
RESEARCH ARTICLE

Contractual Learning to Bridge the Gap Between Contractual Needs and Capabilities

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ABSTRACT

The gap between contracting need and capability exists in collaborative relationships because the transactional parties are bounded rationally, especially when firms coming from emerging economics start to deal with international transactions. However, the existing literature reveals little concerning systematic investigations into how firms learn to overcome the dilemma between contracting need and capability in international contexts. We conducted an in-depth case study to explore how a Taiwanese firm needed to contract with foreign partners but lacked the capability to design contracts at the initial collaborative stage. The firm developed a contracting capability through cross-border learning mechanisms (i.e., social interaction, problem-solving, team, and partner selection) to incrementally accumulate contracting knowledge (i.e., tacit knowledge includes what partners' demand and how to design satisfactory contracts; explicit knowledge includes various contractual provisions). The findings provide implications for firms regarding how leverage contracts in their long-term international partnerships.

KEYWORDS

Contracting learning; Contracting capability; Contracting knowledge

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1. Introduction

Complex contracting is the most widely used formal mechanism in governing the inter-organizational arrangements such as strategic alliances and long-term or repeated transactions through which firms exchange, combine, and create knowledge, services, and products. Transaction parties craft and structure complex contracts and rely on legal rules, standards, and remedies implied in the law to coordinate and safeguard inter-firm transactions. However, it is well recognized that since transaction parties, subject to bounded rationality, are unable to write a complete contract facing uncertain and complex transaction contingencies, there may be important learning dynamics in a firm's ability to craft effective contract clauses especially in a transaction context where repeated exchanges and reciprocal interactions are common (Mayer and Argyres, 2004; Argyres and Mayer, 2007; Poppo and Zenger, 2002; Nysten-Haarala, Lee & Lehto, 2010).

The gap between the need to contract and the capability to contract is even larger for the firms from emerging economies. Along with their path of internationalization process, these firms use more complicated governance modes and contracts to manage their exchanges relationships with their foreign counterparts. As a result, for these inexperienced and unsophisticated firms from emerging economies, the gap between contracting need and contracting capability becomes larger. Contracting learning is therefore more important for the firms from emerging economies as a critical mechanism to close the gap between contracting need and contracting capability. A growing body of research discuss on how organizations learn to contract that impacts collaborative process and outcomes (e.g., Lui, 2009; Lumineau, Fréchet & Puthod, 2011; Ariño, Reuer, Mayer & Jané, 2013). Extending this research stream, this study, using the case study method, focuses on that how a firm from an emerging economy learns how to contract in the international transactions to prevent the associated transaction hazards and accumulate

knowledge that effectively reduce transaction partner's opportunistic behavior, coordinate joint activities, and enhance the performance of inter-organizational exchanges.

The paper proceeds as follows. We first discuss the literature on the long-term contracting and inter-organizational learning in alliance. Next, we present evidence to explore how a firm from emerging economy learns to design contract provisions and accumulate contracting knowledge to fulfill contracting need and enhance contracting capability. We conclude with further insights and implications for future research.

2. Literature Review

2.1 Transactional Cost Economics of Long-term Contracting

Transaction cost economics has been widely used to explain the alignment of various contract forms and inter-organizational exchanges with distinct transaction attributes (Williamson, 1979; Masten & Crocker, 1985; Joskow, 1987; Brousseau & Glachant, 2002; Reuer & Ariño, 2007). A long-term contract is regarded to be more efficient than market and quasi-integration governance when the idiosyncratic transaction-specific investment is engaged and the transactions between partners are recurrent (Williamson, 1979). Under such a contracting relationship, transaction parties want to arrange protected provisions, including exchange and commitment, contingency planning, and enforcement and safeguarding, to avoid transaction hazards and enhance coordination efficiency (Brousseau, 1995; Furlotti, 2007; Schepker, Oh, Martynov & Poppo, 2013). Farsighted parties want to design applicable provisions to achieve collaborative efficiency in the process of coordination, safeguarding, and adaptation. Empirical studies have explained that the contents of contract aligned with transactional attributes could better mitigate contractual hazards and enhance exchange performance (Arruñada, Garicano & Vázquez, 2001; Mayer & Argyres, 2004; Ryall & Sampson, 2006; Ariño & Reuer, 2006; Barthélemy & Quélin, 2006; Jong & Woolthuis, 2009; Din, Dekker & Groot, 2013).

