

FUNDAÇÃO GETULIO VARGAS
ESCOLA BRASILEIRA DE ADMINISTRAÇÃO PÚBLICA E DE EMPRESAS
MESTRADO EXECUTIVO EM GESTÃO EMPRESARIAL

**INFORMATION ASYMMETRY AND TRANSACTION COSTS IN A
CROSS-CULTURAL BUSINESS TRANSACTION**

DISSERTAÇÃO APRESENTADA À ESCOLA BRASILEIRA DE ADMINISTRAÇÃO PÚBLICA
E DE EMPRESAS PARA OBTENÇÃO DO GRAU DE MESTRE

MARTHA JULIA SOLIS-WEBSTER

Rio de Janeiro - 2014

Solis-Webster, Martha Julia

Information asymmetry and transaction costs in a cross-cultural business transaction / Martha Julia Solis-Webster. – 2014.

23 f.

Dissertação (mestrado) - Escola Brasileira de Administração Pública e de Empresas, Centro de Formação Acadêmica e Pesquisa.

Orientadora: Carmen Pires Migueles.

Inclui bibliografia.

1. Comunicação intercultural. 2. Cultura organizacional. 3. Negociação (Administração de empresas). 4. Informação assimétrica. I. Migueles, Carmen Pires. II. Escola Brasileira de Administração Pública e de Empresas. Centro de Formação Acadêmica e Pesquisa. III. Título.

CDD – 658.45



MARTHA JULIA SOLIS-WEBSTER

**INFORMATION ASYMMETRY AND TRANSACTION COSTS IN A ROSS-
CULTURAL BUSINESS TRANSACTIONS.**

Dissertação apresentada ao Curso de Mestrado Profissional Executivo em Gestão Empresarial da Escola Brasileira de Administração Pública e de Empresas para obtenção do grau de Mestre em Administração.

Data da defesa: 24/11/2014.

ASSINATURA DOS MEMBROS DA BANCA EXAMINADORA



Carmen Pires Migueles
Orientador (a)



Marco Tulio Fundação Zanini



Paula Caleffi

ABSTRACT

The intent of this paper is to provide a practitioners insight into the present and foreseeable future of problem of transaction cost economics related to culture and business etiquette that may increase the of complexity of business communication. We will also explore whether it impacts participant's mindsets regarding opportunistic or passive aggressive behavior. We will study the role of culture, ethics, information asymmetry, and legal systems regarding their importance towards the business contracts and lack of knowledge in local environments. We will make connections to contract theory strategies and objectives and recommend business practices. Furthermore, economic theory explores the role of the impossibility of the perfect contract. Historical and present day operational factors are examined for the determination of forward-looking contract law indications worldwide.

This paper is intended provide a practitioners view with a global perspective of a multinational, mid-sized and small corporations giving consideration in a non-partisan and non-nationalistic view, yet examines the individual characteristics of the operational necessities and obligations of any corporation. The study will be general, yet cite specific articles to each argument and give adequate consideration to the intricacies of the global asymmetry of information. This paper defends that corporations of any kind and size should be aware of the risk of international business etiquette and cultural barriers that might jeopardize the savings you could obtain from engaging international suppliers.

TABLE OF CONTENTS

1	RESEARCH METHODOLOGY	1
2	INTRODUCTION.....	2
2.1	Flawed business communication	2
3	UNDERSTANDING BUSINESS DIALECTS IN THE GLOBAL AGE	3
3.1	The impact of culture on business communication	3
4	Leveling the Information Playing Field.....	7
4.1	Contracts as a form of communication.....	7
4.2	Information asymmetries.....	7
4.3	Transaction costs	8
4.4	Asymmetry intersects transaction cost	9
4.5	Disclosure and due diligence.....	10
4.6	The perfect contract.....	11
5	COMMON LAW AND CIVIL LAW	12
5.1	The impact of legal systems on business communication	12
5.2	Consideration and Cause, Revocation, and Penalties.....	14
6	EXAMPLES OF CIRCUMSTANCES IN CONTRACT LAW.....	17
6.1	The Thorny Issues of Impossibility and Changed Circumstances.....	17
7	ONE PRACTITIONER’S VIEW	19
7.1	A tale from the hospitality sector	19
8	CONCLUSION	21
9	REFERENCES	22

1 RESEARCH METHODOLOGY

Although the intent is the application of these concepts globally, to limit the scope of examination, this paper focuses on a single country pair with differing legal systems, one Civil Law and the other Common Law. For instance with Mexico and the United States, we included a similar amount of interviews and references from parties in both countries to reduce bias. This study was guided in order to evaluate the possible challenges that businesspersons may experience, not just in different cultures but also in cases within the same culture.

Purposely, this research will cover the following, the research design and method, the data collection instrument, the interviews, and the data analysis. The interviews are appropriate in this study because it enables the researcher in formulation of generalizations.

Two types of data were used, the primary and the secondary data, to understand clearly, the primary data were resultant from the interviews and the answers respondents gave in the questionnaire administered prepared by the researcher this information obtained from the interviews provided primary research data that supported the study. Secondary data were derived from the findings in published documents and literatures related to the research issue.

The drive of using the descriptive method is to describe the nature of a condition, as it took place through the time of the study and to explore the conditions or causes in a particular situation. The descriptive method of research is to congregate information about the present existing condition. We chose to use this kind of research method because we considerate important to acquire first hand data from the interviewers, so as to formulate rational conclusions and recommendations for this study. Since the study of the present document is focused on the perception of the consultancy lawyer's firm's effective human resource management, the descriptive method would be the most suitable method to procedure.

2 INTRODUCTION

In this new millennium businesses have drastically changed to become more global each minute. Businesspeople are discovering that preparation will reduce the risk when executing transaction across cultures. It was once that in the world of business the parties of a business relationship rule the meetings in English language and was pre-established as a common denominator of doing business. Today the possibility of just doing cross - cultural transactions brings many complexities. The questions are, “How does an organization address these issues on a per transaction basis?”, “ how do we assess the real organizational transaction costs that may offset our initial savings?” and, “Which is the correct department to address the issues?”. Many of the cross-cultural issues have their foundation in communication; therefore we open with a real world anecdote.

