Contract Analysis as a Marketing Educational Tool

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Abstract:

It is known by the literature that bounded rationality makes it almost impossible to build complete contracts. At the other side, incomplete contracts give rise to several problems and undesirable transaction costs that could be reduced if the contract building process was done with more details (accuracy). In some universities, students are not trained in these aspects, and the paper brings an exercise that is being successfully used as a tool for undergraduate and graduate students to analyze marketing contracts. It can be also used by the private sector.

Keywords: contracts, contract analysis, contract strategies, governance, marketing

1 – Problem Statement and Objectives

The fast changing world due to the opening of economies and globalization is changing companies. It can be seen that most companies are trying to focus activities into core competences and are outsourcing several others, reducing diversification. Vertical integration gives place to contracts as an alternative governance structure. Higher product specificities also contribute to move coordination forms from markets to contracts. The called “hybrid forms” gain “market share” in governance choices.

The importance of the training process of building and analyzing contracts is very clear. It is known that bounded rationality makes it almost impossible to build a complete contract. On the other side, incomplete contracts give rise to several problems and undesirable transaction costs that could be reduced if the contract building process was done with more details. In some universities, business undergraduate students are not trained in these aspects, and the article brings an exercise that is being successfully used as a tool for undergraduate and graduate students to analyze contracts. It helps students to learn how to build more complete contracts, mainly focusing in the analysis of the asset specificities, uncertainties and the performance desired for the marketing flows.

2 - Procedures

The process was built up using several authors in marketing and transaction cost economics, referenced at the end of the article, and based on Neves (1999[2]) and was already used in undergraduate (mainly in agribusiness, distribution channels, or supply chain management courses) and graduate programs (MBA’s, Masters and others). Contracts from very different sectors were analyzed, ranging, for

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instance, from a supermarket and a dairy supplier, a veterinarian company and the outside sales force, a clothing company and its retail stores at shopping centers, a car manufacturer and the distribution channels, orange growers and industry and several others in two years of use and improvement.

The procedure is very simple and motivating. As a beginning step, students will divide themselves in groups and will find a contract from any producing chain (in agribusiness courses normally students choose food chains, in general business courses other chains are analyzed). This contract can be either a supply or a distribution contract. Normally they use family relationships and friends in order to get a copy of the written instrument, with the authorization of the companies involved. This contract will be analyzed using the methodology discussed during the course, and during the process, students will fill in the charts and tables and will be able to perceive points where the contract is incomplete (possible sources of future disagreements). This analysis and the group contributions are presented to the other students in a workshop, and final remarks of the group with the comments of the whole class (in workshop) are sent to companies as a contribution. Confidentiality is guaranteed. The company members can be invited to the final workshop, and this is even a more motivating activity, making interactions and discussions possible.

3 – How to Analyze Contracts: The Method

Below are the five steps that have been used:

a) Careful individual reading and understanding of the contract and group discussion
b) Analysis of the Responsibilities
c) Analysis of the Several Asset's Specificities, Strategic Alternatives and Risk
d) Analysis of Possible Sources of Power
e) Contract Improvements and Institutional/Legal Considerations

Detailing the steps:

3.1 - Careful individual reading, understanding of the contract and group discussion

At first students will make copies of the contract, study it and produce a short presentation to the class including interesting aspects of the contract, the company and which transaction the contract is governing in that particular agri-food business system (chain).

3.2 – The Responsibilities in the Contract

The second step will study what responsibilities the contract brings regarding to product, service, communications, financial and information flows, necessary for chains to function and reach final consumers? As a suggestion, table 1, regarding the flows, could be considered, inserting or deleting new points. It is important, during the analysis, to separate each flow (product/service, communications, financial, and information) in different tables.

Table 1 - Product and Services Flow

FUNCTION	RESPONSABILITY	POSSIBLE IMPROVEMENTS
Product and Services Flow		
Inventory management		
Product transportation		
Product modification and after-sale service		
Customizing a product for the needs		
Providing technical service – explaining		
Product maintenance and repair		
Procedure and handling of returned products		
Promote product availability		
Providing other information to customers		
Packaging/ specific packages requirement		
Evaluate new products		
Direct store delivery		
After sales follow up		
Industrial Consumer Services		
Keeping quality and others (fill in)		
Communications Flow (Forward)		
Sales promotion to final consumers		
Information about product features		
Does advertising		
Provides sales force		
Measures consumer satisfaction		
Frequent visits/ face to face contacts		
Packaging information		
Project tracebility requirement		
Does fidelity programs		
Web site participation and others (fill in)		
Information's Flow (Backwards)		
Sharing knowledge of local market		
Scanning data (access to computer data)		
Complains via web site/service line		
Does electronic orders		
Order frequency/formats consideration		
Arrange information about consumption		
Consumer feedback and others (fill in)		
Payments and Financial Flows		
Conducting credit checks on final consumers		
Billing customers		
Caring for specific customer orders		
Arrange for credit provisions/Financing		
Price guarantees and others (fill in)		

Source: elaborated by the author using Corey et al. (1989); Rosembloon (1999), Wilson & Vlosky, 1997; Jackson & D'Amico (1989) and interviews done during Ph.D. research (Neves, 1999).

