Partner Misbehaviour in Strategic Alliances: Guidelines for Effective Deterrence

by T. K. Das and Noushi Rahman

What can be done if the relationship with a strategic partner turns sour?

One of the pervasive problems faced by firms in strategic alliances is the potential for misbehaviour by the partners. Examples of such partner misbehaviour include breaking promises, not sharing resources or facilities as per agreement, bluffing, lying, misleading, misrepresenting, distorting, cheating, misappropriating, stealing, etc. Although the literature contains numerous mechanisms to deter partner misbehaviour, no comprehensive set of guidelines exists for applying these mechanisms effectively in practice. This lack of clear and well-reasoned directions for selectively instituting appropriate deterrence mechanisms is partly due to inadequate attention to the topic by both academics and professionals.

In this article we systematically examine the nature of these deterrence mechanisms in order to compile useful guidelines for controlling various kinds of partner misbehaviour. To that end, we review the complete range of these mechanisms found in the literature, and propose three types of purpose-based mechanisms — namely, preventive, operational, and contingency mechanisms. We also suggest that partner misbehaviour needs to be deterred through different mechanisms depending on the particular stage of an alliance’s development. We discuss in some detail, with examples from industry, a total of 15 deterrence mechanisms, each in the context of the relevant alliance stage. Thus, we propose a contingent approach, embodied in the guidelines here, to the selection of specific mechanisms to deter potential partner misbehaviour.

T.K. Das is Professor of Strategic Management at the Zicklin School of Business, Baruch College; Noushi Rahman is a doctoral student and both are at the City University of New York, USA.
In recent years, firms all over the world have been entering into strategic alliances in order to grow in existing businesses as well as to enter into new ones. Strategic alliances are collaborative endeavours between two or more firms to jointly pursue strategic objectives that are not possible for any one of them to achieve individually. Despite the upsurge in the number of alliances, the failure rates of these interfirm cooperative ventures have generally been very high, hovering around 50 per cent according to a number of studies [1]. We suggest that the premature terminations of alliances can be attributed in many cases to relationship problems between partners as opposed to business difficulties. Relational issues as causes for failure are unique to strategic alliances, whereas performance-related explanations are equally applicable to both alliances and single firms. A frequent source of relationship problems is partner misbehaviour. It is important, therefore, that alliance managers understand the origins and complexities of the relational hazards of partner misbehaviour in strategic alliances.

MacMillan, Money, and Downing [2] recently addressed the need for trust and commitment in interfirm relationships to ensure positive behaviour from member firms. They suggest that certain drivers, such as tangible and intangible benefits, coercive power, termination costs, shared values, equity of exchange, communication, and past trust-related behaviours yield trust and commitment in business relationships and produce positive behaviour from the involved parties in the form of creative co-operation, loyalty, compliance, and trust-related behaviours. Das and Teng [3] have discussed how trust, control and risk need to be managed in an integrated manner to foster partner co-operation.

Although encouraging and ensuring positive behaviour is important for alliance success, deterring partner misbehaviour is even more fundamental for operational efficiency and avoiding premature dissolution of alliances. Practitioners and researchers alike should realize that partner misbehaviour is an obstinate phenomenon that threatens the essence of co-operation in strategic alliances. Nevertheless, its nature is more complex than is generally acknowledged or grasped. To increase the probability of success in their alliances, managers of alliance firms need to appreciate the nuances of partner misbehaviour to be better able to prevent and curb such undesirable tendencies and actions of their partners. Our aim here is to brief managers in alliance firms about partner misbehaviour and offer them a set of guidelines to deter such behaviour.

We divide the article into four parts. First, we discuss the nature and consequences of partner misbehaviour in strategic alliances. Second, we briefly explain the three stages of alliance development (formation, operation and modification) that serve as the context for selecting appropriate mechanisms to deter partner misbehaviour. Third, we propose that all deterrence mechanisms, in practice and in the research
literature, can be classified into three types based on their purpose — namely, preventive, operational, and contingency. Lastly, we present a comprehensive series of guidelines for deploying the various deterrence mechanisms, discussing each mechanism, with illustrations from industry, in terms of its suitability in specific stages of alliance development.

**Understanding Partner Misbehaviour**

**Nature and variety**

What actions of the partner can we consider as misbehaviours in strategic alliances? Broadly, partner misbehaviour occurs when the partner violates the norms of collaborative behaviour [4]. For example, Lear Corporation's self-disbelived promises to procure a large contract from Ford to design and manufacture passenger seats for several Ford vehicles was a form of misbehaviour on Lear's part [5]. Whereas Lear succeeded in getting the contract by withholding information about its lack of adequate competence, it eventually missed supplier delivery deadlines, failed to keep costs down, and compromised quality standards. Obviously, Lear's misbehaviour caused serious problems for Ford. In Table 1 we list selected observations on partner misbehaviour from the literature.

We should note, however, that certain behaviours — for example, hard bargaining and heated arguments — that merely differ from a firm's expectations, are not forms of misbehaviour. For instance, in March 1999, Ultramar Diamond Shamrock (UDS) and Phillips Petroleum terminated their joint venture discussions during the formation stage, when the potential partners could not agree on some key issues after five months of negotiations [6]. Although the alliance never matured to the operation stage, neither party could be blamed for misbehaviour.

Partners can misbehave passively or actively [7]. Examples of passive misbehaviour include breaking promises, not sharing resources or facilities as per agreement, abandoning the alliance to seek other opportunities, collaborating with another firm that is a direct competitor of the focal firm, and making irresponsible decisions about the direction of the alliance. Consider the MCI-Telefonica alliance, established in March 1998 with much enthusiasm. When conflicting goals stalled the alliance from the very outset, both MCI-WorldCom and Telefonica entered into partnerships with each other's competitors, indicating a lack of solidarity on the part of both alliance firms. MCI purchased a controlling stake in Embratel, one of Telefonica's competitors [8] and Telefonica secured a 10 per cent equity stake in IDT, one of MCI's competitors [9]. Notice that the misbehaving actions are not in the form of active aggression, but in bypassing collaborative understandings.

