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Bird, Robert C.; Soundararajan, Vivek

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# The Role of Precontractual Signals in Creating Sustainable Global Supply Chains

Robert C. Bird<sup>1</sup> · Vivek Soundararajan<sup>2</sup>

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## Abstract

Global supply chains enhance value, but are subject to governance problems and encourage evasive practices that deter sustainability, especially in developing countries. This article proposes that the precontractual environment, where parties are interested in trade but have not yet negotiated formal terms, can enable a unique process for building long-term sustainable relations. We argue that precontractual signals based on relation-specific investments, promises of repeated exchange, and reassuring cheap talk can be leveraged in precontract by the power of framing. We show how these framing signals are amplified in precontract because the lack of credible information, minimal time for reflection, and the role of risk-aversion present in supply chain contract negotiations. The result is a process that is uniquely productive for building long-term and value-generating contractual relations in supply chains, particularly in skeptical or even hostile negotiating contexts. We then show how framed precontractual signals generate a joint contractual surplus through a supernormal profit known as a relational rent. This rent can be invested to improve sustainable practices, an efficient option in a competitive market due to the second order effects that sustainable practices generate. This novel process we propose thus potentially generates superior returns to other trust measures and encourages focus on precontract as a fertile environment for building sustainable investments.

**Keywords** Sustainability · Global supply chains · Precontract · Framing · Developing countries

Sustainability is an important component of multi-tier global supply chains (Levy et al. 2015).<sup>1</sup> There is evidence that sustainable supply chains improve product quality (Van der Vorst et al. 2009), unlock new markets (Hassini et al. 2012), increase consumer engagement (Linton et al. 2007), and deliver superior economic performance (Rao and Holt 2005). Sustainability in global supply chains is also of pressing social importance, impacting the health, safety, human rights, and economic development of workers (Maloni and Brown 2006). Sustainable practices also influence important environmental challenges such as climate change, pollution, and hyper-exploitation of non-renewable resources (Linton et al. 2007). As a result, a growing literature has emerged

in implementation of sustainability in supply chains (Van Bommel 2011).

Supply chain sustainability is increasingly understood as implicating issues of contractual governance (Lumineau and Henderson 2012; Lumineau and Malhotra 2011). Contractual governance is defined as the formal means between buyer and seller by which they safeguard the exchange of goods or services (Olander et al. 2010). Contractual governance is based on transaction cost economics, which theorizes that managers align inter-firm relationships to manage potential hazards in the exchange. Such alignment is obtained through agreements that establish outcomes for unexpected events and define remedies for breach (Poppo and Zenger 2002).

The allure of contractual governance is that when unexpected events occur agreements will be enforced as agreed or equivalent damages paid. However, firms in global supply chains increasingly conduct business in economies where institutions responsible for enforcing contracts are weak

<sup>1</sup> We interpret the term ‘sustainability’ in a broad fashion. More than environmentally aware supply chain management, a supply chain is sustainable when it is managed by taking economic, social, environmental, and related dimensions into account in decision-making.

✉ Vivek Soundararajan  
v.soundararajan@bham.ac.uk

Robert C. Bird  
Robert.Bird@business.uconn.edu

<sup>1</sup> School of Business, University of Connecticut, Storrs, CT, USA

<sup>2</sup> Birmingham Business School, University of Birmingham, Birmingham, West Midlands, UK

(Levitsky and Murillo 2009). India, Bangladesh, and similar nations that frequently host source providers for supply chains exemplify such environments (Trebilcock and Leng 2006). Without these prerequisite economic and social institutions, contractual governance in supply chains cannot effectively function through formal enforcement alone (Dixit 2009).

Exacerbating this problem is that firms in the global supply chain environment too often cannot assume the presence of extracontractual governance factors such as trust and relationships (Lund-Thomsen and Nadvi 2010). Lead firms grant suppliers short-term spot contracts, view them as interchangeable, and express little concern for the individual firms from which they source (Grimm et al. 2016).<sup>2</sup> Suppliers in turn perceive lead firms as fickle, demanding, and fixated on lowest price (Soundararajan et al. 2018). As a result, lead firms and suppliers may have little if any trust in one another.

While other works have examined the role of contract performance (Kalkanci et al. 2011), contract enforcement (Lin 2009), and contract remedies (Cafaggi 2013) within the supply chain context, the literature exploring the role of precontractual activity in building sustainable global supply chains is almost non-existent. A precontractual environment is the period when two or more parties have expressed initial interest in negotiating a contract but have not yet agreed on the entirety of the contract's terms (Bebchuk and Ben-Shahar 2001). Precontractual behavior is an essential part of contracting where emergent norms, bargaining power, and enforceable terms are cemented (Kostritsky 1997). Precontractual conduct can impact contractual performance and the effectiveness of successive contracts between the parties (Kostritsky 1998). Although the limited evidence available on the impact of precontractual conduct on supply chain relations and performance is promising (Beer et al. 2017), there is more work that needs to be done to understand the impact of precontractual conduct on sustainable supply chains. We narrow this scholarly gap by developing a process of how precontractual signals by the lead firm and supplier can facilitate the development of sustainable global supply chains. We leverage the role of framing, the organization and presentation of information to emphasize a current or desired state of existence (Soundararajan and Brammer 2018; Giorgi and Weber 2015), as a signaling channel. We show that, unlike environments of contractual performance and remedy, framing is amplified in precontractual environments where trust perceptions remain fluid, anticipation of

future returns is strong, and prior contractual experience with one another has yet to influence the emerging relation.

