

**BUILDING AND SUSTAINING EFFECTIVE RELATIONAL CONTRACTS IN  
MULTINATIONAL FIRMS**

**BY**

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MA Oriental Studies (Japanese)  
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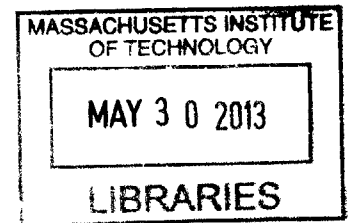
Submitted to the MIT Sloan School of Management in Partial Fulfillment  
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## **ABSTRACT**

The purpose of this thesis is to demonstrate how complex interactions in organizational transactions and behavior can be better understood by using theory related to relational contracts. Further, given this understanding, suggestions are made as to how firms can increase competitive advantage by building and sustaining better relational contracts in their organizations.

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# 1 Introduction and Approach

## 1.1 Outline

Organizations exist in order to co-ordinate complex activities in the marketplace. In order to do so, most firms seek to build organizational structures, processes and capabilities which are closely aligned with the firm's strategic intent and which enhance competitive advantage. These structures are managed and enforced through the use of formal contracts, reporting lines, and incentives that together with structural elements, comprise the strategic design of the firm. Such arrangements, however, are often felt to be imperfect, incomplete and costly, and at times they are non-existent<sup>1</sup>. Moreover, they don't account for much of the motivation behind employees', partners', suppliers', and customers' efforts to manage the complex activities that explain the organization's existence.

The field of Organizational Economics seeks to understand and explain these non-contracted behaviors through relational contracts. Relational contracts are broadly defined as unverifiable and unspoken agreements between parties that account for performance over and above (or in place of) that which is motivated by formal contracts. They exist within the firm and across firm boundaries with suppliers, customers and alliance partners.

Using the language of game theory, relational contracts demonstrate how self-interested parties choose to co-operate with other parties not just because a formal contract or incentive is in place, but also because they believe that repeated cooperation results in future unspecified benefit. In economic terms, this means greater surplus or rent can be created by continued cooperation in a relational contract, whilst the punishment for failing to co-operate (or defection) is felt to be

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<sup>1</sup> Andrews, I. and Barron, D. "The Allocation of Future Business: Dynamic Relational Contracts with Multiple Agents." MIT Job Market Paper. 2012. p. 2

punitive. A critical characteristic of relational contracts is that they cannot be verified *ex- and post ante*.<sup>2</sup> In essence, relational contracts are sustained because of a believable but unverifiable promise of future benefit.

Relational contracts are pervasive throughout firms and between employees and their stakeholders. They are manifest in many areas of organizations where sustainable competitive advantage can be built: between managers and their employees; in the formal and informal networks that employees create; in the complex interactions between suppliers, partners and customers; and in the norms and values which drive how organizations feel themselves to be distinct, with a definable but often undocumented *modus operandi*.

Most firms recognize that these complex, systemic facets of organizational management are extremely difficult to change and improve; yet many would also concede they are unquestionably a source of competitive advantage. Yet whilst there is comprehensive literature surrounding how firms can improve organizational management in these difficult areas, not many firms take the plunge, and among those that do, oftentimes well-intentioned efforts do not lead to sustained improvement. An important part of this thesis is the assertion that a deeper understanding of relational contracts will help leaders renew their efforts to build stronger competitive advantage in these critical aspects of organizational management.

For many firms, the changing context in which they operate points to increased importance in building and sustaining more effective relational contracts. In particular, increasing globalization, shifts toward increased competition on the basis of knowledge and solutions, and an increase in the pace of change amid continued uncertainty all point to a need for firms to rely less on formal organizational structures to achieve competitive edge. Instead, it is suggested that firms build and

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<sup>2</sup> Gibbons, R. 15.903 Organizational Economics and Corporate Strategy. Lecture Note 2: Relational Contracts, 2012 p. 2.

sustain the more cooperative and collaborative behaviors evident in relational contracts.

Firms that believe their competitive interests are served by investing in building relational contracts will need to evaluate a number of factors carefully. Firstly, it is important to consider whether a full-scale change program, which could fundamentally alter the strategic positioning of the firm, is desirable and feasible. Cost (much of which is front loaded) and time-to-benefit of the required change are considerable, and a systemic approach is essential. Given these factors, it is possible to prioritize effort, in favor of those parts of the firm that stand to gain most from improving relational contracts.

Firms that embark on an initiative to build and sustain better relational contracts must take a systemic approach, not least because of the complex, overlapping nature of interpersonal dynamics. Recommendations are made as to how to intervene in creating better relational contracts in individuals, teams, processes, networks, and customer, partner and supplier relationships, and in how the overall change program is led and managed. Suggestions made here are indicative only, but any initiative should address all of those organizational levels and components outlined.

All recommendations made in this thesis are focused on improving clarity and credibility in relational contracts, because these are the two characteristics that are felt to contribute most to improving cooperation between parties. Credibility and clarity in turn create the essential belief in the rewards of cooperating over the longer term. The means by which greater clarity and credibility are achieved are manifold, but often they imply more effective communication. The resulting commitment is critical in managing the variability of the rewards of cooperation in the short term.

Firms that achieve their goals in improving relational contracts will find themselves better able to sustain long-term, profitable growth, and enjoy higher productivity in

interactions within and across firm boundaries. Employees and partners will be more open and co-operative with each other, with a less hierarchical approach to innovating and problem solving, and they will be better able to compete in more complex, dynamic business contexts.

## 1.2 Approach

The thesis has been compiled from an extensive review of literature and case studies on relational contracts and organizational dynamics, combined with the author's own experience over 12 years working as a general management consultant to large multi-national firms in Europe and Asia.

Literature reviewed in the course of research includes monographs on relational contracts and related works in organizational economics, such as game theory, transaction cost economics, and alliance management. Much of the work has been informed by the MIT Sloan School of Management elective 15.903 Organizational Economics and Corporate Strategy, led by Professor Robert Gibbons.

The parts of the thesis that focus on how to address relational contracts rely more heavily on other fields of study in general management, organizational behavior, and psychology. In addition, many case studies of firms that have successfully addressed relational contracts have been reviewed, although in no example was relational contract theory explicitly referenced in making the case for change.

The author's experience working with multinational companies as a consultant has heavily influenced the conclusions. The firms with which the author has worked are large and multi-divisional, ranging between \$0.5 billion and \$20 billion turnover. They are mostly global and are largely from the consumer goods and life-sciences sectors. Two in particular are relevant, one in the agribusiness sector, the other one in consumer packaged goods, for whom the author has led strategic projects

intermittently over six and nine years each. Both these firms are among the most successful in their industry and have invested heavily in addressing organizational issues related to relational contracts, using all of the commonly-known devices recognizable as 'best practice', but with mixed results. It is worth pointing out that whilst these firms have dealt with trying to improve relationships, behaviors and culture, they have not done so specifically with the concepts of relational contracts in mind. Where specific examples are drawn from these firms, for confidentiality reasons, they will be referred to as AgriCo and CPGCo.

The thesis is organized in five sections. First, the theory of relational contracts will be set out, along with its defining characteristics. Examples of relational contracts in existing firms are outlined. Second, the importance of relational contracts in creating competitive advantage will be set out, along with some contextual factors in the global business environment which point to relational contracts being increasingly important. Third, some guidance is offered on how to identify organizational dynamics that indicate urgency of need to deal with relational contracts, along with strategic implications of doing so. Fourth, potential solutions areas are recommended, demonstrating how relational contracts can be worked on and how the overall change program should be led and managed. These solution areas are indicative and high-level; further field-testing and adaptation to specific needs of particular firms are necessary before they can be considered actionable. Finally, areas for further research on relational contracts and their development in organizations are proposed, with a view to enriching the existing literature and testing the ideas set out in this thesis.

### **1.3 Assumptions and Clarification of Terms Used in this Thesis**

#### **1.3.1 Rational Self-Interest**

Relational Contracts are rooted in economic theory and rely on the assumption that rational self-interest in a free market economy leads to economic well-being. Adam

Smith first defined the concept of rational self-interest in the *Wealth of Nations*<sup>3</sup>. The assumption holds true in this thesis and needs to be defined to establish clarity.

#### 1.3.1.1 Rationality

The rationality that Smith refers to means that individuals do not make repeated mistakes systematically– they will evaluate and learn from their errors. This is a very important point for the sustained creation of mutual benefit in relational contracts, as we shall see later.

#### 1.3.1.2 Self Interest

The self-interest described by Smith is often misinterpreted: it does not mean that individuals only act to satisfy their own material wants. Beyond material wants, there may be other more complex dependent needs, such as status or recognition. It implies a broader set of “preferences”, and among these broader preferences is the welfare of others.<sup>4</sup> This interpretation too has important consequences as we examine why organizations need to build better relational contracts.

#### 1.3.2 The Three Lenses of Organizational Analysis

To aid understanding of different perspectives of organizational dynamics, MIT's Three Lenses of Organizational Analysis are used in the thesis.<sup>5</sup> See Figure 1. Each lens offers a different perspective on one or other dimensions of the organization, and together are helpful in connecting relational contract theory with the practical elements of what we see manifest in a living, breathing organization. The first lens, Strategic Design, sees organizations as machines, where action comes from planning. It is the lens through which we see organograms, formal contracts, and a clearly defined rules-based system through which organizations mechanically achieve their goals. The next lens is political, which sees organizations as a contest

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<sup>3</sup> Smith, A. *The Wealth of Nations*, from the Concise Encyclopedia of Economics <http://www.econlib.org/library/Enc/bios/Smith.html> accessed 26 March 2013

<sup>4</sup> “The Benevolence of Self-Interest.” *The Economist* December 10<sup>th</sup> 1998. <http://www.economist.com/node/179495> accessed March 2013.

<sup>5</sup> Carroll, J. S. “Introduction to Organizational Analysis: The Three Lenses.” Cambridge, MA: MIT Sloan School of Management, unpub.ms, 2002.

in a social system, and in which action comes through influence and power. The third lens is cultural, in which organizations are seen as institutions, and actions come from habit, values, and norms. None of the lenses on its own explains how organizations work, but together they account for most of the dynamics we see in organizations today. As such, the lenses provide a useful lexicon for explaining relational contracts. Because relational contracts operate over and above the formal components of organization design, i.e. the Strategic Design lens, they are most often manifest in the Political and Cultural domains.

Figure 1. The Three Lenses of Organizational Design

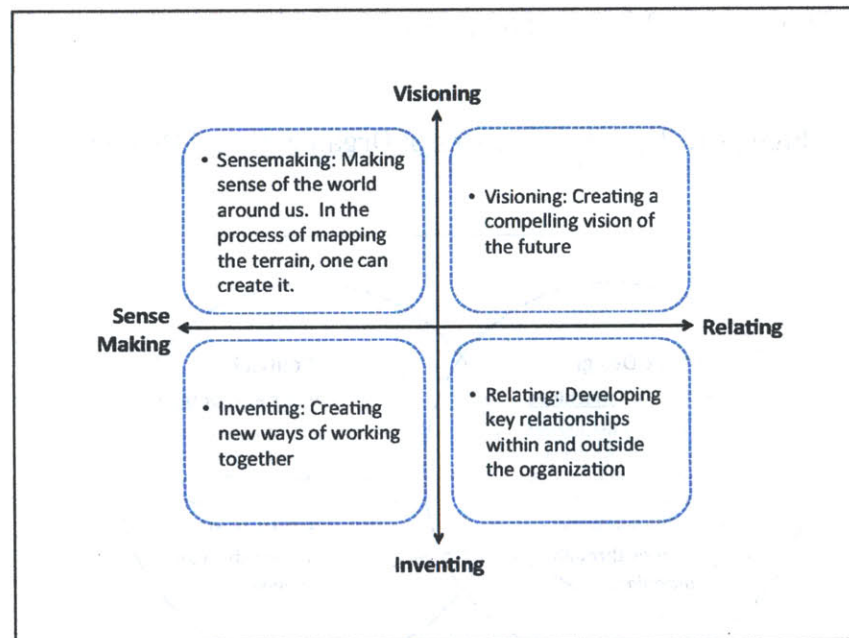


### 1.3.3 Leadership

Again to aid explanation of the concepts in the thesis, a model of leadership behaviors is used. Designed by faculty at the MIT Sloan School of Management, it is called the Four Capability Model, and it divides desirable leadership behaviors into

capabilities: Visioning, Sensemaking, Relating and Innovating<sup>6</sup>. The model provides useful shorthand for explaining which leadership behaviors need to be nurtured or emphasized in the development of relational contracts. Figure 2 describes the four capabilities in summary form.

**Figure 2. MIT's Four Capability Leadership Model**



### 1.3.4 Culture

In addition to the lenses discussion above, it is necessary to define clearly what we mean by organizational culture, because like many terms of great general utility, it has been adopted to explain many things. In this thesis, culture is used to define the unique characteristics of a firm that lie in the norms of behavior, the way people interact, the values the firm holds dear, and the assumed standards in the organization. It is very often unwritten, but implicitly understood, and lends itself well to metaphors and folklore about the company's history.