2.1 Flawed business communication

My close friend’s father Tom, worked on the Mexican border for a manufacturing company. The company is headquartered in Spain with manufacturing plants in both the United States and Mexico. Many of the middle managers were American citizens. Tom would go to the factory to oversee operations on a weekly

basis. His Spanish was limited to “yes. No. Bathroom. Thank you.” and a few other functional phrases. One day the Spanish leadership was scheduled to tour the facilities and Tom’s boss asked him to accompany and translate. Tom assured his boss this was not necessary and that their English was much better than his Spanish, therefore translation would probably reduce the quality over communication. Tom’s boss nonetheless, was very stubborn and insisted. He said, “I won’t ask you to translate everything, just a few key concepts.” Reluctantly, Tom agreed. The Spaniards arrived they all sat in the office of Tom’s boss and had a good chat. Tom’s boss strategically steered the conversation to his crucial moment. He wanted to speak of the relationship the cross border company had built in terms of an analogy. He was looking for something a little more profound than a simple motto, so he broke into a story about an eagle. He asked that Tom translate the story to Spanish because of its symbolic nature. Tom of course panicked and asked his boss to simply relay the story in English. This is exactly the situation he was not prepared for. His boss would not let him off the hook.

In his story, the Eagle was symbolic of the caring parent company. The eagle found a companion, and together a nest was built, one stick at a time. The relationship was fruitful and produced offspring, which eventually learned to fly on their own. The story in its original form was cute but not quite funny. As Tom started to translate, the

Spaniards began to smile excessively. Before the story was finished their grins turned to pure laughter. Tom's boss was overjoyed with the effort and as they walked out of the office heading for lunch his boss nudged him assertively with an "I told you so" look.

Only a few months later, after the team became more comfortable working together, did the Spaniards bother to mention that the story had been mistranslated. Tom had replaced two words. In Tom's translation of the story, he did not know the word *águila* for "eagle", so he used the only bird-word he knew, which was *pajarito*, meaning "little bird". Worse yet, *Madera*, the word for wood was translated to a very similar sounding word, *mierda*, meaning excrement. In Tom's version of the prophetic analogy for the corporate the relationship was of a little bird living in a nest made of feces. Subsequently everyone saw the humor. Not all business relationships are strong enough to survive such a mishap. This is why understanding the landscape of business communications is critical.

While this was an informal communication, we would like to follow the trail of formal business communications, identifying some of the crossroads between the financial transaction costs and ratification of communicated parameters. While we propose no specific solution we insist that to survive the global business landscape we need a skillset that is conscious of cultural idiosyncrasies, information flow, transaction cost, and comparative contract law.

3 UNDERSTANDING BUSINESS DIALECTS IN THE GLOBAL AGE

3.1 The impact of culture on business communication

As the world continues to shrink due to globalization, more companies and more professionals, neither of whom likely ever considered themselves particularly global, find themselves called upon to become international ambassadors and to forge business relationships with people in other countries. In Isobel Doole's and Robin Lowe's 2008 book *International Marketing Strategy*, the authors touch upon the ethical dilemmas that international marketers face when it comes to cross-cultural communication. "Managers need to be aware that simply defining what is ethical by the standards, values and actions from their own culture may be insufficient in satisfying all the stakeholders of a multinational enterprise. What is often seen as an acceptable business practice in one culture can be seen as ethically questionable in another," they write (Doole and Lowe, 2008).

I believe that the organizing principle of any business relationship, and therefore the

founding premise of any business communications that arise from the relationship, is an assumption that both parties are essentially working toward the same thing: a successful business relationship. With this understanding, I believe it is not only possible, but probable that businesses can form long-lasting and successful business partnerships across the globe, but they must become adept at understanding and speaking in what I like to call “business dialects”—the often unique cultural languages that make one people different from another. Spoken language, of course, is the most obvious example, but business dialects can stretch into unspoken cultural languages built upon rules and social norms that often only become apparent after they become problematic, or worse, when they have already torpedoed a promising business relationship.

The international market can be challenging in many regards, Wal-Mart recently got in hot water for a bribery scandal in Mexico, but other well-known companies like Apple, Levis Strauss, Nike and many, many others have been challenged by every sort of public relations crisis imaginable. I would venture a guess that every company that has ever done business with another country has experienced some sort of communication crisis, some worse than others, but crises just the same.

These challenges can appear in any number of aspects of a culture: in its social hierarchies, language, etiquette, personal behavior, education and negotiating styles, among others, but international businesspeople straddling cultures can expect to find themselves facing considerable moral and ethical dilemmas, as well— corruption, environmental degradation, child labor and sweatshop labor conditions, and low wages just to name a few. The potential pitfalls, however, won’t always be so predictable as these. In fact, the really dangerous challenges are likely to be well camouflaged, only to rise unannounced, as if from nowhere, to transform themselves into huge crises seemingly without warning. It is possible that many of these situations could be avoided with a more effective international business communications team.

Accordingly, Doole and Lowe predict international business people will be required to maintain higher ethical and behavioral standards set by their global customer base. “The cultural differences need to be addressed,” they say, “and the international marketer must be fully aware of the culture(s) in the foreign nation, and how they might collide with the culture in the home-country.” (Doole and Lowe, 2008)

While the international business community has been generally slow to respond to these communication challenges, it has not failed altogether. Andrew Boon and John Flood looked at the changing approaches to ethics as formulated by international lawyers’ groups. They see “a movement towards a universal global culture, precipitated by the increasing interdependence of global economies, technologies and political systems.” (Boon and Flood, 1999) Boon and Flood argue that nation states will decline in

importance as differing cultures, political ideologies and value systems migrate to a more universal code of ethics. They warn, however, that this synthesis may not necessarily be good. “[This] global ethic could be materialistic, positivistic, [catering to] the lowest common denominator,” they say, but at the very least it will be a universal system applicable across cultures and, therefore, preferable to the polyglot system in place now. Boon and Flood go on to cite the reason for a lack of universal ethics, at least for the legal profession, is no surprise... a lack of communication. They write: “The relative absence of discourse [is] the barrier to the opportunity for the globalization of professional ethics.” In order to become leaders in globalization, the authors say, lawyers “must seek new ways to articulate, legitimate and transmit their ethical vision.” (Boon and Flood, 1999)

This is my central point, as well: all parties involved in international business must anticipate the cultural and communication differences inherent in globalization and work together not just to avoid these challenges, but to learn to empathize with the parties across the table and find ways to communication in the languages, both literal and figurative, verbal and non-verbal, to which they are most accustomed. In short, we must learn to speak their business dialect. Only then will business communication begin to benefit and rise to the promise of which we all know it is capable.