Examples of active misbehaviour include bluffing, lying, misleading, misrepresenting, distorting, cheating, misappropriating, expropriating, stealing, trying to takeover the focal firm's business, etc. Consider the
strategic alliance between Heron Resources and Centaur Mining and Exploration. Instead of working jointly to achieve alliance goals, Centaur was lured by Heron’s distinctive resources. It made a takeover bid for Heron ‘to gain full ownership of vast nickel laterite resources outside the Centaur group’s exploration tenements,’ but Heron directors branded this offer as ‘opportunistically and totally inadequate’ [10]. Presumably, passive misbehaviour tends to be less harmful than active misbehaviour, being less intense, but alliance managers need to be aware of both types to be able to protect themselves by deploying appropriate deterrence mechanisms.

Causes and consequences

Why do partners sometimes misbehave in their alliances? This is a critical question for alliance firms, and we believe that partners misbehave for a variety of reasons. First, a partner firm may be inclined to gain unfairly from the alliance by cheating the other member firm — which we will call the focal firm for clarity, and adopt its perspective throughout this article. This is especially so when the actual outcome of the alliance falls short of expectations and the partner, thereby, fails to break-even or misses its performance target. Second, a partner’s desire to gain access to the focal firm’s unique competence (e.g., know-how, key employees, distribution network, etc.) may trigger misbehaviour on its part. Third, a partner may misbehave by not being candid and forthcoming to the focal firm. As a result, when new business opportunities emerge, the partner deserts the focal firm to pursue its private interests. The situation worsens when the focal firm is stuck with the alliance because of its irrevocable investments.

The consequences of partner misbehaviour are quite obvious. They could vary from temporary losses to severe setbacks. A focal firm may fail to reap the maximum benefits from the alliance because of its partner’s irresponsible actions, lack of total commitment and effort toward joint task accomplishment, etc.. Also, if the partner misrepresents its abilities while joining the alliance, the focal firm may not be able to enjoy any competitive advantage, because of the partner’s lack of competence. On a more serious note, the focal firm may end up handing over its unique know-how, key personnel, or rare and immobile resources to the partner. Consequently, the focal firm may lose its valuable competitive advantage and, in extreme cases, may even have to abandon its business. Often the focal firm, or a part of it, is taken over by the partner and converted to a subsidiary or a division.

Thus, it is evident that partner misbehaviour is a serious issue in strategic alliances. Unfortunately, no systematic framework exists to control partner misbehaviour. Despite the existence of many deterrence mechanisms, we lack the understanding to apply these mechanisms in the right situation at the right time. We suggest here that partner misbehaviour can be better understood and prevented if we take into account the
<table>
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<th>Author(s)</th>
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<tr>
<td>Gassenheimer, Barcus, and Barcus [66]</td>
<td>'Opportunism may stem from the reluctance of members to fulfill commitments to partners in co-operative arrangements' (p. 70)</td>
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<td>'Lack of desire or shirking commitments may lead to disputes in co-operative arrangements' (p. 70)</td>
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<td>'To achieve their goals through deceit or other means that may harm the other partner' (p. 74)</td>
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<td>Greister [69]</td>
<td>The first form of negative opportunism comes into play when one party to an exchange possesses information about a transaction that could significantly alter the other party’s assessment of the outcomes. Such information has value in the exchange, and its contribution, concealment or misrepresentation may affect the equity of the transaction’ (p. 486)</td>
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<td>'The second form of negative opportunism results when an agreement is abrogated or a relationship abandoned to the advantage of the instigator but without provision or remedy for the other party. In such a case, one party, the victim, is usually more dependent on the relationship than the other; the imbalance of dependency results in the risk of exploitation’ (p. 486)</td>
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<td>The third form of negative opportunism involves the withholding of full effort and co-operation in an ongoing relationship. Shirking, free riding and stonewalling are examples of such behaviours. Even though they are not always easily detected, these behaviours can greatly degrade efficiency’ (p. 487)</td>
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<td>Klein [70]</td>
<td>'To violate the intent of the contractual understanding’ (p. 481)</td>
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<td>Nooteboom [71]</td>
<td>'Individuals may be tempted to defect and be opportunistic while pretending to be trustworthy. The extent of this temptation increases as more people are trustworthy, and if further depends on the efficiency and reliability by which such detection can be detected and communicated and the ensuing risk of a loss of reputation that is detrimental to future partnerships’ (p. 989)</td>
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<td>Provan and Skinner [72]</td>
<td>'Activities like taking shortcuts, breaking promises, masking inadequate or poor quality work and generally being dishonest in order to gain an advantage are examples’ (p. 203)</td>
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<td>For instance, some packers in the meat industry have been known to mix inferior grades and cuts of beef with their regular beef shipments to restaurant suppliers as a way of cutting costs and increasing profits’ (p. 204)</td>
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<td>For instance, in order to ensure prompt and adequate delivery of certain types of equipment and parts from a supplier, a dealer may make false promises to devote a certain amount of showroom floor space to a new product line and to undertake a major local promotional campaign’ (p. 204)</td>
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<tr>
<td>Watne and Heide [73]</td>
<td>'Under certain circumstances, passive opportunism takes the form of shirking, or evasion of obligations’ (p. 41)</td>
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<td>'Passive opportunism under new circumstances takes the form of inflexibility, or refusal to adapt’ (p. 41)</td>
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<td>'Active opportunism under existing circumstances means that one party is engaging in behaviours that were explicitly or implicitly prohibited’ (p. 42)</td>
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<td>In active opportunism under new circumstances, one party uses the new circumstances to extract concessions from the other’ (p. 42)</td>
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<tr>
<td>Weaver and Dickson [74]</td>
<td>'Opportunism results from the willingness to focus on the gain of the individual firm, regardless of the cost to the alliance’ (p. 203)</td>
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<tr>
<td>Williamson [75]</td>
<td>The making of false or empty, that is, self-disbelieved, threats and promises in the expectation that individual advantage will thereby be realised’ (p. 26)</td>
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<td>Williamson [76]</td>
<td>'Calculated efforts to mislead, distort, disagree, obfuscate or otherwise confuse’ (p. 47)</td>
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characteristics of the particular development stage of the alliance. Instead of the random deployment of deterrence mechanisms, we offer a systematic way to institute them selectively in the context of specific alliance stages. This should help decrease the failure rate of alliances due to relational hazards. Also, as we indicated earlier, the large number of deterrence mechanisms that we will present here should afford alliance managers a wide range of ready choices to counter potential threats of partner misbehaviour. We now turn to a brief discussion of alliance stages.

