

**BOILERPLATE AND ECONOMIC POWER
IN AUTO MANUFACTURING CONTRACTS**

Omri Ben-Shahar and James J. White*

University of Michigan Law School
Ann Arbor, MI 48109
omri@umich.edu
jjwhite@umich.edu

* Ben-Shahar is Professor of Law and Economics; White is the Robert A. Sullivan Professor of Law. The authors are grateful to many automotive officials who agreed to be interviewed for this study, and especially to Margaret Baxter of OESA for coordinating the suppliers' survey. Helpful comments on an early draft were provided by two editors of the Michigan Law Review and by participants at the "Boilerplate" conference at the University of Michigan. Financial support from the Olin Center at the University of Michigan Law School is gratefully acknowledged.

INTRODUCTION

Manufacturing contracts in the automotive industry have served a canonical role in the economic theory of contract and bargaining. The famous story of General Motors' relationship with its supplier Fisher Body in the 1920's is a landmark illustration of the problem of contractual hold-up, underlying a prominent theory of vertical integration and the nature of the firm.¹ The theoretical fascination with automotive procurement contracts is well deserved. There is perhaps no other merchant-to-merchant contractual template that governs such fantastic economic stakes—hundreds of billions of dollars per year—and implemented through a process that involves almost no negotiation of the legal terms. Boilerplate rules these transactions.

There is a long line of law-and-economics scholarship studying the attributes of standard form terms in contracts between sophisticated parties in high-stakes transactions. One of the benchmark predictions in this literature is that contractual terms have to be efficient if they are to be consistently utilized by the parties.² Any rent-seeking power that a party has should be translated into a price advantage; it should not be used to dictate selfish but inefficient performance terms. Further, since legal terms such as warranties and remedies affect the costs borne by the parties, we expect that sophisticated parties will be “pricing” the terms and will be ready to redraft terms that cost more than they save. A study of automobile contracts provides an opportunity to test these predictions. These are transactions where economic power is unevenly distributed; much dickering takes place over prices and product design; but everything else is packed into boilerplate. Every transactor reads the boilerplate and understands their legal effect

¹ See Benjamin Klein, *Hold-Up Problem*, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241 (Peter K. Newman ed., 1998); Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

² See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991); Alan Schwartz and Robert E. Scott, *Contract Theory and the Limits fo Contract Law*, 113 Yale L. J 541, 545-6 (2003) (sophisticated firms are expected to write contracts that maximize efficiency).

and their economic consequences. Do strong parties dictate efficient boilerplate and extract rents through prices and other purely distributive clauses? Do they tailor their terms to maximize their net gains from the transactions?

Moreover, automotive supply contracts are the paradigmatic long-term relationships that require a great deal of relationship-specific investments in the form of machinery, location of plants and precontractual technology research. The dependence of suppliers who made investments on their buyers, and of buyers who need specialized parts on their suppliers, can give rise to opportunities for hold up, as indeed predicted by the economic literature.³ These dangers make the contracts all the more important, as a primary tool to deter hold up and to encourage investments. How do the boilerplate contracts in the auto industry address these dangers?

The methodological approach of this paper is simple, almost naïve. We read and compared the boilerplate contracts in the industry, and talked to various attorneys and experts who drafted these forms and who helped us understand the problem they intended to address. As such, we provide a case study, but one that may yield some general insights. For example, reading the boilerplate contract terms between the Original Equipment Manufacturers (OEMs) and the tier-1 suppliers provides a subtle understanding of how economic power is translated into transactional advantages. Looking at the actual terms we can identify the various ways OEMs extract value from their suppliers. We suggest that, contrary to the fabled GM/Fisher Body story, there is no real problem of hold up by suppliers. The argument that, after being awarded a long term contract, suppliers can hold up the OEMs, is based on a misunderstanding of both the legal terms of the deals and the structure of the market. Moreover,

³ OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 7 (1995); OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 114-115 (1985).

comparing the terms that appear in the purchase orders of the various OEMs reveals ways in which they differ and, quite surprisingly, it suggests that some of these terms may be drafted inefficiently. Finally, studying the way the form contract are drafted within the organizations that utilize them provides a more detailed understanding how and when “tailoring” of terms takes place and how internal organizational features are harnessed to affect the outcome of the negotiations.

The study of contracting in the automotive industry provides also an opportunity to investigate the design of contracts in an industry that deals with fascinating economic changes. One major change has to do with the organization of production. By 1960 Ford was making almost everything from floor mats to steel within the company, and the other Original Equipment Manufacturers (OEMs) had a nearly equal degree of vertical integration.⁴ But from the early 1980s, the trend to vertical integration has reversed.⁵ The biggest American OEM, General Motors, which used to produce up to 70% of the parts internally, is now only 30% integrated. OEMs have shed whole divisions, most notably Delphi⁶ and Visteon,⁷ and have commenced to buy large sub-assemblies such as consoles, brake assemblies, and even frames from outside suppliers. With the business changing so vastly, have contracts changed as well?

Another major change in the automotive industry is its profitability. American OEMs lose money; this is no secret. Ford and General Motors, two bastions of American industrial power, issue debt that is graded as junk.⁸ Since the OEMs are unable to renegotiate with their

⁴ See Christopher Scherrer, *Governance of the Automobile Industry: The Transformation of Labor and Supplier Relations*, in GOVERNANCE OF THE AMERICAN ECONOMY 209, 217-18 (John L. Campbell et. al. eds., 1991).

⁵ See *id.* at 220.

⁶ Dale Buss, *Perfect Storm: The Fate of U.S. Manufacturing Lies in the Hands of CEOs like Delphi's J.T. Battenberg*, CHIEF EXECUTIVE, Oct. 2004, at 38.

⁷ Robert Barker, *Visteon: What's that Funny Noise?*, BUS. WK., July 3, 2000, at 159.

⁸ Jamie Butters, *Reasons for Junk Ratings: Downgraded GM, Ford Must Shrink*, S&P Analyst Says, DETROIT FREE PRESS, May 7, 2005, available at 2005 WLNR 7171742.

most burdensome creditors⁹—their current and retired employees—they have turned to their suppliers. The pressure to achieve savings from suppliers that began in the mid-1980s has accentuated, and, as these suppliers are pressed, the pressure cascades down the supply chain. This study traces the cascade of the contract terms that suppliers are required to accept.

The automotive supply industry is sometimes described as a pyramid, built in “tiers.” At the top are the OEMs. The paper focuses mostly on the “Big Three” OEMs—General Motors, Ford, and DaimlerChrysler—but it looks also at six foreign OEMs who assemble cars in the U.S. and who are a growing force in the American manufacturing market. Directly below the OEMs are the “tier-1” suppliers—anyone who sells directly to an OEM. These companies usually sell sophisticated assemblies or parts, and most of them specialize in designing and manufacturing automotive-specific products. They purchase their supplies from “tier-2” suppliers, who in turn purchase from “tier-3” suppliers, and so on. Since there are only few OEMs at the top, but there are roughly 600-800 tier-1 suppliers,¹⁰ a pyramid is an inaccurate metaphor. The metaphor is important, as we will explain below. The main issues that need to be governed by the contracts between OEMs and tier-1 suppliers are different than in lower tiers. Some of that difference will be attributed to the fact that there is a much smaller set of potential buyers above tier-1 sellers than there is above sellers in the lower tiers.

This paper is structured as follows. Part I compares the boilerplate terms of the OEMs and highlights important differences in their respective forms. It argues that these differences cannot be easily reconciled with the prediction that boilerplate terms are efficient. Part II examines how these boilerplate forms are drafted, how they are negotiated, and how the OEMs guard their terms from erosion. It provides some insight on how the internal organization of a

⁹ Eric Mayne, *Ford May Cut Factory Jobs Next*, DETROIT NEWS, June 23, 2005, at 1; Jeff Green, *General Motors Comes Up Short in First Quarter*, SEATTLE TIMES, Apr. 20, 2005, at E2.

¹⁰ *Auto Industry M&A Value Soars*, AUTO BEAT DAILY, Nov. 12, 2003, at 1.

party to a deal affects the terms that this party can secure. Part III focuses on the role of economic power, with special interest in how power is harnessed to administer and modify contracts. This analysis revisits the claims made on the basis of the GM/Fisher Body deal, and argues that some of these claims are not valid. We demonstrate the subtle ways in which hold up and renegotiation are curtailed. Finally, Part IV examines ways in which a less powerful party can nevertheless get favorable contract terms.

I. THE CONTRACTS

Supply contracts in the automotive industry are entered into through a process of competitive bidding. An OEM issues requests for quotations (RFQs) for a particular part or assembly. The supplier whose bid is picked would ordinarily make a significant capital investment, and supply this part for the duration of the car model in which the part is assembled, a period which normally lasts 4-8 years. The winning bidder, however, does not always get the security of a long-term, fixed price contract. While some OEMs would accord the supplier a long-term sourcing commitment, the actual purchase orders are either issued on a short term basis,¹¹ leaving the parties opportunities to renegotiate, which is usually done by the OEMs who demand (and receive) price reductions every year.¹² Technically, most of these adjustments are not modifications of the contract, but rather renewals of short-term purchase orders (POs), all entered into under a master long-term agreement.

The contracts we looked at are the boilerplate purchase orders governing the actual supply agreements. While there is some interest in the long term master agreements, their language is usually brief and subordinates them to the terms of the shorter-duration POs. These

¹¹ ORIGINAL EQUIP. SUPPLIERS ASS'N, OEM NORTH AMERICAN PRODUCTION P.O. CONTRACT TERMS AND CONDITIONS COMPARATIVE ANALYSIS 15 (2004) [hereinafter OESA].

