

# **A Framework to Build or Review Marketing & Networks Contracts**

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## **Abstract:**

It is known by the literature that bounded rationality makes it almost impossible to build complete contracts to govern transactions. At the other side, incomplete contracts give rise to several opportunism problems and undesirable transaction costs that could be reduced if the contract building process was done with more details (accuracy). Business people, in some cases, and students, in some universities, are not trained in these aspects. The paper brings a framework that is being successfully used as a tool to analyze marketing channels or supply chain contracts in business networks.

**Keywords:** contract analysis, contract strategies, governance, marketing, networks

## **1 – Problem Statement and Objectives**

The fast changing world due to the opening of economies and globalization is changing companies. It can be seen that most companies are trying to focus activities into core competencies and are outsourcing several others, reducing diversification levels. Vertical integration gives place to inter-organizational contracts as an alternative governance structure. Higher product specificity's also contribute to move coordination forms from markets to contracts. The called "hybrid forms" gain "market share" in governance choices. Since hybrid governance forms are mostly done by contracts, the importance of the training process of building, analyzing and revising contracts is very clear and also of growing importance in business management.

It is known that bounded rationality makes it almost impossible to build a complete contract. Incomplete contracts give rise to several problems and undesirable transaction costs that could be reduced if the contract building/revision process was done with more details. The article brings an exercise that is being successfully used as a tool to analyze contracts.

## **2 – Procedures**

The process was built up using several authors in marketing channels & networks and transaction cost economics, all referenced at the end of the article. Contracts from very different sectors (supply or distribution contracts) were analyzed, ranging, for instance, from a supermarket and a dairy supplier, a veterinarian company and the outside sales force, a clothing company and its retail stores at shopping centers, a car manufacturer and the distribution channels, orange growers and processing industry and several others in two years of use and improvement. Figure 01 shows some of the contracts that were already analyzed.

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Figure 01 – Contracts analyzed with the method.

<b>Supplier</b>	<b>Distributor</b>
Parmalat (Food Company)	Gimenes (Supermarket Chain)
Ouro Fino (Veterinarian Company)	Outside Sales Force (Representants)
3M (Graphic Communications)	Authorized Dealers
Supplier of Cappuccino	Utam (Roasted Coffee for Supermarkets))
GM – General Motors	Authorized Dealers
Cori (Clothing Company)	Independent Clothing Retailers
Red Meat Producers	Joint Venture to build a high quality red meat chain
Mappin (outlet chain)	Franchisee Contract
Planet Music (entertainment)	Franchisee Contract
Asia Motors (automobiles)	Authorized Dealers
Esso (Oil Company)	Gasoline distribution stations
Sanofi	Biosintetica (agent in Brazil)
Sapori (Fine Food)	Pão de Açúcar (brazilian's largest retailer)
Coca-Cola	Xis Fast Food Chain
Procter & Gamble	Authorized Distributor
Ipiranga (fuel company)	Gasoline distribution stations
Novell (softwares)	Partner (small business specialists)
Cargill (Orange Juice)	Carrefour (retailer)
Skill (language franchise)	Franchisee
Bob's (Fast Food Chain)	Franchisee
Agua Doce Cachacaria – (Casual Dining Franchise)	Franchisee
Holland Genetics	Sales representatives

Obs: all these contracts have confidentiality. They cannot be shown or reproduced.

The chosen contract will be analyzed using the following methodology. During the process, participants (either students or business people) will fill in the charts and tables and will be able to perceive points where the contract is incomplete (possible sources of future disagreements). At the end, these analysis and the group contributions are presented in a workshop, and final remarks are sent to companies as a contribution. Confidentiality is guaranteed. The company members can be invited to the final workshop, and this is even a more motivating activity, making interactions and discussions possible. The use at the private sector is done in the same way, mostly using internal workshops for contracts discussion and improvements.

**3 – How to Analyze Contracts: The Method:** Below are the five steps that have been used:

### **3.1 - Careful individual reading, understanding of the contract and group discussion**

At first, members of the group will make copies of the contract, study it and produce a short presentation including interesting subjects of the contract, the company, and, finally, which transaction the contract is governing in that particular business system (network).

### **3.2 – The Responsibilities in the Contract:**

The second step will study what responsibilities the contract brings regarding to product, service, communications, financial, requests and information flows, needed for networks to function and reach final consumers. As a suggestion, table 1, regarding the traditional marketing channels flows could be considered, inserting or deleting new points.