Stages of Alliance Development

Research in strategic alliances suggests that the alliance process involves multiple stages [11]. Alliancing firms face new challenges in managing their interfirm relationships as they evolve from one stage to the next. Managers of alliancing firms can have a deeper and more sound understanding of their alliances if they are aware of the different dynamics at each alliance developmental stage. There is no consensus regarding how many stages alliances experience in their developmental process. While Brouthers et al. [12] offer a five-stage model (i.e., select mode of operation, locate partners, negotiate the agreement, manage the co-operative venture, and evaluate the co-operative venture performance), Das and Teng [13] suggest seven stages in the alliance process: deciding to form alliance, selecting alliance partners, negotiating the alliance agreement, setting up the alliance, operating the alliance, evaluating alliance performance, and modifying the alliance. Ring and Van de Ven [14] argue for a simpler alliance life cycle with three stages (negotiations, commitment, and executions), and Buchel [15] observes that joint ventures essentially go through three stages (formation, adjustment, and evaluation). Notwithstanding the varying number of stages in the existing models of alliance development, we can discern three generic stages of alliance development that are common to all the models. These three generic stages are formation, operation, and modification.

Formation

The formation stage of alliance development involves partner selection, negotiation, and finalization of an agreement. The focal firm needs to be wary at this stage about potential misbehaviour of the partner that may occur in the future. The threat of partner misbehaviour decreases the attraction of alliancing with the potential partner. By deploying the necessary deterrence mechanisms at this stage the focal firm would seek to discourage partner misbehaviour over the course of the alliance.

If the focal firm has to invest in certain alliance-specific irrecoverable assets, it has to be cautious at this stage, and ensure that the partner does not exploit the assets once the alliance is underway. The focal firm needs to take specific precautions to prevent partner misbehaviour
if the potential partner has prior records of stealing, misappropriating, or misbehaving in other ways. It is possible that the partner may also learn of certain proprietary know-how, get access to secret technology, or use critical resources that do seem useful within the scope of the alliance but have broad utility elsewhere in private undertakings. If the partner's newly acquired knowledge can bring in more private benefits for it than its share of common benefits from the alliance, then the partner will be motivated to abandon the alliance at its convenience. The focal firm should focus on suitable preventive mechanisms to control partner misbehaviour if it anticipates such possibilities.

Operation

In the alliance developmental process, the business activities take place during the operation stage. Alliance members participate in running the alliance to achieve short- and long-term goals. The focal firm has to be fully alert during this stage for signs of partner misbehaviour. The main objective of the focal firm is to detect any misconduct of the partner early enough, so that it can take necessary steps to protect itself from the adverse effects of partner misbehaviour. Utilizing deterrence mechanisms — geared toward detection, conflict management, and mutual adjustment — would allow the focal firm to protect itself from the harms of partner misbehaviour.

Once the alliance enters the operation stage, it is quite natural that member firms will have different views about what short-term goals would lead to the accomplishment of long-term ones, how certain goals should be pursued, and how the alliance should be managed. Goal incompatibility tends to weaken the co-operative spirit existing between alliance firms. The partner may not feel close to the focal firm, and therefore not hesitate to bluff, mislead, or misbehave in other ways. During the operation stage, cultural distance (both organizational and national) between two firms may prove to be critical for binding the alliance firms together. Cultural diversity between alliance members sometimes masks the lack of sensitivity about each other. Hence, the partner has little restraint from misbehaving with the focal firm. The partner may also perceive its share of rewards from the alliance to be inequitable, which will motivate it to restore a sense of equity by any means possible, even if that means misbehaving. Operational mechanisms, geared toward detection and protection, are useful in deterring partner misbehaviour in the operation stage, since these mechanisms decrease the impact and potential dangers of such misbehaviour in the alliance setting.

Modification

Modification is the final stage of the alliance developmental process.
However, it does not necessarily lead to the demise of the interfirm relationship. At the modification stage, the members evaluate the alliance performance. Depending on the outcome and the experience of the collaboration, alliance firms individually decide whether they want to continue their collaboration or go it alone. The disbursement of the gains from the alliance can be a complicated issue to handle at the modification stage. Often, the alliance firms feel they are not getting their fair share during the final disbursement of profits, funds, and other resources. This can lead to serious conflicts of interest within the alliance and partner misbehaviour may become imminent at this stage.

It takes some time before the alliance enters the modification stage. During this time, the potentially misbehaving partner has the chance to discover discreet ways to cheat, steal, or mislead the focal firm without getting caught. There is no way for the focal firm to be prepared for the partner’s misbehaviour, which arises in response to the unique situations that the modification stage has to offer. The alliance may move to the modification stage after a relatively short operation stage, where the partner learns about some critical know-how of the focal firm. Consequent takeover attempts, abandonment of the alliance to seek other opportunities, or blatant exploitation of the situation are some ways that partners can misbehave during the modification stage. Prior research has not explicitly dealt with the deterrence of partner misbehaviour at such a late stage of the alliance. We will, however, propose here a set of contingency mechanisms to deter partner misbehaviour at this stage.

**Mechanisms to Deter Partner Misbehaviour**

We now look at the various deterrence mechanisms available to alliance managers to deter partner misbehaviour. We suggest that deterrence mechanisms can be classified according to their purposes. We thus have three sets of deterrence mechanisms: preventive, operational, and contingency mechanisms. Preventive mechanisms are intended to discourage the partner from misbehaving, and include contractual provisions, structural specifications, mutual hostages, compensation structure, and staffing. Operational mechanisms help the focal firm detect partner misbehaviour so that it can protect itself from the adverse impacts. Examples include monitoring, formal reporting structure, budgeting, partitioning tasks, participatory decision-making, and training. The purpose of contingency mechanisms is to respond to imminent partner misbehaviour when all other mechanisms have failed to keep the partner’s conduct under control. Examples of contingency mechanisms include direct retaliation, indirect retaliation, direct co-optation, and two-step co-optation. In Table 2 we provide a summary listing of the relevant deterrence mechanisms that we now discuss.
### Table 2: Deterrence Mechanisms for Different Alliance Stages