We begin by exploring the conflicting incentives of lead firms and suppliers that impede the development of sustainable practices. We show how framed signals, including relation-specific investments, offers of repeated exchange and cheap talk, can help build trust and generate relational rents in the precontractual environment. We then show how framed signals are amplified in the unique conditions of the precontractual environment. Finally, we explain how relational rents arising from framed precontractual signals solidify contractual performance and encourage a mutual commitment to sustainable practices.

## The Evasion Game Between Lead Firm and Supplier

In the competitive environment of global supply chains, cost becomes the dominant concern of lead firms (Choi and Hartley 1996; Lambert et al. 1998). The lead firms, directly or through intermediaries, choose suppliers to complete their orders. Suppliers compete for business through the production parameters set by the lead firms in the contracts. With suppliers plentiful and goods standardized, lead firms will frequently shift from one supplier to another based on the best price offered in the open market (Gereffi et al. 2005; Gereffi and Frederick 2010). Profit margins in these markets, especially in supply chains in the apparel and agricultural industries, are narrow (Sridhar and Prashad 2006). Under these conditions, a spot market is created whereby anonymous and undifferentiated suppliers compete for the business of distant and indifferent lead firms. The result is an anonymously competitive price-driven equilibrium that delivers profitable but thin margins where sustainability would be of little concern.

Upsetting this cost-driven model is the recognition that environmental destruction, child labor, forced labor, or other improper working conditions are endemic to supply chains, with increasing calls for lead firms to adopt sustainable practices (McCarthy 2017; Scherer and Palazzo 2011; Scherer et al. 2016). Non-Government Organizations (NGOs) and grassroots organizations are aware of these problems facing supply chains, and demand that firms conform to regulations and sustainability requirements (Mena and Waeger 2014). They publicize stories of malfeasance through social media and the public press, which in turn creates a name-and-shame effect on the lead firms who employ the non-sustainable suppliers (Lund-Thomsen and Nadvi 2010).

Lead firms, typically the primary target of NGO advocacy, find themselves under pressure to respond (Barrientos and Smith 2007). For example, a recent report by Global Labour Justice, an International NGO, exposed the sexual

<sup>2</sup> In this manuscript we use "suppliers" to mean suppliers that are at base of the supply chain or are otherwise distant in time, space, or intervening links from the lead firm.

and physical abuses perpetrated on women working in South Asian garment factories supplying brands like Gap and H&M. Media outlets like AlJazeera and The Guardian discussed this report thus putting pressure on brands to respond. As a result, Gap responded to the report emphasizing the policies in place to monitor and penalize such practices (Hodal 2018). Similarly, when SOMO, a Netherland based NGO published a report on bonded labor in garment factories in South India (<https://www.somo.nl/captured-by-cotton/>), lead firms faced immense pressure from the media and other stakeholders to respond immediately. Unresponsive brands were heavily criticized as a result (Bhalla 2015).

However, lead firms have limited ability to witness their suppliers' day-to-day conduct and discover real conditions in the factories (Wilhelm et al. 2016). Even if such monitoring were possible, the cost of monitoring distant and anonymous suppliers would be quite costly and may be too high to achieve profitably over time (Locke et al. 2009). Inspections often fail to uncover problems (Gualandris et al. 2015). Lead firms also face geographic, cultural, linguistic and institutional barriers that further impede monitoring (Zhou et al. 2016). In addition, unlike product quality and quantity, sustainability practices cannot be readily detected through examination of the final product (Wilhelm et al. 2016).

With direct monitoring of sustainability difficult, lead firms turn to sustainability certifications and social audits as information proxies (Bartley 2007; Mena and Palazzo 2012). Sustainability certifications allow lead firms to rely upon these certification entities that review the suppliers and affirm conformance to appropriate environmental and social practices (Locke et al. 2009). Such certifications convey legitimacy to NGOs and consumers in a clear and easily identifiable message (Soundararajan and Brown 2016). Given their relatively low cost and ease of publication, sustainability certifications are widely used across multiple industries in supply chains (Levy et al. 2015).

Suppliers, however, do not have the same incentives as lead firms to support sustainable practices. Suppliers, and particularly low tier suppliers, are relatively poor (Saini and Budhwar 2008). Sustainability standards can impose substantial financial pressure and threaten their ability to survive (Awaysheh and Klassen 2010; Khan and Lund-Thomsen 2011). Furthermore, suppliers can be only weakly impacted by, and thus have limited identification with, the pressure on the lead firm or the drive for sustainability standards. Sustainability messages are often viewed by suppliers as empty statements for public consumption (Soundararajan et al. 2018). Lead firms can be unpredictable in their supplier choices, continually changing their suppliers according to shifting demands (Soundararajan et al. 2018; Blyde 2014). Lead firm buyers can rescind contracts in volatile markets and unexpectedly contest contract terms such as quality and price (Tampe 2018). As a result, suppliers have little

motivation to invest in sustainable standards for the benefit of precarious partnership (Locke et al. 2009).

As a result of these incentives, suppliers seek out the least cost solution by evading sustainable practices through bribery or deceit. Adept at gaming the system, suppliers can bribe the authorities tasked with auditing the enterprise, structure the firm's operations so that they appear temporarily compliant when the audit occurs, or falsify written information that is transmitted to the certifying authority (Soundararajan et al. 2018). Suppliers can also display a 'show factory' for outsiders while operating their remaining facilities in unsustainable conditions. The result is that suppliers are incentivized to pursue only symbolic compliance (Huq et al. 2016; Lin 2009).