<sup>6</sup> Ancona, D. "Leadership in an Age of Uncertainty." Research Brief, Massachusetts Institute of Technology Leadership Centre, 2005.  
<http://leadership.mit.edu/pdf/LeadershipinanAgeofUncertainty-researchbrief.pdf>, accessed March 2013.

### 1.3.5 Collaboration

Like culture, the word collaboration is used prolifically in literature on organizations, but can be used to say many things. For the purposes of this study, it is used to mean cooperation by two or more parties in the pursuit of solving a problem, making teamwork more effective, or defining an innovation of some sort. Implicit in this meaning is that a collaborator makes an elective and discretionary choice to co-operate with colleagues or partners. It is important to understanding relational contracts that collaboration is understood in these terms.

## 2 Understanding Relational Contracts

Relational contracts help explain behaviors in organizations which are not accounted for by formal contracts, structures, and codified norms that comprise the strategic design of the firm. Principles and agents agree or are given formal contracts to motivate high performance in the completion of defined tasks and activities. The strategic design elements, such as a position within a function, a job description, a role on a project team, a contract to supply intermediate goods, defined responsibilities within a documented process, and hard measures-based incentives are all necessary in some measure to co-ordinate the complex activities of the firm.

However, whilst necessary to a greater or lesser degree, these formal contracts are not necessarily sufficient. Often the strategic design elements are incomplete, imperfect, or costly. Instead, principles and agents need to rely on the relationship that exists between them to motivate performance over and above that which is defined by formal structures.

An example of these informal, undocumented behaviors could be a Key Account Manager's exchange of sensitive market information with a customer. This is not a requirement set out in the contract documents, but it creates additional value for

the customer by helping her develop market insights, and it contributes to more effective interactions between the two parties next time they communicate. Another example could be the decision of project team manager to commit extra time and effort during the completion of project work to sharing and discussing work in progress with a wide network of people. Such network members, may be tangentially connected to the outcomes of the project, but do not need to be involved in the project itself. The sharing of progress is done to ensure as many people as possible are reassured by progress, but also with a view to identifying unanticipated problems or innovative ways of resolving issues. An example at the organizational level could be employees having a motivating sense of purpose to work longer than the contracted hours because they believe the organization is just a fulfilling place to work, over and above the compensation and benefits they receive.

In all these examples, there is a sense of cooperation between principles and agents, and they are typified by stronger relationships, underpinned by anticipation of more value being enjoyed by both parties in the future. These are all relational contracts, and they are pervasive in most organizations. A fundamental characteristic of relational contracts is that some degree of trust must exist between parties in order for the relational contract to be sustained.

## 2.1 Relational Contracts' Origins in Game Theory

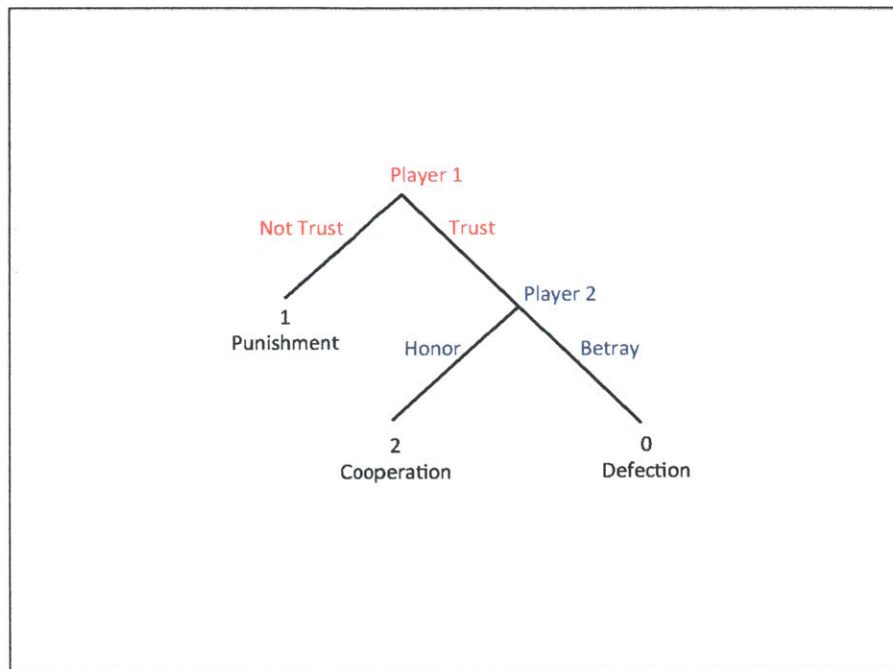
Given that relational contracts are underpinned by a willingness for parties to cooperate repeatedly over time, it is not surprising that they have their source in repeated game theory. In Figure 3 below, the basic concept is explained, abstracted to two parties<sup>7</sup>. In a single iteration of the game, we assume that Player 1 is an employee who is tasked with additional work outside the scope of her formal job descriptions by her manager, who is Player 2. The manager suggests the employee's

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<sup>7</sup> Gibbons, R. "Relational Contracts." Lecture Note 2, 15.903 Organizational Economics and Corporate Strategy, Massachusetts Institute of Technology, Cambridge, MA. PDF File downloaded from <http://web.mit.edu/rgibbons/www/>, accessed November 2012. p 4.

completion of the task will result in his giving her extra endorsement in career management discussions about the employee which he may be party to.

Figure 3 – Game Theory in a Repeated Game, Showing Payoff for Player 2



The employee can choose either to put in the extra work and co-operate, trusting that her manager will look out for her career in the future, or she can refuse to co-operate and finish just the normal assigned work on time, with no additional benefit to either party. If she doesn't co-operate, she also faces the possibility the manager will punish her by firing her on spurious grounds. The manager can have the extra work done for him, and either honor his promise to give extra endorsement for the employee during career discussions, or he can betray his word, making no effort to honor the agreement, while still enjoying the benefits of her effort. In this single game, the payoff is highest for the manager if he betrays the employee. But as with the Prisoner's Dilemma scenario,<sup>8</sup> should both choose to co-operate, each party gets

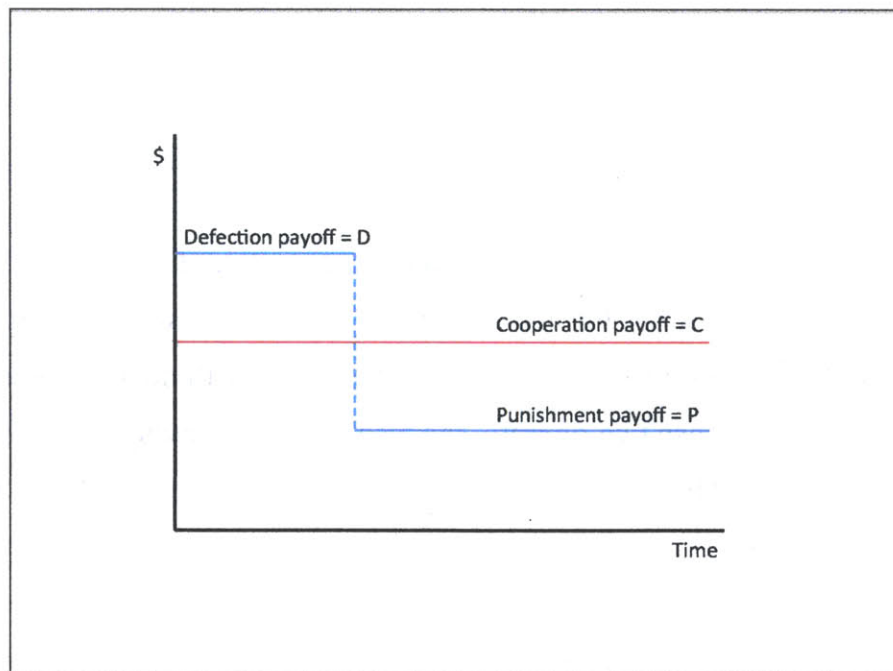
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<sup>8</sup> For an explanation of Prisoner's Dilemma see Dixit, R. and Nalebuff, B. "Prisoner's Dilemma" *The Concise Encyclopedia of Economics*, Library of Economics and Liberty. <http://www.econlib.org/library/Enc/PrisonersDilemma.html> accessed March 2013.

equal payoff. Once either party has betrayed the other, it is unlikely cooperation will be attempted again.

In a repeated game, however, which is most relevant to relational contracts, the dynamic changes significantly, because multiple iterations increase the relative payoff if both players co-operate. In short, the payoff for both parties to co-operate repeatedly outweighs the payoff the manager can enjoy if he betrays the employee. The repeated game is represented in Figure 4 below, which illustrates two time-paths for players to evaluate: does the payoff from continued cooperation outweigh the short-term payoff from defection, and is that payoff higher than the alternative, or punishment?

Figure 4. Time Paths For Continued Cooperation



The repeated game brings with it the promise of future benefit: “[the employee’s] actions today may affect [the manager’s] expectation of her actions tomorrow, which may affect [the manager’s] actions tomorrow, which affect [the employee’s]

payoffs tomorrow.”<sup>9</sup> The game can proceed continuously, provided that a) Player 2, the manager, delivers on his promises to give extra endorsement to Player 1’s performance in discussions about her performance once the extra tasks are completed successfully, and b) Player 1 believes her manager has sufficient influence, power and standing in the business to make the promise credible.

The repeated game also introduces the key concept of credibility in making relational contracts work. Credibility across both parties taking part in the relational contract is vital, as is the clarity with which the relative rewards are expressed. Both these concepts will be discussed further when we consider how to build and sustain better relational contracts in firms.

A further important dynamic in relational contracts relates to long- versus short-term benefit. If the payoff of the game increases with time, then the short-term benefits of non-cooperation are significantly outweighed by longer-term cooperation. This is important because anyone who is party to a relational contract must believe in the long-term prospects of cooperation over those of the short-term.

Players must also be satisfied that the rewards of cooperation outweigh the alternative offered by defection (punishment). If the employee mentioned above feels that she can get a higher salary at a better-perceived company, she is unlikely to cooperate in the first place. If the manager does not feel the employee is worth the effort to make extra attempts to represent her well in career management discussions, then the alternative of finding someone else to work with becomes more attractive. The corollary also holds true: the more the rewards of cooperation increase for players over those for the alternative (i.e. punishment), the more likely the relational contract will sustain. In economic terms, players should use the ongoing cooperation of a relational contract to create more surplus. Continued

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<sup>9</sup> Gibbons, R. “Relational Contracts.” Lecture Note 2, 15.903 Organizational Economics and Corporate Strategy, Massachusetts Institute of Technology, Cambridge, MA. PDF File downloaded from <http://web.mit.edu/rgibbons/www/>, accessed November 2012, p. 4.

belief in that surplus being created is what creates a sense of commitment in players.

Reality is far from the simplicity shown in the models above, however. It is necessary to consider what happens when payoffs fluctuate over time and threaten the sustainability of the relational contract. This happens often: simple things like changing family circumstances, changing needs and wants in employees and managers, or short-term business pressures all conspire to make the alternatives to cooperation more attractive from time to time. These situations can be managed, however, and this is where concepts like transparency and open communications between parties can help. This is particularly the case openness relates to one party feeling comfortable with disclosing concerns about short-term options being more attractive than longer-term options, and the other party makes stringent efforts to restore the equilibrium of long-term mutual cooperation.

Commitment is also important in managing fluctuations. If relational contracts are subject to short-term fluctuations in payoffs, parties need to create a sense of commitment to the longer-term benefit of cooperation as a means to ride out temporary turbulence in the relational contract. Firms that have made strong relational contracts a hallmark of their organization are often called “High Commitment” firms. Such firms will be discussed when we turn to approaches to building relational contracts.

A key feature of relational contracts is that they cannot be verified by other parties either in their establishment or in their execution (i.e. *ex ante* or *ex post*). In the example above, if the manager defects, the employee has no recourse to other authorities, and if he co-operates, she alone needs to be satisfied with the rewards from the manager’s cooperation. This characteristic, combined with the anticipatory nature of payoffs, means that belief in the other player’s willingness to cooperate, and a tacit understanding of the reward he gets for cooperating, are instrumental in sustaining relational contracts. As a result of this tacit

understanding, relational contracts can seem ephemeral and intangible. Moreover, metaphors are often used to describe them, making it very hard effectively to manage relational contracts. Trust is often used to explain willingness to cooperate for undefined and unverifiable ends, but given that the word trust is used to mean many things, it is better to think of relational contracts being sustained by belief in a promise that the other party has made.

A summary of definition for relational contracts is thus:<sup>10</sup>

- A promise you can believe in
- A shared understanding of parties' roles in and rewards from cooperation (so rooted in the details of the parties' relationship that it cannot be shared with a court)
- An equilibrium of a repeated game

In order to build and maintain relational contracts, there needs to be an enduring belief that the rewards of cooperation outweigh the alternatives. This belief is driven by trust, which in turn is created by credibility and clarity between the parties. It also creates commitment, which helps manage variability in payoff over time.

