

MANAGING DISCREPANCIES BETWEEN FORMAL AND PSYCHOLOGICAL SIDES OF ALLIANCE CONTRACTING

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INTRODUCTION

Although many studies have dealt with alliance governance, especially in Transaction Cost Economics (TCE), this stream of research has focused overwhelmingly on the formal agreement. Accordingly, while it is accepted in TCE that there may exist certain disagreements between the parties, the possibility of any confusion and misunderstanding about the contractual agreement itself has been largely overlooked by prior research on strategic alliances.

The purpose of this paper is precisely to address this gap. As expectation fulfillment is crucial to relationship harmony between trading firms, we seek to explore the link between the written contract and the partners' expectations. To investigate this link, we rely on the notion of psychological contract. A psychological contract initially corresponds to the set of expectations that an individual develops in the course and within the framework of an agreement, between him/herself and another individual or an organization (Rousseau, 1995). Although this notion has been developed for analyzing employment relationships, Rousseau (1998) has emphasized the profoundly psychological nature of all contracts. A psychological contract approach should allow us to better explain the tensions which may surface in an alliance, particularly after the formal contract has been signed between firms.

This paper investigates the existence of a psychological contract distinct from the legal contract in alliance relationships. It then addresses the possible discrepancies that might exist between these formal and psychological sides. We suggest that such divergence can endanger the alignment of the contract to transaction's attributes. In so far as the psychological contract, although distinct, is related to the formal contract, we explore the ties between these two sides of alliance contracting. Therefore, this research specifically aims at gaining an understanding of what influences the discrepancies between the formal and the psychological aspects of alliance contracting. To do so, we combined numerous interviews with juridical experts, managers, and engineers, as well as an analysis of very detailed secondary data on three strategic alliances.

Our study contributes to the strategic alliances management and contracting literature in two major ways. First, the analysis of alliance agreements through the double lens of formal and psychological contracts leads us to extend the notion of alignment in TCE. Due to the fact that there can be a feeling that the alliance's contract is breached even when there is no actual breach of the written contract, the psychological contract approach has the advantage of proposing a wider view of alliance contracting. We thus go beyond the approach aligning the formal contract and the transaction to propose an extended alignment between formal and psychological sides of contracting and the transaction. Second, as the alignment of the alliance's contract with the

transaction's attributes can be hampered by discrepancies between the two sides of alliance contracting, we bring insights to identify the role of firms' capabilities to manage those gaps. In the wake of recent works (Argyres & Mayer, 2007; Mayer & Argyres, 2004), we thus refine the analysis of contracting capabilities.

BRINGING PSYCHOLOGICAL CONTRACT INTO STUDIES ON ALLIANCES

A psychological contract firstly lies in the promises, verbal or written, made between individuals (Rousseau, 1995). The legal contract does not necessarily reflect the psychological contract. The feature of the psychological contracts *vis-à-vis* other forms of agreement is that they are highly perceptual and idiosyncratic in nature. In this regard, psychological contracts comprise mental models that facilitate the framing of promises. When formed, these promises result in stable, reliable, and predictable underlying schema helping to define the agreement (Conway & Briner, 2005).

Moreover, psychological contracts represent the perception of one's own, as well as the other parties' obligations. The set of norms embodied in the psychological contract is then used by the people involved in a relationship to assess the extent to which the other party has fulfilled – or not – its obligations. If the psychological contract is breached, dissatisfaction and negative feelings tend to ensue. When the breach is accompanied by the feeling that the other party has acted willingly, the violation of the contract is accompanied by very strong and negative emotional reactions. A challenge for managers is then to avoid breaking the contract while only one part of this contract is explicit.

RESEARCH SETTING AND METHODS

Our empirical study combines two complementary types of data. We brought together exploratory interviews with juridical experts and a multiple case study-based research.

Research Procedures and Data Sources

Interviews with juridical experts. We conducted 28 in-depth interviews with lawyers, law professors, and juridical consultants to obtain multiple perspectives on the nature of contracting between firms. Our informants were all specialized in contract law in inter-organizational relationships.

