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Introduction

Twenty to thirty kilometers east of Kyoto, Omi lies on the coast of Lake Biwa.[1] There, during the Tokugawa (1600–1868) period, the Tokaido and Nakasendo highways crossed. Those routes and others tied the Kyoto-Osaka area to nearby Ise; to Edo (Tokyo); to the mountainous but prosperous Shinano (Nagano) area; to the Japan Sea coast; and to the more distant Tohoku region to the northeast. "Highway" may be a euphemism, of course. These were footpaths, sometimes along the coasts, sometimes through the mountains.

Over time, the merchants from Omi came to specialize in interregional trade. The economy was growing, and producers were increasingly specializing by region. The division of labor is limited by the size of the market, wrote Adam Smith. If only they could sell their goods more broadly, the producers could focus on innovation and scale economies and capitalize on their comparative advantage. The Omi merchants gave them that chance. Pottery, medicines, sake, soy sauce, and textiles – the merchants bought from each community and sold as they went.

Along the various highways, Omi merchants built a vast network of branch offices – by the late 1920s, more than 1,100. Through the networks, they collected information about supply: which regions produced what style of goods, which craftsmen produced the highest quality, and which techniques involved the lowest costs. Through the same networks, they also collected information about demand: which consumers wanted what style of fabric, which villages wanted what flavor of soy sauce, and what price people were willing to pay for each product in each area. Knowing who made what and who wanted what, they matched producers with buyers across the country.

[1] This discussion is based on J. Mark Ramseyer, Review of K. Suenaga, *The Story of Japan's Ohmi Merchants*, in the *Japan Forward*, November 12, 2020.

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During the Tokugawa period, the Omi merchants did this without a post office, a bank, or a national court system, much less Google and the Internet. In the twenty-first century, we email and telephone our sales agents and branch offices. A few decades ago, we used express mail and UPS (in Japan, sokutatsu and takkyubin) and eventually turned to fax machines. Out of our central offices, we monitor the accounts for all of our branches.

Should a customer fail to pay, we take him to court. Should a salesman steal, we call the police. We deposit our cash in government-insured banks. We monitor our inventories, scan barcodes to record deliveries and sales, and reconcile accounts at the end of each day. If we lack the capital to survive a warehouse fire, we buy insurance.

The Omi merchants had access to none of this. To communicate, they met in person. To travel, they walked. They could not entrust cash to national networks of banking outlets. They could not sue for damages in reliable and predictable legal systems. Merchants in Brooklyn and Chicago used to worry about items they shipped that "fell off the back of the truck." During Prohibition, they hired Meyer Lansky and Bugsy Siegel to ensure that fewer cases fell off the back. Omi merchants had no way reliably to know what anyone had even loaded onto a truck (and actually, they had no trucks).

To maintain honesty within their networks of agents and branch offices, the Omi merchants created, cultivated, and grew their own networks of personal, social, and "ethnic" ties. They hired mostly people born within Omi. They intermarried. They devoted themselves to a common Jodo-shin (True Pure Land) Buddhist faith. They sent a young man to a branch office only after they had trained him in the home office for multiple years and observed his abilities, weaknesses, and – crucially – character. To maintain his loyalty, they required him to return to the home office every few years. To motivate him to look out for the good of the house, they keyed his wages to its profitability.

Obviously, there is nothing peculiarly Japanese about any of these problems. Neither is there anything peculiarly Japanese about the way that the Omi merchants approached them. Across a wide range of societies, merchants have intermarried. They have supported common religious institutions. They have lived and worked within guilds laced with gossip networks that conveyed information about each other's trustworthiness. To increase both the depth and breadth of information and the weight of their normative sanctions, people everywhere have cultivated and maintained networks of dense and interlocking ethnic ties and focused their transactions within them. They did the same in Omi.

