

Opportunism in Interfirm Relationships: Forms, Outcomes, and Solutions

Much of the recent literature on interfirm relationships has focused on strategies for controlling opportunism. Somewhat surprisingly, little attention has been paid in this literature to the opportunism construct itself. Specifically, prior research has failed to recognize the different types of behavior that are hidden behind the general opportunism label. As a consequence, the knowledge of strategies for managing opportunism remains incomplete. The authors review the original and emergent conceptualizations of opportunism and illustrate them using actual industry cases. The authors also develop a conceptual framework of governance strategies that can be used to manage different forms of opportunism.

Transaction cost analysis (e.g., Williamson 1985, 1996) has provided the foundation for many recent studies on interfirm relationships and relationship management issues (e.g., Anderson and Weitz 1992; Dwyer and Oh 1987; Heide and John 1992; John 1984). The focus of much of this research has been how the risk of opportunism between exchange partners creates trading difficulties. Although recent reviews (e.g., Rindfleisch and Heide 1997) demonstrate the appeal of the transaction cost approach, the notion of opportunism is controversial. Researchers in both organization theory (e.g., Donaldson 1990; Ghoshal and Moran 1996) and marketing (e.g., Johanson and Mattsson 1987) have expressed their concerns. These concerns pertain both to whether opportunism is a correct descriptor of human behavior and to the implications of the opportunism concept for theory and practice.

In our opinion, Maitland, Bryson, and Van de Ven's (1985, p. 64) observation that "opportunism neither is ubiquitous nor is it very unusual" represents the most useful analytic perspective. Even a casual review of the marketing literature identifies behaviors that seem to qualify for the opportunism label. These include falsification of expense reports (Phillips 1982), breach of distribution contracts (Dutta, Bergen, and John 1994), bait-and-switch tactics (Wilkie, Mela, and Gundlach 1998), quality shirking (Hadfield 1990), and violation of promotion agreements (Murry and Heide 1998).

The occurrence of opportunistic behavior has important practical implications. If the risk of opportunism in a partic-

ular relationship is sufficiently high, considerable resources must be spent on control and monitoring, resources that could have been deployed more productively for other purposes. In addition, the risk of opportunism may produce substantial opportunity costs in the form of "valuable deals that won't be done" (Calfee and Rubin 1993, p. 164).

Although prior research and reviews have discussed the general concept of opportunism, the complexity of the phenomenon has not been fully explored. Three particular issues are noteworthy in this respect. First, Rindfleisch and Heide's (1997) review shows that relatively few studies have measured opportunism.¹ Although this is consistent with the early transaction cost theory's view of opportunism as a fixed or exogenous condition, other research has suggested that opportunism is more appropriately viewed as a variable to be explained (e.g., Anderson 1988; John 1984).

Second, unresolved questions pertain to the conceptual definition of the opportunism construct. In the original theory (e.g., Williamson 1975), opportunism tended to be viewed as a violation of an explicit contract. More recently, the original "strong form" view of opportunism has been augmented to include violations of so-called relational contracts. Under such contracts, the parties augment formal contracts with specific contracting norms (e.g., Macneil 1980). Although several authors explicitly discuss opportunism within the context of such contracts (e.g., Gibbons 1999; Williamson 1996), the extant literature provides limited guidance regarding (1) the specific manifestations of opportunism under relational contracting and (2) the relationship between the original and emergent theoretical perspectives.

Third, the concept of opportunism, as currently used in the literature, includes a broad range of potentially different behaviors. For example, opportunism in the form of quality shirking means that a party is withholding efforts, or *passively* failing to honor an agreement. In contrast, breaching

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¹For exceptions, see Anderson (1988), Brown, Dev, and Lee (2000), Dwyer and Oh (1987), Gundlach, Achrol, and Mentzer (1995), and John (1984).

a distribution contract by selling in an unauthorized territory involves an *active* effort. To the extent that the opportunism construct itself is poorly understood, its potential outcomes remain ambiguous. Also, if nuances among forms of opportunism are unclear, deploying strategies for suppressing opportunistic behavior becomes problematic. On that note, there is evidence suggesting that some of the mechanisms that are often identified as potential solutions to the opportunism problem may undermine an exchange relationship (John 1984; Murry and Heide 1998; Reve and Stern 1986).

This article is organized as follows: First, we review and synthesize existing theoretical perspectives on opportunism. Throughout the discussion, we present actual industry cases that have been described by researchers as involving opportunism of various kinds. Second, we develop a conceptual framework of strategies for managing opportunism. As we show, although the extant literature has identified a range of possible strategies, they have not always been linked with particular forms of opportunism. Moreover, the criteria for selecting strategies have not been made explicit. Regarding

the latter, we identify first-order effects within a particular relationship and second-order effects across relationships. We also draw on the emerging literature on self-enforcing agreements (e.g., Dutta, Bergen, and John 1994) to explore the trade-offs between (1) attempting to suppress opportunism entirely and (2) purposely tolerating some nonzero level of opportunistic behavior.

Theoretical Perspectives on Opportunism

In this section, we explore how opportunism has been conceptualized in the extant literature. We start by reviewing Williamson's (1975) original definition, which involves "blatant" opportunism. Next, we discuss lawful opportunism (Williamson 1991a) within the context of relational contracts. We close by developing a conceptual framework that details (1) the specific forms opportunism may take and (2) their outcomes. In Table 1, we summarize the industry cases we reference throughout the section.

TABLE 1
Examples of Industry Cases Involving Opportunism

Authors and Source	Situation
Phillips (1982), <i>Journal of Marketing Research</i>	Manufacturer–salespeople relationships: Salespeople exaggerating expenditure reports.
Dutta, Bergen, and John (1994), <i>Marketing Science</i>	Manufacturer–reseller relationships: Resellers violating explicit resale agreements.
Wilkie, Mela, and Gundlach (1998), <i>Marketing Science</i>	Suppliers providing an alluring but insincere offer to sell a product or service they do not intend or want to sell.
Murry and Heide (1998), <i>Journal of Marketing</i>	Manufacturer–retailer relationships: Retailers receiving a priori allowances for displaying promotional materials without following through on the original agreement.
Walton (1997), <i>Fortune</i>	Buyer–supplier relationship: Lear Corp. deliberately misrepresented its true skills and resources to Ford.
Kelly and Kerwin (1992), <i>BusinessWeek</i>	Buyer–supplier relationship: López exaggerated the bids from rival suppliers to obtain lower bids.
Hadfield (1990), <i>Stanford Law Review</i>	Franchising relationships: Franchisees failed to follow the system's established quality procedures.
Besanko, Dranove, and Shanley (1996), <i>The Economics of Strategy</i> ; Barrett (1992), <i>BusinessWeek</i>	Franchising relationship: Taco Bell violated the relationship with its franchisees by introducing the Taco Bell Express concept.
Klein (1996), <i>Economic Inquiry</i>	Buyer–supplier relationship: Fisher exploited a cost-plus arrangement with GM by modifying its internal manufacturing process.
Muris, Scheffman, and Spiller (1992), <i>Journal of Economics and Management Strategy</i>	Distribution relationships: Independent bottlers refused to adapt and/or extracted concessions from suppliers.
Swedlow and colleagues (1992), <i>The New England Journal of Medicine</i>	Self-referring physicians ordered unnecessary magnetic resonance imaging scans for patients.
<i>The Economist</i> (1996)	Physicians prescribed excessive quantities of expensive drugs to patients.
Patterson (1992), <i>The Wall Street Journal</i>	Sears's mechanics prescribed and charged for repair services and parts that far exceeded customers' actual requirements.