## 2.2 Relational Contracts Between Firms, Suppliers, Partners and Customers

So far, only relational contracts inside firm boundaries have been discussed, but they also exist across firm boundaries, with suppliers, with alliance partners and with customers.

All of the characteristics of relational contacts noted above are relevant to these relationships. An example might be a Key Account Manager who invests significant time and money repeatedly entertaining customers in anticipation of more business

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<sup>10</sup> Gibbons, R. *Class Lecture Notes: 15.903 Organizational Economics and Corporate Strategy*. Massachusetts Institute of Technology, Cambridge, MA. 28 September 2012. Slide 8

next year, or an outsourcing partner who commits considerable resources to improving the performance of the intermediate product she makes, believing in the promises of the customer not to tender the work out next year to her competitors.

However, there are additional dimensions to consider in relational contracts across firm boundaries, in particular the potential threat of partners holding-up continued progress of the partnership and in the dynamic nature of the payoffs of cooperation. These two features are inter-related.

### 2.2.1 Hold-Ups

If a supplier, outsourcing partner or alliance partner owns an asset (such as a plant, or intellectual property) that produces an intermediate product for a firm, the supplier could put the asset to an alternative use, such as by producing the intermediate product for a competitor. As long as that potential exists, the relationship between the two firms could be compromised<sup>11</sup>. If the supplier believes switching to the alternative use can better reward them, then they are incentivized to terminate the existing relationship. This is called hold-up, by which we mean to 'hold to ransom', rather than cause delay. Even the possibility of switching to the alternative creates the threat of hold-up. Problems like these often cause firms to seek control of critical assets by acquiring them.

In terms of relational contracts, we can think of the threat of hold-ups as potentially increasing the payoff of non-cooperation, and therefore it poses a significant challenge to building and sustaining relational contracts. It follows that relationships across firm boundaries need to be managed with additional effort. Much of it can be taken care of in formal contracting, but the importance of creating

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<sup>11</sup> Gibbons, R. "Make, Buy, or Cooperate?." Lecture Note 4, 15.903 Organizational Economics and Corporate Strategy, Massachusetts Institute of Technology, Cambridge, MA. PDF File downloaded from <http://web.mit.edu/rgibbons/www/>, accessed November 2012.

greater surplus (i.e. increasing the rewards of cooperation in relational contracts) comes into greater relief in these circumstances.

This feature of relational contracts is also relevant when an asset is held within a firm (for example, when a professional services employee has some strong relationships with customers who may follow her to another firm if she leaves) but further detail is not covered here.

### 2.2.2 Transactional Cost Economics

A related problem with relational contracts across firm boundaries occurs when 'the balance of power' changes over time between a firm and its outsourced provider of products or services.

When a firm chooses to outsource one or other activities to another party, in the early stages of the arrangement, the firm that is outsourcing the activity has very strong ownership of the knowledge, skills, and requirements necessary to complete the activity productively. The outsourcing party is very heavily dependent on the institutional knowledge in the firm during this establishment phase. Once the contract between the parties is established however, the balance shifts. The firm loses capability to deliver the activity on its own, whilst the outsourcing party begins to develop increased capability to manage the activity more effectively. This may result in additional rent being created, which could be shared with the firm. It could also be used to create hold-up.

Literature and analysis related to Transactional Cost Economics<sup>12</sup> examines these effects in great detail. First, it is important to note that outsourcing arrangements should be considered not solely on the basis of the production function (i.e. that it is

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<sup>12</sup> For a comprehensive review of literature related to Transactional Cost Economics, refer to Gibbons, R. "Transaction-Cost Economics: Past, Present, and Future?" *The Scandinavian Journal of Economics* 112.2 (2010): 263-288.

believed that outsourcing can lead to better economic results), but rather because the transaction is more effective and efficient. Put another way:

“[T]he substitution of internal organization for market exchange is attractive less on account of technological economies associated with production but because of what may be referred to broadly as ‘transactional failures’ in the operation of markets for intermediate goods.”<sup>13</sup>

Problems which arise from outsourced arrangements can be broadly grouped into three areas, namely: a) unprogrammed adaptation because *ex ante* contracts are incomplete, b) lock-in arising from the “fundamental transformation” and c) haggling (i.e. inefficient bargaining) because *ex post* contracts are incomplete.<sup>14</sup>

Again, formal mechanisms in governance and contracting exist to deal with these effects, and the firm can again decide that internal control is the best way to negate the problems. However, no matter how comprehensive and well-thought through formal governance structures and contracts might be, they will never account for all of the potential problems that may arise during execution.

Joint Ventures (JV) are a good example of the complexities and subtleties of managing these issues. In managing JVs, business leaders often think of them as marriages, requiring the same degree of deep mutual understanding and nurturing to sustain. However robust marriage contracts and pre-nuptial agreements might be, the reality of managing them is significantly more complex than can be formally documented. Many of the problems can be managed through relational contracts, however. Points made earlier about increasing the rewards of cooperation, managing short-term fluctuations in payoffs, building clarity and credibility *et al* are

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<sup>13</sup> Williamson, O. (1971, p. 112) in Gibbons (2010) *Ibid.*, p. 266.

<sup>14</sup> Gibbons, R. (2010). *Ibid.*, p. 268

all the more important in managing relationships across firm boundaries. It is, however, extremely difficult, painstaking and costly.

### 2.3 Relational Contracts at the Organizational Level

Beyond interactions between individuals and across firm boundaries, relational contracts are also important at the team, function or organizational level. It is possible to think of firm culture (as defined above) to be a kind of relational contract, in as much as employees can be motivated by the norms, standards and values of a firm to do more than is defined in formal structural mechanisms, because they believe longer-term cooperation will reward them more highly than short-term interest. In simple terms, employees and managers put in effort over and above that which is necessary to do their job, because they feel the firm is a great place to work, and it responds to their needs for status, recognition and higher purpose.

Most firms would recognize that they have a unique culture, and it is often informed by how the firm evolved through founders, family ownership and mergers. Folklore about why the firm's origins exist, as do metaphors and stories that embody the espoused culture. Most firms recognize that firm culture can be a differentiator, and can be strengthened to create a more effective work environment.

Many firms attempt to take a structured, methodical approach to culture and attempt to codify it, with purpose statements, creeds, values systems, and unique leadership models. These are sometimes explicitly evaluated in performance appraisals and are often celebrated through high-profile award ceremonies. Such attempts to formalize relational contracts might be helpful in defining an ideal set of norms and behaviors, but codification should not be considered a 'catch-all' answer to building relational contracts. There are other dimensions of cooperative behavior that cannot be accounted for in documents and which are better explained by the informal, ephemeral nature of relational contracts.

To illustrate this point, it is helpful to relate the author's experience working with AgriCo and CPGCo. Both these firms are long-standing, multinational firms and they are the product of several mergers over time. They exhibit similar characteristics in how they pursue growth from an organizational perspective. Both invest heavily in the latest 'best practice' tools to manage their organizations, and both have codified leadership, values and behavioral systems. These systems are similar and are designed to motivate employees to achieve higher performance and enjoy happy working lives. However, AgriCo has created significantly more benefit from deploying these approaches than CPGCo. In CPGCo, many employees believe that the systems are honored more in the breach than in the observance, and it is widely felt that lip-service is paid to the espoused aims.

There are of course many reasons why these performance differences may be felt. But the point to be made here is that formal documentation of firm culture and behaviors is no guarantee of success. The focus of leaders and managers trying to build better firm culture must not be solely on codification of behaviors and values et al, but other facets which incline employees to believe in the promise of greater payoff in the future if they buy-in to and embody firm culture. This is more the domain of relational contracts.

#### **2.4 Examples of Relational Contracts in Existing Firms**

In order to illustrate how relational contracts can contribute to effective organizational management, three examples are cited below which illustrate different facets of the theory.

#### 2.4.1 Relational Contracts on the Shop Floor – Toyota’s Production System

A very widely known example of relational contracts is found in Toyota’s Production System (TPS)<sup>15</sup>. TPS has been very widely researched and exhaustively documented. Being so comprehensively codified, it might follow that it is relatively straightforward to train operators in its use and replicate the system. This is not the case, however: many firms have made determined efforts to adopt TPS, with only partial success. The formal design elements are insufficient in explaining success.

It appears that despite the rigid rules and tools that comprise TPS, operators are able to maintain a highly adaptable, flexible approach to running the system, typified by local decision-making and cooperative problem solving. Employees close to the source of problems on the production line are motivated to anticipate problems in advance, are empowered to stop the line if needed, and are committed to resolving problems with fellow-team members, without needing to rely on hierarchical intervention. In contrast to the exhaustive documentation of the tools and techniques of the process, the systemic behaviors that support the process are widely understood, but were not codified until recently<sup>16</sup> (and not by Toyota.) As Spear and Bowen have shown, the key systemic behaviors are:

- All work is highly specified in its content, sequence, timing, and outcome
- Each worker knows who provides what to him, and when
- Every product and service flows along a simple, specified path
- Any improvement to processes, worker/ machine connections, or flow path must be made through the scientific method, under a teacher’s guidance, and at the lowest possible organizational level<sup>17</sup>

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<sup>15</sup> Roos, D., Womack, J. P. and Jones, D. T. *The Machine That Changed the World: The Story of Lean Production*, Harper Perennial (November 1991), Ch 3 and 4

<sup>16</sup> Spear, S., and Bowen, H. K. “Decoding the DNA of the Toyota Production System.” *Harvard Business Review* Reprint 99509, March 2013

<sup>17</sup> *Ibid.*, p. 4.

These behaviors are not explicitly codified in TPS, yet they are critical to extracting the full benefit of the system, employees tacitly understand them, and they are very difficult to replicate.

These behavioral aspects of TPS should be thought of as relational contracts that create enhanced performance and competitive advantage for Toyota.

#### 2.4.2 Relational Contracts Replacing Formal Structures – Sun Hydraulics Corporation

Sun Hydraulics Corporation is a US based firm founded by engineers in the 1970's. They manufacture hydraulic cartridge valves and manifolds for industrial and mobile markets, in fluid power systems<sup>18</sup>. Since small beginnings, the firm has expanded globally and underwent an IPO in 1997 to become a public company, since when its share price has moved from \$9.50 to \$32.42, with a market capitalization of \$845 million<sup>19</sup>.

Since its inception, Sun Hydraulics has largely eschewed the use of formal strategic organization design to manage the organization:

“We have no job titles, no hierarchy, no formal job descriptions, organizational charts or departments. We have open offices, promoting open communication. This environment encourages innovation and helps develop a spirit of entrepreneurship throughout the organization.”<sup>20</sup>

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<sup>18</sup> Barnes, L. B. and Kaftan, C. “Sun Hydraulics Corporation (A&B) (Abridged).” HBS No. 9-491-119. Boston: Harvard Business School Publishing, 1991.

<sup>19</sup> Yahoo Finance SHNY. <http://finance.yahoo.com/q?s=SNHY> accessed March 2013.

<sup>20</sup> Sun Hydraulics Corporation, “About Us”, [http://www.sunhydraulics.com/cmsnet/aboutus.aspx?lang\\_id=1](http://www.sunhydraulics.com/cmsnet/aboutus.aspx?lang_id=1)

Clearly the founders and subsequent leaders of the firm felt that formal strategic design elements typical of organizational management were felt to be unnecessary. Instead, the firm relies on strong relational contracts to drive superior performance in the organization. It is interesting that Sun Hydraulics has managed to persuade the investor community of the merits of this approach in pursuing healthy, profitable growth on a global scale.

#### 2.4.3 Firm “Renewal” Using an Organizational Change Program based on Building Relational Contracts- United Stationers Inc.

Both the former examples demonstrate the importance and potential of relational contracts in contributing to firm performance. However, their relational contracts have evolved organically over time and are an important facet of the legacy of the respective companies. United Stationers, in contrast, is a company that has shown that it is possible to have no strong legacy of competitive advantage through relational contracts, and yet build the relationships, systems, culture, and behaviors typical in a firm with strong relational contracts. In so doing, the company significantly improved its ability to compete and rewarded shareholders handsomely for their patience and understanding.

United Stationers is a wholesale distributor of business products with a market capitalization of \$1.58 billion, 6100 employees and some 25000 customers in 2012<sup>21</sup>. In the two years leading up to initiation of a turnaround strategy in 2003, United Stationers had suffered sales and profit decline. In the subsequent nine years, the company made extraordinary strides forward under the helm of CEO Dick Gochnauer, growing sales to \$5.1 billion<sup>22</sup> from \$3.7 billion in 2002 whilst doubling

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<sup>21</sup> United Stationers Inc., Form 10-K February 22 2013 for the Period ending December 31 2012, accessed March 2013.

<sup>22</sup> Ibid.

operating income and earnings per share. The stock price grew twice as fast as the overall market.<sup>23</sup>

Sandwiched in the middle of the office supplies value chain, and facing stiff competition from disruptive online technologies and larger players like Staples and Office Depot, it would have been difficult to imagine in 2002 that United Stationers could grow so strongly in response to a comprehensive turnaround strategy.