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At stake in the Omi world were information and reliability: The Omi traders needed both access to information and the ability to increase transactional reliability. Like merchants everywhere, they needed information about the producers from whom they bought and the consumers to whom they sold. They needed information about their market rivals. They needed information about their own agents. And like merchants everywhere, they needed counter-parties to their transactions whom they could trust. They needed ways to insure that even their own agents did not cheat them.

Omi merchants did not follow commercial statutes. During the Tokugawa period, there were no commercial statutes to follow. They rarely relied on formal courts. Tokugawa judges were more honest and sophisticated than the judges in many pre-modern court systems, but they lacked much expertise in commercial behavior. Instead, the Omi merchants followed their own customary norms of commerce and negotiated and enforced their contracts within networks of interlaced personal ties that both conveyed information and provided sanctions against opportunistic behavior.

Information and reliability mattered in 1950s Wisconsin too. At the end of the decade, Wisconsin law professor Stewart Macaulay famously "discovered" that Wisconsin businessmen negotiated and enforced their contracts within defined social networks. They hired lawyers who paid attention to formal legal rules and procedures, but they themselves seemed often simply to ignore those rules and procedures. Rather than draft a contract carefully, sometimes they preferred "to rely on 'a man's word' in a brief letter, a handshake, or 'common honesty and decency' – even when the transaction involves exposure to serious risks" (Macaulay 1963, 58). Complained one lawyer to Macaulay: I am "sick of being told, 'We can trust old Max'" (Macaulay 1963, 58). When they sued a defaulting counter-party, the businessmen used lawyers, and the lawyers fought over the contractual terms. When they settled the disputes out of court, however, the businessmen "frequently settled without reference to the contract or potential for actual legal sanctions" (Macaulay 1963, 61).

In both mid-twentieth century Wisconsin and early nineteenth century Omi, successful merchants needed access to information, and they needed reliable contractual counter-parties. In Wisconsin, the businessmen mixed both formal and informal strategies. They could check courthouse records for real estate title and security interests. Were a counter-party to cheat them, they could sue. If the counter-party had assets, they might even collect.

By contrast, Omi traders had no real access to formal strategies. The Tokugawa courts were honest enough. If cheated by a party with substantial

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enough assets, they might even be able to collect. But government records were unlikely to provide much by way of current and reliable information. And against most defaulting counter-parties, the courts could not give much real relief.

Such are the themes I explore in this book, and they concern one obvious question: How do businessmen and businesswomen obtain the information and transactional reliability they need to conduct their business? Modern business executives have access both to formal legal mechanisms and to informal social networks. The formal mechanisms constitute the heart of traditional law school education. The informal mechanisms have remained less fully explored.

In this introductory chapter, I begin by summarizing (very briefly) the (well-known) formal mechanisms by which contracting parties have tried to insure access to information and transactional reliability: court-enforced contract enforcement (Section I.A) and vertical integration (Section I.B). I then turn to the way in which business executives structure their arrangements within their social context. I first review the classic economics-related studies on the relation between contracting behavior and social ties (Section II.A). I then turn to the parallel literature in sociology and political science on "social capital" (Section II.B) I explore how that social capital can facilitate information acquisition and augment transactional reliability (Section III.B). I conclude by discussing how participants "endogenize" that social capital: how they can and do deliberately structure a dense network of personal relations around their transactions (Section III.C).

I Formal Legal Enforcement

A Contract

1. Introduction. – Access to information and transactional reliability work in tandem. With better information, business executives are more likely to trade with a counter-party who is well matched. They are better prepared to meet any stress that the relationship might encounter. Knowing that the other party has access to information about his own behavior, the counter-party is himself less likely to try to defraud.

What is more, when a transaction is more reliable, the contracting parties are more willing to invest in relationship-specific assets and skills; earning a return from those assets and skills, they will be less likely to find termination profitable. Providing information to one's counter-party constitutes exactly such a relationship-specific investment: The contracting parties are

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incurring a cost to exchange information that they each will find valuable only in the context of their relationship.

