166] Dyer & Singh (1998, p. 665)

contractual stages of the SDC, since the absence of information sharing can give a signal of opportunistic behavior and create a strategic misfit. Alternatively, contracting inefficiencies can arise when incentive remedy is costly because of informational asymmetries that lead to adverse selection or moral hazard problems on the part of the distributor.

Adverse selection is an incentive problem arising from pre-contractual information asymmetries and is a pre-contractual opportunistic problem that arises because the private information, which the parties to a SDC have prior to entering an agreement, is unshared. These problems are additional to the moral hazard problem, according to which a problem occurs, when one party's performance will affect the probability for profit for the other party.[167]

Often, in situations marked by pre-contractual private information, some of the privately informed people would gain if they could make their information known. Moreover, the uninformed would gain from learning this information.[168] There must be a gain for private-information holders to make their information known. This creates incentives to find creative ways to convey the information, which is not good when trying to generate rent through the relationship.

5.3.2.2 Know-how in Selective Distribution System

Designing interfirm routines that facilitate information sharing is particularly important since know-how transfers typically involve an iterative process of exchange, and the success of such transfers depends on whether manufacturers and distributors have direct, intimate, and extensive face-to-face interactions.[169] The ability to generate rents through knowledge sharing is reliant on an alignment of incentives that encourages the partners to be transparent, to transfer knowledge, and not to free ride on the knowledge acquired from the partner. In particular, the transferring firm must have an incentive to devote the resources required to transfer the know-how since it typically incurs significant costs during the transfer costs comparable to those incurred by the receiving firm.[170] If the alignment of incentives by alliance-partners is to encourage transparency and reciprocity and discourage free-riding, this will result in a greater potential to generate RR's through knowledge sharing

As a distributor, training and education of the personnel is one of the criteria's to be eligible for selling the good, therefore the question of know-how is slightly less relevant, since it is given. On the other hand, when speaking of know-how in SDC, it could be that the distributor has gained

[167] Arrow (1963) - a situation where a party will have a tendency to take risks because the costs that could incur will not be felt by the party taking the risk. In other words, it is a tendency to be more willing to take a risk, knowing that the potential costs or burdens of taking such risk will be borne, in whole or in part, by others.

[168] Sometimes the private information responsible for adverse selection may be discovered is expending effort and attention. For example, aptitude and achievement test can reveal information about prospective distributors and references from other distributors operating on different territories. There are off course cost and limitations to these tests and this information.

[169] Dyer & Singh (1998, p. 666) - The ability to generate rents from its resources may require these resources to be utilized in conjunction with the complementary resources of another firm.

[170] Id.

know-how from his/her respective territory, which could be valuable for the manufacturer to know of, and it would therefore be relevant to shed some light on the lack of sharing this gained know-how –or information - from the distributors. The absence of sharing know-how will result in a disadvantage for both parties, and effectiveness and success in the territory should be of interest of both parties, since profit is a common factor for both parties. Similarly, SDC's are often accompanied by non-compete obligations, as they involve the transfer of substantial amounts of know-how generated by the manufacturer. Both the distributors and the manufacturer's know-how should serve as a complementary knowledge.

5.3.3 Complementary Resources and Capabilities

Another way for partners in a distribution system to generate RR's is by gearing the complementary resource endowments of a partner. Complementary resource endowments are defined as the following: *distinctive resources of alliance partners that collectively generate greater rents than the sum of those obtained from the individual endowments of each partner.*[171] To generate rents through a selective distribution channel relevant sources must not by neither partner be purchases on a secondary market. [172]

Although complementarity of strategic resources creates the potential for RR's, the rents can only be realized if the firms have systems and cultures that are compatible enough to facilitate coordinated action. Previous research suggests that a primary reason for failure of both acquisitions and alliances is *not* that the two firms do not possess strategic complementarity of resources, but rather because they do not have compatible operating systems, decision-making processes, and cultures. The result of these complementary resource endowments should, consequently, be that these alliances produce stronger competitive positions than those achievable, if they were operating individually. This type of strategic alliance allows firms to procure assets, competencies, or capabilities not readily available in competitive factor markets, particularly specialized expertise and intangible assets, such as reputation.[173]

There are some challenges when parties in a SDS attempt to generate RR's with complementarities. For one, the parties must find each other and recognize the potential value of combining resources. Perfect information is not possessed and partners cannot easily calculate the value of different partner combinations, with which rational alliances would be able to generate the greatest combined value. Yet, it is often very costly and complicated to place a value on the complementary resources of potential partners in advance.[174]

[171] Id.
[172] Buono & Bowditch (1989) in Dyer & Singh (1998, p. 668)
[173] Dyer (1997, p. 707)
[174] Dyer & Singh (1998, p. 667)

The manufacturer's ability to identify potential distributors and value their complementary resources and to generate RR by combining complementary resources increases for three primary reasons: [175] Firstly, a higher level of experience in alliance management might have a more precise view on the kinds of partner/resource combinations that allow them to generate RR. Previous research suggests that prior alliance experience results in more opportunities to enter into future alliances, most probably because of the development of alliance capabilities and reputation.[176] Secondly, the differences in internal search and evaluation capability; many organizations are developing ways to accumulate knowledge on screening potential partners by creating a strategic alliance function. Another information-revealing strategy is signaling. The difference between signaling and screening is determined by whether or not the information-seeking takes the lead.[177]

The openness to share information, signals a collaborative behavior.[178] The role of the manufacturer is to identify and evaluate potential distributor partners as well as to monitor and coordinate their firm's current distributor alliances. The creation of these roles ensures some accountability for the selection and ongoing management of alliance partners and also ensures that knowledge on successful partner combinations and on effective alliance management practices will be accumulated.[179] Thirdly, differences in their ability to acquire information on potential partners owing to different positions in their social/economic network(s), this ability identifies and evaluates partners with complementary resources that, to an extent, depends on the party that has access to accurate and timely information on potential partners – symmetric information. An investment in an internal alliance function will likely facilitate the acquisition of this information, but it also depends on the extent to which the firm occupies an information rich position within social/economic networks. [180]

The distributors are better informed ex-post about the realization of final demand and about their own costs than the manufacturer. The latter is assumed not to be able to obtain this information, directly or indirectly. Hence, informational problems prevent the manufacturer from using contracts based on the true performance (profits) of the distributor.[181]

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[175] Id., p. 668

[176] Gulati, (1995); Mitchell & Singh, (1996) Walker, Kogut, & Shan, (1997) In Dyer & Singh (1998, p. 667)

[177] Screening refers to activities undertaken by the party seeking to achieve the private information in order to separate different types of the informed party. In signaling, the privately informed party takes the lead in adopting behavior, which reveals their information.

[178] Milgrom & Roberts (1992, pp. 155-156)

[179] Dyer & Singh (1998, p. 668)

[180] Previous research suggests that firms occupying central network positions with greater network ties have superior access to information and, thus, are more likely to increase the number of their distributors in the future. - Dyer & Singh (1998, p. 668)

[181] Verouden (2008, p. 1823)

5.3.4 Effective Governance

Governance plays a key role in the creation of RR, because it influences transaction costs as well as the willingness of the parties to engage in value-creation initiatives. One important objective for transactors is that the governance structure (safeguard) chosen should minimize transaction costs, and thereby enhance efficiency.[182]

In order to protect the investments and to manage appropriation concerns, contractual provisions can be implemented to enforce the transactions. In order to avoid termination of the relationship, the parties can ensure that their agreed tasks will be complied by implementing safeguards.[183] There are two classes of governance, one relies on third-party enforcement of agreements the other relies on the self-enforcing agreements. In the second, *no third party intervenes to determine whether a violation has taken place.*[184] If we look back, the transaction cost economics will be categorized by the first class, since it requires that dispute resolution requires involvement from third-parties.[185] On the other hand, self-enforcement agreements involve safeguards. In fact, the safeguarding function of contracts as a self-enforcement function is acknowledged by most of the studies discussing distinct purposes of contracts.

Within the self-enforcement class of governance mechanisms, a further deviation is seen between *formal* safeguards, such as *financial and investment hostages*, and *informal* safeguards, such as *goodwill, trust or embeddedness.* [186] The latter refers to the degree to which economic activity is constrained by non-economic institutions and reputation.[187] These hostages may be financial or symmetric investments in specialized or co-specialized assets, which constitute a visible collateral connection that aligns the economic incentives of exchange partners. Dyer found that Japanese auto companies use informal safeguards such as trust and financial hostages rather than legal contracts to reduce transaction costs with their distributors. Further, Dyer argues that while the initial costs of developing trust are high, over a longer period trust is more effective than contracting, which requires revision for every transaction.[188]

Thus, informal self-enforcing agreements might rely on personal trust relations through direct experience or reputation, or through indirect experience, such as governance mechanisms. A number

[182] Dyer & Singh (1998, p. 668)
[183] Sorsa (2011, p. 204) - Safeguards supply incentives to prevent the actual occurrence of opportunistic behavior, along with providing clear guidance in case of breach of contract for enforcing adequate penalties, such as compensation payments, through legal or other institutions. Safeguards are not a guarantee for total limitation of the occurrence of opportunistic behavior, so provisions such as more appropriate opt-out clauses, and in this case the division of assets, like in a prenuptial agreement, comes more appropriate.
[184] Telser (1980, p. 27)
[185] Williamson (1991)
[186] Klein (1980) & Williamson (1983),
[187] Dyer & Singh (1998, p. 669)
[188] Dyer (1997)

of scholars have suggested that informal safeguards (goodwill trust) are the most effective and least costly means of safeguarding specialized investments and facilitating complex exchange for which SDS are. For instance some have argued that goodwill trust reduces transaction cost related to bargaining and monitoring, and thereby enhances performance.[189] It is important to understand the conditions under which trust and trustworthiness in exchange relationships can, in fact, be a source of competitive advantage for both the manufacturer and the distributor in a SDS.[190]

S*elf-enforcing mechanisms are more effective than third-party enforcement mechanisms at both minimizing transaction costs and maximizing value-creation initiatives.*[191]

Transaction costs are lower under self-enforcing agreements for four primary reasons:

1. Contracting costs are avoided because the exchange partners trust that payoffs will be divided fairly.
2. Monitoring costs are lower because self-enforcement relies on self-monitoring rather than external or third-party monitoring.
3. Self-enforcing agreements lower the costs associated with complex adaptation, thereby allowing exchange partners to adjust the agreement *on the fly* to respond to unforeseen market changes.[192]
4. Self-enforcing agreements are superior to contracts at minimizing transaction costs over the long run because they are not subject to the time limitations of contracts.[193]

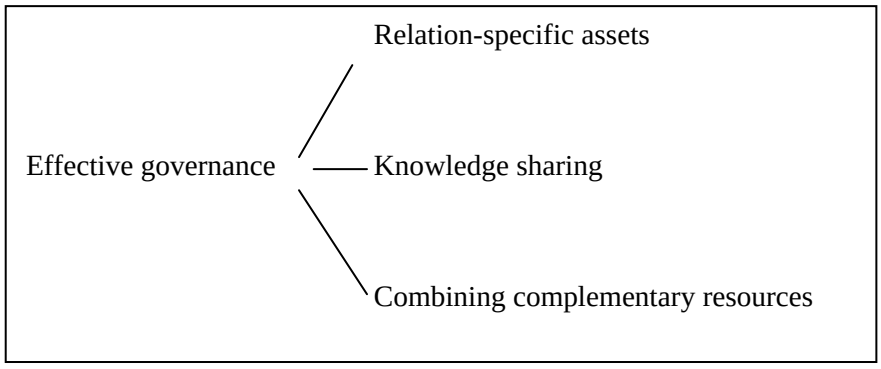

Figure 5.6 - Effective governance

Effective governance proposes that governance mechanisms play an important role in generating RR's that extends further than efficiency arguments. In the figure above it is illustrated that effective governance can generate RR's by either **lowering transaction costs** or **providing**

[189] Barney & Hansen (1994, pp. 177-179)
[190] The development of goodwill trust is subject to considerable causal ambiguity because it is a highly complex and situation specific process. Moreover, the development of trust or partner-specific absorptive capacity is subject to time compression diseconomies because it cannot be developed quickly, nor can it be bought or sold in the marketplace. Arrow (1974)
[191] Dyer & Singh (1998, p. 670)
[192] Uzzi (1997, p.48)
[193] Dyer & Singh (1998, p. 669)

incentives for value-creation initiatives, such as investing in relation-specific assets, sharing knowledge, or combining complementary strategic resources. In the first case transactors achieve an advantage by incurring lower transaction costs than competitors to achieve a given level of investment in specialized assets. In the second case effective governance (trust) may allow transactors to make greater investments in specialized assets than competing transactors, who refuse to make the relation-specific investments because of the high cost of safeguarding them.

