

THE INTERACTION OF TRUST AND CONTRACTUAL GOVERNANCE ON DISPUTE NEGOTIATION STRATEGY IN CONTRACTOR-SUBCONTRACTOR RELATIONSHIPS

Yafan Fu¹ and Shuibo Zhang

College of Management and Economics, Tianjin University, Tianjin 300072, P.R. China

Supply chain scholars have increasingly gained attention to using governance mechanisms to manage inter-organizational relationship and have pointed out their significant impacts on performance outcomes. However, the typical relationship between general contractors and subcontractors is still potential adversarial and disputes are almost inevitable during the construction process, and using governance mechanisms to promote cooperation and eliminate conflicts in the construction industry has been a relatively new topic. Through a comprehensive review and analysis of literature on governance mechanisms, the study has presented the reasons for the inconsistent findings of the interactions between trust and contract, identified different dimensions of trust and contract with consideration of the characteristics of the construction industry. In spite of the links between governance mechanisms and performance outcomes are well established, less well established is how they influence behaviours which intermediate between governance mechanisms and outcomes. By providing a theoretical framework, we can reach a better understanding of how and when trust and contract interact with each other to influence the development of negotiation strategy, so that both general contractors and subcontractors can promote better cooperation in dispute resolution and better manage their relationship. Drawing on governance mechanism literature, we argue that trust can be approached from the goodwill dimension and the competence dimension, while contract can be approached from the control function and the coordination function in the construction industry. These dimensions of trust and contract may interrelated with each other in promoting the development of dispute negotiation strategy. As our research is in progress, subsequent empirical studies are expected to test our theoretical model and focus on each dimension of the constructs in more detail is needed.

Keywords: dispute resolution, governance mechanisms, trust, contract, negotiation, relationship management.

INTRODUCTION

Construction projects are often characterised by large size and high degree of specialisation, which makes it almost impossible for one company to accomplish a project with the entire technical expertise, resource base, or investment capital (Gunasekaran, 1998). Thus, the contractor-subcontractor relationship is very common in construction projects. As both general contractors and subcontractors are the most direct participants, how they interact with each other has a direct impact on project performance outcomes. However, the typical contractor-subcontractor relationship is

¹ fyfailanse@163.com

still cost-driven and potentially adversarial (Greenwood, 2001). Many of such relationships end up in disputes. In addition, technical complexity and uncertainty of construction projects also contribute to the manifestation of dispute between general contractors and subcontractors. Disputes are almost inevitable in most of today's construction projects (Song *et al.*, 2013). If not resolved proactively and for early settlement, disputes will aggregate negative impacts on project performance outcomes. Negotiation is often firstly initiated to get disputes resolved, for it is the least-costly way and most flexible way to reconcile disagreement in terms of time, money, and emotional energy involved (Brett, *et al.*, 1990).

Using governance mechanisms to manage inter-organizational relationship is beginning to attract interest from academia and industry. Most of these researches are primarily in manufacturing, marketing, strategic alliances. Although the concept of governance mechanism has been adopted to the construction industry, there is still large amount of work to be done to improve the relationship management of the construction industry. There are two common types of governance mechanisms that come into play in inter-organizational relationship, as suggested in existing literature (Carey *et al.*, 2011). Contractual governance refers to the formal rules to safeguard parties from opportunism and disputes. The other one is trust which is used to mitigate exchange hazards caused by uncertainty and transaction-specific investments. The two types of governance mechanisms are quite distinct but interrelated with each other in managing inter-organizational relationships. Trust and contractual governance have been traditionally viewed as either complement or substitutes in impacting project performance outcomes.

The aim of this paper is to explore the attributes of contractual governance and trust in the construction industry from a multi-dimensional perspective by conducting a desk study. We also introduce the expectations of continuity as an important moderating variable as suggested by several researches (Axelrod and Hamilton, 1981; Poppo, *et al.*, 2008), to provide a nuanced understanding of how and when governance mechanisms impact the actual behaviours of participants. This study argues that both the complementary and substitute relationships of the two governance mechanisms are possible, due to different contextual factors and contents of the two governance mechanisms