Case studies. In addition, in order to extend the insights gathered during these interviews, we selected cases of innovative alliances. First, as the existence of the psychological contract is more likely to be revealed when there is a breach of this contract, we decided to focus on alliances that had disputes. Second, the three selected alliances belong to the same national and legal Civil Law context and are two-firm alliances involving technology-oriented SMEs. Third, we focused on first-time alliances between the three couples of firms, which meant that no prior ties existed between them at the outset. This was the means to avoid the pre-existence of a relational contract between the trading firms.

Data on the three cases was collected through a law firm and thus includes particularly detailed information on contractual characteristics and the context of the alliance. Each legal file contains around 500 pages; it includes all documents exchanged by each party of the alliance during the dispute resolution process. Our dataset contains documents preparatory to the alliance

(initial drafts of the formal contract, memos, status reports, web pages, and minutes from alliance meetings, etc.), the formal contract, legal consultations, and letters exchanged between the parties. In addition to mandatory legal documents, the lawyers in each case requested from the clients all possible relevant information that could explain their situation and their perception of the conflict: for example, the initial context of the alliance, the origin of the conflict, and its evolution over time.

It was also important to reflect the feeling of contractual breach. We thus interviewed between five and seven individuals – either managers or engineers – for each alliance. During these 18 interviews, we consistently asked informants to describe the chronology and details of events that led to the breach of the psychological contract.

Methodology

Our approach towards data collection and analysis was exploratory in nature and intended to generate insights into the psychological dimensions of alliance contracting. Our process of data collection and analysis proceeded iteratively, with the early stages being more open-ended than the later ones.

DISSOCIATING THE FORMAL AND THE PSYCHOLOGICAL CONTRACTS

In the three cases studied, an alliance was formed between two independent organizations. Those three technological alliances shared a high level of uncertainty due to the innovative nature of the projects. For each alliance, a written contract was drafted between the firms involved. The legally binding agreements established commitments, incentives, procedures, and rights in order to accomplish the transactions. In the three alliances, those formal contracts also included a set of mechanisms for controlling and coordinating the behaviors of the transacting partners. Although each of these legal contracts was perceived as well-conceived and appropriate for the transaction to be realized, some dimensions of the exchange were not expressed directly or clearly during the initial stage.

We observed in those cases that formal contracts did not fully encompass managers' critical expectations. Interviewees did indeed refer to some contractual obligations which were not included in the written contract, thus supporting the idea that actors can nurture a psychological contract that does not strictly correspond with the formal contract. In each of the three alliances, the parties did not systematically check the correspondence between their formal contract and their real expectations.

While the discrepancy arose early in the relationship, interviewees insisted on the fact that no divergence was noticed during the first negotiation stages. When the expectations went unfulfilled, they triggered a feeling of betrayal which led to a deterioration of alliance's relationships. Although the formal contract was not breached, firms' representatives nevertheless perceived that their counterparts failed to follow some essential dimensions of the agreement. It also appeared that while the formal contract did not encompass all critical expectations, discrepancies between formal and psychological contract did not necessarily stem from a contractual design choice.

DISCUSSION

Contracting as the interaction between formal and psychological aspects

The study of the three cases and the 46 interviews leads us to revisit the notion of agreement between independent entities involved in an alliance. In this respect, our study represents a first step in bringing together formal and psychological dimensions of alliance contracting. The psychological contract is distinct from formal contract in so far as parties can have tacit understanding and expectations that have many of the features of formal and strict promises. Certain sorts of agreements constitute commitments that can be promise-like without using the most formal terms of promising (Shiffrin, 2007: 726).

We argue that alliance agreements can be fully understood only through a joint consideration of both formal and informal sides. That is why we prefer to talk about “contracting,” rather than contract, to gather formalized aspects and unwritten expectations of alliances. As it appeared in the empirical section, the two dimensions not only coexist but also interact. On the one hand, the formal contract binding firms helps them to flush out unspoken assumptions and create a genuine meeting of the minds at the outset of the relationship (Smitka, 1994). Firms thus can employ formal contracts both as a technical means of structuring relationships and also as a symbolic means of communicating beliefs (Suchman, 2003: 100). On the other hand, the psychological contract is likely to drive formal contract formation. The psychological dimension combined with the formal dimension strengthens and supplements some aspects of the exchange, especially in areas in which the legal document is mute or uncertain. It therefore appears that, at best, formal contracts serve as blueprints and programs, not as actual governance mechanisms (Suchman, 2003: 107). As pointed out by Goetz and Scott (1985: 308), it is the couple formed by the express and implied terms that constitute the defining instruments of contracting.