What is interesting about the path taken, however, is not that it was a highly effective turnaround strategy involving operational effectiveness initiatives to grow sales while decreasing costs. Rather it was that Gochnauer was able to co-opt employees in defining a wholly new and purposeful sense of cooperation from the existing employees. He did make some significant personnel changes among his management team, but he created a groundswell of high performance and longer-term commitment from current employees, who were motivated to work more closely with existing suppliers and customers radically to transform the business. Gochnauer, recognizing the value of commitment and trust in the organization, believed the culture and values he was creating “provided United Stationers with a unique and enduring source of competitive advantage.”<sup>24</sup>

There are some interesting features in the change instilled in United Stationers. Gochnauer created decentralized problem solving, by making employees believe they are empowered to create value within their relational contracts. In his customer and supplier management teams he also instilled commitment to work with counterparts to create new sources of value for the firm and its partners. Much of this came from creating a longer-term orientation in relationships, and was quite different from the transactional behaviors evident before the turnaround was initiated. In relational contracts parlance, Gochnauer and his leadership team were

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<sup>23</sup> Beer, M., and Eisenstat, R. “United Stationers: Enabling our Partners to Succeed.” HBS No. 9-912-407. Boston: Harvard Business School Publishing, 2011. p. 1.

<sup>24</sup> Ibid., p. 2.

able to create understanding of the significant surplus that results from greater cooperation. More importantly, the benefits of that surplus were shared across individuals, the firm and its partners, which help sustain the relational contracts they had built.

The United Stationers case also gives some indications of the challenges of building and sustaining better relational contracts: it is time-consuming and costly, taking nine years in United Stationers' case, and for these reasons, firms wanting to derive similar benefits need to take account of such barriers.

### **3 The Importance of Relational Contracts**

Whilst most firms would acknowledge the advantages of building more effective working relationships, it is worth emphasizing how significantly they can enhance competitive advantage. In addition, given some powerful dynamics in the global business environment today, business conditions point to relational contracts becoming increasingly important as a source of differentiation in the competitive context.

#### **3.1 Performance Differences Resulting from Managerial Practices**

Over and above the successful outcomes shown in the examples of United Stationers, TPS and Sun Hydraulics, extensive empirical research points to a highly compelling rationale for focusing effort on building better relational contracts.

Hansen and Wernerfelt compared inter-firm profit rates to determine whether both economic and organizational factors are significant determinants of firm performance<sup>25</sup>. Using variables derived from 'organizational climate' analysis<sup>26</sup>,

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<sup>25</sup> Hansen, G. and Wernerfelt, B. "Determinants of Firm Performance: The Relative Importance of Economic and Organizational Factors." *Strategic Management Journal* 10.5 (1989): 399-411. p. 399.

<sup>26</sup> *Ibid.*, p. 402.

which are consistent with creating cooperative, future-benefit oriented behaviors, the research determined that not only are both economic and organizational actors significant determinants of firm performance, but “they are roughly independent and [most importantly] organizational factors explain about twice as much variance in profit rates as economic factors.”<sup>27</sup>

Gibbons and Henderson, in an extensive review of persistent performance differences across firms<sup>28</sup>, demonstrated that many of the significant productivity differences that exist across similar firms could be attributed to heterogeneity in managerial practices. Further, for many of these managerial practices, such as decentralized decision-making and team-based problem solving (both at blue and white-collar level), the role of relational contracts can be considered vital in ensuring effective implementation. Briefly, many managerial practices are difficult to verify *ex ante* and *post ante*, and they require repeated cooperation between parties over a period of time, so they are akin to relational contracts.

At the production line level, Gant, Ichniowski and Shaw demonstrate a similar phenomenon, by analyzing performance differences at similar steel mills<sup>29</sup>. Their analysis focuses on finishing lines in the integrated steel industry, in which they compare human resource managerial (HRM) practices across lines which have a very similar production process, but in which productivity can vary a great deal, usually as a result of production delay or yield loss. The key finding is that on those lines where innovative HRM practices exist, productivity is significantly higher (i.e. up to 7.8%<sup>30</sup>) than on those that have identical production processes, but traditional HRM practices. That is not surprising. The difference between innovative and traditional practices is that innovative practices are very much germane to

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<sup>27</sup> Ibid., p. 399.

<sup>28</sup> Gibbons, R. and Henderson, R. “What Do Managers Do? Exploring Persistent Performance Differences among Seemingly Similar Enterprises.” HBS Working Paper No. 13-020, 2012.

<sup>29</sup> Gant, J., Ichniowski, C. and Shaw, K. “Social Capital and Organizational Change in High-Involvement and Traditional Work Organizations.” *Journal of Economics & Management Strategy* 11.2 (2002): 289-328.

<sup>30</sup> Ibid., p. 293.

relational contracts: problem-solving teams, work rotation and information-sharing are three of the major elements of innovative HRM practices, and combined, they yield 'social capital'. In this instance, social capital includes better communication of work-relevant information with richer networks of employees, and also refers to 'people-friendly' social skills<sup>31</sup>. Whilst these social capital-generating practices may be relatively easy to define, they are very hard to verify, given the dependency on qualitative information-sharing, relationship- and network building. Effective implementation of these practices relies to a significant degree on the relational contracts that drive greater cooperation between employees.

### 3.2 Increasing Importance Driven by the Global Business Context

Three key trends in the global business environment point to an increasing importance in the effective management of relational contracts. The impact of these trends on a firm's competitiveness and the degree to which they are increasing complexity in a firm need to be borne in mind in considering the criticality of relational contracts.

#### 3.2.1 Globalization

The trend of globalization is a critical driver of change in a firm's corporate and organizational strategies. Even if a local firm has no ambitions outside its domestic market, the global nature of competition must be borne in mind.

Firms are increasingly expecting a greater share of revenue and profit from a bigger portfolio of markets, for a number of sound reasons. The implication is that managers need to deal with greater complexity and variability in how products and services are produced and sold. Moreover, with an increase in the number of markets becoming important to growth ambitions, it is more difficult to maintain consistency in how strategies are developed and executed. Equally important to

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<sup>31</sup> Ibid., p. 316.

these quantitative changes are qualitative changes: managers need to be increasingly sensitive to differences in local markets and must accommodate the likelihood that the formal structures and processes of strategic design may be adapted or interpreted differently across the portfolio of products and markets.

Already many multinational firms are relying more on leaders and managers to take significant roles outside their home markets. This implies that individuals with very different national cultural mindsets and with potentially wildly different interpretations of acceptable, effective behaviors need to learn not just to work in an unfamiliar market, but also to work with different cultures.

As an example, the leadership team of the Indonesia business unit of CPGCo at one point in 2011 comprised an Argentinian, a South African, a German, a Malaysian, a Russian and a Korean national, as well as Indonesians. None of the Indonesians had served outside their home market, and few of the non-Indonesians had served in Indonesia for more than several months. This is an extreme example, but it highlights the additional challenges globalization creates and makes the point that rather than the formal aspects of strategic organization design, relational contracts are arguably more important in driving better co-ordination and cooperation in multinational firms.

### **3.2.2 Knowledge and Solutions Basis of Competition**

In many firms today, the development of standardized, high performing products is not enough to win against rising competitive intensity. Customers are finding more value in products which have been adapted to their unique circumstances and that are bundled with additional functionality and services. Those firms that work closely with customers and suppliers to define innovative product and service features find they can raise competitive barriers and derive higher customer satisfaction at a lower price. Many of these innovations are derived not from the technical aspects of product development, but rather from the broader knowledge

that surrounds the product's distribution, purchase, use or repeat use. Increasingly, this kind of innovations drives customer value.

Critically, many of the innovations associated with this trend are developed outside the traditional purview of the R&D function. Instead they emerge from deeper collaboration with partners, and from involvement of other functions such as marketing, sales and finance. Being innovations, they of course cannot be mandated or defined in advance of their development. Firms can only really create conditions for the organization to be orientated towards knowledge. These are the conditions under which relational contracts operate, so it is important for firms to realize that their innovation agenda, particularly where it relates to knowledge and solutions, will be well served by focusing on building and sustaining effective relational contracts.

### 3.2.3 The Increasing Pace of Change

It is widely accepted among multinational firms that in the last 10-15 years, the pace of change in the competitive environment has markedly increased. There are many reasons why this might be so, such is increasing competitive intensity and shortening product life-cycles, but what is important here is that firms now operate in a world where change is the new stasis and uncertainty is the new certain. Strategies that in the past were developed comprehensively and were felt to last five years, now need to be built much more adaptively and with a lower expectation that the underlying assumptions will be durable. In parallel, decisions to change the formal structures of organizations have also accelerated.

The result is that organizational oscillation between centralization and decentralization, fundamental structural change, role changes, decision rights changes, process changes, and personnel turnover now happen with such frequency that it is becoming increasingly difficult to derive the stability and predictability these devices are designed to create. No sooner has a new organizational structural initiative been understood and implemented than another is announced. The

rationale behind the changes is often compelling and persuasive, but the frequency with which change happens imperils satisfactory implementation.

The suggestion here is that the formal strategic design components are less effective in helping firms execute strategies in today's world. Focusing more on the informal adaptable aspects of organizations, such as relational contracts, might be a more effective way of dealing with accelerating change. Whilst relational contracts are very difficult to build and sustain, they can provide a means to create consistent, predictable behaviors, which could be more effective in dealing with competitive dynamics.

#### **4 Diagnosis of Opportunities to Improve Relational Contracts**

Thus far, we have defined relational contracts and have pointed to some of the dynamics that account for their operation, using such terms as credibility and clarity (which foster trust), the need for focused communication in building the same, and the resulting high commitment, which is an important outcome of relational contracts, and which in turn helps manage variability in payoff for cooperation over time.

We have also shown how strong relational contracts contribute to firm performance, from the perspective of research as well as in specific examples, and we have suggested that as a result of current dynamics in the business environment, it is likely relational contracts will become increasingly important in organizational strategies.

We now turn to consideration of where firms might find particular challenges with relational contracts and how to consider fundamental choices relating to the firm's overall strategy.

Clearly, firms that are feeling that their competitiveness is severely affected by any of the three contextual drivers above may want to prioritize the development of better relational contracts. However, the drivers being somewhat high-level, they impact most firms to some degree. What follows below is a more granular approach to considering under what conditions it might be necessary to scrutinize the state of relational contracts in the firm.

No specific guidance is given here on which tools to use to diagnose symptoms of poor relational contracts, if only because tools and techniques that are already well used in organizations are sufficient for the task; no new approaches are proposed here.

In simple terms, standard productivity and profitability analysis and benchmarking are useful for determining a firm's competitiveness within its industry, and if conducted at the business unit or functional level might help determine where productivity problems are most severe. Customer and employee satisfaction survey tools exist in most firms. Generally, data relevant to the state of collaboration, cooperation and communication in the firm is gathered within these surveys. Where it is absent, it can be easily augmented. In addition to these tools, however, the involvement of leadership judgment in diagnosing particular issues is very important. This is because issues related to relational contracts are complex, and sensitive.

#### **4.1 Strategic Conditions Under Which Relational Contracts Issues May be Severe**

##### **4.1.1 High Growth**

Firms that have been through a period of high organic or inorganic growth, or both, will find that their organizations lack consistency in their relational contracts. The result of simply being a bigger firm is more complexity and an increased number of relationships and networks to manage. Information flows, too, will have increased.

The product of high organic growth is subtly different from inorganic growth, however. Organic growth dilutes the strength of relational contracts because the proportion of people who are unfamiliar to the firm's *modus operandi* has increased. For inorganic growth, however, the problem is one of misalignment. In the case of two firms merging, both may have very sound, but different, approaches to building relational contracts. Cultures, norms and ways of working may be implicitly understood in each the two firms, but being undocumented, are unintelligible to the other.

#### 4.1.2 Unsatisfactory Outcomes from Systemic Adoption of 'Best Practice'

Firms may believe that they have been diligent in making sure their organizations are equipped to build a more productive and co-operative working environment. First class capability development in functional skills and knowledge, technology, processes have been carried out, along with introducing many of the human resource practices that aid effective adoption<sup>32</sup>. Moreover, employees and managers may well clearly perceive the need to adopt these best practices; they are inspired to make the change; and they feel motivated to adopt new practices<sup>33</sup>; yet still the putative benefits have not been realized. Many large, leading firms may find themselves in this position. This problem has been termed "The Knowing-Doing Gap"<sup>34</sup>, and along with failure to achieve desired success from general capability development, it is a problem that plagues many firms. It could be that relational contracts are the problem, in that employees do not feel that the application of what they have learned has significant self-interested benefit, and the atmosphere of cooperation in the firm does not encourage experimentation with new tools and techniques.

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<sup>32</sup> For a list of HRM practices that create a better working environment, see Appendix 1. From Ichniowski, C., Shaw, K. and Prennushi, G. "The Effects of Human Resource Management Practices on Productivity: A Study of Steel Finishing Lines." *The American Economic Review* 87.3 (1997): 291-313. p. 297.