To a great extent, the conduct of business between unfamiliar groups requires that both parties set aside their own values, assumptions and communication habits in order to create a common set of communication norms. Shared language and culture can bind together a group that doesn't have a lot in common. This, to me, is the very soul of the concept of business dialect.

Good business dialect involves being willing to discuss openly with full understanding of both sides' cultural perspectives, the things that can bring the two sides together, this is a sort of melding of two or more styles into something entirely new—a sort of dialog that transcends culture.

To improve the chances for success in international business, particularly when developing close relationships with individuals, I believe there are a few basic guidelines that can help improve the odds of success (Cyphert, 2007). First, always hold your colleague in high regard and assume they are equally interested in a successful outcome as you, though the reasons why and the ultimate goal may differ from your own. There is a baseline of respect that must be established first and this often requires looking past cultural differences. If you expect success and believe that your potential partner expects success, success will follow. Focus on what is common between you, and see differences not as roadblocks, but as speed bumps along the way.

Second, learn to appreciate, perhaps even enjoy, the differences in cultures. I've found that you can always learn from new cultures and that learning how others view and adapt to given situations provides important new perspectives and potential ways to do things. Successful people and successful teams minimize cultural differences through shared goals and collaboration (Cyphert, 2007).

Third, always try to speak in the host's native language, whether you take lessons or use an interpreter. While this may seem like a no-brainer, I can't tell you how many potential partnerships have been doomed because one party insisted that business be conducted in English. Never assume that English is acceptable as the universal language of business. To do so risks offending the audience you most want to impress. Likewise, never forget that non-verbal communication is just as important as verbal.

Fourth, understand that the contract is the codification of business communication. Understanding the form of law the contract will be based upon, Civil, Common or otherwise, is critical in capturing the true spirit of the business transaction. Although you may be speaking in the host's native language, you may be basing the communication on drastically different assumptions, a few of which we will explore in the coming pages.

Last, strive always to behave and to communicate at the highest ethical levels. Nothing breeds distrust and sours a business relationship more than a sense that one party is trying to enrich itself at the expense of the other (Cyphert, 2007). No one wants to do business with another believing that one side's loss is the other side's gain. Business relationships, and particularly cross-cultural international business relationships, must be built upon mutual interest and trust and maintaining personal integrity and adhering to ethical goals will help ensure that your potential partner respects you as much as you respect them.

In coming decades, more companies and more professionals will find themselves called upon to become international ambassadors and to forge business relationships with people in other countries. For the upwardly mobile corporate professional or the internationally astute entrepreneur, the opportunities are great, but so too are the challenges of communicating well between peoples of very different cultures. If we, as businesspeople, can become adept in the verbal and physical nuances of business dialects we will all benefit, and so, too, will our companies, our countries and the world.

4 Leveling the Information Playing Field

4.1 Contracts as a form of communication

In the final analysis, all of human history boils down to the history of communication, from the closest one-on-one personal relationships to the grand sweep of geopolitical events. Business communications are no different, but they bring with them their own set of unique challenges. Anyone interested in being or becoming an international businessperson needs to know how to communicate with other businesspeople, whether those people are individuals or representatives of huge international corporations. In business relationships, the basic form of communication is the contract. The contract is to the businessperson, what the text message is to a teenager. Understanding how to communicate through contracts is therefore paramount to business success. In its basic form, a contract is an offer and, depending upon legal system, potential a commitment for compensation. Everything else included in the contract is a list of “what if” conditions that tries to remedy the outcome of any potential miscommunication regarding the parameters. Contract variations due to legal system will be discussed at greater length below.

A contract should not be viewed as a way to manipulate business relationships in one’s favor, nor is it to prevent the relationship being unfairly tipped in the other direction. Rather, I propose looking at the contract as a way of solving *miscommunication* before it happens, so that both parties get what they want. When contracts fail—when miscommunication rules—then the courts must intervene. That’s not good for anyone. The courts consume precious time, they generate stress, they are counter-productive, and expensive to boot. In the courts, no one wins.

The solution, of course, is better contracts, and better contracts start with better communications. To avoid expensive mistakes, businesspeople need to learn to communicate better through the contracts they make, not to tip the scales in one direction or the other, but to realize that business succeeds best when both sides win. Good faith is good for everyone and this applies across the board, from hiring someone to paint your house to the largest international merger. Don’t just take my word for it though; the economists say so, too.

4.2 Information asymmetries

The economic field has a concept known as asymmetry of information and leading economists say that asymmetric information increase the transaction costs of every deal in which it is involved. In 2001, George Akerlof, Michael Spence, and Joseph Stiglitz

won a Nobel Prize in for their study of the market effects of asymmetric information. They concluded that asymmetric information is a huge economic drag on the global economy. (Hylton, 2005.)

Classical economic theory makes the premise that information is available to all players in the market. Although in the real world we know that participants have limited information to make strategic decisions.¹ In contract theory and economics, information asymmetry applies to the examination of decisions in transactions when one participant has more information than the other. In contrast, neo-classical economics assumes just right information is available.

4.3 Transaction costs

Transaction costs are divided into three categories: Search, Bargaining and Enforcement costs. Search costs are incurred in identifying that the necessary good is available on the market at the lowest price. Bargaining costs are the costs of arriving at an acceptable agreement and negotiating an appropriate contract. Bargaining takes place before the business transaction. Enforcement costs are incurred if one of the participants does not abide by the terms of the contract and legal action must take place.

