

Contracting in Business Networks

Stefanos Mouzas

s.mouzas@lancaster.ac.uk *United Kingdom Lancaster University*

Keith Blois

keith.blois@btinternet.com *United Kingdom Lancaster University*

Competitive Paper

Abstract

Companies face the problem that it is often impossible for counterparties to manifest their consent in a complete contract. Barriers to concluding complete contracts are regarded as transaction costs; they are the costs of negotiating, drafting and enforcing agreed transactions. This study investigates one way in which firms deal with this problem by investigating framework contracts between firms in the context of multinational firms involving food and drinks products, pharmaceutical products, service providers and grocery retailers based on an empirical investigation conducted in Germany and the United Kingdom between September 2008 and March 2011.

Key words: Relational Contract, Incomplete Contract, Transaction Costs, Consent.

Introduction

The intent of this study is to investigate firms' efforts to establish and maintain a mechanism that reduces transaction costs and thus facilitates the conclusion of future contracts. The research was conducted between September 2008 and March 2011 in the context of a network of six multinational firms (A, B, C, D, E and F) in Germany and the United Kingdom involving manufacturers of consumer and pharmaceutical products, service providers and grocery retailers. Our attention was focused on eight framework contracts between these six multinational firms. All these framework contracts were re-negotiated annually and regulated recurrent inter-firm transactions. A realist epistemological stance guided our empirical research endeavors. We considered the existence of framework contracts as real and independent of us as observers.

The impetus for this study was the recognition that empirical investigations have revealed that when managing their inter-firm relationships: "reasonably clever businessmen and lawyers cope with problems scholars might consider intractable" (Goldberg and Erikson, 1987: 369) and they do this through the use of ingenious contractual arrangements. Indeed, it has been observed 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: 146).

Companies face the problem that it is often impossible for counterparts to manifest their consent in a complete contract however arguably framework contracts provide one solution to this problem. Other possible solutions are strategic alliances, partnerships and R&D projects, and other forms of continuing relationships in business networks. In theoretical terms, barriers to concluding complete contracts are regarded as transaction costs: these are the costs of running “market transactions” or the “costs of using the price mechanism” (Coase, 1988:7). In contract research, specifically, transaction costs are a function of (1) information asymmetries between counterparts and unforeseen contingencies, (2) drafting costs, (3) enforcement costs, and (4) renegotiation requirements (Tirole, 1999; 2009). These barriers to concluding complete contracts have been discussed extensively in law, economics and organization studies under the aegis of the relational and incomplete contract theories.

Although there is a substantial amount of academic empirical work that aims at interpreting contracting situations, there is a paucity of discussion about the ways in which firms deal with the barriers created by the need to work with incomplete contracts. Recent research emphasizes that there is more to contracts than incompleteness (Furlotti, 2007) and considers contract design to be a firm capability that is relevant in managing inter-firm relationships (Argyres and Mayer, 2007; Mayer and Argyres, 2004).

The Issue of Consent

Existing research, however, does not provide us with an integrative theoretical lens to make sense of firms’ efforts to frame the contracting process. In this study, we posit that one of the missing pieces for a robust explanation of the puzzle of how firms cope with barriers to concluding complete contracts is the concept of *consent* (Barnett, 1986; 1992b; 2002). Consent is an inter-cognitive achievement between contracting parties which brings certain property rights or entitlements to a system of exchange (Biggart and Delbridge, 2004); and counterparts manifest their consent to the transfer of these entitlements (Barnett, 1986). In this way, consent between counterparts is not simply a mental state but an act in which there is a meeting of wills based on objective manifestations of joint intentions that are legally binding. As a result, the process of contract formation has ‘hard edges’ (Atiyah, 1995) and the challenge that counterparts face is how to update their consent over time.

We argue that framework contracts are one method of dealing with limitations identified in the relational and incomplete contract literature. By arranging framework contracts, firms seek to balance the need for certainty and calculability of transactions with the need to remain sufficiently flexible to update their actual consent. This balancing act is achieved through an agreed framework of clauses that regulate future contracts. This is particularly useful in continuing business relationships in business networks as firms anticipate continuing to conduct transactions in the future (Ring and van de Ven, 1999; Das and Teng, 1999). This study: 1) presents evidence of framework contracts between firms in the context of multinational firms involving food and drinks products, pharmaceutical products, service providers and grocery retailers based on an empirical investigation conducted between September 2008 and March 2011; 2) presents a comparative analysis of empirical findings; and, 3) sets out potential research directions in organization studies.

Relational and Incomplete Contract Approaches

Much of the research into the nature and form of business contracts is often referred to as ‘relational’ or ‘incomplete’ contract theory. ‘Relational Contracts’ are self-enforcing agreements between contracting parties which create a “collaboration sustained by the shadow of the future, as opposed to formal contracts enforced by courts” (Gibbons and Henderson, 2011: 1). Over a period of four decades, the impact of the relational contract approach on organization studies is evidenced by a widespread recognition that it is not only discrete transactions that are covered by contracts (Zaheer and Venkatraman, 1995, Leblebici and Shalley, 1996, Harrison 2004, Carson et al. 2006). Business studies approached relational contracting as a governance mechanism (Williamson 1985, 1991, Leblebici and Shalley 1996, Poppo and Zenger 2002) that involves long-term highly specific investments (Ring and Van de Ven 1992); fosters inter-firm trust (Das and Teng 1999, 2000; Zaheer and Venkatraman, 1995); and, minimizes the risk of opportunistic behavior (Carson et al. 2006). The relational approach to contracts, however, was also found to be inadequate to explain contemporary inter-firm arrangements (Schanze 1991, Bernstein 1992, Barnett 1992b, McKendrick 2002). Indeed, the applicability of relational contracts to business relationships in the real world remains limited. This is evidenced by an extensive analysis of relational contracts in US courts (Schwartz 1992) and a leading UK legal case where senior English judges vigorously rejected any attempt to make use of a ‘relational’ argument (Baird v. Marks & Spencer 2001, Blois 2003, Harrison, 2004). A contract is per se relational because it establishes recognition and respect among those who decided to participate (Markovits, 2004).