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<thead>
<tr>
<th>Deterrence Mechanisms</th>
<th>Alliance Stage</th>
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<td><strong>Preventive Mechanisms</strong></td>
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<tr>
<td>Contractual Provisions</td>
<td>X</td>
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<td>Structural Specifications</td>
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<td>Mutual Hostages</td>
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<td>Compensation Structure</td>
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<td>Staffing Policies</td>
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<td><strong>Operational Mechanisms</strong></td>
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<td>Monitoring</td>
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<tr>
<td>Formal Reporting Structure</td>
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<td>Budgeting</td>
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<td>Partitioning Tasks</td>
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<td>Participatory Decision Making</td>
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<td>Training</td>
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<td><strong>Contingency Mechanisms</strong></td>
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<tr>
<td>Direct Retaliation</td>
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<td>Indirect Retaliation</td>
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<tr>
<td>Direct Co-optation</td>
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<tr>
<td>Two-Step Co-optation</td>
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### Preventive Mechanisms

**Contractual provisions**

Contracts are written with the intention to offer directions for alliance functioning. Contracts can effectively deter partner misbehaviour to the extent that the focal firm can foresee the possible situations that may allow misbehaviour by the partner. By assessing the threats in different circumstances over the course of the alliance, the focal firm can make contractual provisions barring the partner from misbehaving in contractually specified situations, such as a hostile takeover and the expropriation of rents due to the focal firm. Similarly, the focal firm can think of situations where the partner may be inclined to steal proprietary technology. Once the focal firm has thought out all the plausible scenarios, it can create contractual provisions to deter future partner misbehaviour within the alliance. If partner misbehaviour is identified and provided for in the contract, the focal firm would be in a position to seek punitive damages through arbitration or litigation.
Consider the joint venture between Bidland Systems, a small provider of dynamic e-commerce in the US, and Telefonica, the telecommunications giant of Spain, established in August 2000. However, within a few months, Telefonica decided to discontinue its participation in the alliance. Telefonica’s action can be deemed as misbehaviour because it abandoned the alliance after it had appropriated ‘Bidland’s proprietary business-to-business auction and dynamic e-commerce business information and technology through the promise of a lucrative joint venture and investment contract’ [16]. Although contractual provisions were not enough to prevent Telefonica’s misbehaviour, the provisions helped Bidland to make a strong case against Telefonica. Bidland sued Telefonica ‘for breach of contract, breach of fiduciary duty, and violation of the Uniform Trade Secrets Act, among other charges’ [17].

To cite another example, TV Guide and Source Media formed a joint venture in February 1999 under certain binding provisions applicable to both firms. However, Source Media sought a similar arrangement with another firm, Insight, a potential rival of TV Guide. By July 1999, TV Guide felt that Source Media had ‘breached several of its obligations under their agreement, including a pledge to negotiate exclusively and in good faith with TV Guide to complete the transaction’ [18]. Thanks to the contractual provisions relating to doing business with rival firms, TV Guide was able to seek remedies from Source Media.

Also, by identifying potential rivals during the contract negotiation process, the focal firm can insist on punitive measures against the misbehaving partner for contractual breach. Banner Homes Group and Luff Developments were in talks to form a joint venture in 1995, and supposedly ‘entered into an oral agreement for ... a joint venture’ [19]. As the story unfolds, ‘Luff subsequently had second thoughts about having Banner as a partner but did not mention them to Banner. Instead, Banner was to be “kept on board until someone or something better turned up” [20]. When Banner sued Luff for damages, the judgment was not in its favour, as the judge argued that Banner “was seeking to invoke the assistance of equity in order to turn a common arrangement of understanding, which was implicitly qualified by the right of either side to withdraw, into an unqualified arrangement or undertaking which denied any such right” [21]. It is apparent that hastily formulated contractual provisions may hinder the litigation process against the misbehaving partner. Since contracts have to be written before an alliance is forged, future-oriented managers of the focal firm would need to draft provisions to bar the partner from misbehaving in various likely scenarios. The comprehensiveness of the contract requires substantial managerial attention, and could therefore be quite expensive [22]. Hence, contractual provisions, while indispensable for preventing specific partner misbehaviours, should be supplemented by other kinds of deterrence mechanisms.
Guideline 1: An alliance firm should use contractual provisions to discourage its partner from hostile takeover attempts, unfairly exploiting alliance-specific investments, stealing proprietary technology, and partnering with key rivals of the alliance firm.

Structural specifications

Research suggests that alliances with equity investment tend to restrict misbehaving tendencies of the partner [23], because equity involvement acts as the glue to keep the alliance firms together. Therefore, the focal firm should favour equity swaps in the alliance if it fears that the partner may abandon the alliance as soon as more appealing business opportunities arise. Usually, alliances in the form of joint ventures or minority equity alliances are best suited to facilitate equity exchange when the focal firm fears that the partner may misbehave over the course of the alliance. For example, the much-publicized joint venture, European Vinsys Corporation (EVC), between the English firm ICI and the Italian firm EniChem, has not been troubled by any kind of partner misbehaviour [24].

Equity alliances also discourage the partner from unfairly exploiting any alliance-specific investments made by the focal firm. Rather, the equity-based governance structure fosters harmonious relationships. Consider the 50:50 joint venture Telmex-Sprint Communications, owned by Telefones de Mexico (Telmex) and Sprint Communications, which was dissolved because the parents felt the need for greater flexibility to pursue business separately. Throughout the course of the alliance, the equity investment kept the two parents tightly knit, and there was no hint of misbehaviour even during the dissolution process. Indeed, Telmex EVP Isaac Rodriguez stated, 'We are dedicating all of our efforts to ensure that this transition is seamless and transparent,' while Sprint SVP Lauren Wright echoed with, 'We look forward to continuing our relationship and will look for opportunities to work together to provide cross-border services' [25]. Clearly, the use of an equity structure not only ties the alliance members financially, but also generates goodwill.

Guideline 2: An alliance firm should use structural specifications to discourage its partner from unfairly exploiting alliance-specific investments, abandoning the alliance to seek other opportunities, and associating with key rivals of the alliance firm.

Mutual hostages

An advantage of equity is that it establishes credible commitment [26] and acts as a mutual hostage. However, hostages need not be in the form of
equity exchange only. Firms sharing each other's critical technology or know-how may also serve as mutual hostages. The defining characteristic of this mechanism is the voluntary acceptance of vulnerability by the alliance members. In other words, by buying a stake in the focal firm or sharing proprietary technology, the partner offers sufficient reasons for the focal firm to believe that the partner can be relied upon for consistent trustworthy behaviour.