A growing body of research tries to understand how parties learn to contract. Mayer & Argyres (2004) found that through repeated transactions, firms is equipped with a better ability to craft the main content of the contract, including mutual communication, clarify responsibilities and expectations, right planning, problem solving, quality assurance, and etc. In addition, this increased contracting capability can be regarded as two parties' knowledge base and the critical basis for further cooperation (Argyres & Mayer, 2007). Argyres, Bercovitz & Mayer (2007), analyzing 386 electronic information services contracts with the client computer manufacturers, finds that the contracting capability enables the focal firm to better interact with the particular customer in the context of tailor-made transaction environment and customer-specific demands. They therefore argue that contracting learning is partner-specific, and such learning would provoke the more comprehensive contract terms in contingency planning and task description. Vanneste and Puranam (2010) find that the formal contract can serve not only as a safeguarding mechanism but also a mutual-agreed framework of coordination behavior of the parties. They used 788 SMEs information technology procurement contracts from the Netherlands as samples, and found that firms with better technical expertise are abler to craft related technical provisions than otherwise. Vlaar (2008) regards contracting as the learning and cognizing process of formalization where parties perceive their roles and expectations. Despite this literature, few studies explore how parties leverage learning mechanisms to construct a long-term contract in a cross-border context.

2.2 Inter-organizational Learning in Alliances

Interorganizational learning refers to a firm's ability to value, assimilate, and utilize new external knowledge (Lane & Lubatkin, 1998). Through 'learning alliances' firms can speed up capability development and minimize uncertainties by exploiting knowledge development. In integrating knowledge, inter-firm alliances are generally superior to market contracts, but are generally inferior to individual firms (Grant & Baden-Fuller, 2004).

To achieve alliance through knowledge development, each party designs knowledge combination and integration mechanisms to access the party's knowledge (Kale, Singh & Perlmutter, 2000; Kale & Singh, 2007). These mechanisms include interpersonal interaction, team support, routine, and direction that depend on knowledge attributes such as tacit and explicit knowledge (Nooteboom, 2000). Through these knowledge mechanisms a party can understand their partners' purpose, intentions, demand and capabilities, as well as what they do not want to do. It is believed that cognitive distance can be reduced to mitigate misunderstandings among the parties and a clearer scope of the alliance will emerge from the interactive process (Grandori, 2001; Nooteboom, 2004). In addition, through learning mechanisms that shape common identity and norms, parties can perceive value in the future relationship. This motivates parties to develop ongoing collaboration (Kogut & Zander, 1996; Kale & Singh, 2007).

3. Methodology

This study is exploratory research. According to Eisendhart (1989) in case studies the first step is to initiate a study on the background of the problem at hand. This involves an extensive literature review. This will hopefully give the researcher a rough

direction towards defining the research questions and the required use of theoretical concepts. The Second step involves screening cases. For this research we have chosen to study overseas market brands of Taiwanese X companies that make contracts with local partner. The contractual relationship between Company X and different trading partnerships is the unit of analysis. The third step is the interview process, which is used to outline important theoretical concepts. The fourth step is to enter the field and design questions relevant to this study. We access Company X managers to interview them about the concept of a contract. Finally, we induct the interview information to construct theoretical ideas.

3.1 Research context and data collection

Company X markets one of Taiwan's leading tool brands and has over 30 years of experience.

