COMMENTARY:

The Process of Relational Contracting: Developing Trust-Based Strategic Alliances among Small Business Enterprises

(O.J. Borch)

Raghu Garud

Amitai Etzioni (1993) laments that marriage has become "disposable"—terminable by anyone at any time with little cause. To emphasize this point, Etzioni quotes Thomas Morgan of the George Washington University School of Law—"It is easier in the United States to walk away from a marriage than from a commitment to purchase a used car." It is a sad commentary that marriage, once a rich metaphor for understanding "relational contracting" in the business world (Macneil, 1978, 1980), now evokes images of transience and distrust that we would rather avoid.

There was once a time when marriage, as an institution, was held sacrosanct with vows such as "together, until death do us part." Marriages often defined relations not only between two people, but also between entire families. Vows were taken in the eyes of God and sanctioned by law and society. The marital relationship was broadly defined, providing enough latitude for its evolution. A marriage could only be understood by looking at the "totality of the relationship" as it had emerged rather than the "contract" that had been signed. Because of its traditional properties, I chose marriage as a metaphor to critique Borch's paper on relational contracting.

Advances in Strategic Management, Volume 10B, pages 137-144.
Copyright © 1994 by JAI Press Inc.
All rights of reproduction in any form reserved.

137
Marriage evokes in our minds images of what is important in our lives and forces us to reflect about ourselves and our value systems. How we deal with the ones we love is a reflection of ourselves and the wider society we live in. By using marriage as a metaphor, I want to suggest that relationships, whether they be in the social or the business arenas, are what we make of them. In other words, there is a self-fulfilling property about our marriages and most other social institutions. I will argue specifically that this self-fulfilling property is true of the theories that we create in the strategic management field. Consequently, theories that may appear strategic from one perspective can be terribly myopic from another.

Before proceeding further, we need a sense of what relational contracts are and their applicability to the business world. While Borch (1994) locates relational contracts between markets and hierarchies, Macneil (1978, 1980) points out that their applicability is broader. Relational contracts can be applied to any situation where the meaning of the relationship evolves over time through endogenous processes. From this perspective, hierarchical relationships too are relational contracts.

To understand why relational contracts are required, Macneil first compares them with classical and neoclassical contracts. Classical and neoclassical contracts are built around discreteness—transactions that are entirely separate, not only from all present relations, but also from all past and future relations. Discreteness would require transactions between total strangers who come together by chance and separate immediately after completing their transactions. Macneil argues that discreteness is clearly a fiction and suggests that we adopt a relational contracting approach.

Moreover, neoclassical and classical contracts attempt to bring the future into the present. Bringing the entire future into the present is again an impossibility because of our bounds to rationality. Therefore, any promise that we might make about the future has to be fragmentary at best. Here again, Macneil argues that we must adopt the more encompassing relational approach to study contracts by including its “nonpromissory” facets.

Borch (1994) picks up on two of the many non-promissory facets implicit in a study of relational contracts—norms and affect. First, he argues that “The interaction pattern developed [between those transacting with one another] should be rooted in the norms and values of the specific culture to which the partners belong.” Second, he suggests that “Affective relations may serve as a communicative tool, a source of energy and enthusiasm, contribute to the creation of loyalty toward an exchange solution, or reduce conflict, especially during the critical phase of establishing a cooperative venture.” Employing norms and affect as his lens for viewing an export-oriented joint venture between five former competitors within the aquaculture industry in Norway, Borch concludes that relational contracts are to be developed when “we have a combination of strong strategic dependence, and a climate for cultural and emotional anchoring of the relation.”
While Borch alludes to the notion of trust to arrive at this conclusion, he does not formally define trust, nor does he use it as a key construct to build upon. Trust, for Borch, seems to be more of an outcome than a process. This focus is unfortunate because the way trust and opportunism arise, and how they are dealt with, are key process issues that have great importance to the field of strategic management.

I want to return to the idea of a marriage to establish this point. While marriage traditionally has meant a relationship characterized by trust, modern marriages often have a very different meaning. In the United States, for example, many consider it desirable to begin a marriage with a pre-nuptial agreement that specifies how the marriage should break up. On the one hand, it may make "strategic sense" to initiate a marriage with a pre-nuptial agreement just in case the marriage does not work out. On the other hand, the very structures that we create to protect ourselves have a quality about them that seem to invite the outcomes that we want to safeguard ourselves against through their anticipation. In this sense, both trust and opportunism have aspects about them that are self-fulfilling. The more I trust a person, the greater the likelihood that I will behave in a trusting way, and the more likely (s)he may be willing to respond with trust; conversely, the more I believe that a person behaves opportunistically, the greater the likelihood that I will behave opportunistically, and the more likely it is that (s)he will reciprocate opportunistically.

