

## **Trust and Contracting in Agri-Food Hybrid Structures**

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## Trust and Contracting in Agri-Food Hybrid Structures

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### Abstract

The paper aims at examining the hypothesis that the influence of trust on contract can be thought of as a dynamic factor of organizational choices in supply chains. The relationship between contract and trust is delineated on the basis of institutional environment, contractual incompleteness, safeguards and restrictive provisions. The interaction between individual and system elements in the formation of trust and its influence in hybrid contracting is considered. According to a New Institutional Economics approach and a theoretical framework is proposed. Empirical evidence is provided by a case study regarding an Italian retailer company establishing hybrid structure with its suppliers. Investments in suppliers selection provide the basis for trust supporting relationships which economize on negotiating and litigation costs.

**Keywords:** *hybrid structures, trust, contract*

JEL: Q13, D23

### 1. Introduction

The paper aims at examining the hypothesis that the influence of trust on contract can be thought of as a dynamic factor of organizational choices in supply chains. The focus is on Agri-Food chains: expanding on a previous analytical framework (Martino, Perugini, 2006), the study considers the contracting basis of hybrid forms and on the centrality of trust to the existence of hybrids structures (Hofstede, 2006).

Trust is a very complex concept addressed under different analytical views. Many definitions have been proposed and an enormous body of literature has progressively widened the comprehension of the role of trust in economic life and analysis. Research in Agri-Food sector have provided several findings contributing to the enhancement of the comprehension of consumers' behaviours and of innovative way of business to business relationship (Frits, 2006; Hofstede, 2006). It is difficult, or probably impossible, to summarize into an unique, shared perspective all the theoretical and empirical evidences. Anyway, scholars seem to interpret often trust in terms of rules of social interaction, thus, under a transactional cost perspective the trust issue can also be conceived in terms of the relationship between the institutional environment and the governance structures. It has been argued that trust can be included in the area of informal constraints and safeguards. This can be conceptualized in terms of the diffusion of rules from institutional environment to governance structures. This is the main view of the paper. The knowledge about this area is really not developed (Mènard, 2000), thus the analysis proposes several problematic steps and some conjectural outcomes.

Mènard and Valceschini (2005) show that the emergence hybrids characterizes the change of Agri-Food sector. According to Mènard (2004), *contracting* characterizes many hybrid forms, since the contract signed by participants is frequently a simple framework where more or less ample room is allowed to everyone.

The hypothesis that influence of trust on contracts represents a dynamic factor of supply chains' organizational choices in Agri-Food sector is examined both under a theoretical and empirical standpoint. The paper considers only the case of business to business relationships.

Firstly, some analytical elements are proposed which suggest that the substantive relationship between contract and trust can be delineated on the basis of institutional environment, contractual incompleteness, safeguards and restrictive provisions. Secondly, the interaction between individual and collective elements in the formation of trust and its influence in hybrid contracting is considered. Deakin *et Al.* (2001) have pointed out that compliance with terms of contracts is central to trust, but also that contract adherence is tempered by flexibility beyond and outside the contract. On the other hand, the institutional forces constraints and channel contractual behaviour opening options for cooperative behaviour.

The paper is organized as follows. The argument for the role of trust in hybrid contracting is illustrated in paragraph 2. Empirical findings are proposed in the paragraph 3. In the paragraph 4 are proposed some final remarks.

## 2. Hybrid forms and Trust

### 2.1 *The diffusion of hybrid structures in Agri-Food Sector*

Ménard and Valceschini (2005) have pointed out the diffusion of hybrid form in Agri-food sector suggesting that their emergence can be thought of as a consequence of three main forces: the evolution on the supply side, the evolution on demand side and the redefinition of quality control emphasizing the control both over process and products (Ménard, Valceschini, 2005, pp. 426-428). A complex public and private institutional framework support the organizational choice in this field (Ménard, Valceschini, 2005, pp. 433-435) involving the rules intended to support quality signals – as in the case of PDO supply and of private brand (Ryanad *et al.*, 2005) – as well as those set by retailers (Fulponi, 2006; Révion and Chappuis, 2005; Mazè, 2002; Sans *et al.*, 2005) or requested by food safety regulation and expectations (Martino, Perugini, 2006).

Ménard (2004) points out three fundamental regularities in hybrid structures: the tendency toward aggregation of resources (*pooling*), the contractual basis (*contracting*), and the tendency toward competition (*competing*). These regularities clarify to what extent hybrid forms are rooted in both cooperation and competition, their functionality depending on whether the mechanisms devised are able to reconcile legal autonomy and interdependence. Namely, *contracting* characterizes many hybrid forms, since the contract signed by participants is frequently a simple framework where more or less ample room is allowed to everyone. Thus a typical problem is then the need to identify the best mechanisms for optimizing alignment of transactions to the government structure by monitoring the organization and the search for solutions to emerging questions (Ménard, 2004).

