Running Head: BUILDING CONTRACTING CAPABILITIES

Building Contracting Capabilities: Party Selection for Template Design and Contract Negotiation

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Abstract

The selections of parties for designing contract templates and for negotiating contracts are two aspects of contracting with important implications for the performance of inter-firm relationships; however, both of these issues have largely escaped careful analysis by economic, legal and organizational scholars. When selecting these parties, the firm is making resource allocation decisions that affect its ability to structure and manage its inter-firm relationships. In this paper, we examine who should be involved in what activities (internal counsel, external counsel, managers and engineers, and purchasing/sales agents) and the roles that each party should play in the task (sole actor, team leader or team participant). Both of these decisions will depend upon the nature of the knowledge needed to complete the task; specifically, we argue that the key drivers of these decisions are requirements for detailed knowledge of technology and/or the firm's processes and the need for specialized legal knowledge. If people without the correct knowledge set are asked to design the contract template or negotiate the contract, we argue that governance is more likely to be inefficient—more costly and/or put the firm at greater risk of malfeasance. Overcoming bounded rationality and the threat of opportunism requires knowing how to effectively design a contract—the key governance mechanism of inter-firm relationships. Knowing how to design a good contract is not easy and may well be a source of competitive advantage for some firms.

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Contracts are integral to conducting business in the United States, and serve as a blueprint or a framework to guide inter-firm relationships (Llewellyn, 1931). As such, it is important to understand their design and use, as well as the development of contracting capabilities by firms that may result in competitive advantage. While most prior research on contracts has focused on either the choice of payment mechanism (Allen & Lueck, 1992), or on the use of specific contract clauses to mitigate exchange hazards (for a review see Shelanski & Klein, 1995), researcher are only beginning to examine the development of contracting capabilities. Mayer & Argyres' (2004) study of software contracting shows that firms learn to work together and design better contracts over time while a related theory paper suggests that contract design and the management of knowledge from this process is an important firm capability (Argyres & Mayer, 2005).

Two related aspects of contracting that have important implications for the performance of inter-firm relationships but have largely escaped examination include the selection of parties for the design of contract templates and for contract negotiation. These selections are resource allocation decisions that affect the firm's ability to manage inter-firm relationships, in that the firm must employ the appropriate knowledge sets, both internal and external, to effectively govern each exchange. In this paper, we draw upon the problem-solving perspective (Nickerson & Zenger, 2004) in an attempt to understand efficient selection of parties for template design and contract negotiation. Uncovering the forces driving these choices will help elucidate our understanding of building competitive advantage through the development of contracting capabilities.

This paper makes three main contributions to the strategic management and contracting literatures. First, it is the initial attempt to separate template design and contract negotiation and addresses how firms strive to develop an overall contracting capability that can contribute to its competitive advantage. Second, by focusing on the knowledge sets that are required to solve the problem posed by the transaction, we can more accurately determine not only who should be involved in various stages of contracting (i.e., template design versus contract negotiation) but also what roles each party should play within the organization to mitigate knowledge formation hazards. Third, the paper is one of few attempts to bring the study of contracting into the strategy literature by further developing the idea of contracting as a firm level capability that can contribute to a firm's competitive position. Managing inter-firm relationships can affect competitive advantage (Anand & Khanna, 2000; Kale, Dyer & Singh, 2002), but we know little about the role contracting can play in this process (see Argyres & Mayer 2005 for one productive effort in this direction).

In the first section of the paper, we discuss the role of contracts in exchanges and the ensuing problems of template design and contract negotiation. The next section reviews the problem-solving perspective and how it can be applied to the study of contracting capabilities. The third section contains an introduction of the four potential parties and the roles that they may play in template design or contract negotiation. We then develop propositions regarding who should be assigned to what roles in template design and contract negotiation under differential conditions of knowledge complexity and task decomposability. Finally, the paper concludes with a brief discussion of the implications of these ideas for our understanding of contracting capabilities, and suggestions of future research in this area.

SELECTING PARTIES FOR CREATING CONTRACTS

Contracts have been extensively studied in the economics, legal, and more recently the strategy literatures because they serve as a starting point for most inter-firm relationships and they provide the mutually constructed framework for the relationships between the parties (Llewellyn, 1931; Macaulay, 1963). A lot of the research done on contracts to date has focused on the inclusion of contracting safeguards in response to exchange hazards (for a review see Shelanski & Klein, 1995). These safeguard provisions are included to prevent potential opportunistic behavior by one or both of the parties (e.g., Gallick, 1984; Joskow, 1987; Masten & Crocker, 1985, Crocker & Masten, 1988; Crocker & Reynolds, 1993). Contracts are viewed in this stream of research as an enforcement tool that enables exchange by preventing opportunism.

In contrast, some researchers are beginning to view contracts in a more strategic light. One such study focuses on the inclusion of an extendibility clause, a provision that is used primarily as a strategic tool to help build the relationship between the parties (Mayer & Weber, 2005). Also, Mayer and Argyres (2004) study the evolution of software contracts between two parties and find that the contents of the contract are largely tied to the history between the parties as firms learn to work together. In a subsequent paper, Argyres and Mayer (2005) develop the idea of contract design as a capability and suggest that firms need to manage the knowledge that accrues to their lawyers, and managers and engineers. This idea is captured nicely in the quote, "The accumulation of past contracting influences present contraction" (Kahan and Klausner, 1997, pg. 729). Therefore, one potential contracting capability that firms can develop is related to both knowledge management and resource allocation. That is, managing the knowledge stores of their internal human resources, and learning to combine them efficiently with external

knowledge stores in order to create new firm knowledge in the form of contract templates and unique contract terms that develop during negotiation.