Blatant Opportunism: The Strong Form Assumption

In the original transaction cost literature, opportunism is defined in general terms as “self-interest seeking with guile” (Williamson 1975, p. 6). What sets opportunism apart from the standard economic assumption of self-interest-seeking behavior is the notion of guile. In his subsequent work, Williamson (1985, p. 47) describes guile as “lying, stealing, cheating, and calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse.” In practical terms, this characterization allows for the possibility that human beings are only “weakly moral” (Douglas 1990) and cannot be counted on to honor contracts or fixed rules of interaction (John 1984; Williamson 1993).

The previous conceptualization has been described as “blatant” or “strong form” opportunism (Masten 1988). As suggested by Williamson’s (1985) discussion, this form of opportunism may manifest itself through both (1) deliberate misrepresentation of various kinds during relationship initiation (i.e., *ex ante*) and (2) various forms of violations over the course of the relationship (i.e., *ex post*).

Consider first opportunism at the relationship initiation stage. The following summary describes the interaction between Ford and Lear Corporation:

In creating the 1996 version of Ford Taurus, Ford Corporation tried to change its prior purchasing practices. Rather than playing the suppliers off against each other with constant rounds of bidding, Ford wanted to form long-term relationships with a few suppliers. One key element in the new car model was the seats. In the case of the new Taurus, Ford decided to outsource the whole process to one single supplier, Lear Corporation. As it turned out, in promising to design and manufacture seats for two sedans, a station wagon, and a high-performance model, Lear deliberately committed to a contract they knew they would not be able to fulfill. Among other problems, Lear had a severe shortage of engineering talent, as a result of having hired “green college graduates who barely knew a bolster from a bezel.” According to Ford, Lear missed deadlines, failed to meet weight and price objectives, and furnished parts that did not work. (Walton 1997)

From a theoretical standpoint, Lear’s failure to disclose its “true attributes” (Williamson 1996) illustrates a particular form of opportunism, namely, the problem of adverse selection (Akerlof 1970). Ultimately, Ford incurred substantial transaction costs, in the form of both (1) direct management costs and (2) opportunity costs due to delivery and quality problems in the downstream market.

Conceptually, the previous example may be viewed as passive opportunism, in the sense that one party to the exchange (i.e., Lear) purposely *withheld* critical information (Kreps 1990) about the lack of engineering talent and other characteristics. Opportunism may also manifest itself actively at this stage, to the extent that a party deliberately lies or “misrepresents material facts” (Shell 1991, p. 238). The so-called López Saga contains evidence of this:

During his nine month control of General Motors’ [GM’s] purchasing department, Jose Ignacio López de Arriortua, in an attempt to slash \$4 billion from the carmaker’s parts bill, was accused of employing a range of questionable strategies. Among other things, suppliers alleged that

López exaggerated rivals’ bids to compel them to bid lower still. (Kelly and Kerwin 1992)

By misrepresenting rivals’ bids, López deliberately misguided GM’s suppliers. Conceptually, this represents an example of active opportunism, in contrast with the Lear example, in which information was (passively) withheld. In essence, these situations represent opportunism by commission and omission, respectively.

Blatant opportunism may also manifest itself in the form of shirking or evasion of obligations in the ongoing relationship. For example, retailers frequently enter into contracts and receive allowances for displaying promotional materials without following through (Murry and Heide 1998). Similarly, franchisees sometimes fail to purchase the required supplies or follow the franchising system’s established quality procedures (Hadfield 1990). These examples, which are manifestations of the so-called moral hazard problem, all involve passive opportunism, in the sense that one of the parties to the exchange is purposely withholding effort (Griesinger 1990; Masten 1988; Rousseau 1995) or somehow refraining from performing agreed-on actions (Goetz and Scott 1981).²

Opportunism in the ongoing relationship may also be active in nature. Interfirm relationships are frequently governed by contracts that forbid certain actions (Al-Najjar 1995; Muris 1981). For example, distribution contracts often prohibit resellers from selling in particular geographical areas or from calling on certain customers (Stern, El-Ansary, and Coughlan 1998). Similarly, dealers are sometimes contractually prohibited from carrying competing product lines in a particular category, that is, so-called exclusive dealing contracts (Heide, Dutta, and Bergen 1998).

Considerable evidence suggests that violations of distribution restrictions are quite common (Cespedes, Corey, and Rangan 1988; Dutta, Bergen, and John 1994). Using our present terminology, such violations constitute active opportunism, in the sense that expressly forbidden acts are committed. Unlike the previous examples of passive opportunism, which involved evasion or withholding of various kinds, this form of opportunism involves active breach (Rousseau 1995).

Lawful Opportunism Under Relational Contracting

The defining feature of blatant opportunism, besides a lack of adherence to general norms such as truthfulness, is the failure to honor a contract. More specifically, the notion of guile, according to Williamson’s (1975) original definition,

²We exclude from the opportunism category situations in which (1) the parties jointly agree to modify an agreement or (2) one party receives compensation in some form (i.e., Masten’s [1988] “efficient breach” concept). We also exclude situations in which parties adjust contract terms *ex ante* in anticipation of shirking. For example, Muris (1981) discusses how a manufacturer can manage suppliers’ quality cheating by decreasing payments by a magnitude of the cost of the cheating. If cheating occurs under such a scenario, it takes place within the limits of the contract and does not constitute a violation. Finally, we distinguish between opportunism and situations in which parties have misunderstandings (Muris 1981) or honest disagreements (Alchian and Woodward 1988) about a contract or subsequent performance.

suggests that explicit contracts may be violated either actively or passively.

Research suggests that formal contracts often play a relatively limited role in interfirm relationships (e.g., Macaulay 1963). Even if a contract exists in a particular relationship, it is often augmented by a variety of norms and informal agreements (e.g., Hart and Moore 1999; Heide and John 1992; Wilson 1980). For example, Palay (1984) describes how rail freight relationships are governed by unwritten rules for volume and equipment use. Baker, Gibbons, and Murphy (1997) note how service standards and pricing practices are established in a similar fashion. Furthermore, purchasing relationships are often governed by contracts of finite duration, yet the buyers and suppliers in question may consider the relationship “evergreen” and firmly expect to renew the contract upon expiration (Heide and John 1995).³

All of these are examples of so-called relational contracts (Macneil 1978). Such contracts, which are sometimes described as “social contracts” (John 1984; Macneil 1980), are often incomplete in a formal sense. These contracts have been described as “frameworks” (Llewellyn 1931) rather than complete governance devices in their own right. Nevertheless, legal scholars have argued that relational contracts should be relied on by the legal system. For example, Hadfield (1990, p. 930) argues that “the courts should determine the likelihood that the contracting parties *themselves* implicitly or explicitly relied on the relational norms to supply the commitments they could not reduce to written form.”

As noted previously, transaction cost theory and related literature have extended the original notion of opportunism to the domain of relational contracts (e.g., Muris 1981; Williamson 1979, 1985, 1991). Williamson (1991a) has used the term “lawful opportunism” to describe violations that do not pertain to a formal contract. Unfortunately, however, the precise meaning of the opportunism concept itself under a relational contracting scenario has not been stated clearly. Macneil (1981, p. 1023) suggests that a necessary starting point is a delineation of the term “guile,” which he defines as “taking advantage of opportunities with little regard for principles or consequences.” However, a full definition requires “principles and consequences” to be defined. Different branches of literature have somewhat divergent perspectives on this: Economists often place greater emphasis on consequences (or outcomes), whereas legal scholars focus more on the principles themselves.

Consider first the economics perspective. Typically, a lack of contractual detail enables a party to exploit loopholes either passively, by evading informally stated obligations, or actively, by engaging in behaviors that unilaterally improve the party’s terms of trade. Regarding the former, a franchisee can (passively) take advantage of a lack of for-

mality in a franchisor’s contract to maintain poor store standards or produce poor-quality food (Rubin 1990). Given that such shirking produces immediate cost savings to the franchisee, it is not an uncommon phenomenon (Hadfield 1990).

