

Relational Contract Theory: Confirmations and Contradictions

Stefanos Mouzas and Keith Blois
University of Lancaster*

ABSTRACT

Scholarly work on contracts offers a valuable lens through which exchange relationships among companies or individuals can be studied. Contracts may regulate business alliances, strategic partnerships or collaborations among parties. The nature and form of contracts have been investigated by a number of academic disciplines each of which has adopted a different approach. Much of this work has been of a theoretical nature and it is often referred as 'relational contract theory'. This paper considers two theoretical approaches to 'relational contracts'. The first theoretical approach to relational contracts is described as the 'norms-based' approach, while the second is that of a group of organizational economists and is often referred as the 'incomplete contracts' approach. In comparison only a limited number of empirical studies have been undertaken. This paper will set out the findings of these two major streams of theoretical analysis of contracts and then contrast them with recent empirical research into contracts described as 'umbrella agreements'. The paper demonstrates that, while the two theoretical streams of relational contract theory are not contradictory, there are differences in their emphases and interpretations and that the results of empirical studies do not always conform to those that might be expected as a result of these theoretical studies.

Keywords: Contracts; norms; relational contracts; umbrella agreements

INTRODUCTION

This paper critically examines some of the studies that contribute to our understanding of the role of contracts in business relationships. Contracts are manifestations of legally enforceable agreements and can be found in all sorts of business alliances, strategic partnerships or collaborations (Heide and John, 1990; Roxenhall and Ghauri, 2004; Baker, Gibbons and Murphy, 2008). Within a corporate world of exchange relationships, which is central to IMP research work, understanding the nature and form of contractual arrangements is an important issue. Such understanding allows us to look at the modes of governance that operate between interrelated companies in business networks and, hence, to examine how contractual decisions are reached and expressed.

The nature and form of contracts has been investigated by scholars from a number of disciplines each of which has approached the matter in various ways and with different emphasis (e.g. Blois, 2002; Schwartz and Scott, 2003; Harrison, 2004; Argyres and Mayer, 2007) and have provided a range of lenses through which to study exchange relationships. Much of this work has been of a theoretical nature and it is often referred as 'relational contract theory'. As a theoretical movement, relational contract theory can be considered as one attempt to take into account all the surrounding circumstances of relationships. In

* Lancaster University Management School, Lancaster LA1 4YW, UK.

Tel: 01524-593908 E-mails: s.mouzas@lancaster.ac.uk; keith.blois@btinternet.com

contrast to this theoretical movement, only a limited number of empirical studies have been undertaken.

This paper will set out the findings of two major streams of theoretical enquiry into the analyses of contracts: a) the norms-based approach; and, b) the organizational economists' study of incomplete contracts. It will compare these approaches with a number of empirical studies that challenge some of the theoretical foundations of relational contracts. While these two theoretical streams of studies are not contradictory, there are differences in their emphasis and interpretation and that the results of empirical studies do not always conform to those that might be expected as a result of these theoretical studies. It argues that there is a research gap that is deeply rooted in the lack of attention to the significance of joint consent in contractual relationships (Barnett, 1986) and that a consent-based understanding of contractual obligations opens the door to new useful empirical insights.

The norms-based approach evolved out of the "Relational Contract Theory"¹ developed by Macneil (1974, 1975, 1985, 1987, 2001). Macneil is a law scholar who has challenged lawyers' traditional premise that all contracts are mere transactions. In particular he stressed the role of norms in determining the manner in which commercial exchanges operate in practice and introduced the concept that individual transactions lie on spectrum ranging from 'discrete' through to 'relational'.

The organizational economists' study of incomplete contracts recognizes that, absent vertical integration, some form of contract is needed between a supplier and a customer. However, such contracts will almost always be 'incomplete' because they contain some 'third-party unenforceable' elements. Such elements are described by economists as the relational elements of a contract and are those parts which help firms "circumnavigate difficulties in formal contracting, i.e. contracting enforced by a third party, such as a court" (Baker et al., 2002, p.40).

The 'relational contracts' analysed by economists do not map exactly onto the concept of 'relationships' as described in Macneil's studies but they do have a common viewpoint which is that all contracts contain a relational element. Macneil reaches this conclusion because he asserts that even a 'discrete exchange' has relational elements as a contract exists within society. Economists argue that, because it is almost impossible to write a contract which does not include some elements which cannot be enforced by a third party, all contracts will contain relational elements. Thus, both Macneil and economists agree that all exchanges are, to some extent, relational.

Even though it is recognized that it is important to understand the nature and form of contractual arrangements between firms there is a lack of empirically-based scholarly work on this topic. This may be a result of an overemphasis on the existence of collaborative relationships and social control mechanisms (Jap and Ganesan, 2000; Heide, Wathne and Rokkan, 2007) for a critique see, e.g. Blois, 2003; and is a reflection of the observation that, even where a written contract exists, frequently companies seek to avoid the use of legal action against their suppliers and/or customers (Macaulay 1963, 2003; Smitka, 1994; Collins, 1999; Roxenhall and Ghauri, 2004). Yet, empirical investigations reveal the existence of detailed contracts that firms use to manage their inter-firm relationships (Mayer and Argyres, 2004). Indeed, empirical research into manufacturer-retailer networks (Mouzas and Ford, 2006; Mouzas, 2006; Mouzas and Furnmston, 2008) as well as into manufacturer-to-manufacturer relationships (Lacoste, 2008) shows that companies attempt to simplify and

¹ Macneil has suggested (2000, p. 877) that the term Essential Contract Theory should be used rather than Relational Contract Theory. However, this suggestion has not received support from other writers on this topic.

facilitate the complex process of a business interaction by embracing a new form of contract described as ‘umbrella agreements’.