On the international scene, a business involved in cross-border opportunities face all three transaction costs. Search costs are incurred finding raw materials or resources and determining their quality. Bargaining costs occur while negotiating a price with the seller and capturing the terms, pre-execution in a contract. Enforcement costs may exist post-execution if the seller is unable to deliver at the negotiated price under the agreed circumstances.

Transaction cost theory takes this concept a step further trying to justify why companies use internal resources versus outsource. The transaction cost theory expects that companies try to minimize the costs of exchanging resources by choosing to use internal or external resources from the ecosystem. Businesses try to minimize the total cost of goods of individual transactions within the company on a project-by-project basis. Managers are thus measuring the costs of producing products or providing services using external resources versus performing like activities in-house.

Once external transaction costs become higher than the company's internal production costs, the company will use internal resources, because the company is able to perform its activities more cheaply, than if the product or service were performed by the external market. Conversely, if the internal costs of production are higher than the external costs, the company will outsource the production or services.

According to Ronald Coase , every company will expand as long as the company's activities can be performed cheaper within the company, than by outsourcing the activities to external providers in the market. According to Williamson a transaction cost occurs "when a good or a service is transferred across a technologically separable interface".ⁱⁱ The factors and parameters that require measurement of course expand when performing business transactions globally. Each geographic location provides its own unique cultural and legal challenges.

4.4 Asymmetry intersects transaction cost

Asymmetry of information addresses balance, ethics, and good faith of an individual transaction. Asymmetry can and does exist anywhere, even in same-culture transactions. Asymmetry of information impacts the cost of goods by impacting transaction cost. This can in turn impact supply and demand. If demand is impacted, cost could go down. This is George Akerlof's position in *The Market for Lemons*. Moving forward in a world where businesses and individuals are more willing to accept these risks, market value will not go down. The challenge for us as global business practitioners is to understand and properly gauge the transaction cost surrounding asymmetry of information and calculate that into the total cost of goods.

For example, the cost of product x is \$100 if I produce it in my country. The cost is \$10 if I produce it in a neighboring country with lower labor costs. To calculate total costs of goods sold I must understand what other transaction costs exist that may be induced by asymmetry of information. Some of the questions I must ask myself are "Can I enforce the production contract? How often will I have to enforce a contract? Do I have a team capable of cross-cultural negotiation? Do I know how to find the right resources or producer in that culture? Do I need an agent to assist in this transaction? Can I find the correct\best product?" In the final assessment the global practitioner must be able to adeptly calculate the financial impact of these answers. Do the transaction costs add \$2 or \$95 to my total cost of goods? If it adds \$95 to the original \$10, is it cheaper to source my product at home? Can I afford to not do business in this other country? If I don't, will my competitors beat me there?

Information asymmetry impacts all forms of business transactions. My legal peers agree, too. I received a rather insightful comment regarding information asymmetry in one interview. I spoke with lawyer Art House, who reminded me of the fallacy of all business owners. He commented, "Business owners insist that getting the lawyers in early and often would be the best course to better contracts, but we know otherwise." He continued, "To avoid miscommunications, we cannot just throw the lawyers in." House

said, "In fact, sometimes, the worst thing you can do to impede communication is throw two lawyers in a room, unless the business owners are present."

Many business owners that come to me have thought the exactly the manner that house describes. They would have viewed early and ample application of legal staff as an efficiency way to negotiate the transaction. House reminded me that we, as lawyers lack the necessary context. Without context, there cannot be symmetry in communication. The businesspeople provide the context. Numerous experiences of mine and those of my peer lawyers are consistent with this view.

At its most basic, asymmetry of information occurs when a person or business in a negotiation has more or better knowledge than his or her counterpart. In a stock trade, which is one of the most basic contracts after all, asymmetric information might take the form of insider knowledge of good or bad news the company has yet to announce. I would argue that even if such insider trading weren't against the law, which it is, such bad faith is just plain bad for business in general. When there is an imbalance of information, business goes awry, and sometimes horribly so, as we saw in the global financial crisis of 2008.

It is therefore incumbent upon businesspeople who possess an unfair or inordinate amount of information favoring them in a given contract negotiation to recognize they enjoy an unfair advantage and to level the playing field before negotiations begin. I know this sounds like a radical concept, but all business would benefit if everyone acted in such good faith. I am not so naïve to think that everyone will adopt this rosy view, but I believe that such a leveling of the playing field, known in economic theory as "perfect information," is the best course for everyone in international business.

4.5 Disclosure and due diligence

Most legal systems already recognize perfect information. It's called disclosure. (Hylton, 1993) Both sides of any legal engagement must share every shred of evidence they have with the other side. Failure to fully disclose information is an egregious offense and against the law. I think the international business world would be best served by adopting, either formally or informally, the goals of perfect information.

A closely related cousin to Disclosure is Due Diligence. The concept of Due Diligence is not unfamiliar to the business or legal professions. The concept is most present in the merger and acquisition field. Stock purchase agreements are extensive contracts, often including hundreds of pages. In the acquisition field of investment banking, lengthy clauses are included in the purchase contract describing both the sellers' responsibility to

disclose all information related to the transaction as well as the buyers responsibility to accept and review the material. Holdbacks are portions of the total deal value that are withheld for a period of time to confirm that both parties have disclosed all of the known parameters. In the event that information was withheld intentionally, or even unintentionally, a pool of money is available to resolve the issue. One very practical way of adopting the goals of perfect information in international business world is to include additional contractual parameters regarding due diligence, holdbacks and the repercussions of either parties' failure to disclose information.

4.6 The perfect contract

There are no perfect contracts, of course, because there is no way to anticipate every possible future eventuality and to include them in the terms of the contract—a theoretical aspiration known in the legal fields as a “complete contract.” . (Hylton, 1993) In a world where complete contracts existed, there would be no need for courts. There would be no miscommunication to be resolved.