The result is an environment where governance of sustainability practices is an evasion game between lead firms, suppliers, and NGOs. Lead firms are forced to retain third-party investigators to ensure that sustainability expectations are satisfied. Suppliers shoulder evasion costs such as bribery and maintenance of false records in order to avoid detection. NGOs expend valuable resources investigating suppliers for violations and mobilizing other stakeholders to coerce sustainable change (Mena and Waeger 2014). The result is an inefficient outcome whereby costs are expended on avoidance, investigation, and sanction, rather than on improving social or economic welfare (Scholz 1984).

## Contracts and Supply Chain Relationships

A contract is a set of mutual and enforceable promises or obligations to perform actions at a future time (Macneil 1978). Contracts are not just tools for exchange, but also "governance mechanisms designed to minimize transaction costs: the costs of crafting a contract and managing a relationship and losses that accrue from opportunistic behavior or lack of adaptation" (Schepker et al. 2014, p. 195). Contracts act as instruments of control (Ariño et al. 2014). They explicitly define the rights and responsibilities of parties through authority mechanisms in order to minimize opportunistic behavior. Contracts also act as instruments of coordination, encouraging dialogue and information between parties that facilitates joint understanding of goals and mechanisms to attain them (Epstein 2014; Salbu 1997).

Within the supply chain management literature, numerous studies have so far examined how contracts can be structured to improve supply chain relationships and performance (e.g., Cachon and Lariviere 2005; Cao and Lumineau 2015; Tsay et al. 1999; Tsay and Lovejoy 1999). For example, Cachon and Lariviere (2005) explored revenue sharing contracts and concluded that, while such contracts can help coordinate a supply chain with retailers who compete based on quantities, they may offer only a small benefit when compared

with administratively cheaper wholesale contracts and in the presence of costly retail effort. Cao and Lumineau (2015) argued based on their meta-analytic study that contractual and relational governance are complementary to each other in producing positive joint impacts on supply chain performance under favorable institutional environments, relationship type, relationship length and contract measurement. Although these studies on contracts extend our understanding of the influence of different types of contracts on supply chain performance, they focus primarily on the economic aspect of supply chain performance. In addition, we find no studies examining how precontractual investments facilitate sustainability in global supply chains. In the next part, we explain how the precontractual phase of bargaining is a fertile environment for signaling relationship orientations.

## The Environment of Precontract

A buyer and seller are interested in exchange. After scanning their respective environments for possible suitors, the parties perceive a potential opportunity for exchange with one another. The parties exchange information with one another in order to determine whether a deal would be value enhancing and if so under what conditions (Johnston 1999). This engagement that begins once bargaining commences and before a contract is formed is known as the precontractual environment. The precontractual environment is distinct from contractual governance, performance, and remedies because no agreement between the parties has yet been formed (Farnsworth 1987). Parties in precontractual negotiations have an interest in bargaining. Each party anticipates outcomes that will increase their overall welfare through trade. The expectation of the profitable bargain incentivizes each negotiating party to reduce the uncertainty of the other sufficient to form a contract (Kostritsky 2008).

Precontractual environments offer distinct conditions compared to their fully formed counterparts. First, performance norms have yet to be established. The parties do not have a pattern of conduct during a particular transaction that guide the parties in areas of ambiguity, known in contract law as the course of performance (Graves 2004). For example, if a supplier were expected to deliver ten thousand garments monthly over a 24-month period, patterns of performance in the first few months can generate soft habits of obligation that guide the parties toward the end of the contracted obligation. In the precontractual phase, however, performance of the contract has not yet commenced and such norms are not available to guide the parties. Parties also may not be able to derive expectations from the parties' course of dealing, which is an experience or pattern that emerges over a period of time through repeated transactions (Ranere 2008). If this is the parties' first time contracting, there will

be no consummated transactions upon which to base norms from one another. Lead firm and supplier will thus not know how each behaves during the performance phase of contract and what norms could function for the mutual benefit of both parties. Thus, in a precontractual environment measures of inferring contractual obligations in the absence of explicit language are weak or absent.

There may be norms established by usage in the trade, which is any practice that is so regularly observable in the industry that it justifies an expectation to be followed by the parties. However, it is unclear whether suppliers can reasonably expect to extracontractually rely on standardized trade practices set by distant lead firms (Gereffi and Frederick 2010). Conversely, it is unlikely that suppliers have sufficient coordination to establish their own trade practices that a lead firm could rely upon (Rahim 2017). In the precontractual context, lead firm and supplier must negotiate terms and infer reliability without these interpretive guideposts.

Second, precise levels of bargaining power have yet to be fully established. As contracts are performed, lead firm can have greater bargaining power due to greater economic flexibility (Gereffi et al. 2005). However, individual precontractual negotiations can vary bargaining power considerably. A supplier may be a rare specialist in a particular product or service, thereby increasing its bargaining power (Dedrick et al. 2010). Conversely, a lead firm may be so dominant in an industry that it can exert even greater leverage than a standard competitor.

