Strategic Alliances

Governance and Contracts

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Interorganizational Governance Trajectories: Towards a Better Understanding of the Connections Between Partner Selection, Negotiation and Contracting

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Introduction

Interorganizational relationships consist of several stages, such as a search and selection stage, a negotiation stage, and a contracting stage (e.g. Jap and Ganesan, 2000; Reuer, 1999, 2000). Each of these stages corresponds with distinct governance decisions, which collectively enable partners to achieve coordination and control during the life-cycle of their relationships. Hitherto, however, little research has examined the use of multiple mechanisms to structure exchange relationships (Jap and Ganesan, 2000), and studies on sequences of successive governance decisions are still rare in the literature (Long et al., 2002; Narayandas and Rangan, 2004). This has led to a significant gap in our understanding of interorganizational governance. This chapter therefore focuses on the following research question: *How are interorganizational relationships governed during different stages of cooperation, and how are the governance decisions in these stages related?*

By investigating this question, the chapter offers several contributions to the interorganizational governance literature. First, the results suggest that interorganizational governance should no longer be depicted as a discrete event, but as a process consisting of multiple, and possibly interrelated, decisions. Our findings illustrate that partners in interorganizational relationships do not align discrete governance decisions with firm and transaction characteristics (as proposed by, among others, adherents to transaction cost economics, agency theory and the resource-based view), but with series of governance decisions so as to achieve optimal performance over the entire lifetime of their relationships. The chapter underscores the importance of distinct phases of collaboration as elements of value creation, thereby offering a broader, more encompassing perspective on interorganizational governance than currently available (Cardinal, 2001; Narayandas and Rangan, 2004). Second, we divert the primary focus in governance research from the studying of contracts to inquiries into other means of coordination and control. Where examinations of the contractual aspects of interorganizational relationships have proliferated, inquiries into decisions concerning, among others, advance payment of suppliers, the use of standard-form contracts, and partner search and selection processes, are much scarcer.

To explore whether and to what extent these and other governance decisions are related to each other, we introduce the concept of *governance trajectories*. Subsequently, we report findings from an analysis of 911 buyer–supplier relationships involving IT suppliers and small- and medium-sized buyers. The results reveal that managers deploy a range of governance mechanisms that influence each other, and that are themselves influenced by distinct sets of antecedent variables, indicating that attempts to coordinate and control interorganizational activities are more diverse and multifaceted than often presented in the literature.

Towards a more comprehensive approach to interorganizational governance

Managers govern interorganizational relationships by directing the behaviour and performance of participants towards the production of actions desirable to the relationship and to themselves. By pursuing partial control over a partner's resources and behaviour, the occurrence of problems arising from goal divergence and asymmetrical objectives is limited (Blumberg, 2001), while coordination costs, resulting from the complexity and uncertainty involved in managing a cooperative relationship, are minimized (Park and Ungson, 2001). Governance is thus aimed at control and coordination, and it contemporaneously affects value creation and value appropriation.

Hitherto, interorganizational governance has frequently been depicted as a one-shot event, in which only a few options are available for coordinating and controlling the activities and behaviour of the partner. Whereas most research focuses on contractual aspects, governance can be achieved in more discriminating ways. Managers use distinct governance mechanisms to achieve similar functions (Miller et al., 2004), but also to address a complex array of problems and contingencies (Cardinal, 2001; Kirsch, 1997; Long et al., 2002). They implement portfolios of control modes to capitalize on a wide array of opportunities for achieving efficiency and effectiveness during the life-cycle of their relationships (Cardinal et al., 2004). In line with this, a large number of governance mechanisms has been proposed to help circumvent, mitigate or alleviate coordination and control problems, and to ensure that tasks are conducted in a way that is consistent with organizational goals (Heide, 1994; Kirsch, 1997). Consequently, research efforts should be redirected from examining singular governance forms to evaluating more complex governance systems (Long et al., 2002).

In this chapter, we therefore propose the concept of *governance trajectories*, which we define as *sequences of interrelated decisions that are made to influence the behaviour of participants in interorganizational relationships during successive stages of the cooperative life-cycle.* We presume that the governance decisions that are embedded in these trajectories are related to each other and that they jointly warrant value creation (Reuer, 1999). We discern three cooperative stages in which governance efforts are known to be ubiquitous: a partner selection stage, a negotiation stage, and a contracting stage. A review of the literature, as reflected in subsequent paragraphs, suggests that these stages at least involve decisions on: (1) the selection of a familiar or an unfamiliar partner; (2) exhaustiveness of selection efforts; (3) advance payments; (4) exhaustiveness of negotiations; (5) the use of standard contracts; and (6) contract completeness. Although the message of this chapter could have been conveyed by illuminating other governance decisions as well, we chose to focus on these mechanisms, as they feature prominently in the literature, and because we could obtain data on them for a large sample of interorganizational relationships. In the following paragraphs, we describe these six governance decisions. We show that they have different sets of antecedents and that they depend on some of the governance decisions by which they are preceded (see Figure 10.1).