Table 1 – Functions, analysis of the responsibility and possible improvements

<b>FUNCTION</b>	<b>ANALYSIS OF THE RESPONSABILITY</b>	<b>POSSIBLE IMPROVEMENTS FOR THE CONTRACT</b>
<b>Product and Services Flow (Forward)</b>		
Inventory management		
Product transportation		
Product modification and after-sale service		
Providing technical service – explaining		
Product maintenance and repair		
Procedure and handling of returned products		
Packaging/ specific packages requirement		
Product range and lines		
Exclusivity		
Territorial Rights		
Re-Exporting		
Market Coverage		
Stock levels and services		
Adaptation to specific laws		
Volumes of sales (performance)		
Property rights		
Duration		
Evaluation of new products		
Others		
<b>Communications Flow (Forward)</b>		
Sales promotion to final consumers		
Information about product features		
Does advertising – providing material		
Training: scope and costs		
Participation in communication budget		
Providing sales force		
Packaging information		
Web site participation and others (fill in)		
<b>Information's Flow (Backwards)</b>		
Sharing knowledge of local market		
Scanning data (access to computer data)		
Information of changes in institutional env.		
Participation in planning process		
Frequency and reports necessary		
Complains via web site/service line		
Does electronic orders		
Order frequency/formats consideration		
Others (fill in)		
<b>Payments and Financial Flows, Orders</b>		
Order frequency		
Pricing policies		
Margins		
Commissions (volume and frequency)		

Conducting credit checks on final consumers		
Billing customers		
Caring for specific customer orders		
Arrange for credit provisions/Financing		
Price guarantees and others (fill in)		

Source: elaborated by the author using Corey et al. (1989); Rosembloom (1999), Wilson & Vlosky, 1997; Jackson & D'Amico (1989) and interviews.

After filling table 01, several discussions about how the contract and the counterpart is working or will have to performance will take part, making it possible to be more

### 3.3 – Asset Specificities, Strategic Alternative Uses of the Assets and Risk Analysis

Normally this is a difficult part to be done, since mostly it is a new way of analysis for the agents that deal with this kind of subjects. Asset specificity refers to how much the asset is specific to that function and the reallocation costs of the asset to other alternative uses. The task is to fill the tables with the possible types of specificities: physical specific assets, technology related specific assets, human specific assets, location specificity and temporal specificity. Factors can be inserted and deleted at table 2. It is also a suggestion to separate these tables at the final presentation.

Table 2– Asset Specificity Analysis: Physical, Technological, Human and Marketing Investments

TYPE OF ASSETS INVESTMENTS	OWNER OF THE ASSET	DEGREE OF SPECIFICITY (High/Medium/Low)	REALLOCATION COSTS/ALTERNATIVE USE (Impossible, High, Medium, Low)
<b>Physical Specific Investment Analysis: Infrastructure and Facilities</b>			
Factory			
Cold storage facilities			
Special storage structure			
Tailored production facility			
Product demonstration facilities			
Repair and service centers			
Distribution channels investments			
Others			
<b>Information and Knowledge Technology Specific Asset Analysis</b>			
EDI/equipment for electronic data exchange investments			
Management process by product category			
Joint logistic planning process			
Joint quality programs			
Traceability programs setting			
Others			
<b>Specific Human Asset Analysis</b>			
General training of distributors			
Joint sales training			
Production process knowledge			
Market knowledge			
Product & brand knowledge			
Others (fill in)			
<b>Marketing/Transaction specific</b>			

<b>Investments Asset Analysis</b>			
Conjoint brand development			
Joint planning advertising			
Packaging development			
Public Relation efforts			
Others (fill in)			

Source: Author, based in Bello & Lohtia (1995); Klein et al. (1990); Kozak & Cohen (1997) and several interviews.

Time and location analysis are considered separately, since their analysis doesn't involve an owner (see table 3). They refer to specific characteristics of products or locations of the assets involved at the transactions.

Table 3- --Specificity Analysis: Time (temporal) and Location (site) conditions

<b>TYPE OF SPECIFICITY</b>	<b>POSSIBLE PRESENCE</b>	<b>DEGREE OF SPECIFICITY (High/Medium/Low)</b>
<b>Time Specificity Analysis: Refers to Time Pressure to do the Transaction (flow)</b>		
Shelf life (perishable)		
Frequent/rapid deliveries		
Seasonally of Production (inventory needs)		
Seasonally of Consumption (inventory needs)		
Other (fill in)		
<b>Site Asset Specificity Analysis: Refers to Physical Locations</b>		
Proximity needs (transport costs)		
Energy supply		
Water supply		
Disposal of materials		
Strategic position of inventory		
Location of Distribution Centers		
Location of outlets (point specificity)		
Others (fill in)		

Source: Author, based in Bello & Lohtia (1995); Klein et al. (1990); Kozak & Cohen (1997) and several interviews.