## 2.2 *Trust and contracting: delineating a framework for analysing organizational choices in Agri-Food sector*

### 2.2.1 Conceptualizations of trust

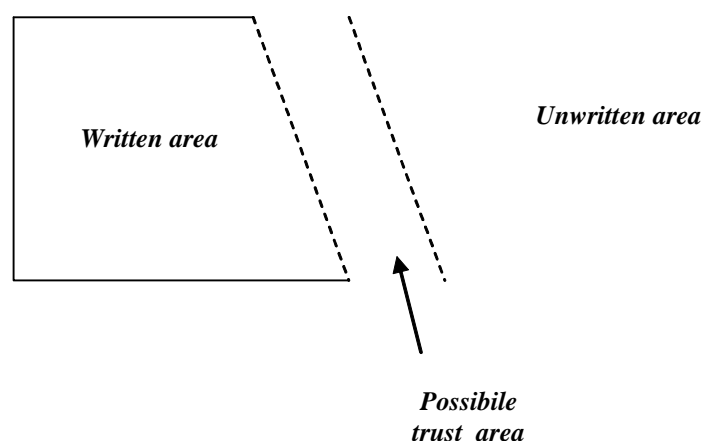
An interdisciplinary body of literature provides many definitions of trust which cannot be discussed here in detail<sup>1</sup>. Broadly speaking, definitions share basic elements, among them are: trust is related to intentional behaviors, relevant in the context of economic relationships; social norms and rules are often invoked as sources; the uncertainty about future events due to human behaviors is also pointed out. Some enhancements of the conceptualization of trust have been obtained by introducing classification of types of trust (for example, see for discussion: Lyons, Metha, 2001; Kelin Woolthuis *et Al.*, 2005, Adler, 2001). Furthermore, McEvily *et Al.* (2003) have suggested an interpretation of trust as a heuristic for how actors interpret and represent information and how they select appropriate behaviours and routines for coordinating actions (McEvily *et Al.*, 2003, p. 92). Adler (2001), emphasizes the nature of trust as a mechanism of coordinating, contributing to the comprehension of the complementarity between forms of interaction and coordinating. In this context, the relationship between trust and contract appears to be complex and, in particular, the causal nexus between trust and contract and the nature of their relationship – whether complementary or substitute – are questioned according to controversial evidence (Klein Woolthuis *et Al.*, 2005). In general, trust seems challenges the political economy view (Levi, 2000)<sup>2</sup>. Distrust – and even the lack of trust – raises the transaction costs of cooperation, while trust can play a role in reducing these transaction costs and provide a mean for moving out of an equilibrium of non-cooperation (Levi, 2000).

The paper aims at addressing the trust as a dynamic factor assuming that changes in the institutional environment promoted by trust enhancements will influence contracting in terms of calculativeness. In the New Institutional Economics the trust issue is linked to the assumption of opportunism. This implies, in turn, that both asset specificity and contractual incompleteness contribute to the definition of the analytical framework.

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1. For example Gambetta (2000, p.218) states that « (...) trust (or, symmetrically, distrust) is a particular level of the subjective probability with which an agent assess that another agent or group of agents will perform a particular action, both *before* he can monitor such action (or independently of his capacity ever to be able to monitor it) *and* in a context in which it affects *his own* action (...) Trust is a tentative and intrinsically fragile response to our ignorance (...) If we were blessed with an unlimited computational ability to map out all possible contingencies in enforceable contracts, trust would not be a problem». Under a sociological perspective, trust emerges within the differentiation of the social systems and appears to be a basic tool contributing to the reduction of the complexity (Luhmann, 2002, 2000)
  2. Emphasizing the role of bounded rationality, Lorenz examines the relationships between trust and cooperation. In this context, defines trust « (...) as the judgement one makes on the basis of one's past interactions with others that they will seek to act in ways that favour one's interests, rather than harm them, in circumstances that remain to be defined. Trusting judgements inevitably remain tentative, rather certain, since they are based on a limited knowledge of others rather a precise calculation of their interests. Correspondingly, there is nothing to preclude that trust will be transformed into mistrust as knowledge and information are accumulated» (Lorenz, 1999, p.305).