Without a joint understanding of the parties' relative contractual bargaining power, the value of that contract remains ill-defined. It is not always the case that dominant influence in contract negotiations will necessarily produce more favorable agreements for the more powerful party (Barnhizer 2005). Furthermore, disparities in bargaining power do not necessarily produce contracts that generate optimal value for both parties (Burkardt et al. 1997; Rubin and Brown 1975). If parties misconstrue their true bargaining power, as is possible in the precontractual phase when relative status is unclear, it can generate tension and unnecessary conflict (Barnhizer 2005). Though extreme differences in bargaining power can invite abuse, a clear definition of relative status in non-extreme environments can bring stability to both parties, and lead firm and supplier in the precontractual environment will be seeking information as to what role each party will play in the coming transaction.

Third, it is during the precontractual phase of bargaining that explicit contract terms hold their greatest power. The parties in precontract spend their time and energy negotiating the terms of the deal. These terms will govern their relationship. Unless there are specific reputational effects that are gathered from third party interactions, no relational norms yet exist that subsume explicit terms (Narasimhan 1989). Goal sharing, relationship value maximization, and



flexibility in signs of trouble, typical attributes in relational contracting that can override contract terms, have yet to evolve (Macneil 1978, 1987). Thus the parties, at least for the moment, will be expected to abide by the explicit language of the contract. Absent a formal dispute later on, the parties' joint focus on the contractual language may never be greater than during this initial negotiation.

## Signaling in the Precontractual Environment

The environment of precontract, where inferential obligations are unknown, bargaining power is uncertain, and relational norms have yet to emerge, is a fertile environment for parties to signal one another. Signaling is a statement or action that communicates information from the sender to the receiver that the receiver comprehends because only a sender with a particular characteristic can be willing to send the particular signal (Posner 2000). For example, willingly concluding a deal with a handshake signals both trust and economic power, as only a person who does not expect trouble and can afford to function without a formal agreement could do so. The harder it is to observe and verify facts about another party, the more important signals become (Moore 2003).

Lead firms can deploy precontractual signals to encourage sustainability conditions in their supply chains. The first and most obvious signal type is a direct investment into the emerging precontractual relation. For example, a supplier invests in lead firm-specific equipment even before the contract is signed with the lead firm. A lead firm can agree to negotiate exclusively with a supplier in good faith for a set period of time. A lead firm can expose the supplier to fair workplace practices by enabling collaboration between the supplier and an NGO. A clothing manufacturer can hire and train quality control personnel to serve a specific retailer and her specific demands prior to a written contract (Beer et al. 2017).

The advantage of relation-specific investments is that the signal is generally unequivocal. Expending resources on relation-specific investments signals to the recipient that the investor is interested in long-term future returns (Crawford 1990). Generally, only the entities that are willing to make such investments are ones that anticipate enough long-term payoffs to recover their costs (Posner 2000). A deceptive or short-term oriented party would be unwilling to make such investments because they could result in a loss for the short-term minded party and make exploitation unprofitable. The limitation, however, is that such investments can be costly. Firms operate on thin margins (Sridhar and Prashad 2006), and thus there may be little room for initial investments. If a firm voluntarily narrows that margin further through a

precontractual investment, the firm has to be confident that it can recoup the loss in the future.

The second precontractual signal is the offer of repeated exchange, which has been found to be valuable in prior studies of supplier–buyer relationships (Elfenbein and Zenger 2014, 2017). A repeated exchange is an offer made by the lead firm to the supplier to commit to multiple transactions of goods for contractually agreed period of time. When the period of time ends, the parties are free to renew their partnership or seek other buyers and sellers elsewhere.

An offer of repeated exchange is valuable to all parties, but especially so to suppliers at the base of the supply chain. One of the most important needs of a supplier is financial and operational stability. Suppliers at the base of the supply chain experience thin margins, inflexible demands, and unforgiving deadlines (Soundararajan and Brown 2016). Suppliers receive orders on an *ad hoc* basis and their survival depends on meeting time-pressured demands of lead firms. Once contracts are completed, further work can be discontinued without warning or reason. Survival for a supplier, particularly a small supplier in a competitive industry, is thus subject to volatility arising from economic forces outside its control (Choi and Hong 2002). An offer of repeated exchange by a lead firm grants needed stability to a supplier who can count on the commitment of multiple transactions. This increases the value of the bargain to the supplier, who may in turn be more willing to invest in the emerging relationship.

The final and perhaps most subtle precontractual signal between negotiating parties is known as cheap talk. Cheap talk is a message from one party to another party that does not impact either party's payoff from the forthcoming transaction (Johnston 1999; Farrell 1987). Although dismissively named, cheap talk is not valueless. Cheap talk has been shown in a variety of experimental contexts to influence human behavior (Dugar and Shahriar 2018; Anbarci et al. 2017; Crawford and Sobel 1982). Cheap talk can communicate expressions of optimism about the eventual outcome of the negotiations (Cooter 2000). Cheap talk can also communicate the confidence that an enduring partnership will be a profitable one.

Cheap talk in precontractual environments can be both informative and credible (Johnston 1999). Such talk enables the parties to test the counterparty's willingness to negotiate further, and can build cooperation in negotiation (Kostritsky 2008; Johnston 1999). Cheap talk also helps filter out parties who are incompatible and would be unwilling to invest in cheap talk exchange and by extension an emerging relationship. In addition to expressions of optimism and confidence, cheap talk can also appear as statements about mutual backgrounds and interests, exchange of gifts, socialization, or suggestions of possible areas of flexibility in negotiations (Shell 1991).