Effective governance is the ability to employ self-enforcement rather than third-party enforcement governance mechanisms, since the self-enforcement agreements will help the parties to a contract limit the probability of disputes escalating to courtrooms, and will help both the manufacturer and the distributor to act more proactively.

5.3.4.1 Trust & Relational governance

Instead of relying on formal contracts, the parties to a SDS will typically engage in repeated exchange that is embedded in a social relationship. This relation should result in relational norms such as trust. Relational governance scholars have argued that these relational norms serve a*s substitutes for complex, explicit contracts or vertical integration*.[194] The values and agreed upon processes initiated in social relationships may minimize transaction costs as compared with formal contracts.[195] Thus, *trust and its underlying normative behaviors operate as a self-enforcing safeguard that is a more effective and less costly alternative to both contracts and vertical integration.*[196]

Governance emerges from the values and agreed-upon processes found in social relationships, lowering transaction costs as compared to formal contracts.[197] Strong formal contracts might weaken a firm's capacity to develop relational governance by signaling distrust of the other party and thereby encouraging opportunistic behavior.[198] Relational governance is associated with trust, and trust improves the performance of interorganizational exchanges. Yet, the development and maintenance of relational governance with its dense network of social ties may involve considerable cost in terms of time and resource allocation.[199] Furthermore, dense social ties in economic exchanges may restrict firms from new information and new opportunities. This reasoning suggests that firms should invest in the development of relational governance only when significant hazards are present. Increase in the exchange hazards will lead to more relational governance.[200] Trust is

[194] Poppo & Zenger (2002, p. 707)
[195] Dyer (1997, p. 687) & Dyer & Singh (1998, p. 23)
[196] Poppo & Zenger (2002, p. 707)
[197] Macneil (1978, 1980), see also Dyer & Singh (1998, p. 662)
[198] Bagley (2010, p. 595)
[199] Larson (1992)
[200] Poppo & Zenger (2002, p. 711)
Poppo and Zenger has used data on outsourcing relationships in information services as evidence for their alternate argument that well-specified contracts may actually promote more competitive, long-term, trusting exchange relationships. Contrary to the claim that formal contracts undermine relational governance, they

therefore considered a trait that becomes embedded in a particular exchange relation. In essence, once an exchange partner is given a *trustworthy* status, they are expected to behave in a trustworthy manor in the future.[201] For economists, the trustworthy status is conditional upon the benefits that accrue from trustworthy status over time – through repeated exchange - contrasted with the benefits that accrue from self-interested moves that break from the trustworthy status.[202] Creating trust is less costly for firms facing rapid demand growth compared to firms with stable or declining demand because the loss of future business by customer termination if the firm is found to be cheating implies a relatively larger cost.[203]

In this context Barney and Hansen categorize three types of trust in economic exchanges; *weak form trust, semi-strong form trust* and *strong form trust;* the conditions under which trust can be a source of competitive advantage are also identified. Implications of this analysis for theoretical and empirical work in strategic management are discussed. In strong form trust, trust emerges in the face of significant exchange vulnerabilities, independent of whether or not elaborate social and economic governance mechanisms exist, because opportunistic behavior would violate values, principles, and standards of behavior that have been internalized by parties to an exchange.[204]
Trust can emerge in economic exchanges in any of the three ways discussed, and can be a source of competitive advantage. A strategic analysis of trust and trustworthiness focuses attention on the conditions under which a particular type of trust will be a source of competitive advantage.[205]

Contracting parties must draft contracts that encourage good behavior, self-regulation, and adapts to changing situations. Furthermore helps to create trust among business partners, and should contain dispute prevention mechanisms. Trust does not emerge from the structure of an exchange. It rather reflects the values, principles, and standards that partners bring to an exchange.

5.4 Summary

Through this chapter it has been encircled how collaborating parties can develop a relationship that result in a sustained competitive advantage. Determinants of interorganizational competitive

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argued that *the presence of clearly articulated contractual terms, provisions, and processes of dispute resolution as well as relational norms of flexibility, solidarity, bilateralism, and continuance may inspire confidence to cooperate in interorganizational exchanges.* Their research has revealed that relational governance and contract customization both directly and indirectly increased exchange performance as measured by satisfaction with the cost, quality, and responsiveness of the outsourced service. Furthermore they found that increases in the level of relational governance were associated with greater levels of contractual complexity and that increases in the level of contractual complexity were associated with greater levels of relational governance - Id., p. 721

[201] Id., p. 710

[202] Klein (1996, p. 445)

[203] Klein, Crawford & Alchian (1978, p. 318)

[204] Barney and Hansen (1994, p. 175)

[205] When significant exchange vulnerabilities exist (due to adverse selection, moral hazard, holdup, or other sources), trust can still emerge, assumed that parties to an exchange are protected through various governance devices. Governance devices impose costs of various kinds on parties to an exchange that behave opportunistically. If the appropriate governance devices are in place the cost of opportunistic behavior will be greater than its benefit, and it will be in the rational self-interest of exchange partners to behave in a trustworthy way- Id., p. 178-179

advantages identify, and relate the various sources of rents at the interfirm unit of analysis, in relation to the application of proactive provisions in SDC and achieve sustainable competitive advantages that cannot be copied and implemented by others. Thereby creating strategic assets that are difficult to buy, sell, imitate or substitute. RR's generated through relation specific assets/investments are realized through lower total value-chain costs, greater product differentiation, fewer defects, and faster product development cycles. In SDS the brand value is an important asset, since it justifies the higher prices, along with the education of the distributors personal.

Both the manufacturer and the distributors create value through their asset skills, the manufacturer with his/her brand and furthermore the contribution of the distributor's insight in the respective market. The manufacturer and distributors ability, in combination, to apply proactive provisions to the SDC and to generate rent depends on these skills. Physical asset specificity, human asset and brand value, are the asset specificities most important to SDS.

The greater the parties in a SDS's are to employ informal self-enforcing mechanisms, the greater the potential will be for RR's. Effective governance in SDS's generates RR's by either lowering transaction costs or providing incentives for value-creation initiatives, such as investing in relation-specific assets, sharing knowledge, or combining complementary strategic resources. Self-enforcement will help the parties limit the probability of disputes escalating to courtrooms, and will help both the manufacturer, and the distributor to act more proactively.

6.0 The Intersection between Law and Strategy – Legal Strategy

In this chapter, the concept of contracting and proactive approaches to contracting will be explained. With the proactive approach to law an integration of law and economics presents itself, and whereby an interdisciplinary management tool emerges – the proactive contract.[206]

Furthermore this chapter will look at some of the legal resources that can help firms in achieving sustained competitive advantages, by encouraging legally strategic thinking, and to extract competitive advantages in a legal environment. Managers who are legally astute can communicate with legal counsels and collaboratively solve problems. This is a valuable skill that enhances firms competitive advantages, and is a set of value-laden attitude that accept responsibility for managing legal aspects of business, and skillful anticipation of future regulations, and how they might be interpreted.[207]

[206] The application of the contract is not solely a legal tool but also a tool where economical and business goal are strived to be met. This is an approach to law where both legal and economical disciplines are being applied through the proactive contract to have far-reaching possibilities. Since, the most important part of acting proactively is being able to manage disputes and avoiding litigation.

[207] Bagley (2008, p. 378)

6.1 Managers Legal Plan (MLP)

In, *Proactive Law for Managers*, Siedel and Haapio have developed a holistic view on law as a strategic tool. The MLP is a four-step process by which firms can better defend themselves against costly and wasteful litigation. It is a tool to making new literary approaches, in the field of using the law to achieve competitive advantages and make them tangible.[208] Siedel makes a clear plan for how firms can approach the new mindsets in theory, by using the law more structurally, and perhaps strategically, and in this way create competitive advantages. Structure, planning and strategy are key concepts.[209] The process, should contribute to help minimizing costly uneconomic and unnecessary legal disputes, and transfer the contracts and the legal resources to competitive and strategic assets, and help managers towards acting more proactively.[210] It is important to make use of the contract to improve the business, and to prevent disputes; in other words, to be proactive in the contracting process to reach sustainable competitive advantages.[211]

It is systematically explored how competitive advantages can be extracted from legal resources. The MLP is a decision-making process and is structured with the manager, not the lawyer, in mind. It enables managers to move from a reactive perception of the law to one that proactively uses legal resources. Managers should apply the law in these four steps to meet business goals, such as strengthening customer relationships and protecting the integrity of commercial transactions. As the authors rightly note, - law is perhaps the most hidden source of all competitive strategy tools.[212] It is sometimes complex, and not all managers like to deal with it - or with lawyers.[213]

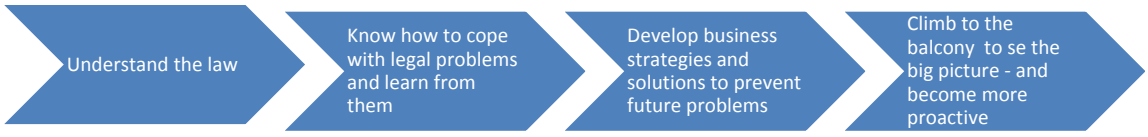

Figure 6.7 - Managers legal plan – Four steps to a more proactive approach

The first step, requires managers to understand the law, as simple as it seems, managers must master the rules and regulations relevant to one's industry; understanding the legal dimensions of business and recognizing the legal aspects.[214] *The second step* – the reactive step - advocates for a fight or flight response, whereby managers should decide whether to take action or leave the status quo in

[208] Siedel & Haapio (2011)
[209] Id., p. 14
[210] Id., Preface
[211] Id., p. 103
[212] Bird (2011, p. 71)
[213] Siedel & Haapio (2011, p. 2)see also Downes (2004, p. 19) - *In most organizations, the legal staff is isolated and paid too much just to say no to the most interesting ideas and strategies.*
[214] Id., p.13 and Orozco (2010). An understanding of both the elements of legally binding contract and the express terms incorporated into the contract is required in contract literacy. The implied terms that will apply to the contract terms must also be understood, these are called the *invisible* terms by Helena Happio, terms regarding the contract, which has not been specified in the contract that are as important as the agreed upon terms - Happio (2004) and also in Haapio (2010b).

their organizations.[215] *The third step* – the preventive step - recommends that managers develop strategies and solutions to prevent future legal problems, for instance, managers concerned about wrongful discharge litigation should think beyond court costs and proactively review firm policies relative to hiring, evaluation, and information disclosure. While such recommendations may seem apparent to lawyers, for managers acting on their own in a legal context, they represent sound decisions that can prevent unnecessary value leakages. This step helps managers move past the reactive approach and to create competitive advantages. The preventive step emphasizes learning from companies' previous fight or flight experiences, in an attempt to limit future legal problems. *The fourth step* – the proactive step - encourages managers to climb to the balcony to see legal decisions in a broader business context. This step directly addresses proactivity, it seeks to give an overview and become more proactive. When the three other steps have been viewed, one must not be tempted to forget this step of the process. Since you could frame the situation completely incorrect, and be unable to understand the bigger picture. It is at most crucial to use the tools and approaches which contributes to a simplification of otherwise complex decision-making processes.[216]

From a business perspective, there are many disagreements that should be solved without the interference of the courts, before they become legal disputes. It is possible to plan at different levels and be preventive and one must ask oneself these questions;

1. How do you avoid disputes from arising?
2. How do you prevent the dispute from doing harm?
3. If disputes arise, how do you minimize these?

MLP is about changing the conviction that the law relates only to legal problems or someone threatening to sue, and does not seem to be a plan, with new varieties of applications of the law, but more as a way of contributing to a more structural planning use of the law. Hence the MLP encourages a closer view of the law. An economical approach is only slightly present, but there is not an integration of law and economics like in proactive law, but more an interaction between the two fields. The MLP can be helpful in developing strategies and solutions, legally as economically, with its basis in the legal tool law is. The law is what the law is, and through this, competitive advantages can be reached. But as to the contract it is seen as being a static tool, unchangeable, but useable in the form it is.

[215]This stage also helps managers decide whether to defend a case in court or settle a dispute. This step usually occurs when a dispute arises after the formation of the contract. When it does the human response often reflects the fight or flight response, the fight usually involves litigation and the flight refers to a settlement of the dispute. The decision of whether or not to fight or flight will be made by contractually literate managers, the same legal tools will be used when making either of the decisions.
Siedel & Haapio (2011, p. 14)
[216]Id., p. 15

6.2 The law - a Source of Competitive Advantages

Competitive advantage opportunities have been identified in most business-related disciplines, including marketing, accounting, human resources, and management,[217] but law is considered to be *the last great untapped source of competitive advantage.*[218] Competitive advantage is defined as a value-creating strategy using firm resources to improve a firm‘s efficiency or effectiveness in ways not in use by current or potential competitors.[219] Even if a firm establishes a competitive advantage, not all competitive advantages are sustainable.