As an example of active opportunism, consider the so-called holdup problem that arises when one party in a relationship invests in specific assets. As noted by Klein, Crawford, and Alchian (1978), such assets are associated with a stream of “quasi rents,” which can be expropriated by the other party. Consider the following example, which involves the relationship between Taco Bell and its franchisees:

Taco Bell franchisees make significant investments in relationship-specific capital, which give rise to quasi rents. These rents make them vulnerable to franchisor opportunism, as was evidenced by Taco Bell’s decision in the late 1980s to increase its market presence through the introduction of Taco Bell Express: small concession stands that offered a limited menu of its food (Barrett 1992). Not surprisingly, existing Taco Bell franchisees strongly opposed this strategy, fearing that new outlets would cut into their business (Besanko, Dranove, and Shanley 1996). In their analysis of the Taco Bell case, Besanko, Dranove, and Shanley (1996) note that the decision to expand market coverage in this fashion redistributed profits from the franchisees to the franchisor. However, because of their investments in specific capital, the franchisees were locked in with Taco Bell, and their next best opportunity was less attractive than continuing to run a Taco Bell franchise.

How can Taco Bell’s actions be considered opportunistic? Some economists define quasi rent appropriation *itself* as opportunism (e.g., Besanko, Dranove, and Shanley 1996; Rubin 1990). Typically, their rationale is based on economic efficiency criteria. For example, designing contracts that specify in advance all possibilities for expropriation involves substantial drafting costs. In addition, bargaining over quasi rents is itself costly and, if anticipated, may motivate the parties to underinvest in productive assets. For example, Helper and Levine (1992) and Bakos and Brynjolfsson (1993) note that parties that expect high negotiation costs may opt for inefficient arm’s-length relationships.

In our opinion, although such arguments describe (economic) consequences, consistent with Macneil’s (1991) definition of guile, it is not clear whether opportunism can be defined strictly on the basis of efficiency-related outcomes. It is noteworthy, however, that some authors have gone further and implied that taking advantage of a lock-in condition may *itself* violate a principle, namely, the exploitation of another party’s vulnerability (Barney 1996; Sabel 1993). Conceptually, a lock-in situation transforms the interaction between two parties from an analytical baseline of unconstrained bargaining or bilateral voluntary exchange (Graham and Peirce 1989) to a command structure (Macaulay 1985), within which one party lacks the ability to retaliate.

In Macneil’s (1981) terminology, the principles that are violated under the previous scenario could be broad bargaining norms (Thibaut 1968), general norms of equity (Homans 1961; Rabin 1993), or distributive justice (Hackett 1994; Kumar, Scheer, and Steenkamp 1995; Messick and Cook 1983). We note, however, that though exploiting vulnerability may be inconsistent with certain general norms, it need not constitute opportunism within a particular relation-

³There are interesting parallels here to the literature on organizational structure and the distinction between formal and informal relations (e.g., Gibbons 1998). As shown by Pennings (1973), there is limited convergence between archival measures of an organization’s formal or designed structure and perceptual measures of the realized one.

ship. In our opinion, taking advantage of a lock-in situation would not be opportunistic unless it violated an existing norm of not doing so. According to Macneil (1981, p. 1024), classifying a given action as opportunistic requires an assessment of whether it was “contrary to the principles of the relation in which it occurs.” Otherwise, a given behavior, even if it takes place under conditions of unequal bargaining power, could be a matter of conventional self-interest seeking.

Consistent with this definition, Macneil (1978, 1980, 1981) has identified several specific contracting norms. Among the most central relational norms are (1) the expectation of sharing benefits and burdens and (2) restraints on unilateral use of power. Briefly, the norm of sharing implies that costs as well as benefits will be divided between the parties rather than assigned or shifted to any particular one. The norm of power restraint imposes limits on the parties’ value-seeking behavior. For in-depth discussions of these and other norms, see Dwyer, Schurr, and Oh (1987), Kaufmann (1987), and Kaufmann and Stern (1988). In summary, according to Macneil (1981), opportunism under relational contracting means that particular relationship-specific contracting norms are being violated. For a given behavior to qualify for the opportunism label, there must be a norm in place, in the sense that the parties share expectations regarding subsequent behavior (Heide and John 1992).

Consider again the Taco Bell case. Given the novelty of the Taco Bell Express concept, there was no explicit contract that prohibited the franchisor from introducing it. In the long run, depending on the concept’s promotional effects, it could also be argued that the concept might expand the “size of the pie” (Jap 1999). At the same time, it was inconsistent with the parties’ initial expectations, as was evidenced by the franchisees’ willingness to invest in specific assets.

The Fischer–GM relationship, which has received considerable attention in the literature, involves a similar scenario. In their extensive analysis of that relationship, Klein (1996) and Klein and Murphy (1997) describe how the two parties jointly crafted an agreement (based on a combination of exclusivity and cost-plus provisions), whose primary objectives were to ensure ongoing sharing and prevent one party from disproportionate rent acquisition. As it turned out, Fisher abided by the letter of the agreement. However, it subsequently modified its internal manufacturing processes in such a way that it made substantial, and unintended, profits at GM’s expense because of the cost-plus arrangement. As Klein’s analyses show, Fisher’s action violated the norm of the relationship and is therefore categorized as opportunistic in the extant literature (Milgrom and Roberts 1990; Williamson 1996).

In the preceding discussion, we suggested how an existing relational contract could be opportunistically exploited. So far, however, we have limited our discussion to violations of contracting norms under the original trading conditions (i.e., without exogenous changes of any kind).

According to Macneil (1978) and Williamson (1991a), relational contracts may also address new circumstances. Specifically, as events unfold in the parties’ exchange envi-

ronment, there may be a need to update the original relationship. Under relational contracting, the updating process is governed by a norm of flexibility (Macneil 1980; Noordewier, John, and Nevin 1990). The upshot of a norm of flexibility is the shared expectation that the parties will adapt to changing circumstances.⁴

As previously, there is a risk that a contracting norm may be opportunistically violated. As an example, consider the relationship between the U.S. soft drink manufacturers and their independent bottlers:

Changes in the external environment and the resulting changes in the strategies of Coca-Cola and Pepsi-Cola raised the costs of contracting between them and their independent bottlers. Throughout the 1980’s, in particular during the so-called “Cola Wars,” there was a need for rapidly changing strategies, in the form of new product introductions, packaging, promotional deals, advertising content, and pricing. A failure to make strategy changes would create a considerable competitive disadvantage. However, many independent bottlers not only refused to participate in the various programs, but opportunistically extracted “special concessions” in exchange for participation.⁵ Ultimately, both Coca-Cola and Pepsi-Cola moved away from distribution through independent bottlers, and towards captive systems. (Muris, Scheffman, and Spiller 1992)

This example highlights two different types of opportunism. First, a refusal to adapt to changing circumstances could be viewed as another manifestation of passive opportunism. Anderson and Weitz (1986) discuss how parties may act opportunistically by showing inflexibility or unwillingness to adapt to new circumstances. Similarly, Williamson (1979, p. 240) argues that opportunism may involve “relying on the letter of the contract when the spirit of the exchange is emasculated.” He further argues that “When the ‘lawful’ gains to be had by insistence upon literal enforcement exceed the discounted value of continuing the exchange relationship, defection from the spirit of the contract can be anticipated” (Williamson 1991a, p. 273).

Second, new circumstances can also be exploited actively. Rather than refuse to adapt per se, a party may use the new circumstances to extract concessions from the other (Masten 1988; Muris 1981). Williamson (1985) discusses the use of so-called contrived cancellation strategies, which are designed to force renegotiation and improve the terms of trade at the partner’s expense.

Forms of Opportunism and Outcomes

The preceding discussion identifies two general categories of opportunistic behaviors, namely, active and passive. As the terms imply, opportunism may occur when a party either

⁴Norms of flexibility may be informal in nature or expressed in a contract (Ghosh and John 1999). The contract need not specify the actual changes but rather (1) the procedure by which adaptations are to be made, such as a price adjustment clause (e.g., Crocker and Reynolds 1993; Stinchcombe 1985) and/or (2) the expectation that the outcome of the relevant adaptations should not produce inequalities (e.g., Goldberg 1985; Joskow 1985).

