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Relational contracting and the myth of trust: Control in a co-opetitive setting

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ABSTRACT

In this paper, we investigate the role of formal and relational contracts in managing alliance risks that arise in co-opetitive collaborations. We undertake a case study of a co-opetitive sales alliance within the independent publishing sector, incorporating data from all firms to the alliance. We provide empirical evidence of the relational risks of misappropriation and opportunism as manifest in both vertical (buyer-supplier) and horizontal activities within the alliance and identify a further relational risk relating to concerns of introducing homogeneity into the product offerings of firms. We also examine the nature of compliance and regulatory risk, which is salient in this setting given the potential for anti-competitive behaviour towards customers and suppliers. We find that the firms mitigate alliance risks primarily through the use of relational contracts (informal self-enforcing agreements). Formal contracts are evident in the buyer-supplier relationship, but are used mainly for ex post co-ordination. We adopt an organisational economics perspective to explain the specific mechanisms that support relational contracting between the firms. We find that shared values, implicit understandings, restricted membership, meetings, and collective sanctions encourage the firms to demonstrate commitment to the alliance, to diffuse information about partners' behaviours, and, crucially, to monitor partners. Informal agreements between partners are sustained by self-regulating behaviours, reinforced by the 'shadow of the future' in that firms have a great deal to gain from continued participation in the alliance and face losses if excluded. Notably, our findings support economic arguments that trust is a weak proxy for observable control mechanisms. Our study contributes to knowledge of the management of inter-firm risks in two significant ways. First, we draw on our empirical findings to develop an organising framework that presents a means of systematically investigating the mechanisms and factors that support the use of relational contracts. Second, by employing an economics approach to the management of alliance risks, we are able to present a richer and potentially more compelling view of inter-firm control than is traditionally presented in studies that rely on intra-firm notions of social controls, in particular trust.

1. Introduction

Collaborative relationships between competitors increasingly define the business landscape, spanning a range of industries (Bengtsson et al., 2010; Thomason et al., 2013). In this study, we focus on the control of co-opetitive alliances, a specific, complex, form of collaboration between competitors. Engaging in co-opetitive activity entails "competing without having to kill the opposition and co-operation without having to ignore self-interest" (Brandenburger and Nalebuff, 1996: 4). Firms must protect and further their own competitive position, potentially at the expense of their partners, while concurrently combining resources in a joint effort to achieve a common goal and share in the resultant benefits (Czakon and Mucha-Kuś, 2014; Gnyawali and Madhavan, 2001). Despite evidence that alliances between competitors are more likely to fail than those between non-competing partners (Park and Russo, 1996), and despite calls to extend management accounting and control studies of inter-firm relationships beyond buyer-supplier exchanges (Caglio and Ditillo, 2008), co-opetitive alliances remain under-examined.

In this study we investigate the use of formal and relational contracting to manage alliance risks in co-opetitive settings. Extant literature has focused extensively on formal contracts, despite evidence that these are often incomplete and that other mechanisms are employed to manage inter-firm relations (Anderson

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and Dekker, 2014). Informal self-enforcing agreements between firms (relational contracts) rely on a range of social and other relationship-based control mechanisms and are sustained by the expected value of the future relationship (Baker et al., 2002; Williamson, 1979). The literature is equivocal as to whether relational contracts are substitutes or complements for formal contracts, although the relation between them appears to be context specific (Cao and Lumineau, 2015).

While the notion of relational contracting has been considered extensively in the management and economics literatures there is little empirical evidence of its role in managing alliance risks (for recent exceptions, see Neumann, 2010; Windolph and Moeller, 2012). Furthermore, it remains under-conceptualised (Cao and Lumineau, 2015; Schepker et al., 2014) and under-researched, with most studies focussing predominantly on the use of social controls for relational contracting (for example, Dekker, 2004; Neumann, 2010). Social controls, commonly captured in these studies through notions of shared values and trust, represent one aspect of relational contracting (Jones et al., 1997), and hence offer only a partial explanation of the governance arrangements between alliance partners. By extending the notion of relational contracting beyond the use of social controls, we thus address recent concerns in the management control literature about the use of intra-firm concepts in the study of inter-firm relationships (cf. Caglio and Ditillo, 2008; Dekker, 2016).