¹² Patricia Panchak, *Supplier Partnerships Provide a Competitive Edge*, INDUSTRY WK., Sept. 2004, at 9.

forms are drafted and issue by the OEMs through a process which will be described in Section II. Each OEM has a single form, titled either “Global Terms” or “General Terms,” which is used for procuring all of the manufacturing parts, almost with no exception. General Motors, for example, enters into roughly one million procurement contracts every year, totaling over \$80 billion—all governed by a single contract form containing 31 paragraphs,¹³ translated into six languages. In terms of economic stakes, this form is perhaps the single most important contractual document ever drafted. In the remainder of this section, we will compare the standard forms of the North American OEMs.

Before launching this study, our conjecture was that we will find very similar boilerplate language throughout this industry. Influenced by the economic theory of standard form contracts, we expected these contracts between ultra-sophisticated parties to include very efficient arrangements. True, OEMs have significant bargaining power vis-à-vis their suppliers; but economic theory teaches us that it would be wise to use this power in extracting more favorable bottom line prices, rather than by extracting inefficient one-sided legal terms.¹⁴ Moreover, our expectation that the forms would be uniform throughout the industry was influenced by the fact that they are all issued in a highly repetitive fashion to the same group of tier-1 suppliers—those very large manufacturing companies that supply the main parts and assemblies to the OEMs. These are sophisticated counterparties who read the contracts and assess the costs of the terms they include. Thus, OEMs cannot “sneak in” inefficient terms that would go unnoticed. Further, a uniform format, we expected, would minimize drafting costs (why draft a new form if you competitor already produced one?). It would also be consistent with learning externalities (why

¹³ GENERAL MOTORS GENERAL TERMS AND CONDITION (Revised Sept. 2004).

¹⁴ Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 Stan. L. Rev. 361 (1991); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 Virg. L. Rev. 1053 (1977).

start with a fresh form when there is already much experience in interpreting and relying on familiar language in existing forms?). Finally, uniform templates would generate network externalities, by making it easier to compare bids across companies and to price individual terms. In sum, we expected little variation in the OEMs' forms¹⁵.

What we found was a different reality. There is significant variance across the OEM contracts. We examined the boilerplates of nine North American OEMs,¹⁶ and recorded the many ways in which they differ. These differences were also confirmed in discussions with representatives of tier-1 suppliers and of the suppliers' trade association, who emphasized that the differences in the legal terms represent in some cases dramatic variations in the consequences of the deals. This variance, which we describe below, casts doubts on the robustness of a fundamental prediction of the economic theory of contracts, that standard form contracts in sophisticated transactions are efficient. These contracts, recall, are between companies that have legions of in-house attorneys reading the forms in their entirety, who have lifetime experience in the auto business, and who are looking for the contracts to manage huge stakes. If these forms vary in important ways, some of them must include terms that are less efficient—that is, terms that cost the weaker party more than the gains they accord the strong party.

According to all of our interviewees, the most important issues that are addressed by the OEM boilerplate contracts are the following: termination rights, warranties and remedies, tooling (the ownership of the production assets), property rights in technological innovations, and service parts. Let us briefly discuss each of these issues.

¹⁵ See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713 (1997); Marcel Kahan & Michael Klausner, *Standard and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997); Michael Klausner, *Corporate Law and Networks of Economic Effects*, 81 VA L. REV. 757 (1995).

¹⁶ The nine OEMs who assemble cars in North America are: General Motors, Ford, DaimlerChrysler, Honda, Toyota, Nissan, Hyundai, VW, and BMW.

Termination. In all purchase contracts, OEMs secure the right to unilaterally terminate the agreement.¹⁷ This right to terminate, which is not available to suppliers, is almost unrestricted. Either for no cause at all, or for reasons stated ambiguously as “competitiveness” of price and quality, the OEMs can with very short notice terminate the contract. In fact, the cancellation rights are so one-sided that they might render the contracts unenforceable on the ground that they lack consideration or fail to state a quantity term under the statute of frauds.¹⁸ There is variation across OEMs’ forms regarding the payments to which suppliers are entitled upon termination. While all OEMs provide some recovery to suppliers for their squandered investments, some are stingy—they pay only for finished parts, work in progress, and raw materials.¹⁹ Others are more generous:²⁰ they will pay for a combination of other termination costs, such as suppliers’ obligations to their own subcontractors and investments in capital. None of the OEMs cover suppliers’ unamortized investment in R&D and engineering—a great source of agony for suppliers who expect to cover their fixed costs only after several years of supply. Indeed, as we

¹⁷ See, e.g., General Motors General Terms and Conditions §13; Ford Motor Company Production Purchasing Global Terms and Conditions §27; Daimler Chrysler Production Purchasing General Terms and Conditions §20.

¹⁸ Ford’s contract says: “27.01 Termination. The Buyer may terminate the purchase order, in whole or in part, at any time and for any or no reason, upon written notice to the supplier. The supplier may not terminate at its option.” This term replaced an earlier termination clause that required a 30 day notice. Similarly, General Motors’ contract gives it the right to cancel the transaction within 30 days if the supplier cannot match the rivals’ lower cost or competitive technology, design, or quality. The requirement of a written notice in Ford’s contract, and of a 30 day notice in GM’s contract, may constitute the necessary restriction to render these contracts enforceable. See, e.g., Williston, Law of Contracts § 105, at 418-419 (3rd Ed. 1957). Still, courts that have adjudicated similar provisions in lower tier cases have held the contracts to be unenforceable, and recently even in OEM-tier-1 case. See, e.g., Dedoes Indus., Inc. v. Target Steel, Inc., 2005 WL 1224700 (Mich. App.) (Unpublished) (holding that a price quote in which seller promises to supply buyer’s steel requirements for the next three years does not satisfy the quantity provision of the statute of frauds); General Motors Corp. v. Steel Dynamics, Inc., Case No. CR-04-056983-CK (Oak. County, Mich. 2005) (GM’s award letter confirming the purchase of approximately 70,000 metric tons of steel did not satisfy statute of frauds because it contained only an approximate quantity, not a guaranteed purchase.)

¹⁹ See, e.g., General Motors General Terms and Conditions §13; Daimler Chrysler Production Purchasing General Terms and Conditions §20.

²⁰ See, e.g., Ford Motor Company Production Purchasing Global Terms and Conditions §27.03.

shall discuss later, OEMs recognize the potential unfairness of a sudden termination and are willing to grant ad-hoc accommodations that go beyond their legal responsibility.²¹

Warranties and Remedies. An important set of legal terms involves the warranty provisions, which determine suppliers' liability for design defects, intellectual property infringements, and the cost of precautionary recalls. OEMs specify what a fraction of the total liability bill would be borne by suppliers, and grant themselves rights to setoff warranty charges against payments owed to suppliers.²² Typically, when an OEM finds itself liable for a design problem, there may be a genuine dispute as to whether the problem originates from a defective part to which the supplier is liable, or from faulty integration of the part by the OEM. Anticipating such future disputes, OEMs draft standard clauses that grant them self-help power to recover from the supplier. Some of the more harsh terms are exemplified by GM's right to recover 100% of the liability when it unilaterally decides that the parts failed to conform to the warranty, and to setoff the entire charge against the supplier's account. Ford, while stipulating that the supplier's share of liability would be negotiated ex-post, allows itself a unilateral setoff of up to 50% of the cost, to be charged before such negotiation concludes, against the amounts owed by the supplier or any of its affiliates and subsidiaries. Some companies draft terms that entitle them to make the liability apportionment in a unilateral fashion, without the supplier being heard. Others commit

²¹ The willingness of parties to go beyond the boilerplate and to grant concessions that are tailored ad-hoc to the needs of their counterparts is discussed in Jason Johnston, *The Return of Bargain: An Economic Theory of Standard Form Contracts and the Negotiation of Business Relationships* (This Symposium) and in Lucian Bebchuk and Richard A. Posner, *One-Sided Contracts in Competitive Consumer Market* (This Symposium). See also Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 *Amer. Econ. Rev.* 356, 358-360 (1980); Clayton Gillette, *Rolling Contracts as an Agency Problem*, 2004 *Wisc. L. Rev.* 679, 704-707.

²² See, e.g., Ford Motor Company Production Purchasing Global Terms and Conditions § 11.01, 23.06 ("Buyer may set off and recoup against the Buyer's accounts payable to the Supplier any amounts for which the Buyer determines in good faith the Supplier is liable to it. [...] the Buyer may do so without notice to the Supplier." And "at its option, the Buyer may debit the Supplier for up to 50% of the actual recall costs ... if the Buyer has made a good faith determination that the Supplier is likely to be liable for some portion of the total costs ...")

to an arrangement in which the parties will negotiate ex-post the allocation of liability costs, to reflect actual responsibility.²³

In practice, these variations in sharing-of-liability clauses reflect true differences in the cost allocations, and, importantly, they enable different systems of monitoring of defects. It appears that OEMs with the most self-serving warranty allocation terms are also ones that take longest to detect and resolve a defect, that is, they are the ones where the total costs of defects are, on average, greater. A figure mentioned by one of our interviewees quoted the warranty cost per vehicle to be roughly \$1000 for an American OEM which uses very harsh warranty allocation terms,²⁴ but only about \$250 for a foreign OEM that applies a more balanced approach.²⁵ Likewise, the former OEM takes on average 180 days from the time of the first indications of a parts defect till it is resolve; the latter OEM takes only 40 days.²⁶ These figures are consistent with the prediction that parties who believe that they can shift the cost of liability onto others would do less to reduce this cost. Put differently, in situations in which joint precautions by both supplier and buyer are necessary to prevent liability from mounting, or where suppliers can efficiently cure a defect, it is not surprising that the allocation of liability costs makes a big difference in terms of cost-minimization.²⁷ What is surprising is that not all

²³ Some of the lower tier contracts we examined include equally harsh warranty burden on the supplier. For example, some large tier-1 manufacturers put in their own contracts with tier-2s a warranty burden of 100% on the supplier. *See, e.g.*, Delphi Corp. General Terms and Conditions §7.3 (March 2004) (“If and goods are reasonable determined to fail to conform to the warranties set forth in this contract, Seller shall reimburse Buyer for *all* reasonable losses, cost and damages cuaed by such nonconforming goods.” *Emphasis* added). There is an important difference, however, between the OEMs terms and the identical tier-1 terms. OEMs have the power to actually impose almost any share of the liability on their suppliers; Tier-1s, in contrast, are more constrained, as they expect their suppliers to fight back.