In comparison ‘Incomplete Contracts’ recognize that, while some elements of a contract can be certain, “complete, fully contingent, costlessly enforceable contracts are not possible” (Klein, 1980: 356). The source of contractual incompleteness is often attributed to bounded rationality (Williamson 1979, Anderlini and Felli 1994, Segal 1999, Tirole 2009). It is usually expensive or effectively unfeasible for counterparts to measure some types of contractual performance (Hart 1995, Tirole 1999). Table 1 provides an overview of how scholars in law, economics and organization interpret *relational* and also *incomplete* contracts.

 Insert Table 1 about here

Some contract researchers accept that “there is another possible remedy when contracts are incomplete: leave the governance structure alone, but move to *relational contracting*” (Gibbons, 2005: 236). In this way, relational contracting allows “parties to utilize their detailed knowledge of their specific situation and to adapt to new information as it becomes available” (Gibbons, 2005: 236). Nonetheless, there is the disadvantage that relational contracting cannot be legally enforced because these contracts would contain substantive elements with regard to which third parties “are unable to verify whether contractual obligations have been met” (Brown et al., 2004: 747). The legal enforceability is often redundant as these contracts are ‘self-enforcing’ because of non-legal sanctions that involve reputation costs or the loss of relationship-specific assets (Charny, 1990; Scott, 2003; Levin, 2003).

Data Collection and Analysis

It became clear at the start of the research that we needed to engage in a longitudinal data collection exercise that captured inter-firm contracts in their temporal and spatial context (Pettigrew et al., 2001). In the first stage of the research, which took place between September 2008 and March 2009, unstructured face-to-face interviews were conducted with key informants such as Board Members, Heads of Business Units, and Country Managers in the United Kingdom and Germany (see Table 2).

 Insert Table 2 about here

The purpose of this initial stage was to gain access to multinational firms, identify additional expert interviewees and develop insights into the history and characteristics of relevant business-to-business relationships. In addition to these interviews, publicly available information in the form of 241 press releases and 32 annual reports were collected representing a total of compilation of 864 pages. Using this information, we reconstructed a graphical representation (see Figure 1) of eight inter-firm contracts and captured the chronology and the number of transactions between firms.

 Insert Figure 1 about here

In the second stage of the research, we carried out between April 2009 and March 2011, the pool of interviewees was expanded from 8 to 83 decision makers (see Table 2). Interviewees included Corporate Lawyers, Sales Directors, Marketing Directors, Key Account Managers, Category Managers, Purchasing Managers, Financial Managers, Trade Marketing Specialist and Logistics Specialists. Each interview was face-to face in the native language of the interviewee and lasted about 45 minutes. The purpose of executing a second stage of data collection was to obtain copies of inter-firm contracts and engage with the actors that are involved with the design and operational use of such contracts. Obtaining contemporary inter-firm contracts was a novel method to move beyond subjective views obtained through interviews and examine objectified records and manifestations of consent between firms. Furthermore, the second stage of data collection placed emphasis on obtaining organizational procedures, archival records, reports prepared for key accounts, e-mails as well as protocols of the six multinational firms.

In the third stage of the research, carried out from March 2011 to June 2011, we moved from data collection to data analysis. This involved a critical examination, evaluation, re-categorization and recombination of findings to identify the contractual mechanisms used to overcome barriers to complete contracts. We used the term 'mechanisms' to delineate the ways in which firms respond to problems that we observed (Tsoukas, 1989; Elster, 1989; Hedstrom and Swedberg, 1998). Although the analysis involved a focus on the temporal and spatial contexts (Pettigrew et al., 2001) that encouraged themes to emerge from the data rather than imposing them on the data, our explanations did not emerge directly from the empirical data. Instead, our explanations were a product of identifying relevant knowledge gaps in the literature and confronting theoretical ideas with empirical observations.

Contextual Setting

The study investigates framework contracts between six multinational firms operating in Germany and the United Kingdom. Manufacturers A and B are producers of fast-moving consumer and pharmaceutical goods that have built worldwide a reputation for developing brands. Manufacturer A's market capitalization in 2011 was €87 billion and employed worldwide 127,000 full-time employees. Manufacturer B reported in 2011 a market capitalization of €18 billion and employed worldwide 51,000 employees. Both manufacturers supply retailers C and D which are grocery retail chains focusing on large hypermarkets with an average outlet exceeding 4,000 square meters. In 2011 retailer C operated: 4600 outlets; employed 84,500 employees; and, reported revenues of €1.5 billion. In comparison, retailer D operated 9400 outlets and generating €68.7 billion revenues in 2011. Furthermore, manufacturers A and B collaborate with service providers E and F which are logistics companies with expertise in the transportation and storage of food and drinks and well as consumer and pharmaceutical products. In 2011 service provider E employed 3200 employees and reported revenues of €1.3 billion while service provider F employed 2800 employees and reported revenues of €1.6 billion.

Germany and the United Kingdom are the two largest markets in Europe representing a total population of 80 and 61 million consumers respectively. Multinational manufacturers of consumer and pharmaceutical products have expertise in the production and marketing of strong consumer brands in specific product categories such as food and drink, laundry, cleaning and medical and pharmaceutical products, while grocery retailers, with their large number of hypermarkets, regularly reach 141 million consumers directly. These consumers are not merely the final stage of the manufacturer-retailer supply chain as their buying behavior, which is influenced by a multiplicity of socio-economic and cultural trends, provides the primary base of recurrent transactions between manufacturers and retailers. Logistics service providers supply manufacturers and retailers with distribution and storage services that facilitate informational, monetary and physical flows between counterparts. Because of the economic interdependence among manufacturers of consumer and pharmaceutical products, grocery retailers and logistics service providers, the primary concern of these firms was not with the completion of individual contracts but rather with the creation of a framework that establishes and maintains recurrent transactions capable of creating and capturing value (Lepak, Smith and Taylor, 2007). The first stage of this research indicated that framework contracts were seen by manufacturers and retailers as structural pillars of an architecture that regulates and facilitates the conclusion of individual contracts. This encouraged closer examination of (1) *recurrent transactions* and (2) *contracting processes* to identify how counterparts cope with barriers to complete contracts.