Like other emerging economics, Taiwan’s manufacturing industry was highly specialized in the 1980s and emphasized export-orientation. Company X was successful in the export of their products. Company X’s president found that the quality of Taiwanese tools was better than other foreign brands, however the price was undervalued. He wanted to change this unequal transaction. In the 1990s, Company X participated in international exhibitions to search for international partners and develop brand-distribution contractual relationships. Now, its brand extends throughout 102 countries worldwide and has the advantage of wide distribution network sales. Company X has its head office in Taipei and has set up R & D centers in Taichung. It also has a branch in Shanghai. The total number of employees in the company is about 250 people. Company X offers professional-grade, industrial grade, and vehicle repair tools.

Company X invests resources in its brand, including product development, and the relationship between the dealer assets investment. Company X uses advanced precision machining equipment from Germany and Japan including precision pressure casting machines (Die Casting Machines), CNC machining tools (CNC Machining Equipment), heat treatment equipment (Heat Treatment Equipment), etc. The introduction of Japanese imports of project high-grade steel, used in important parts, including high strength, tough life needs has been essential. The company has also had to fully grasp the key technological processes involving product testing and validation procedures. The factory must constantly repeat testing and make real world tests which must adhere to requirements and meet design targets. Company X invests resources for distributors as well as advertising sponsors, team technical guidance, education and training.

To sum up, Company X invests huge resources in brand products and client relationships. The content of transactional relationships is reflected in the agency contracts.

We interviewed Company X managers. We asked them how they contract with other national distributors.. There were four interviews, each about 1.5 to 3 hours, covering distributors from Europe, the USA, South Africa, and China. The collaborative duration between Company X and their distributors is shown in Table 1.

Table 1. Company X- distributors

	Company X- U.S. distributor	Company X- Czech & Slovak Distributor	Company X- Russia Distributor	Company X- South Africa Distributor	Company X- Portugal & Spain Distributor	Company X- China Distributor
Collaborative duration (year)	14	14	11	9	7	2

4. Results and Discussion

4.1 Initial contracting: Social interaction develops the contractual concept

Company X learned how to design contractual structures from U.S. and Russian distributors at the initial international contracting stage.

4.1.1 Company X- U.S. distributor

Company X and its U.S. distributor have an asymmetrical relationship in the United States. The only opportunity to obtain customers’ trust is to let them try the products, this creates successful trading opportunities and the next trading volume increases. Company X’s president participated in the U.S. distributor’s social community to develop informal relationships. He started asking the distributor to try products after the distributor was familiar with him. Through long-term interaction Company X understood what U.S. distributor demanded and how much capacity of U.S. distributor had.

The president recalled the following:

"There is no contractual issue. As long as you dare to try, I am very glad. In the end, I said I only paid half of the purchase price, he said such a good deal. He tried the products, a good response, and began seriously to purchase. I learned in the U.S. market, and I should be here to pay tuition fees. He did not take the risk to try the goods. Because he has 2900 stores, he chose 50 or 300 of the stores to try. He chose the 50 most representative stores to try. Second, after a successful trial, there were 2900 stores. If you sell 5 tools in one store, how many in 2900 stores. In the third stage of the real amount of replenishment, replenishment was really large. I passed the second year, third year, with twelve managers. A lot of tough questions came from the experience in the United States and were extended to other countries. They asked the questions I wanted to learn."

Company X understood the idea of block-planning:

Company X developed a long-term relationship with its U.S. distributor. As a result, Company X developed a better understanding of the U.S. market. They also gained a signal market position due to sponsorship of the brand. Company X had confidence to negotiate with their U.S. distributor to divide the U.S. market into industrial and automotive blocks. The manager recalled the following:

"I also hope that he can extend the industrial-grade to the automotive block because then a country a distributor and I hope he will come forward to do this. But he did not do well in the automotive block from the sixth year until a few years ago. Before three years, I said that you should continue to do industrial grade, and I have to reorganize the automotive market. He certainly agreed, because I gave him thirteen years, and he did not do the automotive market. The channel is not the same, so he cannot do business. He uses the original team that is no way crosses the different block, so he could not do it. He knew there was no conflict, so he agreed to give the automotive block to me."

