

## BREAKING THE LETTER VS. SPIRIT OF THE LAW: HOW THE INTERPRETATION OF CONTRACT VIOLATIONS AFFECTS TRUST AND THE MANAGEMENT OF RELATIONSHIPS

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*Contract violations are ubiquitous. There has been little attention, however, dedicated to understanding the mechanisms involved in making sense of and addressing such occurrences. Two experimental studies investigated how people interpret contract violations and how these interpretations affect trust and the management of relationships. By drawing on the distinction between violations of the letter versus spirit of the law, we show that letter violations are more difficult to overcome than spirit violations, due to higher perceived intentionality. These effects generalized across different populations, levels of contracting experience, types of contracting contexts, levels of ambiguity within the contract, and degrees of contract complexity. The results yield important implications for understanding contract violations, trust, and organizational responses as a relationship management capability. Copyright © 2014 John Wiley & Sons, Ltd.*

### INTRODUCTION

The management of relationships has been widely considered to be an important avenue through which an organization can sustain or enhance its competitive position (Kale, Dyer, and Singh, 2002; Kale and Singh, 2007). One major method of managing such relationships is through the use of contracts. Indeed, an extensive research literature has provided a wealth of insights into how contracts can be used to align expectations and establish meaningful safeguards for those involved (e.g., Argyres, Bercovitz, and Mayer, 2007; Macaulay, 1963). Yet contracts are also frequently violated (Robinson and Rousseau, 1994). For this reason, we suggest that if

an organization is going to manage its relationships effectively, then it needs to consider how parties are likely to react when contract violations occur.

Past research, however, has given this matter relatively little attention. In fact, because the primary focus of the contracting and interfirm exchange literatures has traditionally been on how contracts are formed (e.g., Macaulay, 1963; Reuer and Ariño, 2007) or how they should be crafted to function more effectively (e.g., Mayer and Argyres, 2004; Ryall and Sampson, 2009; Vanneste and Puranam, 2010), they generally have not investigated what parties' reactions to contract violations might be or how those reactions might be affected. Some recent efforts have begun to explore such issues by providing valuable insights, for example, into the relationship between contract structure and the likelihood of a dispute (Malhotra and Lumineau, 2011) and the process by which disputes might be resolved (Lumineau and Oxley, 2012). However, this work does not delve into the individual-level cognitive reactions to different types of contract violations,

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which would affect how such violations might ultimately be managed.

In this paper, we seek to explore these issues by investigating how one of the most fundamental considerations that arises during the formation of a contract, namely whether an expectation is documented or not, might influence how parties react to a contract violation and subsequent attempts to address it. To do so, we explore how the two dominant theoretical perspectives regarding the nature of contracts—as instruments of control (e.g., Macneil, 1977; Williamson, 1985, 1991) and coordination (e.g., Argyres *et al.*, 2007; Mayer and Argyres, 2004)—provide competing predictions for how people are likely to interpret letter versus spirit contract violations. We then examine how a violated party's interpretation of a contract violation, in turn, can affect how that relationship is subsequently managed. Through this effort, we ultimately seek to make several contributions. First, we contribute to the contracting and interfirm exchange literatures by highlighting the theoretical importance of, and empirically examining, the interpretation of contract violations, as well as subsequent attempts to address them. Second, we contribute to an ongoing discussion of the relationship between contracts and trust by examining the initial conditions and ensuing dynamics after a violation has occurred in a newly formed contracting relationship. Finally, we add to research on the microfoundations of strategy that draws from psychology to examine strategy-related questions through experimental methods (e.g., Agarwal and Hoetker, 2007; Croson, Anand, and Agarwal, 2007).

## INTERPRETING CONTRACTS AND CONTRACT VIOLATIONS

There are two prominent ways of interpreting the responsibilities arising from any agreement: the letter versus spirit of the law. This distinction maintains a long history, contributing to how we interpret social contracts (e.g., De Tocqueville, 1835/2000; Montesquieu, 1748/1989), a country's constitution (e.g., Hamilton, Madison, and Jay, 1787/2012), and ethical obligations (e.g., Raiborn and Payne, 1990). The simplest way to think about the difference between these two types of interpretations is whether the expectation between the parties was explicitly documented or not. In this sense, while the letter of the law represents

the explicitly documented expectations, the spirit of the law represents the undocumented, and often tacitly held, expectations.

This distinction between the letter and spirit of the law also reflects one of the most fundamental assumptions in contracting theory; namely, that contracts are inevitably incomplete (Grossman and Hart, 1986; Williamson, 1996). Whether the incomplete nature of contracts is due to the bounded rationality (e.g., Simon, 1982) or strategic maneuvering of the contracting parties (e.g., Bernheim and Whinston, 1998; Graebner, 2009), such incompleteness entails that the expectations arising from a formal contract will have either been documented or not, thus ultimately falling into one of these two basic categories. As a result, much effort has gone towards understanding the implications of this distinction, for instance, by examining the appropriate level of detail (e.g., Mayer and Argyres, 2004) and complexity (e.g., Reuer and Ariño, 2007) of documentation a contract should employ in order to be effective. This research is based on the notion that the documentation in a contract will meaningfully influence how the contract is interpreted and followed.