The advantage of cheap talk is that it is low cost. Statements of confidence and optimism, exchange of gifts, and related actions are sufficiently low cost that they would not materially impact the profitability of the emerging transaction (Johnston 1999; Farrell 1987). The limitation of cheap talk is that it might not always work. Parties may have lack a socio-cognitive common ground, language barriers may deter communication, and geographic distance may inhibit that discourages face-to-face exchanges (Abdi and Aulakh 2017; Soundararajan et al. 2017). This can be managed, however, by deliberate engagement with the other party and the use of intermediaries to translate messages through socio-cognitive lenses.

### Framing of Signals in Precontract Encourages Mutual Engagement

While signals are influential tools to communicate commitment in precontract, they become even more influential when leveraged by framing. Framing is the organization and presentation of information, actions, choices or events that emphasize a current or desired state of existence (Giorgi and Weber 2015). Framing generates a perception of outcomes and contingencies associated with a particular risk-based choice (Tversky and Kahneman 1981). In precontract, the lead firm can emphasize the positive gains of an interdependent relationship, such as the opportunity for supplier growth, consistent returns over time, and an enhanced ability to anticipate future market demands. This gain-focused framing influences the supplier to trust by raising expected utility of the transaction (Tversky and Kahneman 1986).

Framing can also influence non-risk-based factors. Attribute framing is a mechanism that impacts interpretation of a specific characteristic (Levin et al. 1998).<sup>3</sup> Framing attributes of the relationship positively can encourage engagement in the emerging relation. Contract attributes such as an incentive for prompt delivery of product can be framed as an on-time reward rather than a late penalty. Rates of long-term engagement by suppliers with the lead firm can be described as 75% success rate rather than a 25% failure rate (Teigen and Karevold 2005; Levin and Gaeth 1988). When events are framed in this fashion, individuals are more likely to view the attribute positively than in absence of the frame (Krishnamurthy et al. 2001; Marteau 1989; Wilson et al. 1987).

Recent research shows promising results for the role of framing on fostering sustainable global supply chains. For example, Soundararajan and Brammer (2018) studied how sub-suppliers respond to sustainability requirements in South India's garment industry. The authors found that framing of sustainability requirements played an important role in influencing sub-supplier perceptions of procedural fairness. These perceptions of procedural fairness in turn influenced their propensity to engage in reciprocal behaviors toward sustainability.

Framing is distinctive from other trust-building mechanisms because it is more effective during precontract than other contract phases. First, framing is more influential when credible information about the counterparty is limited or absent (Druckman 2001a, b). In precontract, and unlike other contract stages, neither party has the hindsight of experience working with the counterparty. This is particularly true for suppliers that communicate with lead firms only infrequently or indirectly. Their awareness of the other party is limited.

Second, framing is more influential when a party lacks the opportunity for careful evaluation and reflection (Hodgkinson et al. 1999; Tetlock 1992). Suppliers in precontract are driven by demands to respond to contract proposals at once, and contract demands are becoming increasingly time-sensitive due to the increased pace imposed by lead firms and global competition (Wilhelm et al. 2016). In the fast fashion industry, for example, increasing consumer demands for novelty has created as many as twenty fashion seasons per year. This forces suppliers to respond immediately to contractual demands and fulfill orders without delay. If a supplier hesitates, buyers will simply go elsewhere (Barnes and Lee-Greenwood 2006). Such an environment discourages suppliers from careful reflection, and thus framing takes over to enable cognitive shortcuts to reach a decision.<sup>4</sup> As a result, framing drives a decision more strongly than when opportunity for reflection is more readily available.

Finally, precontractual framing can leverage prospect theory. Prospect theory posits that individuals make decisions that deviate from expected utility in consistent and predictable ways (Kahneman 2011; Kahneman and Tversky 1979). Prospect theory predicts that individuals will select risk-averse decisions when choosing between options that appear to be gains. Conversely, individuals will be more likely to make risk-seeking decision in the face of choices between losses. (Guthrie 2003). Parties can leverage this deviation from expected utility by framing the precontractual decision to contract as a choice between benefits. This

<sup>3</sup> The classic study of attribute framing was conducted by Levin and Gaeth (1988), who showed that a sample of ground beef was perceived as better quality when it was labeled as "75% lean" than when it was labeled "25% fat."

<sup>4</sup> This effect is similar to fast and intuitive approached termed by Daniel Kahneman as "System 1" thinking, which contrasts the careful and deliberate "System 2" reflection method of processing information (Kahneman 2011).

leverages prospect theory to nudge the decision to contract toward risk-aversion and thus invest relationally even when expected utility might predict otherwise.

## Generation of Relational Rent and Investments in Sustainable Practices

Precontractual signals arising from framing effects encourage the parties to work together with an orientation toward the long-term (Beer et al. 2017; Frenkel 2001). This in turn generates a relational rent, a supernormal profit that is the result of parties pooling idiosyncratic resources, capabilities, knowledge, and governance mechanisms (Dyer and Singh 1998; Eunni 2009; Handfield and Bechtel 2002). Such rents take place when the expected value of inflows of investment and knowledge exceed expected losses due to competitors and knowledge spillovers (Cousins et al. 2006). They typically arise when parties engage in knowledge exchange, logistics responsiveness, and use of common resources (Frohlich and Westbrook 2001). Relational rents cannot accrue individually and are only available through alliances with partners (Lavie 2006). Relational rents are created through dedicated resource allocation and investments to coordinate relationships. These rents result in an increase of the performance of these relations over time (Kale et al. 2002). As noted earlier, both lead firm and supplier benefit from these rents through decreased monitoring costs, increased efficiency-enhancing practices, and relation-specific investments of labor and capital.

