

Chapter 7

Complementarity: Ensuring that Contracts Are Compatible with Collaborative Relationships



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Abstract Contracts, with their focus on safeguarding a firm's interests, traditionally, have been considered to be incompatible with collaborative relationships. This chapter explains the basis for this incompatibility and considers how it may be resolved. The key to ensuring that contracts complement collaboration is in the way the coordination function of contracts is aligned with mutuality and consequent trust development. Even dysfunctional relationships may then be repaired.

Keywords Contracts · Collaboration · Mutuality · Trust · Complementarity

7.1 Styles of Buyer–Supplier Relationship

In a world where outsourcing is a prevalent reality, health and safety need to be managed into the supply chain, especially in relationships involving joint site working. Successful collaborative interaction facilitates the integration of health and safety systems and practices, whereas failing relationships may lead to the need for previously established tacit knowledge to be built anew.

The more complex relationships are, and the higher the inter-firm dependence, the more important it is that stable long-term relationships are established and maintained. However, there are well-established problems in managing such relationships arising from the potential incompatibility between collaborative relationships and contract management practices.

Externally sourced products and services give organisations access to specialist resources to which they may not otherwise have access (Dyer and Singh 1998), as well as capacity flexibility, access to product and process innovation and financial benefits such as overhead reduction. Contracts provide important mechanisms through which terms, conditions and interaction processes are explicitly agreed at the outset.

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Buyer–supplier relationships range from arms–length relationships that are typically transactional and managed only through formal instruments (contracts, terms and conditions, etc.), to highly collaborative long-term relationships that depend heavily on social controls such as trust. No single style is appropriate to all circumstances. Arms–length relationships are highly suitable for periodic product purchases, where there is low commitment between the parties. Prices can be regulated against the market, and formal agreements provide protections to ensure that the terms of the exchange are fulfilled. Each organisation seeks to protect itself against potential opportunism by the other party. However, a collaborative, partnership style relationship becomes necessary where uncertainty and complexity in the supply are high (Carson et al. 2006).

Contracts focus on protecting a firm from potential exploitation by its partner, but this approach implies an underlying distrust between contracting partners that has long been considered to be incompatible with collaborative relationships (Ghoshal and Moran 1996). Contrastingly, collaborative partnerships are predicated on bilateral trust, so how can both coexist successfully? This chapter explains the basis for this incompatibility and considers how it may be resolved by reorienting contracts and contract management processes, through an understanding of the coordination function of contracts.

7.2 Contracts and Their Safeguarding Role

Contracts are legal instruments that define a detailed set of obligations (Zhang et al. 2017) providing firms with safeguards against opportunistic behaviour by a business partner that may negatively impact the firm. In practice, contracts are ubiquitous (Weber and Mayer 2011) and central to significant commercial relationships (Zheng et al. 2008), particularly in regulated sectors. Contracts and contracting processes are necessities in most commercial relationships for: delimiting the scope and timing of the contract, establishing a detailed requirements specification, defining constraints (such as health and safety) on how products and services are delivered, establishing each party's obligations to the other, defining stakeholder roles on each side and most importantly detailing the agreement of commercial terms. Contracts thus constitute a necessary form of due diligence by each party with respect to the other. Contract theory proposes that the more complete a contract is, the more it safeguards the focal firm.

7.2.1 *Problems with Contracts in Complex Business Environments*

However, there are also several problems with contracts, especially in a collaborative context.

Firstly, safeguarding in contracts is predicated on distrust because there is an implicit assumption that a business partner will behave opportunistically if the contract leaves such possibilities open. This starting assumption will itself inhibit trust development (Weber 2017) through negative and potentially intense emotions (Weber and Mayer 2011) that compromise genuine collaboration.