Hence the conclusion: Legal institutions that enforce the terms of an agreement increase both transactional reliability and the amount of information that the contracting parties will find it profitable to exchange.

2. Transactional reliability. – Modern formal legal institutions serve at least two key functions relevant here. First, they potentially extend the range of parties with whom a business executive can profitably trade. The point follows from jurisdictional reach. Formal institutions can enforce compliance from those counter-parties who are subject to the jurisdiction of the court. For most modern societies, this jurisdiction will extend at least to the boundaries of the nation state (and sometimes even beyond). By contrast, informal institutions exert power only within a party's social network. They induce compliance only from those parties subject to the social sanctions of the group.

As a result, rational wealth-maximizing parties to a contract can use the courts as a way to expand their set of potential contract partners beyond those amenable to informal social sanctions. For any business executive, some potential business partners will lie beyond the range of their informal networks. In such situations, court-enforceable legal sanctions potentially extend the bounds of profitable contracting. As Richard Epstein (2008, 279–80) put it:

> In strong, well-functioning legal systems, parties continue to rely on a full range of affective and interpersonal ties to facilitate both exchange and cooperative arrangements. But at the margin, they know that they can be a bit less selective in choosing their trading partners or business associates and in negotiating the terms of their agreement because they have the legal machinery of the state to backstop their mistakes.

Second, the formal legal system will potentially set the contours of the terms by which the parties settle disputes out of court. In cases involving contracts, modern legal systems generally provide a non-breaching party with expectation damages: The profit he could reasonably expect to earn had the counter-party not breached. Given that both parties can generally settle a dispute out of court more cheaply than through trial, rational parties will settle most disputes informally.

When parties to a contract do settle out of court, the legal system potentially sets the contours of their informal settlement. When rational wealth-maximizing parties decide to terminate a relationship, they negotiate – in the famous words of Robert Mnookin and Lewis

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Kornhauser (1979) – "in the shadow of the law." As scholars in law and economics have shown in detail, they settle their endgame disputes within a "settlement window" determined by their respective estimates of the probable litigated outcome, their costs of litigation, and their costs of settlement. In Lisa Bernstein's words (2015, 569):

> A buyer is … unlikely to sue for breach of contract (or have a credible threat to sue) unless the amount he can recover (net of litigation costs, switching costs, secrecy costs, and reputation costs) exceeds the present value of the marginal benefit of continuing to deal with this supplier, rather than the next best supplier, in the future.

Crucially, the expected legal outcome sets the contours of the out-of-court settlement only when the parties have decided to terminate their relationship. Firms (or Midwestern business executives, observes Bernstein) draft contract terms in order to structure the dissolution of a relationship if and when they decide it no longer works. They do not intend the terms to bind them while the relationship remains viable. So long as they find the relationship profitable, they routinely adjust and change their course of dealing to keep it mutually advantageous.

Faced with a contract breach, explains Bernstein (1996, 1999), firms distinguish between those relations they want to keep and those they want to terminate. The former, they work to preserve, and in doing so may ignore completely the terms that a court would impose in court. The latter, they terminate and do so in Mnookin and Kornhauser's shadow of the law. The terms they apply to the relations they want to preserve can – and often do – differ dramatically "from the terms of transactors' written contracts, which contain the norms that transactors would want a third-party neutral to apply in a situation where they were unable to cooperatively resolve a dispute and viewed their relationship as being at an end-game" (Bernstein 1996, 1796).

3. The effect of price. – When transacting across the market, a firm can increase the incentive of its contracting partner to keep its word by increasing the price it pays. Obviously, firms do not generally increase profitability by raising the prices they pay. They raise profitability through higher prices only if those prices induce a contracting partner to so increase its reliability that the firm can produce in a way otherwise not possible.