Such a world, of course, is not possible. No lawyer, no matter how great, can anticipate everything. Instead, we have the notion of good faith—the idea that businesspeople should negotiate fairly and openly. Good faith is an imperfect but critical concept for business, according to legal scholar, Keith Hylton, of Boston University. Hylton writes that, “Good faith plays a central role in most legal systems, yet appears to be an intractable concept ... One of the objectives underlying the law of contract on an economic view is to curtail opportunism.” (MacKaay & LeBlanc 2003) The antithesis of good faith, therefore, is opportunism. Opportunism is, in fact, bad faith, and it is costing the world billions each year. Hylton goes on to tie bad faith back to an asymmetry of information. “Bad faith,” he says, “is present where a substantial informational or other asymmetry exists between the parties, which one of them turns into an undue advantage, considered against the gains both parties could normally expect to realize through the contract, and where loss to the disadvantaged party is so serious as to provoke recourse to expensive self-protection, which significantly raises transactions costs in the (MacKaay & LeBlanc 2003) market.”

Hylton goes on to show how asymmetry skews the outcomes in the courts. Perfectly efficient courts, the theory goes, would only litigate the cases where the law is least clear—cases that have a 50-50 chance of falling one-way or the other. Unfortunately, many courts are slowed down by dockets filled by cases that are biased in favor of one party or the other with cases whose outcomes are largely predetermined. Such inefficiencies rack up great costs in the court's time, legal fees and plaintiff-defendant resources, weighing down the economy in the process. And where does the blame for

this inefficiency fall? Hylton provides the answer that efficient courts can only occur when “neither party has the informational advantage in litigation.” (Hylton, 1993)

As lawyers, we must understand that the contract is the pre-transaction communication. And the courts are the post-transaction referee if the transaction resulted in miscommunication. While the miscommunications may be a result of changing motives, goals and aspirations during the transaction, it can be argued that miscommunications are more likely the result of both party’s expectations not being properly captured during the contract drafting pre-execution phase. Hylton’s theories about good faith were drawn to explain how information asymmetry affects the outcome of legal cases, but they are just as easily applied to economic theory. After all, what’s more inefficient than a contract in which one party held an informational advantage and used it in bad faith?

Better contracts, are the key to efficient business transactions, which I believe should be the goal of the international business community, just as it is for the legal community. Hylton agrees. He says as much when he writes, “The information-based model presented here has implications that modify those of the bidding model.” (Hylton, 2005)

In cross-border, cross-cultural transactions of the sort that occur all the time in international business, the opportunities for informational asymmetry are aggravated by differences in culture, language, and especially legal systems, making the call for better contracts all the more important. And, as we have just seen, better contracts are best derived by informational fairness.

The best-prepared international businesspeople must enter all negotiations equipped with the tools to recognize when information is biased in one direction or another and act—in good faith—to bring those biases back into line. Understanding information asymmetry that can arise from culture, language, and legal system differences is key to realizing that goal. When all businesspeople negotiate on equally footing, the world economy is the beneficiary.

5 COMMON LAW AND CIVIL LAW

5.1 The impact of legal systems on business communication

In his paper, “Civil Law And Common Law: Two Different Paths Leading To The Same Goal,” legal scholar Caslav Pejovic, a professor of law at Kyushu University in Japan, lays out the subtle, and not so subtle differences between the world’s two dominant legal systems, arguing that despite their fundamental variations, civil law and

common law essentially accomplish the same purpose. (Pejovic, 2001).

I like to think of it like an analogy of two cousins with differing communication styles, both of which want to go to the fair. While both may desire the same outcome of getting to the fair, each communicates differently to get their outcome. Cousin one is a no-nonsense type. She speaks directly, without guile or subtlety, stating his intention outright: “Let’s go to the fair!” Cousin two, on the other hand, is more roundabout but no less certain, saying, “It sure is beautiful out today! I bet the people who went to the fair are enjoying themselves. We should join them.” While this analogy is a simplification of a complex reality, it goes a long way toward understanding the difference between common law and civil law—they are two closely related cousins. One relies on what is written; the other on the precedence of earlier decisions.

Most of the world’s countries are governed by either of these two ancient systems. Civil law began in the age of the Romans, whose body of laws, known as the *Corpus Juris Civilis* was established roughly in 529AD by the emperor Justinian. (Pejovic, 2001). As the legions spread Roman domination across Europe, civil law became the guiding system of most European nations and the parts of the world that those countries, in turn, colonized through the ensuing centuries. France, Germany, Switzerland and Japan all use some form of civil law, though the codes have evolved and vary from nation to nation.

Like the Romans before, the principle characteristic of civil law is that it is written in civil codes that are essentially unfringeable. The job of the courts under civil law is to interpret and apply the written law to any given case. In those cases, where there isn’t a specific code, the courts must rely upon a set of general principles that help guide them to an equitable solution. Civil law is the prevailing legal system in countries of French, Spanish or German lineage, including Mexico. Civil law is the most widespread system of law around the world from a geographic perspective. Common law traces its roots to the *Magna Carta* in 11th century England. (Pejovic, 2001). It is not codified rigidly in legislation, but is a historic system in which present interpretations of the law are based upon how previous courts have ruled, using those rulings to guide future decisions. Above all, common law respects precedent. Common law is the prevailing legal system in countries of British lineage, including the United States (except Louisiana), Canada, Australia, New Zealand and others.

In civil law, the codes and statutes—the direct statements of legislators—are preeminent and case law is secondary. In common law, judicial decisions prevail, while a conceptual structure is often lacking. In civil law, legislators legislate and courts apply laws. In common law, the courts essentially create the law through their decisions. If a court overturns a previous decision, that decision effectively becomes

the law of the land.

The fundamental difference between the two systems, Pejovic says, is how each regards precedent. In civil law, precedence takes a back seat to the law as written. In common law, the way previous courts have ruled on a particular law governs how future courts should rule. The consequence—which is particularly important for international business people—“is that lawyers from the civil law countries tend to be more conceptual, while lawyers from the common law countries are considered to be more pragmatic,” Pejovic writes. (Pejovic, 2001).