²⁴ Jane Spencer, *The Best Car Deal Around: Never Paying for Repairs—New Longer Warranties Open Door to Car Hypochondriacs*, WALL ST. J., Nov. 12, 2002, at D1.

²⁵ Craig Fitzgerald, *Getting Serious About Quality*, AUTOMOTIVE INDUSTRIES, July 2004, at 45.

²⁶ [Confirm these figures with other sources]

²⁷ It is interesting to compare the OEM’s warranty terms with those appearing in the boilerplate purchase contract in Germany (“VDA”), which applies to all procurement contract in all tiers. The VDA’s warranty and remedies provisions give the supplier a greater role in assessing any damage claim, participate in repairs and replacements, and be consulted with before any action is taken by the buyer. The VDA’s terms also limit the duration of

contracts are designed to induce more participation of the suppliers in the warranty process, and thus fail to achieve efficiency.²⁸

Service Parts. The arrangements governing service parts can be both a source of important profit for suppliers, as well as a significant burden. Service parts, it is well known, are sold in the retail market at an enormous premium. If the OEM reserves exclusivity in retailing these parts, the supplier is deprived of a share of potential profits. Moreover, if the supplier is obligated to supply the OEM's requirements for these parts for years after the model production ends, when it is expected that volume efficiency, materials, and skilled personnel will no longer be available, the burden on the supplier can be very costly.

Almost all OEMs require the supplier to agree to supply service parts for a period of 10 to 15 years after current-model production ends. Some, however, are willing to share the surplus that this production will yield. Honda and Toyota,²⁹ for example, stipulate that the service part prices will be negotiated by the parties when the time comes, which in fact translates to a profit-sharing deal. Others (e.g., GM) require prices to remain at their low, production-phase price for an initial period, say 3 years,³⁰ after which a higher negotiated price would be agreed upon. Most harsh are terms that require suppliers to commit to 15 years of post-production supply and to

warranties, reduce their scope when the supplier is not negligent, and allow a host of opportunities to cure. *See* The German Association of the Automotive Industry (VDA) General Terms and Conditions (English Translation, 05.12.2002).

²⁸ Similarly, OEMs draft broad indemnity terms, entitling them reimbursements of legal defense expenses of claims (such as products liability) for which the supplier will ultimately be responsible. Suppliers are nervous about their inability to control or influence the litigation of such claims, and at the same time their responsibility for the outcome of the litigation and its cost.

²⁹ *See, e.g.,* Toyota Motors Manufacturing North America, Inc. Terms and Conditions § 4.2(d) (Oct. 1998) (“[Toyota] will establish, after good faith negotiation with Supplier, a price for Service Parts.”)

³⁰ General Motors General Terms and Conditions §20 (“[...] During the 15 year period after Buyer completes current model purchases, Seller will sell goods to Buyer to fulfill Buyer's past model service and replacement parts requirements. [...] The prices during the first 3 years of this period shall be those in effect at the conclusion of current model purchases.”)

refrain from raising prices above the current production-phase prices.³¹ These provisions were described by a tier-1 supplier as “cyanide pills”—leaving the supplier with the high cost of maintaining a production line but without the ability to recoup this expense through high volume of sales.

The service parts provisions are not only a matter of division of surplus, they also have efficiency implications. In the post-model years, production volume of parts can be very low, and maintaining the production line and the skilled labor can be expensive. Pricing the parts at their original current-model production cost is a poor way to reflect the true wholesale economic price, and may lead to sub-optimal purchase decisions. For example, supplier representatives complained about the OEMs’ reluctance to hold minor inventories of parts, which could have saved the suppliers the need to “turn on the machines” too often to produce small quantities of parts. Schemes that accord the suppliers a greater share of the surplus can create incentives to reduce these inefficiencies.

Intellectual Property. The production of assembly parts often requires the development and application of new technologies that have high value as intellectual property beyond that particular application. Much of this technology passes over to the OEMs in the course of designing the parts and assembling them into the vehicles. The contracts grant the OEMs legal rights in these valuable information assets, not only to use them, but also to control other uses. Again there is surprising variation in the scope of appropriation by different OEMs. The most extreme position in some of the contracts accords the OEMs unlimited rights to all intellectual property of the suppliers disclosed in the course of trade, except for patents registered prior to the

³¹ See, e.g., Nissan North America, Inc. Master Purchase Agreement §19 (2003).

supply.³² Suppliers also waive their trade secret protection, and assign to the OEMs all copyrightable works created under the contract without any royalty rights, for unlimited duration, extending beyond the termination of the contract. The more restrained position, drafted by other OEMs, limits the OEM's right to sublicense intellectual property and guarantees that the confidential information of the supplier would not be disclosed.³³

As will be noted below, some suppliers do not budge and refuse to grant such rights in their intellectual property. Companies whose main business is information technology (IT) are stubborn about this factor, and OEMs have learned to expect that they would not be able to dictate their terms to such suppliers. Indeed, some OEMs have specially drafted IT contracts that accommodate the expectations of their IT suppliers for more balanced terms. Still, most production parts are supplied by manufacturing companies whose main business is not IT, and these suppliers manage to retain less protection to their investment in innovative technology.

Since OEMs do not tailor their intellectual property terms specifically per supplier, the use of boilerplate can be a significant source of inefficiency. Suppliers that have the ability to develop new technologies, but who cannot enjoy the full value of the technology they develop, will have weaker incentive to make investments. We can only speculate whether the OEMs that insist on harsher IP terms end up being the ones that assemble cars that incorporate less technological advances.

Tooling. The investment in machinery and production assets to be used in manufacturing the parts can be very costly. When OEMs pay for these investments in tooling, they state in the contract their ownership of the tooling and that the supplier is entitled to use them only in

³² See, e.g., Ford Motor Co. Production Purchasing Global Terms and Conditions §§ 16, 20.01 (2004); Hyundai Motor Manufacturing General Terms and Conditions §19.

³³ See, e.g., General Motors General Terms and Conditions §14; Nissan North America, Inc. Master Purchase Agreement §15.2 (2003).

serving this OEM, forbidding any commingling with property of the supplier or production for other OEMs. Thus, for example, upon exercising their right to terminate the contract OEMs can haul away the tooling, and even charge the supplier with some of the costs of shipping. When separate purchase orders are issued for the production of tooling assets, some OEMs' boilerplate terms have the effect of eliminating any profit on tooling, by restricting the payment to equal the actual costs of the supplier.

Representatives of Tier-1 suppliers voiced many complaints against the tooling provisions. A repeated complaint was that OEMs refused to allow the use of production assets to serve multiple clients. The strict ownership terms and the restriction against commingling and co-serving can lead to wasteful duplicity of investments, and, of course, to inefficiency.

We present this variation in the contracts as a puzzle, casting perhaps some doubt over the efficient-terms hypothesis. While each OEM has its own boilerplate, there is surprisingly little borrowing from each other. Each OEM knows its competitors' forms well, but rarely copies any provision from them. In this sense, boilerplate in this industry has not risen to the level of "quasi-statute" that it achieved in other industries³⁴. And while many factors can explain the persistence of this variation and the lack of convergence, it is hard to find an efficiency explanation. True, there is some indication that inefficient one-sided terms drafted by OEMs are not strictly enforced. For example, in a section titled "Supplier Frequently Asked Questions" that is appended to its Global Terms and Conditions, Ford explains that one of the most troubling new provisions in this form, the setoff term, was never used literally and only infrequently used

³⁴ Stephen Choi and Mitu G. Gulati, *Contract as Statute* (This Symposium); Michelle Boardman, *Contra Proferentem—the Allure of Ambiguous Boilerplate* (This Symposium).

at all.³⁵ So it is possible that the inefficiency of some terms is only on paper and that in practice the OEMs apply systematic “tailored forgiveness” of some of the harsher provisions.³⁶ Still, it is hard to reconcile this understanding with the vehement opposition that suppliers displayed towards Ford redraft and the collective effort that suppliers invest through their association to change some of the terms.

While we believe that the variations in the boilerplate terms do reflect in some cases inefficiency, it is not our claim that the boilerplate terms are the *cause* of the inefficiency. It is more plausible that many of these provisions, as we will argue below, are tailored to leverage the OEMs’ economic and bargaining power in the negotiation stage into advantages at the performance stage, in which the parties are locked in a classic bilateral monopoly. The legal terms in the standard forms are the tail that is wagged by the business concern, and not vice versa. In an era in which American OEMs suffer record-breaking losses, it is clear that any opportunity to shift cost to suppliers would be embraced. It is a classic agency problem: agents find ways to save costs in the domain which they control, but often neglect to consider the effect of these cost saving measures on activities which they do not control. If the pressure on suppliers is strong enough, they’ll accept harsh terms and low prices. And if there are inefficient consequences, they will eventually be counted on the scorecard of a different internal division. The lawyers and purchasing officials who write and negotiate the supply contracts invest much effort in tightening up the legal terms, and in leveraging the OEMs’ bargaining power in securing maximal adherence to these terms.