Secondly, the safeguarding approach is also flawed in complex contracts and contexts where frequent unforeseen issues are likely to occur (high uncertainty). The degree to which effective safeguards can be provided, ultimately, is constrained by humans' limitations in foreseeing all possible future circumstances (bounded rationality). Contracts become progressively more complex and expensive as uncertainty increases and where the attempt is made to cover all possibilities (Schepker et al. 2014). *Complete* contracts become impossible where complexity and uncertainty are high (Cao and Lumineau 2015). In situations of high complexity and uncertainty, firms depend on collaboration to manage unforeseen circumstances in a manner acceptable to both, including changes to the contract itself, or changes to contract management practices.

There has been extensive debate between academics on the compatibility between contracts and collaborative relationships that runs the risk of confusing managers (Cao and Lumineau 2015). However, in complex outsourcing circumstance where both need to coexist, the focus needs to be on how, rather than whether, contracts and collaboration can complement each other.

7.3 Complementarity

The premise of *complementarity* is that if the two can work together, contracts will provide a structural framework for collaboration, whilst collaboration will provide a stimulating mechanism for managing contracts (Luo 2002). Although results from studies into whether contracts can, or cannot, complement collaborative working have been mixed, such that neither viewpoint is definitively established (Rhee et al. 2014), recent studies (Weber 2017; Lumineau 2017; Howard et al. 2017; Pinnington and Ayoub 2019) present more nuanced contingency views on *how* complementarity can be achieved.

The remaining sections of this chapter explain how complementarity can be achieved through a shift in emphasis in the framing and management of contracts. Specifically, a duality is recognised in the coordination function of contracts that needs to be correctly oriented in collaborative relationships (Pinnington and Ayoub 2019). The importance of mutuality as the relationship foundation is discussed for its

impact on trust development. Research from a large maritime construction context is then briefly discussed to highlight the importance of identifying structures, processes and behaviours that inhibit mutuality and consequently inhibit trust development. The example discusses how addressing factors that impinge mutuality enables vicious cycles of distrust to be gradually supplanted with self-reinforcing virtuous cycles of trust building. The final section considers the governance implications arising in relation to complementarity and outlines some important areas where mutuality must be established and embedded.

7.3.1 Contracts and Their Coordination Role

Contracts fulfil two largely different roles (Lumineau 2017), the safeguarding role outlined above and a coordination role through which contingencies and contract change are managed. The coordination function provides the basis through which unforeseen events are managed (Zhang et al. 2017), information exchange is effected (Lumineau 2017), negative behaviour is controlled, and expectations are aligned (Argyres et al. 2007). These functions are particularly important in complex relationships featuring high uncertainty.

In collaborative relationships, safeguards are still needed, but both parties need to consider safeguards to be reasonable and acceptable. This can even increase competence trust, as long as clauses are not perceived to be opportunistic. Complementarity, however, is not as simple as shifting contract focus from safeguards to coordination clauses, as illustrated by inconsistent research findings. The key to achieving a positive relational effect lies in the coordination mechanisms selected and the way they are applied.

Studies have attributed many mechanisms to the coordination function: roles and responsibilities (Howard et al. 2017), scheduling (Oliveira and Lumineau 2017), contingency management (Zhang et al. 2017), monitoring, reporting and enforcement (Reuer and Arino 2007), interaction interfaces (Lumineau 2017) and steering committees (Reuer and Devarakonda 2016). However, these mechanisms can be used in two very different ways, with very different consequences for the relationship; a duality is evident therefore in the coordination role of contracts.

7.3.2 Duality in the Coordination Role

Where the emphasis is on monitoring, reporting and enforcement processes, then the relationship focus will be on the reinforcement of contract safeguards, the relationship will be hierarchical, and especially where enforcement measures (penalties) are applied, trust will be destroyed. Steering committees and contingency management aligned with that approach will further embed contract enforcement. The relationship will be dominated by formal controls.

However, where the emphasis is instead on mutuality (peer respect, shared expectations and mutually beneficial outcomes), then this will reinforce trust building and enable genuine collaboration. Steering committees and contingency management are then used to address issues affecting both parties, equally, and used to meet both parties' relational expectations. The relationship will be dominated by social controls (trust and norms).

Only in this second scenario are contracts complementing (rather than compromising) collaboration.