⁵Notice that the opportunistic party in this case is the reseller, in contrast with the Taco Bell example, in which the supplier engaged in opportunism. As these examples show, opportunism is not limited to any particular party or position in the supply chain.

engages in or refrains from particular actions. As we describe subsequently, the specific manifestations of active and passive opportunism depend on whether a particular behavior (or lack thereof) takes place within existing exchange circumstances or whether the original circumstances have changed as a result of exogenous events.

In Figure 1, we show how active and passive opportunism manifest themselves under existing and new circumstances, respectively.⁶ We also sketch out the possible effects of the different forms of opportunism on relationship outcomes. We rely here on Kaufmann's (1987) and Ghosh and John's (1999) idea that a relationship should be analyzed from the dual perspectives of (1) creating joint value (i.e., total gains) and (2) claiming a share of it (i.e., wealth distribution). In principle, any form of opportunistic behavior has the potential to both restrict value creation and cause redistribution. However, depending on the specific form of

⁶Recall from our previous discussion that opportunism may manifest itself both at the relationship initiation stage (i.e., through misrepresentation efforts ex ante) and over time (i.e., ex post). The primary focus of Figure 1 is on ex post opportunism.

opportunistic behavior, the *manner* in which wealth creation and distribution is affected will differ. In part, this is because of the mechanisms through which outcomes are created (i.e., costs or revenues).

Consider first passive opportunism. Under existing circumstances (Cell 1 in Figure 1), passive opportunism takes the form of shirking, or evasion of obligations. The franchising example used previously, in which a franchisee fails to comply with a franchisor's quality standard, illustrates this scenario. From the franchisee's standpoint, quality shirking produces an immediate benefit in the form of a cost saving. In the long term, to the extent that the shirking creates customer dissatisfaction, the revenues of both the franchisor and other franchisees (i.e., other parts of the system) may also be adversely affected (Klein 1980; Muris 1981). As such, opportunistic evasion may influence both wealth distribution and creation.

Passive opportunism under new circumstances takes the form of inflexibility, or refusal to adapt (Cell 2 in Figure 1). In this case, the direct (i.e., out-of-pocket) cost effect of the opportunistic behavior is likely to be minimal. However, it is possible that the opportunistic party will experience a revenue gain in the short term. In Williamson's (1991a, p. 273)

FIGURE 1
Forms of Opportunism and Possible Outcomes

		Circumstances	
		Existing	New
Behavior	Passive	<p>1</p> <p style="text-align: center;">Evasion ↓</p> <p>Cost effect: Decrease for O (short-term), increase for E (long-term)</p> <p>Revenue effect: Decrease for E, S (long-term)</p>	<p>2</p> <p style="text-align: center;">Refusal to adapt ↓</p> <p>Cost effect: Minimal</p> <p>Revenue effect: Increase for O (short-term), decrease for E and O (long-term, forgone revenues due to maladaptation)</p>
	Active	<p>3</p> <p style="text-align: center;">Violation ↓</p> <p>Cost effect: Increase for E (long-term)</p> <p>Revenue effect: Increase for O (short-term), decrease for E, S (long-term)</p>	<p>4</p> <p style="text-align: center;">Forced renegotiation ↓</p> <p>Cost effect: Increase for E (haggling, concessions)</p> <p>Revenue effect: Increase for O (short-term, from concessions), decrease for E and O (long-term, forgone revenues due to maladaptation)</p>

O = Party engaging in opportunistic behavior; E = Exchange partner; S = System (e.g., other parties).

terminology, there may be “lawful gains to be had by insistence on literal enforcement.” In the long term, to the extent that one party’s inflexibility prevents the relationship from being modified to reflect new circumstances, there may be a different revenue effect in the form of forgone revenues from appropriate adaptation. For example, to the extent that Coca-Cola was unable to restructure its bottler agreements under new market conditions, the system may have found itself at a competitive disadvantage. Thus, overall wealth creation may be impeded, which hurts all of the parties to the exchange.

Active opportunism under existing circumstances (violation, Cell 3 in Figure 1) means that one party is engaging in behaviors that were explicitly or implicitly prohibited. The previous example of distributor violation of customer or territory restrictions falls into this category. This form of opportunism may increase the victim’s direct costs. For example, a manufacturer that is concerned about opportunistic violations of distribution restrictions may need to invest in systematic and costly monitoring efforts. From a revenue standpoint, the opportunistic party’s gains from territory violation come at the expense of other distributors, whose revenue streams are reduced. In addition, these distributors’ service provision may be subject to free-riding as a result of the violation (Dutta, Heide, and Bergen 1999). Ultimately, the manufacturer’s revenues may suffer as well, to the extent that other distributors reduce their support of the focal brand.

Cell 4 in Figure 1 (forced renegotiation) shows active opportunism under new circumstances. In this situation, one party uses the new circumstances to extract concessions from the other, as in the case of the relationships between Coca-Cola and its bottlers. The most apparent outcome of this form of opportunism is a redistribution of wealth in the magnitude of the concessions in question. However, there are also cost and revenue effects that are more subtle in nature. The process of extracting concessions may impose direct haggling and bargaining costs on the other party (Ghosh and John 1999). According to Williamson (1991a, p. 278), strategic behavior under such circumstances gives rise to “bargaining which is itself costly.” Furthermore, to the extent that appropriate changes in strategy are not made, perhaps as a result of concerns about immediate haggling costs, a revenue effect in the form of blocked wealth gains is also possible. As such, opportunism may give rise to opportunity costs (Masten 1993; Williamson 1996). As noted by Williamson (1991a, p. 279), “The main costs, however, are that transactions are maladapted to the environment.” In the long run, a failure to adapt may limit both parties’ potential gains.

In summary, the different forms of opportunism are capable of producing different outcomes. Ultimately, both wealth creation and distribution may be affected. However, the mechanisms through which these outcomes are produced may differ radically.

Managing Opportunism: Selecting Governance Strategies

As noted in the previous sections, the nuances among different forms of opportunism have not been fully developed

in prior research. At the same time, several strategies have been identified that appear capable in principle of solving opportunism problems. The emphasis in the early transaction cost literature was on the use of monitoring efforts and incentive structures. Indeed, the rationale for vertical integration as a governance strategy rests on the ability to control opportunism through monitoring and incentive schemes (Williamson 1975).

The subsequent transaction cost literature has demonstrated how the monitoring and incentive properties of organizational hierarchies can be crafted in relationships between independent firms (Lal 1990; Telser 1980). The emerging literature has also augmented the early work by suggesting that opportunism can be managed through selection and socialization efforts (Ouchi 1980; Stump and Heide 1996).