It would seem that the manner in which elements of umbrella contracts are ‘worked out’ in detail will, in part, be determined by the relational norms that are applicable to the situation and Macneil’s work may provide helpful descriptions of the nature of these contractual norms. On the other hand, organizational economists’ analyses of incomplete contracts seem in places to reach different conclusions than the umbrella agreements approach. In particular Mouzas (2006) has suggested that it is items such as prices and volumes that are “deferred for the future” in umbrella agreements. In contrast, economists assume that both prices and volumes are items that can be determined by third parties - in other words these two items would not fall under the heading of a relational contract.

This paper argues that the specifics of relational contract theory arise from the function of a contractual arrangement and not from fact that it is relational. The contract is per se *relational* because it establishes a relation of recognition and respect among those who decided to participate (Markovits, 2004). Based on a comparison of the two theoretical streams inherent in the relational contracts theory and the empirical evidence regarding umbrella agreements, the present paper suggests that there are three issues which need consideration. First, what confirmations and contradictions that can be identified? Second, can the apparent discrepancy between relational contract theory and empirical evidence of umbrella agreements be explained? Third, what are the research implications?

THE PROBLEM OF PERSPECTIVE

Before reviewing the previous research and contrasting it with the empirical evidence, it is important to bear in mind the inherent problems of using different perspectives. Thus, although scholars may use the same terms (e.g. *relational*) the interpretation of the term may differ between academic disciplines. In addition, when making a comparative analysis, we need to understand how scholars’ ontological as well as methodological choices may vary in terms of: a) underlying assumptions b) the purpose of the analysis c) the level of analysis that is being used; and d) whether or not the analysis is static or dynamic (see Table I). In comparison with other disciplines such as law or economics, business and in particular marketing studies often (but not always, see, e.g. Sweeny, 1972) examine a transaction and/or a relationship from the point of view of one party. Most typically the viewpoint adopted is that of the supplier. It follows that, when comparing and/or making use of the findings of scholars from different backgrounds, it is important to take account of the different perspectives adopted by scholars from and within different disciplines.

Table I: The Problem of Divergent Perspectives

Ontological & Methodological Choices	Norms-Based Approach (Macneil)	Incomplete Contract Approach (Organizational Economists)	Umbrella Agreements (Empirical Studies)
Underlying Assumptions	Social Relations matter	Transactions Costs matter	Joint Consent matters
Purpose of Analysis	Explain Exchange Behaviour	Investigate Efficiency of Governance Forms	Explain repeated exchanges
Level of Analysis	The Relationship	The Exchange	The Category of Business
Static vs. Dynamic Modelling	Static Modelling	Repeated Game Modelling	Dynamic Interaction

As a law scholar, Macneil's underlying assumption is that relationships matter and the prime purpose seems to have been to challenge lawyers' conceptualisation of contract (Macneil, 2001). Macneil therefore developed a contractual analysis that seeks to explain behaviours within an exchange. To do this he uses as his unit of analysis the relationship, taken as an entity, between the contracting parties; and, examines relationships from a rather static viewpoint focusing on behaviours to arrive at a set of ten common contractual norms. In contrast, the underlying assumption of organizational economists is that transaction costs are important (e.g. Klein, 1980; Tirole, 1999). Hence, the purpose of organizational economists' analyses is to investigate the efficiency of different forms of governance. Indeed much of their work explicitly considers what lay-people describe as the 'make or buy problem' (Klein and Murphy, 1997). That is, why and how contracts within firms differ from those between firms and the conditions, which make particular contractual forms the more efficient. As such their level of analysis is the exchange and not the relationship or firm per se. For this reason, organizational economists' perspective often moves on to a higher aggregation, namely that of society. In terms of the static/dynamic divide, their analysis is rather dynamic as it is most frequently based in repeated game-theoretic models over time. In comparison to the two theoretical approaches to relational contracts, the underlying assumption of empirical studies regarding umbrella agreements is that joint consent matters. The implication of such a consent-based view (Barnett, 1986) is that the contractual surplus, i.e. the joint gain, from the exchange is maximized only if a contract involves an 'actual meeting of minds' (Kronman and Posner, 1979). A deal that is not based on a genuine agreement is, therefore, not sustainable. Over time, this 'actual meeting of minds' becomes, however, a rather enigmatic task because of the prevalence of information asymmetries (Akerlof, 1970) and the multiplicity of unforeseen contingencies (Maskin and Tirole, 1999). For this reason, the purpose of the umbrella agreements' analysis is to investigate repeated exchanges between contracting parties. The level of analysis thus shifts towards the 'category of business' e.g. product or service category and the modelling becomes dynamic as contracting parties continuously interact with each other.

