A Model of Self-Enforcing Agreement Use in Business-to-Business Exchange Relationships

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Governance issues and the way exchange relationships and other alliances are structured has been a key theme of much of the business-to-business marketing literature and the focus of considerable empirical research in recent decades. A number of frameworks, such as agency theory (Jensen and Meckling 1976; Bergen, Dutta, and Walker 1992), interaction approach (Håkansson 1982), interorganizational relationships (Johanson and Mattson 1987; Ring and Van de Ven 1994), political economy (Achrol, Reve and Stern 1983), resource dependency (Pfeffer and Salancik 1978), social exchange (Dwyer, Schurr, and Oh 1987; Hallén, Johanson, and Seyed-Mohamed 1991), transaction cost analysis (TCA) (Williamson 1985; Rindfleish and Heide 1997), and others have provided the theoretical bases for this growing literature. Drawn from these origins, an array of governance mechanisms, such as incentive realignments (Shavell 1984), hostages (Williamson 1983), monitoring (Ouchi 1979, 1980; Stinchcombe 1985), decision control (Heide and John 1992), and qualification (Stump and Heide 1996), have been identified, which may be used individually or in a combined fashion to govern these relationships (Bradach and Eccles 1989; Heide 1994; Ouchi 1980). Likewise, these same frameworks identify a range of factors that influence the extent to which these specific governance mechanisms are used.

Little noted among this vast literature is the notion that an exchange relationship may be structured as a self-enforcing agreement (Telser 1980; Klein 1996; Koss and Eaton 1997). Telser (1980, p. 27), defines self-enforcing agreements as a situation where:

> "each party decides unilaterally whether he is better off continuing or stopping his relationship with the other part[y]. He stops if and only if the current gain from stopping exceeds the expected present value of his gains from continuing. No outside party intervenes to enforce the agreement, to determine whether there have been violations, and to impose penalties."

The dominant view expressed in the governance literature that certain trading hazards, such as transaction specific assets (Williamson 1985) or environmental uncertainty (Pfeffer and Salancik 1978), cause market failures such as the "hold-up" threat where one party may try to alter the terms of the exchange to the detriment of the other after the transaction is consummated (Klein, Crawford, and Alchian 1978). Consequently, firms proactively craft ex ante and/or ex post governance mechanisms within interfirm relationships or vertically integrate to ensure

performance and protect their interests. In contrast, the extant theory on self-enforcing agreements focuses on when and why firms *abstain* from installing ex post governance mechanisms, i.e., contractual arrangements that require the intervention of a third-party, vertical integration, or alternative bonding mechanisms.

Surprisingly, there has been little empirical study of self-enforcing agreements to determine whether the core premise espoused by Telser, i.e. that absence of ex post governance mechanisms, does actually hold. Moreover, there have been few attempts to extend this theory by integrating insights from other frameworks and recent findings found in the governance literature to delineate a more comprehensive array of factors that foster or impede the adoption of self-enforcing agreements. Thus, this article will address this gap in the literature by developing a model of self-enforcing agreements that extends beyond the factors identified by Telser and other industrial economists.

Conceptual Model

Self-enforcing agreements, like other governance alternatives, address the potential for a post-contractual "hold-up" occurring, i.e., where one party does not perform as expected or belatedly tries to alter the terms of the agreement to its advantage (Klein, Crawford, and Alchian 1978). The gist of a self-enforcing agreement is that termination is the only effective means of recourse available to one party when the partner is discovered to have violated the agreement between the two parties (Telser 1980). Both parties are expected to act in a self-interested manner and calculate whether violating the agreement provides greater or lesser gain than the future net benefits that would be foregone if the agreement were terminated by the other party upon discovering the violation. Self-enforcing agreements are expected to serve as a more efficient alternative to the costly intervention of third parties to enforce agreements or assess damages for violations, vertically integrating, or relying on other bonding mechanisms (Telser 1980; Koss and Eaton 1997).