7.3.3 Mutuality

Mutuality is key to achieving complementarity. Mutuality provides a basis for trust building which in turn supports collaboration (Pinnington and Ayoub 2019). To achieve a collaborative partnership, firms must demonstrate that they value their partners' knowledge, respect partners' value objectives and deliver on their own obligations to their partners. Recognition of obligations to a partner is often lacking in buyers, especially where contracts are drafted such that only the supplier's obligations and performance are detailed. Mutuality contrasts starkly with arms-length relationships where a firm seeks only to safeguard its own position. Dysfunction in relational trust, norms and communication can each prevent genuine mutuality from emerging, and the recognition and removal of impediments to mutuality is the key to restoring trust between partners (Pinnington and Ayoub 2019).

7.3.4 Impact on Trust

Trust represents the willingness of one party to be vulnerable to the actions of another, based on positive expectations of the other's motives (Lumineau 2017) and is fundamental to collaborative relationships, but is a complex concept. Although much of the contracts literature considers trust as a homologous concept (Cao and Lumineau 2015), at least two distinct dimensions are normally recognised: trust in an organisation's competence and trust relating to commercial opportunism, also known as goodwill (Malhotra and Lumineau 2011). Competence trust and goodwill are interrelated but are each affected by different actions (Weber 2017).

Trust is also widely recognised to be reciprocal. An organisation that feels trusted is more likely to demonstrate trust in return (Doney and Cannon 1997). The reciprocal nature of trust contributes to positive, self-reinforcing cycles through which reciprocated action by a partner leads to further trust building actions by a firm. This is a virtuous cycle of trust building. Trust building occurs slowly over time, but trust destruction can be rapid and even related to a single event, especially in the case of goodwill. Trust destruction can also see reciprocated actions through which relationships can enter a vicious cycle of trust destruction (Das and Teng 1998).

7.3.5 *Trust Cycles in Practice*

The principles described in this chapter are distilled from an empirical case study of five dysfunctional relationships (two terminated, three ongoing) situated in maritime construction (Pinnington and Ayoub 2019). The outsourced relationships featured the provision of skilled labour resources. The project environment was technically complex with many technical design and build issues. Distrust was high with mutual blame attribution and accusations of opportunism on both sides. Although the importance of collaboration was well recognised, implementation attempts were unsuccessful. The parties had different expectations of how it should operate.

Many problems existed that compromised trust in both directions. Management was too hierarchical with too many decisions requiring escalation within the buyer organisation, leading to delays, coupled with unilateral and remote decision-making. Suppliers felt that their expertise was undervalued and were frustrated that they became aware of design and planning decisions too late to be able to manage their own schedules efficiently. Precursors to supplier tasks were often not ready for suppliers resulting in workers being idle on-site. The buyer's limited engagement with suppliers in early design and planning decisions, and root-cause problem management on-site, suggested low trust. In turn, delays that suppliers felt were avoidable reduced the suppliers' trust in the buyer's competence. Suppliers required compensation for under-utilised resources, but with limited understanding of the real operational impact, the buyer suspected its suppliers of opportunistic compensation charges, reducing goodwill trust. A self-reinforcing vicious cycle of trust destruction existed. Buyer power dominance contributed to these problems. The keys to improvement lay in greater empowerment of local decision-makers with reconstituted governance boards, earlier and more open information exchange, acceptance of the need to recognise buyer performance as well as supplier performance and the replacement of performance-based remuneration schemes with more transparent compensation schemes. Improvements in both side's trust in the other's competence further improved their inclination to collaborate. Improved interaction, faster resolution of problems and better understanding of each other's cost drivers improved efficiency, lowering charges and improving both sides' goodwill trust. A self-reinforcing virtuous cycle of trust building had been entered (Fig. 7.1).

7.4 Relationship Governance Implications

The mechanisms through which the complex framing and management of contracts can easily destabilise and compromise the trust upon which collaborative relationships depend have important implications for the governance of long-term relationships. Managers need to understand that whilst the coordination function of contracts holds the key ultimately to trusting, effective relationships, coordination mechanisms need to be correctly aligned if trust is to be achieved or relationships will deteriorate.