4.1.2 Company X-Russian Distributor

Through personal interaction the Russian distributor talked to company X's president about what his needs and concerns:

(1) The border provision

Company X did not know how to divide the border for the Russian distributor. The Russian distributor dominated the contracting process. The Russian distributor's agency area covered Russia and the Independent States of some other small countries. Company X's president recalled the following:

"We learned a lot from the Russian partner. When we signed the contract, we did not know which region it contained, and did not know how set his profit as well as the price, payment, and advertising strategies. These detail events were difficult for us. We agreed with what he said because we had no confidence to negotiate. We permitted his business territory to include Russia as well as three countries in the Baltic Sea area. After collaborating with him, we really entered Eastern Europe."

(2) Revenue setting provision

Company X and the Russian distributor designed revenue through the process step by step. Company X gradually fostered Russian distribution through repeated contracts so that at last their contracting goal achieved. Then they could advance to the next goal. The president recalled the following:

"The first three-year contract is designed by the population, income, as well as how much we want to grow each year. We all agreed that the next year would add 30% -50%. Such as one million years ago, the following year would be 1.3 million. We did not chase revenue in the beginning; the contract would be re-signed in the second and third renewed contracts. The most important questions would be discussed at that time."

(3) Incentive provision

Company X used the terms of support to cooperate with the Russian distributor in order to enhance its brand solidarity. This process also continued indirectly through differentiation from competitors to avoid causing the partner to generate moral hazard because of competition. The president recalled the following:

"Markets have become open and competitive. We could not prohibit who entered which country, especially under WTO policy. Distributors worried that they would lose customers. Why did we need to worry about competition? The Russian distributor had been in the first position of market share. Why does he worry?"

The best way was to ask them to hold regional distributors' meetings in the largest city in Russia. All distributors would come to share with others to tell customers the differences of brand X from other brands, as well as the advantages of brand X and its R&D

capabilities. We have our technical team produce new products every three or six months. In this way we strengthened loyalty and consumers approved of our brand. We had to do brand advertising and promotional activities, a variety of activities in our brand advertising sponsorship that has been written in the contract. Our differential competence has been emerging since we did these activities so that distributors and customers are more confident in brand X.

There were few people to do the racing sponsorship. We gave the Russian partner sponsorship every year because his revenue is growing continually. The terms of racing sponsorship were written in the contract. This was one means of strengthening the brand."

According to above interview data, we derived proposition 1:

Proposition 1: At the stage of initial contracting, social interaction helps to build an organization's contractual concept (how to plan contractual contents)

4.2 Applying formal contracts: Problem-solving learning to add contractual safeguarding function

Company X wanted to apply formal contracts in Europe, and they perceived that they needed to consolidate the contractual function after some problems occurred.

4.2.1 Company X-Czech & Slovak Distributor

Company X and the Slovakian distributor were complementary in branding knowledge and local channel knowledge. Company X needed representative agents for new markets, and the Slovakian distributor wanted to enhance its market position transitioning from cheap hardware products to higher-end products, so the two parties decided to collaborate. However, the Slovakian distributor sold the business to a French company. After this event, Company X increased the provision that distributors cannot be transferred in order to prevent similar problems. The manager recalled the following:

"The Slovakian company sold a relatively low-end hardware, after some time they wanted to upgrade, and to find Company X's brand. When they upgraded, they felt the need to upgrade to a more professional market or industrial level market. They must find a brand, so he found us.

This distributor agreed to let a French consortium of hardware stores to take them over through mergers and acquisitions. We learned from this experience to add a new provision to our contracts that before one of our distribution companies is sold they need to tell us."