GOVERNANCE MECHANISMS IN THE CONSTRUCTION INDUSTRY

The existing literature has suggested two types of governance mechanisms in managing inter-organizational relationships. Contractual governance refers to legal safeguards which explicitly stipulates the responsibilities and obligations of each party (Lui and Ngo, 2004). Transaction cost economics (TCE) is one of the main theories in explaining the effectiveness of contractual governance. It argues that contracts are designed to reduce opportunism and minimize transaction costs caused by uncertainty and transaction-specific investments (Williamson, 1985). Contract structure may vary to a large degree due to different transaction attributes. An effective contract related to complex transaction involving transaction-specific investments and interdependency typically includes clauses to clarify different dimensions of a transaction (Crocker and Reynolds, 1993). For a long time, contracts are considered as control instruments to contend with the potential risk of opportunism (Williamson, 1985). The threat of intervention of a third party is the primary means by which contracts act as the instrument to control both parties' behaviours (Lumineau and Henderson, 2012).

Researchers are coming to realize that contract serves different functions to stipulate a transaction. However, exchange partners also formulate contracts to foster coordination of the relationship formally. Coordination is especially important when the contracted tasks are highly uncertain and complex (Ren *et al.*, 2009), as is true in construction projects. Construction projects require high level of coordination, for there are so much interface of activities and concerns due to the high level of specialisation. Coordination provisions aim at mitigating the risk of misunderstanding and structure collaboration in an efficient way (Mayer and Argyres, 2004). This is also in accordance with the logic of TCE, for the coordination provisions contribute to reducing transaction costs and informs the selection optimal governance choices (Schepker *et al.*, 2014). Both control provisions and coordination provisions are designed in construction contracts, as can be seen from several models of contracting (e.g., FIDIC, 1994; 2011). Empirical studies suggest that different functions of contracts may shape parties' behaviours, and consequently the outcomes of the relationship (Lumineau and Malhotra, 2011). Therefore, we suggest the distinction of control and coordination functions of contracts in our research.

Trust is another governance mechanism to mitigate exchange hazards caused by uncertainty and transaction-specific investments, and the social exchange theory (SET) is the underlying theoretical foundation of trust. Trust is a common phenomenon that exists at multiple levels, like the personal, organizational, inter-organizational, even international level. SET maintains that trust derives from social interaction and it is an effective tool to govern inter-organizational relationships (Cropanzan and Mitchell, 2005). Trust in inter-organizational relationships can be defined as the positive expectation held by one partner that the other party would behave in a mutually acceptable manner and to act fairly even given the chance for opportunism (Morgan and Hunt, 1994). Researchers have identified a variety of antecedents of trust. The various sources of trust indicates that it is not a one-dimensional construct. Trust can be classified into three types—deterrence-based, knowledge-based, and identification-based according to Sheppard and Tuckinsky (1996). Barney and Hansen (1994) suggest that trust at the inter-organization level can be classified into weak form, semi-strong form, and strong form, depending on the degree of potential opportunism.

Barber (1983) divided trust into the competence trust and goodwill trust. Goodwill trust is the confidence that a partner is benevolent and honest, and will not do harm to another's benefits even when given the chance (Das and Teng 2001). In contrast, competence trust refers to the expectation that a partner is technically competent to fulfill its obligations (Rempel, *et al.* 1985). Construction projects are faced with environmental uncertainty and technical complexity. It is almost impossible to anticipate and delineate all the contingencies that may arise during the construction process (Malhotra and Murnighan 2002). Therefore, goodwill trust is essential to handle the relationship in construction. Competence trust is especially important in the construction industry, for construction projects often involve large scales of investment and high risk. Failure of a project means great loss for both parties, or even bankruptcy. Since the division of goodwill and competence trust covers a partner's ability to perform and its intentions to do so, which presents a clear distinction, we adopt the two dimensions of trust in our study.

As both contractual governance and trust have their own effective domains and limitations in promoting cooperation, researchers have devoted in investigating how they interact. One research stream argues that contractual governance and trust act as

complementarities in improving performance outcomes (Poppo and Zenger, 2002). Firstly, trust can complement contract in reducing ex post transaction costs of contract noncompliance and negotiation, for the reason that trust can help overcome the inherent inflexibility of contractual governance. Secondly, well-specified contract may decrease the degree of uncertainty and risks, so that can provide a sound foundation for the development of trust. However, another research stream has provided empirical evidence for the substitute relationship between trust and contractual governance. Firstly, detailed contract may be a signal of lack of trust, and may destroy the existing trust between exchange parties, consequently weaken the positive effect on trust on performance outcomes (Malhotra and Murnighan, 2002). Secondly, trust may also weaken the positive effect of contracts on performance outcomes in turn. For the reason that, parties will less likely to enforce contracts strictly if they have a high level trust (Antia and Frazier, 2001). Obviously, the nature of the interplay between the effects of trust and contractual governance remains equivocal.