How can this analysis be useful? With the transactions and assets specificity remarks, elaborated based on the tables above, a summary about where is the specificity problem in that relationship should be done, if exists possible actions to reduce it (new or alternative uses), and, if it does not exist, points or actions should be selected to be discriminated on the contract, trying to reduce the risk of opportunistic attitudes of firms that can take profit from unexpected factors.

Table 4 – Specificity Summary, Possible Risks and Contractual Warranty

<b>LIST ALL HIGH SPECIFICITY FACTORS</b>	<b>RISKS IN THE SPECIFICITY FACTORS</b>	<b>CONTRATUAL WARRANTY</b>

Source: Author

### 3.4 – Analysis of Possible Sources of Power

In establishing a contract between companies, another important analysis to be produced is the possible power sources that the company has and how these can be used at the agreement (Lusch, 1976; Hunt & Nevin, 1974). It is useful for the company, based on

these sources of power and other sources not listed, to build an analysis involving the company and the contract partner. The following model can be useful, where an evaluation of company's own possible power sources and those related to the contract partner, for example, rating from 0-10, can be done. At Annex 01, a table with the main sources of power is provided. How to reduce power imbalances is the task to be pointed here.

Table 6 - Power Analysis

<b>SOURCES OF POWER</b>	<b>Company</b>	<b>Contract Partner</b>
Insert the source	Grade 0-10	Grade 0-10

Source: Author

### **3.5 - Contract Improvements (suggestions) and Institutional Considerations**

At this moment, several improvements to the document (contract) or next versions of the contract can be done. They can be ordered by importance and it should be considered also the possible desires of the partners and conflict sources. This could be interesting for companies to prepare themselves before the negotiation process takes part.

*Institutional (Law) Aspects:* the marketing proposals and suggestions of contractual improvements must consider the institutional environment, to see if it is possible at that particular environment, to propose such improvements. Specialists at the institutional environment (lawyers) could contribute to such analysis.

## **4- Some Results of the Cases Studied**

Due to confidentiality of the instruments analyzed (contracts), it will be pointed out here only a table with the main subjects listed for improvement, without detailing what were the magnitudes of the improvements. Companies did not allow more details.

Figure 02 – Contracts already analyzed with the method

<b>Supplier</b>	<b>Distributor</b>	<b>Improvements Suggested (Only Topics)</b>
Parmalat (Food Company)	Gimenes (Supermarket Chain)	Contract length, deliveries system, payments and discounts for final consumers
Ouro Fino (Veterinarian Company)	Outside Sales Force (Representants)	Transportation of product, after sales services, product modifications, format of the requests and criteria for client's geographical division
3M (Graphic Communications)	Authorized Dealers	Product return policy, evaluation of new products, credit limit and delivery time
Supplier of Cappuccino	Utam (Roasted Coffee for Supermarkets))	Exclusivity, product production monitoring, price changes and delivery time
GM – General Motors	Authorized Dealers	More precision at the processes, information regarding to financial conditions, minimum prices policies, and opening of new concessions policy
Cori (Clothing Company)	Independent Clothing Retailers	New product evaluations, after sales services, customization of information systems, electronic ordering, share local market's knowledge, credit support and evaluation, and exclusivity.
Red Meat Producers	Joint Venture contract to build high quality red meat chain and brand	None remarks regarding to who would be the owner of the brand.
Asia Motors (automobiles)	Authorized Dealers	Sales planning, more exclusivity, more liberty to choose resellers, joint marketing planning

Esso (Oil Company)	Gasoline distribution stations	Change stock management function, better flow of communications and information, and quality maintenance during reselling.
Sanofi	Biosintetica (agent in Brazil)	Product and service support
Sapori (Fine Food)	Pão de Açúcar (Brazilian's largest retailer)	Contract length, reduce power imbalance.
Coca-Cola	Xis Fast Food Chain	Remove exclusivity, use of cups with Coca Cola brand, more flexibility on the communications, more involvement of Coca Cola.
Procter & Gamble	Authorized Distributor	Conditions for contractual hold-up, visit's frequency.
Ipiranga (fuel company)	Gasoline distribution stations	Outsource logistics, more pricing flexibility.
Cargill (orange juice)	Carrefour (retail)	Return of out-of-date products, damaged products
Skill (language franchise)	Franchisee	Incentives for participation of the franchisee's in innovations and overall franchisor's planning process
Bob's (Fast Food Chain)	Franchisee	All the risks are for the franchisee, no subjects dealing with supply prices changes
Agua Doce Cachacaria – (Casual Dining Franchise)	Franchisee	Short time of contract – should be longer
Holland Genetics	Sales representatives	Information flows from representatives to the company

Source: author

## 5 – Final Comments

It is important to say that this exercise is improving each time that the process is used. The discussions and group works are exciting and productive. It is also a tool for students and private sector to learn more about contracts and how to relate with lawyers. The companies with their contracts analyzed had as consequence new suggestions for the improvement of the instruments (contracts). Executives that participated had nice impressions also about the discussions.