Yet, the implications of documenting one's expectations in a contract may extend beyond the interpretation and execution of the contract itself. It may also affect how *violations* of those expectations are interpreted and, ultimately, how one might address them. This gives rise to the two types of violations we explore in this paper. In particular, we define *letter violations* as the failure to fulfill a clear, documented expectation expressed in the contract, and we define *spirit violations* as the failure to fulfill an undocumented, yet still presumably tacitly agreed upon, expectation.

Given these definitions, it is also important to acknowledge two additional considerations. First, although the simplest distinction between these two violations is one in which the same expectation was either entirely documented in the contract and then violated (i.e., letter violation) or was entirely omitted from the contract and then violated (i.e., spirit violation), we also allow for the possibility that a documented contract term may be equivocal, and thus could plausibly be interpreted as either a letter or spirit violation. We consider both situations in Studies 1 and 2, respectively. Second, we recognize that there may be situations when the expectation held by a party cannot be easily translated into words (i.e., deeply held, taken-for-granted

assumptions). However, because we are interested in specifically comparing the interpretations of letter versus spirit violations while keeping the actual nature of the expectation constant (i.e., to rule out the possibility that differences in the kind of expectation that has been violated, rather than whether a given expectation had been documented or not, could provide an alternative explanation for our results), this paper will only consider violations of expectations that could be documented in the letter of the law, if an attempt was made to do so.

While this distinction between letter and spirit violations may be evident, the manner in which people interpret these violations is less obvious. This becomes particularly unclear in newly formed relationships, or those where there is little to no history of interaction, because expectations or social norms have not yet been established, leading to low predictability and high uncertainty. And given that new relationships are formed all the time (e.g., new joint ventures, hiring new employees, establishing temporary work teams, acquiring another company, etc.), the ability to understand the initial stages of these relationships is critical to an organization's success (Ariño and De La Torre, 1998). As a result, we focus our inquiry on the initial conditions and dynamics in these newly formed relationships, based on the notion that they may not only set the stage for the ongoing renegotiations later in the relationship (Doz, 1996), but also because they represent an optimal context to begin examining how interpretations of letter versus spirit contract violations might diverge.

In this research, we identify *perceptions of intentionality* as the key mechanism driving potential differences in how letter versus spirit violations are

interpreted. Perceptions of intentionality are critical in our context for three reasons. First, such perceptions have been suggested by social psychologists to be based on a variety of considerations that are also critical in contractual relationships, such as the surrounding context and inferences about the counterpart's actions and possible motives (Reeder *et al.*, 2004). Second, such perceptions suggest a point of convergence between both macro- and micro-organizational literatures relevant to this phenomenon. More specifically, perceptions of intentionality have not only been linked to the key notion of opportunism in contracting theory (Williamson, 1979), but they have also been shown to affect how one might repair interpersonal relationships (Kim and Harmon, 2012; Kim *et al.*, 2004). Finally, such perceptions are critical because the violated party frequently does not know the authentic expectations and intentions of his or her counterparts. In fact, researchers have observed that the violated party's perceptions of the violator can significantly influence the violated party's willingness to work with that counterpart in the future even when these perceptions are wrong (Kim *et al.*, 2004; Rousseau, 1995).

The way in which letter versus spirit violations might affect perceptions of intentionality has been complicated, however, by the fact that there are two dominant perspectives regarding the nature of contracts: as instruments of control and coordination. While these perspectives are not mutually exclusive, they represent alternative orientations for understanding the purpose of documenting one's expectations (Malhotra and Lumineau, 2011; Mellewigt, Madhok, and Weibel, 2007; Vanneste and Puranam, 2010). We argue that these

Table 1. The interpretation and management of contract violations

	Contracts as control	Contracts as coordination
<b>Assumptions</b>		
Initial trust level	Low	High
Type of trust	Calculative	Relational
View of human nature	Primarily self-interested	Primarily good-willed
Primary origin of risk	Person	Situation
Function of documentation	Control other party	Clarify with other party
<b>Interpretation of contract violation</b>	<b>(Hypothesis 1a)</b>	<b>(Hypothesis 1b)</b>
Letter violation	Less intentional	More intentional
Spirit violation	More intentional	Less intentional
<b>Post-violation trust in violator</b>	<b>(Hypothesis 2a)</b>	<b>(Hypothesis 2b)</b>
Letter violation	Higher trust	Lower trust
Spirit violation	Lower trust	Higher trust

perspectives also provide the basis for alternative predictions for how people are likely to interpret letter versus spirit contract violations (see Table 1), and that support for either prediction is likely to be found only to the extent that one perspective plays a *larger* role in a given context than another.