<sup>33</sup> Jan Rivkin, in Gibbons and Henderson 2012, Op Cit, p. 5.

<sup>34</sup> Pfeffer, J., Sutton, R. *The Knowing-Doing Gap: How Smart Companies Turn Knowledge into Action*. Boston, MA: Harvard Business School Press, 2000.

The crux of the challenge in these circumstances is to create a greater understanding of the longer-term payoff of cooperation, and the potential for surplus reward to be created. The purpose of any initiative addressing these circumstances, therefore, must focus on demonstration of the roles employees need to play in collaboration and the rewards of collaboration itself. It follows that managers also need to create conditions for trial and experimentation of new methods in the workplace.

#### 4.1.3 Persistent Decline in Overall Competitiveness

Of a slightly different nature is firms that find themselves in difficult market circumstances with a decline in overall competitiveness, such as we saw with United Stationers. Diagnosis of the firm's organizational environment may show that in addition to many other strategic and operational difficulties, the organizational domain is in poor shape. It is possible to include relational contracts development as part of an overall turnaround program, leveraging the opportunity to grow top and bottom line in tandem with reshaping organizational culture. To some degree, the catalyst for change is very apparent in the burning platform of declining competitiveness, so whilst conditions to develop relational contracts can't be said to be ideal, they are at least conducive to doing something fundamentally different in the organization domain.

#### 4.1.4 Cultural Legacy

Many firms have achieved success in their markets by building a very transactional, short-term focused culture, which places emphasis on individual initiative and incentives that encourage and reward individual effort. Limited value is felt in collaboration and cooperation. These organizations have often succeeded for good reasons – the nature of the product or the competitive environment dictates that no purpose is served by doing anything differently. Currently, and increasingly in the future, what little co-ordination the organization provides to facilitate interactions is technology enabled. Much of it can be clearly specified and therefore contracted out.

If the competitive situation changes however, and coordination requirements increase, such as through increasing reliance on knowledge and solutions, firms should consider focusing on relational contracts in response. The key challenge, of course, is that this kind of cultural legacy is often resistant to change generally and specifically may be inhospitable to establishing relational contracts.

Many of these factors are of course not mutually exclusive; they are made distinct here only for the purposes of illustration. Nor are they exhaustive – it is likely there are other causes of challenges related to relational contracts. However, firms that find themselves challenged by a number of the contextual drivers in paragraph 3.2 as well as a number of the conditions highlighted above, are strongly advised to consider increasing competitive advantage through dedicated effort and investment in building and sustaining relational contracts.

#### 4.1.5 Does Size Matter?

Over and above contextual considerations in relational contracts, size of the organization is a factor to consider, in as much as size is a function of complexity. However, the importance and relevance of relational contracts is not necessarily a function of size: start-ups, small firms, and local firms with no ambitions to grow outside of their home market can all benefit from developing their relational contracts. It is obviously less difficult to change smaller organizations however – developing a team of 10 people is a lot easier than a team of 10,000. Regardless of size, however, what is important to consider is whether the investments will yield benefit which doesn't just make the firm a better place to work, but also creates significant impact in employee motivation, problem solving, innovation and in creating additional value for customers and suppliers.

## 5 Suggested Solution Areas for Building and Sustaining Effective Relational Contracts

Firms which believe that a combination of the contextual and strategic factors in Section 4 are relevant to the continued competitiveness of their organization may choose to invest in an initiative to build their relational contracts. This section covers some of the preliminary considerations of making such a move, and provides suggestions for the kinds of interventions which will be needed at different levels in the firm: for individuals, teams, processes, across firm boundaries and in general change management and leadership.

There are two very important initial considerations to be made: alignment of the initiative with corporate strategy; and understanding the degree of co-ordination and collaboration required in different parts of the firm.

It is a generally accepted principle that any strategic organizational initiative must be very closely aligned with business strategy; this principle is still valid for relational contracts. Moreover, careful evaluation of the degree of control required across different parts of the firm is also critical. Bearing in mind that the organization exists primarily to co-ordinate complex interactions more effectively than the market, firms must make sure they have a clear sense of which segments of the business require higher degrees of co-ordination than others, and how likely that is to change in the short- to medium term.

Next, there are choices to be made regarding the high-level method of adoption of relational contracts: are the firm's interests best served by adopting a full-scale approach, or is there a viable incremental approach which might be more suitable for some conditions? There are many examples of firms that have adopted the full-

scale approach. These are often called High Commitment firms<sup>35</sup>, and their success offers a compelling rationale for making the choice to adopt a full-scale approach, but in many firms the incremental route might be more suitable.

Regardless of the high-level approach selected, because the investment required is significant, some degree of prioritization is needed to know where to begin and how to sequence an initiative that focuses on developing relational contracts.

Next, firms need to embark on a comprehensive set of interventions to equip individuals and teams internally and across firm boundaries with the means to develop relational contracts. Some of these interventions are skills based, and can be taught; some of it is behavioral and values based and can only be demonstrated and inspired. Much of it will be difficult, requiring leadership inspiration and painstaking management. Leading and managing the change in particular ways that are conducive to building cooperation is critical.

Fundamentally, interventions need to create a belief in the parties involved that the longer-term rewards of cooperation are greater than short-term self-interest, and that additional 'surplus' reward can be created at the same time. Most of the suggestions made here involve building greater credibility and clarity in relationships, and much of it entails high-quality, focused communication, consistent, widely understood norms and standards, and authentic behaviors. All of these contribute to building the necessary trust that sustains repeated cooperation. The outcome is a firm that in the most critical parts of the business at least, displays the kind of high commitment necessary to achieve superior performance from relational contracts.

## 5.1 Implications for Corporate Strategy

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<sup>35</sup> Beer, M. *High Commitment, High Performance*. San Francisco, CA: John Wiley and Sons, 2009

Building relational contracts entails improving relationships and interactions within and without the firm, involving large numbers of employees, managers and wider stakeholders. By its nature therefore, relational contracts could be termed a capability initiative, and its key outcome will be a firm that increases its competitive advantage in the capability domain.

At a high level, firms develop competitive advantage on the basis of one of two fundamental ways: positioning or capability, and sometimes a mix of the two.

Positional advantage “centers on ownership of a value-creating *asset* that is necessarily in limited supply, thereby enhancing the firms ability to capture value.”<sup>36</sup>, whilst capability-based competitive advantage centers on “managing a value-creating *system of activities* that is hard to replicate, enhancing value-capture.”<sup>37</sup>

The implication of developing relational contracts is that the firm will be enhancing its capability-based advantage, rather than positional advantage. This is not to suggest it will be done at the expense of positional advantage, but there is an implicit shift of emphasis in overall strategic focus.

Firm leaders must be satisfied that the increased emphasis on capability-based competitive advantage is in the best interests of the firm. Investments and resources committed to building relational contracts must be considered more value accretive than if they were used to build further positional advantage, which might be more in keeping with the firm’s long-term aims.

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<sup>36</sup> Saloner, G., Shepard, A., and Podolny, J. *Strategic Management*. New York: John Wiley and Sons, 2001. Ch 3 Competitive Advantage, pp. 39-54.

<sup>37</sup> *Ibid.*, p. 41.

## 5.2 Alignment with Corporate Strategy

In a similar vein, it is very much orthodox thought that any strategic organizational change must be very closely aligned with a firm's strategic intent. The combination of Contingency Theory<sup>38</sup> and Complimentary Systems Theory<sup>39</sup> holds that organization strategy must be designed to serve strategic objectives and that given the complex interdependencies that constitute organizations, a systemic approach must be taken in making choices about building organizational capabilities:

“In order to derive the full benefit of those choices, they should be employed as a system, and that negative consequences may occur if the practices are employed individually and not together.”<sup>40</sup>

## 5.3 Considerations Regarding Full-Scale or Incremental Adoption

Firms can choose whether to adopt a full-scale approach to building relational contracts, or take an incremental approach. The full-scale approach implies a very comprehensive, firm-wide initiative that requires significant front-loaded investment and a long period of gestation. Moreover, most if not all of the organization needs to be involved in developing better relational contracts and the implication is that the firm wants to fundamentally change the way value is created. An incremental approach, on the other hand, refers to focusing effort on particular segments of the organization and its partners. Of course, the incremental approach might also be chosen as a preliminary step or pilot phase before adopting the full-scale approach.

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<sup>38</sup> Lawrence, P. and Lorsch, J. (1967). Cited in in Kates, A. and Galbraith J. R. *Designing Your Organization*. San Francisco: Jossey-Bass, 2007. Ch. 1 Fundamentals of Organization Design.

<sup>39</sup> Milgrom, P. and Roberts, J. “Complementarities and Fit Strategy, Structure, and Organizational Change in Manufacturing.” *Journal of Accounting and Economics* Volume 19, Issues 2-3, (March-May 1995): 179-208.

<sup>40</sup> Whittington *et al* (1999) cited in Kates, A. and Galbraith J. R. *Designing Your Organization*. San Francisco: Jossey-Bass, 2007. Ch. 1 Fundamentals of Organization Design.

There is extensive literature on firms that have adopted the full-scale approach, some of which have been cited in this thesis and which use the term “High Commitment” Firms.<sup>41</sup> A list of firms that fit this description and which were encountered during research for this thesis is at Appendix 2. Similar to High Commitment firms, other approaches have been defined which seek the same outcomes by slightly or significantly different means, such as Heckscher’s Collaborative Community<sup>42</sup> and Otto Scharmer’s Theory U<sup>43</sup>. It is evident that there are many approaches to achieving similar outcomes to that aimed for in building relational contracts, even though the theory is not explicitly used. The focus in this thesis, however, is relational contracts, precisely because some leaders may find the rational, economic logic of relational contracts more compelling in creating mobilization for change than the approaches defined in other resources.

The majority of the firms that are considered High Commitment organizations have chosen the full-scale approach, because they believe that a fundamental change in the organization is required in order to derive full value from the initiative. Given the points made about Complimentary Systems Theory, many would consider it axiomatic that full-scale adoption is the only route to take.

However, whilst there is no doubt that the full-scale approach is plausible, some firms may believe that very significant barriers exist to full-scale adoption, such as risk of failure, general change fatigue, current organizational culture, prohibitive cost or just the sheer scale of the task at hand. In these cases, it may be possible to define an incremental approach to building relational contracts, provided internally-consistent systems of activity can be defined within one or other segments of the

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<sup>41</sup> Beer, M. 2009, *Op Cit*.

<sup>42</sup> Heckscher, C. and Adler, P., eds. *The Firm as a Collaborative Community: Reconstructing Trust in the Knowledge Economy*. New York: Oxford University Press, 2006.

<sup>43</sup> Scharmer, C. *Theory U. Leading from the Future as it Emerges: the Social Technology of Presencing*. San Francisco, CA: Berrett-Koehler, 2009.

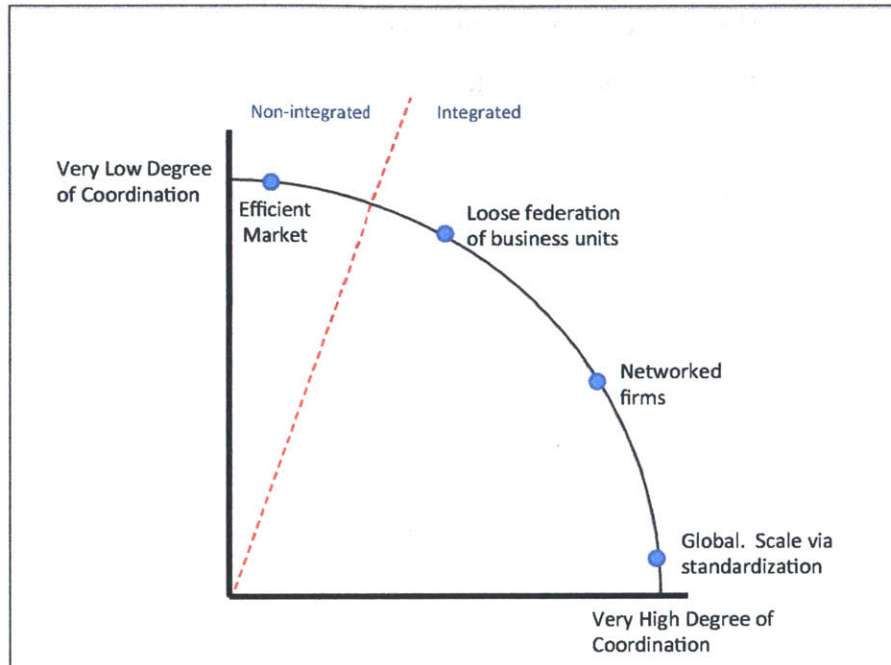
business, such as discrete business units, geographical clusters or product groupings. A simple means for considering prioritization is set out below.

#### **5.4 Understanding the Degree of Co-ordination Required**

In tandem with the strategic considerations above, firms which embark on a change program to build better relational contracts must also have a clear understanding of the differing degrees of co-ordination the organization requires to carry out its prime function, and how co-ordination requirements might change over time.