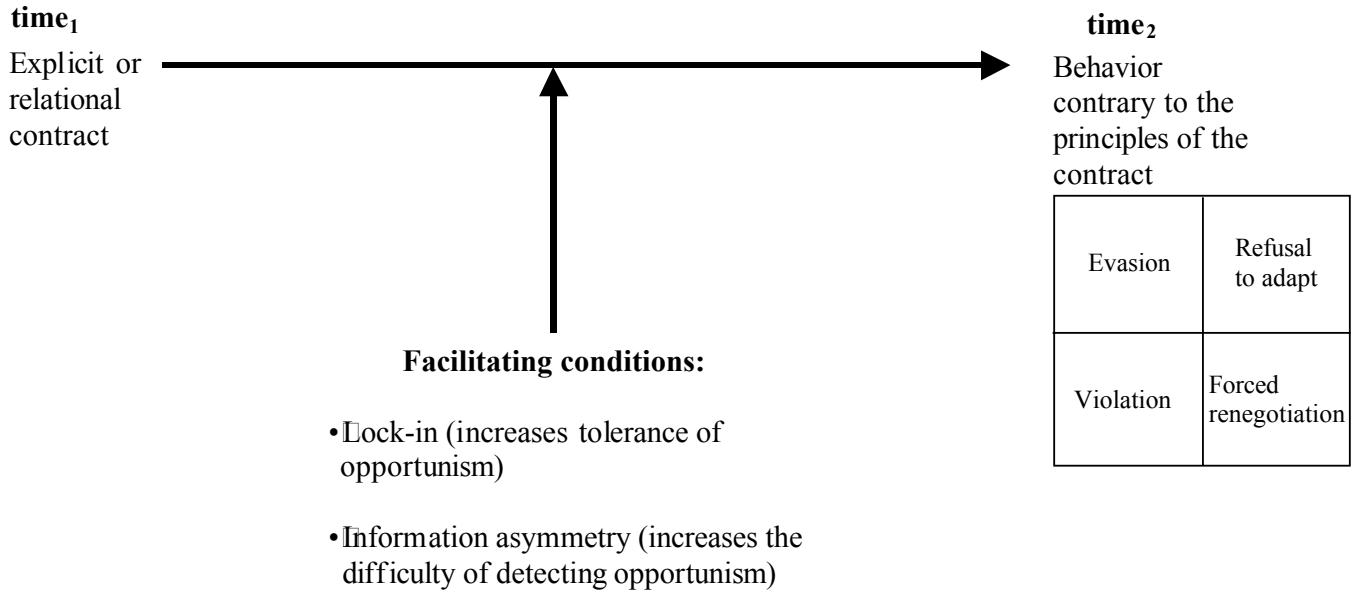
Although prior research has contributed substantially to the understanding of how opportunism can be managed, some key questions remain unanswered. Perhaps most important, the properties of each particular strategy with respect to specific forms of opportunism have not been systematically explored. Our general argument, which is presented subsequently, is that the different governance mechanisms that have been suggested in prior literature possess inherent benefits as well as prerequisites, which must be evaluated with respect to particular manifestations of opportunism. Each mechanism also has the capacity to produce second-order effects beyond controlling opportunism within a particular relationship.

Before discussing each mechanism and its relationship with the different forms of opportunism presented previously, we consider as a starting point how opportunism may occur in the first place. Figure 2, in which we also summarize much of our previous discussion, illustrates this. In general, opportunism means that behaviors are observed that are inconsistent with some prior contract or agreement (i.e., explicit or relational). These behaviors, which can take any of the four forms shown in Figure 1, are displayed on the right-hand side of Figure 2. Hypothetically, these behaviors are seen as taking place at time₂, whereas the original contract was established at time₁.

As noted by Masten (1988), opportunistic behaviors can take place under any circumstances. However, certain conditions facilitate opportunism. Recall from our previous discussion that some authors have linked opportunism to various forms of vulnerability (e.g., Barney 1996). Specifically, we alluded to two different forms of vulnerability—namely, (1) information asymmetry regarding a party’s attributes or actions and (2) a lock-in condition. In general, information asymmetry means that one party’s ability to detect opportunism is limited (Kirmani and Rao 2000). In turn, this gives the exchange partner the opportunity to pursue opportunistic actions without being caught. Lock-in, in contrast, represents vulnerability because a party cannot leave a given relationship without incurring economic losses. As a consequence, a lock-in situation may require a party to tolerate opportunistic behavior. However, information asymmetry need not be an issue.

The specific nature of the vulnerability that exists in a given situation has important implications for how opportunism can be managed. Consider again the different forms of opportunism shown in Figure 1 and the possible vulnerability scenarios that may be involved. The evasion scenario

FIGURE 2
The Emergence of Opportunism



in Cell 1 can occur under two conditions. First, one party may lack the information to detect the evasion or shirking that is taking place. Second, even with full information, a party that is locked in may need to tolerate opportunism. Cell 3 raises a comparable scenario. A distributor can violate resale restrictions if the manufacturer’s detection ability is limited. Alternatively, under conditions of lock-in, the manufacturer may have to tolerate opportunistic violations. Cells 2 and 4, which involve opportunism in the forms of refusals to adapt and the extraction of concessions, raise different problems. Here, the problem generally would not be information based. Rather, the primary source of vulnerability is a lock-in condition.

In the next sections, we discuss how monitoring, incentives, selection, and socialization can be used to manage different forms of opportunism. As we explain subsequently, each strategy’s effectiveness rests, in part, on how the underlying sources of vulnerability are managed. For example, the main purpose of monitoring is to reduce vulnerability in the form of information asymmetry. Indirectly, lower levels of information asymmetry may discourage opportunism in the first place. Notice, however, that monitoring may be ill-suited to managing opportunism if the source of the vulnerability is not information related (e.g., lock-in). Such scenarios may require strategies that directly reduce the likelihood that opportunistic behaviors are (actively) pursued or efforts (passively) withheld in the first place. We discuss each mechanism subsequently, starting with monitoring. We summarize our discussion in Table 2.

Monitoring

General purpose. To the extent that information asymmetry exists in a relationship, it is possible for a party to act opportunistically without being detected. Monitoring of either a partner’s behavior or its outcomes (Celly and Fra-

zier 1996) can overcome this problem. Theoretically, there are two different reasons that monitoring may reduce opportunism. First, from a behavioral perspective, the monitoring process itself may place uncomfortable social pressure on a party and thereby increase compliance (Blau and Scott 1962; Murry and Heide 1998). Second, from an economic perspective, monitoring increases the ability to detect opportunism and ultimately the ability to match rewards and sanctions to the partner’s behavior in an appropriate fashion.

Prerequisites and effects on opportunism. Given that the overall purpose of monitoring is to reduce opportunism by virtue of reducing information asymmetry, monitoring in itself will be ineffective when the source of the opportunism problem is not information related. For example, a party that exploits another’s lock-in by showing inflexibility (Cell 2 in Figure 1) or forcing renegotiation (Cell 4 in Figure 1) can do so under full information.

Beyond this inherent limitation, monitoring has two important prerequisites. The first pertains to the appropriateness of the monitoring criteria themselves (Anderson and Oliver 1987; Ouchi 1980). More specifically, the monitoring criteria must be relevant with respect to particular forms of opportunism. By definition, safeguarding against both active and passive opportunism requires that the forbidden behaviors (Cell 3 in Figure 1) and sources of shirking (Cell 1 in Figure 1) be established in advance.

Second, monitoring may require that a certain “zone of indifference” exists within which monitoring is accepted. As an example, consider the effort made by the owner of the 7-Eleven franchise in Japan to monitor franchisees through a computerized cash register that linked stores electronically to corporate headquarters (Shirouzu and Bigness 1997). This system enabled the franchisor to monitor directly both store sales and the time spent by store managers on various tasks. Not surprisingly, this system created great frustration

TABLE 2
Strategies for Managing Opportunism

Governance Strategy	General Purpose	Prerequisites	Primary Effects on Opportunism	Second-Order Effects
Monitoring	<ul style="list-style-type: none"> •Reducing information asymmetry •Facilitating the deployment of incentives 	<ul style="list-style-type: none"> •Identification of relevant criteria •Implicit or explicit contract that legitimizes monitoring 	<ul style="list-style-type: none"> •Limited to information-based opportunism •Most effective under existing circumstances 	<ul style="list-style-type: none"> •Selection effects
Incentives	<ul style="list-style-type: none"> •Reducing payoffs from opportunism •Aligning interests 	<ul style="list-style-type: none"> •Ex ante bargaining power (hostages) •Direct costs (price premiums) •Information availability 	<ul style="list-style-type: none"> •Effectiveness under new circumstances is limited by range of self-enforcing contract 	<ul style="list-style-type: none"> •Hostages as productive assets •Quality signal
Selection	<ul style="list-style-type: none"> •Reducing information asymmetry •Allowing for self-selection 	<ul style="list-style-type: none"> •Relevance of criteria •Imposing selection costs on partner •Risk of self-selection biases •Information availability (reputation) 	<ul style="list-style-type: none"> •Effectiveness depends on relevance of selection criteria 	<ul style="list-style-type: none"> •Customer signal
Socialization	<ul style="list-style-type: none"> •Promoting goal convergence 	<ul style="list-style-type: none"> •Completeness of socialization efforts 	<ul style="list-style-type: none"> •Effectiveness depends on applicability of role across situations 	<ul style="list-style-type: none"> •Customer signal •Selection effects

among the franchisees. As expressed by one operator, "Sometimes I don't know who's running the store.... It's like being under 24-hour surveillance; it's like being enslaved." Ultimately, such frustration may have the effect of promoting opportunism, as is shown in John's (1984) and Murry and Heide's (1998) studies.