Rather than focusing on the regulatory and constraining aspects of law, the enabling aspects must be addressed, and the ability to use a variety of legal tools as part of the strategy to manage the firm more effectively. Law and strategy research examines the ability of managers to extract competitive advantage in a legal environment that is already established, and encourages the lawyer to be threaded as a strategic partner in decision-making, since the use of the law is a mechanism for capturing value and reducing risk.[220]

Legal astuteness is established through a proactive approach to regulation, an exercise of thoughtful judgment toward legal opportunities, and possession of legal literacy.[221] Managers who view the law purely as a constraint, something to comply with and react to rather than use proactively, will miss opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm.[222]

Firms legal-strategic behavior can be classified into five pathways, and each of these pathways in relation to the benefits and cost through a strategic fit, since many of the activities are fundamental in the ability for firms to achieve a sustained competitive advantage.[223]

6.2.1 Legal Astuteness

Legal astuteness is a valuable managerial capability that may provide a competitive advantage for firms seeking to generate RR, and is defined as the ability of a top management team to communicate with legal counsels and collaboratively solve problems, a valuable managerial skill that enhances firms. Legal astuteness is also established through a proactive approach to regulation, an exercise of thoughtful judgment toward legal opportunities, and possession of legal literacy.[224]

Bagley has defined four components of legal astuteness;

- A set of value laden attitudes about the importance of law to firm success,
- A proactive approach to regulation,

[217] Bird (2011, p. 63)
[218] Downes (2004, p. 19)
[219] Barney (1991, p. 101)
[220] Bagley (2006, pp. 1-2)
[221] Bagley (2008)
[222] Id., p. 378
[223] Porter (1996 p. 73)
[224] Bagley (2008, pp. 380-382)

- The ability to exercise informed judgment when managing the legal aspects of business, and
- Context-specific knowledge of the law and the appropriate use of legal tools. [225]

The degree to which legal astuteness can increase value and help parties to a SDS generate RR, can by using informal contracting and relational governance as complements define and strengthen relationships and reduce transaction costs, this will strengthen the parties ability to employ self-enforcement rather than third-party enforcement governance mechanisms.[226] Manufacturers and distributors can increase their value creation by converting regulatory constraints into opportunities for value creation. Furthermore, protect the value of their combined resources, by gearing the complementary resource endowments of each partner along with using legal tools to create opportunities. Legal astute parties will be better, at protecting, and leveraging the value of firm resources than those lacking that capability. Conversely, failure to implement appropriate legal measures can prevent firms from fully realizing the benefits of the other resources they control.[227]

The use of legal tools to create options, which is sometimes included in a contract, is an investment in the right to defer a decision until additional information becomes available or until uncertainties are otherwise resolved. To go beyond compliance with the letter of the law and converting regulatory constraints into opportunities, a focus on performance can lead managers to make decisions that result in illegal behavior. Failure to comply with applicable law can impose added costs, foreclose markets, and jeopardize the distribution system.

Manufacturers who are legally astute can apply their skills to capture value by using formal contacts to strengthen relationships with their distributors and reduce transaction costs, protecting and enhancing the value of firm resources, creating options through contracts, and converting regulatory restraints into opportunities.[228] This legal astuteness is a valuable ability if the parties to a SDC wish to generate RR's and create competitive advantages.[229]

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[225] Id., p. 379
[226] Dyer & Singh (1998, p. 668)
[227] Bagley (2008, p. 380)
[228] Id., p. 383
[229] A different view from the American school presents itself through DiMatteo's view. DiMatteo illustrates the importance of the legal tool that the contract is and for the opportunities it gives for competitive advantages. - DiMatteo (2010). The legal literature is concerned with contracting especially the distinction between *hard contracting* and *soft contracting* in which the contract serves mainly as a framework. These issues were already addresses in 1931 by Karl Llewellyn's in an essay. He observed that transactions come in a variety of forms and that a highly legalistic approach can sometimes get in the way of the parties instead of contributing to their purposes. This is especially true where continuity of the exchange relation between the parties is highly valued. The acknowledgement must consist of both hard and soft terms, provided that the contract is entered with the end to create alliances, innovation and so on, where a new contract might be formed. A further explanation on how this new contract should be formed and used does not seem to be present, but a focus on how this contract and the terms should discourage and frighten the parties to fulfilling the agreement. Willamson (1981, p. 552). This is not a change in the way of using the contract towards a more proactive use, but rather a reflection on how the conventional contract has always been. DiMatteo (2010, pp. 748-750). The strategic aspects on the contracts use and form and the impact it has on competitive advantages are highlighted. Like Bagley the importance is on

6.2.2 Strategic Fit and Pathways of Legal Strategy

The legal frames encircled for SDS's are by many firms viewed upon solely as a burden, which the contract will be a result of. Bird has classified five pathways that firms pursue when interacting with their legal environment, and show the benefits and costs of each pathway through the lenses of a fit. The five pathways of a firms legal behavior are; *avoidance, compliance, prevention, advantage* and *transformational*.[230] Firms must assess their own legal environment and market positioning in order to implement a mature legal strategy. Strategic fit among many activities is fundamental not only to competitive advantage but also to the sustainability of that advantage.[231]

	Avoidance	**Compliance**	**Prevention**	**Advantage**	**Transformation**
Strategy (external)	Operational effectiveness	Operational effectiveness	Competitive Advantage	Competitive Advantage	Sustainable Competitive Advantage
Fit (internal)	None	Consistency	Consistency	Reinforcement	Optimization
Sustainability	None	None	Short Term	Short Term	Long Term

Figure 6.8 - Attributes of Strategic Legal Action[232]

Figure 6.8 illustrates the interrelationship of strategic legal behavior with fit and sustainability.

Avoidance firms are defined as those that view regulations as costly and senseless obstacles to be evaded whenever possible. Accompanying avoidance behavior is the perception that legal rules are unfair, and must be overcome as quickly and as cheap as possible.[233] While *compliance* firms seek only to follow the law as written, and share common characteristics as avoidance firms, compliance firms view their legal resources as cost centers. However, they do not pursue illegal behavior to avoid costs, but is a rather conservative interpretation of legal standards.

Prevention firms implement business approaches to anticipate future legal problems, and shares overlapping behavior with the avoidance and compliance stages. It is at this stage that a legally based strategy begins to emerge.[234] The purpose of prevention and compliance behavior is to identify and assess potential legal risks and try to minimize them. Both types of firms have a c*onsistency fit,* which is a *simple consistency* between each activity and the overall strategy, a low-cost strategy.[235] Successful behavior in these two stages avoids running afoul of legal rules and the costs associated with litigation and regulatory penalties.

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the integration of law and strategy. Bagley (2010). Both Bagley and DiMatteo seeks legal strategies to attain competitive advantages.

[230] Bird (2008)

[231] Porter (1996 p. 73)

[232] Bird (2008, p. 22)

[233] Id., p. 13

[234] Bird (2008, p. 23)

[235] It minimizes portfolio turnover and does not need highly compensated money managers. The company distributes its funds directly, avoiding commissions to brokers. It also limits advertising, relying instead on public relations and word-of-mouth recommendations. Vanguard ties its employees' bonuses to cost savings. (Porter, 1996 p. 71)

An effective prevention programme encourages a culture where *correct* legal decisions become intuitive. The difference between these two stages is that prevention firms utilize their legal resources to achieve a strategic result - a competitive advantage. *Advantage* firms equate the strategic relevance of the legal environment with other business disciplines. Like the preventive stage the advantage approach uses the law to capture a competitive advantage, however it does not just integrate a legal practice with beneficial non-legal activities. Firms who use this strategy view the business, and legal resources as equally valuable to strategy.[236] The advantage firms differ since they achieve a higher order of fit known as *reinforcement fit,* which occurs when *activities are reinforcing*. [237] Finally, the rare *transformation* firm succeeds in using the legal environment to redefine a core mission or aspect of the organization. This approach is the most advanced stage of strategic legal activity, and these firms use legal resources to create value through competitive advantages, like advantage firms do. The difference is that a transformation strategy achieves a competitive advantage that is retainable over the long-term and can be used to improve key mechanisms within the firm.[238] Firms in this stage cross the threshold from competitive advantage to sustained competitive advantage, which occurs when a firm engages in a strategy that competitors cannot easily copy.[239] This applies a widely used strategy framework to the legal environment and explores whether law may be a source of sustainable competitive advantage. The type of fit that categorizes this type of firm is a fit that goes beyond activity reinforcement to what *optimization of effort*.[240]

Exchange of coordination and information across activities to eliminate redundancy and minimize wasted efforts, is the most basic types of effort optimization. But there are higher levels as well. Product design choices, for example in A SDS, can eliminate the need for after-sale service by the distributors or make it possible for customers to perform service activities themselves. Similarly, coordination with manufacturers in distribution channels can eliminate the need for some in-house activities, such as end-user training.

As firms achieve higher stages of integration, legal approaches become more strategic and yield more enveloping benefits, and the most effective legal strategies allows firms to achieve a competitive advantage.

[236] Bird (2008, p. 27)
[237] Porter (1996, p. 71)
[238] Bird(2008, p. 31)
[239] Barney (1991, p. 105)
[240] The three types of fits, simple *consistency, reinforcement and optimization* are far more central fit is a far more central component of competitive advantage than most realize, important because discrete activities often affect one another. (Porter 1996, p. 71)

6.3 Summary

The proactive contract is a result of the integration of law and economics, which presents itself through the contract, where it becomes a strategic management tool. The four steps of the MLP helps contracting parties to achieve competitive advantages by helping them in seeing the bigger picture, through the important role law plays. It is through the fourth step that one becomes more proactive. Contracting parties must distance themselves from viewing the contract as being solely a legal formal document but instead treating is as a tool where mutual business goals are being met.

The parties must see the opportunities in the law as a competitive advantage, and the ability to use a variety of legal tools as part of the strategy to manage the firm more effectively. This will create opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm. Even if a firm engages in a legal strategy, not all strategies are good strategies and certain practices lend themselves to unethical and destructive behavior.

The ability to be legal astute can increase value and help parties to a SDS to generate RR, by using formal/informal contracting and relational governance as complements to define and strengthen relationships and reduce transaction costs, this will strengthen the ability to employ self-enforcement governance mechanisms.

The transformation firm succeeds in using the legal environment to redefine a core mission or aspect, and uses the legal resources to create value through long-term sustainable competitive advantages, and thereby creates a strategic fit, which also enable the parties to strengthen their relationship.[241] Law can be used for value creation; both positive value creation and to reduce effects that cause value reduction. Scholars are becoming increasingly aware that legal issues, are too important to be left solely to lawyers and that business strategy, could significantly benefit from an understanding of the legal environment in which all businesses operate. In spite of these welcome advances, the research on law and strategy still needs significant development.[242]

7.0 Contractual Disputes and the Negotiation Process

7.1 Contractual Disputes: Going to the Root of the Problems

An assumption will be that contracting parties enter into contract because they see a potential for benefits. Parties agree on the contract terms, because they see an economical profit for both parties, so the contract has an economical objective. Qua the contract is a legal document, it has legal obligations as well as economical.

Previous experiences and examples of contract terms that have been misused and misunderstood, can be used proactively to prevent future disputes from arising by sharing experience and utilizing it

[241] Hart & Moore (1988, p. 755)
[242] Bird (2011, p. 72)

during proactive contract reviews. A fundamental principle of successful contracting is by learning from experience such as the complementary resources endowments.

The law is the only profession which records its mistakes carefully, exactly as they occurred, and yet does not identify them as mistakes.[243] A quote by Professor Louis M. Brown in his *Legal autopsy* methodology; a method to learn from past mistakes in the legal field, by suggesting practical steps to implement and organize change, through a further appreciation of the different dimensions of using the law. The legal *dead body* is discussed, as a case, which can be *opened up* as doing historical research of both sides of the dispute.[244]

IACCM's tenth annual survey in 2011, *top terms in negotiation*, shows that if contracting parties want to maximize their chances of realizing their benefits, the focus must be shifted to a different set of contract terms.[245] In this survey, business managers were asked, which terms were considered the most frequent sources of claims or disputes. Disagreements over acceptance or delivery turned out to be the number one cause of contractual claims and dispute. Experience tells us that this is likely due to confusion on requirements, either through ambiguity from the beginning or the implementation of change management procedures.[246]

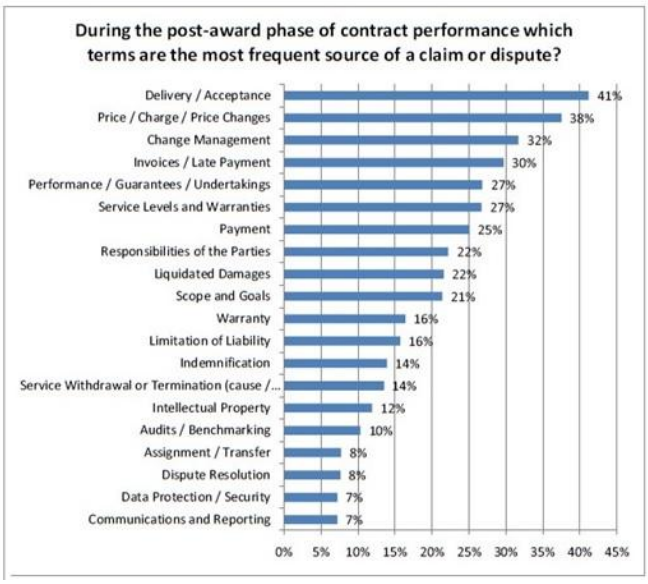

Figure 7.9 - Most frequent sources of claims or disputes[247]

Figure 7.9 shows the core findings of the most frequent sources of claims and disputes, and as mentioned above the most frequent sources is on acceptance and delivery. Parties enter contracts

[243] Brown (1955, p. 47)

[244] Id., p. 48, - He had high hopes for this methodology, which is still almost 60 years later, still relevant and for which business people and scholars have not fully adapted into legal processes. Further development and proactive methodologies are necessary, within the legal field of inter-disciplinary methodologies that provides the means for developing a more holistic approach to contracting.