Mutual hostages reduce the risk of exploitation of the focal firm's alliance-specific investments, because the partner risks losing its hostage if it were to misbehave that way. For the same reason, the partner would ordinarily be reluctant to abandon the alliance to seek other business opportunities. For example, the ten-year long alliance between Publicis of France and True North of the US started its dissolution process in November 1998 without any recognizable misbehaving acts on either partner's part. Publicis and True North both invested in each other's equity. "The cross-shareholdings were established in 1988, as part of a trading alliance through which each company represented the other in markets where it was better established" [27]. Even after the termination of the alliance, True North was expected to hold 8.8 per cent of Publicis, whereas Publicis was scheduled to maintain a 10.6 per cent equity stake in True North. Indeed, the equity exchange in the formation stage of the alliance set the tone for a harmonious collaborative relationship.

**Guideline 3: An alliance firm should use mutual hostages to discourage its partner from unfairly exploiting alliance-specific investments and abandoning the alliance to seek other business opportunities.**

**Compensation structure**

In the formation stage, alliance firms should also agree on a compensation structure. A focal firm that invests upfront for the alliance should demand lump sum payments or at least fixed royalties to prevent future misbehaviour in terms of payment delays, defaults, etc. If the partner's role in the alliance is to provide service to the focal firm, then the focal firm should remunerate the partner by incremental markups to reduce the possibility of shirking. For example, in the alliance between Elcotel and CenturyTel, formed in 1998, Elcotel's role was to equip its partner with cutting edge 'intelligent' payphone systems. Elcotel was compensated with high margins on a recurring basis. Elcotel also received the privilege for its customers to use CenturyTel's well-regarded operator service [28].

When the performance prospects of the alliance are uncertain, the alliance members may find profit sharing in terms of proportional dividends or milestone payments to be the most effective means to prevent partner
defection or failure to meet obligations within the alliance. Consider the alliance between Minntech and Advanced Sterilization Products (ASP) that gave ASP the rights to market Minntech's advanced endoscope reprocessors [29]. Minntech's compensation of $1.5 million took the form of periodic license revenues, depending on the sales of the endoscope reprocessors achieving certain milestones.

Alliance managers should realize that the focal firm can use a combination of several of the compensation schemes too. Lump sum payments and milestone-based profit sharing were used as compensation methods in the alliance between Vertex, an American pharmaceutical company, and Serono, a Swiss pharmaceutical company [30]. The purpose of the alliance was to develop and market caspase inhibitors, a drug used for inflammatory and neurological diseases. For Vertex's prior research on caspase inhibitors, which it contributed to the alliance, Serono was to pay a lump sum of $5 million (to be disbursed over a period of 13 months). This was appropriate, because the prior independent research by Vertex used in the alliance can be seen as an alliance-specific investment. However, given that the environment of the pharmaceutical industry was highly uncertain, Serono agreed to pay Vertex up to $70 million contingent upon satisfactory progress of their collaboration, in terms of the development of certain drugs. Vertex was also promised $20 million by Serono as research funding over five years.

Guideline 4: An alliance firm should use compensation structure to discourage its partner from payment delays and defaults (demanding lump sum payments or royalties), shirking (offering incremental markups, not lump sum payments or royalties), and defection (sharing dividends based on milestones).

Staffing policies

Alliance staffing can also play a role during the initial stage to prevent partner misbehaviour throughout the life of the alliance, for it allows the focal firm to keep a check on technology and know-how dissemination, discourage shirking behaviour from employees, and influence critical decisions affecting the alliance's direction. 'The personnel comprising the alliance interface serve both as gatekeepers of information and as potential receptors of partner skills' [31, p. 112]. The focal firm's staff, interacting with the partner's staff within the alliance, 'should be well briefed in what skills can and cannot be shared' [32]. The focal firm that is apprehensive about partner misbehaviour should try to fill key positions to influence alliance direction and ensure fair play by the partner. For such a firm, staffing policies 'should be incorporated into the broad strategic planning process for the alliance, not left to chance or to 'ad hoc'
decision-making by the respective parties' [33, p. 69]. In its joint venture with Fiat's IVECO unit, Rockwell International had to safeguard its know-how of truck axles [34, pp. 433-434]. However, physical proximity of engineering and manufacturing departments was critical for efficiency of alliance operations. Rockwell opted to protect its exclusive know-how by designing a staffing policy whereby one of its engineers would always keep track of engineering records. As a result, the restricted know-how remained exclusively with Rockwell.

However, the focal firm should not be taken in by the seductive appeal of token corporate positions. The title of President or CEO may be merely ornamental — with little influence over alliance staff and fellow top officials. Morgan Stanley realized this truth the hard way in its joint venture — China International Capital Corp. (CICC) — with the China Construction Bank [35]. The CEO of CICC consistently came from the Morgan Stanley side. However, one of the junior members of the top management team, Levin Zhu Yunlai, the son of the Chinese premier, held all the power regarding the management of CICC. Mr. Zhu's stature within the joint venture turned out to be a cause of frustration among Morgan Stanley's top officials, who were basically treated as pawns without any control over the joint venture's directions. As a result, Morgan Stanley had to be party to certain controversial activities, such as supporting the Three Gorges Dam. This particular action of CICC hurt Morgan Stanley's image in the US. The Chinese partner's lack of regard and respect for Morgan Stanley forced the American firm to distance itself from the alliance. Hence, the focal firm must pay careful attention to drafting a staffing policy that effectively addresses key problem areas where partner misbehaviour can possibly occur.

**Guideline 5:** An alliance firm should use staffing policies to discourage its partner from stealing proprietary technology, shirking, and making irresponsible decisions about the alliance's direction.

**Operational Mechanisms**

**Monitoring**

Monitoring means keeping an eye on partner behaviour. Close attention to organizational processes is critical to effective deterrence of partner misbehaviour. In its alliance with ETEL Communications Corporation, Alliance Group Services (AGS) was able to detect signs of partner misbehaviour early enough to avert the negative impacts. In June 1998, AGS terminated its alliance because it observed 'changes in marketing direction by ETEL that were incompatible with Alliance Group's understanding of the business intent of the agreement' [36]. Evidently, AGS's monitoring facilitated the detection of the inconsistencies between task implementation and the alliance agreement.
Monitoring increases the chances of detecting partner misbehaviour, and thereby diminishes the partner’s ability to gain unfairly from misbehaviour [37]. In particular, monitoring would increase the chances of detecting cases of shirking by the partner. Often a partner would also withhold or distort critical information. When using monitoring systems, there is a high probability of finding out possible discrepancies between what is said by the partner and what is actually implemented. USA Technologies and Mail Boxes Etc. (MBE) formed a joint venture in October 1997 to co-market MBE Business Express — a fully automated business center [38]. Soon after the alliance entered the operation stage, USA’s monitoring detected material breach of the joint venture agreement on MBE’s part [39]. On grounds of contractual breach, USA Technologies pulled out of the alliance stating that further affiliation with a misbehaving partner like MBE did not fit its best interests.