The Transaction and Embedded Problems

In order to understand how to create an efficient team for the design of a contract template or for a negotiation, the firm must examine both the transaction and the embedded problems that must be solved in order to complete it. That is, for each exchange that the firm conducts, two problems arise, for which the firm must search for a solution. The first one stems from the decision regarding the use of a contract template. Depending upon the characteristics of the exchange, the firm may choose to use a previously created template, create an entirely new template or design the contract from scratch during the negotiation. If the firm chooses to create a template for this exchange in anticipation of future similar exchanges, then the firm faces the problem of creating a template that is appropriate to this transaction as well as future similar transactions. While creating or revising a contract template will not be an issue for every transaction, the second activity, negotiating the contract with the exchange partner, exists in all transactions. Therefore, for each transaction, the firm will always face the problem of negotiation, but may or may not choose to design a contract template.

Template Design

Contract templates are extremely prevalent in that they serve as the basis of a majority of formal agreements, particularly in the United States (Cooter and Ulen, 2004). Generally, these templates consist of a mixture of fixed clauses (e.g., a uniform confidentiality clause) and variable clauses that are subject to negotiation between the parties (e.g., fill in the blanks or

different issues that need to be considered but will vary slightly for each exchange). This level of negotiation may range from as little as specifying the quantity and price of the product or service to be delivered, to as much as specifying specific safeguards and contingency clauses with a few fixed terms that must be included as a minimal template. Often the items to be negotiated (the variable clauses) are simply blanks to be filled in by the contracting parties. This situation is in contrast to the more customized contracts that may start with a more condensed template of standard clauses, but allows the parties to create terms specific to the transaction. The generic fixed clauses in both of these contract types are generally known as "boilerplate" terms. These clauses are potentially standardized across the firm or even the industry, and act to state the laws that are applicable to the agreement (Lundsmark, 2001).

Law and economics researchers have been investigating this phenomenon of standard form contracts, but primarily from the perspective of legal judgments (Yale Law Review staff, 1949) or purely in terms of economic efficiency (Isaacs, 1917, Kahan & Klausner, 1997). While these are interesting perspectives, these studies do not directly address a primary interest of strategy scholars: the development of capabilities. Although this phenomenon has not yet been studied from a strategic perspective, Argyres and Mayer (2005) do suggest that firms using lawyers to design specific contract terms while allocating others to functional personnel are more likely to develop superior contract design capabilities. Their study suggests that the firm's development of contracting capabilities involves allocating the resources with the appropriate knowledge to the contract terms that most directly draw on that knowledge.

Not all contract negotiations will involve a template. The main trade-off in deciding to create and use a standard form contract (i.e., a contract template) is whether the future transactions that the contract will be used for are similar enough to benefit from the economies of

scale and increased speed of negotiation derived from having a standard contract. There is a significant fixed cost to creating and maintaining standard form contracts, so firms will only undertake this effort if the sunk costs can lower the contracting costs for a large number of the firm's transactions. The up-front costs include, but are not limited to, deciding what, of the vast array of documented clauses to include in the standard form contract and keeping up to date with legal and regulatory changes that could affect its use. Having a contract struck down for a single transaction is bad enough, but if a clause in the firm's standard form contract is not upheld, it affects many contracts and thus involves a much higher cost.

The benefits of creating a standard form contract will be highest when there are many future transactions that can use it. This is most likely to occur when the firm has a large number of similar transactions. However, if the firm's transactions are very diverse, then using a standard form contract could actually increase negotiation costs. Such a contract could introduce contingencies that are not relevant and thus extend negotiations. Introducing such contingencies could also lead the other party to assume that the firm is being excessively legalistic or litigious and impede the development of a strong relationship between the firms.

Contract Negotiation

As mentioned above, assembling the appropriate knowledge resources to search for the solution to a problem is critical for the firm. This need also arises for contract negotiation, which is a part of all inter-firm transactions. Although most of these negotiations start with a template, the level of customization to the template will depend on the transaction. This customization can range from as little as filling in the blanks on quantities (as with a standard purchase order, which is an enforceable contract) to specifying technological details and contingencies involved in a

custom product. These two extremes demonstrate the different types of knowledge that may be required for the most efficient negotiation of a transaction. Therefore, the firm needs to ensure that it has the appropriate knowledge at its disposal, either from internal or external sources, and senior managers must be skilled in choosing the correct governance structure for the negotiation teams if the transaction requires the expertise of multiple parties. It would be costly and inefficient to ask lawyers to conduct negotiations that consist of little more than prices, quantities and delivery dates. It is equally problematic to ask purchasing agents or managers and engineers to negotiate complex issues that have important legal ramifications that could expose the firm to legal sanctions or create unintended legal obligations. There are situations when only one party needs to be involved in the negotiation or template design, while there are other situations when multiple parties must be involved to fully define the transaction and protect the firm's interests.

It is not only critical to get the right people involved, but also to put the right people in charge. The structure of a team will affect the outcome it produces (Dionne, Yammarino, Atwater & James, 2002; Guzzo & Dickson, 1996; Salancik & Pfeffer, 1978), so we consider not only who should be involved, but who should lead the team (or if it should be a consensus-based team without a defined leader).

The Potential Participants

Four different parties are potential participants in the design of the contract template and contract negotiation: internal counsel, external counsel, purchasing/sales agents and managers/engineers. Each of these parties possesses specific knowledge sets and offer significant but different benefits and risks depending on what is required in the contracting situation. A

close examination of the capabilities and incentives of each party leads to several predictions regarding the best choice of negotiating party for template design and for the exchange.