Recurrent transactions: The six multinational firms that participated in this research are embedded in continuous relationships with their suppliers and customers marked by recurrent transactions and not by spot market transactions. Figure 2 demonstrates this. The lowest average number of transactions per annum in the period 2008-2011 was between Manufacturer B and Retailer D (86 transactions); the highest average number of transactions per annum in the same period was between Manufacturer A and Service Provider E. There was evidence that the average number of transactions per annum between manufacturers and service providers (AE, AF, BE, BF) was significantly higher, varying between 248 and 352 transactions per annum. The reason

for this difference is that service providers were logistic firms that facilitated the storage and transportation of manufacturers' products to multiple customers, such as other retailers, petrol stations and wholesalers. In comparison, the transactions between manufacturers and retailers (AC, AD, BC, BD) were customer specific transactions varying between 86 and 116 transactions per annum.

 Insert Figure 2 about here

Recurrent transactions as we observed in this study are a typical pattern for many inter-firm arrangements because a great deal of business nowadays occurs through strategic alliances, partnerships and collaboration projects and other forms of continuing relationships (Ring and Van de Ven, 1992; Das and Teng, 1999; 2000; Reuer and Arino, 2003; 2007). Extant research indicates that recurrent transactions between counterparts encourage firms to put greater effort into contingency planning in subsequent contracts, which is consistent with learning effects over time (Argyres et al., 2007, Mayer and Argyres, 2004). Recurrent transactions necessitate a domain consensus between counterparts over functions and roles in continuing relationships. Counterparts may lack assets, technological or organizational capabilities to fulfill certain functions or they may specialize in a certain domain. Alternatively, firms' capabilities may alter and thus, domains may be disputed and redefined over time. This is demonstrated vividly in the engagement of retailers in boosting private labels (Dunne and Narasimhan, 1999; Narasimhan and Wilcox, 1998). Private labels can be regarded as a deliberate attempt by grocery retailers to invade domains that are traditionally the preserve of consumer goods manufacturers, and hence it constitutes an attempt to redefine role-sets and redraw the boundaries of domains. It was, therefore, necessary in this study to examine the firms' boundary conditions and property rights. Manufacturers A and B are not simply producers of consumer and pharmaceutical products; they are also involved in research and development; they own patents and the property rights of brands. Nonetheless, manufacturers A and B need to engage in recurrent transactions with a relatively small number of major retailers such as retailers C and D to obtain listing for their brands, shelf space and promotional support at retailers' outlets. Furthermore, manufacturers A and B need the assets and logistics expertise of service providers E and F in the transportation and storage of sensitive consumer and pharmaceutical products. The service providers' role is to facilitate cost-efficient and well-timed deliveries from manufacturers to retailers. In comparison, retailers C and D are involved in direct contact with consumers. Thus they are concerned with the competitiveness of their outlets and the development of a distinct image among consumers. Regular rounds of price increases, usually at the start of a calendar year, create significant friction between manufacturers and retailers. This prompts retailers to introduce "variable pricing" in which final consumer prices change continuously according to costs and encourages them to launch their own retailer brands (private labels) produced by third-party manufacturers (Dunne and Narasimhan, 1999). Recognizing their interdependence, manufacturers, retailers and service providers seek to minimize friction in recurrent transactions and pave the way toward jointly agreed framework contracts.

Contracting Process: Our attention was focused on framework contracts which were re-negotiated annually and regulated inter-firm transactions over a four year period. In

the annual negotiations of framework contracts that take place between September and December, service providers' managers contact manufacturers' logistics managers. Similarly, the manufacturers' key account managers contact retailers' purchasing managers to review the annual performance of their business relationship. In principle, counterparts AC, AD, BC, BD, AE, AF, BE, BF are driven by their wish to maintain and improve their existing relationship. Counterparts recognize the value of their relationships and acknowledge their determination to identify new, innovative ways to create joint gains. In practice, however, the whole contracting process is driven by: a) their particular interests, for example, considerations of property rights in private labels or manufacturers' brands, exclusivity or liability issues; b) the performance of repeated transactions, for example, manifested through information-based systems such as Continuous Stock Replenishment or Vendor Managed Inventory; and, c) the recurrent negotiations of, for example, periodic business reviews and task reviews. For this reason, service providers, manufacturers and retailers need to negotiate an exchange process (Sebenius, 1992). Usually manufacturers' key account managers ask retailers for shelf and promotional space for their brands, offering trade allowances as a fee or payment for the distribution that brands obtain (Sullivan, 1997). Retailers' purchasing managers might confront manufacturers' key account managers with requests or demands for the production of private labels. Strong manufacturers usually show resistance to this temptation by arguing that this is not within their business policy. Weaker manufacturers, however, are more likely to agree to produce private labels because by this means they can generate incremental sales volume without having to run expensive advertising campaigns. The contracting process is driven by the objectified measures of resources, such as promotional and trade allowances that manufacturers need to pay to retailers, and market performance as evidenced by market shares and direct product profitability. In this way, objectified criteria take precedence over the subjective views and personal opinions. Service providers' managers, manufacturer's key account managers and retailers' purchasing managers are sophisticated and experienced negotiators that work across different functions and are usually senior managers responsible for the coordination of client/customer relations, as well as the internal coordination within their own firm. In drafting framework contracts, contracting parties draw on the expertise of other staff departments, such as legal, marketing, or operations. Exit scenarios or termination clauses, for example, are drafted by corporate lawyers in the legal department.

