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How contracts and enforcement explain transaction outcomes

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ABSTRACT

This study considers the influence of contracts on enforcement and the subsequent performance impact of aligned and misaligned enforcement. We define enforcement as a corrective action aimed at remedying problems occurring in the transaction. First we explain the role of contracts and show that at the component level, contracts can both increase and decrease enforcement. Building on an alignment perspective and accounting for the endogeneity of enforcement, we use these contractual components and variables related to enforcement to predict the occurrence of enforcement. We use such predictions to show that aligned enforcement results in higher performance. We also show that the performance impact of *misaligned* enforcement is relatively greater for transactions where enforcement is not expected. We conduct the study using a unique dataset reporting on 971 business transactions across a wide range of industries.

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1. Introduction

Enforcement is a corrective action aimed at remedying problems (Antia, Bergen, Dutta, & Fisher, 2006). Taking such corrective action requires firms to balance the benefits of enforcement against its costs. The key benefit is that it may curb or reverse violations of contractual agreements (Antia et al., 2006). Enforcement may also reduce or reverse behaviors such as suppliers not remedying product breakdowns or providing limited or inadequate service. Thus, enforcement may help suppliers resolve problems (Wuyts, 2007). On the other hand, exchange partners stung by enforcement may react through further acts, such as protracted conflicts, retaliation, or even relationship termination (Antia & Frazier, 2001). As such, firms need to understand when to enforce and the potential consequences of enforcement.

The role of contracts on enforcement is little understood. One perspective is that having explicit contractual agreements *ex ante* can facilitate or even trigger enforcement *ex post*. In fact prior literature, predominantly taking an agency perspective, assumes that enforcement is automatically triggered when contracts are violated (cf. Bergen, Heide, & Dutta, 1998). Another perspective is that such explicit contractual agreements may reduce transaction problems or promote cooperation, thereby reducing the need for enforcement (Mooi & Ghosh, 2010). Recent work acknowledges the role of contracts in enforcement but has conceptualized contracts as monolithic governance devices (cf. Kashyap, Antia, & Frazier, 2012). A more fine-grained analysis of the effects of

contracts on enforcement is needed to advance our understanding of whether and how contracts impact enforcement.

We also know little about the performance consequences of enforcement. Recent work correlated enforcement with outcomes but found no effects (Kashyap et al., 2012). Taking a discriminating alignment position may help uncover performance consequences as enforcement is likely best used when matched to circumstances. Based on governance theories, such as transaction cost economics (TCE), the discriminating alignment view argues that governance (enforcement in our case) that is aligned (expected or called for, as based on transactional attributes) may help performance while misaligned enforcement is detrimental to performance. Such an alignment approach to enforcement has, however, not been examined conceptually and empirically. Moreover, the performance implications of *misalignment* are not well understood. Specifically, comparing the differential performance of aligned enforcement with misaligned enforcement provides insight into the cost of mistakes. Such analyses are rare, yet valuable, as they provide evidence of the importance of carefully choosing governance (Masten, 1993).

The goal of this paper is to study the effects of contracts on enforcement, to understand the performance effects of aligned enforcement, and to understand the performance consequences of misaligned enforcement. In doing so we make three contributions.

Our first contribution is to describe the role of contracts in enforcement. In this light, Bergen et al. (1998) suggest that the assumption is often made that once contracts are in place, the *ex post* management task is trivial. We demonstrate that enforcement is not automatic and different contractual components can both *increase* and *decrease* the use of enforcement. As such, we also show that contracts are not monolithic governance structures. To support this

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contribution, we argue that terms in the contract that support the parties' relationship (e.g., joint management, nondisclosure) reduce enforcement, while terms designed to protect the transaction increase enforcement.

Our second contribution is to test the importance of alignment between these contractual components, transactional attributes, and enforcement. By comparing the outcomes of aligned (predicted) versus nonaligned (not predicted) enforcement, we account for the little-researched issue of the benefits of aligned governance in an enforcement context (Geyskens, Steenkamp, & Kumar, 2006). We consider performance consequences in terms of *satisfaction with problem resolution*, which is the satisfaction of the buyer with how problems regarding the product have been resolved. Satisfaction is fundamental to understanding interfirm relationships (Geyskens & Steenkamp, 1999).

A third related contribution is to provide understanding of the performance consequences of *misalignment*. Prior work has found interesting asymmetries regarding the circumstances under which misalignment has the most severe (negative) performance implications (Ghosh & John, 2009). Specifically, such work suggests that under greater hazards, misalignment has the most severe consequences. Addressing this issue in an enforcement context helps us understand where the risks are in making enforcement choices and helps managers make informed decisions.

We conduct our investigations by using the External Management of Automation dataset, access to which is provided by the Steinmetz Archive. This unique dataset reports in detail on 971 randomly selected transactions executed between information technology (IT) buyers and suppliers. It includes a broad spectrum of firms from industries such as logistics, parts production, and wholesaling.