[245] IACCM (2011)

[246] Dimatteo, Siedel & Haapio in Berger-walliser & Østergaard (2012, p. 59)

[247] IACCM (2011, p. 8)

because they believe that there is mutual benefit to be achieved. A focus on the consequences of failure undermines the probability of success. In part, it damages trust and collaboration. But more importantly, it results in key areas of the contractual content being overlooked or paid inadequate attention – specifically - clarity over scope and goals, and over the on-going governance and management procedures for the relationship. This could be likely due to confusion around requirements, either through ambiguity from the beginning or the implementation (or perhaps lack) of change management procedures.

In the legal field, requirements in management has been widely researched in other fields, it has not attracted much interest, nor is it high on negotiators agendas as evidenced by the list of the top ten terms that are negotiated with most frequency (see figure 7.10 below).

TOP 30 TERMS in 2011	↑↓	2011	2010	2009	2008
Limitation of Liability	-	1	1	1	1
Indemnification	-	2	2	2	2
Price / Charge / Price Changes	-	3	3	3	3
Intellectual Property	-	4	4	4	4
Payment	↑	5	6	8	8
Liquidated Damages	↑	6	9	9	11
Performance/Guarantees / Undertakings	↑	7	18	-	15
Delivery / Acceptance	-	8	8	7	9

Figure 7.10 - Top negotiated terms[248]

Figure 7.10 shows a divergence between highly negotiated terms most often at the centre of the disputes. Good risk management is achieved through a balance of probability and consequence. The biggest division between negotiators today is in how they seek to allocate risk. Therefore the polar extremes are in their approaches to allocating liabilities and seeking or granting indemnities. These topics - along with price and payment - overwhelmingly dominate negotiations. *Today, the effort is focused on a narrow battle over the price and the allocation of risk.*[249]

In commenting on the figure above, the results conclude that the top ten negotiated terms reveals the extent to, which negotiators are, channeled strongly into asset protection and the consequences of failure, such as, intellectual property rights, liquidated damages, governing law, and payment terms.[250] Furthermore, that the top four terms have remained unchanged for the past four years. IACCM's most frequent sources of disputes, and previous case law (in section 3.6) reveals that the negotiated terms, and disputes are not the same, what contracting parties negotiate differs. One reason could be explained in by the mindset of the actual contracting parties.

[248] Id.
[249] Id., p. 7
[250] Id., p. 5

7.2 Negotiation Process: Deal-making- & Implementation mindset

Ertel describes different mindsets in relation to contracts and contracting, the distinguishing is between two types of mindsets the; *deal-making*- and *implementation.*[251] Applied in these two theories is the fact that people, who are responsible for entering the contracts, are not responsible for the implementation of it. Their incentives are more based on the entering into the contract, and the signing of it, rather than the following implementation. This can create a deal-making mindset, where the focus is on the entering of new agreements, and on risk management, and penalty provisions. With focus on the final agreement, the firm can easily apart itself from the implementation, and not have the actual financial affects of the agreement in mind. The contract might be good on paper but can lack the relational element, which is necessary for a successful implementation.[252] In the implementation mindset, there is a shift in the focus. The figure below shows Ertel's five approaches that can be helpful when changing the focus away from the deal-making mentality to an implementation mindset.

1. Start with the end in mind.	Imagine the deal 12 months out: What has gone wrong? How do you know if it's a success? Who should have been involved earlier?
2. Help them prepare, too.	Surprising the other side doesn't make sense, because if they promise things they can't deliver, you both lose.
3. Treat alignment as a shared responsibility.	If your counterpart's interests aren't aligned, it's your problem, too.
4. Send one message.	Brief implementation teams on both sides of the deal together so everyone has the same information.
5. Manage negotiation like a business process.	Combine a disciplined preparation process with post-negotiation reviews.

Figure 7.11 - A new mindset - from a deal-making mindset to an implementation mindset

Figure 7.11 illustrates the five shifts needed when taking the leap to an implementation mindset. It is important that negotiators start with the end in mind, and helps the counterpart to prepare for the negotiation, treats the alignment as a shared responsibility. Furthermore it is important that the parties have the same information and that they manage negotiation like in a business process.

Leaving some money on the table is OK if you realize that the most expensive deal is one that fails.[253]

The quote illustrates this new mindset the entering into the contract is not the main-goal, but rather the implementation of the agreement. There is a greater focus on openness and the parties' tendency to withhold information – causing asymmetric information and moral hazard.

[251] Siedel & Haapio (2010, p. 681). See also Ertel (2004, p. 60-68) where a further clarification of these mindsets are present.
[252] Siedel & Haapio (2010, p. 681)
[253] Ertel (2004, p. 5)

It can therefore have significant importance, how the contractual negations have been, to prevent the relation from being harmed, before the actual implementation of the contract. Apart from recognizing the importance, there is not any revolutionary in this, and in addition no new approach is being presented to and of the use of law. This leads to the next section on effective negotiation processes, hence both the contracting process and the implementation process has significant importance for the final outcome of the relationship, and the competitive advantages for both contracting parties in the SDS.

7.2.1 Effective Negotiation Process

Disagreements over acceptance or delivery are the number one cause of contractual claims and disputes. So it is not surprising that the parties to a contract focus so strongly on the question of who will be liable for the consequences of failure.[254]A question which comes to mind is; if the frequency of failure can be linked to the negotiation process? My answer to this question would be yes. Why? Because parties to a contract, enter it, because they believe there is a potential for benefit. But to achieve these benefits it is crucial for the parties to not solely focus on own gains - meaning – restraint from acting opportunistically. If they do that, in the early stages of the process, the risk of a failed business relationship will be largely bigger, than, if they did not.

To be able to maximize the potential for benefits the parties of the contract must negotiate the contract effectively. Fisher and Ury – have developed four points which will lead to an effective negotiation process.[255] *Principled negotiation* is a more effective way of reaching good agreements, and can be used effectively on almost any type of dispute. The four principles are:

1) Separate the people from the problem
2) Focus on interests rather than positions
3) Generate a variety of options before settling on an agreement
4) Insist that the agreement be based on objective criteria

These principles should be observed at each stage of the negotiation process. The process begins with the analysis of the situation or problem, of the other parties' interests and perceptions, and of the existing options. The next stage is to plan ways of responding to the situation and the other parties. Finally, the parties discuss the problem trying to find a solution on which they can agree.

People tend to become personally involved with issues, and with their own side's positions, and take responses to those issues and positions as personal attacks. Separating the people from the issues allows the parties to address the issues without damaging the relationship. It also helps in getting a clearer view of the substantive problem.[256] Negotiation can be a frustrating process. People often react with fear or anger when they feel that their interests are threatened. IACCM list on the most

[254] IACCM (2011, p. 3)
[255] Fisher &Ury (1981, p. 11)
[256] Id., p. 15

frequently negotiated terms can help in improving the negotiation processes and result in fewer dispute cases.

7.3 Ex-post Renegotiation

If the negotiation fails, and the contract has been entered despite of all the arguments above, for proactive contracting process, and without taking the mention factors into consideration, there might be a need for the manufacturer and the distributor to renegotiate the contract at some point to avoid termination.

Contracts are usually written for a fixed duration, in effect, and depreciate because they only provide protection during the designated length of the agreement. At the end of the contract duration, the parties need to write a new contract (or employ a different safeguard). Exchange partners can avoid the costs of re-contracting by employing self-enforcing agreements, which, over time, may in fact *appreciate* in the sense that trust or embeddedness increases with increased familiarity and interaction. The greater the parties in a SDS's ability is to employ self-enforcing safeguards (trust or hostages) rather than third-party safeguards (legal contracts), the greater the potential will be for RR's, owing to lower contracting monitoring, adaption and re-contracting costs, and superior incentives for value-creation initiatives

There might also be advantages for the parties to renegotiate the contract ex-post, because what might have been efficient might not be once implementation has begun, and further information has been revealed. If the formation of the SDC contains limitations or is incomplete, the parties can make up for this incompleteness, to some extent, by building into the contract, a mechanism for revising the terms of trade as they each receive information about benefits and costs. If the parties can rescind the original contract and write a new one, severe limitations are placed the form the revisions can take.[257]

Contracts are meant to align incentives and hereby protect people, and this alignment becomes imperfect, when contracts are incomplete.[258] Ex-post renegotiation may be an ex-post transactional problem, and if informal self-enforcement is employed into the contract costs of re-contracting can be avoided.[259]

7.4 Summary

A fundamental principle of successful contracting is by learning from experience such as the complementary resources endowments by being proactive. Contracting parties have been too focused on negotiating claims of delivery and acceptance, and there needs to be a shift away from

[257]Hart & Moore (1988, p. 755)

[258] Contracts can also be seen as a mechanism to achieve binding commitments that the parties can bank on in their planning. When contracts are incomplete and imperfect, however, they have only limited effectiveness for achieving commitment. Milgrom & Roberts (1992, p. 133)

[259] Anderson & Decker (2005, p. 1743)

the focus on the consequences of failure which undermines the probability of success. The focus should rather be on scope, goals, the on-going governance and the strengthening of the relationship and thereby enhancing the proactivity of the contractual terms. The way to do this is by changing the mindset of the negotiators, to an implementation mindset. This mindset enhances openness, and limits the tendency of withholding information and only concentrating with own gains in mind through principled negotiation. There must be a strategic fit through an ongoing dialogue between the manufacturer and the distributor – information sharing. Ex-post renegotiation is a commitment problem, which is a result of contractual incompleteness. If the parties are able to understand the actual agreement and that they will later face these incentives, they might not be able to draft the contract in a way that later generates the desired RR.

Through the previous chapters, it has now been established which tools and mindsets there must be present when drafting a SDC that contains proactive rent generating provisions. The next chapter presents a number of suggestions for proactive provisions, which are not exhaustive for the SDC, but serves as examples of provisions, which to an extent are proactive and prevents parties in a SDS from getting into disputes. Figure 7.12, illustrates a funnel containing the elements contracting parties should have in mind, when drafting the proactive provisions into the SDC.

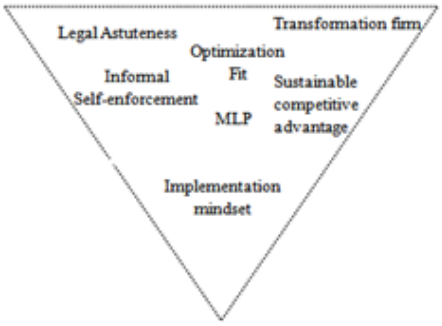

Figure 7.12 - Elements of drafting a SDC

8.0 Contract Design

For firms using SDS's, monitoring and enforcement efforts appear critical, as unauthorized sales outside of assigned territories, because they can cause considerable disruption. Monitoring and enforcement, as it has been stated previously, is an element that can hinder the parties' ability to earn and preserve RR and sustain competitive advantages.[260] Therefore this chapter will, explore how firms should design contracts, containing key sources of RR, since monitoring sales of intermediaries, and enforcing territorial boundaries when using highly selective distribution is an important avenue for future research.[261]

[260] Dyer & Singh (1998, p. 661)
[261] Dutta, Bergen & John (1994)

The SDC is a strategic contract that creates a private governance structure needed to sustain a long-term relationship. The selective distributions frame of contracting contains provisions on; business goals, psychical location and website, termination, changes, duration, training of personal, reporting, enforcement, changes, marketing and advertising, supplies, performance. These are central provisions that serve to protect against free-riding from competitors and support the achieved brand value. The success of these provisions depends and the manufacturer and the distributors fair allocation of risks and benefits.