The Evidence from Framework Contracts

What is unique in the framework contracts that we obtained is the fact that they are not concerned with *volumes* or *prices* of one specific transaction (see Table 3). Instead, framework contracts are concerned with the parties' consensus regarding the conditions, e.g. exclusivity, confidentiality or subcontracting, under which transactions may take place. The parties to a framework contract are not required to: a) specify new terms in their future transactions; b) refer to the pre-existence of a framework contract; or, c) buy a specified amount of goods or to accept future offers. The reason for this is that these companies are embedded in stable and established relationships and are only seeking to frame a give-and-take process to deal with on-going developments. In these established relationships, contracting parties recognize their interdependence and seek to articulate contract clauses which facilitate the conclusion of future contracts. We identified 17 types of contract clauses that move beyond specifying the volumes and prices of individual transactions. Contract clauses refer to terms of payment, termination rights, subcontracting, saving clauses,

renegotiation, property rights, applicable products/services or category or products, notification requirements, liability, legal venue, information flow, force majeure, exclusivity, duration of the agreement as well as arbitration or mediation (see Table 3).

 Insert Table 3 about here

There is evidence that these contractual clauses are used in a variety of ways and this can be traced back to the observed diversity of existing norms and counterparties' divergent interests. In our study, manufacturers A and B, retailers C and D and service providers E and F pursue different objectives; they make different assumptions and have different priorities. Specifically, framework contracts AC, AD, BC and BD stipulated contract clauses that regulated the transfer of property rights and confidentiality while framework contracts AE, AF, BE and BF were concerned with liabilities and the obligation to remedy deficiencies applied to services obtained from subcontractors. Similarly, manufacturers A and B agreed with retailers C and D that prices and volumes will be determined in the future, while manufacturers A and B agreed to confer power on service providers E and F to determine prices unilaterally based on a predefined cost-plus-margin frame, although manufacturers A and B maintained the right to obtain competitive offers at any time.

As manufacturers A and B, retailers C and D and service providers E and F are embedded in continuous relationships, their framework contracts contain clauses that regulate recurrent transactions. For example, counterparts may agree that *payment is due in 30 days; delivery cost is paid by the supplier* or they might agree on clauses regarding the listing of products or services, shelf space or trade allowances. Counterparties to framework contracts emphasize the importance of information flow and notification requirements. For example, parties may agree that mutual notification is required for all future capital investment and R&D or that an electronic data interchange is established. A critical part of framework contracts refers to property rights and assurances that that no third person has obtained property rights. This is particularly relevant in two areas: a) intellectual property rights on concepts and art work; and, b) control over private labels manufacturer brands. Similarly critical are framework clauses on exclusivity rights, and confidentiality. For example parties might agree that all information exchanged is confidential and "*shall not to be available to third parties without written consent of the other party*". Exclusion or force majeure clauses may address risks that could occur as a result of contextual contingencies. For example, parties may agree that they "*bear no liability for damages occurred as a result of war, political unrest, strikes, lockouts, and governmental interventions*". To create an in-built contractual flexibility, contracting parties may insert saving clauses. For example, parties may agree that "*unless it is of major importance, invalidity of one or more clauses will not have any effect on the agreement as a whole*". The possibility of renegotiation is usually restricted to annual or period business reviews. This allows calculability and certainty of transactions and reduces the potential for opportunistic behavior. Usually parties have the right to terminate the agreement giving one year's prior notice, although some of the frameworks are technically indefinite agreements that are mutually re-confirmed each year.

The Contribution of framework Contracts

The norms applicable to particular industries or countries will determine the manner in which contracts are implemented (Arrighetti et al., 1997). They are often implied as ‘default rules’ because they comprise customary and expected conventions (Ayres and Gertner, 1989; Riley, 2000). Norms are important because they create a structure that guides the management of transactions (Nee, 1998). Without norms, contracting parties face difficulties when interacting with each other and the possibility of transactions is constrained (Buchanan, 1975; Choi, 1993; Loasby, 2000). The use of framework contracts draws attention to two intriguing aspects. Firstly, framework contracts transform ‘implicit’ norms, which are embedded in customs and commercial practices, into ‘explicit’ contract clauses. Thus, they introduce a stratified contracting process that consists of several interactive layers or events; they codify the parties’ knowledge about efficient ways to interact; and, hence, become “knowledge repositories” (Mayer and Argyres, 2004: 405). The evidence that the primary concern of framework contracts is the exchange of information between contracting parties is supported by studies of strategic alliance contracts. These demonstrate that repeated transactions among firms forming alliances deepen inter-partner communication and leads to a tacit development of contractual provisions for troubleshooting (Taylor and Plambeck, 2007; Reuer and Arino, 2007). Secondly, the framework contract’s function is not to predetermine contractual decisions but to provide an agreed framework within which they can be made. This *functional* particularity is crucial for understanding how contracting parties cope with barriers to creating a complete contract. Scholarly work on relational and incomplete contracts has obscured the difference between contractual decisions and the framework in which contractual decisions are made. Individual contracts anticipate and ‘presentiate’ future transactions between contracting parties (Atiyah, 1986). In contrast, parties to a framework contract manifest their consent to a framework within which future transactions may take place.

Consent: (Barnett, 1986; 2002) can, therefore, be regarded as the underlying assumption for the conclusion of framework contracts. Historical evidence and theory suggests that, absent genuine consent, contractual arrangements are not sustainable because they do not facilitate the creation of the maximum potential value (Kronman and Posner, 1979; Sebenius, 1992). This is also apparent in the instabilities of those strategic alliances which fail to manage tensions such as “cooperation versus competition, rigidity versus flexibility or short-term versus long-term orientation” (Das and Teng, 2000: 94). In theoretical terms, framework contracts allow the re-adjustment of consent over time in such a way that the contractual surplus is maximized, though this does not imply anything about how value is appropriated (Lepak et al., 2007). Because consent matters, parties to framework contracts regard information exchange as critical in managing the data flow from the customer’s decision, up to merchandising and production planning. This exchange of information strengthens the connectivity between actors and reduces transaction costs (Collins, 2009).