In contrast, if a relationship exists a priori within which monitoring is permitted, it may serve to control opportunism. For example, Anderson's (1988) study shows that integrated sales forces display significantly lower levels of opportunism than independent ones do. This result is consistent with the transaction cost argument that the greater monitoring capability of an integrated firm suppresses opportunism. It is noteworthy, however, that not only do integrated systems have greater monitoring capacity, but their members may also accept such practices. Accepting certain forms of monitoring may be part of the (implicit) employment contract. In contrast, the studies by John (1984) and Murry and Heide (1998) involve monitoring of independent firms. Conceivably, monitoring in such a situation may be perceived as a contract violation and thus may give rise to opportunism.

Second-order effects. Explicit monitoring may have second-order benefits beyond a particular relationship. For example, monitoring may serve as a selection device. To the extent that a firm is known for efficient monitoring, parties that are opportunistically inclined may be discouraged from

entering into the relationship in the first place. Murry and Heide (1998) suggest that manufacturers that monitor compliance with their promotional programs on a regular basis may be able to (1) discourage opportunistic retailers that pocket allowances without subsequently participating in the program and (2) motivate appropriate retailers to self-select into the relationship.

Incentives

General purpose. In the original transaction cost framework (e.g., Williamson 1975), one of the inherent benefits of an organizational hierarchy is its ability to administer incentives that reduce the payoff from opportunistic behavior. Recent research on so-called self-enforcing agreements (e.g., Kaufmann and Lafontaine 1994; Telser 1980) has suggested that similar effects can also be achieved in relationships between independent firms. The basic premise of such agreements is to align parties' individual interests by creating an incentive structure that makes the long-term gains from cooperative behavior exceed the short-term payoff from opportunism. If such agreements are appropriately structured, they reduce the likelihood of opportunism in the first place.

Self-enforcing agreements can take a variety of forms. Williamson (1983) discusses the use of hostages, in the form of assets that have limited salvage value in other relationships. For example, franchisors require franchisees to make investments in dedicated equipment, procedures, and train-

ing (Rubin 1990). In the event of franchisee shirking, or passive opportunism as in Cell 1 of Figure 1, the franchisor can fail to renew the contract or perhaps limit expansion possibilities (Hadfield 1990). Thus, the potential economic loss serves as a disincentive for opportunism.

Incentives can also be created by means of price or margin premiums (a form of an efficiency wage). Rao and Bergen (1992) demonstrate that buyers compensate suppliers for quality maintenance by paying price premiums that exceed the marginal cost of producing high quality. After repeat sales, the price premiums yield supplier profits that exceed the short-term payoff from opportunistic quality debasement. Similarly, Dutta, Bergen, and John (1994) show how manufacturers can pay their resellers margin premiums as an incentive to comply with assigned territorial restrictions. Under this scenario, the objective is to discourage active opportunism (Cell 3 in Figure 1) by creating a (future) revenue stream of sufficient value.

Self-enforcing contracts are also capable in principle of managing opportunism under new circumstances (Cells 2 and 4 in Figure 1). However, their effectiveness may change depending on the circumstances surrounding the relationship (Casson 1991). Telser (1980, p. 49) notes that “a self-enforcing agreement between two parties remains in force only as long as each party believes himself to be better off by continuing the agreement than he would be by ending it.” Consider the use of hostages in the form of specific assets as an example. Under conditions of high technical change, there is a risk of asset obsolescence that decreases the value of the hostage to the party holding it. Thus, the self-enforcing range of the original agreement may change and subsequently increase the risk of opportunism (Klein 1996).

As an example, consider Gulati, Khanna, and Nohria’s (1994) description of the alliance between a U.S.-based designer of disk drives and a Japanese disk drive manufacturer. The Japanese firm agreed to manufacture disk drives for the U.S. firm in exchange for the rights to market them in Asia. To signal its commitment to the relationship, the Japanese firm offered a hostage in the form of a \$6 million investment in tooling. Shortly thereafter, a technology shift forced the U.S. firm to modify its design. This in turn meant that a large portion of the initial hostage offered by the Japanese firm lost its value to the U.S. firm. To signal its continued commitment to the relationship, the Japanese firm unilaterally absorbed the costs of adjusting its manufacturing process. The example illustrates how technological change may alter the existing incentive structure in a relationship. More generally, the preceding discussion highlights the potential limitations of incentive design as a strategy for controlling opportunism under new circumstances.

Prerequisites and effects on opportunism. Incentive arrangements possess several prerequisites. Extracting a hostage from another party may require a certain degree of bargaining power (Rubin 1990). Paying a price or margin premium does not require *ex ante* bargaining power but may create a financial burden, especially if the premiums must be matched across several relationships.

Furthermore, deploying incentives may require the availability of certain types of information. Kreps (1990, p. 105) argues as follows: “When one player cannot observe

directly that the agreement is being carried out, and when this player can only rely on noisy, indirect observations, the problem of finding self-enforcing arrangements is vastly more complicated.... As we become less and less able to observe compliance, we become less and less able to use this device at all.”

We offer two specific examples of this problem. First, Klein and Leffler’s (1981) original argument for the use of price premiums to discourage opportunistic quality cheating only holds for experience goods, for which buyers can ascertain quality at some point in time. The logic of disciplining suppliers by denying them repeat purchases does not hold for credence goods (Darby and Karni 1973), for which neither search nor actual experience provides an accurate indication of quality. Although true credence goods are rare, the more difficult it is for a buyer to evaluate quality (and, conversely, to detect opportunism) at a given time, the lower is the value of price premiums as enforcement devices.

Second, Axelrod’s (1984) principle of using a “tit-for-tat” strategy to promote cooperation in a repeated prisoner’s dilemma game only holds if the players can accurately distinguish between opponent cooperation and defection on a given move and can select their own strategy accordingly. Thus, in the absence of information, incentive arrangements may risk market failure at another level in the relationship.

This suggests that strategies based on reducing information asymmetry (e.g., monitoring) and incentives may complement each other. For example, using incentives to manage opportunistic inflexibility, as in Cell 2 of Figure 1, may be an ineffective strategy if refusals to adapt can go undetected. If so, incentive deployment may need to be combined with monitoring.

Second-order effects. In addition to aligning interests within a given relationship, some of the incentive strategies discussed previously may also have second-order benefits of various kinds. For example, a hostage may serve as a quality assurance device for end customers. In addition, sunk investments, to the extent that they are dedicated to a particular relationship, may be highly productive, from the standpoints of both reducing costs and increasing revenues. For example, dedicated supply chain integration systems often have such properties (Womack and Jones 1996).

Selection

General purpose. In principle, the most straightforward way of managing opportunism is to select exchange partners *a priori* that are not opportunistically inclined or are inherently cooperative with respect to a particular task (Orbell and Dawes 1993). As described by McMillan (1992, p. 92), “If you want a ditch dug, it is a good idea to hire a fitness fanatic, who will do the work eagerly, regarding it as a workout.” Similarly, “you are likely to get good treatment from a physician who finds it an interesting intellectual puzzle to diagnose your illness.”⁷

⁷In essence, the challenge in both of these situations is to identify a party that naturally or inherently possesses the right incentives in regard to the task in question.