The proactive provisions are, presumably, dynamic, since the SDS evolves over time, and therefore the proactive provisions must evolve over time as well. Furthermore, the barriers and complications caused by lack of implementing proactive approaches to firms, and organizations corporate practices that can be overcome through the implementation of proactive methods, and tools in the contracting process and practices.

8.1 An Interdisciplinary Management Tool

With the proactive approach to law, and an integration of law and economics, it is perceived that an interdisciplinary management tool occurs, which is the proactive contract. The contract will not solely be a legal tool but likewise a management tool where economical and business goals will be obtained.

First and foremost, the conscious use of contracts as a management tool, which guides and supports business success. To wit bring the security needed to succeed in applying legal tools that makes it possible to achieve the desired goals, and to prevent legal disputes is one of these objectives – though it comes second.[262] Proactive law in proactive contracting is considered as being an enabling tool; the enabling element which refers to the accomplishment of the desired goals of the contracting parties.[263]

In the proactive contracts interdisciplinary uses of application there are several opportunities for the use of the contract to optimize, and make effective use of the manufacturer and distributor activities and processes.[264] These opportunities are present through the interfirm resources and routines that help in spanning their boundaries.[265] It is an approach to the contract, where both legal and economical disciplines are employed, which gives the proactive contract far-reaching prospects.

[262] Siedel & Haapio(2011, p. 106)
[263] Sorsa (2011, p. 19)
[264] The objective of proactive contracting is to set a framework for integrating legal forcibility to the tangible execution of the daily business and to merge great contracts, juridical, quality and risk controlled management practices with a proactive approach to the law. The proactive view to contracting is a consequence of the fact that the principle of freedom of contract (sec. 3.2) is widely acknowledged throughout the world, which turns contracts into important transactional tools in fine-tuning the legal framework regulating the transactions.
[265] Dyer & Singh (1998, p. 660)

Furthermore, governance plays a key role since it influences the willingness of the manufacturer, and the distributor to strengthen the contractual-relationship.[266]
As stated previously, the value-creation lies in the better use of the contract as the source it is sought to be, and hereby optimizing and make efficient use of the interfirm activities and processes.

A value-creation is reached through the access to the manufacturers and the distributors resources. Since, the interdisciplinary application of the proactive contract is sought to have more opportunities for the use of the contract to optimize the activities and processes. A focus on the allocation of risks creates a defensive behavior. By using a proactive contract in the distributor relations, where the focus is on success rather than protection, an opportunity for value-creation through a manufacturers distributor-relations occurs, which will result in an effect on the value-creation for the whole supply-chain in the firm.

A firms relations is therefore of importance for the whole firms supply-chains and the proactive contract becomes a very interesting tool in disciplines as supply-chain management.

8.2 Guidelines for Proactive Contracting

The proactive contract has far-reaching uses of application, and the contractual content can differentiate depending on the contractual aim and objective. A set of general and overall guidelines might create a rule of conduct for the formation of the contractual content. The mind-set and fundamental characteristics in the proactive contract is established in the following.

8.2.1 Promote, Prevent and Manage

A proactive contract should contain elements to prevent and manage risks, since a reactive approach is not sufficient enough to deal with the problems and disputes that might occur. An opportunity for prevention and managing elements in the proactive contract can be a dispute solution plan. Such a plan can generally be divided into two levels where, the first seeks to prevent disagreements and that disputes arise, and the second, that manages disputes if they do arise. Subsequently, a plan will be established where possible disputes are dealt with solved if they should occur.[267] The proactive approach to contracts differentiates between two aspects of proactivity: the *preventive* dimension, and the *promotive* dimension.

The aim of the proactive contract has its roots in the previously stated goals for the proactive contract, which in summation are the following:

1) To promote successful *performance* towards successful relationships, identify and eliminate sources to potential disputes.
2) To optimize *risk* and *contingencie*s along with minimizing harmful effects when a problem occurs and

[266] Id., p. 669
[267] Sorsa (2011, p. 200)

3) *Dispute resolution*; prevent litigation along with minimizing cost and losses, when it is inevitable.[268]

In these concepts the preventive and promotive dimension in the proactive contract should be visible, whereas, the managing dimension presents itself through dispute resolution. Contrary to the conventional contract, that to a high degree is affected by reactive protective elements, contrary, the proactive contracts focus must be on joint goals and success, through the use of both preventive and enhancing elements in the contract. The promotive element is especially significant, which is equal to an enhancing dimension, and the preventive and managing element that is viewed as a part of the preventive dimension. If the proactive contract consists of these promotive, preventive and managerial elements, that focuses on enhancing the reach for joint success in the joint goals, a plan for preventing disputes will be clarified, which makes it possible to manage disputes. The proactive contract will then enable the possibilities for identifying and eliminating sources of potential disputes, optimizing risks and returns, and minimizing the damaging effects when such disputes arises, and also minimizing the costs and loses where it is inevitable.[269]

The promotive dimension has a positive and constructive emphasis. In proactive law, the emphasis is on achieving the desired goal in particular circumstances where legal expertise works in collaboration with the other types of expertise involved.[270] In the field of proactive contracting, promoting of firms success comes first and minimizing legal risks and preventing legal disputes, consequences and prevention comes second.

When using the contract to reach these goals, a thoroughly planning, negotiation, documentation, implementation and course of action is needed. Towards reaching the objectives with proactive contracting, contracts and contracting processes can be used to improve, guide and lead, these are key point and they are important to have en mente; the law uses ranges from creating value to wielding it as a weapon to sustain advantages.

As mentioned earlier (chapter 6), the American school seeks a more strategic use of law to gain competitive advantages. Through this mindset it is not likely that there is a change in the law, but in dealing with the law, so the contract will remain within the conventional paradigm. A legal strategy is thought of as rational, a strategy of firm's use of law that can make the firm more aware of the opportunities it consists.[271] Common for the legal strategy is, as written earlier, a strategy for the use of law, where the law is a legal tool. The firm plans how to use and deal with the law, before the

[268] Siedel & Haapio (2011, p. 106)
[269] Id., p. 118
[270] Pohjonen (2010, p. 54)
[271] Through several figures Bagley illustrates which big influence the law has through the whole firm, and hereby also the choice of strategy. Derived from this, a legal strategy can mean several things, for example; to ensure the patents and other intellectual property rights, minimizing product liability and environmental effects, a plan for dealing with employees and employment contracts, plus establishing good relations with manufacturers. Bagley (2010, p. 604)

parties are faced with issues waiting to be solved. The point is, not to design a contract that advances one parties competitive advantages at the expense of the other contracting party that would eliminate, the whole point of strong relational contracts.

In many cases the parties realize the possibility or likelihood of advantages after the contract has been formatted, so they undertake to provide incentives or penalties to prevent purely self-interested acts.[272] There needs to be a shift from the focus on terms, such as limitation of liability and indemnification that deals with the consequences of failure to terms that focuses on the causes and avoiding failures.

8.2.2 Clarity

In addition to the above, clarity must likewise be an important element in the proactive contract. A good contract implies that the parties involves of elements such as expectations, performance and resolution. In combination these can ensure, that the contract create a frame for dealing with the agreement and the relation, where the likelihood for a mutual successful outcome increases significantly. The probability of success will be undermined with a focus on the consequences of failure. In part, it damages trust and collaboration.[273] But more importantly, it results in key areas of the contractual content being ignored or paid inadequate attention – specifically, clarity over scope and goals and over the on-going governance and management procedures for the relationship.[274]
Likewise in the proactive contract it is thought that such clarity is a positive element. Clarity on the agreed terms and clauses can help reduce the probability for misunderstandings and disagreements in the created relation.

8.2.3 The Relational Contract

Relational contracts are contracts that focus on the relation between the contracting parties to an agreement.[275] In these types of contracts, the parties do not agree on detailed plans of actions, but instead on goals and objectives, and general provisions that can be broadly applicable to shifting

[272] DiMatteo (2010, p. 729)
[273] Dyer & Singh (1998, p. 669)
[274] IACCM (2011, p)
[275] The distinction has previously been between the classical contract law and the neo-classical contract law. Classical contract law endeavors to implement discreteness and presentation in several ways. For one thing, the identity of the parties to a transaction is treated as irrelevant. In this respect it corresponds exactly with the "ideal" market transaction in economics. Second, the nature of the agreement is carefully delimited, and the more formal features govern when formal (for example, written) and informal (for example, oral) terms are contested. Third, provisions are narrowly prescribed such that, "should the initial presentation fail to materialize because of non-performance, the con-sequences are relatively predictable from the beginning and are not opened "Additionally, third-party participation is discouraged. The emphasis, thus, is on legal rules, formal documents, and self-liquidating trans-actions. Not every transaction fits comfortably into the classical-contracting scheme. In particular, long-term contracts executed under conditions of un-certainty are ones for which complete presentation is apt to be prohibitively costly if not impossible. This last brings us to what Macneil refers to as neoclassical contracting. As Macneil observes (Macneil 1974, p. 864), "Two common characteristics of long-term contracts are the existence of gaps in their planning and the presence of a range of processes and techniques used by contract planners to create flexibility in lieu of either leaving gaps or trying to plan rigidly.""Third-party assistance in resolving disputes and evaluating performance often has advantages over litigation in serving these functions of flexibility and gap filling. Lon Fuller's remarks on procedural differences between arbitration and litigation are instructive. (Williamson 1979, p. 237)

markets, and on criteria's that seek to determine what to do when deciding unforeseen contingencies.[276] Relational contract scholars theorize that firms who form arrangements with one another develop a relationship that generates planning, trust, and solidarity norms that far exceed the terms of the original agreement.[277]

In general, situations where complete contracts are too costly or impossible, actual contracts are relational. They serve to structure a good relationship and set common expectations, and they establish mechanisms that will be used to make decisions and allocate costs and benefits.[278] The element of preserving the good relationship, between both the manufacturer and the distributor is elementary, since they operate on different markets and monitoring and control can be either costly or insufficient and even impossible.

According to Macaulay the term contract is used as a device for conducting exchanges. Contracts are not treated as synonymous with an exchange itself, which may or may not be characterized as contractual. Nor is contract used to refer to a writing recording an agreement.[279]
The arguments and clarification above of opportunistic behavior, enlarges the importance of relational contracting. The Manufacturer and distributors must seek to resolve problems and disputes, since third party mediator's involvement is not always optimal, and their knowledge and insight to the problems might be limited, and understanding the actual conflict can be a conflict itself. Furthermore, effective governance requires the parties to use self-enforcing mechanisms, rather than third-party mediators, to be able to generate RR through the relationship. Relational contracts are a means of limiting and perhaps totally excluding the occurrence of opportunistic behavior in the contractual stages.

8.3 The Contractual Content

A determining difference between the conventional and the proactive contract is a shift in the view of the contract. From a defensive and reactive view where failure is anticipated and limitation of liability is a high priority. The proactive contract is more forward-looking and focuses more highly on preventing and enhancing, what is wanted and unwanted. The focus is on success and sustainable competitive advantages.

Figure 8.13 illustrates Siedel & Haapios view on what contracts are tools for, through this figure it is clarified that the proactive contract is a multifunctional tool. The contract sets a frame for the

[276] Mayer & Argyres (2004)
[277] Bird (2005, p. 151)
[278] Borch (1994)
[279] Contracts involve two distinct elements: 1) Rational planning of the transaction with careful provision for as many future contingencies as can be foreseen, and 2) the existence or use of actual or potential legal sanctions to induce performance of the exchange or to compensate for non-performance - Macaulay (1963, p.55).

relation between the parties and seeks to create; advantages and protect value. The commitment in the proactive context is positively related to performance.[280]

.

Contracts are tools for:

1. Managing business, projects and commitments;
2. Creating, allocating, and protecting value;
3. Communication, coordination, motivation, and control;
4. Sharing, minimizing and managing risk;
5. Problem prevention, dispute avoidance, and dispute resolution.

Good-quality contracts serve as *visible scripts* for parties working together.

Figure 8.13 - What proactive contracts are tools for[281]

The contract must be a tool for communication, coordination, motivation, and control and at the same time, to be able to; divide, minimize and manage risks so that problems and disputes are being prevented and solved. These elements are important assets, and the previously mentioned, human-asset specificities and the development of knowledge sharing routines allows the parties to communicate efficiently and effectively, which reduces communication errors that can lead to disputes.[282] Therefore, the greater the parties are to encourage transparency and reciprocity and to discourage free-riding, the greater their potential will be to generate RR through knowledge sharing.[283] Herein, elements that helps the parties prevent and manage, along with setting the fundament for the guidelines above. As previously mentioned the proactive contract creates some general conditions for the relation between the parties to the contract. The relation between the contracting parties is a fundamental element for the use of the proactive contract, and as a way for the parties to generate RR through this contract. The relational view of competitive advantages combined with the proactive approach to contracts and law, will help manufacturers and distributors in earning and preserving RR, through routines and processes as an important unit for understanding competitive advantages.