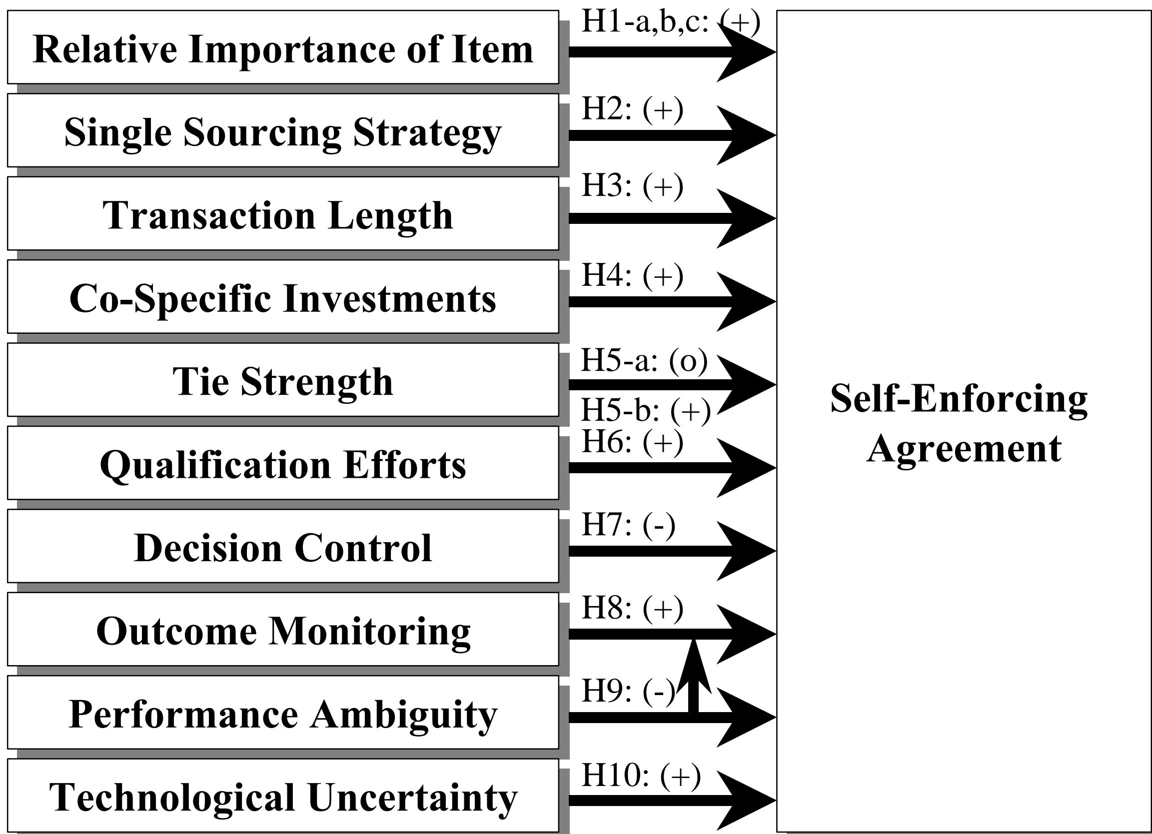
In Telser's treatise, he identifies a series of conditions that make it more or less likely that an agreement to be structured in a self-enforcing fashion. We expand on these and draw upon the governance literature to propose a model that incorporates a more comprehensive array of antecedent factors and explicates the process by which self-enforcing agreements are adopted. In particular, we are concerned with whether a newly originated transaction between two separately owned firms is structured as a self-enforcing agreement, which in operational terms would mean:

1) the absence of explicit contractual stipulations that would rely upon adjudication or intervention by another third-party to enforce performance or collect monetary damages if a violation of the terms of the agreement later occurs (Crocker and Masten 1988; Joskow 1987; Masten and Crocker 1985; Shavell 1984).

