

**Commentary: The Process of Relational Contracting:  
Developing Trust-Based Strategic Alliances Among  
Small Business Enterprises**

**Raghu Garud**

**IS-97-35**

Commentary: The Process of Relational Contracting:  
Developing Trust-Based Strategic Alliances among Small Business  
Enterprises

Raghu Garud  
Leonard N. Stern School of Business  
New York University

December 1997

Working Paper Series  
Stern #IS-97-35

## COMMENTARY:

### *The Process of Relational Contracting: Developing Trust-Based Strategic Alliances among Small Business Enterprises*

(O.J. Borch)

Raghu Garud

---

Amitai Etzioni (1993) laments that marriage has become “disposable”—terminable by anyone at any time with little cause. To emphasize this point, Etzioni quotes Thomas Morgan of the George Washington University School of Law—“It is easier in the United States to walk away from a marriage than from a commitment to purchase a used car.” It is a sad commentary that marriage, once a rich metaphor for understanding “relational contracting” in the business world (Macneil, 1978, 1980), now evokes images of transience and distrust that we would rather avoid.

There was once a time when marriage, as an institution, was held sacrosanct with vows such as “together, until death do us part.” Marriages often defined relations not only between two people, but also between entire families. Vows were taken in the eyes of God and sanctioned by law and society. The marital relationship was broadly defined, providing enough latitude for its evolution. A marriage could only be understood by looking at the “totality of the relationship” as it had emerged rather than the “contract” that had been signed. Because of its traditional properties, I chose marriage as a metaphor to critique Borch’s paper on relational contracting.

---

**Advances in Strategic Management, Volume 10B, pages 137-144.**

**Copyright © 1994 by JAI Press Inc.**

**All rights of reproduction in any form reserved.**

**ISBN: 1-55938-851-X**

While Borch alludes to the notion of trust to arrive at this conclusion, he does not formally define trust, nor does he use it as a key construct to build upon. Trust, for Borch, seems to be more of an outcome than a process. This focus is unfortunate because the way trust and opportunism arise, and how they are dealt with, are key process issues that have great importance to the field of strategic management.

I want to return to the idea of a marriage to establish this point. While marriage traditionally has meant a relationship characterized by trust, modern marriages often have a very different meaning. In the United States, for example, many consider it desirable to begin a marriage with a pre-nuptial agreement that specifies how the marriage should break up. On the one hand, it may make “strategic sense” to initiate a marriage with a pre-nuptial agreement just in case the marriage does not work out. On the other hand, the very structures that we create to protect ourselves have a quality about them that seem to invite the outcomes that we want to safeguard ourselves against through their anticipation. In this sense, *both trust and opportunism have aspects about them that are self-fulfilling*. The more I trust a person, the greater the likelihood that I will behave in a trusting way, and the more likely (s)he may be willing to respond with trust; conversely, the more I believe that a person behaves opportunistically, the greater the likelihood that I will behave opportunistically, and the more likely it is that (s)he will reciprocate opportunistically.

Underlying these two dynamics are two very different meanings of trust that I gleaned from Ring and Van de Ven’s (1994) work. The first has to do with the confidence or predictability in one’s expectations and equates trust with risk. Ring and Van de Ven point out that this risk can be reduced through a variety of formal contractual means, like guarantees, insurance mechanisms, hostages, and laws. The second definition of trust represents confidence in the other’s goodwill; it emphasizes the moral integrity or goodwill of others in dealing with future unpredictable issues. Ring and Van de Ven suggest that confidence in the other’s goodwill is produced through interpersonal interactions that lead to social-psychological bonds of mutual norms, sentiments, and friendships.

These two meanings of trust are often confused, leading to confused theory and practice. Indeed, the first meaning of trust has created road blocks in our ability to nurture and promote trust as goodwill. As Mahoney, Huff, and Huff (1994) suggest, contracts based on the implicit assumption that the other cannot be trusted in the present are unlikely to lead to trust in the future. They also suggest that “attempts to constrain opportunism along the lines suggested by agency theory will have continuing economic as well as human costs.”