II. Drafting of Boilerplate

³⁵ Ford Motor Company Production Purchasing Global Terms and Conditions, Supplier Frequently Asked Questions, Section 11.02 (2004).

³⁶ See Jason S. Johnston, , *The Return of Bargain: An Economic Theory of Standard Form Contracts and the Negotiation of Business Relationships* (This Symposium).

One of the striking features of automotive supply contracts between OEMs and their Tier-1 suppliers is their simplicity. Each OEM has a single form, used for procuring all of the manufacturing parts. General Motors, we mentioned, enters into roughly one million procurement contracts every year with suppliers all over the world, and with very little exception these deals are governed by GM's "Global Terms" and never get challenged, neither at the negotiation stage (e.g., by battle of the forms) nor in litigation.³⁷

A notable feature of these boilerplate forms is their durability. DaimlerChrysler, for example, is still using the form that was drafted in 1985; GM's form goes back to 1986. Ford's old form was in place since the 1950's, until recently revised in quite a dramatic fashion in 2004. While minor revisions are patched onto these forms occasionally, addressing "new" problems,³⁸ the main terms and conditions remain unchanged over a long period of time. This rigidity of the forms is not so much a feature of interpretive or learning externality (that is, the adherence to something familiar), but rather a reflection of an OEM's belief that the terms in their form work well and serve their profit goals.

These boilerplate contracts are simple. The terms are written in plain English. Although most of the Tier-1 suppliers are large corporations with sophisticated legal counsel who read every word of the OEM contracts, and although each provision in these contracts can have significant effects on the division of the surplus, the clauses are drafted in a much simpler and

³⁷ Only three such cases were found. In the most recent, GM was granted summary judgment. *See* Narton Corp. v. General Motors Corp., No. 232085, 2003 WL 1985261, at *9 (Mich. Ct. App. April 29, 2003). Another only arose because of an ex post fight over an indemnification provision; a third party was hurt while installing a piece of equipment at GM's plant and the equipment manufacturer tried (successfully) to get out of the indemnification provision that was in GM's purchase order. *See* Hallberg v. General Motors Corp., No. 87 C 6478, 1989 WL 153340 (N.D. Ill. Nov. 2, 1989). The only other case is from 1979. *See* S.C. Gray, Inc. v. Ford Motor Co., 286 N.W.2d 34 (Mich. Ct. App. 1979).

³⁸ An example for the type of revisions we observed is GM's employment conditions clause, requiring the supplier to refrain from engaging in "corrupt business practices" such as utilizing child and prisoner labor. *See* General Motors "General Terms and Conditions", Revised Draft (September 2004) § 25.

shorter form than ordinary consumer contracts. For example, GM’s warranty provision is three sentences long. The main part says that

“Seller warrants/guarantees that the goods covered by this contract will conform to the specification, drawing, samples, or description furnished to or by Buyer, and will be merchantable, of good material and workmanship and free of defect.”³⁹

The warranty paragraph adds that the goods “will be fit and sufficient for the particular purposes intended by the Buyer” and that the duration of the warranty will match the warranty provided by the Buyer to its customers.⁴⁰ This paragraph is strikingly different than warranty terms in, say, consumer contracts, which are usually lengthy, cumbersome, and legalistic. Perhaps this difference owes to the greater government regulation of consumer warranties; perhaps it has to do with identity of the drafter—a buyer or seller. A seller-drafter needs to avoid the sweeping warranties of the UCC, whereas buyers like the OEMs need only to strengthen these pro-buyer UCC warranties. Note, also, that the difference between warranty terms in the auto production context and other, consumer-related contracts, cannot be explained by factors like trade usages and course of dealings. The supplier’s warranty to the OEM is governed solely by the express warranty term.

Since boilerplate terms have to deal with many different types of situations and address many possible contingencies, drafting the standard form from scratch would seem a daunting task. It is often perceived, therefore, that the drafting of boilerplate language in mass contracts involves not much more than a cut-and-paste task, whereby the “drafter” identifies similar forms used by other organizations that do similar business and—on the premise that ‘if they work for

³⁹ See General Motors “General Terms and Conditions”, Revised Draft (September 2004) §9

⁴⁰ Ford’s Purchase Order form is an exception, in that it is a long contract stretching over 31 pages. This form, which was launched in 2004 following a significant overhaul, also contains simple language, but it covers many more contingencies than other OEM contracts. Still, Ford’s warranty term is almost identical to GM’s, and equally short.

others they'll also work for me'—borrows their language.⁴¹ Interestingly, however, the American OEM supply contracts were not drafted in this fashion. Each OEM contract was drafted by in-house attorneys in a concentrated effort over a short period of time, with very little revision since.⁴² Unlike the drafting work done by outside law firms, the in-house drafting attorneys have a task that is on-going. While revisions in the forms are rare, the drafting attorneys remain with the organization for a long period of time, carrying with them the “institutional memory” concerning the drafter’s intent and the rationales for the chosen language. Memory, of course, is a necessary trait for parties who enter long-term relationships or into portfolios of deals, where violations are addressed (and deterred) by informal sanctions within the relationship or by refusals to deal.

Given the simplicity of the forms and the ambitious goal to apply them to each and every manufacturing parts contracts, how do OEMs overcome the different needs and objections of their thousands of Tier-1 suppliers? Part of the answer, of course, concerns the performance and enforcement strategies, which we will discuss later. There, we will show, some patterns of flexibility have emerged. In the contract formation stage, however, we observe very little flexibility. Either take our contract as it is, or leave. This rigidity is maintained in several ways, as explained below.

No Battles of forms. Battles of forms, where the seller responds to the OEM’s purchase order with a confirmation that contains different boilerplate terms, have the standard result that conflicting terms on both sides drop out. The battle of the forms might, of course, enable a

⁴¹ There are many theoretical accounts of this “stickiness” of boilerplate. See, e.g., Marcel Kahan and Michael Klausner, Standardization and Innovation in Corporate Contracting (Or “The Economics of Boilerplate”), 83 Va L Rev 713, 761-64 (1997); Robert B. Ahdieh, Between Mandate and Market: Contract Transition in the Shadow of the International Order, 53 Emory L J 691 (2004); Choi & Gulati, *supra* note __, at 61; Omri Ben-Shahar and John Pottow, *On the Stickiness of Contractual Default Rules*, Florida St. L. Rev (Forthcoming, 2006).

⁴² *But see* Klaus-Dieter Floercke, *German Suppliers Revolt Against Ford Motor: Vendors Demand Contract Revisions*, AUTOMOTIVE NEWS, Apr. 19, 2004, at 10.

supplier to substitute their own terms for some of the OEM's more onerous terms. One might predict that the battle of the forms would be common in automotive contracting.

As far as we were able to determine there is no battle of the forms maneuvering against OEMs.⁴³ We could not find reference to a single legal dispute on battle of the forms with an OEM, and none of the OEM or tier-1 representatives were able to quote an example.⁴⁴ Battles of the forms disputes are avoided, not by forcing the supplier to acquiesce ex post to the OEM's terms. Rather, they are prevented ex ante by the OEMs insisting at the time that bids are invited that, as a condition for bidding, the supplier must agree to be bound by the boilerplate terms of the OEM's form. Since the bidding occurs before the contract has been "issued" and at the time when the supplier's position is the weakest—at the time in which its refusal to commit to the OEM's boilerplate could cost it the opportunity to bid⁴⁵—it is not surprising that most tier-1 suppliers agree not to engage in the battle of the forms and instead sign or otherwise agree to a form that binds them to the OEM terms.

Suppliers who do attempt to sneak in their boilerplate terms either on the invoices or acknowledgments or through what they sometimes call "letters of interpretation" or side-memos are generally doomed to fail. OEM attorneys instruct their purchasing managers to abort any incipient attempt to do the battle of the forms by affirmatively rejecting any of the sellers' forms or by getting the seller's signature on the buyer's form. The same is true for other sophisticated, high-tier buyer when dealing with the forms of their own down-stream suppliers.⁴⁶

⁴³ We suspect, but we could not confirm, that the battle of the forms may occur as one goes deeper into the supply chain down to Tier three and Tier four suppliers.

⁴⁴ *But see supra* note 30.

⁴⁵ For example, suppliers who objected to Ford's new Global Terms & Conditions "were threatened with new business hold and award of pending business to competitors." One survey shows that 31 out of 46 Ford suppliers were warned that they will experience business reduction if they refuse to accept Ford's terms. *See* "Ford Global Terms and Conditions: Status Report Web Conference," OESA (April 2, 2004)

⁴⁶ The finding that battles of the forms almost never occur is based on many conversations with attorneys in the industry. It may well be, though, that the picture portrayed by attorney is not precise. Purchasing agents and

No Authority to Dicker. Another way in which OEMs prevent deviations from their own terms is by restricting the authority of agents within the organization to approve different or additional terms. Suppliers in the chain periodically try to negotiate or change the terms of the boilerplate imposed by the OEMs or other buyers. Both OEM and supplier representatives agree that changes in the boilerplate resulting from negotiations with an individual seller are as rare as hens' teeth. Ford, for example, has erected a clever and conscious barrier to such negotiation. At that company, only the global vice president for purchasing has the authority to change the terms on the form contract. Similarly, in another OEM we observed a procedure in which only a senior purchasing committee of executives can approve a variation from the standard terms. By taking the authority away from the lower level purchasing agents and their executives, and granting it only to a person who presumably does not answer every phone call, these companies have raised a significant barrier to negotiation. Thus, no revision of a term can occur unless the person proposing it can talk to someone in authority or can persuade a lower level person to do so. And what first level purchasing manager wishes to besmirch his in-firm reputation as a tough negotiator and impair his chances for advancement by proposing to the big boss that the company make concessions to a tier-1 supplier? In fact, this barrier is recognized by suppliers as credible and intimidating, discouraging them from even demanding that some term be negotiated.