### Contracts as instruments of control

During the initial stages of a newly formed relationship, there is a high degree of uncertainty and risk. This is made problematic by the traditional assumption in the contracting literature that people may act opportunistically (Williamson, 1979). And even if one adopts a weaker assumption that people simply act in their own self-interest (rather than self-interest with guile), contracting parties still must concern themselves with the very real risk of exploitation by their counterparts (Walker and Weber, 1984; Williamson, 1985). Because of this, the traditional consensus has been that, although trust can build over time as parties gain knowledge about their counterparts (Lewicki and Bunker, 1995), initial trust levels may be quite low (Coleman, 1994; Williamson, 1993). Hence, contracting parties are likely to seek ways of protecting themselves from any negative consequences their counterparts might impose. This reasoning provides the foundation for what has been the most dominant and longstanding perspective in the contracting literature—the notion that contracts function as instruments of control (e.g., Macaulay, 1963; Macneil, 1977; Williamson, 1985, 1991).

This view of contracts as instruments of control suggests that contracting parties may seek to limit the ways in which a counterpart may act opportunistically by increasing the level of documentation in the contract. So long as the terms of the contract are clear and understandable, an increase in the level of specification and agreed-upon terms will likely mitigate one's risk. This is because, once these terms are documented, the counterpart is likely to put in a good faith effort to fulfill them, given that the legal underpinnings of these agreed-upon terms would provide clear and easily obtainable evidence for legal recourse if a violation happened to occur (e.g., Joskow, 1987). If a counterpart thus violates explicit terms of a contract (i.e., letter violations), the violated party is likely to assume that such actions must have been out of the immediate control of their counterpart and instead influenced by situational factors. Under these circumstances, the violated

party may be less inclined to assume that the violator was actively trying to take advantage of them.

The violation of undocumented expectations (i.e., spirit violations), however, may result in precisely the opposite interpretation as letter violations, given the assumption that people might behave opportunistically if given the chance to do so. Because contracting situations often involve a misalignment between individual incentives and the joint goals of the exchange, contracting parties will naturally expect their self-interested counterparts to take full advantage of opportunities they have to better their position within the bounds of the written contract. Further, there will always be expectations that are left undocumented, whether it is because the vulnerable party forgets to include them or because their counterpart avoids bringing them up because they have no intention of fulfilling those expectations later (e.g., Graebner, 2009). In these situations, such omissions present a major vulnerability that a self-interested counterpart may seek to exploit, based on the presumption that this lack of documentation would make legal recourse less feasible.

Thus, this perspective suggests that documenting one's expectations can help control a counterpart's self-interested inclinations. As a result, if a documented term does get violated, the likely inference is that it had been less intentional, due to the notion that the violator would have avoided agreeing to that explicitly documented expectation if they had been intentionally planning to violate it. On the other hand, the violation of an undocumented expectation will likely appear to be more intentional, given the concern that the self-interested counterpart might take advantage of gaps in the written contract if given the opportunity. The control perspective thus provides a straightforward and intuitive prediction that spirit violations would be interpreted as more intentional than letter violations.

*Hypothesis 1a: Spirit violations will be interpreted as more intentional than letter violations.*

### Contracts as instruments of coordination

In contrast to viewing contracts as instruments of control, other scholars point to how contracts can also be important for improving coordination and collaboration (e.g., Argyres *et al.*, 2007; Mayer and Argyres, 2004). While the coordination perspective is still concerned with uncertainty and risk in the contracting process, this concern shifts from risks



originating from the counterpart (i.e., the counterpart's potential opportunism) to risks that are a function of the situation (i.e., due to expectations not having been communicated clearly). This more collaborative view of contracts assumes that the other party is generally well intentioned, but that one must work to resolve uncertainties and risks arising from the situation by using contracts as a coordination mechanism.

To achieve this goal of coordination, contracting parties find themselves documenting contract terms to clarify responsibilities rather than to control. As a result, the expectations that are documented tend to be clear and presumably easier to follow, given that the purpose is to make explicit their mutual expectations so misunderstandings will not disrupt the relationship (e.g., Malhotra and Lumineau, 2011). Yet because of this, a breach in these simple, explicitly agreed-upon terms (i.e., letter violations) may raise concerns about the counterpart's underlying motive. More specifically, since the documented terms should have been clear and easy to follow, yet had still been violated, such letter violations may offer the violated party a clearer signal of the counterpart's intentions. As a result, the coordination perspective suggests that the violated party may be more inclined to interpret a letter violation as an attempt to take advantage of the collaborative relationship.

By the same token, this perspective suggests that contracting situations often involve a misalignment of expectations (e.g., Gulati, Lawrence, and Puranam, 2005; Malhotra and Lumineau, 2011), which can create divergent interpretations and ambiguity in a situation when something goes wrong. If so, this ambiguity may also make it harder to infer the motive of the violator after violations of such undocumented expectations (i.e., spirit violations) have occurred. This ambiguity and difficulty in inferring the motive of the violator, in turn, may lead violated parties to question their own clarity in communicating their expectations and wonder whether the violation had simply been the result of a misunderstanding. As a result, the violated party should be less likely to interpret a spirit violation as an attempt to exploit the relationship.

Thus, this perspective suggests that documenting one's expectations can help clarify expectations and behaviors between parties. As a result, if an undocumented expectation gets violated, the likely inference is that it had been less intentional, due to miscommunication or a lack of clarity in

understanding. By contrast, the violation of a documented term will likely appear to be more intentional, given the fact that this expectation was communicated clearly, yet was still violated, leading the violated party to question the underlying motives of the violator. The coordination perspective thus provides the prediction that letter violations would be interpreted as more intentional than spirit violations.