The present study of framework contracts shows that they are being used to overcome the problems identified in the relational and incomplete contract literature. Framework contracts convert established rules and principles into mutually agreed contractual clauses that can be used in a specified set of future transactions. They do not predetermine future selection processes (Crone, 1993); instead, they create the framework of reference points within which future selection processes may take

place. This function appeals to the concept of ‘contract as a framework’ (Llewellyn, 1931) and the view of ‘contracts as reference points’ that express parties’ consent to ‘entitlements’ (Hart and Moore, 2008; Fehr et al., 2011). Framework contracts may also be viewed as including ‘recurrent contracts’ which usually regulate short-term repeated transactions (Ring and Van de Ven, 1992; Das and Teng, 2000). What differentiates framework contracts from other contract forms is not the time horizon of the contractual arrangement but their function which is to supply clauses that can be used in a defined set of subsequent transactions.

A Comparative Analysis

Any attempt to compare framework contracts with relational contracts and incomplete contracts, would require awareness of the diversity of perspectives adopted by different literatures. Thus, although scholars may use the same terms, e.g. *relational contract*, the interpretation of a term often differs both within and between academic disciplines. When a comparative analysis of divergent perspectives is undertaken, there is a need to understand how scholars’ ontological as well as methodological choices may vary in terms of: a) their underlying assumptions; b) the purpose of the analysis; c) the unit of analysis; and, d) their modeling. It follows that, when comparing the findings of scholars from different backgrounds, awareness of the perspectives adopted is important (see Table 4). For example, relational contracts seek to explain behaviors within an exchange process and, therefore, the unit of analysis is the *relationship*, taken as an entity, between the contracting parties. Furthermore, this analysis uses a sequence of bilateral episodes in the form of narratives.

 Insert Table 4 about here

Incomplete contracts assume that transaction costs are important in investigations of the efficiency of different forms of governance. In the incomplete contract approach, the level of analysis is the *transaction* and not the relationship or the firm. In terms of modeling, the analysis is that of repeated game-theoretic models over time expressed mathematically. The unifying assumption of framework contracts is that consent matters because it leads to the maximization of the contractual surplus. In contrast, consent is not a relevant element in relational and incomplete contract approaches (for a critique, see Barnett, 1992a; 1992b; 2002). The purpose of analyzing framework contracts is to investigate repeated transactions between contracting parties. The level of analysis thus shifts towards the ‘category of business’ e.g. the product category and the modeling focuses on framework clauses that guide the way contracting parties wish to interact with each other.

Conclusion and Future Research

Contracts are relevant as they are found in all sorts of business alliances, strategic partnerships, collaborations or other ‘give-and-take’ processes (Baker et al., 2008; Markovits, 2004; Heide and John, 1990; Poppo and Zenger, 2002; Roxenhall and Ghauri, 2004; Reuer and Arino, 2007; Argyres and Mayer, 2007; Faems et al., 2008). However, the work of Macaulay S. (2004) and Macneil (2000) has shown that, in practice, firms find the rigidity of traditional legal contracts constrain their ability to work together in an effective manner. As a consequence companies enter into

framework contracts because they derive benefits from ‘framing’ the whole process of exchange relationships as compared with the difficulties that complete contracts present. Framework contracts: a) reduce the costs of managing recurrent transactions; b) provide certainty regarding the conditions under which transactions may take place; and, c) reduce information asymmetry by providing a platform for continuing interaction and coordination. In this way, framework contracts can be regarded as ‘constitutions’ of contracts (Mouzas and Furmston, 2008).

Three directions for future research can be proposed: a) research on consent; b) research on default rules; and, c) research on the stratified nature of contracting.

Research on Consent: A consent-based understanding of contractual arrangements may offer new empirical insights into organizational research. Consent is the ‘test’ to examine how contracting parties facing information asymmetries (Nayyar, 1990) and unforeseen contingencies (Tirole, 1999) cope with the problems of designing contracts in collaborative relationships characterized by high degree of interdependence (Ring and Van De Ven, 1992). In this way, a consent-based understanding of contractual obligations may stimulate empirical research about how firms update their commitments through *negotiation* processes (Sebenius, 1992) to *create stability* and *manage risks* in their collaborations, partnerships or strategic alliances with counterparts (Das and Teng, 1999; 2000). Consent is an inter-cognitive achievement that requires continued updates over time and is, ultimately, the moral component that differentiates between valid and invalid transactions among actors (Barnett, 1986; 1992b). Consent treats contracting parties as actors that bring ‘property rights’ to an exchange process. Property rights define the boundaries within which counterparts may act without the forcible interference of others. Understanding the role of consent in contractual arrangements requires, therefore, an 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; Barnett, 1986; Foss and Foss, 2005).

Research on Default Rules: While it is often impossible for contracting parties to define all terms of a complete contract, default rules are relevant in organizational research because they form a ‘baseline’, i.e. they operate as bases of pre-existing agreements. In this way, default rules articulate a common-sense order of shared conventions (Young, 1993; Choi; 1993) that comprise customary, expected, legal, and often non-legal rules and principles which fill in possible ‘gaps’ in contracts (Ayres and Gertner, 1989; Riley, 2000). However, there are two inherent problems with default rules filling in gaps in contracts. First, shared conventions that pre-exist as norms vary as they are specific to an industry or a region (Scott, 2000). Secondly, default rules can be overridden by a contract because they apply ‘unless otherwise agreed’ (Barnett, 1992a). Contracts may build upon bases of agreements that pre-exist as norms or common practice in a particular industry or region and transform them into a framework for managing business relationships. Organizational research might provide new insights about: 1) bases of pre-existing agreement among companies on issues such as information sharing, domain consensus, lobbying, reciprocity, notification requirements, terms of payment or even termination rights; and, 2) the extent that these pre-existing agreements are transformed into contractual clauses.