Furthermore, any variation in the legal terms would need drafting by a staff attorney. The legal offices of the OEMs simply do not have the resources to oversee frequent changes in the

engineering officers may have a particular interest in the deal—say because of the attractive price or the unique technology offered by the supplier—which would lead them to care little whether some “legal” terms are contested in a boilerplate letter sent by the supplier. The attorneys’ score card, on the other hand, depends on their success in blocking ex-post disputes and securing the most favorable boilerplate terms. It is perhaps this desire to boast and to display a successful legal record that distorts the picture we report.

thousands of contracts entered into daily. This lack of legal capacity is another internal organization hurdle, known to suppliers and deemed credible by them, that blocks any process of dickering over the legal terms.

Equality of Treatment. Another factor that limits the incidence of variation from the boilerplate terms is the strong formal commitment of OEMs to treat all their suppliers equally. Of course, transactions with suppliers vary significantly with respect to the goods purchased, prices, volume, and the like. But all suppliers—from the mega corporations who produce car frames to the sellers of nut and bolts—must take the same legal terms: payment provisions, termination rights, warranties and remedies, and the like. OEMs believe that the fact that these terms are presented as non-negotiable and that variations are not approved provides their suppliers the clarity that there is horizontal equity, that everyone is treated the same. In fact, this equity factor is a reason why one of the OEMs recently revised its entire set of boilerplate provision. It clarified to its suppliers that any concession negotiated by them in previous contract will of course be honored for the duration of that contract (usually one year), but thereafter all term revert to the new set of “Global Terms and Conditions,” and the old concessions would expire unless affirmatively approved by the vice president.⁴⁷ OEMs believe that suppliers recognize that for the OEM more is at stake than the individual concession. Their implicit position—“if we give one of you an accommodation, we’ll have to give it to others”—works strategically to block any accommodations, in the same what that most-favorable-nation clause bolster the commitment to avoid price discounts.⁴⁸

⁴⁷ Ford Motor Co. Production Purchasing Global Terms and Conditions §4.09 (2004)

⁴⁸ AVINASH K. DIXIT & BARRY J. NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE 147-48 (1991).

Open Ended Provisions. The automotive industry is the typical example for a market in which contractual arrangements are long-term. This is particularly true of OEM/Tier-1 relationship, where specific agreements to procure parts as long as the car model is produced, normally 4-8 years, but relationships extend beyond a single model, to encompass many such car-model contracts, and to cover the many years of supply of service parts. Given the difficulty of anticipating many factors that may become relevant in the course of performing the agreements, it is commonly noted that the contracts signed upfront must exhibit flexibility and must leave room for governance by ad-hoc adjustments, agreements to agree, and informal norms. Indeed, the OEM boilerplate forms, although “tight” in many respects, contain many open-ended provisions that leave it for the parties to determine, in due time and if the contingency arises, matters of significant value. These open-ended clauses include price adjustments for changes in design; allocation of liability regarding the cost of recalls and other failures of components; indemnification of litigation costs in defending against injury claims by car owners and infringement of intellectual property claims; and more. These clauses leave it for the parties “attempt in good faith to reach agreement” or to “negotiate diligently” the precise ex-post term. In this way, upfront dickering is avoided, and suppliers are willing to accept the contract although none of their needs are directly addressed.

Interestingly, OEMs use such open-ended provisions to address some of the issues that would otherwise be most troubling for suppliers. When Ford recently redrafted its entire form, suppliers were invited to voice their concerns and reactions to the proposed draft. While these meetings were not an open invitation to negotiate the new terms, they did represent the closest thing to negotiations over boilerplate, whereby uniform objections by suppliers did lead to some—albeit minor—changes in the draft. Specifically, suppliers were disgruntled over terms

that allowed OEMs to impose costly changes in design, terms that permit OEMs to set-off any cost incurred in servicing a recall or a warranty against the account of the supplier of the allegedly defective part, and terms that allocate a fixed share of the liability to the suppliers. Not surprisingly, it is with respect to these issues that the OEM elected to implement open-ended terms, postponing the dickering of the actual resolution of individual cases, if the issues arise, to the post-performance stage.

The dissemination of boilerplate terms across tiers. OEM contracts with their Tier-1 suppliers affect the contracts entered into in lower tiers. Tier-1 suppliers, being strapped to the onerous OEM terms, turn around and offer the same terms to their own tier-2 suppliers. Of course, they may have less bargaining power to mandate their own terms, but at least the very large tier-1 companies—the 25 or so mega-corporations like Delphi and Visteon that supply a large portfolio of parts—ordinarily have enough leverage to require suppliers to use their terms. Representatives of tier-1 suppliers admitted to us that they would have much preferred to use a more balanced contract both upstream and downstream. But given the OEM terms that are imposed on them in their capacity as sellers, they cannot afford to use other terms in their capacity as buyers. A striking metaphor that a tier-1 representative used is “contractual DNA.” Looking at contracts down the supply chain, one can identify the OEM for which this supply is eventually intended by the terms of the lower tier contracts. With each tier buyer copying some of the terms it had to accept as a supplier, the OEM’s terms are “genetically” replicated down the chain.

The special position of tier-1 suppliers explains their ambivalence towards the otherwise concerted effort of suppliers in the automotive industry to advocate for more “fair” contracts. Some of this effort is coordinated by the suppliers’ association, OESA. One of the project of this association was the drafting of Model General Terms and Conditions, which is self-proclaimed

to be “fair to both parties” and would “help increase cooperation and communication between buyers and sellers.”⁴⁹ Tier-1 representatives have generally been less than enthusiastic, however, in supporting this initiative. Their concern is that if such an initiative would succeed and the use of the model terms would become a standard request of suppliers, it would harm their position vis-à-vis their lower tier suppliers, without helping them much vis-à-vis the OEMs. If a tier-1 supplier has to sign a fixed-price contract with an OEM for 5 years, he needs a contract with a tier-2 supplier that extends for the same period of time to enable him to maintain the fixed price.⁵⁰

III. Economic Power

Although courts and lawyers sometimes talk about form contracts as non-negotiable and subject to no limits, we know that is not true. Some drafters pull back from the limit of their economic power, some decline to exercise the rights that their contract gives, some contracts are invalidated by courts and others are constrained by legislation, regulation or by threat of litigation or legislation. In this part we examine how market power shapes the deals and the contracts, with an eye to the specific provisions in the OEMs’ purchase orders that are aimed at securing their economic power.

At the outset of this study, we hypothesized that OEMs’ bargaining power would be strongest at the bidding and contract formation stage, and decline once relationship specific investment were made and performance began. We imagined that one once the OEMs become dependent on a supplier, they would face instances of holdup, where the supplier demands better

⁴⁹ <http://www.oesa.org/publications/index.php>

⁵⁰ In Germany an organization called [VDA] negotiates with the OEMs on behalf of the suppliers. The OEM forms used in Germany are the product of this collective bargaining. If initiatives in the U.S. like OESA’s are to succeed the way they succeed in Germany, they have to start with the OEMs; the term will then trickle down the supply tiers. Because the OEMs do not appear willing to enter into such a bargain and because the tier-1 suppliers cannot afford to enter into a bargain with the OEMs entering into one first, we do not foresee a collective agreement in the United States among the suppliers and the OEMs of the kind that apparently exist in Germany.

price and other terms. The standard hold up account seems to fit perfectly this situation—in fact, the hold up theory was developed in the context of the GM/Fisher Body saga, which was an OEM/tier-1 relation. This hypothesis turned out to be surprisingly misguided, as we will explain below. We also hypothesized that economic power would echo down the supply tiers, with tier-1 suppliers being dominated by OEMs but exercising their own dominance over tier-2 suppliers. This too turned out to be only partially true. Some powerful companies, such as Exxon and General Electric, are in the tier-2 levels and are able to wield power because of their size and product mix. Other tier-2 suppliers have power because of their wide base of clients, extending beyond the automotive industry, and can afford to pass on automotive contracts. Yet other low tier suppliers have power that is supported by the uniqueness of their technology. Finally, the financial integrity of a firm turned out to affect its economic power in ways that are more subtle than we expected.

As we mentioned above, the OEM representatives freely admitted that their forms included most terms that the drafters thought necessary or helpful to protect their clients' interest, and that they did not feel obliged to add similar terms that their sellers' might have liked. For example all of the OEM contracts (and presumably most between suppliers) give the buyer the right to terminate the contract without cause in certain circumstances and to cancel it for cause in other cases. The sellers get no corresponding rights of termination or cancellation. This power, along with the absence of a quantity commitment on the part of the OEM, make the contract so one-sided that it runs the risk of being unenforceable.⁵¹ European suppliers have complained that such one-sided terms would be unenforceable under various European doctrines of contractual fairness, competition law (e.g., the term prohibiting suppliers from selling part in

⁵¹ We are aware of only one case in which a supplier rejected the contract and argued lack of mutuality. See *General Motors Corp. v. Steel Dynamics Inc.*, (unpublished, Mich.)

the aftermarket), and corporate governance (does the supplier's corporate executive have the internal authority to sign such a poor contract without shareholder authorization?)⁵²

How far can OEMs go in drafting one-sided terms? Surely, if suppliers have choices, they can bargain away these clauses. But for automotive suppliers who sell a large chunk of their output to OEMs, in a market in which suppliers suffer severe over-capacity, there does not appear to be much choice. A CEO of one of Ford's suppliers was quoted in the *Automotive News* to say that Ford's terms are effective in "closing every possible loophole. We're responsible for acts of God now."⁵³ At the same time, the collective disgruntlement that echoed in the suppliers' corps did not change any of the terms. Another supplier admitted that "if you don't have a point of leverage, you don't have much ability to fight back."⁵⁴ Other attempts by suppliers to collectively draft a more favorable form to the seller, which were made under the umbrellas of their trade association (OESA),⁵⁵ have not as far as we can tell influenced even a single term of the OEMs' contract forms.