In the network economy, the process of building more complete contracts is very helpful. This article brought some contributions to help the process of building or reviewing contracts.

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Table - Sources of Power, what do they refer to, some examples and problems of using

POWER	WHAT DO THEY REFER TO	SOME EXAMPLES/CHANNELS	PROBLEMS
Coercive power (use is negative) (economic)	Threat approach - due to the capacity of one chain member to punish another. It is based on the magnitude of the punishment and the credibility of the message (threatened member perceives higher costs in not agreeing).	<ul style="list-style-type: none"> <li>Discontinuing sales.</li> <li>Refusing to deal.</li> <li>Threatening to do vertical integration.</li> <li>Full line forcing.</li> <li>Add another distributor to area.</li> <li>Allowing bypasses in channels.</li> <li>Sell against manufacturers brand.</li> <li>Threat of using gray markets.                             <ul style="list-style-type: none"> <li>Threat of using direct sales or electronic sales.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Legal problems if the use is continuous.</li> <li>Stimulate associations in the other levels for countervailing power.</li> <li>More conflicts in the chain/channel.</li> <li>Reduces information exchange incentives.</li> <li>Risks of losing a partner and fewer incentives to build relationship marketing.</li> </ul>
Reward power (use is positive) (economic)	Possible rewards to members contribute to power and for them to work as established.	<ul style="list-style-type: none"> <li>Sales force compensation.</li> <li>Price discounts due to performance.                             <ul style="list-style-type: none"> <li>Offering goods in short supply.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Difficult to distinguish between this and coercion depending on the way it was used.</li> <li>It can be limited to the geographic area or amount of rewards.</li> <li>Diminishing returns, since agents get used to the rewards and want more.</li> </ul>
Referent power (use is positive) (non economic)	Image or brands carried contributes to its power. There is a desire to be identified with this member of the channel.	<ul style="list-style-type: none"> <li>Strong brand.</li> <li>National or global presence.</li> <li>Store loyalty.                             <ul style="list-style-type: none"> <li>Private label loyalty.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Looses image and trust in cases of wrong attitudes.</li> </ul>
Expertise power (use is positive) (non economic)	Use of the knowledge in operation systems, market knowledge, marketing knowledge and others.	<ul style="list-style-type: none"> <li>High economies of scale.</li> <li>Cost structure of business.</li> <li>Training skills.</li> <li>Site location knowledge.</li> </ul>	<ul style="list-style-type: none"> <li>Looses trust in cases of wrong suggestions and actions regarding to market, marketing and others.</li> </ul>
Persuasion power (use is neutral) (non economic)	Rational appeals based on size, financial position, knowledge and concentration. Refers to the role as leader.	<ul style="list-style-type: none"> <li>Large discounts.</li> <li>Shelf space.</li> <li>Market share.</li> <li>Centralized purchasing.</li> <li>Slotting allowances.</li> </ul>	<ul style="list-style-type: none"> <li>Ethical and legal problems.</li> </ul>
Legitimate power (use is positive or negative) (economic)	Guaranteed by contract. There is the knowledge in the chain that power exists.	<ul style="list-style-type: none"> <li>Using franchising and all other contract forms.</li> </ul>	<ul style="list-style-type: none"> <li>All problems regarding to uncompleted contracts.</li> </ul>
Information power (non economic)	Data on costs, sales and prices used to influence negotiations.	<ul style="list-style-type: none"> <li>All sources of information that can bring asymmetry and advantage.                             <ul style="list-style-type: none"> <li>Examples: scanned data.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Not sustainable strategy.</li> <li>Ethic problems and difficulties in building strong relationships.</li> </ul>

Source: author, based in Berman, 1996; Lusch, 1976; Hunt & Nevin, 1974; El Ansary & Stern, 1972, Pelton et al 1997; French and Raven (1959); Stern and El Ansary (1972), Etgar (1978), Gaski (1984) and several interviews.