Internal Counsel: Lawyers who work in a law department of a firm are generalists who focus on doing the routine legal work of the firm, although they are also used strategically to routinize some of the specialized work that the firm does on a regular basis (Edelman & Suchman, 1999). They can also act as managers for the external counsel that is retained by the firm. As employees, their incentives are more aligned with the interests of the firm than the external counsel, and are perceived by other firm employees are part of the team instead of outsiders (Spangler, 1986). These internal law departments only exist if the firm has enough legal work to make it worth the overhead of maintaining such a group, although in startup companies, the internal legal counsel can be a single lawyer. The number of internal lawyers, those employed by corporations rather than law firms, has doubled from 1975 to 1990 (Edelman & Suchman, 1999), so there are a significant and increasing number of firms utilizing in-house counsel. There has been little research, however, that explores how these internal lawyers contribute to a firm's competitive advantage.

External Counsel: In contrast to internal counsel, lawyers in large law firms are incentivized to become very specialized early in their career (Gilson & Mnookin, 1989). This specialization consists of a specific type of law, such as patent law, or practicing in specific industries, such as information technology. They are often rewarded for specializing by becoming a junior partner after three to five years, and then with senior partnership in another three to five years (Spangler, 1986). This reward structure promotes extreme loyalty of the lawyer to their firm, and aligns the goals of the lawyers with those of the law firm. Additionally, the lawyers in law firms rely on the reputation of the firm to advance their own professional reputations (Gilson & Mnookin, 1989),

so they are particularly focused on meeting their law firm's goals, which may not be perfectly aligned with the goals of the client firm.

Purchasing/Sales Agents: Purchasing personnel understand the day-to-day activities involved in managing a supplier relationship, while sales agents have similar knowledge for customer relationships. Both of these groups also possess extensive knowledge of the customers (for sales agents) and suppliers (for purchasing agents) as they have built relationships with them through repeated interactions. These employees are well suited for routine tasks that don't require special knowledge of the law or technology, but in which the relationship with the customer is important.

Managers/Engineers: Managers possess very detailed industry and firm-specific business knowledge, while engineers have extensive technical expertise specific to the firm's products. These two groups usually work together to conceive and design the products or services of the firm. They have deep knowledge of internal capabilities and competitors. Managers and engineers tend to enjoy more trust within the firm than either internal or external counsel, as they escape the stigma sometimes attached to lawyers as an impediment to business. Their interests are highly aligned with those of the firm because they rely upon the firm for their continued employment and are socialized into the firm in order to share its values (Chatman, 1991).

The Potential Roles

The process of template design or contract negotiation consists of two stages. The first is creation (of the template or the specific contract) and the second is the legal and managerial review of what was created. Virtually all firms sensibly include lawyers and often senior managers in the review process. While this review is very important, most of the action resides in

the creation of the template and the specific contract. If the creation is done properly, the review becomes less important. In addition, problems caught at the review stage (once preliminary agreement has been reached) can damage relationship development and significantly lengthen negotiations. Thus we believe that the area that can contribute the most to competitive advantage is in the creation of the contract template and the contract for the specific exchange.

The four parties may play one of three different roles in the creation process for the template or the specific contract: 1) sole actor, 2) team leader, or 3) team participant. In some cases, the firm will find it more efficient for one group (i.e., internal or external counsel or managers/engineers) to conduct the template design or the negotiation by themselves. This instance will correspond to the sole actor role. Other times, the task will require more than one group to participate. In this case, a party could either lead the group in the task, possessing the authority to make the final decision (i.e., impose their will on the other party), or they could merely be a participant in the task while someone else leads, or they could participate in a consensus-based group without a clearly defined leader. Both the characteristics of the transaction and the particular task together determine which groups should be involved and the roles that they should play in the task. The potential roles of the four participants, as well as their specific areas of knowledge, are summarized in Table 1 below.

Insert Table1 here

THEORETICAL BACKGROUND

The problem-solving perspective (Nickerson & Zenger, 2004) is ideal for approaching the issues of template design and contract negotiation. It uses the problem as the unit of analysis and suggests that the firm must use the correct human resources (drawing from both internal and

external sources) at the appropriate time. If the wrong resources are used, then performance will suffer (Nickerson & Zenger, 2004). Additionally, it suggests that the complexity of the problem that the firm is trying to solve has a direct influence on the search process and the governance of the parties involved. Finally, this perspective is concerned with minimizing two knowledge-related exchange hazards when a problem requires interaction between different parties: knowledge appropriation and strategic knowledge accumulation (ibid).

The knowledge appropriation hazard follows directly from the properties of information itself (Shapiro and Varian, 1999). First, information is non-rival in that if a person uses the piece of information, it is not diminished and can still be used by another person. It is also non-excludable in that people cannot be prevented from using it if they have access to it. Because of these two properties, if the information is shared with the exchange party, there is no further incentive for the exchange partner to pay for the information because they cannot be excluded from using it, and it has not diminished in value. However, until the information is revealed to the exchange partner, it is difficult to assess the value of the information. This situation creates a disincentive to share knowledge between parties, so in cases where a problem requires extensive knowledge sharing, a governance structure that addresses this issue is required (Nickerson & Zenger, 2004).