At stake are the rents that a contracting party can expect to earn from the relationship. If the rents are sufficiently high, the party will find it profitable to pay more to insure that the relationship continues. If information disclosure will increase the viability of the contractual relationship, rational

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parties will each disclose additional information. They will continue to invest in the relationship-specific attributes (like information) until they have reduced the return on the contract to market levels.

More generally, consider this the contractual analogue to the concept of "efficiency wages." Sometimes, an employer can raise profitability by raising wages. It can do so when those higher wages raise productivity by an amount that more than offsets the higher wage costs. The classic example is Henry Ford. He had conceived a new manufacturing technique: the assembly line. To make the technique work, he needed workers who would stay on the job. He needed workers who would accumulate experience and then draw on that experience to engineer the hundreds of changes necessary to make the assembly line work. As long as he paid the going rate in Detroit – $2.50 per day – workers quit as they pleased. Ford doubled the pay to $5.00, and workers now stayed on the job. They studied the assembly line and made it work.[2]

B Vertical Integration

If one plausible way that formal legal procedures can increase access to information and contractual reliability is through contract law, another is through merger. On the one hand, two contracting parties can use the formal contract apparatus to buy and sell their goods and services to each other. On the other, they can use the merger apparatus to work together within a single firm.

In the classic language of economics workshops, the parties can either "make or buy." If "to buy" is to contract through formal legal mechanisms, "to make" is to use those same legal institutions to merge. As early as 1937, Ronald Coase explained the choice – like so much else – through transactions costs. Rational parties will place the two counter-parties within a single firm when the transactions costs of contracting across the market exceed the transactions costs of administering a transaction within the firm. They will contract across the market when the transactions costs of internal organization exceed the costs of market contracting.

In the 1980s and 1990s, scholars tried to explain mergers through the extent that the firms relied on assets whose value was specific to the transaction. Such a transaction-specific investment would generate "quasi rents," they explained. Should the two parties try to contract for the assets across the market, those rents would create incentives for

[2] Raff and Summers (1987); see also Shapiro and Stiglitz (1984).

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them to try to "hold up" each other (e.g., Klein, Crawford & Alchian 1978; Williamson 1985). The point is obviously true. Unfortunately, as an explanation for actual mergers, the concept lacked much empirical currency. Scholars had initially focused primarily on one historical example (the GM-Fisher Body merger). That example, however, turned on factors later shown to be entirely orthogonal to the "transaction-specific asset" hypothesis (Casadesus-Masanell & Spulber 2000; Coase 2000). When scholars did find other applications, many of them involved clearly nonstandard venues like government procurement (e.g., Masten, Meehan & Snyder 1991).

In his own theory of the firm, Oliver Hart (Grossman & Hart 1986; Hart & Moore 1990) instead suggests that the question of whether to merge or contract turns on whose involvement is most important to the value of the key assets. Assets, he reasons, should be owned by the firm whose involvement raises the value of those assets to its highest use. As Halonen-Akatwijuka (2019) summarized the argument:

> If … assets are so complementary that they are productive only when used together, they should have a single owner. … Furthermore, if there are such strong complementarities between an asset and a party that the asset is productive only with that party, then this indispensable party should own the asset.

If the land is most valuable when used for the production of sake, for example, it should be owned by the entity whose role is most important in producing that sake (see Chapter 2).

Crucial to our discussion here, formal merger (or vertical integration) does not solve the problem of either information acquisition or transactional reliability. Coase's point – as important now as in 1937 – is that a merger will change the nature of the transactions costs involved. Sometimes a merger will reduce the level of transactions costs – and when it does, rational parties will tend to merge. Sometimes it will increase the level of the transactions costs – and when it does, rational parties will contract across the market. But in either case, some transactions costs will remain.

Posit two contracting parties, A and B. When they contract as independent parties across the market, they bring interests that sometimes diverge. Because they are each residual claimants to their separate businesses, they each have an interest in diverting as much of the residual revenue stream as possible to themselves. Toward that end, they may find it advantageous to renege on their bargains (hence the problem of transactional reliability). Given that risk of opportunism, they may hesitate to

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disclose much information to each other (hence the problem of information acquisition).