Research on the stratified nature of contracting: Recent research provides evidence that contracting is not a snapshot taken at the moment the transaction was agreed but is a dynamic and stratified process. For example, studies in the USA demonstrate the ability of firms to sustain repeated transactions through contractual arrangements (Argyres and Mayer, 2007; Argyres et al., 2007; Taylor and Plambeck, 2007). For many firms, the need to create a framework within which individual contracts can be concluded is important because their business activity increasingly appears to be via strategic partnerships, alliances or other inter-organizational arrangements (Das and Teng, 1999; 2000; Reuer and Arino, 2003; 2007). Yet research on the stratified nature of contracting remains a largely unexplored area. Further research on contracts between firms should be responsive to the recent calls for more attention to the specific contract clauses incorporated into contracts (Poppo and Zenger, 2002; Reuer and Arino, 2007; Furlotti, 2007) rather than adopting a theoretical lens based on the relational or incomplete contract approach. In doing so, further research needs to be clear about the ontological and methodological choices; the underlying assumptions; the level and purpose of analysis; as well as the choice of model.

REFERENCES

- Aghion, P. and Bolton, P. (1992). An ‘Incomplete Contracts’ Approach to Financial Contracting, *Review of Economic Studies*, 59, 473–494.
- Argyres, N. and Mayer, K.J. (2007). Contract design as a firm capability: An integration of learning and transaction cost perspectives, *Academy of Management Review*, 32 (4), 1060–1077.
- Arrighetti, A., Bachmann, R. and Deakin, S. (1997). Contract law, social norms and inter-firm cooperation, *Cambridge Journal of Economics*, 21(2), 171-195.
- Atiyah, P.S. (1986). *Essays on Contract*. Oxford: Oxford University Press.
- Atiyah, P.S. (1995). *An introduction to the law of contract*. Oxford: Clarendon Law.
- Ayres, I. and Gertner, R. (1989). Filling the gaps in incomplete contracts: An economic theory of default rules, *Yale Law Journal*, 99, 87-130.
- Baker, G., Gibbons, R. and Murphy, K.J. (2002). Relational contracts and the theory of the firm, *Quarterly Journal of Economics*, 117(1), 39-84.
- Baker, G., Gibbons, R. and Murphy, K.J. (2008). Strategic alliances: bridges between ‘islands of conscious power’, *Journal of the Japanese and International Economies*, 22(2), 146-163.
- Barnett, R.E. (1986). A consent theory of contract, *Columbia Law Review*, 86(2), 269-321.
- Barnett, R.E. (1992a). The sound of silence: default rules and contractual consent, *Virginia Law Review*, 78, 829-59.
- Barnett, R.E. (1992b). Conflicting visions: A critique of Ian Macneil's relational theory of contract, *Virginia Law Review*, 78, 1175-1206.
- Barnett, R.E. (2002). Consenting to form contracts, *Fordham Law Review*, 71(3), 627-645.
- Biggart, N.W. and Delbridge, R. (2004). Systems of exchange, *Academy of Management Review*, 29(1), 28-49.

- Blois, K. (2003). B2B “relationships”: a social construction of reality? A study of Marks and Spencer and one of its major suppliers. *Marketing Theory*, 3(1): 79–95.
- Brown, M., Falk, A. and Fehr, E. (2004). Relational contracts and the nature of market transactions, *Econometrica*, 72(3), 747-780.
- Buchanan, J.M. (1975). A contractarian paradigm for applying economic theory, *American Economic Review*, 65(2), 225-230.
- Carson, S.J., Madhok, A. and Wu, T. (2006). Uncertainty, opportunism, and governance: The effects of volatility and ambiguity on formal and relational contracting, *Academy of Management Journal*, 49(5), 1058-1077
- Charny, D. (1990). Nonlegal sanctions in commercial relationships, *Harvard Law Review*, 103, 373-467.
- Choi, Y.B. (1993). *Paradigms and conventions: Uncertainty, decision-making and entrepreneurship*. Ann Arbor: University of Michigan Press.
- Coase, R. (1960). The problem of social cost, *Journal of Law and Economics*, 3, 1-44.
- Collins, H. (1999). *Regulating Contracts*. Oxford: Oxford University Press.
- Collins, H. (2009). The weakest Link. Legal Implications of the Network Architecture of Supply Chains. In *Networks: Legal Issues of Multilateral Co-operation*, G. Teubner and M. Amstutz (Eds.), Hart Publications, 187-210
- Crone, von H. (1993). *Rahmenverträge. Vertragsrecht-Systemtheorie-Oekonomie*. : Zürich: Schulthess Polygraphischer Verlag.
- Das, T.K. and Teng B.S. (1999). Managing Risks in Strategic Alliances, *The Academy of Management Executive*, 13, 50-62.
- Das, T.K. and Teng B.S. (2000). Instabilities of Strategic Alliances: An Internal Tensions Perspective, *Organization Science*, 11, 77-101.
- Demsetz, H. (1966). Some aspects of property rights, *Journal of Law and Economics*, 9, 61-70.
- Dunne, D. C. and Narasimhan, C. (1999). The New Appeal of Private Labels, *Harvard Business Review*, 77(3), 41-49.
- Eisenberg, M.A. (2002). Relational Contracts. In *Good Faith and Fault in Contract Law*, Beatson, J. and Friedmann, D (eds). Oxford: Clarendon Press, 291-304.
- Elster, J. (1989). *Nuts and Bolts for the Social Sciences*. Cambridge: Cambridge University Press.
- Faems, D., Janssens, M., Madhok, A. and Van Looy, B. (2008). Toward an integrative perspective on alliance governance connecting, *Academy of Management Journal*, 51(6), 1053-1078.
- Fehr, E., Hart, O., and Zehnder, C. (2011). Contracts as Reference Points- Experimental Evidence, *American Economic Review*, 101(2), 493-525.
- Foss, K. and Foss, N.J. (2005). Value and transaction costs: How property rights economics furthers the resource-based view, *Strategic Management Journal*, 26, 541-556.
- Furlotti, M. (2007). There is more to contracts than incompleteness: a review and assessment of empirical research on inter-firm contract design, *Journal of Managerial Governance*, 11, 61–99.
- Gibbons, R. (2005). Four formal(izable) theories of the firm? *Journal of Economic Behavior and Organization*, 58. 200-245.
- Gibbons, R. and Henderson, R. Relational Contracts and Organizational Capabilities, *Organization Science*, forthcoming.
- Goldberg, V. and Erikson, J. (1987). Quantity and price adjustment in long-term contracts, *Journal of Law and Economics*, 30, 369-398.