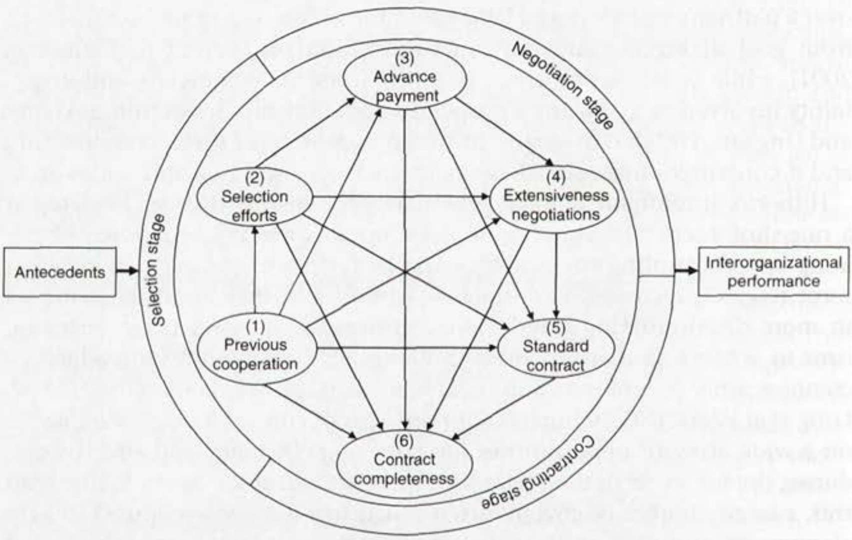

Figure 10.1: Conceptual framework of governance trajectories: antecedents, governance decisions and interorganizational performance

Partner selection stage

Partner selection refers to the identification of potential exchange partners and assessments of their quality and intentions (Buskens et al., 2003; Gulati, 1995). It serves to proactively solve potential governance problems and to guarantee complementarity of allying firms (Wathne and Heide, 2004). In this stage, focal organizations have to decide whether it is desirable and possible to work with a familiar partner or not. Furthermore, a decision has to be made as to the amount of effort that is invested in selecting a partner (Buskens et al., 2003). Concerning the first decision, it is recognized that organizations show a propensity to initiate relationships with familiar partners (Gulati, 1995; Kale et al., 2002), as these: have had the opportunity to build up interorganizational trust and reputation (Gulati, 1995); experience less uncertainty regarding their partner's reliability, intentions, interests, resources and capabilities (Li and Rowley, 2002); frequently intend to maintain a profitable relationship during longer time horizons (Ryall and Sampson, 2004); and do not require exhaustive evaluations (Li and Rowley, 2002). A second major decision in this stage concerns the *extent* to which search and selection efforts are undertaken. Extensive partner selection efforts reputedly assist in assessing the overall viability of interorganizational relationships (Geringer, 1991), and in reducing the occurrence of problems and conflicts of interests stemming from cultural, organizational, resource and strategic misfits.

Negotiation stage

In the negotiation stage, organizations at least have to make decisions on whether a supplier or another partner has to be paid in advance, and on what the appropriate length or exhaustiveness of negotiations should be. Concerning the first decision, the alliance literature is replete with articles on the choice between equity and non-equity relationships. However, other types of cooperation also entail decisions on equity transfer. Buyers and suppliers, for example, jointly decide whether advance payments for products and services are made. Such payments minimize the risk of hold-up experienced by suppliers (Helm and Kloyer, 2004), but they also pose additional risks to buyers, possibly influencing their use of other governance decisions. Next to advance payments, parties have to decide on the extent to which they want to negotiate. This governance decision concerns the length and intensity of formal bargaining processes (Ariño and Ring, 2004), and it differs conceptually from search and selection efforts and from contractual issues. Search and selection efforts, for example, might improve one's ability to negotiate. Furthermore, partners may be reluctant to lay down certain outcomes of their negotiations, as this might lead to high transaction costs or hold-up problems.