Returning to the notion that organizations exist to co-ordinate complex activities (when markets are less efficient at doing so unaided), we can envisage a spectrum for different degrees of co-ordination requirements. On the one hand, the market is efficient and transparent and transactions can occur efficiently, with a low degree of co-ordination, whilst on the other, complexity in transactions determines that high degrees of co-ordination are required. Figure 4 below illustrates this point.

Figure 4 – Degree of Coordination By Firms



In considering whether or not to invest considerable time and resources in building relational contracts, firms need to consider where on the axis of co-ordination their business units or product groups lie, and how co-ordination requirements might change in the future. Building relational contracts is fundamentally about improving cooperation. Cooperation in turn points to better co-ordination of complex activities, so it is likely that the highest impact from building relational contracts will come from deploying effort on the right hand side of the spectrum. Put another way, relational contracts development is most suited to highly complex situations. That is not to say relational contracts are irrelevant to contexts that require low co-ordination; on the contrary, very important relationships may exist at this end of the scale, and many critical activities may be outsourced to other parties, which require sensitive management. However, it is likely that less systemic benefit can be enjoyed from relational contracts where co-ordination requirements are low.

By way of example, AgriCo has a large number of products that are not differentiated or as regulated as are some of the more advanced technology products; in essence they are commoditized. They are sold to more developed end-user segments through tender-based channels and they are frequently reformulated or used as intermediate products. Market pricing information is highly transparent, demand is stable and information technology enables many of the transactions with customers. The market is efficient and a low degree of co-ordination is required. On the other hand, technologically advanced sell through fragmented channels to end-users who need significant information support in order to purchase and use the products effectively. Regulatory authorities provide limited coordination support and prices fluctuate highly. Because of the considerable difference in co-ordination requirements, development of relational contracts in the latter business unit is likely to achieve a far greater impact.

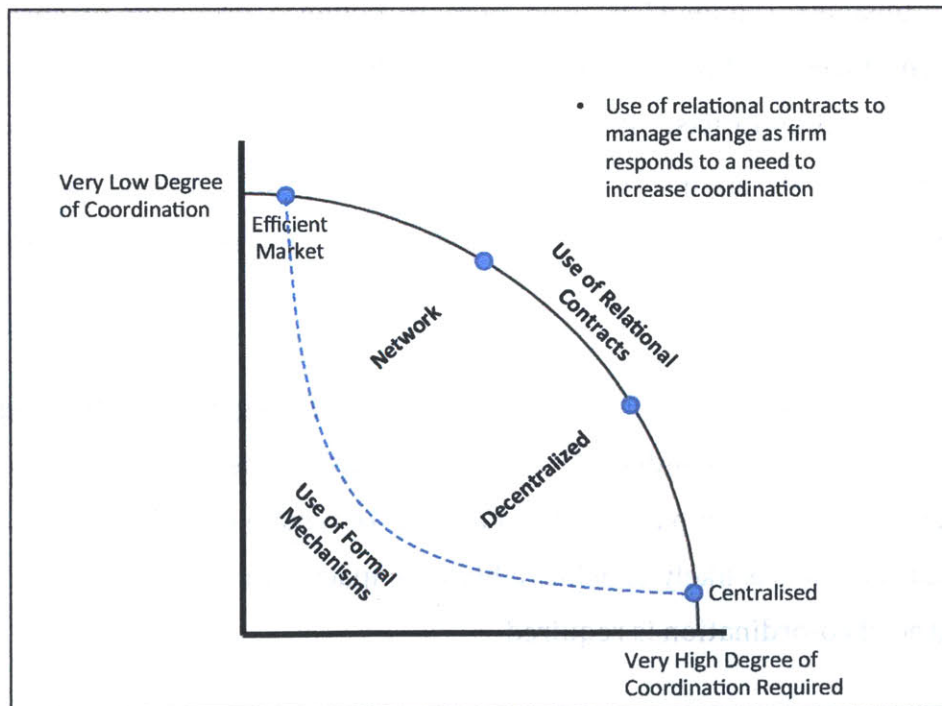
In the case of CPGCo, some markets and brands are well-established and earning good margins, with mature and comparatively transparent channels. However, the market is declining and there are limited opportunities for innovation. This contrasts with other markets where new brands are being deployed, with slim but growing margins, and there is significant opportunity for innovation in distribution, product functionality and positioning. It follows that the higher degree of co-ordination required in the latter grouping would suggest there is more to be gained in developing relational contracts.

In both these cases, in order to focus relational contracts effort on the more complex parts of the business, AgriCo and CPGCo would need to ensure that internally-consistent systems exist which encapsulate all the making and selling activities relevant to that part of the business. This will need to be done vertically, encompassing markets, channels, manufacturing and supply, as well as horizontally, encompassing all relevant functions and alliances. Such groupings may not be discrete however, in which case some strategic organizational design may be

necessary to ensure systemic intervention can be conducted. Such structural considerations are important, but are not dealt with further in this thesis.

Within a firm's industry, the dynamic across the spectrum of co-ordination is critically relevant here, not just because firms need to focus effort in the direction of increasing co-ordination requirements, but also because relational contracts can help with the transition to greater co-ordination. If an industry or part thereof is trending towards requiring greater co-ordination, anticipative development of relational contracts can aid a smooth transition to a more coordinated market. This is a finer point about relational contract: they can be used as an effective change management tool. Figure 5 illustrates this point.

Figure 5. Using Relational Contracts to Aid Change Management



## 5.5 Prioritizing Business Segments

Given that this thesis is agnostic of industry and geography (i.e. it could apply to wide variety of firms), only broad guidelines are offered below.

Following on from the strategic logic above, it is sensible for managers to prioritize effort in developing relational contracts, so that focus is applied to areas of greatest need and impact. Prioritization can also help sequencing, by identifying a logical path for rolling out organizational changes related to relational contracts. The prioritization scheme described here is most relevant to the incremental deployment approach, but can also be used for full-scale deployment.

The term “business segment” is used here to define a grouping of customers, suppliers, employees and partners that can logically undertake a systemic initiative to build relational contracts. It is designed to refer to the internally consistent grouping noted in paragraph 5.4 above, and could be a cluster of geographies, customers, channels, partnerships, functions and employees, or combinations thereof.

The prime variable against which to prioritize business segments is the degree of co-ordination required to conduct the activities for which the business segment has been designed, as set out in paragraph 5.4 above. To restate the point, development of relational contracts is likely to achieve higher impact in business segments where a high degree of co-ordination is required.

The second variable, independent from co-ordination, is the degree of decentralization required, as determined by a firm’s corporate strategy. This is particularly relevant for larger, multinational companies where complexity is driven by size and scale of the firm. Multinational firms are required to manage large

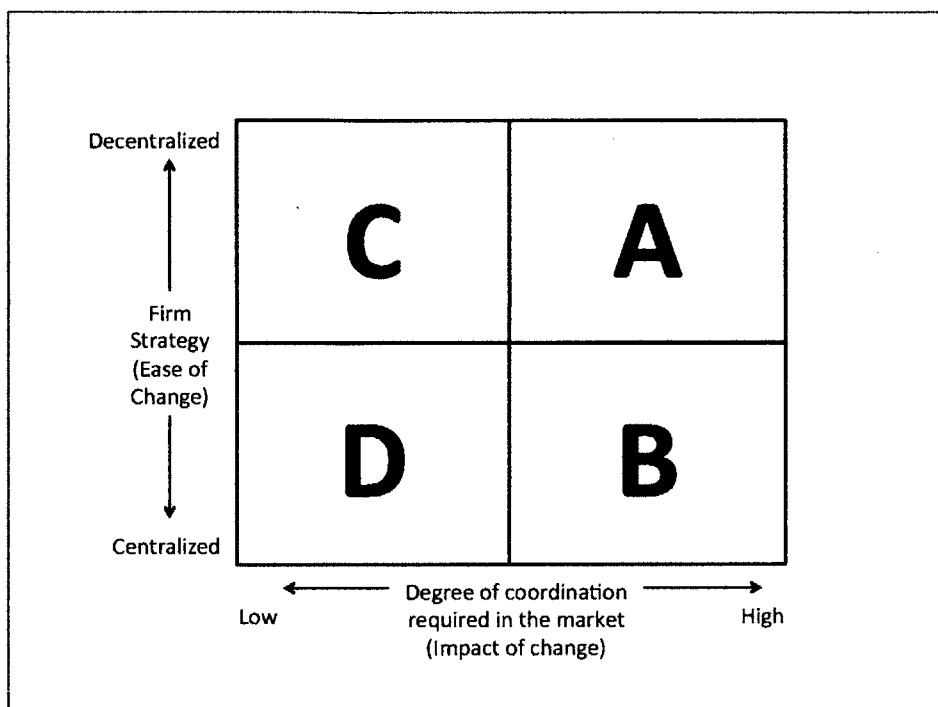
portfolios of products in a range of very different markets. If a firm's strategy dictates that a high degree of centralization is desirable, it is likely to be easier to develop a consistent approach to managing the organization. Likewise, developing relational contracts will be less challenging than for decentralized organizations. In the latter case, firms make the choice to decentralize for many reasons, but often it is to allow local variations in the market to be effectively accommodated and managed. The implication is that there will be greater variability in the application of formal organizational design components of the firm, and in the nature of relationships and networks inside the firm and across firm boundaries.

The purpose here is not to second-guess firms' decisions regarding decentralization, nor indicate whether these choices are consistent with building an organization which is better at cooperation and collaboration. Rather it is to point out that the relative differences in organizational structure and management that result from decentralization versus centralization changes how relational contracts development should be prioritized. More decentralization implies more difficulty in building and sustaining more effective relational contracts.

The quantification of prioritization variables can be conducted quantitatively or qualitatively, but given the complexity inherent in defining measures related to organizations, the qualitative approach is simplest. Methods for quantifying variables are not discussed here.

In order to carry out prioritization, a firm needs to define logical business segments as indicated above and plot them on a matrix of prioritization, as illustrated in Figure 6 below:

Figure 6 – Prioritization of Business Segments



The prioritization scheme informs which business segments are more or less likely to yield significant impact if relational contracts were developed, and which segments will be more or less difficult to change. Logically, segments in Quadrant A above are the highest priority, followed by Quadrants B and C. Quadrant D is the lower priority and should attract the least attention and focus.

The question of where to start or where to pilot an initiative can only be answered subjectively: it could be equally valid to begin with Quadrant A as it could be to start with an “easier to change” segment in Quadrant B. It depends rather firm-specific factors: it might be sensible for a firm to start with an easier-to-change segment rather than begin with a more difficult segment.

Within the prioritized business segments, it is also desirable to prioritize roles, teams and customer groups where particular skill in relational contracts is needed.

This level of prioritization is likely to be highly firm specific, however, so approaches are not defined here. It is enough to point out that certain aspects of managing relational contracts require a higher degree of attention in assigning, training and managing the right people and skills.

## **5.6 Selected Interventions – Within Firm Boundaries**

In considering interventions to develop relational contracts, the point about systemic change noted in paragraph 5.1 is re-iterated. Developing relational contracts requires a comprehensive initiative that involves many parts of the business, and discrete interventions must be integrated. However, for ease of explanation, the indicative interventions outlined below are dealt with discretely.

### **5.6.1 Individual Level**

At the individual level, firms can develop a wide range of skills and behaviors that support building and sustaining effective relational contracts. Many of the techniques relate to communication skills, and they are behavior based. Behaviors are notoriously difficult to create and change, so to a certain degree firms need to accept that not every individual is capable of mastery of relational contracts. The natural conclusion is that there is value in assigning those who are good at creating cooperation and collaboration to roles where they can contribute most to the initiative.

Common to all managers and employees involved in developing relational contracts is a basic behavioral orientation in favor of cooperation. Fundamentally, behaviors need to be conducive to creating a belief in other parties in the rewards of repeated cooperation. This is perhaps the most difficult facet of building relational contracts, not least because it is somewhat ethereal, abstract and therefore difficult to define and measure.

The basic behavioral orientation required is characterized by openness, willingness to listen and learn, an ability to set one's own assumptions aside in understanding other people's perspectives, and advanced enquiry skills in interacting with other parties. These behaviors, combined, do three things: they increase clarity in what parties are trying to achieve in relational contracts; they allow credibility to grow (largely through mutual understanding) and they make it easier for parties to identify potential sources of mutual-value which could be achieved by continued cooperation. They also help deal with the issue of fluctuations in the short-term payoffs of cooperation. At times when the rewards of cooperation seem to be less attractive than the alternative, open communication is needed to head off the risk of defection.

In addition to the basic behavioral orientation above, there are also some fundamental individual values that contribute to developing strong relational contracts. These are, *inter alia*, a belief in the benefits of repeated collaboration over short-term self-interest; an ability to give trust and respect trust when it is given; and a sense of authenticity, of genuine belief that more value (or surplus) can be created through relational contracts.

Values, of course, are fundamental and very hard to change, so in creating relational contracts, firms need to recognize that some of their employees make take more time than others to adapt to the new organizational environment, whilst others will not be able to make the change at all.