4.2.2 Company X- Portugal & Spain Distributor

Company X entered Portugal. The first Portuguese distributor labeled their products as company X's brand but actually sold low-cost products that came from other companies. After this serious event, company X changed its distributor. Company X found a second distributor and this solved the problem. The second distributor had excellent capacity which allowed company X to feel this partner could be trusted and they could move forward with a collaborative plan. Company X's president recalled the collaborative plan with the second distributor:

(1) Transfer the experience of dividing borders

Company X applied its past experience in Russia and the Americas. The Spanish distributor also took responsibility for African and Portuguese possessions except Portugal. Company X learned that a more capable partner is able to cover more geographic market areas. The president recalled the following:

"I felt we had a strong team and we should give them a wider area. Otherwise, they would lose value, so I told the Portuguese partner that they could have the Spanish area. He was very grateful. He also received the Portuguese controlled areas in Africa such as Angola and Madagascar. These two Portuguese controlled areas really saved him, and they have been growing. The distributor became very stable, and he now puts the entire strength in Spain."

(2) Adding the terms of partner characteristics

Through its interactions with its Portuguese distributor, Company X learned about the importance of choosing the right partner. The conditions of partnership include having car dealership experience as well as having existing sales channels. Company X has codified these conditions into its contracts. The manager recalled the following:

"He had the experience in the automotive area such as airport buses that were very long and very low. Besides that, they were agents for Toyota for 25 years. So I just said, if he is not in the automotive field, it is un-useful, ever that we give him three years. Finding the right person is more important than training one. It is so simple and priceless!

Therefore, we require that distributors must have a car channel and an automotive operation team. You can save at least five to ten years. Otherwise, you need to take five to ten years to build the local channel."

According to the above interview data, we derived proposition 2:

Proposition 2: At the stage of applying formal contracts, the attitude of problem-solving learning helps to design contractual safeguards

4.3 Adjusting contracts: Team and appropriate partner interaction develop the contractual adaptation and coordination functions

At the contract adjustment stage, company X had the capability to know how to leverage partners' capacities as well as to know who could design a mutually acceptable contract in the local context.

4.3.1 Company X- South Africa Distributor

Company X's experience in South Africa in the beginning was quite strange. As a result, Company X did not coerce how much revenue to the local distributor. After a long time operating in South Africa, Company X has become familiar with the area. In addition, the African distributor has a new and strong team so that Company X could plan to coerce the South African distributor to achieve a specific level of revenue. Thus, revenue setting was flexible depending on the African distributor's internal conditions. The manager recalled the following:

"Because we did not really have experience in Africa, the South African partner got the agency areas including some countries near Africa except South Africa. He thought that we would agree with what they wanted. However, we gave them six or seven years, but they did not achieve their target revenue.

We learned by doing, and accumulated experience step by step. Following these stages, we asked the South African partner to sign revenue agreements based on every country. It depended on how much revenue they received in South Africa, Lesotho, or Nigeria."

4.3.2 Company X- China Distributor

Company X chose an appropriate partner so that local business practice could be adapted towards a collaborative relationship.

(1) Terms of after-sales service

Providing after-sales service is routine in the Chinese market, but this rule wastes product. Customers usually ask for a replacement which creates costly pressure for distributors and Company X. Company X selected a particular service to respond to this rule.

"It is an ugly rule. Their habit is replacement no matter what you say. The influence is that no one wants to contract with us. Finally, we chose some products and gave them a lifetime warranty. We also said that our products had a lifetime warranty."

(2) Cash payment

Company X took payments in cash to avoid bad debts.

"The sale conditions were such that if you ordered five hundred thousand goods, we would send you a car. After three months, the payment and goods were gone. We only received cash to avoid this problem."

According to above interview data, we derived proposition 3:

Proposition 3: At the contract adjustment stage, team and appropriate partner interactions facilitate contractual functions for coordination and adaptation

4.4 Creating contracting value: Knowledge sharing mechanisms transmit a signal of credible commitment

Company X organized distributors who spread around the world in global and local meetings to create interactive opportunities and share knowledge. Distributors began to develop interdependence and enhance their solidarity. In addition, Company X plans its training programs allowing distributors to come to Taiwan to understand the culture of the products home country. This signal for credible commitment creates a willingness among distributors to invest specific relational assets in the future.

(1) Creating global knowledge sharing: Global distributor meetings

The manager recalled the following:

"In our industry, there are few people to create a global meeting. The first difficulty is that every countries distributor wants you to commit to taking time to participate in the meetings. We provide value for them by allowing them to participate voluntarily.