INTELLECTUAL ORIGINS AND PREVIOUS RESEARCH

Relational Contract Theory: The Norms-Based Approach

While there are many others, especially Macaulay (1963, 2003), who have made substantive contributions to this school of thought, the norms-based approach to contract is most strongly associated with the work of Macneil. The role of norms in determining the manner in which commercial exchanges operate in practice has been central to Macneil's work. A particularly important aspect of his analysis is the setting out of the way in which the applicable common contract norms alter depending upon where an exchange lies on the spectrum running from discrete (which Macneil believes to be a theoretical construct) to relational exchange. Macneil has argued that the manner in which contracts operate is determined by the applicable common contract norms and his work has primarily been to develop a detailed interpretation of the meanings of these norms. He, however, provides few insights into the factors that determine where on the discrete/relational spectrum an exchange might be expected to lie.

Building on the work of Macaulay (1963), Macneil developed a set of norms that determine "the behavior that does occur in relations, must occur if relations are to continue, and hence ought to occur so long as their continuance is valued" (Macneil, 1980, p. 64). Yet, given the variety of forms of exchange which do exist it is necessary to consider how widely applicable is Macneil's theory. It is first necessary to determine what Macneil means by the term 'contract' which he defines as "no more and no less than the relations among parties to the process of projecting exchange into the future" (1980, p. 4). This opinion is shared by other

legal scholars (e.g. Macaulay, 1963) and by scholars in other disciplines. Quite simply, in Macneil's view, where an exchange occurs a contract exists and therefore a contract is present in all business to business exchanges. Indeed, Whitford suggests that "because Macneil sees exchange occurring almost everywhere, his theory (viz. relational contract theory), becomes in effect a general theory of the social order" (Whitford, 1985, p. 252). Furthermore, Macneil recognizes that contracts vary widely in the depth of the relationship to which they are applied. Thus, he states that "[n]evertheless, some contracts, called here 'contractual relations' are far more relational than others. They lie towards one end of a relational spectrum of contractual behaviour, opposite from the non-relational end where the discrete transaction is found." (Macneil, 1983, p.342).

Initially Macneil developed nine norms or principles "of right action binding upon the members of a group and serving to guide, control, or regulate proper and acceptable behaviour" (Macneil, 1980, p.38). He later (1983) developed a tenth and changed the label applied to one of the original nine. He argues that these ten norms constitute an abstract summary of the wide variety of specific norms that can be found in the many different forms of contracts that do exist in a modern society.

These ten common contract norms are:

- (1) Role integrity.
- (2) Reciprocity.
- (3) Implementation of planning.
- (4) Effectuation of consent.
- (5) Contractual solidarity.
- (6) The linking norms: restitution; reliance; and expectation.
- (7) Creation and restraint of power.
- (8) Flexibility.
- (9) Proprietary of means.
- (10) Harmonization of the social matrix.

Macneil's view is that the importance given to these common contract norms varies according to where an interaction lies on the contractual spectrum ranging from relational to discrete and indeed that some of these norms are transformed according to where they lie. To emphasize this distorting effect Macneil introduces new terms. In the case of discrete exchanges he suggests that two of the common norms, 'implementation of planning' and 'effectuation of consent' are greatly magnified and merged into a norm that he labels: *enhancing discreteness and presentiation*. By creating this term he is seeking to emphasize that an exchange can only be purely discrete if it is 100 per cent planned; 100 per cent consented to; and "separated from all else between the participants at the same time and before and after" (Macneil, 1980, p.60). He is however careful to add that even if much diminished in importance, the other eight common norms are still present.

In the case of those exchanges that are more relational, he suggests that five norms have the greatest significance. Two of these (*role integrity* and *proprietary of means*) are identical to two of the common contractual norms. The other three are based on a combination of a number of the other eight common norms. They are:

- (1) Preservation of the relation. This norm is primarily an intensification and expansion of the norms of *contractual solidarity* and *flexibility*.
- (2) Harmonization of relational conflict. This norm is mainly a combination of elements of the norms of *flexibility* and *harmonization of the social matrix*.
- (3) Supra-contractual norm. This norm is mostly derived from the norm of *harmonization of the social matrix*.

The essence of Macneil's approach is perhaps well summarized by Kimel (a writer who is not particularly sympathetic to Macneil's views) who comments that empirical research has identified "how parties to certain types of contract do not see the contract to which they are party as a conclusive list of fixed rights and obligations, but rather as a starting point for re-negotiation and adjustment when circumstances change or difficulties arise; parties in practice not insisting on their contractual rights and not taking too seriously the option of litigation, but rather exhibiting the ongoing willingness to make the necessary adjustments in order to continue to co-operate" (2007, p.250). The extent and the nature of any 're-negotiation and adjustment' which occurs being determined by the norms established in that business context.

Although it has been commented that "we are all relationalists now" (Scott, 2000, p.852), Macneil's work is still subject to substantial challenges not least from practicing² as well as academic lawyers. 'Relationalists' are arguing that as long as contract theory fails to adopt a relational paradigm "it is bound to remain out of touch with reality and riddled with fiction, and thus fail to explain precisely what it sets out to explain" (Kimel, 2007, p.250). However, some scholars (e.g. Bernstein, 1992) still reject the relationalists' approach. Others, for example Kimel (2007), argue that their acceptance that 'relationalism' exists does not mean that they assume that traditional contracts have no value or role. Indeed, Kimel introduced into his argument recognition of the fact that relationships do not suddenly 'occur' but develop over time arguing that the continuing existence of traditional contract law is "What often enables parties to contracts to develop co-operative relationships that go over and above the bare terms of the contract – indeed, what often enable *potentially*³relational contracts to develop into truly relational ones" (Kimel, 2007, p.247). Thus Kimel's view is that legal contracts of the traditional kind provide an essential background "in order for the potential encapsulated in potentially relational contracts to be realised" (2007, p.254).