Lower Tier Contracts

When we move down from OEM contract to lower tiers in the supply chain, bargaining power is no longer one-sided. Tier-1 suppliers cannot exert the same influence on tier-2s as OEMs exerted against them. For one, Tier-1 suppliers do not offer the same magnitude and uniqueness of deals as OEMs. If an OEM turns down a bid by a manufacturer of passenger seats, a big chunk of the business cannot be salvaged. On the other hand, if the same manufacturer of seats breaks the negotiations with the supplier of leather, that supplier would have many other

⁵² Bradford Wernle, *Ford Vendors Balk at Tough Contract – Terms Are Called Invasive, Illegal*, AUTOMOTIVE NEWS, July 5, 2004, at 8.

⁵³ Amy Wilson & Brad Wernle, *Ford Give Suppliers Tough Terms – Parts Makers that Don't Comply May Lose Business*, AUTOMOTIVE NEWS, Feb. 16, 2004, at 1.

⁵⁴ *Id.*

⁵⁵ OESA, *supra* note 11.

business opportunities. Moreover, under contracts with OEMs, tier-1 suppliers occasionally are bound to use specific tier-2 suppliers. Similarly, once awarded a big contract by the OEMs, tier-1s have less flexibility to turn down suppliers. Time is of the essence and the tier-1 supplier must secure its own sources of supply, exposing him to potential hold-up by a tier-2 supplier who is particularly well-positioned to supply the goods in time.

Still, we find that tier-1 suppliers have some success overcoming these weaknesses and imposing their own terms on their suppliers. Some tier-1 self-drafted contracts include terms that their own attorneys admit are more onerous than the OEM terms. For example, the tier-1 contract we saw provided that the tier-2 supplier must indemnify the buyer for 100% of the liability that the buyer bears vis-à-vis the OEM. That is, while OEM contracts leave the issue of the division of liability for costly recalls and other defect either open, or impose a 50%-unless-otherwise-agreed-upon split, the tier-1 contract imposed a 100% liability on the supplier.⁵⁶ The reason, it was explained to us, is that OEMs have the ex-post power, once a recall occurs, to dictate the supplier's share, and there is not much a disgruntled supplier can do other than plead for a fair allocation. On the other hand, tier-2 suppliers can fight back and in some event go to litigation or arbitration to settle these issues. Thus, to counter the greater ex-post power of tier-2s, that contract was written in a more onerous term.

Moreover, when terms are disputed by their suppliers at the negotiation stage, tier-1 companies resort to what can be labeled a "golden rule." Since pro-buyer boilerplate terms were imposed on the tier-1 by the OEMs when the tier-1s played the role of a seller, it is only fair that the tier-1 company would use symmetric terms in their roles as buyers. The argument made by tier-1s, that they cannot afford to give their sellers better terms because they cannot turn around

⁵⁶ See Delphi Corp. General Terms and Conditions, *supra* note 23.

and negotiate similar concessions as sellers to the OEMs, is often successful. It is this mechanism that causes the OEM terms to be replicated downstream.

Sellers' Power due to Switching Costs

An important factor that appeared to influence the contracts among the OEMs and suppliers is the OEMs' significant switching costs. All of the OEM representatives, while recognizing that they have much of the bargaining power at the bidding stage, acknowledged that the pendulum shifts and suppliers may have some power in the course of carrying out a long term contract. Many current contracts are for intricate sub-assemblies that will be installed wholesale into a finished automobile. For example an OEM might buy the entire heating and cooling system from a supplier, and the supplier might be the principal designer of the system. Since any such system must integrate with the car's electrical and other systems and must conform to the physical location that is set aside for it in the completed automobile, the "part" may be unique. It is this uniqueness that accords the supplier the power.

Put differently, there are high switching costs in auto manufacturing. Switching costs are high because of the significant technological investments that other suppliers would have to expend to be able to fill the required order. For example, a tier-1 supplier may make all of the frames of high volume vehicle. That supplier built an assembly line to manufacture the frames and had considerable difficulty meeting the OEM's technological requirements. These same complexities of building and operating an entire assembly line would confront any new supplier if the OEM fired its current supplier. Such difficulties cannot be overcome in a short period of time.

Switching costs are also high because safety problems. If the supplier's work relates to the brakes, engine operation, passenger restraints or the car's suspension, defects may pose

safety risks and may be an integral part of the OEM's satisfaction of governmental safety regulations. If the replacement of a supplier's part with another's would require additional safety tests to comply with governmental regulations, one can be sure that any change of suppliers would be costly and time consuming. Moreover, even without having to comply with safety regulations, switching costs may be high because of the need to integrate the component with other parts and to test its performance before assembling it into the vehicle. It is for these reasons also that an OEM usually relies upon the "sole-source" supply method, under which it purchases its requirements of parts or raw materials from one supplier. Using more than one supplier—either by switching over time, or contemporaneously—would significantly increase the testing and tooling costs, lead to inconsistent quality, and undermine economies of scale.

If an OEM who abandons a supplier would suffer prohibitive costs in finding and qualifying a replacement, it may be conjectured that the original supplier has some economic power over the OEM for the contracted goods or services for some period—perhaps even to the end of the model run of the vehicle in which the part or assembly is installed. This power, we should expect, would be at its height shortly after production commences when the supplier looks forward to five years of work, and when the competing bidders have turned to other things. In fact, this conjecture—that a tier-1 supplier can exert hold-up power against an OEM after production begins—is widely recognized as *the* benchmark example in economic theory for the general problem of contractual hold-up. The standard account of the hold-up problem was developed and generically illustrated in the context of the very same OEM-tier 1 contracts that we explored. It suggests that in the 1920s Fisher Body (a tier-1 supplier of automotive bodies) had a 10-year requirements contract with General Motors. When GM's requirements increased due to the greater demand for closed-body cars, Fisher Body enjoyed an "intolerable" position to

hold up General Motors and to refuse to make adjustments that are overall efficient, and was therefore acquired and vertically integrated into GM.⁵⁷ It is not clear how much evidence substantiates the GM/Fisher Body hold-up story,⁵⁸ and yet it seems plausible that in light of the high switching costs, OEMs would indeed be vulnerable to rent-extraction. As one leading economist explains:

“Why did GM and Fisher Body not simply write a better contract? Arguably, GM recognized that, however good a contract it wrote with Fisher Body, [...] contingencies might occur that no contract could allow for. GM wanted to be sure that next time around it would be in a stronger bargaining position; in particular, it would be able to insist on extra supplies, without having to pay a great deal for them.”⁵⁹

Our own findings suggest that, at least in the automotive business, this bargaining position/hold-up account is misguided. For one, the contracts are pretty good at dealing with this problem, as we will show below. But even without looking into the contractual language, this account ignores the fact that each individual transaction is only part of a larger portfolio of business, both concurrently and into the future. Even for unique goods, the power of the supplier to hold its buyer up is effectively limited. If the seller uses his power to engage in explicit hold up (e.g. “Give me an increase in price or I won’t ship.”), he knows he will lose in the long run. One OEM representative emphasized that the buyers “have long memories” and assured us that a successful threat by a seller would surely count against him in the award of new contracts. Even more threatening, the representative told us that a major disruption at one OEM is likely to

⁵⁷ See Klein et al. *supra* note 1; Benjamin Klein, *Vertical Integration as Organizational Ownership: the Fisher Body – General Motors Relationship Revisited*, 4 J.L. ECON. & ORG. 199 (1988). The Klein account of the Fisher Body – GM merger and its illustrative role for the theory of the firm has been widely embraced. See, e.g., Yorisho Miwa & J. Mark Ramseyer, *Rethinking Relationship-Specific Investments: Subcontracting in the Japanese Automobile Industry*, 98 MICH. L. REV. 2636 (2000).

⁵⁸ In recent studies, Ronald Coase and others have argue that GM takeover of Fisher Body did not intend to solve contractual hold-up by Fisher Body—in fact, no such hold up ever occurred—but rather to secure GM’s stronghold over a critical supplier vis-à-vis other OEMs. See Ronald Coase, *The Acquisition of Fisher Body By General Motors*, 43 J.L. & ECON. 15 (2000); Douglas Baird, *In Coase’s Footsteps*, 70 U.Chi. L. Rev. 23 (2003); Robert Freeland, *Creating Holdup Through Vertical Integration: Fisher Body Revisited*, 43 J.L. & ECON. 33 (2000); Ramon Casadesus-Masanell & Daniel F. Spulber, *The Fable of Fisher Body*, 43 J.L. & ECON. 67 (2000).

⁵⁹ OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 7 (1995)

become known to the others and to be considered by other OEMs when bids are being evaluated. Representatives of suppliers concurred with this skeptical view. If a supplier puts a gun to the head of the OEM, it will be “suicide,” they claim; the short term benefit from extracting some concession will be more than offset by the long term reputation sanction.

The myth that suppliers can engage in hold-up overlooks a very basic fact. Suppliers trying to hold-up OEMs must threaten to halt production of a part that is necessary to keep the assembly line working. Such a threat, if carried out, would lead to enormous losses, constituting an entire “melt down” in the industry. The tier-1 supplier who commits such hold up would therefore be subjected to potentially bankrupting damages, some of which can be set-off by the OEM against the supplier’s account as a matter of self-help. Moreover, the OEM would likely be able to get injunctive relief,⁶⁰ thus barring such threat from being carried out in the first place. In other words, the hold-up account assumes lethargic contractual obligation and legal enforcement, which is probably the opposite for the truth.