*Hypothesis 1b: Letter violations will be interpreted as more intentional than spirit violations.*

## ADDRESSING CONTRACT VIOLATIONS

Moreover, because the control and coordination perspectives provide alternative predictions for how people are likely going to interpret letter versus spirit contract violations, we might also expect these perspectives to differ in their assessments of how easy it is to address such incidents. In particular, since contract violations have the potential to damage the relationship by decreasing the violated party's trust in the violator (e.g., Rousseau, 1995), the violator, in turn, may subsequently attempt to repair that damage by issuing a response. We examine this effort by focusing on the effects of one of the most commonly studied ways of addressing violations in general—an apology (e.g., Schlenker and Darby, 1981), which has also been suggested (Dirks, Lewicki, and Zaheer, 2009) and shown (Lamin and Zaheer, 2012) to be an important strategic organizational response after something goes wrong. This may, furthermore, be important in the initial stages of newly formed contracting relationships, given that it can often set the stage for future renegotiations between parties going forward (Ariño and De La Torre, 1998; Doz, 1996). In what follows, we draw on recent trust repair work in the micro-organizational literature to examine the effectiveness of an apology in restoring trust (Kim *et al.*, 2004, 2013). Since the relative effectiveness of apologies for repairing trust has been found to depend on how violations are interpreted, and because the control and coordination perspectives offer alternative predictions for the interpretations contracting parties are likely to make after letter versus spirit violations, the effectiveness of an apology for trust repair after these different types of contract violations can provide an additional test for which perspective plays a larger role (see Table 1).

To begin, recall that the control perspective, which views contracts as a means to control the self-interested behavior of one's counterpart, assumes that initial levels of trust in newly formed relationships are typically low. One might, therefore, consider two possible implications of this control perspective for efforts to apologize for a contract violation, depending on whether the low initial trust prior to the violation entails that trust had been (1) completely absent, or (2) low but still meaningfully above zero. First, given that contracting parties in newly formed relationships would have no history of interaction, little or no prior information about their counterparts, and a general presumption that those counterparts may act opportunistically, it is plausible that initial trust in such relationships might not exist at all. If so, neither letter nor spirit violations should affect trust levels, since that trust would not have been high enough to be lowered by such incidents. Moreover, even if contracting parties perceived the intentionality of letter versus spirit violations to differ, efforts to address these incidents with an apology may in each case do very little, given that trust had not been high enough to be lowered by such violations in the first place and any success in restoring the relationship to its pre-violation state would again entail that initial trust would be zero.

Alternatively, the control perspective's assumption that initial trust should be low also leaves open the possibility that this low initial trust would, nevertheless, exist at levels that are high enough to be damaged by a contract violation. If this were the case, and trust were lowered by the contract violation, then any differences in perceived intentionality between letter versus spirit violations should lead to differences in the effectiveness of an apology for repairing that lowered trust. This is because an apology, which is defined as a statement that acknowledges both responsibility and regret for a violation (Kim *et al.*, 2004), has been found to be more effective at repairing trust for unintentional violations than for intentional violations (Kim and Harmon, 2012; Kim *et al.*, 2004). And because the control perspective would predict letter violations to be interpreted as *less* intentional than spirit violations, this would entail that an apology would, in turn, be more effective at repairing trust for letter violations than spirit violations. As a result, an apology should, ultimately, lead to a higher level of trust in the counterpart after a letter violation than a spirit violation. In sum, based on these two possible

implications of this control perspective for efforts to apologize for a contract violation, we can derive the following hypothesis.

*Hypothesis 2a: Trust will be repaired as, or more, effectively when an apology is offered after a letter violation than a spirit violation.*

In contrast to the control perspective, the coordination perspective, which views contracts as a means to clarify expectations and facilitate interaction with one's counterpart, maintains an assumption that initial levels of trust are typically high. Thus, given that even high initial trust has been observed to be quite fragile (McKnight, Cummings, and Chervany, 1998), one might again expect that this trust would, ultimately, be lowered by a contract violation. When this occurs, as already discussed with the control perspective (i.e., under the scenario in which initial trust was assumed to be low but still high enough to be violated), the perceptions of intentionality attributed to the counterpart's contract violation should produce differences in how effective an apology is for trust repair. However, in contrast to the control perspective, the coordination perspective predicts that letter violations are likely to be interpreted as *more* intentional than spirit violations. As a result, an apology should be more effective at repairing trust for spirit violations than letter violations.

*Hypothesis 2b: Trust will be repaired more effectively when an apology is offered after a spirit violation than a letter violation.*

Finally, recall that the control and coordination perspectives suggest that these potential differences in the relative effectiveness of an apology for repairing trust are based on how intentional the contract violation appears to be to the violated party. For this reason, one might expect that, regardless of which perspective ultimately receives support, perceived intentionality should mediate these effects. That is, we would predict a causal relationship whereby the type of violation will lead to differences in perceived intentionality, which in turn, will alter the effectiveness of an apology for trust repair. These considerations lead to our final hypothesis.