Underlying these two dynamics are two very different meanings of trust that I gleaned from Ring and Van de Ven's (1994) work. The first has to do with the confidence or predictability in one’s expectations and equates trust with risk. Ring and Van de Ven point out that this risk can be reduced through a variety of formal contractual means, like guarantees, insurance mechanisms, hostages, and laws. The second definition of trust represents confidence in the other's goodwill; it emphasizes the moral integrity or goodwill of others in dealing with future unpredictable issues. Ring and Van de Ven suggest that confidence in the other's goodwill is produced through interpersonal interactions that lead to social-psychological bonds of mutual norms, sentiments, and friendships.

These two meanings of trust are often confused, leading to confused theory and practice. Indeed, the first meaning of trust has created road blocks in our ability to nurture and promote trust as goodwill. As Mahoney, Huff, and Huff (1994) suggest, contracts based on the implicit assumption that the other cannot be trusted in the present are unlikely to lead to trust in the future. They also suggest that "attempts to constrain opportunism along the lines suggested by agency theory will have continuing economic as well as human costs."

Strategic management theories may have a similar self-fulfilling quality about them. Our ways of theorizing, when translated into practice, may promote the very outcomes we want to safeguard against. To the extent that we create theories built around opportunism, we implicitly invite opportunism
to unfold in a self-fulfilling way. In contrast, theories built around trust implicitly invite trust.

This is my concern about Borch's work; it deviates from a full appreciation of the self-fulfilling properties inherent in trust and opportunism. Borch suggests that his contribution over extant views on relational contracting lies in his "pyramidal" concept of contracts. The structure he proposes layers markets, hierarchies and relational contracts upon each other. Borch notes that "one has to be aware of the danger of acting opportunistically inside the relational contract" and suggests that an entrepreneur must craft formal and hierarchical systems as a safety net in case a relationship does not endure. This recommendation to me sounds very much like a pre-nuptial agreement that may sow the very seeds for future distrust.

Some might question my judgment in not insisting on a pre-nuptial agreement to act as a safety net in a strategic alliance. I concede that when a relationship is characterized by extreme distrust, procedural safeguards may be in order. But, it is important to understand that such legal recourse is only required when the level of distrust progresses below a critical threshold level where opportunism has become self-sustaining and where no amount of wishful anticipation will restore broken trust. Macneil (1980) makes this point effectively when he suggests:

> Lawyers often forget that imposed procedural regularity is needed and useful only when good faith and trust decline below certain levels. They also forget that it in turn breeds distrust. Most people require relatively little procedural regularity in their marital relations because of high levels of good faith and trust. So too the relations between partners and associates in many law firms. The rise of procedural regularity respecting student-university relations is often hailed as a great step toward equality and justice. It can just as well be viewed as the result of decline in trust and perceptions about an absence of good faith. So viewed, it is a huge step backward (Macneil, 1980, p. 68).

The difference between self-fulfilling and self-sustaining dynamics and their zones of applicability is key to an understanding of the purposes that our theories serve—as ideologies or as predictors of behavior. To the extent that we can enact our realities, we have a system capable of self-fulfilling dynamics. Within such a system, our theories may serve more as ideologies that influence behavior. In contrast, to the extent that we are powerless to shape the course of events, we confront a system exhibiting self-sustaining dynamics. Within such a system, our theories serve more as predictors of behavior.

It is for this reason that in a land of self-sustaining opportunism, theories based on trust may be misplaced. By the same token, we must realize that in a land of self-sustaining trust, theories based on opportunism are not required. In between these two lands, we have self-fulfilling systems where the theories we chose to develop and apply might take us either to the land of trust or to the land of opportunism.
It appears that in many ways, we in the United States have been operating in a land of opportunism, while those in Japan have been operating in a land of trust. We have become a litigious society where nothing proceeds without a lawyer, whereas Japanese businesses have thrived during the past decade with business practices that emulate families (after all, as McNeil, 1980 points out, contracts are not about law; they are about getting things done). The importance of these observations strikes home when we consider the additional transaction costs that our society has to bear because of the social order that emerges from the application of particular types of theories (cf. Bromley & Cummings, 1993; Mahoney et al., 1994; Rose & Ito, 1993). For instance, transaction cost economics begins with opportunism as an important premise. To the extent that this theory fosters opportunistic behavior, the overall transaction costs that our society bears will be higher than those borne by societies where trust prevails.

In our own academic writings, there is sufficient evidence to support the self-fulfilling and sustaining nature of our social institutions. Weick (1979), for instance, suggests that most facets of social life are the outcomes of self-fulfilling dynamics. Weick summarizes Kelley and Stahelski's (1970) work which demonstrated that a competitive person's anticipation of how other people will behave tends to have a self-fulfilling aura about it that transforms those other individuals, regardless of their preference for cooperation, into competitors. In the context of interorganizational relationships, Van de Ven and Walker (1984) found that excessive formalization and monitoring of the terms of interorganizational relationships also results in the creation of conflict and distrust among parties.