In marketing contexts, selection efforts are implemented through screening and qualification programs of various kinds. For example, franchisors seek to minimize the risk of quality shirking (Cell 1 in Figure 1) by subjecting potential franchisees to comprehensive screening processes. Similarly, automobile manufacturers subject their component suppliers to formal qualification programs to prevent subsequent quality problems.

Prerequisites and effects on opportunism. Traditionally, transaction cost theory has deemphasized the role of selection in managing opportunism. Two particular limitations are noteworthy. First, although careful selection may identify parties that possess the appropriate skills, it does not in itself guarantee that the skills in question will be used in the ongoing relationship (Mishra, Heide, and Cort 1998). Thus, passive opportunism in the form of shirking (Cell 1 in Figure 1) could still present a problem.⁸ Second, selection efforts that are based on existing attributes or criteria may offer limited protection against opportunism under new circumstances (Cells 2 and 4 in Figure 1).

How can selection efforts be used to solve these particular opportunism problems? We suggest two strategies pertaining to (1) the nature of the selection process itself and (2) the specific criteria used, respectively.

Consider first the process. Xerox Corporation demands that all potential suppliers participate in a customized certification process, which includes the so-called Xerox Multi-national Supplier Quality Survey. The certification process serves two particular purposes. First, the ability to observe potential suppliers on a trial basis enables Xerox to reduce information asymmetry with respect to supplier skills and eliminate from consideration suppliers that fail to meet certain minimum standards. Second, the process permits appropriate suppliers to self-select into the relationship by demonstrating their willingness to undergo certification. To the extent that participating in a certification program involves an investment of time and money on a supplier's part, only suppliers that adhere to Xerox's criteria over time will get a return on their investment through repeat sales. As such, a customized certification program may constitute a safeguard against (passive) shirking or evasion (Cell 1 in Figure 1). It may also increase a party's motivation to adapt to new circumstances, as long as the relationship remains within the self-enforcing range of the original incentive structure (Klein 1996). As such, selection efforts may also serve as a safeguard against inflexibility, as in Cell 2 of Figure 1.⁹

The logic of a costly selection process may also be applied to the selection criteria themselves. If a selection criterion can be identified a priori whose subsequent contra-

dition involves a monetary loss, it enables partners with appropriate skills and motivations to self-identify.

A firm's reputation may serve such a purpose (Ganesan 1994; Kumar, Scheer, and Steenkamp 1995; Weigelt and Camerer 1988; Weiss, Anderson, and MacInnis 1999). In a similar fashion to the cost of a certification process, establishing a reputation involves costs that can be recaptured only through repeat sales. As such, an existing reputation provides a disincentive for opportunistic behavior.

For example, Calyx & Corolla established a partnership with Federal Express to support its strategy of delivering fresh-cut flowers directly from growers to buyers with guaranteed delivery dates.¹⁰ From Calyx & Corolla's standpoint, Federal Express's existing reputation for delivery provided assurance that it was both able and motivated to support Calyx & Corolla's strategy. Thus, an existing reputation or past behavior in other relationships can be used as a criterion for judging ability and motivation in a current one (Shapiro 1983).

Some additional prerequisites for selection need to be pointed out. First, the previously mentioned cost argument assumes that certain relationships hold. Specifically, the cost of participating in a certification program must exceed the short-term payoff from opportunistic misrepresentation. In addition, the rewards to appropriate partners for honest disclosure (i.e., the net present value of future sales) must outweigh the initial cost of participating in the selection process (Farrell and Gibbons 1995).

Second, it is important to identify criteria that do not produce self-selection biases. For example, cost considerations sometimes motivate firms to adopt search proxies that fail to provide valid information about the attributes in question. Staten and Umbeck (1986) provide an example involving the Office of Workers' Compensation Programs and its effort to link job stress among air traffic controllers and disability compensation claims. In the absence of a readily available measure of stress, the organization decided to rely on self-reports of job-related stressful incidents. As it turned out, the adoption of this proxy created an incentive for controllers to alter their job performance by reporting aircraft separation errors. Thus, the particular criteria used in a given situation may produce self-selection biases.

Third, a reputation possesses certain inherent limitations as a selection device. Most important, for a reputation to be valuable, it is necessary for information to be available to firms about other firms' past and current behaviors. In Sappington's (1991) terminology, reputations require public observability of outcomes. For example, Brickley, Smith, and Zimmerman (1996) note that quality cheating in the diamond trade in New York is quite rare, because the market is dominated by a close-knit community of Hasidic Jews among whom information about opportunistic behavior spreads rapidly. In contrast, Hadfield (1990) notes that the reputation of a given franchisor may carry little informa-

⁸Theoretically, selection efforts may solve the adverse selection problem, but moral hazard problems may still prevail.

⁹It should be noted that this example takes a single-sided perspective on the opportunism problem. Specifically, a supplier that incurs the cost of undergoing certification increases its lock-in in relation to the buyer and consequently may face a problem with buyer opportunism. We thank one of the reviewers for this suggestion.

¹⁰Harvard Business School Case #9-592-035; "Calyx & Corolla."

tional value to potential franchisees. Specifically, in evaluating terminations of past franchisees, it is difficult for new ones to make appropriate attributions among franchisor opportunism, bad management, and market conditions. Thus, information asymmetry may permit a firm to “milk” its reputation opportunistically for some time (Shapiro 1982).

Fourth, a reputation can be systematically manipulated opportunistically. Williamson (1991b) describes how a firm may fail to reveal or may distort its experiences with a trading partner as a means of misleading its own rivals. Similarly, Hadfield (1990) discusses how franchisees may mislead prospective buyers in this fashion. Specifically, a franchisee that has been exposed to opportunistic behavior on the part of a given franchisor will be reluctant to discourage buyers by disclosing the franchisor’s true behavior.

Second-order effects. The main benefit of selection is to reduce information asymmetry within a particular relationship. It is noteworthy, however, that selection efforts may also have second-order effects in other relationships. For example, in its advertisements to end consumers, Rolex explicitly describes the time and effort spent on selecting and training its official Rolex jewelers. Although the primary purpose of Rolex’s selection efforts is to ensure that potential dealers are capable of supporting the company’s quality strategy, these efforts serve the additional purpose of a quality signal toward end customers. Similarly, Calyx & Corolla emphasizes its relationship with Federal Express in its communication efforts. Indeed, Federal Express has become an integral part of the Calyx & Corolla brand.

Socialization

General purpose. Selection strategies, as described previously, are based on the general premise of identifying exchange partners that possess the inherent skills and/or motives to perform a particular task. In principal-agent terminology, the primary purpose of selection is to identify agents whose goals are consistent with those of the principal. An alternative strategy is to use socialization processes to make the agent internalize the principal’s goals.

To place the concept of socialization in perspective, consider sociological critiques that transaction cost theory is based on an undersocialized view of human behavior. For example, Granovetter (1985) argues that transaction cost theory has failed to recognize that economic transactions frequently are embedded in social relationships that mitigate the risk of opportunism. More recently, researchers have described behaviors in exchange relationships that are not motivated by reputational concerns and persist even in so-called end games (Uzzi 1996).

According to this view, one apparent solution to the opportunism problem is to deploy deliberately socialization tactics that promote goal convergence. There are many examples of firms that rely extensively on socialization programs of various kinds. For example, McDonald’s uses its management institute, commonly referred to as “Hamburger University,” both to teach business skills and to promote its corporate philosophy. As noted in *The Economist* (1999), McDonald’s is as concerned with getting everyone

to “march to a single McDrum” as with promoting technical efficiency. Toyota and other firms organize special seminars for dealers during which greater emphasis is placed on the firm’s values than on strategy and selling skills per se (Zellner 1989). Biggart (1989), in a comprehensive analysis, demonstrates that systematic socialization efforts are the foundations on which companies such as Amway, Tupperware, and Mary Kay Cosmetics base their strategies.