*Hypothesis 3: Perceived intentionality will mediate the effect of violation type on trust.*

## OVERVIEW OF STUDIES

We sought to test these hypotheses in a manner that would allow us to identify and isolate people's interpretations of contract violations and draw clear conclusions about causality. Thus, for Study 1, we created an interactive contracting situation in which participants felt personally involved by developing a paradigm that allowed the contracting process to naturally unfold. It is important to note that our goal was not to examine complex negotiating techniques or the expertise sometimes involved in contracting, but rather to understand the interpretations that would occur during a general contracting process. Thus, the scenario we explored in this study was the writing, and subsequent violation, of a contract developed to complete a specific task. Then, for Study 2, we sought to extend the insights from Study 1 by generalizing our findings across different populations (i.e., MBAs and working professionals), levels of contracting experience, types of contracting contexts, levels of ambiguity within the contract, and degrees of contract complexity.

### STUDY 1

The purpose of Study 1 was to test our hypotheses in a context where a contractor and subcontractor were involved in the construction of a house. We asked the contractor to write a contract that included the specifications of a house they wanted built based on a picture we had provided. The subcontractor, only after agreeing to the terms, then used only the contract to physically build a house out of provided materials. The contractor then experienced either a letter or spirit contract violation committed by their subcontractor. We measured initial trust before the contract violation, perceptions of intentionality after the contract violation, and then assessed the level of trust after the subcontractor apologized using measures of the (1) contractor's trusting intentions, which concerned their willingness to make themselves vulnerable to their subcontractor again in the presence of risk (McKnight *et al.*, 1998), and (2) a behavioral measure of the contractor's willingness to punish their subcontractor. Our experiment was thus a between-subjects design in which participants were randomly assigned to either the letter or spirit violation condition.

## Method

### Participants

One hundred fifty-seven undergraduate students enrolled in organizational behavior courses participated in this study for course credit. Participants averaged 20.9 years in age ( $SD = 2.36$ ), averaged 2.4 years of part-time work experience ( $SD = 1.83$ ), and 60 percent were male.

### Procedure

Participants signed up online for a one-hour study located at Site A, which notified them that they would be contracting with another participant located at Site B. The study was conducted in a computer lab with 16 computers that were partitioned so participants were unable to see each other's screens. Of the 13 sessions held, the average number of participants was 12 (minimum 7 and maximum 14). The variation in the number of participants per session arose from their occasional last-minute decisions not to participate due to personal conflicts as well as the need to exclude participants that failed to write a full contract.

In reality, there was no Site B. We took several steps in preparation for this study, however, to make that fictitious site seem real. First, we set up an e-mail account (which appeared in the school directory) for the fictitious research assistant at Site B, which was the person the participants would ostensibly be communicating with during the course of the study. Second, we installed a telephone at Site A that the researcher in the room could control without participants' knowing. This enabled the researcher to appear as though communication was occurring between Site A and Site B when it was in fact being simulated. Thus, although both the researcher and participants at Site A appeared to be actively communicating with Site B, all communication was being directed through the researcher at Site A.

After filling out a consent form, participants were told that the purpose of this study was to understand mixed-motive contracting situations between contractors and subcontractors and that this was important because these two parties often have different financial motivations in the real world, resulting in potential complications in trying to maintain a relationship. We also told participants that we would be offering them a financial incentive for their performance. Participants were then informed that they were the contractors and that each of them had been

paired with a subcontractor located at Site B, on the floor below them. As the contractor, they would be writing a contract with the goal of getting their subcontractor, using only the written contract, to build a house out of provided materials that looked as close as possible to a picture of a house that only the contractor would be able to see. Each Site A participant would earn \$25 cash unless there was a major flaw that would require reconstruction to the house. Any major flaw, as determined by an inspection conducted by the research assistant at Site B, would result in losing the ability to earn \$25 cash and instead receiving 10 lottery tickets, each of which gave the owner of the lottery ticket a chance to win one of three \$25 gift cards at the end of the semester. Regardless of whether the participant earned cash or lottery tickets, participants were told that they would have the option at the end of the study to allocate a portion of their earnings (i.e., either cash or lottery tickets) to their subcontractor for their involvement.

We then told participants that, while their financial incentive as the contractor came from writing a complete contract so that the house was built to match the picture they would be given as closely as possible, their subcontractor had a financial incentive not only to follow their contract (because they might get allocated a portion of the \$25 cash if they avoided any major flaws), but also to use as few materials as possible in order to save on costs. In other words, subcontractors could earn as much as \$10 cash by using fewer materials. Thus, our study design made it clear that the violator had (and could capitalize on) an ulterior motive and that sanctions were available to subsequently punish the violator (i.e., due to the contractor's ability to withhold some, or even all, of the cash/lottery tickets from the subcontractor).

To begin, participants were sent a picture of the house they needed built, which was a two-story house with a garage that had roughly 15 unique specifications that could be documented (e.g., color, number and location of windows, physical dimensions, etc.). They were then asked to write a contract that would be provided to the subcontractor to build the house. Upon completion, each participant e-mailed the contract to the research assistant at Site B, who ostensibly printed it out for the subcontractor to evaluate, request clarifications, and if necessary ask to be revised. After roughly five minutes, the researcher at Site A received a phone call that communicated that each subcontractor had fully

agreed to all the terms of their contract and would take the next 15 minutes to build the house. The researcher relayed this message directly to participants, and then sent out the first online questionnaire for them to complete.