### 2.2.2 Contractual incompleteness and contract formalization

Scholars emphasize the relationship between trust and contractual incompleteness. According to Brousseau and Glachant (2002, pp. 12-13), in *Transaction Costs Economics* the contractual incompleteness is due to both uncertainty and institutional failures. Given that the bounded rationality of the agents and that clauses related to unverifiable variables cannot be enforced, the contract creates a “private order” allowing the parties to cooperate (Brousseau, Glachant, 2002). On the other hand, the formalization of the contract has been considered in order to analyze the role of trust (Chen, 2000; Lyons, Metha, 2001). Trust appears to be relevant for the interpretation of written words in the sense that, in case of trust, some interpretations accounting for expectations of opportunistic behaviours are reasonably excluded: it would be irrational to expect these results. The distinction between formal and informal contract refers often to the use of written words in supporting legally binding contractual terms. The “unwritten area” is relevant to the parties because of the outcomes of not ruled possible actions. The distinction between complete and incomplete contract refers to the fact that a contract cannot be completely verified by a third party in order to be enforced, even if the parties can observe all elements of the contract itself. Whether a third party is entitled to verify an unwritten term depends upon the law: for example, in some cases, the contractual law may allow the judge to implement an agreement. In this case, a judge may look for verifying elements left in the “unwritten area”. The parties could be costly engaged in reducing this area, expanding the set of formal contractual terms. Trust may expand the area between the “unwritten” and “written words”, introducing unwritten trusted elements and allowing the parties to save costs of negotiating (figure 1). The literature about trust in business to business relationship, for example, suggests that a party may allocate, at least, partially, her/his decision rights to the trustworthy trading partner. Whether or not the emerging “trust area” will reduce the degree of incompleteness it is a different story: it depends upon the fact that this “area” may (or may not) concern verifiable variables. Unwritten verifiable variables do not increase the degree of incompleteness of the contract, but could force the parties to a costly *ex post* negotiation. Unverifiable variables, written and unwritten, determine contractual incompleteness. Trusting a partner about unwritten, unverifiable variables does not reduce the degree of incompleteness of the contract. Rather it would facilitate the relationship, incompleteness becoming to some degree less effective.



**Figure 1.** A hypothetical relation between trust and contractual formalization

### 2.2.3 Trust as a weak hybrid form

In the analysis of hybrids trust is firstly conceptualized a *weak* form of governance. According to Mènard: « (...) private governments admit more or less formal embedded entities, possessing various amounts of power. At one end of spectrum, the closest to market arrangements, are *hybrid forms relying primarily on trust*. In these hybrids, decisions are decentralized, and loose coordination is implemented through mutual influence and reciprocity. From a *calculative perspective, trust can maintain cohesion and guarantee some coordination because it is rooted in the need to maintain continuity in the relationship*. We are not talking about a purely informal relationship here. Trust can operate a (weak) form of government because it is based on specific arrangements and performed by specific actors» (Mènard, 2004, p. 367, italics added). Under this view, trust is conceived as less a centralized hybrid structure.

But Transaction Costs Economics also considers trust under a more general view. Levi have pointed out that Williamson (1993) is right in criticizing the broad use of the term trust. The assumption of opportunism is central to the transaction cost economics, thus distrust or absence of trust represent the baseline of behaviour (Levi, 2000, p. 140)<sup>1</sup>. Under this hypothesis and drawing from a restricted body of literature, some elements can be delineated which suggest that: a) trust influences the contracting in hybrids; b) trust may act as a factor affecting the dynamic of organizational arrangements. These elements deal with:

- Institutional environment;
- Contractual incompleteness;
- Safeguards;
- Restrictive provisions.

These elements are illustrated in the following subsection.

### 2.2.4 Trust and contract

***Trust and institutional environment*** Transaction Costs Economics states that institutional environment influences the choice of governance structures. Mènard (2000) argues that there is a lack of analytical knowledge about how rules diffuse from this environment to governance structure. How institutional trust may affect a governance structure is thus primarily an analytical problem. As the institutional environment is characterized by some class of trust, the choices of governance form will differ with respect to the case of an environment characterized by distrust or absence of trust. This is a consequence of an exogenous influence (Williamson, 1993). On the other hand, agents are interested to increase the degree of flexibility of organizational arrangements, namely in order to deal with exogenous shocks (Williamson, 1996). *Thus changes in the terms of economic calculation and the demand for flexibility may affect the contracting basis of hybrids*. On the other hand, mechanisms for coordinating transactions, organizing transactions and solving disputes find their legitimacy and support in the institutional environment. *These mechanisms may be influenced by trust* (Furubotn, Richter, 2001; Akerlof, 1970), *thus institutional trust influence contracting*.

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1. Thus the analysis may elucidate when distrust is both the most rational and useful reaction and when trust or its functional alternative would be useful. Finally Levi states that: a) distrust raises the transaction costs of cooperation; b) trust can contribute to reduce these transaction costs and provide a means for moving out of an equilibrium of non-cooperation; c) trust is not always the solution to problems created by the absence of trust and distrust; d) both absence of trust and distrust may spur the creation of institution that facilitate gains from trade, although raising transaction costs (Levi, 2000, p. 151).