A firm benefitting from relational rent could choose to allocate that rent toward non-sustainable practices such as lowering prices. However, significant incentives exist for both parties to invest relational rent in sustainable practices. Sustainable policies and practices capture market value, encourage innovation, and promote new business platforms (Nidumolu et al. 2009). Sustainable practices can also improve risk management, foster innovation, improve financial performance, better engage customers, and motivate employees (Whelan and Fink 2016; Rao and Holt 2005).

Sustainability also helps suppliers through reduced local NGO resistance, increased productivity, and reduced turnover as a result of engagement in sustainable practices (Huq et al. 2016). Consequently, this reduces their overall operational cost (Wilhelm et al. 2016). In a price-sensitive setting like global supply chains, reducing operational cost without damaging the environment and exploiting labor is a unique selling point that would attract the attention of sustainability-focused lead firms.

If all firms could easily adopt sustainable supply chains, the benefits would be absorbed and cleared by market forces. Sustainable practices in supply chains, however, are not easy to imitate. Sustainability takes time, trust,

and coordination to achieve, and firms in supply chains can lack the culture, vision, or incentive to move successfully toward sustainable goals (Laughland and Bansal 2011). Firms already benefitting from relationships built on framed precontractual signals have already overcome many of these barriers. While the benefits of sustainability remain the same, the cost of achieving sustainability remains lower than firms dealing in the spot market. This encourages firms in trusting relations to pivot toward sustainable practices and overcome organizational frictions faster than competitors (Harbison 1956).

Incentives toward sustainable practices also emerge from the relationship. Both the lead firm and the supplier operate with thicker margins because of relational rent. The relational rent alleviates the financial pressure of avoiding genuine sustainability practices due to financial exigency. In addition, in spot market environments, a lead firm could avoid responsibility for unsustainable supply chain practices by denying responsibility for its suppliers or simply switching suppliers when external monitors apply pressure (Lerbinger 2014). Moral disengagement costs are low in spot markets because the lead firm holds no affiliation with the supplier and switching costs are negligible (Eriksson and Svensson 2016). However, when a lead firm has a long-term relational partnership with a supplier, denial of moral responsibility is unrealistic and decoupling costs are high. Switching suppliers would mean the loss of relation-specific investments, frame resonance and the relational rent.

There are also supplier-specific incentives to engage in sustainable practices. The supplier is aware that the lead firm's monitoring costs are low as a result of the relational partnership, increasing the risk of detection (Huq et al. 2016). In addition to the increased risk of detection, the supplier also has more to lose if inauthentic practices are uncovered. If the lead firm exits due to sustainability problems, it could trigger increased financial volatility, layoffs, and the loss of cultivated trust and relation-specific investments. A supplier accustomed to steady orders from a single lead firm in which it has made relation-specific investments may no longer be as nimble as its spot-market counterparts if involuntarily separated (Lazzarini et al. 2008). The increased risks and costs result in suppliers having a greater incentive to take sustainability practices seriously when expected from the lead firm. For example, global furniture seller IKEA manages their suppliers with these incentives in mind. IKEA executives adopt a partnership model rather than an adversarial model towards their suppliers. Through this model, IKEA works with suppliers to identify potential business improvements and correct them cooperatively. Suppliers reciprocate from this treatment by more readily meeting their production requirements, including their engagement in sustainability practices (Ivarsson and Alvstam 2010).



External monitoring incentives also change the lead firm and supplier relationship. External monitors or auditors remain important influences for promoting sustainable supply chains (Huq et al. 2016; Mena and Palazzo 2012; Mena and Waeger 2014). They will be aware of the firm-specific investments and other costly commitments that bind the supplier and lead firm. Those ties that bind, in turn, will enable monitors to target more effective and concentrated pressure on stable relationships rather than having to continually uncover the nature of partnerships between lead firms and shifting suppliers. In addition, monitors will generate a greater return on their resource investments by pressuring for sustainable change in relationships that will likely continue to endure rather than remain transient in the spot market. Lead firms who claim ignorance of supplier practices will be put to task given their steady and profitable engagement with the same suppliers.

The stability of lead firm and supplier relations also encourages the development of partnerships between the lead firm and external monitors. Monitors do not only have the ability to investigate and encourage sanctions, they often possess substantial expertise on the implementation and utilization of the practices for which they advocate (Teegen et al. 2004). Monitors can share this expertise with lead firms and suppliers in order to lower their cost of adopting sustainable practices. This can evolve into a relationship of its own, whereby monitors partner more closely with lead firms to promote a variety of mutually beneficial business competencies such as legitimacy with customers, access to local expertise, and development of new markets (Dahan et al. 2010). Firms will thus be motivated both through encouraging rewards and discouraging sanctions to engage in sustainable investments.