After 15 minutes, the researcher at Site A received a second phone call indicating that the subcontractors were finished building the houses. The researcher told participants at Site A that the research assistant at Site B was done inspecting the houses and was in the process of taking a picture of each house and e-mailing the picture, along with their assessment of the house, directly to each participant. Participants were also told that their subcontractors had been asked to provide a handwritten comment about the assessment and that these comments had been delivered to Site A for the contractors to respond. The researcher momentarily stepped out of the computer lab and returned with a manila folder that contained the subcontractor comments. (This folder had been placed out of sight at the entrance of the computer lab since the beginning of the study.) After passing out the comments, the researcher asked participants to write a response back to their subcontractor. Once these responses were collected, the researcher sent out the second online questionnaire to the participants, which was completed before the participants were finally dismissed.

### *Manipulation of violation type*

We sought to manipulate violation type in a way that allowed for the exact same violation to be experienced in two entirely different ways. To be experienced as a letter violation, the participant must have included the "soon-to-be-violated expectation" in their contract and be able to recall that they had included this expectation in the contract after the violation had occurred. To be experienced as a spirit violation, the participant must have excluded the "soon-to-be-violated expectation" from their contract and be able to recall that they had excluded this expectation from the contract after the violation had occurred. Through pilot testing, we decided on the depth of the house as the basis for our manipulation because participants assumed that it needed to be at least as deep as the garage, yet naturally excluded it from the contract itself because they assumed that it was already sufficiently clear. While we recognize that some researchers have suggested that contract terms may function either to control or coordinate



(for a summary, see Malhotra and Lumineau, 2011; Parkhe, 1993; Reuer and Ariño, 2007), we suggest that some terms, such as the depth of the house, may easily function as both or, at minimum, do not cleanly fit into one characterization over the other.

Our manipulation of letter versus spirit violations took place across two phases. The first phase was implemented when we provided participants the instructions for writing their contract. In addition to the general instructions of what to do, we also provided each participant a short, nonexhaustive list of aspects of the house to consider while writing their contract (e.g., color of house, number of windows, etc.). Although we *did not* mention the depth of the house in the spirit condition, thus resulting in participants naturally excluding it as a contract term, in the letter condition we *did* mention the depth of the house, thus prompting participants to include it in the contract. The second phase of the manipulation came in the assessment e-mail. In both conditions, the assessment (1) noted that the house had a major flaw, resulting from the subcontractor using too few materials that were subsequently cashed in for \$7 cash, (2) stated that the contractor had only earned the 10 lottery tickets instead of \$25 cash due to the major flaw, and (3) contained a picture that showed a house that matched the desired house in every major way except that the depth of the house was far too narrow. In the letter violation condition, the assessment noted that “the house is too narrow, differing significantly from the picture,” and that “the house is not deeper than the garage, as documented in the contract.” In the spirit violation condition, the assessment noted that “the house is too narrow, differing significantly from the picture,” and that “the house is not deeper than the garage, which is clearly not what was intended.” Finally, in both conditions, participants received a handwritten response from their subcontractor that said, “I’m really sorry about this, the major flaw was my fault. If there’s anything I can do, let me know.”

### Dependent measures

Subsequent to the contract violation, we first asked participants to report their earnings (i.e., \$25 cash or 10 lottery tickets), as this would determine the following questions they would be asked to answer. Since all participants received the 10 lottery tickets due to the contract violation, this preliminary question allowed us to develop items that were tailored

directly towards this violation without raising suspicion. The following items represent our proposed mediator and two dependent variables.

**Perceived intentionality.** Three items assessing the perceived intentionality of the subcontractor’s violation were developed: (1) My subcontractor was fully aware that the house that was submitted would result in a major flaw, using a seven-point Likert scale (1 = *strongly disagree*, 7 = *strongly agree*); (2) The major flaw was based on an act that was (1 = *very unintentional*, 7 = *very intentional*); and (3) In my opinion, my subcontractor’s actions were (1 = *very unintentional*, 7 = *very intentional*) ( $\alpha = 0.91$ ).

**Trusting intentions.** Five items assessing participants’ trusting intentions were adapted from Mayer and Davis (1999): (1) I would feel comfortable working with this subcontractor again in the future; (2) I would feel comfortable with this subcontractor working on a similar task in the future without oversight; (3) If I worked with this subcontractor again, I would keep my eye on them (reverse-scored); (4) If I had a choice, I wouldn’t let this subcontractor have any influence over issues that are important to me (reverse-scored); and (5) I would give this subcontractor a task that was critical to me, even if I could not monitor their actions, using a seven-point Likert scale (1 = *strongly disagree*, 7 = *strongly agree*) ( $\alpha = 0.88$ ).