***Trust and contractual incompleteness*** It has been argued that where there is trust the terms of contract can be relatively incomplete and any bargaining less formalized than where there is distrust (Levi, 2000, pp. 142-143). *This is a consequence of the attenuation of probability of opportunistic behaviour. It implies that trust can directly influence the choice of the contract terms. To some extent thus trust facilitates the adherence to contracts obligations: in other words trust can be thought of as a tool for reducing the “unwritten words area”* (see section 2.2.2)

***Trust and safeguards*** In contracting approach, the typical content of hybrids derives from the combination of ways of coordinating partners. These mechanisms are (Ménards, 2004, pp. 361-363): a) decision regarding the number of participants to the agreement; b) duration; c) specification requirements; d) adaptation clauses; e) complementary safeguards. Safeguards can be formal or informal: « (...) this is where the issue of trust enters into the picture. Several authors see trust as a way to secure transaction when the contract are incomplete (...) Trust would alleviate opportunism and would be made operational through recurrent transaction (...) In that respect, it can be argued that trust is a form of calculativeness, (...) although it has been challenged» (Ménard, 2004, p. 364).

*Trust can affect the nature of informal safeguards* (Furubotn, Richter, 2001) *and thus alleviate opportunism.*

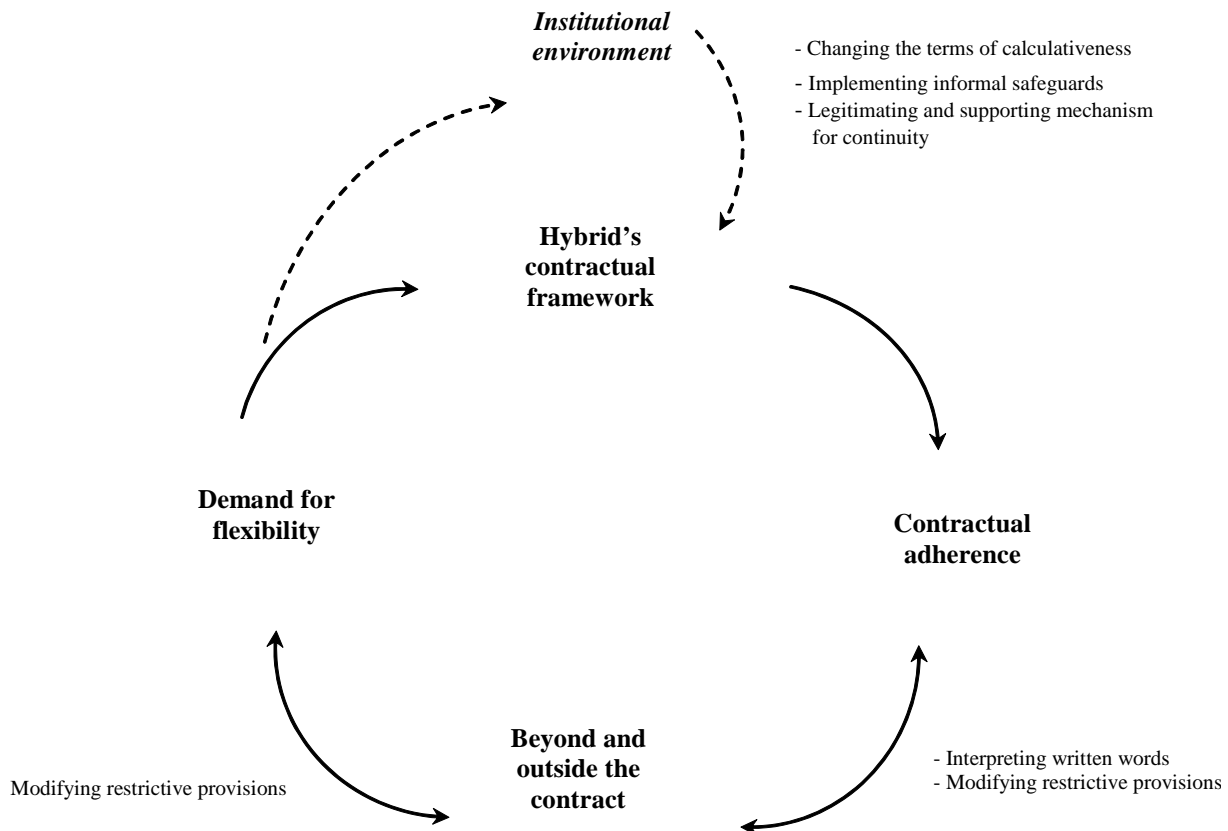
***Trust and restrictive provisions*** Hybrids require continuity, specific mechanism have to be created for coordinating activities, organizing transaction and solving disputes. Among these *restrictive provisions* delineate the domain of action of partners, limiting their autonomy and identifying areas in which collective decisions must prevail (Ménard, 2004, p. 365). To what extent they make individual and collective decisions compatible may depend upon how an individual relies on her/his partners. *Limiting her/his individual autonomy a party connects it interest to the allocation of decision rights to the other party. This is related to the economic calculation but it also implies that the party allowed will operate according to the understanding of the agreement. To some extent, this may imply trust as a belief that inform on how to act* (Levi, 2000, p. 139).