#### **5.6.1.1 Recruiting and Assigning**

Given that we have a (partial at least) definition of the individual and team behaviors that support development of relational contracts, firms can target recruiting efforts in favor of employees who have these attributes. Likewise, in filling roles and building teams, it is possible to assign individuals to match needs with basic capabilities.

Many systems in human resources are already capable of selecting and assigning individuals on the basis of the behaviors and values suggested. Psychometric and behavior-based selection techniques only need to be slightly adapted for emphasis. Indeed, the well-known human resources assessment approach known as the Five Factor Model<sup>44</sup> includes two traits, Agreeableness and Openness, which are entirely consistent with the behaviors necessary to build relational contracts.

Moreover, recent developments in the study of collaborative behavior have identified specific tests adapted from psychoanalysis that evaluate and measure a capability called collective intelligence<sup>45</sup>. Collective intelligence is very consistent with the required behaviors and values outlined above. Evaluation of collective intelligence includes techniques such as measuring social perceptiveness by guessing emotions shown in the eyes of photographed faces, and evaluation of behavioral flexibility by measuring the evenness of conversational turn-taking among groups. These are recent developments, but they point to ongoing improvement firms' ability to identify and select individuals who are more likely to build effective relational contracts.

Firms also need to consider assigning individuals to roles and teams according to their abilities in relational contracts. A number of other factors might also determine role assignment, but it is critical that due consideration is made of an individual's basic behaviors and values in relational contracts before she is assigned.

#### **5.6.1.2 Developing and Training**

In tandem with routine training and performance management, firms will need to include training and development interventions relevant to relational contracts. Again, this is difficult because of the ephemeral nature of relational contracts.

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<sup>44</sup>McCrae, R. and John, O. "An Introduction to the Five Factor Model and its Applications." *Journal of Personality*. Volume 60, Issue 2. (June 1992): 175-215.

<sup>45</sup>Malone, T., Laubacher, R. and Dellarocas, C. "The Collective Intelligence Genome." *MIT Sloan Management Review* 51.3. (2010): 21-31.

Traditionally, firms focus training and development on hard, rational skills and knowledge. Certainly AgriCo and CPGCo find it hard to provide effective training in the softer behavioral aspects related to relational contracts. However, it is necessary to ensure concepts such as trust, productive interactions and authenticity are clearly understood and frequently applied to actual business situations to understand ways of improving capabilities.

As part of the overall training and development infrastructure of the firm, there are some enabling processes and policies, which whilst not directly related to relational contracts, provide essential mechanisms and conditions for their development. These include routine team problem-solving tools, information-sharing approaches, long-term employment and job rotation policies<sup>46</sup>. Such advanced HRM practices should be considered necessary precursors to building relational contracts, and their effective implementation and continuous improvement is vital. Most multinational firms have long-since adopted these practices, but it is still worth pointing out their importance.

#### *5.6.1.3 Formal Incentives*

Formal incentives for motivating individuals to develop relational contracts have not been covered in any detail so far. This is because, strictly speaking, they are part of the strategic design of the organization and this study is focused on political and cultural dimensions of organization design. That being said, it is important to summarize how formal incentives can be adjusted to motivate building relational contracts.

Pay-related incentives, i.e. salary and bonus, must be aligned with the overall collaborative, co-operative behaviors which relational contracts create. This might include profit-share or share in ownership of the organization. Clearly, in contrast to individual-performance related financial rewards, team-based rewards are more consistent with the overall intent to drive collaboration and provide tangible

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<sup>46</sup> For a comprehensive list, see Appendix A

evidence of the rewards of repeated collaboration. In a nutshell, because relational contracts seek cooperation over the long run, long-term, shared incentives are necessary to create alignment.

### 5.6.2 Team Level

At the team level, in addition to the behavior and values expected of individuals in the previous section, the importance of building effective networks is key.

Most managers would recognize the importance of networks in helping teams work effectively. However, there are both quantitative and qualitative measures in network development that can be taken to improve relational contracts.

The science and tools of Organizational Network Analysis<sup>47</sup> analyze the number of connections that exist between network nodes and determine how effective the network is in achieving its defined purpose, such as advice seeking, problem solving or information seeking. It is possible to determine how rich (or dense) network interactions are and who the key players are in making it operate effectively. These key players naturally act as informal coordinators of the network, and this of course describes a role that is valuable to building relational contracts and teams.

In evaluating the role of networks among employees and managers on a production line, Gant, Ichniowski and Shaw were able to determine that effective networks can improve productivity<sup>48</sup>. Comparing two very similar production lines, it was demonstrated that frequency of horizontal communication in networks greatly improved the capability of the team to solve problems causing downtime and yield loss.

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<sup>47</sup> For examples see Wasserman, S. and Faust K. *"Social Network Analysis: Methods and Applications."* Cambridge University Press 1994.

<sup>48</sup> Gant, J., Ichniowski, C. and Shaw, K. "Social Capital and Organizational Change in High-Involvement and Traditional Work Organizations." *Journal of Economics & Management Strategy* 11.2 (2002): 289-328.

Researchers often describe team-level relational contracts as social capital. This is apt, because it captures the surplus benefit available to teams who collaborate effectively and who value behaviors that typify repeated cooperation. Network development is largely focused on building social capital.

Thus to develop team capabilities to build relational contracts, firms need to analyze the networks that operate across teams and encourage the development of more frequent, targeted interactions. This is clearly a managerial task, and should arguably be taken on by managers in supervisory and project roles.

Related to team network analysis, but in the context of improving innovation capability, research has also been able to identify specific roles employees can play in building and enhancing networks<sup>49</sup>. Termed “idea connectors” and “idea scouts”, these are individuals in a team who are particularly adept at either searching for new information within a network or ensuring relevant information is transmitted to the right parts of the network. To explain it in simple terms, there are team members who are always curious and determined to seek out new ways of addressing old problems, and there are team members who are gregarious and social with all members of the network. The former ensure new ideas are continually brought into a team, and the latter ensure information is rapidly recycled. Both are important to maintaining effective networks, and should be assigned to and nurtured by networks and teams who are building relational contracts.

### 5.6.3 Processes and Decisions

Processes connect many of the routine transactions that drive a firm’s business. As such, they encapsulate some of the most critical business decisions an organization makes. They are thus highly important in creating the kinds of behaviors associated with building credibility and clarity in relational contracts.

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<sup>49</sup> Whelan, E., Parise, S., de Valk, J. and Aalbers, R. “Creating Employee Networks That Deliver Open Innovation.” *MIT Sloan Management Review* 53.1 (2011): 36-44.

Examples help to illustrate how critical decisions within processes can be leveraged to build cooperation. The key account management processes that many large firms operate contain many different activities necessary to manage interactions between commercial teams and customers. They also contain key decisions about resources and sales campaign management, to which customers are usually not party. However, the involvement of customers in making these critical decisions could contribute to building confidence and credibility through information sharing. Sales forecasting is another process that includes many critical decisions for the business. Firms which run a collaborative forecasting process, involving key functions, customers and suppliers, find that not only are business results more accurate, but that better relationships are built as a result of the transparency which is created.

Firms often overlook processes as a means to build a better collaborative environment, approaching their development from the perspective of efficiency. This is often the result of successive system implementations, which seek to automate processes as much as possible. However, if firms change their perspective on those critical processes that are run between parties with important relational contracts, and focus their attention on the handful of key decisions that are made across the process, then processes can be used as a vital platform for building relational contracts.

In essence, firms need to identify the critical decisions of a given priority process, and determine who and when should participate in each decision and with what information. This should be in addition to any moves to create greater empowerment in decision-making, which will likely naturally develop from any initiative that focuses on relational contracts.

## 5.7 Selected Interventions Across Firm Boundaries - Suppliers, Customers and Partners

Most of the suggestions made so far about individual, team and process management are of course relevant to relational contracts that work across firm boundaries. However, some additional points of emphasis need to be made in this domain.

Relational contracts across firm boundaries tend to be more difficult to build and sustain than internal relational contracts. Two reasons account for this. First, the existence of boundaries implies less frequent interaction between parties and lower intimacy than if the activity was conducted internally. Secondly, and most importantly, additional benefit created between the two parties as a result of cooperation is not so easily shared as in the case of internal relational contracts. Indeed, it is rent, and either party might be incentivized to withhold it. This is the hold-up effect described in paragraph 2.2 above. In outsourcing partnerships in particular, we should also bear in mind that the balance of power shifts over time, owing to the ability of the outsourcing provider to improve the services provided over and above that stipulated in contract agreements as a result of the learning curve effect. Combined, these factors unique to cross-boundary relational contracts point to increased difficulty and higher risk.

In all of the case studies cited above, the generation of extra value for customers in particular is noted as an important product of sustaining strong relational contracts. This is especially noteworthy because of the potential for relational contracts to create economic value (as opposed to social capital) for the firm. This increases the importance of relational contracts across firm boundaries. If relationship, account and alliance managers continually seek out new ways of working more effectively, in particular in ways that create additional value for the partner, more durable and sustainable relational contracts will be built.

In paragraph 2.2 above, the concept of hold-up was discussed, with the observation that as outsourced relationships proceed over time, the creation of extra rent by the outsourcing party incentivizes hold-up. Relational contracts can help mitigate that threat: if there is a high degree of collaboration and parties believe in the promise of rewards through continued cooperation, it is more likely that additional rent will be shared rather than withheld or used to jeopardize the relationship.

It follows therefore, that an extra degree of effort and focus is required in building relational contracts across firm boundaries. Most important is the selection of relationship and alliance managers who are particularly capable in building relational contracts. Many firms, AgriCo and CPGCo included, tend to assign people who are experienced and qualified in the formal aspects of managing across boundaries: lawyers and sales operations managers are often appointed to roles leading alliances and partnerships, when in fact these roles require individuals who have more skill in the relationship building domain.

Similarly, in managing networks and creating platforms for cooperation and collaboration (such as with key decisions), efforts in cross-boundary relational contracts need to be particularly stringent. The same principles apply as for internal dimensions, only they must be more diligently applied.

## **5.8 Firm-Wide Cultural Change Initiatives**

In addition to the suggestions proposed above, it is recommended that overarching cultural change program is initiated, certainly at the level of the priority business segments in which relational contracts are being developed, but also possibly firm wide.

The rationale behind this recommendation is that efforts to address the values and norms across the firm help deal with the intangible, ephemeral nature of relational contracts. Because relational contracts seek to establish a spirit of longer-term cooperation on the basis of unverifiable promises of future payoff, it is important to reinforce that belief by instilling a motivating sense of purpose in the wider organization. This heightened sense of purpose will support the building and sustaining of relational contracts in all the other levels of the business above.

As noted above, the codification of value systems and purpose statements, and making them more visible and seemingly high profile through performance evaluation and awards ceremony is not a guarantee of success. This implies that firm culture is itself a relational contract: employees and managers need to believe that the firm stands for something more than is defined by its basic purpose of generating value for shareholders. The firm's culture needs to feel rewarding and sustaining of employees needs for a sense of security, status and recognition.

Rather than formal codification of firm culture, what is needed is more informal dives, such as folklore about the origins and history of the company, some stories about how particular employees have embodied the firms culture in difficult times, and for metaphors to be used which describe why the firm is worth committing oneself to.

The way in which culture is communicated is most critical. Again, this being a relational contract, formal publication, signage etc. is only part of the requirement. Verbal communications, both specific and routine, need to be infused with the language of the rich culture that supports the organization. In the example of United Stationers, the CEO Dick Gochnauer constantly references the motivating effects of firm culture, and in communications with employees and partners alike consistently evokes a sense of higher purpose of the firm.

There is a danger that focusing on culture in this way may appear Orwellian. If it appears to be a confection, the effort may be counterproductive. The norms and values which culture encapsulates must be felt to be genuine, and communication about firm culture must be authentic, in common with all of the interactions related to relational contracts in the previous sections.

## 5.9 Managing Change

It has been pointed out that efforts to build and sustain relational contracts need to be systemic. This implies a major change program will result, and so some change management will be needed. Over and above routine and familiar change management, some additional steps should be taken, which are explained below using John Kotter's familiar and enduring 8 Step Change Model.<sup>50</sup>

### 5.9.1 Create Urgency

The use of coordinating devices such as burning platforms, critical market dynamics or significant events in the competitor domain are of course valid, but in the case of relational contracts, it is worth creating a sense of urgency by demonstrating examples of parts of the business where today, strong relational contracts are delivering value to employees and partners. The purpose here is to show that appreciable change is not too remote to inspire action.

### 5.9.2 Form a Powerful Coalition

Given the intangible nature of relational contracts, the creation of a guiding coalition is all the more important. This is because employees need to see the intangible facets of relational contracts demonstrated in live action, more than they need them to be codified in formal means of communication. The guiding coalition needs to be a group of people who are not just committed to the change, but are selected because of their particular aptitude in managing relational contracts.

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<sup>50</sup> Kotter, J. "The 8-Step Change Model" from Mindtools .com  
[http://www.mindtools.com/pages/article/newPPM\\_82.htm](http://www.mindtools.com/pages/article/newPPM_82.htm) accessed March 2013.