Relational Contract Theory: The Incomplete Contract Approach

In recent years an increasing number of organizational economists have been analysing the wide variety of forms of governance which firms can be observed to utilize. This activity has arisen in recognition of the fact that "[e]ven brief inspection of the existing governance structures in industries such as pharmaceuticals, biotechnology, medical devices, airlines, and telecommunications shows that firms have invented far more ways to work together than organizational economics has so far expressed (not to mention evaluated)" (Baker et al., 2008). There are two strands of this work which are pertinent to this paper. First, there have been a substantial number of studies of incomplete contracts but the majority of these studies have been entirely theoretical. Second, there have been several studies which have investigated the conditions under which relational contracts, as compared with the 'make' solution, can be more efficient. Most of these studies have incorporated formal models.

Incomplete Contracts: Economists' traditional approach to the 'make or buy' problem has been to compare the efficiency of alternative forms of governance and to recognize that under any form of governance, other than 'make', that a contract (though not necessarily a written one) will exist between the two parties. It is accepted that while with regard to some elements of an exchange, such as: price; quantities; payment terms; etc., it is possible for a contract to be certain but that there are two reasons why "complete, fully contingent, costlessly enforceable contracts are not possible" (Klein, 1980, p.356). First, a large number of possible contingencies exist and it may be costly or impracticable to specify in advance responses to

² See Baird Textile Holdings Limited and Marks & Spencer plc. (2001) para. 16 for a legal dispute where senior English judges rejected an attempt to make use of a "relationalist" argument.

³ Italics in original.

all of them. Second, transaction costs such as: unforeseen contingencies; the cost of writing contracts; the cost of enforcing contracts; and, the cost of renegotiating contracts (Tirole, 1986; 1999) may make it very expensive or effectively unfeasible to measure some types of contractual performance. Examples are the quality of promotional activity undertaken by a franchisee or the commitment of a supplier, which is being paid on a cost-plus basis, to keep costs low. Third, information asymmetries exist (Akerlof, 1970).

However, some economists accept that “there is another possible remedy when contracts are imperfect: leave the governance structure alone, but move to ‘relational contracting’” (Gibbons, 2005, p. 236). A ‘relational contract’ being one which, while it contains some elements which can be enforced by a third party, contains substantive elements where third parties “are unable to verify whether contractual obligations have been met” (Brown et al., 2004, p.747). Indeed, relational contracts often include informal agreements and are frequently based upon unwritten codes of conduct. For economists the difficulty of relational contracts is that they create a situation which is indeterminate in that it cannot be established how the relational elements of the contract will, in the case of a dispute, be interpreted. So, on the one hand the benefit of relational contracts is that they allow “the parties to utilize their detailed knowledge of their specific situation and to adapt to new information as it becomes available.” (Gibbons, 2005, p.236) but, on the other hand for the very same reasons, they cannot be enforced by a third party. It is because of this that it has been observed that: “Traders are very much concerned about the identity of their trading partners if third party enforcement is ruled out” (Brown et al., 2004, p.748).

Economists contend is that relational contracts are, within limits, ‘self-enforcing’ because both parties have an incentive not renege for, as Levin commented: “reneging would bias future trade terms against the deviator or even end the relationship” (2003, p.836). In addition any transactor who reneges would suffer from a loss of reputation and it has been argued that the value of each transactor’s reputation can be thought of as delineating what Klein and Nevin call “the self-enforcing range of the contractual relationship” (Klein & Nevin, 1997, p.417). Klein and Nevin (1997) suggest that a supplier will give a high level of service if the difference between the expected discounted profit that they could earn from supplying a low level of service and the expected discounted profit that could be earned from supplying a high level of service is less than the value of the damage that could be done to the supplier’s reputation by a dissatisfied customer. These two profit levels, associated with differing levels of service, thus define the extent of “the self-enforcing range” and indicate the amount that market conditions can change without occasioning non-performance. This indicates that, as long as market conditions leave the transactor operating in manner which enables them to achieve a level of profit within this range, the contract will be self-enforceable.

The ‘efficiency’ of alternative forms of governance: There is a change in tone when Economists switch from discussing why relational contracts arise and what they typically cover to determining their impact on the efficiency of different forms of governance. These studies rely heavily on the Transaction Cost Analysis to investigate the forms of governance categorized as ‘hybrids’ by Williamson (1985). Formal models are used to analyse the efficiency issue and this requires the setting out of, usually rigorous, assumptions so that mathematical analyses can be used. For example, states that his *main* assumptions are: “that parties are risk neutral, that they have symmetric information, that they do not renegotiate contracts, that all variables are contractible, but that writing contract involves costs that rise with the number of contractual terms” (2006, p.290). Economists’ analyses thus provide a series of results which are tightly constrained by their assumptions and which, as Shavell, commented require that their conclusions “be applied with caution to the actual world of contracts and judicial practice” (2006, p.292, fn.5).