Contracting stage

In the contracting stage, decisions have to be made as to whether standard contracts are being used and to what extent complete contracting is sought. Regarding the first decision, standard contracts lower the efforts required to specify or compose contracts; enable fast interaction with a broad range of partners; reduce the strain on interpretive practices; and minimize the risk of inconsistent interpretations of contract clauses. However, they also preclude active buyer involvement and flexibility, and they are reputed to reflect the contract-issuing organizations' requirements, possibly leading to dissatisfaction on the part of partners (Korobkin, 2003). The resulting predicament indicates that decisions on the application of standard contracts are very significant. The second decision in this stage concerns the degree of contract completeness, which is a frequently used proxy for the extent to which partners attempt to coordinate and control interorganizational activities and outcomes (e.g. Anand and Khanna, 2000). Although higher levels of contract completeness facilitate coordination and control, they also entail higher transaction costs and reduced flexibility. Such dilemmas heighten the salience of decisions on contract completeness.

Interrelationships between governance decisions

Although each of the six foregoing governance decisions (see Figure 10.1) have been studied in isolation, relatively little is known about the relationships between them. Argyres and Liebeskind (1999) introduce the notion of governance inseparability to describe situations where there are interdependencies between governance decisions. Heide (1994) and Leiblein (2003) add that firms' past and current governance decisions constrain and enable the range and types of governance mechanisms that can be adopted in subsequent exchanges. In this respect, Avadikyan et al. (2001: 1448) suggest that the life of an interorganizational relationship should be considered as 'a succession of [value] allocation and creation problems and the events taking place within a given phase have strong impacts on the following periods'. Although these and other researchers have presumed that there are potential interdependencies across individual governance decisions, it is unclear what the nature of these interdependencies is (Heide, 2003).

Authors have, for example, demonstrated that the selection of a familiar partner influences contract completeness, as the need to reduce opportunistic behaviour is probably lower (Gulati, 1995), and the ability to contract may be higher (Poppo and Zenger, 2002). It appears that combinations of governance mechanisms generate positive synergy or negative tensions (Cardinal, 2001), making examinations of how governance decisions relate to each other highly pertinent (Heide, 1994; Reuer, 2000). We investigate whether each of the six governance decisions identified in this chapter at least possesses one direct link with another decision, which would substantiate our claim that studying series of governance decisions instead of discrete decisions is valuable.

We are also interested in differences between the antecedents of the six governance choices. When each of the governance mechanisms that we discerned has the same set of antecedents, results from the analysis on one governance decision can serve as a basis for inferences on other governance decisions. However, when different governance strategies are found to be appropriate under different conditions, this would demonstrate the efficacy of the concept of governance trajectories.

Method and results

Following Jap and Ganesan (2000), we examine data that have been collected at one point in time, and we classify variables along different stages of a relationship. To assess whether the concept of governance trajectories holds, we analyse survey data from a large sample of Dutch buyer–supplier relationships involving IT transactions, which were obtained from a data set called *The External Management of Automation* (MAT95) (Batenburg and Raub, 1995).[4] We perform ordinary logistic regression and logistic regression analyses to predict the application of each of the six governance mechanisms distinguished before. Although our measurements are generally consistent with other research based on the same data (see Batenburg et al., 2003; Buskens, 2002), we shift the analytic focus from the application of singular governance mechanisms towards series of governance decisions. Our analysis differs from these studies, because they either involve a smaller number of governance mechanisms (Buskens, 2002), or because they reduce the governance mechanisms that we distinguish to one additive measure (Batenburg et al., 2003). Consistent with recent work (Reuer and Zollo, 2005), and in line with recommendations from Colombo (2003) and Madhok (2002), we include both firm-level and transaction- or relation-level factors as explanatory variables of governance choices (see Table 10.1). The effects of most of these variables on various governance decisions are intuitively straightforward; they influence the need for and ability to coordinate and control.

Our analyses indicate that each of the six governance decisions is influenced by different sets of antecedents. Familiar partners are selected because partners might benefit from relation-specific investments, which they have made in earlier transactions with the same supplier (see also Zollo et al., 2002). Furthermore, cooperation with a familiar partner is more likely in situations characterized by higher measurability, higher importance of reputation, and larger numbers of alternative options, suggesting that buyers revert to suppliers they know when assessments of product or service quality are more difficult, or when products are highly standardized. The positive