Moreover, in his rebuttal of the Fisher Body myth, Ronald Coase speculated that problems of supplier hold up can be addressed by OEMs contractually.⁶¹ We have seen some evidence for such contractual arrangements. First, OEMs have almost unconstrained authority to terminate contracts. That is, if anyone has the contractual power to threaten to walk away, it is the OEM, not the supplier. True, they may not want to terminate a contract for supply of unique parts, but they can threaten to terminate other contracts with this same supplier, to “phase out” its business. Second, OEMs maintain significant property rights in “tooling,” namely in the machines and production assets at the suppliers’ plants, and they can haul these assets away once

⁶⁰ Johnson Controls, Inc. v. A.P.T. Critical Sys., 323 F. Supp. 2d 525 (S.D.N.Y. 2004).

⁶¹ See Coase *supra* note 56.

the contract is terminated, often with only stingy compensation for suppliers' sunk investment.⁶² Thus, a supplier is in effect posting a bond against hold-up: their investment will be amortized in the course of production, but only if they stick around for the long haul.⁶³ Third, OEMs reserve themselves, in other boilerplate terms, the right to control the very profitable market for service parts for years, sometimes decades, into the future, and to potential share this profit with suppliers. Suppliers that hold-up the OEM in the short run will lose in a big way in the division of the aftermarket surplus. Finally, buyers in this industry do enjoy some success in securing court injunctions against breach,⁶⁴ and can thus fend off suppliers who are holding up in order to renegotiate existing terms.

In his rebuttal of the GM-Fisher Body myth, Coase then is correct in asserting that contractual provisions can protect OEMs from hold-up.⁶⁵ But a more important aspect, we believe, and one that is also recognized by Coase, is that the “concern for their reputation would also have deterred the Fisher brothers from engaging in [hold up].”⁶⁶ The explanations we heard from all the participants confirmed that it is indeed the OEMs' long memories and the sanctions they can levy upon bad supplier in future deals—that is, reputation sanctions—that render hold up a bad strategy for tier 1 suppliers. Any short term gain to be had by offensive bargaining tactic will be greatly offset by long term losses in future deals. The “hold-up myth” fails because it is based on a false empirical assumption that suppliers specialize in a single part/assembly. In

⁶² See also Baird, *supra* note 58, at 26 (noting that the GM/Fisher hold up account is not plausible because GM could have retained ownership of dies, which it would be able to retrieve in case Fisher engaged in hold up.)

⁶³ This ownership-of-tooling mechanism may appear to conform in part to the Klein-Crawford-Alchian hypothesis, that the problem of hold-up is addressed through vertical integration. See *supra* note 55. What we found in the contracts is indeed an ownership solution, but not one that rises to complete integration. Instead, OEMs have devised a sophisticated scheme in which they maintain partial ownership rights in the supplier's tooling, rights that gradually diminish over the life of the contract, as the hold-up scare diminishes. The rights do not give them actual control of the organization of production, but may allow them to exclude commingling and other uses, thereby reduce the alternative value of the assets to the supplier.

⁶⁴ See, e.g., *Delphi Automotive Systems v. Eaton Corp.*, Case No. 05-55257-CK (Saginaw County, Mich. 2005).

⁶⁵ Coase, *supra* note __, at 30.

⁶⁶ *Id.* at 30.

reality, many of the suppliers—and the large ones in particular—supply hundreds of parts and assemblies to the OEMs. Their business is not to supply a part, but a portfolio of parts. Even if they have some power with respect to one part, it does not change the fact that as suppliers of *portfolios* whose only clients are the few OEMs, they are captives, rather than hijackers. That if, the business plan of these supply firms—large diversified companies that specialize in automotive parts—is to build a symbiotic relationship with their clients, a fabric of reliability that will be completely undermined by hold-up.

Thus, if long term contracts confer power on the weaker seller, but if the seller cannot engage in hold-up, how is that power used? First the power ameliorates the standard contract termination or cancellation terms. If the buyer cannot find a replacement, he cannot exercise his legal right to cancel. Second, particularly with a weak supplier, the contract may mitigate an OEM's setoff or hold back of funds earned where the OEM claims that the supplier broke the contract. If the supplier is in a weak financial state, the OEM risks losing the supplier's production if it reduces the supplier's cash flow by setoff. We suspect that the seller's power is also expressed in more subtle effects on the buyer's use of its boilerplate. For example we can imagine buyers hesitating to be as aggressive as they might be in using the boilerplate indemnity provision against an important seller. As we suggest above, a seller needs to be felicitous in its use of this power (e.g. "Can you give me some help with my increased material costs."), to escape identification as a chiseler who should be avoided when new contracts are awarded. Further, since many tier-1 suppliers produce a portfolio of parts, they can leverage the power they have in the supply of one crucial component to secure additional deals for other parts.

Bankruptcy

The picture of a weak tier-1 supplier, squeezed by powerful OEMs that demand ever growing discounts, can change dramatically when the supplier experiences insolvency. When this happens, suppliers' threats to stop performing critical contracts become credible. They are credible because they come not from a company that is concerned with long term business, but from stern bankruptcy workout specialists who have no attachment to next year's business or even to next month's if current crises could be surmounted.⁶⁷ In the automotive industry of today, where suppliers' bankruptcy has become a real danger,⁶⁸ and their threat to file in Chapter 11 more credible, many suppliers who are known to be suffering losses have a more powerful negotiation position vis-à-vis their buyers.⁶⁹

Ironically, at times when the supplier's costs increase unexpectedly it is that very weakness of the supplier's economic power and its inability to secure modifications to the contracts with the OEMs that can send it to bankruptcy, and eventually bolster the credibility of its threat. Threats from the weak and desperate are more powerful than threats from the strong and rational. Indeed, the increasing hardship of the American automotive industry provides ample examples of this unfortunate dynamic.⁷⁰ They confirm that tier-1 suppliers have no power

⁶⁷ For a general discussion of why threat to breach become credible in bankruptcy, see Oren Bar-Gill and Omri Ben-Shahar, *Credible Coercion*, 83 TEX. L. REV. 717 (2005). See also Jeffrey McCracken, *Plan OK'd for Aid to Keep C&A Supplying*, DETROIT FREE PRESS, July 8, 2005, available at 2005 WLNR 10705184.

⁶⁸ During the time we conducted this study, four major automobile suppliers have filed in Chapter 11: Tower Automotive (a builder of frames for the Ford Explorer), Intermet (a steel supplier), Meridian (a steering parts producer) and Collins and Aikman (a maker of plastic trim, interior fabric and plastic parts such as dash board consoles and head liners). See Robert Sherefkin, *Suppliers' Woes Put Bond Ratings on the Junk Heap*, AUTOMOTIVE NEWS, Aug. 8, 2005, at 1.

⁶⁹ For example, the behemoth tier-1 supplier Delphi recently issued a threat to General Motors and to the UAW, demanding renegotiation of many prior agreements. See Brett Clanton, *Delphi's Troubles May Cost GM*, DETROIT NEWS, Aug. 31, 2005, at 1.

⁷⁰ One prominent example is Collins and Aikman (C&A), a tier-1 supplier who entered bankruptcy in May 2005. This company, which makes parts used in 90% of American cars, many of which are irreplaceable complex assemblies manufactured in factories that are symbiotically attached to OEMs' plants, was unable to leverage the uniqueness of its products into profitable contracts. The more it grew, the more dependent it became on future contracts from the OEMs and the weaker was its economic power in the bargaining game. When C&A filed for bankruptcy under Chapter 11, it threatened to stop performance unless its contracts are renegotiated and the prices increased—that is, it engaged in classic old-up. Given its well known cash shortage and the demands of unsecured

to hold-up the OEMs when the OEMs know that their suppliers regard the costs of long term retribution as greater than the near term gains from improved terms. But when retribution loses its effect, hold-up can be significant. Still, suppliers generally believe that even if bankruptcy drives the price renegotiation the victorious supplier will suffer significant detriments in future dealings.

IV. The Exceptions: Deviations from the Boilerplate

Information Technology Transactions. In this sea of refusal to budge, which we describe above, we did find one area where the OEMs often negotiate boilerplate terms and agree to deviate from the global terms. All of the OEMs reported that their relationship with respect to information technology (IT) providers was different from their relationship with respect to conventional suppliers. IT suppliers sometimes successfully force the OEMs to sign on to their own forms; othertimes they successfully negotiate revisions of the standard global terms in areas of great importance. Ordinarily, IT suppliers insist on terms that grant them greater ownership in the intellectual property. They also successfully limit their liability and cap it at level far below the liability that conventional suppliers may face, usually not to exceed the price paid for the component. Finally, they are reluctant to provide the same types of extensive warranties that OEMs usually demand.

Why do IT suppliers succeed in extracting more favorable boilerplate? We heard conjectures concerning the concentration and leverage of the IT suppliers, led by Microsoft and other superpowers. This is probably true in the automotive context, where the IT firms are more

creditors to stop performance of losing contracts, C&A had a credible threat. The payoff from the use of this power was quick: the three OEMs agreed to give C&A \$82.5 million by raising the prices on their existing supply contracts with C&A by 15%; to purchase \$140 million of tooling; and to make a loan of \$82.5 million. *See* McCracken, *supra* note 64.

diverse suppliers, less dependent on their OEM buyers. But this explanation does not account for the fact that even less powerful IT suppliers enjoy the more favorable terms. Another conjecture is that for IT companies the intellectual property clauses in the contracts are critical, as this is their only asset. Standing to lose more from the OEMs' IP provisions, their resistance to these expropriatory clauses is therefore more credible.