Strategic management theories may have a similar self-fulfilling quality about them. Our ways of theorizing, when translated into practice, may promote the very outcomes we want to safeguard against. To the extent that we create theories built around opportunism, we implicitly invite opportunism

It appears that in many ways, we in the United States have been operating in a land of opportunism, while those in Japan have been operating in a land of trust. We have become a litigious society where nothing proceeds without a lawyer, whereas Japanese businesses have thrived during the past decade with business practices that emulate families (after all, as Mcneil, 1980 points out, contracts are not about law; they are about getting things done). The importance of these observations strikes home when we consider the additional transaction costs that our society has to bear because of the social order that emerges from the application of particular types of theories (cf. Bromiley & Cummings, 1993; Mahoney et al., 1994; Rose & Ito, 1993). For instance, transaction cost economics begins with opportunism as an important premise. To the extent that this theory fosters opportunistic behavior, the overall transaction costs that our society bears will be higher than those borne by societies where trust prevails.

In our own academic writings, there is sufficient evidence to support the self-fulfilling and sustaining nature of our social institutions. Weick (1979), for instance, suggests that most facets of social life are the outcomes of self-fulfilling dynamics. Weick summarizes Kelley and Stahelski's (1970) work which demonstrated that a competitive person's anticipation of how other people will behave tends to have a self-fulfilling aura about it that transforms those other individuals, regardless of their preference for cooperation, into competitors. In the context of interorganizational relationships, Van de Ven and Walker (1984) found that excessive formalization and monitoring of the terms of interorganizational relationships also results in the creation of conflict and distrust among parties.

An appreciation of self-fulfilling and self-sustaining properties of trust and opportunism complicates our efforts to study relational contracts because they force us to look at "relationships in-the-making." By definition, we must look at the entirety of a relation as it unfolds in time rather than look at the relation at one point in time. Our task is further complicated by a need to appreciate the relationship from the perspective of those involved rather than from an outsider's perspective. But only by taking this broader perspective will we be able to understand the forces governing a relation's evolution and have a means for shaping its future.

Following a relationship over time from the perspective of the people involved is truly a challenging task and it can only be accomplished by adopting an ethnographic approach. Yet to the extent that each relationship is different (that is why a relational contracting approach is so interesting), what kind of knowledge can we generate from observing just one relationship? To the extent that we "enact" future outcomes (implicit in the notion of self-fulfilling dynamics), what is the meaning of reliability and validity in such situations?

Strategic management theorists must grapple with these issues. We must feel comfortable in an approach that transfers the onus for generalization from

Marriage used to be a good metaphor to design relational contracts in the business world. I use the past tense to highlight the changing meaning of marriage. To the extent that we ask those we love to sign a pre-nuptial agreement, we emphasize the instrumental aspects of marriage while ignoring its larger meaning. Our fears appear to dominate any concerns that we may have that through our actions we create the very structures that may finally destroy what little trust there is. In this sense, these contractual modes and the governance structures they foster are a reflection of ourselves and the structures that trap us. As Frank (1988, p. xi) argues:

Our beliefs about human nature help shape human nature itself. What we think about ourselves and our possibilities determines what we aspire to become; and it shapes what we teach our children, both at home and in the schools. Here the pernicious effects of the self-interest theory has been most disturbing.<sup>3</sup>

My summary observation is that what we must eventually confront in ourselves is a “weakness of will problem.” We appear to have difficulties in adhering to our commitments, may they be personal resolutions, marriage vows or, business contracts. It is this weakness of will that is the root cause of opportunism. By implementing relational structures that address the symptoms rather than the cause, we exacerbate the disease. In a related context, Hobbes (1962) pointed out that we might have to give up some freedom to gain more freedom. In a similar vein, Etzioni (1993) suggests that our society requires a change in the habits of the heart, in the ways we think about marriage and other relationships. We will have to take a few chances in managing our relationships in order to cultivate trust. Otherwise, we ought to change our marriage vows to read “until death do us part, or until we breach the first contract.”

## ACKNOWLEDGMENTS

I thank Amy Hurley, Roger Dunbar, and Anne Huff for their comments.

## NOTES

1. See Hurley (1993) for a further discussion of the distinction between these two dynamics.
2. Note how Lincoln and Guba (1985) move away from validity and reliability as the key criteria for evaluating naturalistic efforts to suggest “trustworthiness” of naturalistic efforts as a critical test of acceptance.
3. Cited in Mahoney et al. (1994).