2) the absence of other bonding mechanisms that do not require the intervention of others (e.g., exclusive dealing, exclusive territory arrangements).

This model (displayed in Figure 1) depicts the use of self-enforcing agreements (SEA) as being subject to the influence of a range of factors that include 1) procurement risk factors, 2) structural aspects of the focal transaction, 3) the nature of the pre-existing relationship between the two parties, 4) unilateral governance mechanisms available to the buyer, 5) task and macro environmental characteristics. We elaborate on each below and formalize these with a series of research propositions.

Figure 1



The buyer's perceptions of risk. Not all procurements pose equal risks to the buyer. Thus when assessing the relative efficacy of different governance options, buyers take into consideration factors such as:

- The relative importance of the item being procured (Stump 1995). Here the notion is that buyers are likely to walk away from unsatisfactory transactions that have low consequences to them since the cost of enforcement is likely to be perceived as being prohibitively high in relation to the benefit from the item being procured. Item importance may be in terms of its functional criticality, degree of customization to the buyer's needs, and/or the dollar amount being procured.

  Proposition 1: Procured items perceived to be unimportant because they are: a) functionally non-critical, b) standardized/commodity-like, or c) comprise little dollar risk will be positively associated with the use of self-enforcing agreements.

How the focal transaction is structured. Here the focus is on the buyer's procurement strategy, terms of the contractual agreement between the parties, which reflects the time horizon of the transaction (Telser 1980), and whether credible commitments (Williamson 1983) accompany the execution of the agreement.

- Whether the buyer is using a single source procurement strategy (Segal 1989; Stump 1995; Tullous and Utect (1992). Here the expectation is that SEA will only exist in a single sourcing situation since multisourcing can be construed as an alternative, market based enforcement mechanism. This leads us to propose:

  Proposition 2: A single source strategy will be positively associated with the use of self-enforcing agreements.

- Whether the transaction has a finite length, with no or limited renewal provisions, versus having "evergreen" renewals or an open-ended duration (Telser 1980). Transaction length is expected to be positively associated with SEA as it approaches an uncertain future horizon since it reduces the current gains of violating the agreement and increase the retaliatory threat of lost future profits.

  Proposition 3: Contracts with longer or indefinite term lengths will be positively associated with the use of self-enforcing agreements.

- Interdependence structure, or co-specific investments, i.e., considering both the magnitude and symmetry of specialized investments (buyer specific asset - supplier specific assets) (Anderson and Narus 1990; Grossman and Hart 1986; Gundlach and Cadotte 1994; Koss and Eaton 1997; Kumar, Scheer, and Steenkamp 1995; Williamson 1983). Transactions where both parties are mutually dependent upon one another are more prone to use self-enforcing agreements because specific asset investments depict a relationship where the burdens and benefits are being shared and where the potential payoff to behaving opportunistically is constrained. Thus because of these endogenous means, firms are less likely to seek outside intervention.

Proposition 4: Transactions accompanied by co-specific investments will be positively associated with the use of self-enforcing agreements.

Relationship characteristics. Here the concern is whether and how the past relationship between the two exchange partners will alter the governance structure in a subsequent transaction (Stump 1993).

- Tie strength, or extent of mutual impact, of the prior relationship between the buyer and supplier (Koenig 1990; Stump 1994). Telser (1980) argues that the probability of continuing a relationship honestly should not hinge on the past experience with the other party, deeming it to be "inconsistent with rational behavior" (p. 35). On the other hand, theories of social embeddedness (Granovetter 1985), relational norms (Macneil 1980), and generalized safeguards (Stump and Joshi 1998) suggest that strong (close) relationships that have developed though past exchange may attenuate the likelihood of opportunism.

Proposition 5: Strong ties arising from past exchanges will: a) have show no association (Telser's view), or b) will be positively associated (view expressed by the alternative theoretical frameworks) with the use of self-enforcing agreements.