It is not therefore easy to make clear concise statements about the relative efficiency of relational contracts. A case in point being Baker et al. who conclude: “The preceding section characterized upstream actions and total surplus under four alternative governance structures. In a given environment, the efficient organizational form maximizes the total surplus. For some parameter values, relational employment will be the efficient organizational form; for others, relational outsourcing will dominate; for still other parameters, neither relational outsourcing nor employment will be feasible and spot outsourcing or spot employment will dominate” (2002, p.58). Yet, one senses that several of the investigators feel that relational contracts are, in those cases where ‘make’ is not the preferred option, overall beneficial. Thus they often use terms other than ‘efficiency’ to describe the benefits of relational contracting and they make comments such as: “relational contracts can encourage *useful*⁴ actions” (Baker et al., 2002, p.41); “[w]e also show that the seeds for a *successful*⁴ long-term relation are planted at the very beginning of the relationship” (Brown et al., 2004, p.748); Gibbons comments that Klein’s studies “emphasize that *successful*⁴ transactions *between*³ firms often achieve adaptation by using relationships” (2005, p.209); “The literature on vertical supply contracting suggests that *adaptability*⁴ is a key feature of successful long-term relationships” (Levin, 2003, p.837); and, that: “it is not surprising that that relational contracts *can*¹ help parties remedy imperfect formal contracts -a theoretical statement-” (Gibbons, 2005, p.237) Indeed, given Shavell’s argument that: “the interpretation of contracts is in the interest of contracting parties” (2006, p.289) particularly because this will improve otherwise imperfect contracts, there would seem to be an acceptance that relational contracting is not without benefits.

There is also in these economists’ comments a presumption that long-term relationships bring benefits over short-term ones. This becomes evident in the discussion of the factors which may discourage renegeing where great emphasis is placed on the need to recognize the risks associate with renegeing. Indeed Brown et al. argue that “[t]he parties can create higher gains from trade due to relation-specific investments if they stay together than if they separate” (2004, p.749).

Thus, economists use the word ‘relational’ in a specific manner. The implication is that it refers to situations where there is an expectancy that both parties will benefit from its continuance. This position does not make any presumption about the need for commitment and trust to exist between the parties and is no more than a rational calculation of cost minimizing and benefit maximising. In other words it assumes that the prime interest of a firm is the creation of value for itself and that the co-operation needed to create an exchange “does not require commitment to the goal of the other party and indeed may, within prudential limits, be inimical to it” (Campbell and Harris, 1993, p.181).

THE EMPIRICAL EVIDENCE

Empirical research into manufacturer-retailer networks shows that companies attempt to simplify and facilitate the complex process of a business interaction by embracing a new form of contract known as ‘umbrella agreements’ (Mouzas, 2006; Mouzas and Ford, 2006; Mouzas and Furmston, 2008)⁵ whose nature and form constitutes a paradigm shift. Firms arrange umbrella agreements to achieve improved interaction with each other and thus retreat from

⁴ Italics added.

⁵ These studies are based on empirical investigations of contemporary contractual arrangements in the United Kingdom and Germany. The investigations comprise umbrella agreements between firms such as fast-moving consumer goods companies, pharmaceutical companies, service providers and grocery retailer completed during the years 2002-2006.

inflexible contractual arrangements. Because umbrella agreements are contracts that define established rules and principles that can be used in all future agreements they create a framework for continuing negotiation and exchange, companies are thereby better able to maximise their joint gains. Umbrella agreements are not concerned with immediate contractual decisions and are in fact 'framework contracts' that provide a set of clauses which regulate the conclusion of future contracts. For this reason, umbrella agreements are contracts that do not predetermine future selection processes. Instead, they create the framework within which future selection processes may take place (Crone, 1993). This does not imply that umbrella agreements are necessarily long-term business contracts. What differentiates umbrella agreements from other contractual agreements is, therefore, not the time horizon of the contractual arrangement but its function; and the function of an umbrella agreement is to supply clauses that can be used in a defined set of transactions.

The parties to an umbrella agreement are usually not required to specify new terms in their future transactions nor are they required to refer to the pre-existence of an umbrella agreement. The advantage for buyers is that if they need a particular product or service, they only need to specify the quantity and price or arrange continuous stock replenishment. It must be emphasized that the buyer has no obligation to buy a specified amount of goods or to accept future offers. However, the buyer (e.g. a grocery retail chain) may agree with the seller (e.g. a manufacturer) that successive orders will be met. The advantage for sellers is that they gain a source of incremental business and that they only need to deliver according to the needs of their customers. For this reason, umbrella agreements are often encountered in regular, stable and established business relationships such as manufacturer-retailer relationships, manufacturer-supplier relationships, agency relationships (e.g. service providers in banking, consulting, technology or advertising) as well as in business-to-business co-operations, strategic partnerships and alliances (Mouzas and Furnston, 2008). In these established relationships, contracting parties acknowledge and recognize their interdependence and seek to articulate the basic norms that could pave the way toward a jointly decided action. This effort to create a framework requires multiple levels of managerial interface and inter-firm negotiation. The managerial interface between manufacturers and retailers, for example, involves key account management, purchasing or category management, while inter-firm negotiations are usually conducted in the shape of institutionalized forms of repeated annual trade negotiations.