And yet IT firms succeed not only in securing better IP terms, but also far more lenient warranty and remedies provisions. We found this feature to be the most puzzling. The prevalence of warranty and remedy limitations in the IT area can perhaps be explained by the nature of information products. It is often difficult to determine whether a defect in the operation of the integrated component is a result of bugs in the software or inadequate specification requested by the client. When a machine shuts down due to software problems, the consequential harm may be huge, and yet the fix may be simple and cheap. Moreover, IT firms provide their services to a variety of industries and products. Similar technologies and information can be adapted to heterogeneous products and applications. Thus, it is beyond the expertise of the IT supplier to foresee the types and magnitude of the consequential harm that a defect might cause, and it is therefore hard to insure. Self-insurance by the more specialized buyer makes economic sense. As a result, suppliers of IT are unwilling to provide warranties beyond repair and replacement.

Japanese Manufacturers. Outside the area of IT contracts, we discovered that at least some of the Asian OEM's will modify some parts of their boilerplate terms. One Tier-1 supplier reported that a Japanese OEM would listen to focused and well reasoned objection to particular provisions of its form contract. The Tier one supplier emphasized that even the Japanese OEM would not agree to wholesale changes to its form, but he made clear that the Japanese attitude toward negotiation was markedly different from that of American OEMs. Another resource confirmed

that while Toyota and Honda have contracts with strict terms, they view their relationship with suppliers as long-term and place more value on suppliers' satisfaction.

So why are the Japanese OEMs more generous than the American OEMs to their suppliers? Doubtless part of the reason is cultural,⁷¹ having to do with norm of negotiations and the like.⁷² Also, it is sometimes speculated that Japanese manufacturers may be sensitive to the hostile publicity that they might earn if they are contribute to the demise of a large American manufacturer of supply parts.⁷³ But we believe that an important reason is the economic distress of the American OEMs. Several representatives traced the current state of “war” between OEMs and suppliers to a managerial change that occurred in General Motors in the 1980's.⁷⁴ Earlier, American OEMs in general, and GM in particular, were more generous with suppliers in all phases of their relations. But the mounting losses of the auto manufacturers could find an outlet in only a few places. Even though improvident contracts for pay, pensions and health benefits with the UAW may be the principal cause of the current economic distress, no OEM has the power to open a labor contract and get large concessions from the union. That OEMs turned to easier prey, their suppliers.

⁷¹ See generally John L. Graham, *The Japanese Negotiation Style: Characteristics of a Distinct Approach*, 9 NEGOTIATION J. 123 (1993).

⁷² The following anecdote illustrates the type of behavior that we denote “cultural.” One of our respondents in an American tier-2 company explained how a tier-1 Japanese supplier agreed to give a price increase. The American supplier had agreed to make and sell a part to the tier-1 supplier for approximately \$3.00. When the first parts were delivered they were missing one weld. The weld had been identified on the drawings in Japanese and the seller had failed to translate that part of the instructions. When the parties discovered this, the Japanese buyer agreed to add 7¢ to the price to cover the cost of the additional weld-with the admonition that the seller had better get it right the next time. The seller's representative assured us the any American OEM would have "pointed to the contract" and forced the seller to eat the cost.

⁷³ Norihiko Shirouzu, *Toyota Lobbies to Avoid Blame Amid U.S. Auto Industry Woes*, WALL ST. J., Aug. 12, 2005, at A2.

⁷⁴ [cite to Lopez]

Most of the Japanese manufacturers (Nissan and Mitsubishi may be exceptions) have not suffered the same distress. Both Toyota and Honda have been consistently profitable⁷⁵ for many reasons, e.g. good management, the absence of union contracts with their American workers, the comparative youth of their American workers, and the Japanese state's assumption of some of the liabilities in Japan that private companies must bear in the United States. Both the earlier American experience and reason suggest that insistence on one's own tough terms with no exceptions is the kind of thing that no business person does without a strong economic incentive, like business distress.

“Backdoor” Negotiations. Staff attorneys within the OEMs are of course the organ that keeps the tightest control of the boilerplate terms and guards against deviations. Other organs—specifically, engineers and purchasing agents—may have slightly divergent goals and motivations. The purchasing representatives are interested in the cost of the item and their performance is measured by their success in getting the lowest price. Engineers are interested in quality and uniqueness of features, and operation and are less interested in cost. Their own performance is measured by how well the car works, how much warranty cost it causes and how well it sells. A time honored but relatively crude way for a supplier to get better legal terms is to convince the OEM engineers that the supplier's part is the only acceptable part and to get the engineer to write the specifications to exclude others. Or one might get the engineers to agree to “engineering change orders” that change the product and increase the profit on its sale. These ploys can result in a higher price that will offset any cost of unfavorable boilerplate, and by the change order, they may nullify the bite of particular terms in the boilerplate.

⁷⁵ Jay Palmer, *Taking on the World: Toyota's Revving Up for a Bigger Chunk of the Global Auto Market*, BARRON'S ONLINE, May 5, 2003, available at <http://www.logos4me.com/Investment%20News/Taking%20on%20the%20World.htm>; Yuval Rosenberg et. al., *The Top Picks from 50 Great Investors*, FORTUNE, Dec. 29, 2003, at 70.

More subtle indirect changes in the contract may also come in through the engineers or by the addition of a term that the purchasing manager does not regard as part of his “cost.” For example a supplier may negotiate for a side agreement that permits the supplier to use the OEM’s tooling to make aftermarket parts, a right that the boilerplate would deny. Since the supplier’s profit on the aftermarket parts may be substantial, yet the purchasing manager might not regard that as part of his “price,” the seller gets something of considerable value. One tier-1 representative spoke of the pricing for service parts and change in the terms of the warranty process as examples of terms in the boilerplate that the OEM’s might alter by a side agreement, if an successful pitch has been made to an organ within the OEM who cares more about other factors. In these cases too, the base price stated in the contract would not change but the change would have measurable and predictable value for the supplier.

Conclusion

So there you have it—sophisticated companies using the rigid boilerplate forms to govern hundreds of billions of dollars of sales every year. The drafters of these forms are not the least embarrassed in admitting that they draft every term in a one-sided, self-serving manner. It turns out that such unrestrained economic power in contracting is exercised not merely against the weak and ill advised, but also against sophisticated partners to relational contracts. And yet, in numerous discussions with suppliers and their representatives, we have not heard the word ‘unconscionability’ even once. Obviously, there is no element of duress or unfair surprise in the formation of these contracts. It is the understanding of all who are involved in this market that bargaining power is the name of the game, and that the only way to reform the contracts is to alter some fundamental features of this market, such that could affect the underlying division of economic power.

A study such as this has obvious limitations. As our primary interest was the boilerplate contracts, the evidence we collected came from “legal” sources—the contracts, the lawyers who draft them, the attorneys representing the parties to the purchase agreements, and the very small body of case law. It may well be that in the shadow of this legal cloud there is a different business reality in which transactions occur in a more balanced way, where OEMs exercise their power and their contractual entitlements in a selective and less selfish manner. While we cannot rule out such a possibility, as a general matter it does not seem very plausible. Representative of suppliers with whom we spoke exhibited too much frustration with the OEMs’ legal terms, suggesting that they indeed believe that the reality of the business is very much consistent with the picture portrayed by the boilerplate.

What are the lessons that can be drawn from this study? Is there anything to be learned beyond the immediate context? Unlike some prior studies of automotive contracts, we are careful not to claim any general conclusions about contractual behavior, nor do we aim any critique at the law or advocate any legal reform. The automotive production business has enough unique characteristics that may limit much of what we have learned to the particular context. For one, it is clear that much of the bargaining power account stems from the specific structure of the industry, in which specialized tier-1 companies are “captives”—they have immense investments in production capacity and can only sell to very few clients. Still this study uncovers patterns that may have broader application. It identifies the important role that internal organization structures play in the formation of form contracts.⁷⁶ A story we all heard many times is that organizational concerns can explain the necessity of standard forms. That is, forms are a way for principals to exert control over terms offered by their agents. But what we found here was the flip side of this account. The internal hierarchy is not the *reason* for the forms, but rather an instrument in

⁷⁶ Cite Rakoff’s 1983 article.

implementing it. Constantly under pressure by counterparties to vary some terms, buyers have erected artificial internal structures to prevent purchasing agents from yielding to such pressures.

Some of the findings that we report are not sufficiently rationalized. We do not offer a satisfactory explanation for the variance of terms across the different OEM contracts, or for the conjecture that some of these terms are inefficient. If we are right in suggesting that there is inefficiency in the legal provisions, it is possible that—given the enormous stakes in this industry—a lot of money is left on the table. Clearly, the OEMs are using any means to reduce costs and are pressuring their supplier to the maximal extent. But by using overly harsh terms, it is questionable whether they succeed in minimizing the deadweight loss. Another finding that left us somewhat puzzled are the IT forms, which represent a remarkable exception to the otherwise one-sided boilerplate in this industry. Again, we can only offer exploratory guesses as to why IT firms succeed in securing better terms. We leave this question for future inquiry.

Finally, this study reinforces some doubts about theories of asymmetric information in contracting. We mentioned that a prominent line of thought in economic theory identify contractual “failures” as the reason for why firms organize the way they do, and why some activities are outsourced and others are done in-house. Since auto production contracts have served an important role in demonstrating these insights (the GM/Fisher Body story), we took a closer look at the actual contracts. We discovered a reality in which more things are “contractible” than previously suggested; where asymmetric information and imperfect verification are rarely obstacles for contracting; and where reputation sanctions quickly fill any void that the contracts may have left.