Monitoring techniques should seek a balance between formal and informal approaches. While formal monitoring (e.g., video monitoring, tracking computer logs, etc.) conveys how seriously the focal firm takes the issue of partner misconduct, excessive usage of formal monitoring would hinder the trust building process. A total neglect of formal monitoring, however, may signal to the partner that the focal firm is unaware of partner misbehaviour possibilities or is simply indifferent to such harmful actions by the partner. Therefore, when monitoring the partner’s actions, the focal firm should try to use both formal and explicit techniques as well as informal and unobtrusive means.

**Guideline 6:** An alliance firm should use monitoring to protect itself from its partner engaging in shirking, withholding critical information, and misrepresenting results.

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**Formal reporting structure**

The formal reporting structure specifies the boundaries of acceptable and unacceptable behaviour by alliance members. By formally assigning roles and responsibilities to alliance employees and establishing an unambiguous chain of command, a formal reporting structure pinpoints expected behaviour from employees of the partner firm. Hence, such a structure can act as a deterrence mechanism for partner misbehaviour. Shirking or not fulfilling obligations is unlikely in the presence of this mechanism. Due to a clear framework of accountability, the partner cannot get away with delayed payments. Bluffing and distorting facts are also likely to get detected under the formal scrutiny of alert alliance managers.

The GM-Daewoo 50:50 joint venture, formed in 1984, is a case in point [40]. Implementation of the formal reporting structure was lacking on the factory floor — Daewoo never complied with GM’s repeated
instructions to manufacture higher quality products. Instead, Daewoo went ahead with its original objective of increasing market share. In fact, GM was not able to detect Daewoo's negotiations for selling 7000 cars in Eastern Europe — which is GM's market — early enough to protect itself from this partner misbehaviour. Daewoo did indeed manage to sell 3000 cars. Surely, implementing a formal reporting structure is necessary during the operation stage of the alliance to detect early signs of partner misbehaviour.

Another example is the joint venture between Dresdner Bank of Germany and Meiji Mutual Life Insurance of Japan. Dresdner's formal reporting structure required that its Global Chief Investment Officer supervise manufacturing, quality, and consistency of a variety of products and services [41]. In May 2000, Dresdner and Meiji merged two of their jointly-owned ventures — Meiji Dresdner Asset Management Co. and Meiji Dresdner Investment Trust Management Co. — to establish a comprehensive joint venture called Meiji Dresdner Asset Management Co. [42]. The rationale for the merger was to co-ordinate better, through one joint venture company, the range of businesses that the parent firms previously ran through the two jointly owned companies. Thanks to the formal reporting practised in Dresdner Bank, no instances of misbehaviour have been reported so far by either parents.

Guideline 7: An alliance firm should use formal reporting structures to protect itself from its partner engaging in shirking, bluffing and obfuscating performance, and delaying payments.

Budgeting

Budgeting not only restrains the partner from spending without proper justification, but also requires a certain level of performance, depending on the value of budgeted funds and available time. Therefore, this mechanism also allows the focal firm to detect performance problems such as deliveries of goods of lesser quality than expected from budgeted resources.

Budgets make the partner accountable for its actions, and keep its deliberately wasteful behaviour in check. In the troubled joint venture between P&G of the US and Phuong Dong of Vietnam, one of the serious allegations by Phuong Dong was about P&G's extravagant way of remunerating its employees working for the alliance and the high marketing expenses incurred by the American firm [43]. Proper implementation of budgeting during the operation stage would have alleviated this problem, which eventually shifted beyond Phuong Dong's ambit as P&G took control over 93 per cent of the venture. By documenting fund allocation and usage, and establishing certain performance criteria based on the
allocated resources, budgeting can effectively deter partner misbehaviour during the operation stage of the alliance.

**Guideline 8:** An alliance firm should use budgeting to protect itself from its partner engaging in deliberately wasteful behaviour and delivery of substandard goods.

**Partitioning tasks**

Task partitioning involves physically separating alliance functions to avoid leakage of proprietary technology and know-how. In many alliances the potential outflow of proprietary technology is partially controlled by partitioning tasks” [44]. Task partitioning requires a great deal of coordination from alliance managers of all member firms for the alliance to function well. The advent of faster communication technologies can facilitate this coordination.

Texas Instruments’ implementation of task partitioning deters possible misbehaviour by its partners in India. According to Baughn et al. [45], “Texas Instruments orchestrates a consortium in Bangalore, India, for the on-line development of TI software. The software is developed in self-contained modules, which can be recombined elsewhere.” By integrating the different pieces of work carried out separately by its partners, TI reduces the risk of partner misbehaviour, most likely in the form of technology misappropriation. In other words, partitioning tasks can be a very effective instrument against involuntary dissemination of know-how, or, in extreme cases, technology theft by the partner.

**Guideline 9:** An alliance firm should use partitioning tasks to protect itself from its partner stealing proprietary technology or learning secret know-how.

**Participatory decision-making**

While operating the alliance, goal incompatibilities, cultural diversity, etc. can generate conflicts of interest, which may trigger partner misbehaviour. Participatory decision-making can deter partner misbehaviour in three ways. First, it may serve as a proxy to monitoring, as it increases ‘the likelihood that a partner’s opportunistic behaviour will be recognized’ [46]. The logic is that close relational bonds would make the partner’s intentions and actions more transparent, reducing the scope for withholding or obfuscating critical information that the focal firm needs to know.

Second, participatory decision-making would alleviate potential goal conflicts by dealing with the conflicting issues in the presence of each other [47]. Cultural diversity may breed misunderstanding, which again can be sorted out by the alliance members through participatory decision-
making. Participatory decision-making would also enhance the level of coordination between alliance members. For example, the alliance between Disney and Toysmart prematurely fell apart partly because of the lack of participatory decision-making. ‘The Disney-appointed directors seldom showed up in person for board meetings, preferring phone-in contact’ [48]. As a result, the alliance firms could not coordinate their activities in a value-driven way. On the one hand, Disney’s late responses to Toysmart’s suggestions made it extremely difficult for the young toy company to meet sales expectations. On the other hand, Disney alleged that Toysmart was more interested on establishing a brand name at Disney’s expense, rather than focusing on actual sales. Severe goal conflicts and organizational cultural diversity led both firms to feel that the other misbehaved.