Given the rapidly evolving nature of sustainable practices, no lead-firm and supplier relationship will be perfect. Even firms with long-term, trustful and resonant relations will continue to experience difficulties with sustainability compliance. In any contractual exchange that lasts for a period of time, trouble between the parties is expected as a matter of course (Macneil 1987). Whereas in the precontractual context the parties build relations through investments, offers and communication, as the partnership solidifies precontractual signals between contracts evolve to serve as a check to preserve the partnership over time.<sup>5</sup> Parties can mismanage

contract performance, misinterpret intentions, or experience external social or economic shocks that destabilize their faith in the association. Instead of embedding norms during precontractual bargaining, investments now signal continuing commitment in between contracts when a partnership is threatened (Jap and Ganesan 2000). A temporary relaxation of contractual terms, sharing of production expertise, or a reaffirmation of commitments resting on a bedrock of precontractually cultivated trust can help fractured relationships get back on track.

## Boundary Conditions

Although precontractual signals, when framed appropriately, can facilitate profitable and sustainable relations, their ability to do so is not unlimited. Supply chains typically contain some risk, and a certain level of risk is required in order for the precontractual signals to work because risk is necessary for social exchanges to occur (Molm et al. 2000). If an association presents too little risk to the parties, there is no voluntary restraint from exploitation upon which mutual trust, and thus relational elements, can develop (Serva et al. 2005; Rousseau et al. 1998). Conversely, too much risk can prevent relationships from forming at all. Bargaining under high risk can encourage patterns of mutual resistance, suspicion, and hostility that derail a potentially valuable association (Boyle and Lawler 1991). When risk is excessive, precontractual signals may be rejected as insufficient displays of relationship development or exploited as signs of weakness. Thus, a level of risk that is neither non-existent nor extreme is necessary for precontractual signals to function.

In addition, even though precontractual signals are market-driven and rely on self-interest, an external incentive may be necessary to initiate the sustainability-generating mechanism in supply chain partnerships. For example, firm leadership may have the vision to pursue the superior value that exists when companies pursue long-term supplier relations in their supply chain (Prajogo and Olhager 2012). This in turn will encourage the relational climate that advances sustainable policies. External monitors can place sufficient pressure on firms that they eschew ‘window dressing’ in favor of wanting genuine sustainable investments. In some cases, a tragedy such as the Rana Plaza disaster can motivate even firms uninvolved in the event to invest in sustainable practices as a safeguard (Jacobs and Singhal 2017). Finally, firm leaders may display a moral motivation to act (de Colle and Werhane 2008), based upon an altruistic commitment to fairness, social justice and worker well-being. These triggers, whether by altruism, incentive, or coercion, enable precontractual investments to promote sustainable practices through profitable exchange.

<sup>5</sup> As the partnership has progressed beyond initial bargaining and exchange, investments at this time could more accurately be called intercontractual investments. At the end of a contract, the parties reassess their relationship before negotiating a new contract. Intercontractual investments are signals and actions taken in between the performance of completed and anticipated contracts. For purposes of this manuscript, intercontractual investments play a similar role as precontractual signals, though further research may unearth intriguing differences between the two contexts.

Third, our arguments suggest the existence of a relational rent in order to motivate the investment in sustainability initiatives. In spite of the literature that theorizes the conditions under which relational rent may be created (Dyer and Singh 1998; Handfield and Bechtel 2002), there may be situations where a shared surplus may not materialize. Capital and human investments may either be unavailable or be so homogeneous as to be not firm-specific. Relation-specific investments may not produce a return that exceeds the short run opportunity cost or returns from the second best use of the resource (Dyer and Singh 1998). The spot market may already be so efficient that relation-building adds little value. Cultural, temporal, linguistic, or intermediation barriers may be so strong that a shared surplus cannot take root. Relational commitments may turn myopic, leading parties to miss new opportunities and stagnate (Grayson and Ambler 1999; Zahra et al. 2006). Firms can also squander relational rent through myopia, mismanagement, or stagnation and thus deter sustainable initiatives.

Fourth, scholars across disciplines agree that “frames are effective at influencing an intended listener or audience when they resonate, i.e., match or align with the audience’s beliefs, values, aspirations, or ideas” (Giorgi 2017: p. 712; Carter 2013; Benford and Snow 2000). Some frames may be non-resonant with the recipient, such frames that are culturally sensitive to time and context (McDonnell et al. 2017). Therefore, in order for the lead firm’s framing of a precontractual signal to make an optimal impact, the frame must sufficiently resonate with the supplier to provoke a response or an action.

Finally, the success of the precontractual signals depends on the existence of absorptive capacity in lead firms and suppliers. Absorptive capacity is the ability to assimilate and apply valuable external knowledge (Zahra and George 2002) of lead firms and suppliers. Both lead firms and suppliers must be capable enough to absorb and utilize the knowledge transferred between them. Research suggests that absorptive capacity is influenced by various factors including past experience, knowledge source and complementarity (Zahra and George 2002). Efforts directed at reducing information frictions, for example, may be obstructed by differing perceptions of knowledge absorptive capacity among lead firms and suppliers. For the precontractual signals to work, both lead firms and suppliers must be able to process knowledge in order for relationship development to occur.

## Discussion

Research suggests that the impact of existing measures to improve sustainability in global supply chains is limited (Locke et al. 2009; Soundararajan and Brammer 2018). As sustainability expectations are often a part of contracts, and

that the complexities of global supply chains impede contractual performance, poor implementation of the sustainable practices becomes a significant risk. By drawing on insights from the literature on contracts (Bebchuk and Ben-Shahar 2001; Kostriksy 1998), we explain how transaction-specific material and non-material signals during precontractual bargaining, when framed appropriately, can facilitate contractual performance of sustainability obligations.