The hazard of strategic knowledge accumulation occurs because each particular party is incentivized to gain experience that is relevant to their area of expertise while working on the problem at hand (ibid). As such, they attempt to shape the solution to the problem in such a way to draw on the knowledge that is specific to their expertise. As a result of all parties involved pursuing this individualistic goal, the performance on the task at hand may suffer in comparison to the potentially higher performance level that may have been achieved if all parties were

focused on the same overall goal. Therefore, governance mechanisms are also required to address this potential hazard.

In template design and contract negotiation, both of these hazards may come into play. First, if more than one party is required to design the template or to conduct the negotiation, the disincentive for sharing information specific to the party is high. This is true both within the firm and across firm boundaries with the external counsel. For example, if the external counsel has designed a template for a competitor of the focal firm in the past, the information learned in that transaction may not be used in the design of the template for the focal firm. In fact, due to non-disclosure agreements, this information may not legally be available for use. Additionally, engineers may choose to leave some issues out of the contract for fear that a lawyer may get in the way by insisting on a variety of contingencies around that issue that could damage the relationship.

Second, the strategic knowledge accumulation hazard in template design and contract negotiation is also a significant factor, as each party has different incentives to increase their specific knowledge base. This problem may be particularly exacerbated by differences in language between the parties and in different perspectives on the transaction itself. For instance, if the external counsel is focused on enforcement of the contract, while the engineers are focused on the technical description of the product, the resulting contract may not be optimal and may involve significant conflict, especially if no one is working to integrate these two different approaches into a cohesive contract. Therefore, the problem-solving perspective serves to address not only who should be involved in template design and contract negotiation, but also the roles that they should play within the specific governance mechanisms required for optimal knowledge fusion.

THEORY DEVELOPMENT

In examining which parties should be included in designing a contract template or in conducting a negotiation, two major issues must be considered: (1) whether the task can be decomposed so that different parties that need to be involved can work independently, and (2) what knowledge sets are required to complete the task. If the problem of either designing a template or negotiating a contract is decomposable, then the parties the firms need to be involved (from the four groups we discussed above) can operate relatively independently of one another. If the task is non-decomposable, then integration is required and a hierarchical team structure will typically be needed to achieve the integration.

The transaction, and the problems that must be solved to complete it, will define the knowledge sets that will be involved. There are three potentially specialized knowledge sets that are applicable for template design and contract negotiations: (1) routine legal knowledge, (2) specialized legal knowledge and (3) specialized technological knowledge. Figure 1 depicts the costs/risks associated with using the three most specialized groups (internal counsel, external counsel, and managers/engineers. The appropriate group or groups to design the template or negotiate the contract will depend upon both the specialized knowledge sets that need to be accessed (Figure 1) and the decomposability of the problem to be solved. These two factors will also determine what roles various groups should play when more than one of them is involved.

Insert Figure 1

Routine Legal Agreements—Decomposable (Low Interaction)

A routine legal agreement, which contains does not require any specialized knowledge sets (i.e., no legal or technological specific knowledge is involved) and does not require knowledge interdependence (i.e., the problem is decomposable) is akin to a standard purchase order. The knowledge set required for creating new capabilities in the form of a standard contract template is one of broad legal knowledge and some familiarity with the firm's products and services. Legal knowledge is required so that the template protects the interests of the firm and complies with relevant laws and regulations. Knowledge of the firm's products and services is also helpful so that the template can be designed so as to be useful for the widest possible array of the firm's products and services.

Given these knowledge requirements, the most relevant group is internal counsel. While purchasing/sales agents also have knowledge of routine transactions, this knowledge is most useful in negotiating the contracts; they may provide some input to the internal counsel, but there is not a sufficient need for their involvement to necessitate creating a team in order to have them work with the internal counsel. Internal counsel has the broad legal knowledge, coupled with a familiarity with the firm's products and services to be able to handle the legal aspects of the template coupled with a basic understanding of the firm's product line so as to design the template to be useful for a variety of the firm's products and services.

The knowledge sets of the managers and engineers, who are intimately familiar with the firm's technology and products but not with business law or with the details of routine transactions, will not be well suited for the task. Additionally, external counsel, with deep knowledge in very specialized areas of law, will not contribute to the creation of new knowledge for the firm because their specialty will have little impact on a routine contract template. As such, the internal

counsel's knowledge set of broad legal knowledge, coupled with familiarity with the firm's products provides the best basis for the development of a contract template when the problem has these particular characteristics.

Proposition 1 *When the exchange is a routine legal agreement (i.e., does not contain technical legal or engineering content) and the template design task is decomposable, internal counsel should design the contract template.*

When the problem of contract negotiation for this same type of simple transaction is considered, knowledge about the exchange partner and the standard details required for these types of routine tasks becomes most important. Since the negotiation is based on a standard template, little knowledge of the law is required, as the negotiator basically is filling in price, quantities and delivery dates. Again, external counsel is not necessary, as their specialized legal knowledge set would not contribute to the negotiation. Also, internal counsel's broad legal knowledge would not benefit the firm in this situation given the rather narrow and legally straightforward issues involved in the negotiation—the legal issues having been dealt with in the template. The specialized knowledge of managers and engineers is also not required because there is no technological complexity to the negotiation. Instead, purchasing/sales agents, who possess extensive knowledge of exchange partners due to previous interactions, would provide the most suitable knowledge set to build a capability in contract negotiation in this situation.