**Willingness to punish.** One item was developed specifically to assess the degree to which the participant behaviorally punished the subcontractor. We informed participants that they had the ability to allocate a portion of their earnings to their subcontractor for their involvement, and that 50 percent was typical. We asked: “How many lottery tickets would you like to allocate to your subcontractor?” During pretesting for this study, we had also provided a set of participants with an adequately built house (i.e., no major flaw), asked them how many tickets they would allocate, and found that their mean allocation out of 10 tickets was 5.31 ( $SD = 1.85$ ). Hence, by giving participants the ability to enter any whole number between 0 and 10, and observing that all conditions had a mean below the indicated 50 percent standard mark, we can support the use of this measure as an indicator of participants’ willingness to punish the violator.

## Results

Prior to the main study, we also conducted another pretest to (1) the assess the level of familiarity the student population has with written agreements, and (2) to validate the effectiveness of our manipulations. Forty-nine undergraduate students enrolled in organizational behavior courses ( $M = 21.2$  years,  $SD = 2.72$ ; 51% male) participated in this pretest. After writing the contract but prior to the contract violation, participants were asked about their level of familiarity with contracts in general (1 = *none at all*, 5 = *a lot*). Ninety-four percent of students responded that they had at least some familiarity with contracting, with a mean of 3.73, lending support for the notion that the student population has a meaningful level of familiarity with these types of situations. Next, after experiencing the violation, we assessed the effectiveness of our manipulations by asking participants whether their subcontractor built an adequate house (causing them to receive \$25 cash) or whether the house had a major flaw (causing them to receive 10 lottery tickets); 100 percent of the participants correctly answered that the house had a major flaw. We also asked to what degree the major flaw involved something they had explicitly written in their contract, noting that participants in the letter condition indicated that their violated expectation had been made significantly more explicit ( $M = 5.27$ ) than those in the spirit condition ( $M = 3.07$ ),  $t(1, 47) = 11.66$ ,  $p < 0.001$ . These results confirm that participants were able to recognize that a violation had occurred, correctly identify the nature of the violation, and recognize that the violation had been of an expectation that they had (or had not) explicitly documented.

## Preliminary analyses

We then pursued the main study based on these supportive pretest results. To do so, we first read each participant's contract to determine that the contract (1) mentioned the depth of the house if in the letter violation condition, (2) did *not* mention the depth of the house if in the spirit violation condition, and (3) provided sufficient detail to make it believable that a house could have been built based on their contract alone. Based on our analysis, 18 contracts did not meet these criteria and were dropped from the sample.

Next, we assessed initial trust levels for three reasons. First, because our competing predictions

based on the control and coordination perspectives make different assumptions regarding initial trust levels (see Table 1), we wanted to measure initial trust shortly after the experiment began but before the violation had occurred. We therefore asked participants to respond to three statements: (1) I trust my subcontractor to follow the instructions of our contract, (2) I can count on my subcontractor, and (3) my subcontractor will make a good effort to live up to the terms of our agreement (1 = *strongly disagree*, 7 = *strongly agree*) ( $\alpha = 0.77$ ). The results revealed that participants' initial trust in their subcontractor was quite high ( $M = 5.14$ ), above the middle of the scale. Second, we also checked to make sure that participants' initial trust across both the letter ( $M = 5.21$ ) and spirit conditions ( $M = 5.06$ ) did not significantly differ,  $t(1, 156) = 1.02$ ,  $p = 0.31$ , thereby ensuring an equivalent starting point from which they would experience the contract violation. Finally, we compared this initial trust ( $M = 5.13$ ) to the level of trust after the subcontractor apologized for the violation ( $M = 3.03$ ), and noted that trust had indeed dropped as a result of the contract violation,  $t(1, 156) = 17.14$ ,  $p < 0.001$ . Table 2 presents descriptive statistics, reliabilities, and intercorrelations for the study variables.

## Primary analyses

To conduct our primary analyses, we use regression and present means where applicable. Table 3 presents our findings. Hypothesis 1a predicted, based on the control perspective, that spirit violations would be interpreted as more intentional than letter violations, whereas Hypothesis 1b predicted, based on the coordination perspective, that letter

Table 2. Study 1—means, standard deviations, reliabilities, and intercorrelations

Variable	<i>M</i>	<i>SD</i>	$\alpha$	1	2	3
1. Initial trust	5.14	0.92	0.77			
2. Perceived intentionality	3.90	1.57	0.97	0.00		
3. Trusting intentions	3.03	1.24	0.84	0.01	-0.44**	
4. Willingness to punish	2.74	2.36	—	0.03	-0.19*	0.52**

$N = 157$ .

Dash indicates that  $\alpha$  cannot be obtained, since it is a single-item measure.

\* $p < 0.05$ ; \*\* $p < 0.01$

Table 3. Study 1—primary analyses

	Perceived intentionality (Hypothesis 1a/Hypothesis 1b)	Trusting intentions (Hypothesis 2a/Hypothesis 2b)	Willingness to punish (Hypothesis 2a/Hypothesis 2b)
Violation type <sup>a</sup>	0.52*	−0.73***	1.19***
<i>R</i> <sup>2</sup> (adjusted <i>R</i> <sup>2</sup> )	0.03 (0.02)	0.09 (0.08)	0.06 (0.06)
<i>F</i> -value	4.32	14.65	10.47

<sup>a</sup> Given Violation Type was coded (letter = 1, spirit = 0), a positive coefficient represents letter violations being perceived as more intentional than spirit violations.