The second difficulty is that if the distributors are not satisfied with your products or services, they may gossip or spread bad information to hurt your brand. Be careful and be confident before creating this kind of global meeting.

Meanwhile, we also have a harvest. First, we finally hear their positive ideas like the quality of marketing in their country, price, strategy, and the service of our team. This is very difficult after a long-time fighting.

Second, we get a better understanding of what we can expect from them as well as how responsible they are. Third, the brand X signal would be spread through this global meeting. Distributors who un-know X brand might consider joining us. Distributors who have been the agents for brand X want to accelerate their steps to develop their business boundaries."

(2) Creating local knowledge sharing: Local distributor meetings

"Why do we encourage local distributors to copy the global meeting? The South African meeting and our global meeting are almost the same. They arranged presenters who were the right people to give very persuasive speeches."

(3) Taiwanese Culture: Training program

"We have two or three education training programs. Various countries' distributors volunteer to learn. The import thing is to share Taiwanese culture including learning about products, teaching how to drink Taiwanese tea, and eating Taiwanese cuisine.

I teach them marketing strategy. We have such good products, but how do you get the word out. Even though they have their local experience, I have thirty years of experience in 102 countries. I share it with them."

According to above interview data, we derived proposition 4:

Proposition 4: At the contract value creation stage, distributors understand future contracting value through knowledge sharing mechanisms

Through various contracting stages company X has overcome the unknown to contracting and forward knowing how to leverage contracting in different countries. During this process, company X has learned how to contract with partners to solve transactional problems through diverse learning mechanisms and accumulated contracting tacit knowledge. Some parts of this contracting knowledge are also manifest in the contractual provisions. The findings are summarized in table 2.

Table 2. The summary of contractual learning

Learning parties & contents	Foreign distributors	Learning mechanisms	What company X learns (tacit contracting knowledge)	Contract provisions (explicit contracting knowledge)	Contracting focus
Initial	U.S.	Social interaction	What distributor's demand and capacity	block-planning	Concept: how to plan contract
	Russia	Inter-personal interaction	What distributor cares	border provision; Revenue setting provision; Incentive provision	
Apply	Czech & Slovak	problem-solving	What events need to be forbidden	Forbid to transfer ownership	Safeguards
	Portugal & Spain		Knowing how to select the right partners	Partner condition	
Adjust	South Africa	Team interaction	What can facilitate distributor's capacity	Flexible revenue setting	Coordination and adaptation
	China	Interact with appropriate partners	How to choose the right partners	Terms of after-sales service; cash payment	
Create contracting value	Company X develops knowledge sharing mechanisms (global and local meetings) to let distributors understand Company X's branding value and strengthen their willingness to maintain future ongoing relationships based on the past and present contractual stability and flexibility.				

5. Conclusion

This study explores how a Taiwanese firm from an emerging economic learned to contract and developed improved contracting capabilities. We interviewed the president of a Company X investigate how Company X and foreign distributors build long-term relationships. Contributions that have been drawn from this case are as follows: (1) learning mechanisms help to accumulate

contracting knowledge: Company X accumulated various contracting knowledge through diverse learning mechanisms in its relationships with different distributors. Tacit contracting knowledge let company X understand its partners' thoughts as well as how to design contracts. Explicit contracting knowledge shaped contract provisions. (2) Change of contractual functions: Company X understands how to leverage contracts at the different stages and across different countries. The need to develop safeguarding functions and to avoid cheating problems both occurred during the development of contracts in Europe. At the contract adjustment stage in Africa and China coordination and Adaption functions were designed while partners' capacity was enough to satisfy company X's demand. These contributions could provide firms that want to shift from an export mode of production to co-marketing and co-production collaboration mode.

Any future studies should go forward to explore the longitudinal cases for the distributors in the various countries involved in order to understand how provisions are emerging and changing. As well, the concepts of culture and institutions could be considered to enrich the contracting process.

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