Unilateral governance actions undertaken by the buyer. This aspect reflects the growing body of theoretical development and empirical evidence of the use of plural governance forms (Bradach and Eccles 1989), i.e., where multiple governance mechanisms are used in a complementary fashion, and that certain governance mechanisms may be functional alternatives.

- Qualification efforts, i.e., ex ante evaluation of the supplier's ability and motivation to meet the buyer's needs and be a reliable source (Stump and Heide 1996). Qualification efforts are deemed to make SEA more likely since the buyer will have had a better chance to screen out an unreliable exchange partner, or the adverse selection problem highlighted in agency theory (Jensen and Meckling 1976; Bergen, Dutta, and Walker 1992). Thus in this sense, qualification can be viewed as operate in a complementary fashion by serving as a *facilitator* of SEA.

  Proposition 6: Transactions preceded by extensive qualification efforts will be positively associated with the use of self-enforcing agreements.

- Decision control, i.e., the extent to which a buyer obtains or shares decision authority over particular areas related to the transaction that normally are considered to be in the supplier's realm (Heide and John 1992). When greater decision control has shifted from the supplier, the buyer's ability to retaliate short of terminating the agreement improves. Thus this governance mechanism can be viewed a functional alternative to SEA.

  Proposition 7: Transactions where the buyer exhibits a high degree of decision control will be negatively associated with the use of self-enforcing agreements.

- Outcome monitoring, i.e. use of ex post surveillance or auditing activities to track supplier performance (Williamson 1985; Heide and John 1990). Monitoring can be considered to be another facilitating governance mechanism in that it increases the prospect of nonperformance being detected quickly, thereby reducing the incentive for the supplier to act opportunistically.

  Proposition 8: Transactions where the buyer engages in extensive outcome monitoring efforts will be positively associated with the use of self-enforcing agreements.

Task and macro characteristics. The governance literature is replete with theoretical bases and empirical evidence that interfirm relationships and transaction governance are influenced by extra-dyadic factors (Pfeffer and Salancik 1978; Williamson 1985).

- Performance ambiguity, or difficulty monitoring supplier performance (Heide and John 1990; Stump and Heide 1996). This variable is not expected to have a direct association

with SEA, but instead is expected to moderate the effect of outcome monitoring. SEA rely upon the ability to clearly attribute malfeasance, whose detection is thwarted under conditions of high performance ambiguity.

Proposition 9: Performance ambiguity will moderate the influence of outcome monitoring.

- Environmental characteristics, in the form of technological uncertainty, or the inability to predict changes in product and/or process technologies (Walker and Weber 1987; Heide and John 1990). Greater environmental uncertainty increases the likelihood that extraneous conditions may cause the sequence of transactions to terminate regardless of the actions of both parties to the agreement. Thus, in this way it too would have an indirect effect. Still another view is that incomplete contracts reduce the rigidity that would be created by negotiating and pre-specifying extensive contingency arrangements that would require court-enforcement (Klein 1996). Under this final scenario, the influence of technological uncertainty is expected to be direct.

Proposition 10: Technological uncertainty will be positively associated with the use of self-enforcing agreements.

Discussion

The prospect that firms will intentionally forego installing ex post governance mechanisms has intriguing theoretical and managerial implications. From a theoretical perspective, we extend the theory of self-enforcing agreements drawn from industrial economics by integrating it with other perspectives from the governance literature. Our model has also served to elaborate on the underlying process by which firm's decide whether or not to structure a transaction as a self-enforcing agreement, as well as to identify a broader range of factors that impinge on this decision. Furthermore, our series of research propositions directly lend themselves to empirical testing.

From a managerial perspective, our model has normative implications. It expands the rationale for when self-enforcing agreements may be an efficient governance solution. Our model also provides a more comprehensive array of decision factors that firms should consider than is presently espoused in the SEA literature.

The logical next step is to empirically test the propositions posed herein and to assess whether satisfactory performance outcomes do accrue from structuring transactions in this manner.

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