### 2.2.5 System and individual level

It has been argued that the complex nature of business relationships implies both elements of immediate self-interest and of mutuality and reciprocity the expected benefits from which are enhanced by trust Deakin *et al.* (2001, p.110). The mix of competition and co-operation characterizing hybrids thus implies a relationships between self-interest and mutuality and reciprocity. Co-operating parties adopt a distinctive attitude of flexibility with regard to contractual performance which in turn implies a relationship between contract adherence and flexibility (Deakin *et al.* 2001, 130). According to Williamson (1991), flexibility is a relevant factor contributing to the emergence of hybrid structures in Agri-Food sector (Martino, Perugini, 2006). Contract adherence and demand for flexibility characterizes the dimension of the relationship which is relevant for individual agents (*individual level*).

On the other hand, the contractual environment constraints but also channels the contractual behaviour opening options for cooperative behaviour (Deakin *et al.*, 2001, p. 133). Thus at *system level* the contracting framework established by hybrid take into consideration the flexibility *beyond the contract* (being ready to exchange business information; honouring informal understandings; and being ready to renegotiate the terms of contract at any time, Deakin *et al.*, 2001, p. 129) and the flexibility *outside contract* (being ready to help in an emergency, being prepared

to give and take, and being willing to overlook occasional faults, Deakin *et al.*, 2001, p. 129). The more effective are the institutional forces in increasing information flows, and reducing the element of conflict, monitoring and risk, the greater will be the potential within individual relationships for trust-building (Deakin *et al.*, 2001, p. 110). At system level hybrid organizations thus may enhance the trust level of individual relationships influencing the information flows and promoting conflicts resolution. The analytical elements identified and described above can be allocated in the conceptual “space” defined by the individual and system dimensions (Figure 2). The resulting framework aims at illustrating the change promoted by trust in hybrid contracting basis. Given the contractual framework, contract adherence essentially concerns the individual parties. Interpreting the written words and modifying restriction provisions contribute to establish the threshold between the contractual contents and the “beyond and outside area”. Similarly the modification of restricted provisions may affect the emerging demand for flexibility which in turn tends to influence the definition of contractual framework. The dot line indicate the relationship between the micro level and the institutional environment. North (1990) explained the processes supporting the interaction between organization and institutions: the influence of institutional trust on the level of governance choices can be conceptualized according to this analytical basis.