3.3 – Asset Specificities, Strategic Alternative Uses and Risk Analysis

Normally this is the most difficult part for the students, since mostly it is a new way of analysis and understanding. Asset specificity refers to how much the asset is specific to that function and the reallocation costs of the asset to other alternative uses. Since that, other agents in the channel can take opportunistic actions in order to have quasi-rents (Williamson, 1985; Klein et al. 1990). This analysis will help to bring insights about how to organize, to coordinate the transactions in the channel. The task is to fill the tables with the possible types of specificities: physical specific assets, technology related specific assets, human specific assets, location specificity and temporal specificity. Factors can be inserted and deleted at table 2. It is also a suggestion to separate these at the final presentation.

Table 2– Asset Specificity Analysis: Physical, Technological, Human and Marketing Investments

TYPE OF ASSETS INVESTMENTS	OWNER OF THE ASSET	DEGREE OF SPECIFICITY (High/Medium/Low)	REALLOCATION COSTS/ALTERNATIVE USE (Impossible, High, Medium, Low)
Physical Specific Investment Analysis: Infrastructure and Facilities			
General Factory			
Cold storage			
Special storage structure			
Tailored production facility			
Product demonstration facilities			
Specialized warehouses			
Repair and service centers			
Distribution channels investments			
Others			
Information and Knowledge Technology Specific Asset Analysis			
EDI/equipment for electronic data exchange investments			
Management process by product category			
Joint logistic planning process			
Joint quality programs			
Traceability programs setting			
New process joint generation			
Stock management process			
Others			
Specific Human Asset Analysis			
General training of distributors			
Joint sales training			
Production process knowledge			
Market knowledge			
Market knowledge			
Product brand knowledge			
Others (fill in)			
Marketing/Transaction specific Investments Asset Analysis			
Conjoint brand development			
Joint planning advertising			
Packaging development			
Public Relation efforts			
Others (fill in)			

Source: Author, based in Bello & Lohtia (1995); Klein et al. (1990); Kozak & Cohen (1997) and several interviews done during PhD. Research (Neves, 1999).

Time and location analysis are considered separately, since their analysis doesn't involve an owner, (see table 3), since they refer to characteristics of products or locations of the assets involved at the transactions.

Table 3- –Specificity Analysis: Time (temporal) and Locational (site) conditions

TYPE OF SPECIFICITY	POSSIBLE PRESENCE	DEGREE OF SPECIFICITY (High/Medium/Low)
Time Specificity Analysis: Refers to Time Pressure to do the Transaction (flow)		
Shelf life (perishable)		
Frequent/rapid deliveries		
Seasonally of Production (inventory needs)		
Seasonally of Consumption (inventory needs)		
Time procedures		
Other (fill in)		
Site Asset Specificity Analysis: Refers to Physical Locations		
Proximity needs (transport costs)		
Energy supply		
Water supply		
Disposal of materials		
Strategic position of inventory		
Location of Distribution Centers		
Location of outlets (point specificity)		
Others (fill in)		

Source: Author, based in Bello & Lohtia (1995); Klein et al. (1990); Kozak & Cohen (1997) and several interviews done during PhD. Research (Neves, 1999).

With the transactions and assets specificity remarks, elaborated based on the tables above, a summary about where is the specificity problem should be done, if exists possible actions to reduce it (new or alternative uses), and, if it does not exist, points or actions should be selected to be discriminated on the contract, trying to reduce the risk of opportunistic attitudes of firms that can take profit from unexpected factors.

Table 4 – Specificity Summary, Possible Risks and Contractual Warranty

LIST ALL HIGH SPECIFICITY FACTORS	RISKS IN THE SPECIFICITY FACTORS	CONTRATUAL WARRANTY

Source: Author

Other analysis that can collaborate in the process is the need of monitoring, even as a consequence of factors listed above. Table 05 is a suggestion of how to analyze monitoring activities. Which of them should be monitored, what is the ability of the company to monitor, is it possible to monitor, and even, what are the cost related to monitoring.