DISCUSSION ON CURRENT LITERATURE

With our analysis of articles related to governance mechanisms in different industries and institutional environments, we found that the paradox of the contractual-trust governance interplay can be attributed to several reasons. Firstly, most of existing literature do not make the distinction that whether they are talking about the mutual relationships between the two governance mechanisms or their interplay on performance outcomes. Most of these literature implicitly assumes that the logic of how the two governance mechanisms relate to performance outcomes is always in accordance with the logic of how the two governance mechanisms relate to each other. However, Cao and Lumineau (2014) provided evidence that the two kinds of logic are not always in accordance with each other by conducting a meta-analytic research on 139 published journal articles.

Secondly, both the complementary and substitute arguments are possible, depending on the emphasis on different dimensions of trust and different functions of contractual governance (Woolthuis *et al.*, 2005). As contractual control and coordination are rooted in different frames, they may have different impacts on relational governance.

Thirdly, the existing literature we employed to analyse is conducted in various industries and institutional environments. The inconsistent findings on the interplay between the two governance can be explained by the existence of possible contextual factors. However, the investigation of the possible moderating variables is fragmented and far from perfect. In this study, we chose “*the expectations of continuity*” as our interest moderating variables. “*The shadow of the future*” means whether exchange partners have expectations of continuous cooperation in the future. It is an important factor that may have effect on reconciling disputes mentioned in several studies (e.g., Schepker, *et al.*, 2014). From the logic of game theory, the behaviours of continuous reciprocity depends on sufficient value being placed on future returns (Axelrod and Hamilton, 1981). In the construction industry, subcontractors are in different professional fields. Due to the characteristics of specialised market, the degree of market competition may vary to a large degree. Thus, general contractors and subcontractors may have different expectations of continuous cooperation, which may result in different behaviours. However, prior literature has not offered enough attention to it.

In addition, most of existing literature focused on how governance mechanisms impact performance outcomes, less well established is how governance mechanisms

influence actual behaviours of both parties. To the best knowledge of the authors, how the two governance mechanisms interact to impact the behaviours in dispute negotiation in the construction industry is far less researched.

THEORETICAL FRAMEWORK OF THE INTERACTIONS OF CONTRACT AND TRUST

Researchers in inter-organizational relationship have revealed that trust and contractual governance can function together to influence the actual behaviours in dispute negotiation (Lumineau and Henderson, 2012). We envision that the view may be applied to the construction context as well. Including the possible moderator of the expectations of continuity, the authors developed a comprehensive theoretical model to explore the effects of all the dimensions of governance mechanisms on negotiation strategy. Following prior study, we classified negotiation strategies into a cooperative strategy and a competitive strategy. Parties using a competitive strategy primarily focus on demands, penalties and interruptions. Using such a strategy is more likely to result in a win-lose outcome. In comparison to the competitive strategy, parties using a cooperative strategy are more likely to behave cooperatively in order to solve the dispute. They tend to negotiate with a view of underlying interests. Such a strategy entails reaching a mutually acceptable settlement. However, the two kinds of strategies are not mutually exclusive, they are just two extremes of one thing. In our research, we evaluate the degree to which kind of strategy is adopted in negotiations. The theoretical framework is presented in Figure 1