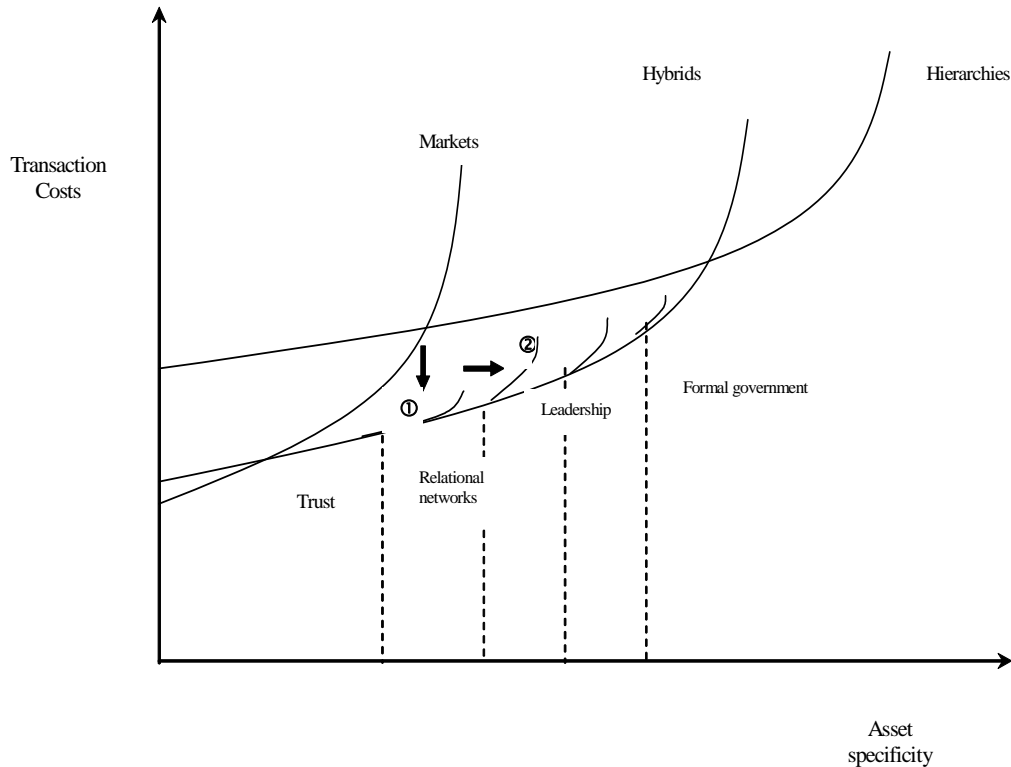


**Figure 2.** *Institutional environment and Hybrid's contractual framework*

The analysis proposed suggests that at a given level of asset specificity the diffusion of trust-oriented beliefs and behaviours may favour the emergence of *trust* type hybrids: in the figure 3, this is represented by the step n.1. An intensification of formalization of rules and conventions changes the nature of hybrid from *trust* to *relational networks* (Ménard, 2004): as the asset specificity increases, the form of governance tends to a more intensive centralization. This trends has been clearly identified and discussed (Ménard, Valceschini, 2005). The step n.2 proposes a



further change toward *Leaderships* forms, which is a consequence of the emerging of authority established by a firm over the remaining partners. The range of assets specificity compatible with relational networks may be increased, whether trust-based rules really became able to attenuate



**Figure 3.** *Trust and changes in the choices of hybrid structures*

### 3. Empirical findings: the Case Study *Grandi Magazzini Fioroni (GMF)*

Some empirical evidences are proposed in order to corroborate the theoretical framework delineated. The demand for flexibility can be studied by considering change promoted by the quality signals (Raynaud *et al.*, 2005), the relationship between agents along supply chain (Fearne, 1998) and the evolution stimulated by consumers' preferences (Fearne *et al.*, 2001). Secondly, a case study research conducted in a previous research step (Martino, Perugini, 2006) and concerning Coop Italia, an Italian large company operating in the distribution stage, proposes some interesting elements concerning the demand for flexibility and the related change in the organization of its supply chains. The quest for enhancements in safety and quality of brand products has implied the emergence of a hybrid organization (Martino, Perugini, 2006). Some degrees of freedom for the suppliers have been then introduced in order to mobilize their competences in solving problems eventually emerging: trust has to be considered the factor promoting the change of the hybrid organization. Namely, in many supply chains managed by Coop the degree of asset specificity has implied more centralized form of governance, based on buyer's authority. Nonetheless, a comparable degree of asset specificity appear to compatible with a more decentralized form, allowing the suppliers to operate with more degree of freedom. This is a direct consequence of experienced relationships and consequent trust (see: Martino, Perugini, 2006, for details about the source of data).

Evidences from the GMF case study are then proposed in order to examine the relationship between the contract and the trust in the case of less complex hybrid structure.

### 3.2 The GMF Case Study

From the methodological point of view, according to the usual approach in agri-food sector (Sterns *et al.*, 1998), a set of *research questions* has been preliminarily specified. The literature about trust provides a large amount of theoretical issues and interpretations of empirical findings: they provide the basis for research questions of this paper. The main questions here concern: a) the main role and the content of contracts adopted by Agri-food companies, involved in hybrid arrangement; b) the perceived role of trust within the contracting approach. The generalization method is the *analytical generalization* in which a previous developed theory is used as a template for comparing the empirical evidence from case study (Yin, 1994, p.31) and in which results are generalized to theory.

*Theoretical propositions* have been then composed and structured in order to define a prediction pattern. As regards this paper, the basic theory from which the predicted pattern of nonequivalent variables (Yin, 1994) is derived, is the framework of TCE and of the economics of hybrid forms (Ménard, 2004). The theory predicts that contracting framework provide by a hybrid organization stimulate contractual adherence which, in turn, may require some degree of flexibility. Thus the trust-based rules of interaction among agents, derived from institutional environment, may imply change in the contracting framework. Therefore the predicted pattern includes: a) general characteristics of hybrid forms chosen; b) nexus between contract and flexibility; c) role of the institutional environment. The matching between the predicted and the empirical patterns would provide a control of the theory proposed.