Table 5 - Monitoring Activities, Company’s Ability, Possibility of Observation, and Cost

List of Activities	Ability to Monitor	Possibility of Observation	Cost of Monitoring
	High/Medium/Low	High/Medium/Low	High/Medium/Low
Insert activities			

Source: Author

3.4 – Analysis of Possible Sources of Power

In establishing a contract between companies, another important analysis to be produced is the possible power sources that the company has and how these can be used at the agreement (Lusch, 1976; Hunt & Nevin, 1974; El Ansary & Stern, 1972, Pelton et al 1997; French and Raven, 1959); Stern and El Ansary ,1972; Etgar, 1978). It is interesting for the company, based on these sources of power and other sources not listed, to build an analysis involving the company and the contract partner. The following model can be useful, where students (or the company) evaluate company’s own possible power sources and those related to the contract partner, for example, rating from 0-10.

Table 6 - Power Analysis of Distribution Channels Sources

SOURCES OF POWER	Company	Contract Partner
Insert the source	Grade 0-10	Grade 0-10

Source: Author

This analysis will bring more insights for suggestions to the contract. Table 7 brings some of the already classified sources that can be applied.

Table 6 - Sources of Power, what do they refer to, some examples and problems of using

POWER	WHAT DO THEY REFER TO	SOME EXAMPLES/CHANNELS	PROBLEMS
Coercive power (use is negative) (economic)	Threat approach - due to the capacity of one chain member to punish another. It is based on the magnitude of the punishment and the credibility of the message (threatened member perceives higher costs in not agreeing).	• Discontinuing sales. • Refusing to deal. • Threatening to do vertical integration. • Full line forcing. • Add another distributor to area. • Allowing bypasses in channels. • Sell against manufacturers brand. • Threat of using gray markets. • Threat of using direct sales or electronic sales.	• Legal problems if the use is continuous. • Stimulate associations in the other levels for countervailing power. • More conflicts in the chain/channel. • Reduces information exchange incentives. • Risks of loosing a partner and fewer incentives to build relationship marketing.
Reward power (use is positive) (economic)	Possible rewards to members contribute to power and for them to work as established.	• Sales force compensation. • Price discounts due to performance. • Offering goods in short supply.	• Difficult to distinguish between this and coercion depending on the way it was used. • It can be limited to the geographic area or amount of rewards. • Diminishing returns, since agents get used to the rewards and want more.
Referent power (use is positive) (non economic)	Image or brands carried contributes to its power. There is a desire to be identified with this member of the channel.	• Strong brand. • National or global presence. • Store loyalty. • Private label loyalty.	• Looses image and trust in cases of wrong attitudes.
Expertise power (use is positive) (non economic)	Use of the knowledge in operation systems, market knowledge, marketing knowledge and others.	• High economies of scale. • Cost structure of business. • Training skills. • Site location knowledge.	• Looses trust in cases of wrong suggestions and actions regarding to market, marketing and others.
Persuasion power (use is neutral) (non economic)	Rational appeals based on size, financial position, knowledge and concentration. Refers to the role as leader.	• Large discounts. • Shelf space. • Market share. • Centralized purchasing. • Slotting allowances.	• Ethical and legal problems.
Legitimate power (use is positive or negative) (economic)	Guaranteed by contract. There is the knowledge in the chain that power exists.	• Using franchising and all other contract forms.	• All problems regarding to uncompleted contracts.
Information power (non economic)	Data on costs, sales and prices used to influence negotiations.	• All sources of information that can bring asymmetry and advantage. • Examples: scanned data.	• Not sustainable strategy. • Ethic problems and difficulties in building strong relationships.

Source: Neves (1999), based in Berman, 1996; Lusch, 1976; Hunt & Nevin, 1974; El Ansary & Stern, 1972, Pelton et al 1997; French and Raven (1959); Stern and El Ansary (1972), Etgar (1978), Gaski (1984) and several interviews.

It is interesting for the company, based on these sources of power and other sources not listed, to build an analysis involving the company and the contract partner. The following model can be useful, where students (or the company) evaluate company's own possible power sources and those related to the contract partner, for example, rating from 0-10.

Table 7 - Power Analysis of Distribution Channels Sources

SOURCES OF POWER	**Company**	**Contract Partner**
Insert the source	Grade 0-10	Grade 0-10

Source: Author

This analysis will bring more insights for suggestions to the contract.

3.5 - Contract Improvements (Suggestions) and Institutional Considerations

At this moment, several improvements to the document (contract) or next versions of the contract can be done. They can be ordered by importance and consider also possible desires of the partners and conflict sources. This is interesting for companies to prepare themselves before the negotiation.