Proposition 2 *When the contract is a routine legal agreement (i.e., does not contain technical legal or engineering content) and the negotiation task is decomposable, the purchasing/sales agent should negotiate the contract.*

Routine Legal Agreements—Non-Decomposable (High Interaction)

When the exchange is again a routine legal agreement, but interdependence between knowledge sets is introduced due to the requirements of the problem to be solved in the

transaction, the template design becomes more complex. Although the same general legal knowledge is required as in the routine legal agreement with low knowledge interaction, the knowledge set for determining the appropriate boundaries for interdependence between the relevant groups within the firm is also necessary. As in the previous situation, the knowledge sets of the external counsel and managers and engineers are not well suited to this problem, in that no specialized legal or technological knowledge is required.

The main difference in this case is that there is now an interdependence between internal counsel and purchasing/sales. When interdependence was low, internal counsel could simply seek out whatever isolated knowledge was required and then design the template. Now that multiple knowledge sets need to work together to craft the agreement, a team should be created to design the template. The knowledge set of the purchasing/sales agents should be combined with that of the internal counsel to produce new knowledge for the template design in this situation. Since there is a need for the combination of knowledge, there is also the potential for knowledge creation hazards. As such, the roles of the parties also need to be defined. In this situation, the generalized legal knowledge is the more dominant component of the template, so the internal counsel should lead the team tasked with template design, with the purchasing/sales agents participating in the process to advise on the task.

Proposition 3 *When the exchange is a routine legal agreement (i.e., does not contain technical legal or engineering content) and the template design task is not decomposable, internal counsel should lead purchasing/sales agents on the design of the contract template.*

As in the template design, the contract negotiation also requires knowledge of the other party and general legal guidelines. However, since the legal clauses have been laid out in the template, this now becomes the secondary concern in contract negotiation. When negotiating the contract, knowledge of the exchange partner and the details of standard transactions dominate

this task. Therefore, the knowledge of the external counsel and managers and engineers is again not required, and the knowledge of the internal counsel and purchasing/sales agents need to be combined for the optimal solution to be found. In contrast to the template design, however, the purchasing/sales agents should lead the negotiation. The key issue is that those with the knowledge that is most central to the task should lead the team. Purchasing/sales agents know the nuances of negotiating routine deals and thus can be put in charge, while internal counsel participate to ensure that no inappropriate changes to the template or promises are made.

Proposition 4 *When the exchange is a routine legal agreement (i.e., does not contain technical legal or engineering content) and the negotiation task is not decomposable, purchasing/sales agents should lead internal counsel on the negotiation.*

High Legal Complexity—Decompoable (Low Interaction)

If the exchange involves an extremely specialized legal issue, such as a transaction subject to a regulatory oversight board or dealing with a specialized area of law (e.g., patents), but does not require interdependence between parties (i.e., the task is decomposable), then the knowledge set required to build a capability for the firm in this area would also have to be specialized. Unlike the contract templates for routine legal agreements that benefited from more generalized knowledge, designing the template for this type of transaction requires the use of external counsel.

The knowledge sets of purchasing/sales agents and managers and engineers are not particularly applicable because they lack knowledge of the legal complexities that will be most central to any template in this specialized legal area. Additionally, internal counsel is insufficient for this task for two reasons. First and foremost, their knowledge tends to be broad but not deep, which is a problem when a transaction requires extensive knowledge of a specialized area of the

law. It is hard for internal counsel to keep up with changes in the law, while specialist lawyers must do this to attract clients. Second, in an increasingly litigious society, especially after corporate scandals such as Enron, senior managers are increasingly concerned with litigation defense and doing what appears correct and justifiable to those outside the corporation. Hiring an expert from a specialist law firm is an action that can appeal to outsiders such as shareholders who want an objective look at the transaction as well as being an action that provides a strong legal defense if something goes wrong with the transaction (more for the executives than the firm).

Proposition 5 *When the exchange involves a highly specialized legal area and the template design task is decomposable, external counsel should design the contract template.*

In contrast to the template design, the negotiation of a highly technical legal contract, without interdependence between groups within the firm, does not require the deep, but narrow legal knowledge of external counsel. In this case, that specialized legal knowledge is already captured in the template that the negotiation is based upon. Therefore, the general legal knowledge of the internal counsel is adequate to perform this negotiation.[1] As with the template design, the knowledge sets of the purchasing/sales agents and managers and engineers are not relevant to this type of negotiation.

Proposition 6 *When the exchange involves a highly specialized legal area, the firm uses a contract template and the negotiation task is decomposable, internal counsel should negotiate the contract.*

[1] This assumes that the firm is using a contract template that has been designed by external counsel. If this is not the case, then external counsel will lead and internal counsel will also participate in the contract negotiation.

High Legal Complexity—Non-Decomposable (High Interaction)

When interdependence among the groups is added to a highly specialized legal agreement, the importance of the specialized legal knowledge increases, as this adds increasing complexity to the legal transaction. Thus, as was the case in the absence of interdependence, the knowledge possessed by external counsel will be very important in designing the template. In additional, the non-decomposable nature of the task means that internal counsel will need to provide an understanding of the firm's business practices in order to design a template that would benefit the usefulness of the template in future transactions. As the knowledge of the external counsel is more relevant, they should lead the team while internal counsel participates. The need for specialized legal knowledge is of first priority while the firm-specific input of internal counsel is secondary. Managers and engineers and purchasing/sales agents are still not required for a legally complex but technologically straightforward contract template.

Proposition 7 *When the exchange involves a highly specialized legal area and the template design task is not decomposable, external counsel should lead internal counsel on the design of the template.*

In the contract negotiation, the situation is virtually identical to the design of the template. The increased complexity of the specialized legal environment predominates, but the need for understanding of the firm's business is also necessary. As with the template design, the external counsel should lead, and the internal counsel should participate in finding the optimal solution. The lack of decomposability is critical in this situation. Internal counsel can only lead or operate independently when working from a template designed by external counsel. In the presence of such interdependence, the external counsel should lead internal counsel in the negotiations. If internal counsel were to lead the negotiations, the input of the external counsel may be relegated to a secondary concern, which is too problematic when legally complex issues are present.