Our article offers multiple contributions to the literature. First, we contribute to the growing research on sustainable global supply chains (Huq et al. 2016; Levy et al. 2015). While significant research has addressed contracts in supply chain management (Cachon and Lariviere 2005; Cao and Lumineau 2015), we know little about the influence of precontractual signals on sustainable practices in global supply chains. The influence of framing precontractual signals, including relation-specific investments, offers of repeated exchange and cheap talk, offers a promising line of research into precontractual behavior in supply chains.

Second, we add to the literature on supply chain governance (Bartley 2011; Detomasi 2007; Nadvi 2008; Parmigiani and Rivera-Santos 2015; Scherer et al. 2006) by opening up a new line of inquiry into governance mechanisms that blend together market forces, self-interest, and precontractual conduct. The literature on governance in global supply chains is divided. One strand focuses more on economic competitiveness (e.g., Gereffi et al. 2005; Humphrey and Schmitz 2002) and the other strand emphasizes more on social and/or environmental sustainability (e.g., Lund-Thomsen and Lindgreen 2014; Soundararajan and Brown 2016). By highlighting the precontractual process through which these two strands can be combined and relationship can be improved between lead firms and suppliers, we add to the emerging literature on governance for sustainable global supply chains.

Third, our research advances the application of framing into a novel contractual context. The concept of framing has been used extensively in social sciences to understand a wide range of topics, including collective action (Benford and Snow 2000), political communication (Scheufele 1999) and investment decisions (Giorgi and Weber 2015). Nevertheless, the concept is significantly underutilized within the sustainable supply chain literature (Soundararajan and Brammer 2018). By highlighting the role of framing as a channel through which precontractual signals can be effectively transmitted, we suggest the power of framing in contract performance in complex contexts like global supply chains.

Fourth, the extant research on sustainable global supply chains offers limited insights about the micro-level behavioral processes that are involved in the sustainability-related exchanges between lead firms and suppliers (Soundararajan and Brammer 2018). By emphasizing the importance of embedding interactional and communicative processes in

the precontractual signaling process, we contribute to the emerging literature on the micro-processes of sustainable global supply chains.

Finally, our work advances understanding on interplay between formal contracts and relational governance. There is a split in the literature, with some finding that contracts reduce relational motivations and behavior (e.g., Malhotra and Murnighan 2002) and others concluding that contracts facilitate trust-building and initial cooperation between contracting parties (e.g., Poppo and Zenger 2002; Gulati and Nickerson 2008). Our work supports the latter view and highlights how formal contracting and relational governance are not substitutes in supply chains, but value-generating compliments. We suggest that formal contracts and their precontractual negotiation are necessary bases from which relational governance can emerge. Also, formal contracts remain a backstop of protection when relational governance is challenged through misinterpretation of terms or non-performance. Contract terms prevent devolution of problems into mistrust and enhance likelihood of repair (Lumineau and Henderson 2012).

## Future Research Directions

Our paper is one of the first to explore the role of precontractual signals in building sustainable global supply chains, there are avenues for future research. First, we focused on a few types of precontractual signals, namely relation-specific investments, offers of repeated exchange and cheap talk. Future research can unveil other types of precontractual signals and their influence on negotiations and subsequent impact on performance and sustainable practices. Second, given that precontractual negotiations play an important role in the sustainability performance of the supply chains actors, future research is needed to explore how precontractual negotiations occur, and the factors that shape such negotiations (Beer et al. 2017). Third, more research is needed on violations of contracts within global supply chains. We do not know enough about how and why suppliers violate contracts, and how lead firms respond to contract violations. Fourth, while we highlighted the importance of framing precontractual signals to avoid signal distortion, we did not explore the influence of different types of framing. Future research can explore the effects different framing of precontractual signals can have on relationships and sustainability performance. Fifth, future research can also explore the conditions under which framing resonance of precontractual signals can occur. Sixth, more work can be done on the impact of prospect theory and framing on developing sustainable relations, particularly in varying informational, cultural, and economic conditions. Finally, some supply chains are heavily reliant on intermediaries who provide data

about suppliers, facilitate economies of scale, ensure quality assurance and tailor relationships to specific customer needs (Boyle et al. 2008). Further work can explore the positive or negative influence of intermediaries on the precontractual negotiations related to sustainability, and development and maintenance of contractual relationship between suppliers and lead firms.

## Conclusion

As the conventional tools to implement sustainability in global supply chains, including standards, conventions and regulations have not produced the intended outcomes; it is becoming apparent that research and practice ought to explore novel tools. While other work examines contract performance and breach, we direct our attention to the precontractual stage, which lays the foundation for the contractual performance of a lead-firm-supplier relationship. We suggest that when signals like relation-specific investments, offers of repeated exchange, and cheap talk are used during the precontractual stage, they can leverage the benefits framing not fully available in other contractual stages. As a result of the relation-specific investments and offers of repeated exchange, a surplus in the form of relational rent can be generated. This rent can then be used to implement and improve sustainable supply chain practices. By emphasizing the importance of precontractual investments as a mechanism to enable sustainable global supply chains, we show how precontractual forces can encourage sustainable practices. Precontractual investments can in fact complement other mechanisms under certain conditions and are a promising avenue for further scholarship.

## Compliance with Ethical Standards

**Conflict of interest** The authors declare that they have no conflict of interest.

**Ethical Approval** This article does not contain any studies with human participants or animals performed by any of the authors.

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