Table 8: Aspects to be considered on the external contractual analysis, company's desire, channel's desire and conflict sources

Contractual Aspect for Improvement (see table 01)	**Company's desire For Improvements**	**Contract partner's desire**	**Conflict Source and Alternative to Resolution**
Product and product line treatment			
Communication treatment			
Geographical area			
Duration			
Exclusivity			
Price and payment terms			
Information flow and report			
Market research			
Renegotiations			
Fiscal rights			
Conditions to rescind the contract			
Others picked form table 1			

Source: Author

Institutional (Law) Aspects

The marketing proposals and suggestions of contractual improvements must consider the institutional environment, to see if it is possible at that particular environment, to propose such improvements. Table 9 (annex) brings some issues relating to contracts and possible problems that these actions can bring. So if some of these are being proposed, the possibility of having such problems must be considered. Specialists at the institutional environment (lawyers) could contribute to such analysis.

4 – Final Comments

It is important to say that this exercise is improving each time that the process is used. The discussions and group works are exciting and productive. It is also a tool for students to learn about contracts and how to relate with lawyers.

The companies with their contracts analyzed had as consequence good results and some of the executives that participated had nice impressions also about the discussions, even at the undergraduate level. It can be seen that there is a growing interest to have contracts analyzed by this method and that it can be a useful tool for students to be trained with, since this will be happening each time more at their professional life.

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Table 9: Issues, Actions and Consequences in Channels Regarding to Institutional Issues

ISSUE	ACTION	CAN BRING	Possibility
Exclusive Dealing	Customers sell only manufacturer's products or at least no products in direct competition.	Ready-available market to the seller. Limits buyer choice	
Tying Agreements Full-line forcing	a buyer must purchase one good to secure another (in case of two products) Forced to order, inventory, and display each type of product produced by a manufacturer that is applicable to its trade area.	Limit competition by forcing wholesalers and retailers to purchase a large selection of a manufacturer's product mix	
Resale restrictions	Manufacturer restricting authorized distributors from selling its products to unauthorized consumers. A territorial restriction either prevents or discourages from selling outside a particular area, while a customer restriction prohibits from selling to specific customers or classes of customers	Territorial and customer restrictions reduce intra-brand competition	
Reciprocity	The practice of buying goods and services from your major customers; in turn, these customers then purchase goods and services from the company.	Reciprocity severely limits the competition among noncustomers	
Refusal to deal	Involves a manufacturer or wholesaler refusing to sell goods to selected intermediaries. For example, a manufacturer can refuse to sell goods to a retailer that does not meet the manufacturer's sales quota. A seller can select its own distributors or dealers according to its own criteria and judgement	Legal issues: whether the refusal can be characterized as a conspiracy between firms that excludes other firms from being able to buy from that channel member.	
Vertical or Horizontal Integration	Relates to the legality of a firm acquiring channel members at different stages of the channel of distribution (vertical integration) or at the same stage of the channel (horizontal integration).	Courts are biased toward internal expansion by growth versus external expansion by merger or acquisition	
Price discrimination	Refers to price differences charged to competing channel members at the same level in a channel of distribution. In general, prices charged to competing channel members must be the same unless there are cost differences in selling and manufacturing goods to each channel member, a channel member meets another seller's lower price, or when conditions change (such as technological obsolescence). In addition, promotional allowances or services cannot be given unless they are offered to all competing customers on proportionately equal terms	Price discrimination legislation severely restricts the ability of channel members to charge different prices to competing channel members unless the channel members are able to cost-justify these differences	
Resale Price Maintenance	Manufacturers to set final retail selling prices, seeking to force dealers to sell products at specified prices, attempt to terminate dealers because of their failure to adhere to suggested prices, and ask dealers to report discounting dealers to them.	Generally, companies do not have the right to impose resale price maintenance on their customers.	
Gray market	Goods that are distributed through unauthorized channels of distribution. While gray market distribution generally refers to foreign goods purchased abroad that were not intended for the domestic market, it also includes goods that were transshipped from authorized dealers to unauthorized dealers.	Goods compete for market share with those imported through authorized channels. Infuriate authorized importers and retailers who pay higher prices and are forced to contribute to cooperative advertising programs.	
Unit pricing	Channel members are required to post not only the total price of an item, but also the price per standard unit of measure.	This allows consumers to compare prices when package sizes differ.	
Bait advertising	Involves the promotion of a product at an unusually low price. When a consumer seeks to purchase the advertised good, it is either unavailable or is disparaged by sales personnel	Channel members to increase customer inquiries or store traffic cannot use bait advertising.	

Source: Resumed by the author from Berman, 1996, and adding new aspects from interviews.