Table 10.1: Results from regression analyses

Antecedents	*Selection stage*		*Negotiation stage*		*Contracting stage*	
	Familiarity partner	*Selection efforts*	*Advance payment*	*Negotiation efforts*	*Standard contract*	*Contract complexity*
Financial volume		+	+	+	−	+
Complexity				+	−	+
Asset-specificity	−	+		+		
Measurability	+	−				+
Size buyer				+	−	
Size supplier					+	+
Legal expertise						+
Other relationships		+				
IT expertise						
Importance reputation	+	+		+		+
Alternative options	+					−
Perceived dependence	+		+	+	−	
First user group	−					−
Age supplier	+	−	−	−		
Age of respondent				−		

association with perceived dependence suggests that organizations are occasionally forced to work with partners, possibly due to lock-in effects or the relative absence of alternatives (Klein Woolthuis et al., 2005). Finally, cooperation with a familiar partner becomes less likely when a buyer belongs to the first user group in its industry, or when a supplier is relatively young. These findings suggest that the selection of *familiar partners* is not only determined by a focal organization's ability to discern capable and reliable partners, or the routinized and standardized selection of partners (Li and Rowley, 2002). It also depends on the availability of familiar partners, and the difficulty on the part of a focal organization to break away from a familiar partner, as indicated by investments in relation-specific assets performed during earlier interactions, and the perceived degree of dependence on familiar partners.

Consistent with previous work on partner selection (Buskens, 2002; Buskens et al., 2003), *selection efforts* are influenced by a different set of antecedents, including the financial volume associated with a transaction, the importance a buyer attributes to the reputation of the supplier, and the prevalence of other relationships between a buyer and external organizations. These variables have a significant positive association with selection efforts. Investments in relation-specific assets tend to increase the exhaustiveness of firms' selection efforts. Measurability has a negative effect, which is congruent with the notion that selection efforts are being driven by uncertainty (Beckman et al., 2004). Finally, a supplier's age also shows a negative influence, which can be explained by the fact that older suppliers have better-known accomplishment records, and because they are perceived to be less risky business partners.

Advance payment of suppliers is influenced by the financial volume involved in a relationship and the perceived dependence of buyers on suppliers. Both variables exhibit positive relationships with ex ante payment. In contrast, the supplier's age has a significant negative influence on the likelihood that a supplier receives advance payments. This indicates that suppliers primarily demand advance payments from their buyers when the financial volume associated with a relationship carries significant costs and/or risks if not passed on to the buyer. Considering *negotiation efforts*, financial volume, complexity, asset-specificity, size of the supplier, importance of reputation, and perceived dependence are found to have a significant positive influence. In contrast, age of the supplier and age of the respondent exhibit a significant negative relationship to negotiation exhaustiveness.

Antecedents of the use of *standard contracts* consist of financial volume, complexity of the deal, size of the buyer, and perceived dependence. These are all found to have a negative association with the use of standard contracts. Size of the supplier has a positive influence on the use of standard contracts. Larger suppliers possess more resources and experience for developing standard contracts, and they have better opportunities for leveraging standard contracts over a larger number of transactions. Given that standard contracts are generally beneficial to suppliers (Korobkin, 2003), our finding that larger buyers show stronger resistance to the application of standard contracts is not surprising. Finally, *contract completeness* is positively affected by financial volume, complexity, measurability, the importance of reputation, legal expertise, and size of the supplier. The existence of alternative options and membership of a first user group exhibit a negative association with contract completeness.

We now extend previous work by researchers using the same database (Batenburg et al., 2003; Buskens, 2002), by assessing whether previous governance decisions influence subsequent governance decisions (see Figure 10.2). Hierarchical regression analyses reveal that the decision to cooperate with a familiar partner has a negative effect on selection efforts, negotiation exhaustiveness and contract completeness. The latter corroborates findings from Anand and Khanna (2000), who suggest that contracts between familiar organizations are systematically different from the ones in de novo pairings. It also supports the observation from Klein Woolthuis et al. (2005) that some firms do not fear opportunism during negotiations and contracting, because of their experiences with the other party. Selection