Proposition 8 *When the exchange involves a highly specialized legal area and the template design task is not decomposable, external counsel should lead internal counsel on the negotiation.*

High Technological Complexity—Decomposable (Low Interaction)

The situation changes dramatically when the specialized knowledge required for the contract is technological and not legal. In a situation in which there is no interdependence among the relevant groups (i.e., external and internal counsel, purchasing/sales and managers and engineers), both technological knowledge and general legal knowledge are important in template design. Broad legal knowledge is required to ensure that the template meets all legal requirements and protects the firm's interests, while technological knowledge is required to ensure that the template is useful for the nature of transactions for which it is being designed. The knowledge of external counsel is not required because there is no legal complexity to the transaction. Likewise, the knowledge of purchasing/sales agents is not required for this template because of the specialized nature of the technological product or service that is being exchanged. Purchasing/sales agents are very useful for routine transactions, but much less useful when specialized knowledge is required.

Since these elements are decomposable in the design of the template, the two parties whose knowledge is required can pursue these areas separately. The knowledge of the managers and engineers would be required to detail the technological specifications required for the template (e.g., common contingencies, limitations, proprietary issues that are likely to arise), while the generalized legal knowledge of the internal counsel would be necessary for the addition of the standard legal clauses. There is no compelling reason to create a hierarchical team to manage the template design because the lack of interdependence means the task can be easily

isolated and performed independently (with internal counsel incorporating the technological input from the managers and engineers).

Proposition 9 *When the exchange involves a highly specialized technological area and the template design task is decomposable, managers and engineers should design the technological portions of the template, while internal counsel should design the standardized legal clauses.*

In the negotiation of this contract, the situation is similar to both early situations that were discussed above. Once the legal issues have been dealt with in the template, the individuals with the most relevant knowledge of the task should handle the negotiation of the details of the transaction. Since the negotiation is based primarily from a standard template, the need for the generalized legal expertise is diminished in the negotiation when compared to the template design. However, the need for the technological knowledge set becomes even more important than in the template design as the details of the technology and its impact on delivery need to be included in the contract. As such, the managers and engineers should conduct the negotiation in this situation.[2]

Proposition 10 *When the exchange involves a highly specialized technological area and the template task is decomposable, managers and engineers should negotiate the contract alone.*

High Technological Complexity—Non-Decomposable (High Interaction)

If interdependence is added to the situation involving a technologically complex exchange, then as in the exchange involving specialized legal complexity, this particular area becomes more complicated. As such, the knowledge set of the managers and engineers become even more important than without the interdependence, but the issue of integration with the internal counsel to protect the firm is also crucial. There is no clear-cut proposition in this

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[2] This assumes that the managers and engineers are working from a contract template that internal counsel helped create. If no template is used, then the managers and engineers should lead internal counsel in negotiations.

situation. If internal counsel is put in charge, they may trample the technological issues and focus on protecting the firm. If managers and engineers are put in charge, then they may downplay the legal issues. The nature of the firm's internal counsel should dictate who is in charge. If the firm's internal counsel are relatively militant and focused on protecting the firm at all costs, then managers and engineers should be put in charge. On the other hand, if internal counsel sees their role as business enablers (i.e., facilitating business while watching out for the firm's interests) who allow those with specific knowledge to make most business decisions, then the internal counsel should be put in charge.

When considering negotiations, however, the solution is much more straightforward. Since the legal implications can also be more complex, it is necessary for the internal counsel to be more involved in the negotiation than was the case in the absence of interdependence. Since this involvement of more than one party in a non-decomposable task creates the possibility of knowledge creation hazards, one party will have to lead the search for a solution. Since the technological issues outweigh the legal ones in this situation (the technological knowledge is specialized and must be carefully considered when agreeing upon the transaction), the managers and engineers should lead the negotiations, while the internal counsel also participates.

Proposition 11 *When the exchange involves a highly specialized technological area and the template task is not decomposable, managers and engineers should lead internal counsel on the negotiation.*

High Legal and Technological Complexity—Decomposable (Low Interaction)

In a situation in which there is no interdependence among the relevant groups (i.e., external and internal counsel, purchasing/sales and managers and engineers) but the transaction involves both legal and technological complexity, the specialized knowledge sets of external counsel and managers and engineers are required. The situation is too complex to involve

purchasing/sales agents and the decomposable nature of the task means that external counsel and managers and engineers can do their parts of the template creation independently without significant involvement by internal counsel. When specialized legal areas are involved, the deep knowledge of external counsel is more relevant than the generalist knowledge of internal counsel. Any firm-specific issues will be addressed by the managers and engineers, who know more about the firm's processes and technology than the internal counsel.

As the task is decomposable, the two relevant groups—external counsel and managers and engineers—can work independently without the need for a hierarchical team structure. Thus the optimal governance structure is likely to be a consensus based team where there is no leader and each group is assigned particular parts of the contract template.

Proposition 12 *When the exchange involves both highly specialized technological and legal areas and the template design task is decomposable, managers and engineers should design the technological portions of the template, while external counsel should design the standardized legal clauses.*

The situation is quite different when analyzing who should be involved in contract negotiations. Even when the task is decomposable and the knowledge sets can operate independently, it is hard for firms to have very different groups independently negotiating a single contract. There is a need for someone to integrate the two knowledge sets, which means that we either place one in charge of the other to serve as the lead in negotiations or we bring in a third player to act as the integrator.