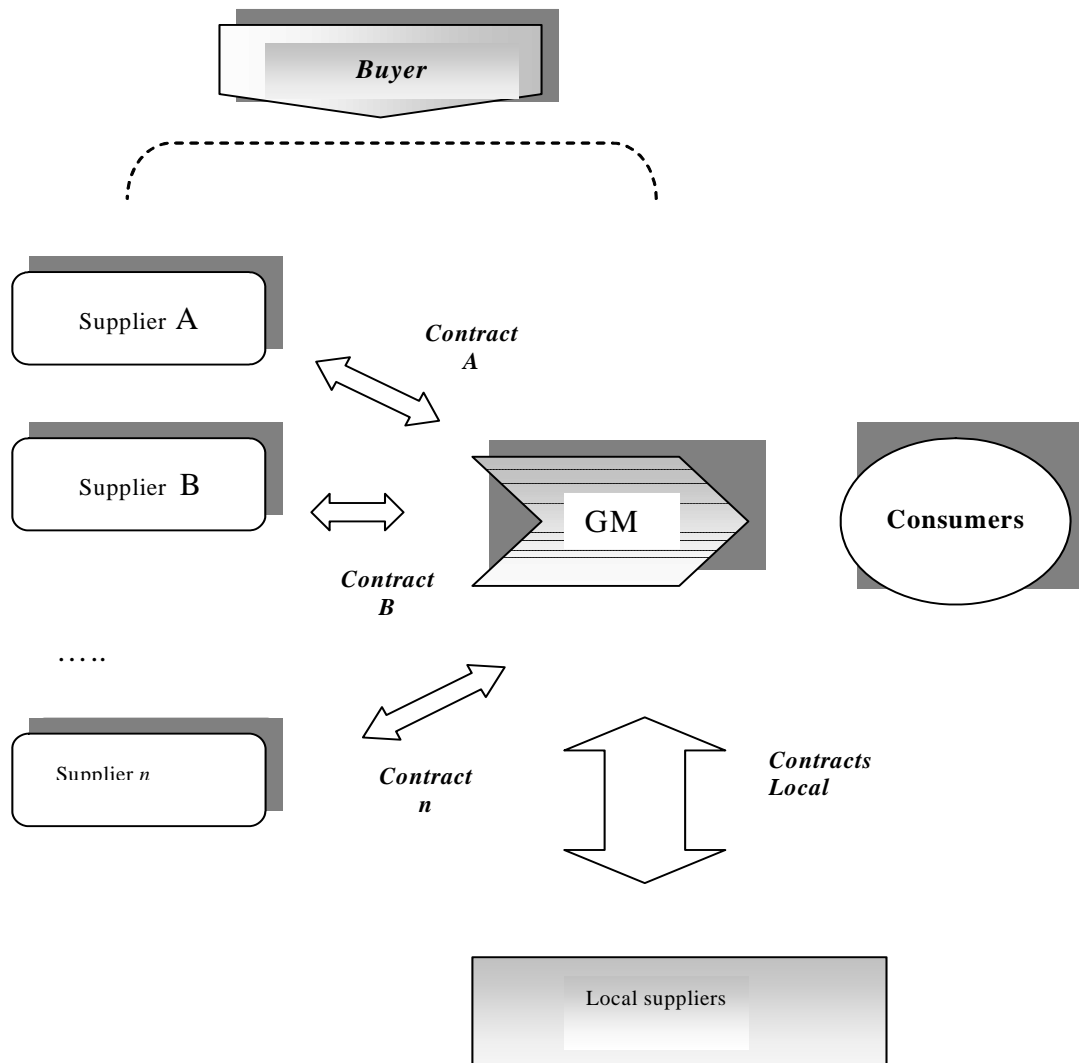
Given the limited knowledge of the process of diffusion of rules from institutional environment to governance structures (Ménard, 2000), the economics of hybrid form (Ménard, 2004) provides the analytical framework *to link empirical data to theoretical propositions*. *Criteria for interpreting the findings* are derived from the usual business study approach and from the general proposition emphasizing the interaction between individual and system level (Deakin *et al.*, 2001).

The *case study design* includes a single unit of analysis and aims at examining the relations along the supply chains as they are shaped by the *GMF* strategies. The case study has been carried out through different activities of data collection. The sources of the data used are: a) *documents*: internal reports, administrative documents and newspaper articles; b) *interviews*: focused repeated interviews. In order to enhance the information validity, data triangulation among different sources has been performed.

The following sections briefly summarizes the interviews reports and the other collected data. The GMF is a 50 years old company involved in several distribution activity in Central Italy.

It employs 900 workers and clerks and manages 230 units involving 100.000 m<sup>2</sup> (two Distribution Centers; eight Cash and Carry; 9 Ipermarkets; 29 supermarkets and several discount centers). The company is involved both in food and no-food distribution activities. The distinctive organization of the supply chain is illustrated in Figure 4. The GMF design general contract with large food companies (*national level*) settling a network relationships with these supplier. The centralization of this contracting stage allow the GMS (and the other firms forming the “central buyer company”) to economize about the contracting costs. The need for flexibility – both for supplier (specific marketing policies) and for the GMF (specific consumers’ requests) – induces