- Grossman, S. and Hart, O. (1990). The costs and benefits of ownership: A theory of vertical and lateral integration, *Journal of Political Economy*, 94, 691–719.
- Harrison, D. (2004). Is a Long-term Business Relationship an Implied Contract? Two Views of a Relationship Disengagement. *Journal of Management Studies*, 41: (1) 107-125.
- Hart, O. and Moore, J. (1990). Property rights and the nature of the firm, *Journal of Political Economy*, 98, 1119–1158.
- Hart, O. and Moore, J. (2008). Contracts as Reference Points, *Quarterly Journal of Economics*, 123, 1–48.
- Hedstrom, P. and Swedberg, R. (Eds.) 1998. *Social Mechanisms. An Analytical Approach to Social Theory*. Cambridge: Cambridge University Press.
- Heide, J.B. and John, G. (1990). Alliances in industrial purchasing: The determinants of joint action in buyer-supplier relationships, *Journal of Marketing Research*, 27(1), 24-36.
- Klein, B. (1980). Transaction cost determinants of ‘unfair’ contractual arrangements, *American Economic Review*, 70(2), 356-362.
- Kronman, A.T. and Posner, R.A. (1979). *The economics of contract law*. Boston, Mass: Little, Brown and Co.
- Leblebici, H. and Shalley C.E. (1996). The organization of relational contracts: The allocation of rights in franchising, *Journal of Business Venturing*, 11(5), 403-418.
- Lepak, D.P., Smith, C.E. and Taylor, M.S. (2007). Value creation and value capture: A multilevel perspective, *Academy of Management Review*, 32(1), 180-194.
- Levin, J. (2003). Relational incentive contracts, *American Economic Review*, 93(3), 835-857.
- Llewellyn, K.N. (1931). What price contract? An essay in perspective, *Yale Law Journal*, 40, 704-751.
- Loasby, B.J. (2000). Market institutions and economic evolution, *Journal of Evolutionary Economics*, 10(3), 297-309.
- Macaulay S. (2004). The real and the paper deal: empirical pictures of relationships, complexity and the urge for transparent simple rules, *Modern Law Review*, 66, 44–79.
- Macneil, I.R. (1974). Restatement (Second) of contracts and presentation, *Virginia Law Review*, 60(4), 589-610.
- Macneil, I.R. (1975). A primer of contract planning, *Southern California Law Review*, 48, 627-704.
- Macneil, I.R. (1980). *The New Social Contract*. New Haven, CT.: Yale University Press.
- Macneil, I.R. (1983). Values in contract: internal and external, *Northwestern University Law Review*, 78, 340-418.
- Macneil, I.R. (1985). Relational contract: What we do and do not know, *Wisconsin Law Review*, 483-525.
- Macneil, I.R. (2000). Relational contract theory: challenges and queries, *Northwestern University Law Review*, 94, 877-907.
- Markovits, D. (2004). Contract and collaboration, *Yale Law Journal*, 113, 1417-1518.
- Maskin, E. and Tirole, J. (1999). Unforeseen contingencies and incomplete contracts, *Review of Economic Studies*, 66(1), 83-114
- Mayer, K.J. and Argyres, N. (2004). Learning to contract: evidence from the personal computer industry, *Organization Science*, 15(4), 394-410.

- McKendrick, E. (2002). The Regulation of Long-term Contracts in English law. In *Good Faith and Fault in Contract Law*, Beatson J, Friedmann D. (eds). Oxford: Clarendon Press, 306-333.
- Mouzas, S. and Furmston, M. (2008). From contract to umbrella agreement, *Cambridge Law Journal*, 67(1), 37-50.
- Narasimhan, C. and Wilcox, R.T. (1998). Private Labels and the Channel Relationship: A Cross-Category Analysis, *Journal of Business*, 71(4), 573-600.
- Nayyar, P.R. (1990). Information asymmetries: A source of competitive advantage for diversified service firms, *Strategic Management Journal*, 11(7), 513-519.
- Nee, V. (1998). Norms and networks in economic and organizational performance, *American Economic Review*, 88(2), 85-89.
- Pettigrew, A.M., Woodman, R.W. and Cameron, K.S. (2001). Studying Organizational Change and Development: Challenges for Future Research, *Academy of Management Journal*, 44(4), 697-713.
- Poppo, L. and Zenger, T. (2002). Do formal contracts and relational governance function as substitutes or complements? *Strategic Management Journal*, 23, 707-725.
- Reuer, J.J. and Arino, A. (2003). Strategic alliances as contractual forms, *Academy of Management Best Paper Proceedings*.
- Reuer, J.J. and Arino, A. (2007). Strategic alliance contracts: Dimensions and determinants of contractual provision, *Strategic Management Journal*, 28, 313-330.
- Riley, C.A. (2000). Designing default rules in contract law, Conventionalism and Efficiency, *Oxford Journal of Legal Studies*, 20(3), 367-390.
- Ring, P.S., A.H. Van de Ven. (1992). Structuring Cooperative Relationships between Organizations. *Strategic Management Journal*, 13: 483-498.
- Ring, P.S., A.H. Van de Ven. (1992). Structuring Cooperative Relationships between Organizations. *Strategic Management Journal*, 13: 483-498.
- Ring, P.S., A.H. Van de Ven. 1992. Structuring Cooperative Relationships between Organizations, *Strategic Management Journal* **13** 483-498.
- Roxenhall, T. and Ghauri, P. (2004). The Use of written contract in long-lasting business relationships, *Industrial Marketing Management*, 33(3), 261-268.
- Schanze, E. (1991). Symbiotic Contracts: Exploring Long-term Agency Structures between Contract and Corporation. In *Franchising and the law: Theoretical and Comparative Approaches in Europe and the United States*, Joergens C. (ed). Baden-Baden: Nomos Verlagsgesellschaft, 67-103.
- Schwartz, A. (1992). Relational contracts in courts: An analysis of incomplete agreements and judicial strategies. *Journal of Legal Studies*, 21(2): 271-318.
- Scott, R.E. (2000). The Limits of Behavioral Theories of Law and Social Norms, *Virginia Law Review*, 86(8), 1603-1647.
- Scott, R.E. (2003). A Theory of Self-Enforcing Indefinite Agreements, *Columbia Law Review*, 103(7), 1641-1699.
- Sebenius, J.K. (1992). Negotiation analysis: A characterization and review, *Management Science*, 38(3), 18-38.
- Sullivan, M.W. (1997). Slotting allowances and the market for new products, *Journal of Law and Economics*, 40(2), 461-493.
- Taylor, T.A. and Plambeck, E. (2007). Supply chain relationships and contracts: The impact of repeated interaction on capacity investment and procurement, *Management Science*, 53(10), 1577-1593.