We believe that the best solution is to have internal counsel serve as the lead negotiator and bridge the very disparate knowledge sets of external counsel and managers and engineers. Internal counsel can understand, at a high level, both the legal issues and the firm-specific issues that will be raised by external counsel and managers and engineers respectively. They also have the necessary credibility to confront each of these groups to help drive changes and compromise.

The alternatives are either to put the external counsel or managers and engineers in charge of the negotiation. If we put external counsel in charge and have managers and engineers report to them, we face two key problems. First, the main negotiator is not even part of the firm, so there may be an incentive alignment problem. External counsel does not have to live with the long-term implications of the contract because they are not part of the firm. Second, there is a large gap between the knowledge sets of the external counsel and the managers and engineers, and it is likely that external counsel may enforce their preferences even over the objections of the managers and engineers, which could lead to significant conflict within what is supposed to be a unified negotiating team. The knowledge gap could also lead to misunderstandings as each may not fully understand why the other wants to do something in a particular way.

There are also problems that are created by putting managers and engineers in charge of the project team. First, the conflict or misunderstandings due to the large gap between the knowledge sets of the two involved parties that existed if we put external counsel in charge is still an issue. Second, this could create legal exposure to the firm if managers and engineers do not pay attention to the input from the external counsel or if they misunderstand how to apply it because of the gap between their knowledge sets.

Another alternative is to put internal counsel on the team to serve as a bridge, but put either external counsel or managers and engineers in charge. The problem with this plan is that internal counsel would have little standing in the project team because they bring no specialized knowledge to bear. It is difficult to serve as a bridge without authority and putting another group in charge would undermine the ability of internal counsel to serve as an effective mediator. Thus we propose internal counsel, even though their knowledge set is not central to the exchange,

should lead external counsel and managers and engineers when the transaction involves legal and technological complexity and is decomposable.

Proposition 13 *When the exchange involves both a highly specialized technological and legal area and the template design task is not decomposable, internal counsel should lead both external counsel and managers and engineers on contract negotiation.*

High Legal and Technological Complexity—Non-Decomposable (High Interaction)

The final scenario presented here is one in which there is both legal and technological complexity as well as interdependence in the exchange. The interdependence (non-decomposability) requires a different solution than a task with similar complexity that lacks interdependence. While allowing the two relevant groups, external counsel and managers and engineers, to operate independently is fine when the task is decomposable, the same is not true when interdependence is introduced. Now a third party is required to integrate the efforts of the two primary parties, as was the case with the contract negotiation discussion above in the presence of legal and technological complexity. In fact, the template design and contract negotiation in the presence of interdependence should be organized like the contract negotiation without interdependence because of the need to integrate such disparate knowledge sets. The same problems exist with putting one specialist in charge of the other and with putting internal counsel on the team as a participant. When you need to integrate two specialists, a generalist who can speak to both (and has credibility with both) can be a very effective leader.

Proposition 14 *When the exchange involves both a highly specialized technological and legal area and the template design task is not decomposable, internal counsel should lead both external counsel and managers and engineers on the template design.*

Proposition 15 *When the exchange involves both a highly specialized technological and legal area and the template design task is not decomposable, internal counsel should lead both external counsel and managers and engineers on contract negotiation.*

Our propositions are summarized in Tables 2-5.

Insert Tables 2-5

DISCUSSION AND CONCLUSION

This paper identifies a new contracting capability that firms may develop--knowledge resource allocation with respect to template design and contract negotiation. The ability of firms to make these decisions effectively should develop over time, culminating in a contracting capability associated with knowing which parties possess the relevant knowledge for the task and which roles they should play in searching for the optimal solution. This is another aspect of contracting capability (Argyres & Mayer, 2005) that serves as a basis for understanding how firms use contracts strategically to increase their performance. If firms can develop strong capabilities around template design and contract negotiation then they may be able to greatly improve their survival chances by improving their ability to create value in inter-firm relationships. As globalization and increased competition lead more firms to work in partnerships and alliances with other firms, the ability to effectively attract and work with other firms will be critical. Creating a contracting capability that enables the firm to create effective contract templates and negotiate quickly and efficiently can help a firm attract and retain partners. By taking advantage of the experiences of specific parties, both internal and external, through the design of standard form contracts and negotiation of these contracts with their exchange partners, firms can improve the governance of their inter-firm relationships, thus leaving management with more time to allocate to internal products and capabilities related to their competitive advantage.

Knowing which parties should be involved in template design can be an important aspect of a firm's contract capability. A capability in this area will help firms create more optimal templates from which contract negotiation may be conducted more quickly and may enable some activity to take place through a market or hybrid structure that would not be possible if the firm lacked such a capability. Mayer and Salomon (2005) show that governance capabilities raise the level of contractual hazard necessary to lead a firm to internalize a transaction. Contracting capabilities related to knowing what knowledge is necessary for the construction of a contract template and who should negotiate the exchange from this template may have a similar effect.