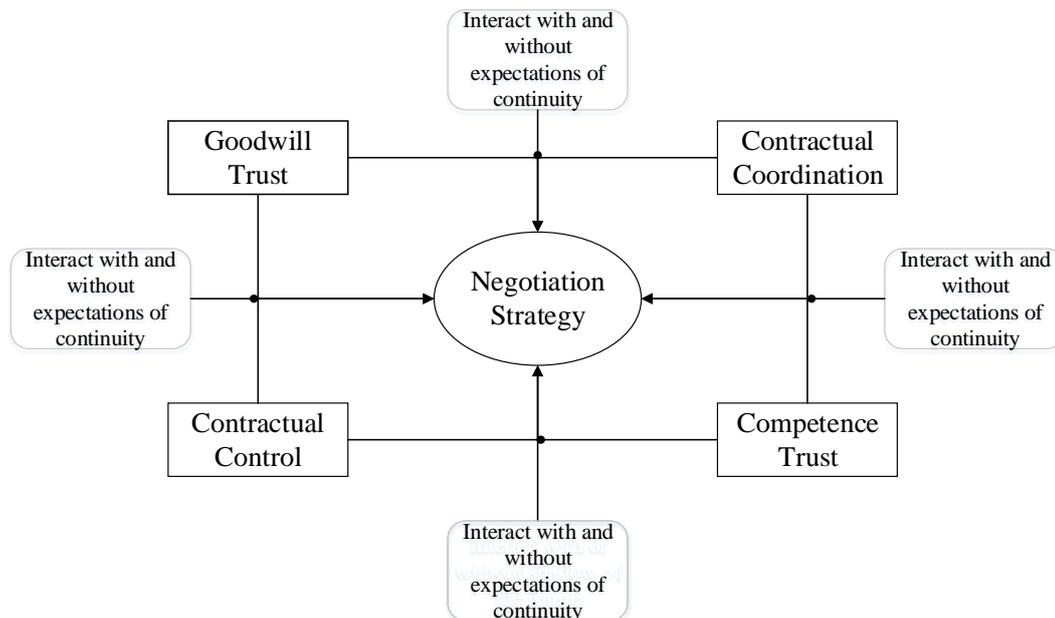


Figure 1: Theoretical Framework

The interaction between goodwill trust and contractual control governance

From the logic of game theory, an expectation of continuous interaction is crucial to promote perceptions of goodwill trust (Axelrod and Hamilton 1981). Based on a rational assessment of forward-looking conditions, it can be rewarding to behave cooperatively if parties trusted their partners. As the increase of confidence in its partner's goodwill to fulfil their responsibilities, more open information sharing and a closer cooperation will be adopted (Paulraj *et al.* 2008). Considering an example in which the level of one's goodwill trust in its partner is rather high, it will devote less time and resources in formulating and monitoring the contractual control. When

disputes arise, it will seek integrated solutions through better communication to enhance efficiency, rather than rely on the contractual control governance to safeguard short-term interest. Because relying on contractual control governance too much will do harm to the relationship, and the gains from cooperation and repeat business are higher than short-term gains (Poppo *et al.* 2008). Therefore, with expectations of continuity, more contractual control will weaken the positive effect of goodwill trust on the adoption of a cooperative negotiation strategy.

Although one's goodwill trust in its partner can facilitate a closer cooperation, one of the strongest incentives for parties to be honest is that he can obtain continuous patronage from his partner. If without expectations of continuity, the finite endpoint of exchange will loom large on the horizon. One's goodwill trust in its partner will be more likely to be exploited by its partner to seek for gains. As contractual control governance will impose a higher cost of declining or terminating the relationship, contractual control provisions as safeguards devices to give a credible commitment to parties (Helm and Kloyer, 2004), thus increase the effectiveness of goodwill trust in promoting better cooperation when disputes arise.

The interaction between goodwill trust and contractual coordination governance

When exchange partners have positive expectations of their continuous cooperation, it means that they can gain more from the forward-looking conditions. Considering the best financial interest, exchange partners tend to cooperate through many value-sharing behaviours, like sharing some key information and tacit knowledge, to increase the level of goodwill trust, and consequently, better cooperation and performance outcomes. The coordination aspect of contract aims to make explicit of both parties roles and goals, and can facilitate better communication and timely information sharing in case of contingencies (Mesquita and Brush 2008). Information sharing and communication have been shown to be critical in developing mutual understanding (Paulraj *et al.* 2008). With better mutual understanding, both the parties can align expectations and make great endeavours to search for integrative solutions. Both the partners can leverage flexible behaviours and efficient collaboration, for the coordination provisions provide how to make bilateral adjustments and communication flows (Lumineau and Henderson 2012). In this way, the goodwill are enhanced, and the relationship is strengthened.

Coordination provisions in a contract aim at structuring the means of efficient collaboration by providing formal procedures to promote cooperation (Lusch and Brown 1996), and maintain their relationship. Although contractual coordination is in line with the logic for reducing transaction costs, however, more contractual coordination means more time and resources devotion in coordination to reach a mutual-benefit solution when disputes arise. When general contractors and their subcontractors don't have prospect for future business, transaction costs involved in coordination may outweigh their one-shot gains, so more contractual coordination may have a negative influence on the adoption of a cooperative strategy other than a positive influence.