5.2 Consideration and Cause, Revocation, and Penalties

Pejovic illustrates his point by examining the concepts of consideration and cause. Under common law, a contract cannot be binding without the exchange of something of value—goods, services, or money. The exchange is known as the *consideration*. This same goal is expressed in civil law in a slightly different way. A contract is not binding without a lawful *cause*—a reason that either party enters the contract. The difference is subtle, but a cause does not require that the second party obtain something in return. One could, in effect, agree to legal contract in which he or she gets nothing in return. In practical terms, the difference between consideration and cause means that, under common law, there cannot be a contract between two parties for the benefit of a third. The thing of value—the consideration—went to the third party; therefore there can be no contract. The second party hasn’t received anything of value.

The difference between the systems extends to how offers are revoked, as well. In common law, any offer can be revoked or changed until the second party accepts it—even if the offering party says the offer is irrevocable. Unless accepted, there can have been no consideration and, therefore, no contract. In civil law, on the other hand, an offer is binding from the moment it is tendered, whether accepted or not. Understanding the potential problems arising out of these differences, the international commercial law community has tried to create a compromise solution to bridge the gap.

A third example, Pejovic explores, lies in how the two systems handle liquidated damages and penalties, which “often causes confusion and creates problems of interpretation.” (Pejovic, 2001) In common law, contractual clauses specifying liquidated damages remove the burden of proof from the innocent party, who will receive the compensation specified in the contract, regardless of the amount of actual damages. Penalties, on the other hand, can be much larger, greater even than the amount of the greatest loss possible under the contract. Consequently, penalties are rarely enforced by courts, while liquidated damages usually are.

In civil law, these concepts create problems. Pejovic goes on to discuss how in French law the term "clause penale" and the English term "penalty clause" sound the same but, in fact, are not. (Pejovic, 2001) In reality, the amount specified in a clause penale must approximate the actual loss caused by the breach, thus it more closely resembles the concept of liquidated damages under common law.

For international business people, the differences in the two systems are a rat's nest of potential problems. International mining lawyer Cecilia Siac, in her 1999 paper, "Mining Law: Bridging The Gap Between Common Law And Civil Law Systems," describes in detail some of the more challenging aspects of Latin American civil law (Siac, 1999).

The procedure for granting, maintaining and transfer mineral rights is very formal, very bureaucratic and cumbersome, and contracts must be registered to be valid. This is a huge source of misunderstandings and adverse legal consequences. The government has inalienable eminent domain over mineral wealth of the country and obtaining of these rights cannot be acquired, but are awarded through administrative action that is very labor intensive for the applicant (Siac, 1999).

The applicant, if so lucky to be granted rights, cannot transfer, mortgage, pledge, lien or deal them without consent in writing from the state. And, if that doesn't complicate things enough, there is also a sharp distinction between owning rights to the surface soil and owning the subsoil. Each type of soil is governed by a different set of civil laws.

To illustrate, Siac describes one particularly tortuous Venezuelan case. In early 1986, two mineral concessions were granted at Las Cristina—the world's largest undeveloped gold reserves. The concessions were originally granted to Culver de Lemon and then, just months later, transferred to Ramon Torres who in turn transferred them to Inversora Mael S.A. on May 16 of the same year. Unfortunately, the Ministry of Mines failed to publish the relevant transfer notice (Siac, 1999).

Meanwhile, as the concessions expired and Inversora Mael applied for renewal, the Ministry of Energy and Mines denied the request because of the missing paperwork. The Ministry then granted the mineral rights to CVG, the state owned mining company, which in turn entered into another agreement based on the concessions. To end the row, the courts eventually cancelled the rights and powers granted to CVG. While CVG's pre-existing contracts with third parties remained valid, control remained with the Ministry of Energy and Mines.

In light of the potential quagmires, Siac provides some advice for lawyers charged

with cleaning up such problems. Siac writes: “extra due diligence should be exercised by common law lawyers when dealing with a non-common law jurisdiction in order to avoid severe adverse consequences ... Extrapolation, reasoning by analogy and trying to impose common law concepts ... are common mistakes.” (Siac, 1999)

Given the worst-case examples such as this, Siac says it is incumbent upon common law lawyers to ensure adherence to common law requirements. In turn, the civil law lawyers needs to be aware of the high due diligence standards in common law. (Siac, 1999) If any concept differs system to system, the differences should be noted and explicitly stated in the contract. Furthermore, she says that these examinations should only be done manually and with direct help of local legal counsel.

In contrast to Pejovic and Siac, Professor Giuditta Cordero-Moss, of the University of Oslo, delves into the subtle concept of good faith in her paper, “International Contracts between Common Law and Civil Law: Is Non-state Law to Be Preferred? The Difficulty of Interpreting Legal Standards Such as Good Faith.” She states, in no uncertain terms, that because most international contracts are written in English and typically adopt common law structure and language, therefore they tend to follow common law. (Cordero-Moss, 2007)

In particular, she notes that because common law “is based on the principles of certainty and predictability” and the shared risk between the parties, the concepts of good faith and fair dealing are not necessary and, in fact, are “undesirable” because they introduce uncertainty into the concrete world of business. (Cordero-Moss, 2007) Civil law, on the other hand, places an emphasis on justice and often requires interpreting specifically for reasonableness, good faith and fairness. These differences obviously can lead to trouble, especially in cases where interpretation of the parties’ good faith is at question.

To overcome these difficulties, she says, it can be helpful to refer to international sources of law that do not make reference to any specific national legal system. (Cordero-Moss, 2007) For instance, Moss points to the UNIDROIT Principles of International Commercial Contracts and the European Principles of Contract Law, which attempt to codify for the world all the finer points of international contracts. And, when all else fails, Moss says, there is always arbitration, though even this choice is limited. Cordero-Moss says that even though arbitrators have some leeway, “they are still bound to apply the law accurately.”