- Tirole, J. (1999). Incomplete contracts: Where do we stand? *Econometrica*, 67(4), 741-781.
- Tirole, J. (2009). Cognition and Incomplete Contracts, *American Economic Review*, 99, 265–294.
- Tsoukas, H. (1989). The Validity of Idiographic Research Explanations, *Academy of Management Review*, 14(4), 551-561.
- Williamson, O.E. (1983). Credible commitments: Using hostages to support exchange, *American Economic Review*, 73, 519–540.
- Williamson, O.E. (1985). *The Economic Institutions of Capitalism*. New York: Free Press.
- Williamson, O.E. (1988). Corporate Finance and Corporate Governance, *Journal of Finance*, 43, 567–591.
- Williamson, O.E. (1991). Comparative Economic Organization, *Administrative Science Quarterly*, 36, 269-296.
- Young, H.P. (1993). The Evolution of Conventions, *Econometrica*, 61(1), 57-84.
- Zaheer, A. and Venkatraman, N. (1995). Relational governance as an interorganisational strategy: an empirical test of the role of trust in economic exchange, *Strategic Management Journal*, 16, 373-92.

Table 1: Perspectives in Law, Economics and Organization

Disciplines	Relational Contracts	Incomplete Contracts
Law	<p>Relational vs. discrete transactions (Macneil 1974, 1975, 1980, 1983, 1985, 2000)</p> <p>Real deal vs. paper deal (Macaulay 2004)</p> <p>Relational contracts are not recognized as a legal category (Schanze 1991, McKendrick 2002, Eisenberg 2002)</p> <p>Relational contracts are incomplete (Schwartz 1992)</p>	<p>Contracts are invariably incomplete (Collins 1999, Barnett 1992a)</p> <p>Self-reinforcing contracts via reputational effects (Charny 1990, Scott 2003)</p>
Economics	<p>Relational exchange may be the most economical manner (Gibbons 2005, Baker et al. 2002)</p> <p>Self-reinforcing relational contracts (Levin 2003)</p>	<p>Emphasis on opportunistic transaction costs:</p> <ol style="list-style-type: none"> (1) information asymmetries and unforeseen contingencies (2) drafting costs, (3) enforcement costs, (4) renegotiation requirements (Tirole, 1999, 2009, Maskin and Tirole 1999) <p>Applicability to a) inter-firm arrangements (Williamson 1985, 1991), b) credible commitments (Williamson 1983), c) corporate finance decisions (Williamson 1988, Hart and Moore 1989, Aghion and Bolton 1992, Hart 1995) d) property rights and the nature of the firm (Hart and Moore 1990, Grossman and Hart 1990).</p>
Organization	<p>Relational governance (Williamson 1985, 1991, Leblebici and Shalley 1996, Poppo and Zenger 2002, Gibbons and Henderson 2011)</p> <p>Long-term highly specific investments (Ring and Van de Ven 1992, Harrison 2004)</p>	<p>Applicability of transaction costs analysis to economic organization (Williamson 1991)</p> <p>Contract complexity is distinct from 'contract completeness' (Reuer and Arino)</p>

A: Multinational Consumer Goods/ pharmaceutical Firm

B: Multinational Consumer goods/ pharmaceutical Firm

C: Grocery Retail Chain

D: Grocery Retail Chain

E: Logistics Service Provider

F: Logistics Service Provider

Table 4: Divergent Perspectives

Ontology and Methodology	Relational Contracts	Incomplete Contracts	Framework Contracts
Underlying Assumptions	Social relations matter	Transactions costs matter	Consent matters
Purpose of Analysis	Explain exchange behavior	Investigate efficiency of governance forms	Explain recurrent transactions
Level of Analysis	The relationship	The transaction	Category of recurrent transactions
Modeling	Narratives of bilateral Episodes	Mathematical game-theoretic modeling	Clauses that guide recurrent transactions

Figure 1: Graphical Representation of Eight Inter-firm Contracts

▪

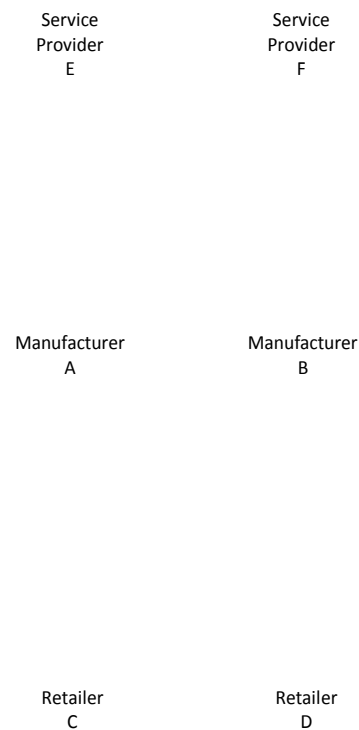


Figure 2: Average Number of Transactions per Annum (2008-2011)