Now suppose that A buys B's business. B (or someone else named by A as B's replacement) will continue to operate the assets and people that constituted B's business, but now under A's ownership. In effect, B (or his replacement) now works as a paid agent of A. Given that A has a claim to the entire residual revenue stream from the combined A-B business, he no longer needs to worry about how B splits the stream. After all, no one splits the stream at all.

Instead, however, A does now need to worry about B diverting the firm's revenue stream to himself as hidden compensation. He can take money from customers under the table. He can steal assets from the firm. He can steal the most profitable business opportunities for himself. If not pecuniarily inclined, he can simply stop working hard. A no longer worries about splitting the residual income stream with B; instead, A now worries that B will divert revenue before it ever reaches that residual level.

Hence the importance of Coase: When (a) the potential loss from divergent interests in the residual revenue stream exceeds (b) the potential loss from the efforts of an in-house agent to increase his pecuniary or non-pecuniary compensation, the parties will tend to join together in a single firm. When the latter exceeds the former, they will tend to contract across the market. Call it "transactions costs" if you will – but vertical integration does not eliminate informational and reliability problems. It may reduce those problems, but never to zero. It may eliminate the problem that arises from having two independent claimants to a business's residual revenue stream. But in eliminating that problem, it simultaneously compounds the problem that arises from employing an agent with his own selfish interests.

II Informal Enforcement

A Introduction

No one relies exclusively on formal legal institutions, of course. No one ever did. Legal scholars traditionally focused on those institutions, and many scholars in economics have done the same. Yet in both fields, over the course of the last century, scholars have increasingly also studied the way that people integrate their formal legal tools into the social world within which they live and work (Section B). Simultaneously, sociologists and political scientists have used a different set of terms to explore a largely overlapping phenomenon (Section C).

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B The Classic Examples

Scholars examining the relationships among formal legal institutions and social context focus on several closely observed studies. In all of these classic studies, the authors examined a relatively small and insular community. Throughout – whether explicitly or implicitly – they focused on the way that the parties involved increased the reliability of their transactions and the information to which they had access.

1. Macaulay. – The modern literature begins with Stewart Macaulay (1963). As described above, Macaulay's Wisconsin businessmen transacted with people they knew. They transacted with them because they knew them (had better information) and could trust them (could more reliably predict transactional performance). "At all levels of the two business units personal relationships … exert pressures for conformity to expectations," wrote Macaulay (1963, 63). "The top executives of the two firms may know each other. They may sit together on government or trade committees. They may know each other socially and even belong to the same country club."

Macaulay's businessmen knew each other from a variety of fora. They could use those fora to obtain information. And they could rely on those fora to induce the other to perform.

2. Landa. – If Macaulay saw himself as a sociologist, Janet Landa (1981) tied her studies to modern economics. Landa examined Chinese middlemen in the Southeast Asian rubber market. There, she (1981, 350) found trade dominated by several clans bound together through "a tightly knit kinship structure" and "linked together in complex networks of particularistic exchange relations." An "ethnically homogenous middlemen group," she called them. The clan functioned as "a low-cost club-like institutional arrangement," she (1981, 350) explained, "an alternative to contract law and the vertically integrated firm."

These Chinese middlemen traded, Landa and Robert Cooter (1984, 15–16) continued, within "a repository of trust that reduces the probability of breach on a contract between insiders." Through their personal ties, they were able "to rely upon informal means of enforcement of contracts." As Richard Epstein (2008, 280) explained Landa's work, "the group members tend to cooperate with each other because they have common ties of kinship that antedate their business relationship." They understand that "to treat someone badly on the job is to risk social censure and ostracism, which in turn makes breach more costly than would otherwise be the case."

3. Ellickson. – Robert Ellickson (1986, 1991) identified much the same apparent irrelevance to the formal legal system among the farmers and

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