As mentioned several time throughout this thesis trust has a significant influence, and is not something that is created with a provision in the contract. It is built over time throughout the different stages of the co-operation. The provisions can help in the creation of trust, through openness in the negotiation stages, a realistic allocation of risks, the sharing of assets and sharing of information. According to Reuer and Ariño, asset specificity is an important transactional attribute that affects the contract design, as well as having a strategic importance, that encourages a greater

[280] Dyer & Singh (1998, p. 664)
[281] Siedel & Haapio (2011, p. 118)
[282] Id., p. 662
[283] Id., p. 666

use of such provisions.[284]

IACCM have stated which terms that would be more productive in the support of successful relations. Figure 8.14 illustrates, that the biggest gap between trading partners today is in how they seek to allocate risks. Therefore allocating liabilities and seeking or granting indemnities is at the top, along with along with price (changes) and payment dominates the negotiations. The figure shows the top ten negotiated terms and a quick review of it reveals that the negotiators are channeled into asset protection and the consequences of failure – intellectual property rights, liquidated damages, governing law and payment terms being examples.[285]

	The terms that are negotiated with greatest frequency	**Terms which would be more productive in supporting successful relationships**
1.	Limitation of Liability	Change Management
2.	Indemnification	Scope and Goals
3.	Price / Charge / Price Changes	Responsibilities of the Parties
4.	Intellectual Property	Communications and Reporting
5.	Payment	Performance / Guarantees / Undertakings
6.	Liquidated Damages	Limitation of Liability
7.	Performance / Guarantees / Undertakings	Delivery / Acceptance
8.	Delivery / Acceptance	Dispute Resolution
9.	Applicable law / Jurisdiction	Service Levels and Warranties
10.	Confidential Information / Non disclosure	Price / Charge / Price Changes
11.	Service Levels and Warranties	Audits / Benchmarking

Figure 8.14 - What should we be negotiating?[286]

This focus damages the value achieved from trading relationships, but according to IACCM the effort in negotiation should be placed in scope and goals, change or amendment procedures, communications and reporting. But for as long as contracting remains a largely transactional activity dominated by a legal/financial axis, there is little likelihood of change. Executives should be demanding more from their contracts. *They should be asking why so many relationships fail to deliver to their potential – and what role contracting and negotiation are playing in that failure.*[287]

The right side of the figure illustrates what negotiators should be negotiating instead, which is some of the same terms I have highlighted throughout the designing of the contractual content. Listed in the same rank on the left side is what they actually do negotiate. A section of these terms have been included in the following, where it can be noted that some of the elements of the contract, can have supporting and promoting characteristics and preventing and managing qualities. With starting point in the previously formulated guidelines, the content of the proactive contract can generally be separated into two aspects, it can have a supporting and promoting quality and be preventing at the

[284] Reuer and Ariño (2007, p. 316)
[285] IACCM (2011, p. 5)
[286] Id.
[287] Id.

same time. The following sections will illustrate the provisions in this more closely. Figure 8.15 is an overview of the RR generating SDC, and the following sections will illustrate the provisions in this more closely.

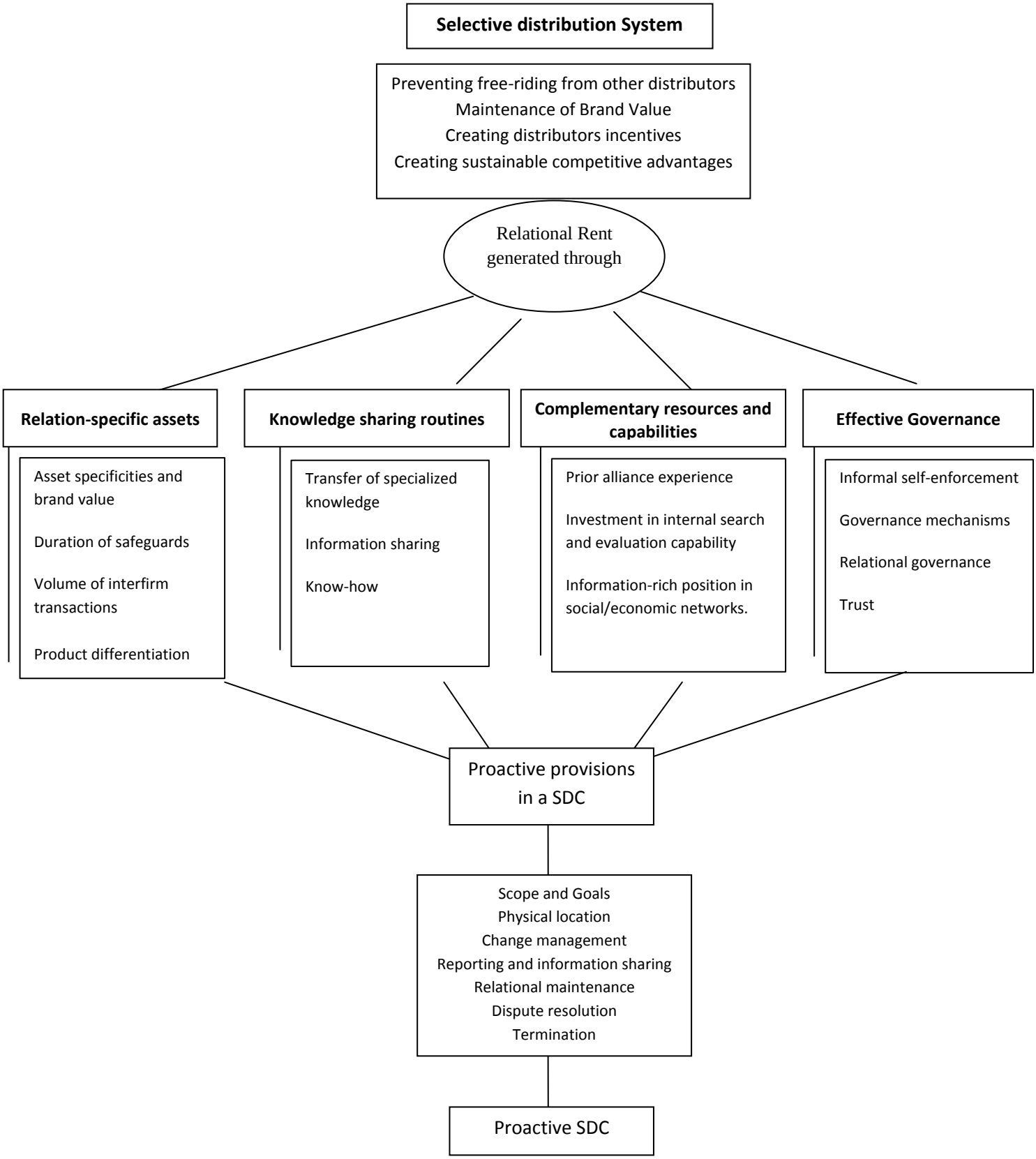

Figure 8.15 - The content of the RR generating SDC

8.3.1 Support and Enhance

Terms in the proactive contract should support and enhance the parties' perception of the mutual goals. Focus should shift from failure and protection to a focus on reaching success and business and creating a strong relationship that has economical value. Opportunities must be exploited as to being limited and hindered through a reactive and protective approach to the contract.

Some proactive terms does not necessarily create a proactive contract. Whether a contract is proactive or not, based solely on proactive provisions, or the fact that the contract can be seen as proactive will be discussed further.

In the previously conducted guidelines it was explained that a proactive contract should contain a preventing and promoting aspect. The proactive contract should support and enhance the business strategy and if the proactive contract is employed across disciplines a high level of inclusion, co-operation and communication between the manufacturer and distributor must be present to get the full benefit from the proactive contracts possibilities.
If the contract is employed with a specific aim – like to create a strong relationship and to generate rent through this relationship – then it must be important that the parties who are liable in this interaction, to be drawn into the dealing and formation of the agreement and contract.

A fundamental proactive approach, and mindset must be present throughout the whole contract to ensure that the elements, and terms in the contract supports and enhances the same goals and mutual success, and avoids conflicting elements and terms in the contract. There is not a clearly defined line between a conventional contract and a proactive contract, therefore there has been set some clearer guidelines throughout this thesis for the proactive contract that contains provisions or incentives that generates RR. In the next sections some central conditions that must be regulated in the proactive SDC will be outlined. The aim is to illuminate, which terms and conditions that can contribute in creating a strong relational contract.

8.3.1.1 Scope and Goals

An important element in the proactive contract should be objectives and goals in the agreement, since a great part of the contractual content must support and enhance this. Objectives and goals must therefore be clearly formulated, and clarity is therefore an important feature, as to preventing the parties from misunderstanding what must be reached through the contract.

In the proactive contract a joint vision where the parties can share their understanding of success, must exist, to be able to develop and formulate the right terms and tool to the given contract. This way a common understanding of success will be ensured.[288] However, implementing proactive

[288] Sorsa (2011, p. 260)

contracting and the related areas of risk management and contract management, is not an end in itself, but the means to an end. It is essential that all contracting decisions and actions focus on the outcomes the parties are seeking to achieve.[289] In this context this end is achieving sustainable competitive advantages.

The SDC must contain means dealing with the goals of the SDS, goals that strengthens and clarifies brand value created by the manufacturer, which hopefully enhances the value of the SDS between the parties. A detailed description of the product lines, why and how the distributors can contribute in maintaining the brand value, as well as his/her knowledge on the products in order to market and resell. Furthermore, obligations on the distributor to, at any time act loyally to promote the value created by the manufacturer. Differences in goals between the manufacturer and distributors may lead to disputes on how the channel revenue, and costs are allocated among them. An unsatisfactory allocation of these benefits and costs can lead to incentive problems. According to agency theory, if a manufacturer had complete information about the behavior of a distributor, a behavior based control system would be most efficient because it inhibits shirking behaviors by distributors.[290] If the manufacturers cannot observe distributor behavior with certainty, they have two options; they can either transfer some risk to the distributor or they can invest in information systems to monitor distributor behavior and coordinate it with manufacturer strategy.

An example on a joint business goal could be:

Exhibit 8.1 - Scope and Goals

> *The parties to this contract aim at creating value for both parties, in accordance with the brand and to prevent free-riding from unauthorized distributors on the investments made.*
>
> *The objectives and goals concerning this agreement shall be clearly formulated enlisting goals, that strengthens and clarifies the relationship between the parties, and furthermore the brand value created.*

Within the contract it must be stated that the manufacturer operates a SDS in order to maintain and enhance the brand value created, and that the distributor must comply with the requirements set out by the manufacturer, for him to be a part of the SDS. The distributors must act loyally within the frames of the SDS, and it must also be considered that the manufacturer on a continuing basis contributes to the SDS to ensure that the distributors also benefits from the agreement.[291] The example below illustrates such a provision. In the SDS the proactive provisions in the contracts must support the distribution strategy chosen by the parties; to be able to do this the manufacturer must be sure of the fact that the conceived value of the SDS in no way harms or in worst case terminates the contract, and the proactive provisions must as a minimum uphold the value of the SDS.[292]

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[289] Id., p. 180
[290] Eisenhardt (1985)
[291] Østergaard in Berger-walliser & Østergaard (2012, p. 257)
[292] Id.

Exhibit 8.2 - Distributor Obligations

The distributor must at all times act loyally to promote the value created by the manufacturer, and may only sell the Goods to other approved distributors or end-users, and shall take all necessary measures to ensure that the Goods are sold in accordance with this provision.

The distributor may promote and sell the Goods by mail-order and/or the Internet provided that the distributor complies with the agreed upon criteria set out in XX.

The distributor agrees to not alter or make any changes to any Good, and that he must at all time restrain from harming the brand value, by reselling unapproved products from competing manufacturers.