To the extent that socialization efforts are effective, they directly reduce the likelihood that opportunism will take place regardless of the level of vulnerability present, consistent with our previous definition. Complete socialization would permit a party to tolerate vulnerability in the form of lock-in and information asymmetry. As such, as a governance strategy, socialization does not possess any inherent limitations with respect to any of the four forms of opportunism in Figure 1.

Prerequisites and effects on opportunism. The effectiveness of socialization as a strategy for managing opportunism rests on its completeness, or its ability to promote values that apply across contexts or situations. This potential limitation is well illustrated in Montgomery’s (1998) effort to add precision to the embeddedness concept.

Recently, rational choice theorists have attempted to formalize Granovetter’s (1985) argument by equating embeddedness with mutual cooperation in a repeated prisoner’s dilemma game (e.g., Gibbons 1992). As noted by Montgomery (1998), rational choice and embeddedness theory share an assumption about how a prisoner’s dilemma game is played. Specifically, each makes the assumption that games are played by individuals who possess fixed characteristics and preferences—either a businessperson who attempts to maximize payoffs or a friend who adopts a general rule of cooperation. Montgomery challenges these assumptions of a unitary actor and suggests the alternative view that individuals consist of collections of roles. Ultimately, these roles, rather than the individuals, constitute the players in a game. Furthermore, instead of assuming endogenous altruism or fixed playing rules, Montgomery argues that different situations evoke different roles in individuals. From a practical standpoint, the key is to understand how transitions among roles take place.

The previous discussion raises another issue, namely, the level at which opportunism takes place. Although Williamson (1993) discusses how people are opportunistically inclined, much of the extant transaction cost work implicitly treats opportunism as a firm-level phenomenon. Some interesting insights can be gained by examining the different roles individuals play within the firm and within an exchange relationship.

As a specific example, consider the context of franchised automobile repair, in which a given franchisee’s customer relationships are mediated by individual mechanics (Mishra, Heide, and Cort 1998). At the firm level, the franchisee (e.g., firm) may act opportunistically toward both the franchisor and the end customers by failing to supervise the mechanics (Muris 1981). This would constitute passive opportunism in the form of evasion (Cell 1 in Figure 1),

according to our previous framework. However, the mechanic may either exacerbate or alleviate the firm's opportunistic tendencies, depending on the specific role that is pursued. Regarding the former, the mechanic may aggravate the initial problem by (passive) shirking. In addition, as is discussed in the final section, individual agents may actively prescribe services that exceed the customer's actual needs. However, it is also possible that individual agents whose roles are more closely aligned with the customer may correct a firm's opportunistic tendencies. Thus, the role pattern at the individual level determines the nature of the product the end customer receives.

Differences in roles may also provide some insight into how opportunism under new circumstances can be managed. Kanter (1989) and Lyons, Krachenberg, and Henke (1990) describe the difficulties some U.S. automobile manufacturers experienced when changing market conditions required the adoption of a partnership approach toward their component suppliers. Specifically, corporate-level initiatives to pursue cooperative relationships were systematically undermined by individual purchasing agents who continued to treat suppliers in an opportunistic fashion. Established commitment to old roles and/or insufficient socialization into new ones contributed to the problem.

Second-order effects. In a fashion similar to the other strategies, socialization efforts may have benefits that extend beyond a particular relationship. First, the socialization process may serve a promotional or signaling purpose. For example, Ritz-Carlton relies on its "Gold Standard" of employee values in both its internal and external communication efforts (Berry 1995). Second, socialization processes may also be used as screening devices or to attract partners that either possess the appropriate values or are willing to participate in the socialization process.

Concluding Observations

The framework shown in the previous section integrates different forms of opportunism with particular governance strategies. Its primary purposes are to (1) provide some heuristics for managerial decision making and (2) suggest avenues for further research. In this final section, we expand on the agenda for further research. Specifically, we discuss opportunism as managing over- and undersupply of quality and the problem of eliminating versus tolerating opportunism.

Opportunism as Under- or Oversupply of Quality

Throughout much of this article, opportunism has been discussed as some form of cheating or undersupply relative to an implicit or explicit contract. For example, the traditional moral hazard problem, which is subsumed within the larger opportunism umbrella (Williamson 1993), describes how information asymmetry enables one party to supply lower levels of quality or output than was contracted for.

On the basis of our previous definition, such behavior is passive in nature. Consider, however, whether an opposite scenario may exist, in which one party violates a contract actively by providing output or quality levels in excess of (1) what was agreed on or (2) what is actually needed by the other party.

There are many examples of such a scenario. In the health care industry, Swedlow and colleagues (1992, p. 1506) note that magnetic resonance imaging scans were medically inappropriate 38% more often when ordered by self-referring physicians. Similarly, *The Economist* (1996) describes an "overprescription machine," in which physicians prescribe excessive quantities of expensive drugs to patients. In the context of automobile repair, Sears's mechanics were found to prescribe and charge for repair services and parts that far exceeded customers' actual requirements (Patterson 1992).

As in the conventional moral hazard models of quality cheating (e.g., Holmstrom 1979), violations such as these can take place because of information asymmetry among the relevant parties. However, unlike the standard moral hazard problem, in which the customer lacks information *ex post* about the quality level supplied, the risk of overprovision may also arise from customer uncertainty *ex ante* regarding actual needs or requirements.

An interesting research question is which governance mechanisms lend themselves to solving the overprovision problem. This problem becomes particularly complex when the exchange in question comprises more than two parties. For example, as noted previously, car repair services often involve complex relationships among (1) franchisors, (2) franchisees, (3) mechanics, and (4) end customers (Mishra, Heide, and Cort 1998). In principle, all the mechanisms discussed previously are available, though particular care must be taken in their implementation. For example, Sears's problems were due in part to a flawed incentive system that rewarded mechanics for overprescribing parts and repairs.

Eliminating Versus Tolerating Opportunistic Behavior

Explicitly or implicitly, the focus in the extant transaction cost literature has been on deploying governance mechanisms that are capable of eliminating opportunism. Recently, however, Dutta, Bergen, and John (1994) have suggested the somewhat counterintuitive idea that establishing a *tolerance limit* for opportunistic behavior may be a more fruitful approach than striving for complete elimination.

Why may that be the case? Consider again the prerequisites for deploying the various strategies. In some situations, administering a governance apparatus that is sufficiently stringent to eliminate opportunism entirely may be so costly that it outweighs the benefits. In Dutta, Bergen, and John's (1994) example, the focus is on using self-enforcing agreements based on margin premiums to ensure distributor adherence to assigned sales territories. Paying a distributor above-market margins represents an ongoing revenue stream to the distributor as long as it honors the assigned sales agreement. In the event of opportunistic violations of the territory, the manufacturer can terminate the agreement, a threat that reduces the likelihood of opportunism. Notice, however, that designing such a self-enforcing setup involves a cost to the manufacturer in the form of an efficiency wage, or "margin premium" in Dutta, Bergen, and John's (1994) terminology. As shown by these authors, if the margin required to discourage opportunism is sufficiently high, it may be profitable for a firm to tolerate a nonzero level of opportunism. Thus, a firm is required to make a trade-off

between managing opportunism and economizing on governance costs.

In our terminology, the previous logic pertains to the first-order considerations, that is, within a given relationship. The decision whether to tolerate some level of opportunism must also account for possible second-order effects. For example, allowing a particular distributor to violate territorial restric-

tions may cause difficulties with regard to other distributors whose revenue streams are expropriated. It may also attract inherently unattractive distributors to the overall channel. In principle, however, we believe that viewing opportunism as a policy variable that is subject to cost-benefit assessments represents an important avenue for further research.

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