Third, shared decision-making would gradually develop a sense of camaraderie between alliance members. Even in strict rational terms, the partner will refrain from misbehaviour when it treasures its relationship with the focal firm more than the value of its gain from misbehaviour [49]. In such instances, the partner will not exploit the focal firm’s vulnerability arising from, say, its alliance-specific investments. Apparently, relational values never got to play a role in the alliance between AT&T and Olivetti. This alliance failed because of increasing tension, which was mostly due to each firm’s way of dealing with the partner. One top AT&T executive, Robert Kavner, recalls: ‘AT&T’s attempts to fix the problems, such as delays in deliveries, were transmitted in curt memos that offended Olivetti officials,’ and along the same lines, ‘the Olivetti side would explain its own problems ... and AT&T managers would simply respond, “Don’t tell me about your problems. Solve them”’ [50, p. A4]. In short, participatory decision-making during the operation stage can be of decided advantage to the focal firm in protecting itself from partner misbehaviour.

Guideline 10: An alliance firm should use participatory decision-making to protect itself from its partner withholding critical information and unfairly exploiting alliance-specific investments.

Training

Training can invoke loyalty in the partner for both the focal firm and the alliance [51]. A loyal partner would be unlikely to cheat the focal firm. Training deters partner misbehaviour in several ways. Employees from the partner’s side can be trained to appreciate the long-term objectives of the alliance, which should have greater import than short-term outcomes. Hence, the partner firm would start to realize that trying to achieve short-term gains from shirking or other misbehaving acts is not worthwhile in the partner’s own long-term interests. Consider GM’s Chinese joint venture
with Jinbei Automobile. In 1992, GM started with a 30 per cent stake in the venture, but also opted to ‘manage the factory, train its workers and provide tools’ [52]. GM’s attention on training joint venture employees reduced the chances of misbehaviour by employees from the Chinese side, and also gave GM the necessary confidence in the alliance project as well as the partner. Despite a major setback in 1995 that halted the joint venture and some temporary shortfalls during the course of the operation stage of the alliance, both GM and its Chinese partner seem to be committed to their joint venture [53]. No incidence of partner misbehaviour has been reported so far.

When employees from firms with different cultural backgrounds and organizational practices have to work together, misunderstandings are to be expected. Such misunderstandings can heighten tension between alliance members, triggering partner misbehaviour of some sort, such as shirking and withholding information [54]. Training can be geared toward eliminating narrow views of the world, making the employees of an international joint venture more ready to accept cultural differences. For a case in point, NEC of Japan trains its alliance managers to make sure that they are sensitive to cultural differences when interacting with colleagues from the partner’s side. Parkhe [55] points out that NEC’s training ‘includes differences between Japanese and American decision-making, several periods of simulated negotiations with non-Japanese, and a course in English conversation so intense that teachers are replaced every few days.’ Such training helps bridge the gap in understanding between the focal firm and its partner and facilitates the trust building process.

**Guideline 11:** An alliance firm should use training programs to protect itself from its partner engaging in shirking, withholding information, and other disloyal behaviours.

**Contingency Mechanisms**

**Direct retaliation**

Schelling [56] cautions that taking revenge against a partner’s misbehaviour is not consonant with the idea of deterrence. However, we think that the sheer capability for taking revenge could very well deter partner misbehaviour. For instance, if the partner delivers substandard goods, the focal firm can retaliate with delayed payments. Also, if the partner is about to steal proprietary information, the focal firm can threaten to misappropriate the partner’s rewards from alliance-specific investments. It is imperative that the partner be aware of the focal firm’s capabilities of retaliation. The partner would then restrain itself from misbehaving for its own sake, since it might have to incur losses from the focal firm’s vengeance.
Direct retaliation is most useful as a deterrence mechanism when alliance firms are equals. In the roller-coaster alliance of Northwest and KLM, Northwest successfully survived KLM’s initial attempts to takeover the American firm. To neutralize the takeover threat, Northwest diminished its attractiveness as an acquisition candidate [57]. Additionally, Northwest’s ability to respond to KLM’s sly behaviour with its own set of devious actions kept KLM on guard. The Dutch partner did not want trouble from Northwest because the alliance contributed approximately $150 million to its profits [58]. In August 1997, Northwest and KLM settled their partnership disputes. During the modification stage of their original alliance, both parties agreed to a new 10 year, closely integrated alliance. A threat of retaliation may work well against a potentially misbehaving partner because it tends to convey the clear message that the partner’s self-interest may be jeopardized.

**Guideline 12:** An alliance firm should use the threat of direct retaliation to manage the partner’s imminent misbehaviour in the form of hostile takeover attempts, misappropriating proprietary technology and know-how, and delivery of substandard goods.

**Indirect retaliation**

The idea of indirect retaliation is similar to that of direct retaliation except that it is dependent on the role of a third party. Indirect retaliation is suitable to the focal firm with a weak position in the alliance. Such a firm may not be in a position to retaliate against the dominant partner right away, even if partner misbehaviour occurs. To retaliate indirectly, the focal firm can harm the reputation of the dominant partner. The more serious the nature of partner misbehaviour, the higher the potential to harm the partner’s reputation. Thus, exploitation of the focal firm’s alliance-specific investments, stealing an exclusive research formula, or abandoning the focal firm and the relationship to seek other business opportunities could be successfully deterred with the threat of indirect retaliation. The misbehaving partner would be adversely affected because its desirability as a potential alliance partner will likely decrease. Within the social network of firms, a potentially misbehaving partner will find it difficult to join in strategic alliances [59].

Consider the case of Right Start, a California-based retailer specializing in the dual operation of on-line/in-store retailing, which successfully utilized the threat of indirect retaliation to deter partner misbehaviour. Right Start’s partner Hyce, a mall owner from St. Louis, tried to restrict Right Start’s operations in its mall premises, complaining that the ‘tenants couldn’t promote e-commerce business from mall stores’ [60, p. 177]. Right Start was in a position to question the integrity
of Hycel’s complaints, since its expertise in achieving synergy with online/in-store retailing was well established. As a mall owner, Hycel could not afford a bad image of dealing with its clients. Therefore, ‘Right Start initiated an immediate retaliation that squelched the unrealistic regulation and prompted Hycel to reconsider its position and issue a retraction within two weeks’ [61].