An appreciation of self-fulfilling and self-sustaining properties of trust and opportunism complicates our efforts to study relational contracts because they force us to look at "relationships in-the-making." By definition, we must look at the entirety of a relation as it unfolds in time rather than at look at the relation at one point in time. Our task is further complicated by a need to appreciate the relationship from the perspective of those involved rather than from an outsider's perspective. But only by taking this broader perspective will we be able to understand the forces governing a relation's evolution and have a means for shaping its future.

Following a relationship over time from the perspective of the people involved is truly a challenging task and it can only be accomplished by adopting an ethnographic approach. Yet to the extent that each relationship is different (that is why a relational contracting approach is so interesting), what kind of knowledge can we generate from observing just one relationship? To the extent that we "enact" future outcomes (implicit in the notion of self-fulfilling dynamics), what is the meaning of reliability and validity in such situations?

Strategic management theorists must grapple with these issues. We must feel comfortable in an approach that transfers the onus for generalization from
the ethnographer to the person who reads an ethnographic account. And, we must be comfortable with the fact that the process (or at least the generative forces underlying any process) has to be inferred. These are the tenets of "naturalism" that are so different from the tenants of positivism (Lincoln & Guba, 1985). 

A naturalist study of relationships need not be unsystematic. An important first step is the articulation of what it is that we want to study. Borch (1994) has focused on behaviors (norms) and affect that characterize a relationship. I would like to offer a third unit of observation—the nature of the interdependence (commensalistic and symbiotic for example, see Garud, 1994). I propose that the distinctions between behaviors, affect and interdependencies helps us understand not only the formation of relationships (the subject Borch's work focuses on), but also the processes whereby they are sustained and dissolved (see Ring & Van de Ven, 1994). Such a focus is vital, for only then will we be able to understand the blend of exit and voice (Hirschman, 1970) in alliance relationships, and be able to understand abusive relationships that endure without trust. Only then too will we be able to understand dynamic networks where firms temporarily come together while still maintaining a long-term "relationship" characterized by trust.

Dynamic networks and the contractual maze they imply may evoke an image of multiple marriages. Indeed, in a recent article, Ehrenreich (1993) suggests that we may be expecting too much from a single spouse and that these unrealistic expectations, that no one person can fulfill, may be the roots of divorce. (Recall that in the past we often didn't marry just one person but rather a family.) Today, the answer may be to have separate "marriages" for separate types of marital functions, such that—"All our needs will be met by individuals who are actually qualified to fulfill them" (Ehrenreich, 1993).

This image may be too provocative a view of marriage. Yet, it suggests how the metaphor linking the institutions of marriage and business can be used to uncover new insights. In fact, these two contrasting view of contracts may in practice be crossing one another. For instance, we appear to be shaping our marriages around a notion of what business contracts once were. And, in the business world, we aspire to create family like relationships—something that the Japanese have been successful in creating to their advantage. In this context, it is instructive to note what Ring and Van de Ven (1994) say about complex business relationships. 

We will also demonstrate that informal psychological contracts will increasingly substitute for formal legal contracts in specifying commitments for future actions among parties in a cooperative interorganizational relationships in which the ability to rely on trust is high because of interactions and exchanges in the past that were perceived to have produced efficient and equitable outcomes (Ring & Van de Ven, 1994).
Commentary

Marriage used to be a good metaphor to design relational contracts in the business world. I use the past tense to highlight the changing meaning of marriage. To the extent that we ask those we love to sign a pre-nuptial agreement, we emphasize the instrumental aspects of marriage while ignoring its larger meaning. Our fears appear to dominate any concerns that we may have that through our actions we create the very structures that may finally destroy what little trust there is. In this sense, these contractual modes and the governance structures they foster are a reflection of ourselves and the structures that trap us. As Frank (1988, p. xi) argues:

Our beliefs about human nature help shape human nature itself. What we think about ourselves and our possibilities determines what we aspire to become; and it shapes what we teach our children, both at home and in the schools. Here the pernicious effects of the self-interest theory has been most disturbing.

My summary observation is that what we must eventually confront in ourselves is a “weakness of will problem.” We appear to have difficulties in adhering to our commitments, may they be personal resolutions, marriage vows or, business contracts. It is this weakness of will that is the root cause of opportunism. By implementing relational structures that address the symptoms rather than the cause, we exacerbate the disease. In a related context, Hobbes (1962) pointed out that we might have to give up some freedom to gain more freedom. In a similar vein, Etzioni (1993) suggests that our society requires a change in the habits of the heart, in the ways we think about marriage and other relationships. We will have to take a few chances in managing our relationships in order to cultivate trust. Otherwise, we ought to change our marriage vows to read “until death do us part, or until we breach the first contract.”

ACKNOWLEDGMENTS

I thank Amy Hurley, Roger Dunbar, and Anne Huff for their comments.

NOTES

1. See Hurley (1993) for a further discussion of the distinction between these two dynamics.
2. Note how Lincoln and Guba (1985) move away from validity and reliability as the key criteria for evaluating naturalistic efforts to suggest “trustworthiness” of naturalistic efforts as a critical test of acceptance.
3. Cited in Mahoney et al. (1994).
REFERENCES


