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Upfront

Doing Away with Lawyers New research shows that binding contracts may actually reduce trust

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NEGOTIATION TACTICS

Doing Away with Lawyers

New research shows that binding contracts may actually reduce trust

Organizations and individuals solve problems of trust by signing contracts. Well-written contracts make clear *what* one party should expect from another. But, according to a new study, contracts can also change perceptions of *why* people behave as they do.

The study, published in *Administrative Science Quarterly* (Fall 2002), contradicts the notion that binding contracts are the foundation for mutual trust. Indeed, the study found that “the use of binding contracts seems to have kept interacting parties from seeing each other’s cooperative behaviors as indicative of trustworthiness.”

If that sounds counterintuitive, consider the following hypothetical example. Two competitive companies agree not to use a manufacturing process that harms the environment but makes production cheaper. They decide to trust each other’s word and not to sign a formal contract. As time goes by, the companies honor the verbal agreement, and the CEOs begin to trust one another. Now, rewind, and imagine that the companies had signed a formal contract. As time goes by, the companies assume that the contract – and not goodwill – is the only reason their competitors resist the cheaper process.

Researchers Deepak Malhotra of the Harvard Business School and Keith Murnighan of Northwestern University’s Kellogg School of Management devised an experiment to simulate this sort of situation. Participants played a “game” designed to measure trust. One person was given \$8 and had two options: Keep the

money and end the game, thereby becoming \$8 richer and giving the second person nothing; or give the money to a second person, tripling the pot to \$24. At that point, the second person also had a choice: Honor the first person’s trust and split the money down the middle, \$12 each; or exploit the first person’s trust, keeping \$20 and leaving them only \$4.

The participants went through four rounds of entrusting their money to each other. There was one key vari-

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able in the game. Some participants were told that the second person had opted to use a binding contract; and then, after two rounds, they were told the second person rejected that contract. Others played all four rounds without contracts.

The results of the experiment were telling. When contracts were selected and then rejected, there was a precipitous drop in people choosing to trust (from 100 percent of the time to about 40 percent). Participants that played the entire game without contracts made slightly fewer trusting choices at the start (about 86 percent), but their

level of trust did not decline in the third round as it did for those who had contracts revoked.

“Attempting to mitigate risks early in the relationship,” the authors wrote, “can make it difficult to build the trust necessary to take greater risks in the future.”

This is especially true if a contract fails. For example, when pharmaceutical companies Johnson & Johnson and Amgen disagreed over the interpretation of a contract, the outcome was a bitter lawsuit. “When companies or individuals use the structural force of a contract as the primary (or sole) basis for their relationship,” the authors wrote, “they may encounter tremendous difficulties when the contract does not fulfill its intended purpose.”

The researchers offer one potential solution for this dilemma: nonbinding contracts. Nonbinding contracts, such as informal verbal promises, set norms for behavior between cooperating parties, but they also allow parties to infer that each other’s motivations are pure. Nonbinding contracts are not enforceable but in the long run can foster more of the trust that may be needed for parties to collaborate.

Such an approach may be particularly useful for nonprofit organizations, engendering trust while allowing flexibility in the relationship.

“When strict and extremely detailed contracts are used to delineate ... rights and responsibilities,” Malhotra said, “you take away [nonprofit managers’] ability to go out of their way to cooperate, to experiment, and to adjust.”

–J. Magee