Our notion of indirect retaliation is different from Hill’s [62] argument about the invisible hand of the market. He argues that ‘in the long run the invisible hand of the market will delete opportunistic actors’ because it will ‘result in lower payoffs than those generated from cooperation and trust’ [63]. In our view, the focal firm has to deliberately threaten the potentially opportunistic partner to deter misbehaviour, instead of waiting uncertainly for the market to determine the outcome.

**Guideline 13:** An alliance firm should use the threat of indirect retaliation to manage the partner’s imminent misbehaviour in the form of misappropriating proprietary technology and know-how, misrepresenting or distorting results, and abandoning the alliance to seek other business opportunities.

**Direct co-optation**

Direct co-optation involves persuading an influential executive of the partner firm to be a part of the focal firm’s decision-making team during the modification stage of the alliance. This is different from giving a seat on the board because of equity exchange. Direct co-optation is a gambit in the form of voluntary sacrifice of some control of the focal firm to have some reciprocal control over the partner’s decisions and actions. This stratagem gives the focal firm the ability to pressure the partner to behave in certain ways. As Selznick [64] would argue, by allowing in an intruder the focal firm does not actually give away power, but rather the co-opted member assumes some responsibility for the fate of the focal firm. Hence, the partner can be persuaded not to expropriate technology, exploit alliance-specific investments, or attempt forcibly to take over the focal firm. Allowing the partner to become an insider of the focal firm could be risky at times, for the partner may infiltrate the decision-making process of the focal firm and take charge in the long run. Hence, direct co-optation should not be implemented until all other deterrence mechanisms of the formation and operation stages of the alliance have failed to serve their purpose.

Many of the troubled alliances in their modification stage could benefit from this terminal deterrence mechanism. For example, Deutsche Telekom tried to partner with Telecom Italia in a merger, going against the
understanding it had with France Telecom [65]. This not only caused problems in the Deutsche Telekom - France Telecom alliance, but also created some problems in two other joint ventures in which these two firms were members (namely, Global One and Wind). France Telecom could have averted this trouble if it had had some influence in Deutsche Telekom's decision-making. It is possible that cajoling a couple of Deutsche Telekom executives to the France Telecom board would have elicited more collaborative behaviour from Deutsche Telekom. For the focal firm, utilizing direct co-optation is like playing the last trump card to save a game, but it promises results in desperate situations.

Guideline 14: An alliance firm should use direct co-optation to manage the partner's imminent misbehaviour in the form of hostile takeover attempts, unfairly exploiting alliance-specific investments, and partnering with key rivals of the alliance firm.

Two-step co-optation

Two-step co-optation is similar to direct co-optation, except that a third party is involved in influencing the partner. Gargiulo [66] argues that, whereas direct co-optation may create unnecessary problems by bringing a stranger into the decision-making team, two-step co-optation astutely dodges these potential problems. Yet, the benefits from two-step co-optation are just as valuable as those from direct co-optation. The third party can influence the partner to neither misappropriate benefits accruing from focal firm's alliance-specific investments nor abandon the relationship, for then the partner may not receive sanctions from the third party. The third party has to have substantial influence on the partner's decision-making for this deterrence mechanism to work. This may also have significant implications for network governance.

Consider the alliance between Alitalia and KLM, announced in November 1998. Notwithstanding KLM's substantial equity investment of Euros 100 million in the alliance, it severed the partnership in April 2000 [67]. At about the same time, an alliance between Northwest, KLM, Alitalia, and Continental was in the works. Northwest announced its plans of continuing bilateral ties with both Alitalia and KLM. Thus, Alitalia could have controlled KLM's misbehaviour (abandoning a relationship to seek other opportunities) by using the two-step co-optation, whereby it would have been possible for Alitalia to persuade Northwest to exert its influence over KLM's decision-making, and thus contain the latter's sudden exit from the alliance. Depending on the richness of the focal firm's connections, two-step co-optation can come in very handy in deterring partner misbehaviour in the modification stage of the alliance.
Guideline 15: An alliance firm should use two-step co-optation to manage the partner's imminent misbehaviour in the form of unfairly exploiting alliance-specific investments and abandoning the alliance to seek other business opportunities.

Concluding Remarks

The nature of potential partner misbehaviour is specific to each stage of alliance development. In the formation stage, partner misbehaviour is a matter of apprehension and the focal firm can only take preventive actions. In the operation stage, partner misbehaviour can be expected with some degree of certainty. The focal firm tries to learn about any incidence of partner misbehaviour, so that it can nip it in the bud or leave the alliance in time to protect itself from the adverse consequences. In the modification stage, partner misbehaviour may become imminent with the focal firm being unprepared to tackle it. Managing the hostile situation is about all the focal firm can do at this late stage.

We discussed the diverse nature of partner misbehaviour. With the inventory of deterrence mechanisms presented here, managers should be in a position to know what to look for to detect partner misbehaviour or what behaviour to worry about during various alliance stages. We suggest that managers use a combination of deterrence mechanisms to control partner misbehaviour. Our contingent approach suggests that managers should use preventive mechanisms during the formation stage, operational mechanisms during the operation stage, and contingency mechanisms during the modification stage.

This approach has two major advantages. First, a more focused use of the deterrence mechanisms to control partner misbehaviour would increase the probability of success in strategic alliances. And second, such contingent application of deterrence mechanisms to different stages of the alliance life cycle would eliminate waste, because a random application of deterrence mechanisms results in redundant deterrence at some stages and inadequate deterrence in others.

Our advice to the managers of alliance firms is threefold. First, know the various forms of partner misbehaviour so that you can estimate the partner's potential to misbehave in various ways. Second, identify the specific developmental stage of your alliance for which you have to deploy deterrence mechanisms. Third, select the appropriate deterrence mechanisms from the relevant category in our inventory and implement them to curb partner misbehaviour. Of course, managerial discretion and business pragmatism are indispensable for instituting an effective set of deterrence mechanisms to curb and control partner misbehaviour in strategic alliances.
References


[44] Baughn et al., op. cit., p. 110.

[45] Ibid.


[47] Ibid., p. 446.


[58] Ibid.


[61] Ibid.


[63] Ibid.