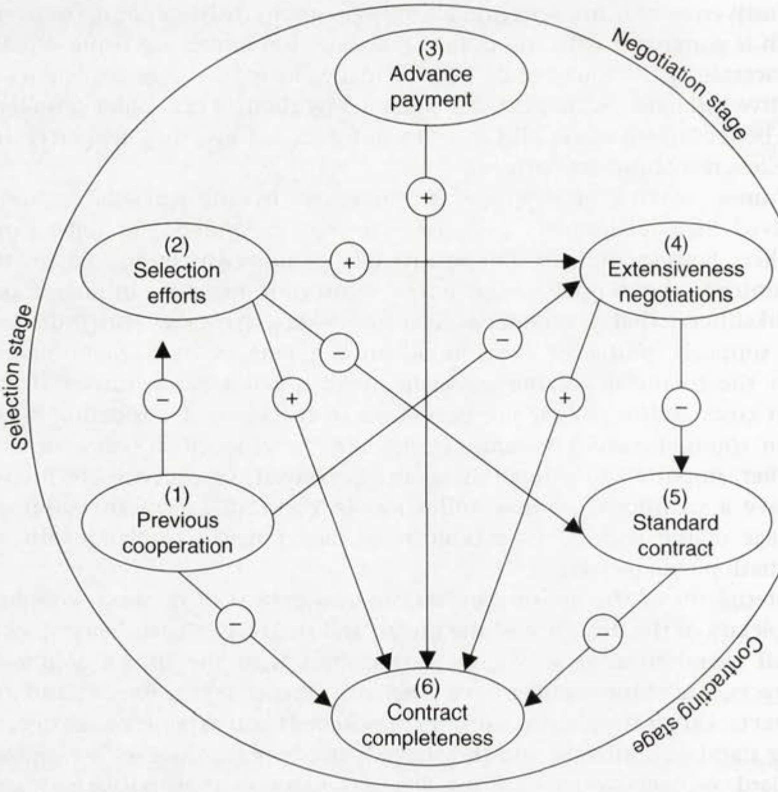

Figure 10.2: Relationships between governance decisions

efforts, in turn, positively influence the extent of negotiations and contract completeness, while they exhibit a negative relationship with the use of standard contracts. This suggests that searching, screening and selecting suppliers and products helps to assess the reliability and level of competence of potential suppliers (Blumberg, 2001), thereby reducing the risk of a transaction, and possibly reducing the need for formalization. Advance payment does not appear to be influenced by other governance decisions, but it does itself influence the degree of contract completeness.

Finally, the exhaustiveness of negotiations reduces the use of standard contracts and propagates contract completeness. In conclusion, it appears that each of the governance decisions discerned here at least influences one other governance decision within the same governance trajectory. Moreover, the six governance decisions are all associated with different sets of organization-level and relational-level antecedents, supporting our conceptualization of governance trajectories.

Discussion

In this chapter, we argued that interorganizational governance research frequently focuses on explaining singular governance decisions. However, in practice, managers deploy various governance mechanisms for the purpose of coordinating and controlling interorganizational activities and outcomes during the life-cycle of their relationships. This provoked the question as to how interorganizational relationships are governed during various stages of cooperation. In response to this question, we introduced the concept of governance trajectories, which was proposed to consist of *sequences of interrelated decisions that are made to influence the behaviour of participants in interorganizational relationships during successive stages of the cooperative life-cycle*.

Results from our analysis of 911 interorganizational relationships support our conceptualization of governance trajectories, showing that interorganizational governance should no longer be depicted as a discrete event, but as a process consisting of multiple, and possibly interrelated, decisions. Partners in interorganizational relationships align firm and transaction characteristics with series of governance decisions so as to achieve optimal performance over the entire lifetime of their relationships. The chapter thereby shifts the attention from discrete governance choices to a broader, more encompassing perspective on interorganizational governance than currently available (Cardinal, 2001; Narayandas and Rangan, 2004). It also diverts the primary focus in governance research from the studying of contracts to inquiries into other means of coordination and control, such as advance payment of suppliers, the use of standard-form contracts, and partner search and selection processes.

Managerial implications predominantly concern managers' awareness of the effects of governance decisions made in earlier stages of cooperation on decisions and outcomes in later stages. It appears that managers may use the interdependencies between these governance decisions deliberately (see also Heide, 2003). They may invest more in partner selection, for instance, to increase their ability to negotiate with potential partners, and to enable the development of tailor-made contracts. Furthermore, managers are advised to take multiple governance mechanisms, task-characteristics and contextual attributes into account when deciding on how to govern their relationships.

Future research could be directed at extending and refining the model presented here. A promising opportunity consists of including renegotiations and extensions of scope during the execution and implementation stage of collaboration in the model. This could reveal which firm and transaction characteristics and which of the governance decisions described in this chapter can predict whether renegotiations and redefinitions of scope are likely to occur.

Notes

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4. The data set *The External Management of Automation* has been collected as part of the NWO-pioneer programme 'The Management of Matches' (PGS 50-370) and is available from the Steinmetz-Archive (study number P1512). For more details on the data-collection procedure, we refer to Batenburg (1997) and Batenburg et al. (2003).

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