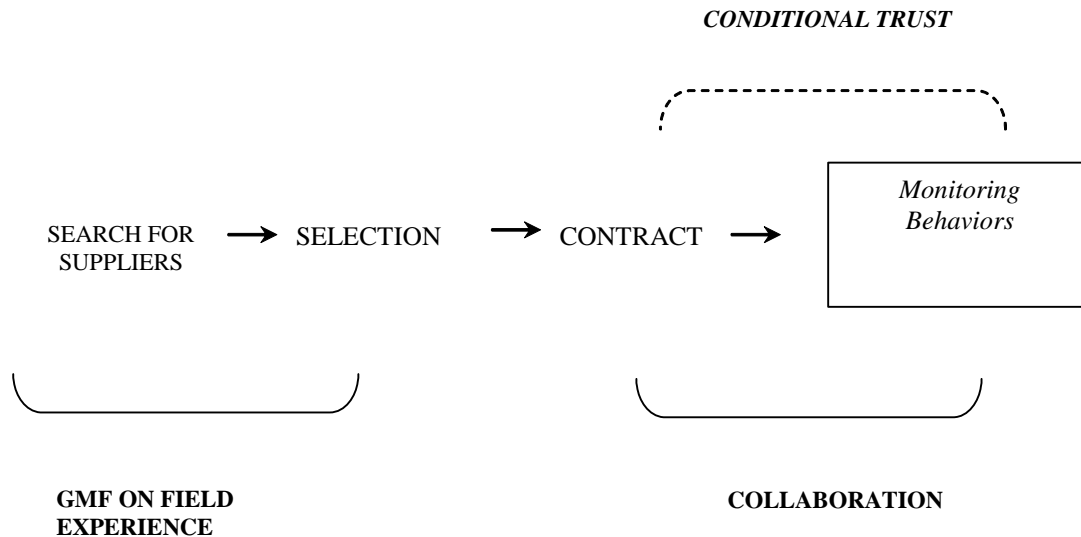
the trading parties to admit a second level of contracting (*local level*) which has to be compatible with the national level.



**Figure 4.** The contractual networks of GMF

The role of institutional environment is strictly due to the Italian contract law, while a structured contractual environment emerges and influences the relationships along supply chains. With respect to the single transaction between the GMF and a supplier the framework provided at national level allows a degree of flexibility which may be managed by transactors. This defines the boundaries of the area which may be interpreted as “beyond and outside the contract”. The relationship between trust and contract emerging in the case study is illustrated in the figure 5. The experience of the managerial staff of GMF is central to the development of the economic relationships among the GMF and the supplier. The use of the distinctive knowledge and experience of the company represents a feature of the entrepreneurial model adopted. Having selected a supplier, e.g. a local supplier, according to the quality strategy, the contractual relationship is firstly a consequence of investment in searching and selecting potential suppliers. Secondly, the company prefers *simple written contract* and has not never had the necessity of solving a commercial conflict by legal judgements. The low number of contractual terms (price, quantity, basic qualitative characteristics) reflects the reciprocal trust of the parties, established by a long

term relationship. Trust is also at the basis of the possibility of solving potential conflicts without any legal judgement. Here becomes also clear the ability of parties of interpreting trust in the sense of economic calculativeness: the long term relationship allow them to look for cooperative solution to potential conflict, avoiding the costs of legal judgements. Since the company verifies the behaviours of each supplier, but also allocate to the supplier some decision rights – given the little “written area” – then the type of trust at stake could be defined as a “conditional trust”.



**Figure 5:** Experience, Collaboration and Trust in GMF

This case shows that contract adherence and the “beyond and outside” area are linked (see previous section), with the interpretation of written words and the definition of restrictive provision influencing this link. A critical point is provided by the evidence about the joint management of market crisis. Depending to extent of these crisis, the parties vary their behaviors. When the demand for a given product decreases, the GMF is allowed, beyond the contract, to manage the market at his best, while some critical contractual terms could be also jointly revised or differently managed by the parties. This is the crucial case of the price fixed by contract, which may be revised (i.e. decreased) due to market crisis, as both the GMF and the supplier prefer to share the economic losses in order to maintain the market link. A temporary loss is thus preferred to a the loss of a market share: this reflects the abilities of the parties to make reciprocal trust as an element of economic utility.

#### 4. Final remarks

Hybrids forms are increasingly diffuses in Agri-Food supply chains, thus their contracting basis can be investigated under different views. The paper has taken into consideration the relationship between trust and contract. The analysis suggests that trust can be thought of as dynamic factor in the organization choice, namely in the interaction between the hybrid and the institutional level. A preliminary empirical evidence seems provide some elements in order to corroborate the theoretical views proposed.

The research strategy needed to enhance the outcomes has to include: a) a more detailed inquiry about the theoretical elements: the role of analytical elements mentioned should be, for example, better discussed; b) the empirical set of data has to be enlarged, in particular relying on the opportunities provided by case study research.

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