8.3.1.2 Site and Physical Assets

In the contract the physical location of the SDS must be dealt with, since the location in most SDC is a criteria. Such a provision is crucial in order to maintain and strengthen the brand value, and by considering such, the manufacturer will to an extend take interest in securing the good to be resold in a specific manner.[293] Furthermore such investments can substantially reduce inventory and transportation costs and can lower the costs of coordinating.[294] The distributor's location and display of the contracted good must correspond with the quality level, and reputation of the manufacturer. The manufacturer is most liable to estimate the values and the needs, which the distributor must meet, and he must therefore include these obligations into the contract. Such needs could for instance be, a certain way to display the goods with the logo. An example is By Malene Birger, an exclusive Danish clothing company that has very comprehensive demands regarding the store design and displaying of the clothes and accessories.[295] The picture below shows how the distributors should design the store, and for example in Lisbon, not only did the store look exactly like the one in the photo, but the exact same Danish architect, that designed the main-store in Denmark, was hired.[296]

These assets make way product differentiation and may improve quality by increasing product integrity or fit.[297] For the distributor there will therefore be very high cost associated with this, since the distributors are required to invest in physical assets and hire and train specialized personnel, and bear the full

[293] Id., p. 258
[294] Dyer and Singh (1998, p. 662)
[295] http://www.bymalenebirger.com
[296] Peter Bundgaard - http://www.mypitangas.com/
[297] Dyer & Singh (1998, p. 662)

cost of product inventory.[298] The manufacturer might lend or sell the display cabinets to the distributor. In such cases the manufacturer must secure title to the cabinets, since they might represent high value. In a SDS there is a high level of investments in the physical assets, therefore the manufacturer and distributor's ability to generate rent through the specialized physical assets is an important point.[299] A challenge that the manufacturer might meet with his/her distributors, is how to discourage the distributor from reselling other goods from other manufacturers in the stores or display cabinets, provided by the manufacturer.

An example of a provision on location and display of the contracted good, which corresponds with the brand value, could be:

Exhibit 8.3- Site and Physical Assets

> *The physical location of the store must be in an exclusive environment that corresponds with the value of the brand. Furthermore, the displaying of the Goods must at all times be in a manner that looks appealing, and signals a recognisability to the store design, in harmony with already existing stores.*
>
> *A detailed description of the product lines will be provided to the distributor, containing ways for the distributor to contribute in maintaining the brand value, as well as creating an opportunity for the distributor to contribute with his/her (later) gained knowledge on the products, in order to market and resell.*

The training of the personnel is a human-asset specificity in the SDS, and a very specialized value generating assets that should be preserved and maintained. This is of course subject to a lot of cost, and it must be explicitly mentioned in the contract, whether the manufacturer or the distributor should bear these costs. This could be explicit like in the following example:

Exhibit 8.4 – Training of Personnel

> *It is required that the distributor's personnel attend the training-courses provided, to acquire sufficient product-knowledge and that transportation cost associated with these courses will be covered by the distributor.*

8.3.1.3 Change Management

The designing of the proactive contract can be contemplated as a balancing act. The contract must be sufficiently detailed, to eliminate doubts on what must be performed and delivered, and at the same time the contract must be flexible enough, to be open towards opportunities that might occur, and does not undermine innovation and development.[300] Many of these elements obvious in the early

[298] It could be likely that the manufacturer accepts to bear some of the inventory cost to help the distributor in start-up, but this a special case.
[299] Id., p. 664
[300] Sorsa (2011, p. 200)

stages of the contracting processes, but those that are not, must not be a cause of value destruction. This calls for a contract based on trust, and willingness to change along with the circumstances.[301]
The contract can contain terms regarding change management, where it is clarified how the parties will manage changes in conditions that can have influence on the agreed upon contract.
The distributor might over the years like to change physical location, increase or decrease the number of physical locations or product lines from where the contract goods are resold, and product lines he is entitled to sell. These changes of location should be in accordance with the manufacturer, to prevent the brand value from being diminished. Such issues must be taken into consideration in the contract, since the contract is a long-term contract, and from an economic point of view, and as mentioned above in the section of asset specificity, both parties to the contract are having active relational specific expenditures.[302]
Effective knowledge sharing routines will help the parties to enhance the communicational level, which is an important source of new ideas and information that result in performance enhancement.[303] The degree to which the manufacturer and distributor are able to recognize and assimilate valuable knowledge from each other, and transfer this to a strong relational contract is an important capacity. This capacity will be a strong asset when it comes to the management of changes, in the agreed upon contract.

A forward-looking view is important, and a formulated procedure for dealing with changes that might occur, where sources for possible problems are identified and if possible eliminated. In addition to a forward-looking view, a past-oriented view that includes the differences in the manufacturer and distributors prior alliance experiences must also be present.[304]
These can be more or less detailed depending on the size of the changes, which the parties wish to safeguard themselves against, and whether or not they in advance wish to clarify a detailed process for how these changes must be dealt with. A change in product line might require further additional training of the distributor and his/her personnel, depending on the complexity of the product lines. An example of a provision on change management could be:

Exhibit 8.5 - Change Management

> *Should conditions that are fundamental for the agreement, cause change in such a manner that it no longer creates value for one of the parties, or that these conditions creates new opportunities for the agreed upon contract, the parties are free to renegotiate the agreed upon conditions.*

[301] See also Dyer & Singh (1998, p. 669)
[302] Østergaard in Berger-walliser & Østergaard (2012, p. 260)
[303] Dyer & Singh (1998, p. 665)
[304] id., p. 668

8.3.1.4 Reporting and Information Sharing

In the proactive SDC, provisions regarding reporting and sharing of information between the manufacturer and the distributors, must be present for the parties to be to generate rent through their co-operation. Though the contract contains obligations to buy a certain quantity during a given period, the manufacturer can still have an interest in getting information on a more frequent basis. This information sharing routine, could be regarding the development of local market, information of the customers and so on. One must keep in mind that these routines have transactional costs on both the manufacturer and the distributors, so the value of such a system must be weighted with the costs of reporting and information sharing. Furthermore, that the relationship is important, and the costs of control bears far-more comprehensive costs, than the costs of creating solid provisions in the contract, which seeks to strengthen the relation. An example of a provision, on how parties can create knowledge sharing routines could be:

Exhibit 8.6 - Reporting and information sharing

> *The parties to this contract must draw attention towards creating a communicational system, which suits and creates value for both parties. Such a system must contain approaches on how and when relevant information and reporting should be shared.*

8.3.1.5 Relational Maintenance

The figure below illustrates the manufacturer and the connections to the distributors in the channels, to illuminate that, when speaking of relational maintenance, it is between the manufacturer and the authorized distributors in the first generation. Since distributors might have authorized under-distributors and it in some cases might become a comprehensive task for the manufacturer to generate RR through all the distributor-relations.

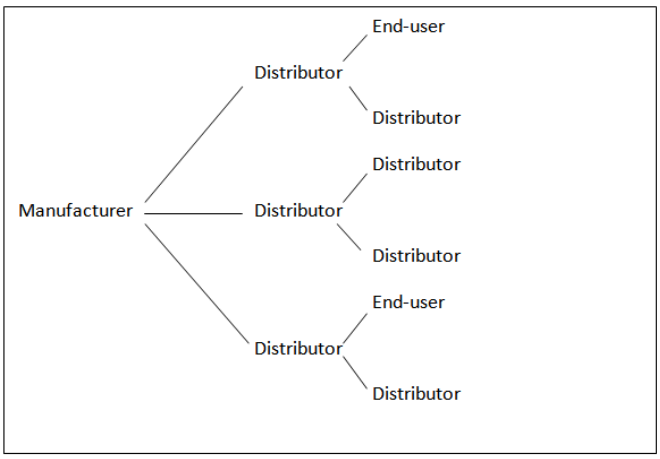

Figure 8.16 – Distributor-connections

Dyer and Singh's determinants for generating rents through the relationship, are important and can be included as provisions in the contract, in order to maintain and enhance the relationship between

the parties.[305] Parties to the contract will in most cases come to an agreement on the applicable law that will govern the contract, in cases, where a dispute might arise. Most contracts do not contain provisions that prevent disputes from going to court. Formalized provisions in the agreement that serves as mechanisms to avoid disputes from escalating seem wise, and furthermore that these provisions enhances the relationship and the business between the parties. Such provisions could be provisions on, for example, physically meeting twice a year and mutually discussing the obstacles and the possibilities for the SDS. A balancing of expectations could be an opportunity, and interest in the business partner as a way to catch signals of dissatisfaction. These meetings will go beyond reporting in writing and are of course subjects to transactional costs therefore the costs of these meeting must not exceed the actual value of the outcome, a measurement that is difficult and tacit to measure. An example on such a provision could be the following:

Exhibit 8.7 - Relational Maintenance

> *The parties to this contract are obligated to have at least two annual meetings, where a balancing of expectations will be discussed and dealt with, in order to strengthen the relationship and further business between the parties.*
>
> *At these meetings potential causes of disputes will be clarified and treated in harmony with the agreed upon business goals. The date and location for these meeting will be set a month in advance.*

To keep in mind, the presence of an obligation on having face-to-face meetings does not totally eliminate the occurrence of a dispute, hence the next section.

8.3.1.6 Dispute Resolution

Even if, the contract contains provisions of meeting more often, and provisions that has strengthened the relationship and resulted in combined profit generated from a stronger relational contract, a dispute might still arise. Mechanisms to avoid disputes are seldom formalized in the contract between the parties.[306] Therefore a dispute resolution system in the contract seems reasonable, as to help catch and manage disputes in time, before they escalate to e.g. courtrooms. If the parties are unable to solve disputes, it will most likely be taken to court; a costly and time-consuming affair, which at the same time has negative effects on their relationship. Knowledge sharing routines play a great role in the communication between the manufacturer and its distributors, since it promotes interaction for dispute resolution. The dispute resolution system illustrated in the figure below, serves as a guidance tool for parties tending to self-enforcement and third-party mediators.

[305] Id.

[306] Østergaard in Berger-walliser & Østergaard (2012, p. 262)

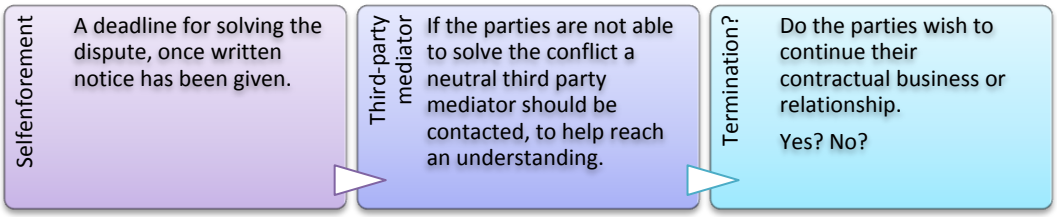

Figure 8.17 - Dispute resolution system

Self-enforcement, rather than third-party mediation seems more rational given the arguments earlier for effective governance. Effective governance advocates that disputes must be dealt with through self-enforcing mechanisms, since they are more effective than third-party enforcement mechanisms at both minimizing transaction costs and maximizing value-creation initiatives.[307] The distinction between formal and informal self-enforcement mechanisms advocates that, the greater the parties' ability to employ informal self-enforcing safeguards (e.g., trust) rather than formal self-enforcing safeguards, the greater the potential will be for RR, owing to lower marginal costs and difficulty of imitation.[308] The parties should agree on a deadline for solving the dispute, once written notice has been given. An example of such a self-enforcing provision could be:

Exhibit 8.8 - Self-enforcement

> *The parties should immediately try, in good faith, to solve any dispute arising from the contract or in relation to the contract, through negotiations with the parties, or representatives for parties who have the competencies to solve the dispute.*
>
> *Should the parties to the agreement end in a dispute situation, a written notice must be given containing elements of the dispute from both parties point of view. Once this notice has been received by both parties, a deadline for solving the dispute must be set minimum 1 month and maximum 3 months upon receiving date.*

Situation may occur where self-enforcement no longer seems to be an option and the parties might therefore tend to use **third-party mediators** to settle a dispute rather than escalating to litigation. The choice of using a third-party mediator seems complicated, because the parties to the relational contract can be so integrated, that a third-party will not be able to solve the dispute efficiently.

Third parties or mediators can have a hard time solving disputes between the manufacturer and the distributors, it can be time-consuming and very difficult as a third-party to understand all aspects of an agreements disputes, because each party presents his/her point of view.

Thus, my recommendation would be that parties to a SDC who are unable to self-enforce and therefore chooses to use third-party mediators, choose a distributor within the distribution system as a mediator. The third-party distributor does not take part in the contract governing the relationship between the parties in dispute, but is a member of the distribution system, and has an insight that a party outside the SDS does not have.