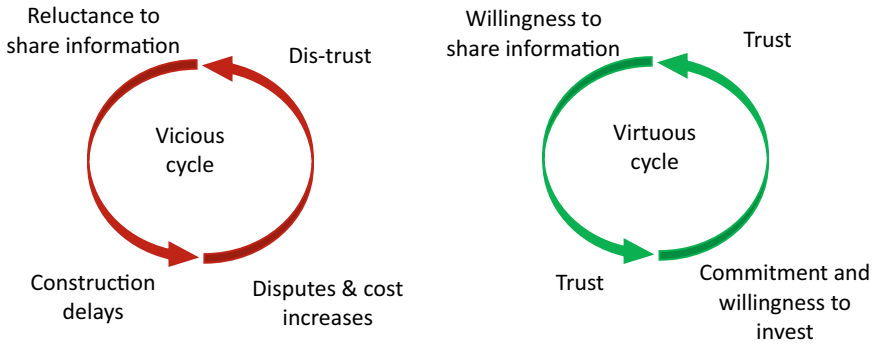


Fig. 7.1 Cycles of trust

7.4.1 Structure, Roles and Decision-Making

Relationship governance boards typically operate at different structural levels: an executive or strategic meeting that oversees the long-term relationship and commitment between organisations; a relational or contract management board through which senior stakeholders steer contract change and medium-term objectives, and an operational or programme level, through which the detailed requirements of the contract are managed through frequent interaction. The purpose and scope of each of these management boards need to be clear, and competence trust will be enhanced where both parties dedicate relevant and suitably empowered managers. Goodwill will be maintained where the focus is on joint problem solving of issues affecting either or both parties, with negotiated, reasonable compensation where appropriate to maintain relational equity (Pinnington and Scanlon 2009).

7.4.2 Provide a Foundation for Mutuality in the Relationship

Governance boards and manager relationships are key to establishing the values and behaviours that characterise the relationship. Through appropriate leadership behavioural norms based on mutual respect, trust can be developed. Buyer organisations can demonstrate peer respect and confidence in their suppliers' competence by early, close engagement in technical design discussions and planning activities. Through close interaction, the supplier will accumulate tacit knowledge of the buyer operations enabling them to demonstrate better operational competence, increasing the buyer's trust in the supplier. In parallel, the buyer will accumulate tacit knowledge of the supplier's operational and commercial challenges and will better understand the implications of its operational decisions. Where buyer decisions can be made that minimise impacts on the supplier's efficiency, then supplier trust in the buyer competence will increase. Norms need to be established through which it becomes

second nature to value a partner involve them in discussions and decision-making and the pursuit of mutually beneficial solutions to problems.

7.4.3 Buyer Obligations to Suppliers

In outsourced contracts, suppliers often have significant dependencies on buyer-provided systems and processes, standards, production equipment, and IT. In co-located arrangements, suppliers are likely to be subject to significant site-related constraints. Buyer obligations to suppliers, upon which supplier performance depends, are often under-specified in contracts and under-managed in governance processes. Governance processes in fully collaborative relationships should dedicate equal priority to the review and resolution of problems in both buyer performance (obligations) and supplier performance.

7.4.4 Alignment Checks and Contextual Customisation

Finally, many experienced practitioners may be familiar with the tensions between managing to the letter of a contract and maintaining good working relationships, but may be less aware of mechanisms at play, and their consequent effects on trust. To enable trust development, governance processes need to ensure that inhibitors to mutuality have been resolved and that relationships remain healthy and aligned:

- Are relational expectations consistent for both parties?
- Are trust perceptions (goodwill and competence) similar?
- Have all structural, procedural, behavioural and learning factors that are inhibiting mutuality, been assessed for this relationship?
- Are plans in place to address mutuality issues?
- Do suppliers feel valued, involved and trusted?

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