### 5.9.3 Create a Vision for Change

Over and above the strategic vision typically used in these circumstances, a vision needs to be created which describes the value of repeated cooperation and the open, trusting behaviors that typify strong relational contracts. It is recommended that this is not formulaic, but draws on some of the folklore and metaphors that describe the sense of higher purpose the firm is striving for.

### 5.9.4 Communicate the Vision

Similar to Kotter's guidance in this area, communication about relational contracts needs to involve not just 'town-hall' type broadcast communications, but a process of deep engagement with employees and partners, in informal settings. Leaders and managers must see every informal interaction as an opportunity to communicate the vision and relate it to the day-to-day activities being conducted in the firm, particularly when those activities pertain to relational contracts. This is painstaking and difficult; during times when there is short-term pressure, it will be very challenging to maintain faith in continued cooperation.

### 5.9.5 Remove Obstacles

Provided that communication is maintained in an open and frank fashion, employees and partners will quickly point out barriers to and raise concerns about continued cooperation. It is critical that all efforts are made to address these barriers and resolve related difficulties, particularly when to do so contributes to building relational contracts.

### 5.9.6 Create Short-Term Wins

Given the longer-term nature of change resulting from initiatives to build relational contracts, it is all the more important to demonstrate and communicate early successes. The focus here should be on sharing the rewards of collaboration, particularly where it has resulted in a productivity-improving problem-solving event, or a value creating event with customers, suppliers or alliance partners.

Again, the language that is used should be less formulaic, and more metaphorical, contributing to the overall positive litany of firm culture.

### **5.9.7 Build on the Change**

Relational contracts rely on continued cooperation, so in addition to communicating the incremental improvements achieved in the short-term, significant effort needs to be made to exhort employees to build on successes. Clear language that relates the multiplier effect of repeated cooperation must be used, and demonstration of continued success must be clearly communicated.

This point is best demonstrated by an example: if an alliance manager has early success in creating mutually-beneficial information flows with a partner, it is likely further value will come from repeated cooperation. Over time, it will be possible to build a success story that shows a line-of-sight from early actions taken through to subsequent actions and further value-creation later on. The inter-relationship of the successive steps is very important in demonstrating how the continued cooperation reinforces success. These success stories provide a further opportunity to inspire the kind of efforts needed to build strong relational contracts. In turn, greater commitment is fostered, which will help the organization maintain focus during difficult times when the rewards or cooperation appear less attractive in the short-term.

### **5.9.8 Anchor the Changes in Corporate Culture**

Guidance here is similar to that offered by Kotter, and is related to the points made earlier in paragraph 5.8. Culture itself is a kind of relational contract, so dedicated efforts need to be made to infuse culture with evidence of the rewards of relational contracts as they improve. Again, enhancing the folklore of the firm with metaphors and stories that motivate greater commitment is the recommended course of action.

## 5.10 The Role of Leadership

Leadership is instrumental to the success of any major change initiative, and this is all the more the case with relational contracts. It is difficult to imagine a change program such as this being driven bottom-up; on the contrary, it needs to be led top down.

It is worth explaining why that is the case, because it also highlights the role leaders need to play to create conditions for cooperation. If we abstract back to the original game theory behind relational contracts, in the repeated game, the manager, who creates the conditions for the employee to believe (initially and subsequently), that it is worth co-operating. Provided the employee can see the advantage in cooperation, she is content to trust her manager. But it is the manager who needs to create the conditions for that trust to be given in the first place, and repeatedly thereafter.

It follows that leaders need to accept their role in creating the conditions for cooperation. In so doing, their behaviors and actions need to typify the clarity and credibility that drive effective relational contracts. In listening to the CEOs of two firms who have mastered relational contracts, United Stationers and IDEO, the style and language they use is distinct. Stylistically, they are modest, reflective and inquiring, and the language they use constantly references the value they perceive in their firms' repeated cooperation in relational contracts. In both there is humility, openness and very clear authenticity. The achievements of their managers and employees in building and sustaining relational contracts seem natural and unforced.

Clearly the leadership characteristics most conducive to creating the conditions for relational contracts are not of the directive, autocratic, all-knowing type. Rather they are the opposite: required characteristics are the ability to inspire through

example, coaching and supporting, and understanding the drivers of trust in other people, be they employees, managers, customers, suppliers or alliance partners.

In terms of MIT's Four Leadership capabilities, the skills most needed for leadership in building relational contracts are in the domains of Relating and Sensemaking<sup>51</sup>. Leaders need to work hard to understand others' perspectives and withhold judgment. Bearing in mind the ephemeral, difficult-to-define nature of relational contracts there could be many reasons why an individual is motivated to co-operate, which may not be known to the other party. Furthermore, leaders must encourage open dialogue from others, to ensure variability in the payoff of cooperation in the short run can be effectively managed. In the sensemaking domain, three behaviours are noteworthy: deep engagement with multiple sources of information pertaining to relationships; avoidance of the use of stereotypes; and the use of metaphors and storytelling. All contribute significantly to creating conditions for success in building relational contracts.

For many leaders, adapting behaviors to achieve all of the above will be very difficult and may in itself be a transformative experience. The rewards are high, however, from both an economic and social perspective, and leaders can take inspiration from others who have successfully created or transformed firms that create significant value from effective relational contracts.

## 6 Conclusion

Relational contracts have been shown to be pervasive in organizations, and their effective use is a compelling source of differentiation and competitive advantage.

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<sup>51</sup> Ancona, D. "Leadership in an Age of Uncertainty." Research Brief, Massachusetts Institute of Technology Leadership Centre, 2005.  
<http://leadership.mit.edu/pdf/LeadershipinanAgeofUncertainty-researchbrief.pdf>, accessed March 2013.

They work over and above formal strategic design components of the organization, and can be seen as a vital mechanism for achieving performance over and above that which is set out in formal contracts. Relational contracts are often unspoken and are very difficult to verify, giving them a somewhat ephemeral quality.

The key concepts associated with relational contracts are the creation of belief that the rewards of cooperation over the long term are greater than short-term gains, although at times defection to seize short-term gain may appear attractive.

In order to build and sustain relational contracts, credibility and clarity are needed to manage interactions in order to create the necessary belief in the rewards of repeated cooperation. In turn, trust and commitment result, both of which help manage the variability in payoff over time.

Firms can increase competitive advantage through building and sustaining effective relational contracts. However, the heavy investment required dictates prioritization is necessary. In establishing a change initiative focused on relational contracts, a systemic approach is needed within prioritized business segments, with change effected in many levels of the organization. In addition, the overarching development of firm culture, unique change management approaches and leadership are critical to success.

There are many firms that have focused on making relational contracts a critical part of their capability-based competitive advantage, either since inception of the firm (such as Sun Hydraulics), or as result of a decision to make a strategic change (such as United Stationers). All the examples discussed in this thesis provide inspiration for leaders who seek similar outcomes. However, firms that are already focused on building more collaborative, cooperative organizations have taken different approaches to articulate the case for change, and few if any have explicitly used the theory of relational contracts. A central tenet of this thesis is that the concepts and language of relational contracts could be an attractive alternative. If

the outcomes describe an organization that is more competitive as a result of managing cooperative relationships better, leaders might find the rational, logical concepts of relational contracts a compelling route to creating the case for change.

## **7 Further Research**

The ideas and concepts as set out in this thesis are based on literature and the author's own experience in working with multinational firms. Further, recommendations made in relation to addressing relational contracts are highly generic, without any attempt to make them specific to context, industry or geography. Before the ideas can be considered actionable, it is important they are tested and validated with firm leaders. The most important test is to ascertain whether the logic of relational contracts is considered as compelling in creating the case for change as other methods of achieving the same outcomes.

In a similar vein, the incremental approach advocated for in this thesis needs to be validated further. There is a risk that partial improvement of relational contracts may not be satisfactory, and may compromise sustaining any gains made.

A natural outcome of improved relational contracts will be a flattening of hierarchies, an increase in value in horizontal relationships and a reduced dependence on formal components of strategic organization design. However, power and influence, which are products of hierarchy, are part of the motivation for cooperation in the first place. As organizations flatten, it is likely these notions of power and influence will be replaced by factors such as information flow, and the dynamic of relational contracts may change. It would be valuable to research how relational contracts operate in more horizontal settings, free of the effects of power and influence.

Relational contracts as described in this thesis primarily relate to firms that originate in the West and are infused with mindsets and norms of that hemisphere. It is likely that different perspectives and beliefs about relational contracts will be held in the Eastern hemisphere, and that as a result the universality of relational contracts might not hold true. Drawing on the author's experience in Japan to illustrate this point, it is noted that Japanese firms generally require very high degrees of commitment from their employees, and relationships with suppliers, customers and partners are strongly infused with the characteristics of relational contracts. Indeed, the three pillars of the Japanese employment system<sup>52</sup>, lifetime employment, seniority-based wages and bonuses, and enterprise-based unionism (to which a fourth is often added: community consciousness within the company), indicate relational contracts are highly valued in that country. However, whilst some shining examples of competitive advantage exist, such as Toyota, success is not a corollary of running these systems. Perhaps the role of hierarchy acts a barrier to achieving the full benefits of relational contracts; it would be interesting for the matter to be researched further.

New forms of organization are emerging which leverage technology to manage co-ordination of complex activities in the marketplace. MIT's Centre for Collective Intelligence has identified at least 300 companies which operate effectively as distributed systems without either formal contracts or, seemingly, relational contracts. They operate instead by using information and communications technology to coordinate problem solving and value creation. Although these are different forms of organization, it is clear that individual's willingness to participate and co-operate repeatedly is driven by some of the motivations that drive relational contracts in conventional organizations. It might be the case the collective intelligence approaches to managing organizational complexity are a viable route to addressing organizational issues instead of or in addition to developing relational contracts.

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<sup>52</sup> Whitaker, D, H. Labour Unions and Industrial Relations in Japan: Crumbling Pillar or "Forging a Third Way?" *Industrial Relations Journal* 29:4 ISSN 0019 8692 (1998): 280-294. p. 289.

Appendix 1

Complementary Human Resources Practices that Enable Effective Relational  
Contracts<sup>53</sup>

Serial	Title	Description
1.	Incentive Pay	Profit sharing and shared incentives
2.	Recruiting and Selection	High degree of screening
3.	Teamwork	Multiple work teams formed, with formal team practice
4.	Employment Security	
5.	Flexible Job Assignment	Job rotation
6.	Skills Training	Routine training and qualification
7.	Communication	Routine, structured information sharing Formal workers and union meetings with management
8.	Labor Relations	Union formation

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<sup>53</sup> Ichniowski, C., Shaw, K. and Prensushi, G. "The Effects of Human Resource Management Practices on Productivity: A Study of Steel Finishing Lines." *The American Economic Review* 87.3 (1997): 291-313.

## Appendix 2

### List of Firms that have Developed Collaborative, Cooperative Relationships in their Organizations

Serial	Name	Source
1.	Sun Hydraulics	Barnes, Louis B. and Kaftan, Colleen. "Sun Hydraulics Corporation (A&B) (Abridged)." HBS No. 9-491-119. Boston: Harvard Business School Publishing, 1991.
2.	United Stationers	Beer, Michael and Eisenstat, Russell. "United Stationers: Enabling our Partners to Succeed." HBS No. 9-912-407. Boston: Harvard Business School Publishing, 2011.
3.	W.L. Gore & Associates	Shipper, Frank, Manz, Charles C. and Stewart, Greg L. "Developing Global Teams to Meet 21 <sup>st</sup> Century Challenges at W. L. Gore & Associates." Case 26 C391-C405 Accessed March 2013
4.	Herman Miller	Shipper, Frank, Manz, Karen P., Adams, Stephen B. and Manz, Charles C. "Herman Miller: A Case of Reinvention and Renewal.
5.	Toyota	Roos, Daniel, Womack, James P. and Jones, Daniel T. <i>The Machine That Changed the World: The Story of Lean Production</i> , Harper Perennial (November 1991).
6.	SAS Institute	Beer, Michael. <i>High Commitment, High Performance</i> . San Francisco, CA: John Wiley and Sons, 2009
7.	Merida Rugs	Henderson, Rebecca M. and Isaacs, Kate. "Merida Rugs: Building the Responsible Business." HBS No. 9-612-066. Boston: Harvard Business School Publishing, 2012.
8.	Zappo's	Frei, Fances X, Ely, Robin J. and Winig, Laura. "Zappos.com 2009: Clothing, Customer Service, and Company Culture." HBS No. 9-610-015. Boston: Harvard Business School Publishing, 2011.
9.	Southwest Airlines	Beer, Michael. <i>High Commitment, High Performance</i> . San Francisco, CA: John Wiley and Sons, 2009
10.	IDEO	Lakhani, Karim R., Fayard Anne-Laure, Levina Natalia and Healy Pokrywa, Stephanie. "OpenIDEO." HBS No. 9-612-066. Boston: Harvard Business School Publishing, 2012.

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