[307] Dyer & Singh (1998, pp. 669-670)
[308] Id., pp. 669-671

The third-party, from within the distribution systems, needed neutrality is a relevant reflection that the parties in dispute must take into consideration, so that a trigger-effect is avoided. Furthermore an effective governance system will strengthen the parties' ability to self-enforce and solve disputes, without third-party interference. The following example serves as an example of such a provision:

Exhibit 8.9 - Third-party Mediation

> *If the parties to the contract are unable to solve the dispute through self-enforcement, and all self-enforcing methods have been attempted, the parties must tend to a third-party mediator before letting the dispute escalate to courtrooms. The mediator will, serve as a neutral part, and should have sufficient insight to the relational matters.*
>
> *It is advised that the parties have agreed on a third-party mediator in advance.*

In situation where self-enforcement and third-party mediation fails, termination can be a result of the unsolved dispute, breach of contract or perhaps a result of market failure. Even though proactive contracting tools aim at avoiding termination, such measures must be taken into consideration if continuation does not seem efficient (more on termination in sec. 8.3.1.7).[309]

There are several possibilities within dispute resolution, where a disagreement or dispute is prospered to be solved through alternative methods. Alternative dispute resolution (ADR) typically refers to processes and techniques of resolving disputes that fall outside of the judicial process – formal litigation in the courts of law. ADR is generally classified into at least four subtypes: negotiation, mediation, conciliation, and arbitration.[310]

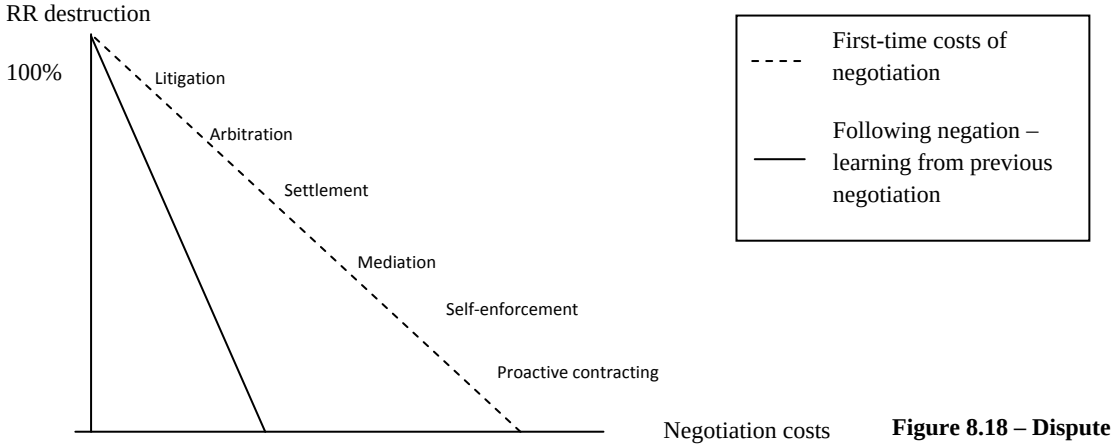

Figure 8.18 – Dispute Stages

[309] An example of a manufacturer-distributor relation, where self-enforcement mechanisms and third-party mediations has not been applied is Georg Jensen A/S (GJ), a Danish design company has recently had problems with their Chinese main-distributor. The problems concerned the fact that GJ - being the manufacturer – has had meetings with other potential distributors in the main-distributors territory. In other ways they have acted opportunistically and in a way that could only benefit one party, and as a result caused distrust and inability to be able to generate RR. The main-distributor has tried to solve the dispute by self-enforcing, though this initiative has not been meet by GJ. Status quo is now unfortunately litigation, which will presumably, causes great losses on both parties. If the parties had invested in information sharing and better at dispute resolution this might have been prevented. (source: http://www.business.dk/detailhandel/partner-vil-presse-georg-jensen-ud-af-kina)

[310] Sorsa (2011, p. 89)

Figure 8.18 shows the different dispute stages, and the cost and destruction associated with the stages. RR destruction escalates from bottom to top whereas the degree of the parties' negotiation costs increases from left to right. The distress and the severity of the dispute escalate from bottom to top, along the line starting at proactive contracting to litigation. For instance, if the parties have been proactive in their contracting processes, the losses will be significantly lower when resolving disputes, compared to litigation, which is binding and gives the parties very poor level of control, and the enforceability of the outcome. The settlement or decision - arbitral award or judgment - increases from left to right along the lines. The dashed line indicates the first time negotiation cost, as proactive contracting parties (should) learn from previous alliances and negotiation processes by gearing the resources of a partner. Therefore the more the parties engage and put effort in the negotiations the better the long-term outcome will presumably be, illustrated by the black line. The two lines serve as illustrating guiding-lines, and hopefully parties in a SDS will put more effort into the negotiations, despite of the costs, since the formation of the contract will set the fundament for the relationship.

The closer the parties are to RR destruction = 0% the higher the level of trust and self-control will be. Furthermore, the closer the parties are to proactive contracting and self-enforcement, the higher the level of RR will be – keeping in mind that RR is not given by proactive contracting. It also shows how problems and disputes develop and escalate if these are not prevented and dealt with when they occur.

The more these disputes escalate the more costly and time-consuming it will be to solve the disputes, and at the same time the hostility increases and the level of trust in each other decreases as well. The result will be a negative effect on the relationship. The graph does not illustrate the cost of value destruction, delay in delivery, and other problems caused by lack of effort into the relationship. Should a dispute arise, the best manner to handle it calmly is at the lowest level closest to the cause of the disagreement and before the problem becomes intractable. The best solution is not what the parties can do - referring to their rights and let the law solve the problem - but what they should do to find a solution to the best interest and minimal losses for both of the parties.[311]

8.3.1.7 Termination

The manufacturer must take into consideration what might happen if termination with or without notices is the outcome. Once one of the parties starts using the law, they will already be in a dispute situation that can lead to litigation, and once disputes arise the relationship and business will be affected. Therefore relational contracting is important since there in selective distributions is presumably a lot at stake, and termination is not always a good solution. The proactive provisions in the contract are not a guarantee as to avoiding litigation. If mechanisms from the dispute resolution strategy have been applied, termination can be considered as being the most optimal solution for

[311] Id., p. 90

solving the dispute. Either one of the parties should give notice of termination in accordance with, the agreed-upon, contractual terms, or one of the parties declares the contract a being void caused by breach of contract.

Since, in SDS the value and exclusivity of the brand is essential, the contract must contain a right that gives the manufacturer an option to re-buy the terminated goods, to avoid the goods being sold in a manner that harms the brand value and reputation. Once the contract has been terminated, there is always, unfortunately, a risk that the distributor will act in an opportunistic manner.[312]
Thus, an economic argument is that the contract should contain such a right provision could be like the following:

Exhibit 8.10 - Termination

In cases, where termination is the outcome the manufacturer has the option to re-buy, the contractual Goods. The price for re-buying the Goods must not decrease more than 30% of the actual cost price. In addition both parties must restrain from acting in a manner that will harm the SDS.

Either party may terminate this agreement at any time by giving not less than three months' prior written notice expiring on the last day of a calendar month, without giving a reason.

Exhibit 8.11 - Governing law and Place of Jurisdiction

This agreement and any dispute or claim arising out of or in connection with it or its subject matter or formation shall be governed by and construed in accordance with Danish law.

The parties agree that the Danish courts shall have non-exclusive jurisdiction to settle any dispute or claim that arises out of or in connection with this agreement or its subject matter or formation

8.4 Summary - Contract Design

Earlier in this thesis it was illuminated that after finding the causes of legal disputes of preventive law, the breakdown of contractual relations can be prevented. After this is accomplished, proactive contracting seeks to confront causes that are unavoidable, and minimize any harmful effects of the relationship. Starting at a more general point of view and further leading it towards a more specific point of view, resulting in examples on provisions. Throughout this chapter proactive provisions in the SDC have been established, and supplemented with examples on what such provisions can look like in a proactive contract. The aim of these provisions has been to proactively contribute, to the parties' ability to generate RR from the relationship, as well as, preventing the contractual-relational outcome being litigation.

[312] Østergaard in Berger-walliser & Østergaard (2012, p. 262)

9.0 Conclusion - A Proactive Contract that Generates RR

A paradigm-shift has seen the light of day, with a proactive mindset that offers a fundamental change in the perception of the contract and the law. The proactive contract is a result of the integration of the legal and economical discipline, where it becomes an interdisciplinary strategic management tool. Contracting parties must distance themselves from viewing the contract as being solely a legal formal document, and instead regard it as a tool to gain long-term sustainable competitive advantages. The proactive dimensions will help the manufacturer and distributor in reaching these goals. In other words, law can be used for value creation and to reduce effects that cause value reduction.

The aim is to generate rents through a relation-based approach with provisions that proactively contributes to the parties' ability to generate RR from the relationship as well as preventing the contractual-relational outcome being litigation. These provisions have been characterized through Dyer and Singhs determinants for RR, being interfirm relation-specific assets, interfirm knowledge sharing routines, complementary resource endowments and effective governance. These determinants have been supplemented with IACCM's suggestions of which terms that would be more productive in the support of successful relations. This has resulted in provisions regarding; *scope and goals, site and physical assets, change management, reporting and information sharing, relational maintenance, dispute resolution, and termination.* Through a closer evaluation of the proactive contracts uses of applications, it can be concluded that the proactive contract is a value-creating tool, and that the contracting parties can draw great use of. The designing of the proactive SDC (in Chapters 8) has served as a platform for these provisions, by illustrating examples of proactive rent-generating conditions.

The greater the parties in a SDS's are to employ informal self-enforcing mechanisms, the greater the potential will be for RR's. Through effective governance the parties will be able to generate RR's by either lowering transaction costs or providing incentives for value-creation initiatives, such as investing in relation-specific assets, sharing knowledge, or combining complementary strategic resources.

A fundamental principle of successful contracting should be to learn from previous experience by combining complementary resources and being proactive. Therefore it is important to combine the future-oriented view with a past-oriented view, and not merely overlook previous obstacles. Furthermore, the ability to be legal astute can increase value and help parties to a SDS to generate RR by using informal contracting and relational governance as complements to define and strengthen relationships as well as, reducing transaction costs and the occurrence of opportunistic behavior.

This will create opportunities to use the law and the legal systems to increase, both the total value created and the share of captured value. The result will be a firm that succeeds in using the legal

environment to redefine a core mission, and use the legal resources to create value through long-term sustainable competitive advantages, and thereby creating a strategic fit.

Future Perspectives

Interdisciplinary research on law and economics could contribute, to improving relations in contracts. The contractual conditions that are being negotiated should be more relation- and future-oriented, and contracting parties should always have these goals in mind. Furthermore, that the empirical research made by IACCM is being included into the developing of contracting methods, to help contracting parties to learn from previous business to improve future business. In, these empirical researches' there has not been any significant shifts, in past 10 years on what contracting parties invest the most resources and time into negotiating. Further research and education in this field is needed, before proactive law can be viewed as a fully applicable discipline. A strong dispute resolution system or product and market strategy has not been present in Dyer and Singhs theory of RR, and by my humble opinion proactive law has been lacking a stronger economical fundament. The integration of law and economics is headed in a highly interesting direction, where the law and contract will, hopefully, be a tool and result of this integration.

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http://www.preventivelawyer.org/

Why do people sue doctors? A study of patients and relatives taking legal action:
http://www.ncbi.nlm.nih.gov/pubmed/7911925

Annex A

The concepts

This thesis is built around notions and concepts, all of which need appropriate definitions. In the following I will seek to define and clarify the leading notions individually in relation to the field of research, since they are fundamental in answering the research question: *Proactive Law*, *SDS*, *Strategic Contracting* and finally *RR*.

Proactive Law

The purpose of Proactive Law is to slightly move away from the traditional reactive way of thinking law that is by turning to a lawyer no earlier than arise of a dispute. Proactive means, being preventive and acting in anticipation of future disputes, problems, needs or changes, which is quite expressive on how proactive law should be understood and used.[313] The opposite of being reactive, and furthermore implies that you take control and self initiate. This contributes further to aspects of pro-activity; a *promotive* dimension and a *preventive* dimension, these terms will be discussed more thoroughly later in this thesis.[314]

Selective Distribution System

The manufacturer seeks an optimal number of sales places, which meet the minimum demands, regarding store design, product assortment, product knowledge and financial strength. SDS is defined as a: ...*distribution system, where the manufacturer undertakes to sell the contract goods or services, either directly or indirectly, only to distributors* ***selected*** *on the basis of the* ***specified***

[313] Gyldendal dictionary
[314] Berger-walliser in Berger-walliser & Østergaard (2012, p. 16)

criteria *and where these distributors undertake not to sell such goods or services to unauthorized distributors within the territory reserved by the manufacturer to operate that system.*[315]

Strategic contracting

To be able to see the potential in a contract and not seeing it only as a legally signed document, and further to take advantage in the strategic use of contracts and the contract paradigm to gain or sustain competitive advantages.[316] This so, by surveying the strategic role contracts play in the creation of value and as a source of competitive advantage.

Relational Rent

Dyer and Singh, define RR as: *a supernormal profit jointly generated in an exchange relationship that cannot be generated by either firm in isolation and can only be created through the joint idiosyncratic contributions of the specific alliance partners.*[317] A pair or a network of firms can develop a relationship that can result in continuous competitive advantages. These competitive advantages can be reached with RR's, in four potential sources to inter-organizational competitive advantages, which will be examined, discussed and analyzed further down.

[315] Commission Regulation (EU) no. 330/2010, Article 1 (e) - my highlights
[316] DiMatteo (2010, p. 728)
[317] Dyer & Singh (1998, p. 662)