This paper proceeds by discussing theory on enforcement in Section 2. We develop arguments on the structure of contracts and the expected effects of different contractual components on enforcement in Section 2.1. We continue by building hypotheses on why aligned enforcement results in better performance in Section 2.2. In Section 2.3 we argue that relative performance loss is higher when buying firms mistakenly enforce.

2. Theory and hypotheses

Enforcement is an important governance mechanism in economics, contract law, and marketing (Crocker & Masten, 1991; Williamson, 1996). Despite the importance of enforcement, little work in marketing considers enforcement. Exceptions include Dutta, Bergen, and John (1994), Antia and Frazier (2001), Gilliland and Bello (2002), and Kashyap et al. (2012). Despite these efforts, the role of contracts in enforcement is little understood, as are the performance consequences of (mis)aligned enforcement. We focus on buyers' informal (or private) enforcement and not on public enforcement, such as via courts.

To clarify the process by which enforcement takes place, we turn to an example. Frequently, buying firms postpone payments as an enforcement behavior. Bungee Loyalty Programs LLC (<http://www.bungeeloyaltyprograms.com>) is a US-based firm that provides loyalty programs through the integration of complex software. Bungee Loyalty Programs had agreements with its supplier on the delivery of such software. When substantial problems arose in a software purchase, the firm saw a need to postpone payments as a direct result of perceived problems. Once the payments were postponed, the supplier resolved problems, and Bungee Loyalty Program's satisfaction with the resolution of the problems was much improved.¹

The generalizable insight from this example is of an ordered series of events as depicted in Fig. 1. Specifically, after the deal and contract are decided on, problems may occur in the transaction. Buying firms

may then enforce or may refrain from enforcement. As enforcement is a corrective action aimed at remedying problems, some or even complete problem resolution is likely. Enforcement is consequently reflected in the buyers' satisfaction with problem resolution.

Governance theory provides several perspectives on enforcement. We define enforcement as a corrective action aimed at remedying problems occurring in the transaction. Various types of enforcement exist. These typically follow a pattern where less severe actions precede more severe actions (Rooks & Snijders, 2001). Less severe actions include seeking resolution of problems by referring to or renegotiating the original agreement (Hart & Moore, 1988). If these actions do not result in acceptable outcomes, more severe actions may be administered in the form of delaying payments (Zbaracki, Ritson, Levy, Dutta, & Bergen, 2004). The type of enforcement studied in this paper is important because it is severe, yet more common than legal action, such as seeking sanctions, mediation, or arbitration.²

2.1. How do contracts impact enforcement?

We believe that different components of the same contract can increase and decrease the likelihood of enforcement as contractual components serve different functions (Anderson & Dekker, 2005). Past work has suggested that multiple components are present in contracts. For example, Argyres and Mayer (2007) suggest that specific components are written into contracts to protect and delineate relations, such as communication, roles, and responsibilities, while other terms protect the specific transaction. Related work in the contracting literature suggests the existence of contract components designed to safeguard the specific relationship, as well as to define the terms of the transaction (Anderson & Dekker, 2005; Chen & Bharadwaj, 2009).

As such, we expect contracts to have multiple components. *Relational safeguards* are components written into a contract that are designed to protect the parties' interests in maintaining the relationship with one another for an extended period of time. Such components include intellectual property rights, joint management during the relationship, and how provisions in the contract are updated. Because these components are negotiated into the contract to protect the relationship we describe these components as relational safeguards (Poppo & Zenger, 2002). Such relational safeguards are meaningful in determining future behaviors (Ring & Van de Ven, 1992). *Transactional safeguards* are designed to protect the specific transaction by countering undesired or opportunistic behaviors (Carson, Madhok, & Wu, 2006). Typical transactional safeguards include sanctions on late payment, supplier liability, and arbitration clauses. *Service and warranty* safeguards outline service and warranty terms, thus protecting the buyer from faulty service provision. Finally, *product and price* safeguards concern determination of the technical specifications and prices or changes in price levels, thereby allowing the buyer to be confident in associated costs of the transaction. The argument for this structure of four components is rooted in the control system design literature (Jensen & Meckling, 1992). These four components map well with the control framework. Our first component, relational safeguards, relates closely to the "decision rights and responsibilities" component, which considers maintenance of the relationship. Our second component, transactional safeguards, maps onto Jensen and Meckling's notion of "rewards and punishments" for maintaining or breaking the transaction. Our other two components, service and warranties, and product and price, address the "performance measures" of the control framework.

The incomplete contracting approach suggests that buying firms emphasize drafting the contract to protect various elements of the

² Of the 971 transactions included in our dataset, only two transactions resulted in a court case. Prior work suggests that such court cases are rare, likely because courts are not reliable enforcers for various reasons, including equivocality in wording and other uncertainties (Crocker & Masten, 1991). Moreover, taking legal action involves costs, such as legal expenses.

¹ Interview with the CEO of Bungee Loyalty Programs LLC, August 7th, 2012.

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