In drafting umbrella agreements, purchasing managers and key account managers draw on the expertise of other experts or staff departments, such as the legal, marketing or production departments. Termination clauses or exit scenarios are usually inserted as pre-packaged 'boilerplates' carefully drafted with the help of corporate lawyers (Christou, 2002). Theoretically, in regular and established business relationships, contracting parties are driven by the common objective to maintain and develop their existing exchange relationship. In this way, both parties recognize the value of their business relationship and acknowledge their determination to create joint gains through repeated exchanges. In reality, however, umbrella agreements do not constitute any obligation to buy or sell anything. For example, during the annual negotiations of umbrella agreements between manufacturers and retailers, contracting parties may agree on the listing of products or services e.g. shelf space and on the umbrella terms e.g. trade allowances which are the fees to obtain distribution (Sullivan, 1997; Villas-Boas and Zhao, 2005). Subsequent orders (future contracts), however, will be determined by the consumer demand expressed as consumer off-takes. Of course, manufacturers may underwrite heavy media advertising and intensive promotional spending at the point of sale for favourable shelf space and thereby pay less in trade allowances. But even expensive consumer advertising and promotion activities cannot fully guarantee consumer off-takes (sales to final consumers) and thus they cannot secure subsequent orders (future contracts).

Table II: Umbrella Agreement as a Framework of Agreed Norms

Type of Contract Norm	Examples of Umbrella Clauses
Product/Service Category	Laundry and Cleaning Products
Property Rights	Supplier ensures that no third person has obtained property rights
Exclusivity	Parties have the right to obtain competitive offers at any time
Information Flow	It is agreed to establish an Electronic Data Interchange
Notification Requirements	Mutual notification regarding all future capital investment and R&D
Confidentiality	All information exchanged is confidential and shall not to be available to third parties without written consent of the other party
Subcontracting	Subcontracting is only possible upon consent
Liability	The obligation to remedy deficiencies applies also to services obtained from subcontractors
Force Majeure	Parties bear no liability for damages occurred as a result of war, political unrest, strikes, lockouts, and governmental Interventions
Renegotiation	Annual Renegotiation/ Quarterly Business Reviews
Terms of Payment	Payment in 30 days; delivery cost is paid by the supplier.
Termination Rights	Each party has the right to terminate the agreement giving one year's prior notice
Volume / Prices	Volume and Prices to be agreed / Unilateral price determination
Saving Clause	Unless it is of major importance, invalidity of one or more clauses will not have any effect on the agreement as a whole
Arbitration/ Mediation	International Chapter of Commerce
Duration	Indefinite Agreement/ Annual Agreement
Legal Venue	London

Umbrella clauses between firms usually start with the description of the scope of business by defining product categories or the range of services exchanged (see Table II). Then they move on to circumscribe a framework of norms such as property rights, exclusivity issues, information flow, notification requirements, confidentiality, renegotiation, terms of payment, as well as termination rights according to which voluntary and informed exchange may take place.

As umbrella agreements usually do not specify prices or volumes, the conclusion of further specific contracts is always made under the aegis of the pre-agreed umbrella clauses which guide the conclusion of further contracts. For example, contracting parties in manufacturer-retailer networks might agree to appoint a manufacturer as 'category captain' which is equivalent to the status of 'preferred supplier' in other industries. According such an umbrella agreement, the retailer will work exclusively with the appointed manufacturer (category captain) in optimizing the planograms of the retailer's shelf space which display the allocation of shelf space. In a similar way, contracting parties may draft an umbrella agreement for the exclusive production and distribution of own labels (retailer brands). In this case, the consumer goods manufacturer will produce the retailer's own labels, and the umbrella agreement will specify all relevant norms that regulate future business. The umbrella agreement, however, will not specify any volumes or prices as these are variables to be agreed in the future. Therefore, the primary concern of umbrella agreements is not with immediate contracts or with concrete transactions but rather with contract rules that guide the creation of

joint gains. This function of umbrella agreements contributes to the achievement of joint consent over time. By not predetermining any prices and volumes, umbrella agreements cope with the existence of barriers to a final and complete agreement, such as unforeseen contingencies or asymmetries of information between the contracting parties. Empirical evidence, suggests that contractual arrangements that are not based on a genuine consent are usually not sustainable over time because they fail to maximize the value that can be created through potential exchange processes (Kronman and Posner, 1979; Sebenius, 1992). In contrast, umbrella agreements allow the re-adjustment of joint consent over time in such a way that the contractual surplus, i.e. the value created from the exchange, is maximized, though the maximization of value creation does not imply anything about how value is being appropriated by the contracting parties (Lepak, Smith and Taylor, 2007).

Because consent matters, contracting parties in umbrella agreements regard the exchange of information as a major step toward managing the increasing data flow from the consumer's decision, up to merchandising and production planning. Such information exchange tightens the connectivity between retailers and manufacturers and contributes to a reduction in handling and administrative costs. Some business contracts especially those that require substantial capital investments e.g. in the construction industry might include a number of immediate contractual decisions leaving some of the terms open. In these particular cases, it seems to be more appropriate to view the agreed contracts as open-terms agreements (Gergen, 1992). Contracting parties with a strong bargaining position may include umbrella clauses that confer powers to them to determine prices unilaterally. Similarly, in asymmetric relationships contracting parties with strong bargaining power may insert umbrella clauses that restrict the retailers' ability to revoke orders after manufacturers' production start (Mouzas and Ford, 2007). The empirical evidence shows that some umbrella agreements may restrict or confer powers on parties to vary their initial position or renegotiate some of their own duties. For example, umbrella agreements may confer discretionary powers on retailers to have a continuous stock replenishment according to consumer off-takes or discretionary powers to manufacturers to deliver according to a Vendor Managed Inventory system.