In my experience as an international lawyer, I would argue that all legal systems have migrated to some variant of its original intent. I would argue that no countries legal system is purely Civil law or Common law based. This is actually a moving target based on politics, society, and the courts. In this middle-ground between common and civil

law one thing is clear: venturing into international business and trying to make sense of the differences is not for the faint of heart and effective communication is the only real predictor of success.

In this regard, it seems international businesspeople have a choice to focus in three different vectors. First, we can trust in pre-transaction communication in the form of due diligence. Cecilia Siac instructs them to obtain legal opinions from local civil lawyers and to commit to an excessive standard of due diligence. Second, we can try to better codify the communication through the contract itself. Pejovic teaches that businesspeople need to be aware of the systemic differences and try to improve the legal systems through their contracts. And, third, we can settle our differences post-execution as seen in Cordero-Moss's recommendation forgoing both systems in favor of neutral international standards like UNIDROIT. If all else fails, he says we should rely upon arbitration. (Pejovic 2001).

6 EXAMPLES OF CIRCUMSTANCES IN CONTRACT LAW

6.1 The Thorny Issues of Impossibility and Changed Circumstances

Above, I established my argument that, as the legitimization of all business negotiations, the contract is the essential and ultimate vehicle of business communication. It is the single most important document in business-to-business communication, and, as such, it also holds the most potential for trouble. As with any interpersonal communication, the contract is not a perfect vehicle. There is always a risk of miscommunication and perfect communication is theoretically impossible. Our job as businesspeople, therefore, is to recognize these risks and do everything in our power to mitigate it through better and more open communication.

I would like to look at some potential opportunities where miscommunication often arises—specifically the notions of Impossibility and Changed Circumstances as they apply to international contract law. These two concepts are fraught with danger and necessitate that business people doing international business place a heavy influence on the value of comparative law to avoid some painful, and potentially costly, mistakes.

The two concepts actually chart their beginnings to Roman law. In its “Impossibility Doctrine,” the Romans asserted that, “there is no obligation to the impossible.” (Posner, Rosenfeld, 1977) Essentially, the doctrine holds that one cannot be held contractually bound to complete a task that is undoable. The Romans, however, made a subtle distinction between tasks that are impossible from the start and those that start as achievable goals, but become impossible during the course of the contract period. No

party can be held to perform tasks that are inherently impossible, but if the task becomes impossible during the contract period, the party can only be relieved of contractual responsibility if the impossibility is not their fault.

Roman law did not directly address the notion of “changed circumstances”—the idea of an unforeseen change in circumstance that had not been contemplated by either party before the contract was signed. Medieval lawyers, however, saw a need and developed “The Doctrine of Changed Circumstances,” which asserted there was moral obligation to perform, unless the circumstances underlying the contractual promise had changed (Posner, Rosenfeld, 1977).

These two doctrines become more complex when a particular contract straddles the line between common and civil law. Civil law requires all contracts include “an intent to be bound,” allowing many jurisdictions to excuse performance when the underlying *cause* for the contract changes. Common law, on the other hand, emphasizes the *consideration* involved in a contract—the exchange of something of value—that binds the parties to the contract even if the purpose for the contract changes.

In his paper, “The Confusing Legal Development Of Impossibility And Changed Circumstances: Towards A Better Understanding Of Contractual Adaptation At Common Law,” lawyer and legal scholar Daniel Behn notes that this variation between common law and civil law has yielded an interesting, potentially dangerous, shift in international contract law. While the doctrine of changed circumstances has bounced between strict adherence and equity in civil jurisdictions, Behn says there has been a noted shift toward equity in recent times in civil law states, but this is not so in common law jurisdictions. He writes, “As such, the doctrine of changed circumstances, as it has developed throughout the world during the 20th century, is considered generally incompatible with the common law.” (Behn, 2009) He notes that critics of changed circumstances say it is a threat to “the sanctity of contract.” Behn argues to the contrary that good faith and equity increase, not decrease, the stability of contracts over time and laments that common law has failed to incorporate these principles into the law of contracts.

If this concept subtlety poses challenges for lawyers, I’m sure many others are left wondering, “if the simplest concepts of contract law such as what to do when the parties are unable to comply with a contract because it has become impossible to do so cannot be resolved, how can we ever have an adequate, much less a perfect contract between common and civil law jurisdictions?”

This is but one example of the potential differences between common and civil law that

have heads spinning and have profound implications for international business. Such discrepancies have increased the value of comparative law upon the future of globalization. To survive, much less thrive, in the global age, will require businesspeople and companies to think more strategically about the importance of comparative law. How we answer these thorny questions will largely determine the fate of many careers, if not entire companies.

7 ONE PRACTITIONER'S VIEW

7.1 A tale from the hospitality sector

As a developer of hotels seeking the backing of a foreign name, I turned to the United States hotel franchising system to search for an appropriate brand to bring to the country of Mexico. Going in, we anticipated search related transaction costs would increase due to a cross border, cross culture search. We presumed availability of information would be relatively equal as most brands were publically held corporations with regulated disclosure requirements.

Search transaction costs actually turned out higher than expected as each brand had differing interest and experience levels regarding operating globally. While all brands seemed to express desire in their marketing plan, less had actual intention and even fewer possessed the ability to actually execute outside of their existing geographic footprint. Requests for information from some brands even resulted in a long discourse on the barriers and cost of entry into new markets that were clear inconsistent with stated corporate vision.

The most adept hospitality franchises understood business dialects and embraced the concept that to go global, you must have a local presence. These brands ranged from adequate to elaborate in their local teams size and experience. Nonetheless, even the most capable global teams varied as negotiations crossed the border. While the Mexican counterpart had truly adapted the franchise vision and mission to the host country, once the deal approval stage was required at headquarters, the corporation demonstrated its lack of universal understanding required for international business. Along the way, business, legal, and financial so-called experts revealed their ignorance of non-US practices.

While a relationship with the ideal franchise partner may have allowed us to leverage a large database of historical market data, in Mexico we were left to our own defense to identify the ideal location, our target market, and brand subdivision. We ended up conducting multiple markets studies regarding multiple locations during the

development of the project. Inevitably, we selected the franchise that demonstrated the most knowledge and willingness regarding our national and market and its position in their global plan.