Broadly similar conceptualisations of relational contracting are evident in both the management and economics-based literatures, but they differ significantly in one particular respect. While the management literature relies heavily on trust-based constructs to explain relational contracting, organisational economics theory contends that the concept of 'trust' offers a largely impoverished explanation of the nature of relationships between firms (cf. Chaserant, 2003; Williamson, 1993). Economic exchanges require safeguards to protect investments from opportunistic others; employing the concept of 'trust' obscures the nature, use, and rationale underpinning such protection (Williamson, 1993). In economic terms, mechanisms used to manage alliance risk lead to ex post labelling of trust (Barney and Hansen, 1994); it is these mechanisms that must be carefully identified in order to understand better the nature of inter-firm control. Trust is thus regarded in the study of inter-firm relations as an inappropriate and weak proxy for observable mechanisms of control. First introduced into management control research by Tomkins in 2001, the concept of trust as an analytical device to explain inter-firm relations remains unchallenged in the management control literature. The current study, with its focus on a broad conceptualisation of relational contracting, therefore provides an opportunity to investigate inter-firm exchanges through an economics lens, rather than from the narrow management perspective traditionally adopted in the control literature.

We pay particular attention to specific alliance risks that formal and relational contracts are designed to mitigate in a co-opetitive setting (cf. Caglio and Ditillo, 2008), moving beyond the traditional use of transaction characteristics (asset specificity, uncertainty, and frequency) as proxies for such risks. Anderson et al. (2015) argue that the use of transaction characteristics as proxies for risk emphasises risk at the level of the transaction at the expense of broader risks within the totality of the alliance.

We undertake a case study of a co-opetitive alliance within the independent publishing sector in the United Kingdom, drawing on interview data collected from all partners to the alliance. We thus respond to calls for more field research in this area in order to provide contextual richness to our current understanding of relational contracts (Cao and Lumineau, 2015). Our study investigates a complex setting involving the governance of both buyer-supplier (vertical) and horizontal activities between competing partners. This co-opetitive context is characterised by a non-equity based relationship and the absence of a super-ordinate governing authority. Our setting allows us to consider how alliance type, beyond the more frequently researched dyadic buyer-supplier context, influences the risks that arise and the subsequent control mechanisms employed to mitigate these risks (cf. Anderson et al., 2014; Cao and Lumineau, 2015; Caglio and Ditillo, 2008; Dekker, 2016). We also examine the interplay between relational and formal contracting in managing these risks (Cao and Lumineau, 2015).

We focus primarily on the relational risks within the alliance given that joint activity between competitors is argued to offer greater incentives and potential for opportunism (Park and Russo, 1996; Tidström, 2014).[1] We find evidence of wide-ranging appropriation concerns within the alliance, consistent with this view. However, we also find that the value of the alliance to each firm reduces their motivation to engage in such behaviours. Each firm's motivation to act opportunistically is further tempered by the ability of their partners to better identify such opportunistic behaviours. We also identify a type of relational risk unique to co-opetitive alliances, not previously identified in the literature, that we refer to as the risk of homogeneity in firm identity and product offering. This risk arises from unwitting imitation between competitors as they share information and engage in other inter-firm exchanges. Finally, we highlight the salience of regulatory risk, in the co-opetitive setting. Regulatory risk arises because competing partners must avoid both actual and perceived anti-competitive behaviour.

The firms in our study manage the alliance risks inherent in co-opetitive relationships through a combination of formal and relational contracting. We find that formal contracts manage the buyer-supplier relationship between partners to the alliance. However, these are used mainly for ex post co-ordination of these vertical activities between firms (i.e. to manage the performance rather than the relational risks of the alliance). While the formal contracts do include measurable targets, we find that attainment of these targets is regarded by the purchasing partners as secondary to sustaining the alliance. This is consistent with the inclusion of formal contracts prepared for the management of buyer-supplier activities to indirectly mitigate alliance risks associated with the horizontal activities of the alliance we study. To this end, formal contracts address regulatory risk by addressing perceptions of anti-competitive practices and ensuring compliance with relevant legislation.

The governance of the alliance relies heavily on relational contracting. Specifically, the firms in our study make extensive use of shared values, group norms, meetings and informal gatherings, partner selection, restricted access (number of partners to the alliance), and the threat of collective sanctions to manage various relational risks associated with the co-opetitive alliance. Relational contracting establishes credible commitments between firms. Firms act according to principles of 'enlightened self-interest', in that they have a great deal to gain from continued participation in a range of collaborations and face potentially significant losses if excluded. Furthermore, by co-operating with a select group of firms who share similar knowledge and expertise, firms are aware that their partners can readily identify behaviours that run counter to the norms of the alliance and adjust their behaviours accordingly. We therefore demonstrate the critical role

[1] Performance risk, the risk that collaborative efforts are unsuccessful despite full co-operation between parties, is another crucial matter for inter-firm relationships (Das and Teng, 2001; Langfield-Smith, 2008; Schreiner et al., 2009). We do not focus on the performance risk, or the risk of 'co-ordination failures' in this study. We do however, highlight pertinent co-ordination concerns and responses in the presentation and discussion of our findings.

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