Extending the TCE’s notion of alignment

Through data analysis we identified the possible co-existence of formal and psychological contracts. Although the two contractual elements interact with each other during alliances, they do not necessarily match. This dissociation between the legal agreement and the psychological contract leads us to extend the notion of alignment as developed in Transaction Cost Economics.

A central tenet of TCE is that a discriminating alignment of transactions with governance leads to more efficient outcomes via reduction of transaction costs (Williamson, 1985: 22-23). This is a valuable framework, but our exploratory findings suggest that it needs augmenting to account for a different set of activities in alliances. Whereas TCE focuses on formal structural safeguards, the interviews with juridical experts and analysis of the three alliances show the presence of psychological contracts in complement to the written contract signed by the trading parties. As we have seen through the study of these three alliances, situations of misalignment can also derive from a mismatch between the formal and the psychological contracts and transaction’s attributes. Possible consequences are negative emotional reactions and a general decrease in relationship harmony. The formal contract can be observed while at the same time one partner feels that obligations have not been fulfilled. We therefore suggest that the discriminating alignment of transactions must be broadened to take into account contracting

understood as the combination of the formal and the psychological contracts.

We argue that the minimization of transaction costs goes through an alignment linking the psychological and formal contracts and the transaction's attributes. Costly misalignments are not always due to an inappropriate choice of governance structures. As the psychological contracts of the trading partners interact and influence the formal contract in alliance contracting, we argue that TCE could be complemented by integrating the underlying psychological contracts with the formal contract. Alignment or misalignment thus results from a proper coordination of the expressed and implied dimensions of contracting with the transaction to be made.

Capabilities to manage discrepancies between formal and psychological aspects of alliance contracting

This extension of the TCE framework then suggests revisiting the contracting capabilities in alliances. Contract-designing activities have to adequately take into account the multiple facets of alliances' agreements. As the formal and psychological contracts do not form independently, firms can take advantage of the interactions between the two sides of contracting. In particular, our cases and interviews suggest that firms have to find the right balance between detailed contractual formalization and development of unwritten expectations. Although gaps between the two sides are not a problem in themselves, firms have to be careful not to develop too large a divergence between what is formally agreed and what they really expect from the alliance. In other words, alliance contracting can play on the interactions between formal and psychological aspects, but a general consistency must be kept in order to avoid a contractual breach. We suggest that on one hand alliance contracting relies on tensions between each firm's psychological contracts, on the other hand between the formal contract and the psychological contracts. In addition to dealing with tensions between the psychological contract of each firm, management of discrepancies requires two-way information processing: from the psychological side to the formal side and from the formal side to the psychological side.

Whereas contracting capabilities have been so far mainly understood with regards to formal contractual arrangements (e.g., Argyres & Mayer, 2007), our analysis suggests that alliance contracting capabilities must be reconsidered as going beyond mere technical dimensions of contract writing. Although such efforts can especially take the form of additional *ex ante* transaction costs, they can be a means to avoid costly *ex post* misalignments.

CONCLUSION

By providing a broadened explanation of exchange governance, this study can facilitate a more careful governance selection in strategic alliances. Following Mayer and Argyres (2004), we believe that firms might be able to build up their contracting design capabilities and, therefore, differ in their levels of such capabilities. We shed new light on the search for appropriate contractual governance designs and warn managers against focusing only on formal aspects of agreements.

In conclusion, our arguments and empirical conclusions depart sharply from most prior studies, which do not consider alliance contracting according to their two complementary sides, i.e. psychological and formal sides. This study has therefore conceptually refined and empirically extended previous work on contractual governance and management of strategic alliances, thus opening new ways to Transaction Cost Economics.

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