Furthermore, umbrella agreements between contracting parties show a variety of notification and termination procedures. In established and continuing business relationships, umbrella agreements may include, for example, that the agreement is indefinite or that unless otherwise agreed, the cooperation between the parties is terminated at the end of a calendar year, giving one year's prior notice.

CONTRASTING THEORY AND EMPIRICAL EVIDENCE

Both streams of relational contract theory provide an interesting contribution to an academic discussion of the nature of contractual relationships and provide a number of conceptual tools that have been adopted and used in management studies (Dwyer, Schurr and Oh, 1987; Poppo and Zenger, 2002; Harrison, 2004; Taylor and Plambeck, 2007). The norms-based approach to relational contracts provides a panoply of important relational norms and demonstrates the embeddedness of contractual parties in continuing exchange relationships. Similarly, organizational economists' incomplete contract approach provides elegant mathematical models of repeated interactions and sheds significant light on governance forms. There are, indeed, clear indications that these two approaches are converging (Poppo and Zenger, 2002). For example, the economists' observation that 'relational contracts' may include informal agreements based upon unwritten codes of conduct leads to the question of whether or not such unwritten codes are the same as norms? Before moving on to contrast these theoretical insights and the available empirical evidence, is worth examining some inherent contradictions and problems.

The norms-based approach to relational contracts has been criticised for over-emphasizing the importance of contextual variables and thus is considered less relevant to practice (Schanze, 1991; Eisenberg, 2002; McKendrick, 2002). One reason for this is that relational contracts are not recognized as legal categories in common law countries such as USA, Australia or England (e.g. see Endnote 2; Schwartz, 1992; Eisenberg, 2002). In civil law jurisdictions, such as those encountered in continental Europe, some types of ‘relational’ contracts recognize the legal term ‘Dauerschuldverhaeltnisse’ (long-term contractual obligations). Such long-term contractual obligations include tenancy and leasing agreements, licence agreements, distribution agreements as well as management or knowledge transfer agreements. These long-term agreements require that contracting parties show mutual respect to their counterparts’ interests, especially with regard to the principle of good faith (Flohr and Klapperich, 2002). However, the “length of time during which performance is likely to occur should not be regarded as significant for the purpose of the analysis of contractual relationships” (Collins, 1999: p.142). For this reason, courts in common law countries, such as United Kingdom, argue that the ‘length of time’ during which performance has occurred does not by itself create an implied contract between the parties. If, for example, two parties had chosen to work together for decades without any written agreement, the ‘length of time’ of their co-operation would not be regarded as significant factor by the courts. The well known case of Baird versus Marks & Spencer⁶ illustrates this (Blois, 2003; Harrisson, 2004; Mellahi, Jackson and Sparks, 2002; Mouzas and Furmston, 2008). Despite the valuable contribution of the norms-based approach to relational contracts in challenging the premise that all relationships are merely transactions, it can be posited that all relationships have *discrete* and *relational* components (Blois, 2002) and that a relationship hides behind even the simplest discrete transaction. For this reason, Eisenberg (2002) emphasized the inadequacy of relational contract theory by making the cogent argument that all general principles of contracts should be responsive to both relational and discrete relationships. In a similar way, McKendrick (2002) rejects the claim for relational transactions being a separate category and suggests that it is largely left to the related parties to include in their contracts clauses such as: ‘force majeure’; ‘hardship’; or ‘third-party intervener’ clauses which deal with particular contextual eventualities. While this critique of relational contract theory reminds us that the specifics of a relational contract derive from the particular function of the contractual arrangement and not from the fact that a contract is relational, it must be noted that a contract *per se* is relational as it establishes a relation of *recognition and respect* among those who participate (Markovits, 2004).

The organizational economists’ incomplete contract approach to relational contracts avoids the above critique because it shifts the unit of analysis from the relationship to the exchange. The economists’ underlying assumption that transaction costs matter along with their analysis of governance forms in terms of the ‘make or buy’ decision postulate alternative forms for conducting transactions: markets and hierarchies. These alternatives provide a simple but strong contingency model for investigating the governance structures under which organisations can most efficiently conduct transactions. The problem with these alternatives is that they do not contribute conceptually to the identification of any distinctive properties of contractual relationships (Collins, 2005). Transaction cost analysis is useful but it has a number of intrinsic weaknesses that make it problematic for the purpose of researching contracts. First, the transaction cost by itself is not adequate for exploring the process of contracting and therefore, because it is limited to efficiency as the dominant motivation behind a firm’s transactions, it is not sufficient for explaining complex inter-firm exchanges. Secondly, the underlying assumption that transaction costs are important neglects other

⁶ See Baird v. Marks & Spencer plc, [2001]. It can be argued that the relationship between the two parties was asymmetrical. Marks & Spencer deliberately avoided a long-term commitment and Baird deliberately avoided exercising pressure for a contractual commitment.

human and socio-cultural aspects of business relationships. The critique of transaction cost theories is now well rehearsed (Ghoshal and Moran, 1996).

The use of repeated game modelling where, although the output from one analysis is the input for the next one, is not a dynamic analysis but is a form of repeated and deterministic analysis. This explains the contradiction between the economists' results and the studies of umbrella agreements for under an umbrella agreement future behaviours while strongly influenced by previous events are not predetermined by them. This means that while the economists' analyses would assume that both prices and volumes are items that can be determined by third parties - in other words these two items would not fall under the heading of a relational contract. Whereas these items are "deferred for the future" Mouzas (2006) in umbrella agreements, are not certain and cannot be contractually specified.