As we rolled past the search phase and into the negotiation phase transaction costs, information asymmetry seemed paramount to the entire franchise scheme. Our first search resulted in a very rigid bargaining partner. Truthfully, all franchises preached the impossibility of changes in the franchise contract. All swore to its universality across franchisees. All negotiators attempted to convince us that a single change to the franchisee contract would result in a cascade of changes to every other franchisees contract worldwide. Simple put, this was false. While these fabrications may have some basis in truth nationally, they were neither true nor plausible on the international scale.

Adding to the information asymmetry, the legal team, often more experienced than their counterparts internationally turned out to be outright bullies. Our experience in relation to contract law supported the studies cited in this paper. All contracts were based on US common law concepts and any attempts to address local law and regulation were severely resisted. In many instances we needed to debate conditions and requirements of the local laws and regulations that must have been address in prior international transactions in our region. Regional building codes, zoning, taxes and corporate law items that were inflexible due to national standards were debated based on their nationalistic, but non-applicable perspective.

While this franchisee had documented hundreds, even thousands, of similar transactions worldwide, there negotiations seemed based on their informational advantage and unwillingness to share information. This behavior was not different than that of which we witnessed during the discovery stage in relation to their unwillingness to share market surveys from our region.

Finally, hospitality franchisers seem to have the upper hand as they have designed all contracts with provisions regarding arbitration jurisdiction. All US hospitality franchisers approach demanded local arbitration. Although we have not had to cross this bridge, we calculated high enforcement transaction costs for our business model. Not only will enforcement of contract terms required international travel, but also the use of international lawyers with a strong understanding of common law and at least a basic understanding of the comparative law issues.

While this experience is far from our lofty goals for all global activities described above, it remains this practitioner's view that a form natural selection will take place in the coming years favoring the organizations that are in line with the views of the scholars cited.

8 CONCLUSION

In coming decades, more companies, organizations and more professionals will find themselves called upon to become international ambassadors and to forge business relationships with people in other countries. For the upwardly mobile corporation or the internationally astute entrepreneur, the opportunities are great, but so too are the challenges of communicating well between peoples of very different cultures. If we, as businesspeople, can become adept in the verbal and physical nuances of business dialects we will all benefit, and so, too, will our companies, our countries and the world.

All parties involved in international business must anticipate the cultural and communication differences inherent in globalization and work together not just to avoid these challenges, but to learn to empathize with the parties across the table and find ways to communication in the languages, both literal and figurative, verbal and non-verbal, to which they are most accustomed. In short, we must learn to speak their business dialect. Only then will business communication begin to benefit and rise to the promise of which we all know it is capable.

The best-prepared international businesspeople must enter all negotiations equipped with the tools to recognize when information is biased in one direction or another and act—in good faith—to bring those biases back into line. The practitioner will recognize transaction cost deltas that exist in international opportunities. Understanding information asymmetry that can arise from culture, language, and legal system differences is key to realizing that goal. When all businesspeople negotiate on equally footing, the world economy is the beneficiary.

In this regard, it seems international businesspeople have a choice to focus in three different vectors. First, we can trust in pre-transaction communication in the form of due diligence and full disclosure. We can obtain legal opinions from local civil lawyers and to commit to an excessive standard of due diligence. We can try to better codify the communication through the contract itself. Businesspeople must be aware of the systemic differences and try to improve the legal systems through their contracts. In the event of a failed execution, we can settle our differences by forgoing both systems in favor of neutral international standards and arbitration.

Such discrepancies have increased the value of comparative law upon the future of globalization. To thrive, in the age of corporate globalization, businesspeople and companies will be required to think more strategically about the importance of comparative law. How we answer these questions will largely determine the fate of entire companies.

9 REFERENCES

Boon, Andrew and Flood, John, "Globalization of Professional Ethics? The Significance of Lawyers' International Codes of Conduct," *Legal Ethics*, Volume 2, No. 1, 1999

Cyphert, Dale, "Differences in Communication Culture," *Business Communication Self Study*, University of Northern Iowa, College of Business Administration, 2007.

Doole, Isobel and Lowe, Robin, *International Marketing Strategy: Analysis, Development and Implementation*, Fifth Edition, South Western Educational Publishing, 2008

Hylton, Keith N., "Asymmetric Information and the Selection of Disputes for Litigation," *The Journal of Legal Studies*, The University of Chicago Press, Vol. 22, No. 1, pp. 187-210, 1993

Hylton, Keith N., "Information, Litigation, And Common Law Evolution," Boston University School Of Law Working Paper Series, Law And Economics, Working Paper No. 05-07, 2005

MacKaay, Ejan, and LeBlanc, Violette, "The law and economics of good faith in the civil law of contract," prepared for the conference of the European Association of Law and Economics, Nancy, France, 18-20 September 2003

Cordero Moss, Giuditta, "International Contracts between Common Law and Civil Law: Is Non-state Law to Be Preferred? The Difficulty of Interpreting Legal Standards Such as Good Faith," *Global Jurist*: Vol. 7: Iss. 1 (Advances), Article 3, 2007.

Pejovic, Caslav, "Civil Law And Common Law: Two Different Paths Leading To The Same Goal," *Victoria University of Wellington Law Review*, v.32, no.3, p.817-841, August 2001.

Siac, Cecilia, "Mining Law: Bridging The Gap Between Common Law And Civil Law Systems," *Comité Jurídico Interamericano, Curso de Derecho Internacional XXVI*, OAS General Secretariat, 451, 1999.

Behn, Daniel, "The Confusing Legal Development Of Impossibility And Changed Circumstances: Towards A Better Understanding Of Contractual Adaptation At Common Law," *Centre for Energy, Petroleum, and Mineral Law and Policy (CEPMLP) Annual Review*, The University of Dundee, 2009.

Posner, Richard & Rosenfeld, Andrew M., "Impossibility and Related Doctrines in Contract Law: An Economic Analysis," 6 *Journal of Legal Studies* 83, 1977