The interaction between competence trust and contractual control governance

If a general contractor and its subcontractors have the belief that they can cooperate repeatedly in the future, a competent partner means sufficient resources and abilities to fulfil its roles and performance outcomes, not only in the present construction project, but also in a series of projects subsequently. Also, the high level in competence in exchange partners may lead to an inferior position when disputes arise,

the potential vulnerability to opportunism can be countered by contractual control governance. In this sense, contractual control governance can make exchange partners perceive to be protected by the contract. Thus, the confidence in its partner is increased to some degree, ultimately leading to better cooperation (Lui and Ngo 2004).

The same logic can be applied to the situation when general contractors and subcontractors don't have expectations of continuity. Under this situation of one-shot transaction, exchange partners will rely more on contractual control governance to protect their own interest when disputes arise, as contractual control governance have the legal enforcement to safeguard interests of both parties (Lumineau and Henderson 2012). It can help to make up for the deficiency of exposure one's greater vulnerability to risks (Das and Teng 2001) and give the parties a sense of being protected by the contract, thus increase the confidence and will to better cooperation to some degree. Therefore, we propose that, without expectations of continuity, competence trust and contractual control will have a strengthened positive effect on the adoption of a cooperative negotiation strategy.

The interaction between competence trust and contractual coordination governance

One's competence trust in its partner will lead it to higher probability of potential vulnerability of opportunism (Lui and Ngo 2004). That's mainly because its partner is the expertise in its particular field, it may grasp more knowledge and key information. It will be easier for its partner to hide or deceive key information and knowledge. However, given expectations of future interaction, they will regard the competence trust as a signal of continuity patronage from their partners. Parties learn how to transact with each other in a more effective manner (Poppo *et al.* 2008). They expect to establish standard routines and procedures to facilitate adaptation to unexpected disputes. In this way, they can maximize the use of potential resources and competence of exchange partners and focus on mutual interests of both parties. Coordination provisions in contracts can facilitate better communication and timely information sharing in case of contingencies. Information sharing can positive effect the development of mutual understanding. Ultimately, one's sense of inequity in positions in transaction can be weakened, and they can perceive to be protected, hence better cooperation can be reached.

However, without the expectations of continuity, short-term gains would derail parties' will to better cooperation. The competence trust in its partner may be interpreted as higher probability of potential vulnerability of opportunism. As coordination provisions in a contract may be not so legally binding as control provisions (Woolthuis 2005), they are not easily verifiable or observable. This may leave the back door open to making such provisions to interpret and enforce. Considering the lack of long window of continuity, parties may be more easily to interpret the coordination provisions in their own favour and use this opportunity for self-gain. Thus, competence trust may weaken the positive effect of contractual coordination governance on the adoption of a cooperative negotiation strategy.

CONCLUSIONS

Scholars and practitioners in supply chain management have devoted much attention to using governance mechanisms to manage inter-organizational relationships. However, more attention should paid to the construction specific supply chain

management, especially the contractor-subcontractor relationships. For the reason that, the typical relationship between general contractors and subcontractors is potential adversarial and disputes are almost inevitable. The importance of using governance mechanisms manage contractor-subcontractor relationship should never be underestimated. Proper combination of different types of governance mechanisms can have a positive impact on cooperation behaviours, and thus improve performance outcomes.

By conducting a desk study on governance mechanisms in different context, we present a comprehensive understanding of the paradox of the interactions of contract and trust. We also analyse the research gap and the possible reasons for the inconsistent findings in current literature. After analysing the characteristics of the two governance mechanisms in the construction industry, we propose a theoretical framework of how and when different dimensions of contract and trust interact with each other to influence the development of negotiation strategy. This paper introduce the argument that both trust and contractual governance can be viewed as multi-dimensional constructs which are intertwined with each other to influence exchange partners' behaviours. We provide a conceptual base for how to use governance mechanisms to promote cooperation behaviours during dispute negotiations in the construction industry. The theoretical framework is what is needed so that further empirical research can verify the arguments, focus on each dimension of the constructs in more detail, and provide managerial implications for construction practitioners.

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