Translating proper resource allocation into competitive advantage is challenging but still possible, even when external counsel leads the team designing the template and/or negotiating the contract. It is difficult to build a contracting competitive advantage when dealing with high legal complexity because the key knowledge resides outside the firm—with external counsel. One option for firms is to hire specialist lawyers and thus use internal (but now specialized) counsel for these transactions. While this is possible (and occurs in some instances), it is may be problematic as internal counsel may lack the incentives to stay current (they don't have to hunt for business on a daily basis) and they may be a weaker legal defense for the corporate executives if something goes seriously wrong. What firms are more likely to do is to use internal counsel to manage the external lawyers and build a capability in bringing diverse legal knowledge sets together to solve the firm's problems. Integration is a key, but underappreciated, function of internal counsel. They have the knowledge to be credible and effectively communicate with multiple external legal specialists (and internal technology specialists). Just as firms can create an alliance function (Kale et. al, 2002) to collect knowledge about how to properly handle alliances, firms can also use internal counsel to pool knowledge on how to most

effectively handle external counsel in designing contract templates and negotiating contracts. While this may not obviate the need for external counsel, a firm's ability to manage external counsel may still be a source of competitive advantage. The knowledge that internal counsel may collect could also reduce the firm's risk by enabling them to better govern external counsel—i.e., select better external counsel and better monitor them (Mayer & Salomon, 2006).

This paper also offers insight into how the problem-solving perspective can inform resource allocation in the design of contract templates and contract negotiations. The problem-solving perspective can offer more complex predictions regarding knowledge resource allocation than transaction cost economics and we hope this will cause people to look at contracting issues from a problem solving lens as well as a transaction cost lens. In fact, using the problem-solving lens, which focuses on capability creation not hazard mitigation, may actually lead to even more insight into the strategic use of contracts by firms as capability building can become the focus of the investigation.

Finally, since research in this area has just begun, there are many different ideas regarding choice for template design and contract negotiation, and contracting capabilities that merit further research. First, the propositions in this paper from the problem-solving perspective need to be empirically tested either through detailed case studies or by collecting data on the choice of template design or negotiation parties in a wide variety of inter-firm exchanges to understand the process of choosing between different parties as a function of both transaction and problem characteristics. Additionally, empirical work could be done to understand if the choice between the different parties and the roles that they assume result in a performance differential at the level of the inter-firm dyad and if they eventually aggregate up to affect firm performance. Finally, more work on contracting capabilities in general is necessary, so that we

can push forward our understanding of how to use contracting as a strategic tool, not just as a means of enforcing agreements.

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Figure 1. The effect of the type of content relevant to the transaction on the type of negotiator.

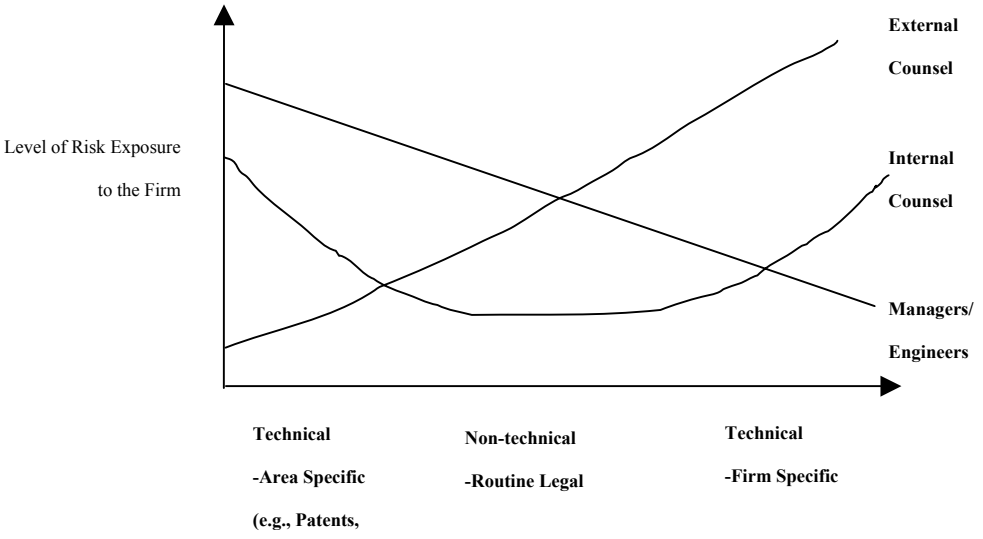

Table 1: The Players and Their Knowledge Sets

Resource	**Knowledge area**
Managers & engineers	Detailed knowledge of firm's technology, customers and business procedures/no knowledge of the law
Purchasing/Sales Agents	Detailed knowledge of the firm's customers and suppliers and routine management of those relationships.
Internal counsel	Detailed knowledge of the firm's business and relevant areas of law/ knowledge of law is broad, but shallow
External counsel	Detailed knowledge of a specific area of the law/knowledge of law is deep, but narrow

Table 2: Low Legal Complexity, Low Technological Complexity

	Decomposable	Non-Decomposable
Template Design	IC Alone	IC Lead, PA Participate
Contract Negotiation	PA Alone	PA Lead, IC Participate

Table 3: High Legal Complexity, Low Technological Complexity

	Decomposable	Non-Decomposable
Template Design	EC Alone	EC Lead, IC Participate
Contract Negotiation	IC Alone	EC Lead, IC Participate

Table 4: Low Legal Complexity, High Technological Complexity

	Decomposable	Non-Decomposable
Template Design	M/E - Technical components, IC - Std legal components. Run as Consensus Team	M/E & IC involved, leadership roles firm specific
Contract Negotiation	M/E Alone	M/E Lead, IC Participate

Table 5: High Legal Complexity, High Technological Complexity

	Decomposable	Non-Decomposable
Template Design	M/E - Technical components, EC - Legal components. Run as Consensus Team	IC Lead, M/E and EC Participate
Contract Negotiation	IC Lead, M/E and EC Participate	IC Lead, M/E and EC Participate