It appears that that the manner in which incomplete contracts are 'worked out' in detail will, in part, be determined by implicit or explicit relational norms that are applicable to the particular situations or contexts, e.g. industry standards or common use. Although Macneil's work provides helpful descriptions of the nature of these contractual norms, organizational economists do not make use of the Macneil's taxonomy of contract norms. Notwithstanding the significant scholarly work on the importance of conventions and norms (Buchanan, 1975, 1978; Young, 1993) work on contracts has paid less attention to the relevance of contract norms for the contracting process.

As a result of the implicit norms in common usage, a variety of forms of contract between individuals as well as between firms have evolved over time. Norms are important because they create a structure for business interaction and guide the conclusion of exchanges (Nee, 1998). Without the existence of norms, contracting parties would face tremendous difficulties when interacting with each other and, thereby, the possibility of exchange would be severely constrained (Casson, 1982; Choi, 1993; Loasby, 2000). In this respect, the empirical evidence of the use of umbrella agreements draws attention to two intriguing aspects. Firstly, umbrella agreements as new contract forms transform implicit norms, which are embedded in customs and business practices into explicit, basic rules and principles for business interaction (Mouzas, 2006; Mouzas and Ford 2006). Umbrella agreements are therefore contractual manifestations which codify the parties' knowledge about efficient ways to interact and, hence, become "knowledge repositories" (Mayer and Argyres, 2004, p.405). The empirical evidence that the primary concern of umbrella agreements is with the exchange of information between contracting parties is supported by studies of strategic alliance contracts that demonstrate that repeated exchange among firms forming alliances deepens inter-partner communication and leads to a tacit development of contractual provisions for troubleshooting (Reuer and Arino, 2007). Secondly, the function of an umbrella agreement is not to predetermine contractual decisions but to provide an agreed framework in which contractual decisions can be made. This *functional* particularity is crucial for understanding how contracting parties deal with barriers to complete and final contract and how they arrive to a joint consent. One of the enduring puzzles in understanding contract problems refers to the question why there is ever disagreement? For example, contracting parties may have a) divergent expectations, b) they may hold asymmetric information, c) they may be uncertain about the structure of their interaction with others or whether a deal is possible and d) they might have locked themselves in other irreversible commitments (Farber and Bazerman, 1987). Scholarly work on contracts has rather obscured the difference between contractual decisions and the framework in which contractual decisions are made (compare e.g. Macneil, 1987b).

CONCLUSIONS

There is a degree of convergence in the approaches of law scholars and of economists to the issues of relational contracting. However, the extent of this convergence must not, as it easily can be, exaggerated because although scholars in these separate disciplines often use similar or identical terms there are fundamental differences in their assumptions regarding levels of analysis, etc. In part the convergence that has occurred has arisen in response to the implicit challenge of the observation that: “reasonably clever businessmen and lawyers cope with problems scholars might consider intractable” (Goldberg and Erikson, 1987, p.369). The use of umbrella agreements is one example of the way in which managers have sought to find solutions to the difficulties they encounter in managing their interactions with other organizations. On the one hand is their reluctance to rely on contract law with its costliness and especially, when disputes arise, its adversarial nature but on the other hand their desire for a degree of certainty as to the consequences of any predictable behaviour by those organizations with whom they interact.

These conclusions are in line with recent studies in the USA that demonstrate the capability of firms to learn how to sustain repeated exchanges through contractual arrangements (Schwartz and Scott, 2007; Argyres and Mayer, 2007; Argyres, Bercovitz and Mayer, 2007). For many companies, the need to sustain repeated exchanges through various contract forms is increasingly important because a great deal of their business activity appears to be occurring via strategic partnerships, alliances or other forms of inter-organizational arrangements that are regulated through contracts (Reuer and Arino, 2007); yet there has been relatively little study of these contract forms in their real life context. Umbrella agreements as new contractual forms build upon bases of consent that pre-exist as norms or common practice and transform them into an applicable framework for managing business relationships (Mouzas and Ford, 2006). Joint consent is a significant aspect that deserves more research attention; A consent-based understanding of contractual obligations (Barnett, 1986) may stimulate further empirical work that delivers new insights about how actors manage their interactions with their counterparts. Understanding the role of joint consent in contractual arrangements requires a fundamental insight into the significance of property rights or entitlements which specify the substance of rights that actors may possess, acquire or transfer in their interactions with other actors (Coase, 1960, Demsetz 1966). The importance of joint consent draws attention to the significance of inter-cognitive articulation as well as its manifestation in contract provisions. Further empirical work should be responsive to the recent calls for more attention to the specific provisions that managers incorporate into contracts (Poppo and Zenger, 2002; Reuer and 2007; Furlotti, 2007) rather than adopting a theoretical norms-based or incomplete contract approach.

When conducting further empirical work on business contracts, it is important to be clear about our ontological and methodological choices. Also, it is necessary to be cautious about the underlying assumptions, the level and purpose of analysis, as well as with the choice of model. This study demonstrates the inherent problems of using divergent perspectives in contract research. The confirmations and contradictions of the two major streams of theoretical analysis of contracts as well as their contrast with the recent empirical research has, hopefully, provided a platform for the study of contemporary contract forms.

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