\**p* < 0.05; \*\*\**p* < 0.001

violations would be interpreted as more intentional than spirit violations. Our results indicate that letter violations were perceived as significantly more intentional ( $M = 4.17$ ) than spirit violations ( $M = 3.65$ ). This supports Hypothesis 1b and the coordination perspective.

Hypotheses 2 then built on this logic by predicting that, if letter violations were considered more intentional than spirit violations, an apology would ultimately repair trust more effectively after spirit violations than after letter violations. Consistent with this prediction, we observed significantly higher Trusting Intentions after spirit violations ( $M = 3.39$ ) than after letter violations ( $M = 2.66$ ). Moreover, we observed a significantly lower Willingness to Punish the violator, as evidenced by the allocation of more lottery tickets to the violator, after spirit violations ( $M = 3.31$ ) than after letter violations ( $M = 2.12$ ). Thus, Hypothesis 2b was clearly supported, offering additional support for the coordination perspective.

Finally, Hypothesis 3 predicted that Perceived Intentionality would mediate the direct effect of Violation Type on Trusting Intentions and Willingness to Punish. We assessed this mediation prediction by bootstrapping (with 5,000 samples) the indirect effects on both dependent variables (Preacher and Hayes, 2008). This revealed that Perceived Intentionality mediates both Trusting Intentions (lower limit = −0.36, upper limit = −0.02; adjusted  $R^2 = 0.23$ ,  $p < 0.001$ ) and Willingness to Punish (lower limit = −0.36, upper limit = −0.01; adjusted  $R^2 = 0.08$ ,  $p < 0.001$ ), as evidenced by the fact that the 95 percent confidence interval does not include zero. This provides support for Hypothesis 3.

## Discussion

The results demonstrate that people interpret letter versus spirit contract violations differently.

Consistent with the coordination perspective, violated parties perceived letter violations to be more intentional than spirit violations, and, as a result, letter violations were more difficult to overcome than spirit violations. These findings are also consistent with the evidence that initial trust was quite high. More specifically, while the control perspective assumes low levels of initial trust, the coordination perspective assumes high levels of initial trust (see Table 1). Thus, the fact that initial trust levels in this study were found to be relatively high may help explain why the coordination perspective was ultimately found to play a larger role.

Nevertheless, one might raise three sets of concerns about our findings. First, while the complexity of the contracts used in Study 1 might be considered relatively low, many contracts in everyday life can be quite complex (e.g., Reuer and Ariño, 2007) and pose practical concerns for managers (i.e., by becoming harder to interpret and execute). As a result, exploring whether our findings extend to contracts with higher levels of complexity would be an important extension of this work. Second, one might wonder whether our findings are limited to situations in which violations concern expectations that were either entirely documented in the contract or entirely omitted. While this was how we operationalized letter versus spirit violations in Study 1, the question of whether an expectation has been documented cannot always be answered in such a binary manner. Instead, it is often the case that an expectation may be documented, but is not as explicit as it could be, leading to an ambiguous contract term that can be interpreted in more than one way. When this happens, its violation may raise questions not only about whether the letter or spirit of the law had been violated, but also to what degree. As a result, exploring whether our findings might extend to situations in which the violated expectation is documented, yet somewhat ambiguous, would help broaden the potential implications

of this work. Finally, one might wonder whether our findings are limited to an undergraduate population that, despite reporting some familiarity with contracts, still has relatively less experience with writing, negotiating, and executing contractual agreements than seasoned managers. For this reason, it would be worth determining whether these findings can be extended to working professionals with more contracting experience.

## STUDY 2

Study 2 thus seeks to generalize our findings from Study 1 by addressing each of the limitations raised above. First, we examine the possibility that contract complexity might alter a person's reaction to letter versus spirit violations. For instance, one could imagine that, as contract complexity increases, the violated party may begin to perceive a letter violation as increasingly unintentional because the violated party may infer that the complexity of the contract had overwhelmed the violator, leading them to have accidentally overlooked that contract term. While this seems reasonable, we believe that it is unlikely to change the overall relationship predicted by Hypothesis 1b. More specifically, even if increased contract complexity does make letter violations seem less intentional, such complexity should make spirit violations seem less intentional as well, given that it should be harder to interpret the implicit expectations of the other party when the contract becomes more complex. And for this reason, we would expect letter violations to be perceived as more intentional than spirit violations, regardless of whether contract complexity is high or low.

Second, we examine whether our findings would generalize to expectations for which the matter of documentation is more ambiguous. More specifically, we contend that the letter versus spirit distinction might not only be thought of as a binary feature of a contract (i.e., whether an expectation was documented or not), but also as the degree to which an ambiguously documented expectation is *perceived* to be explicit. In this sense, participants who perceive a documented expectation as more explicit should view a violation of that expectation as more of a letter violation and therefore consider it more intentional, whereas participants who perceive a documented expectation as being less explicit

should view the violation as more of a spirit violation, and therefore consider it less intentional. Thus, we would expect similar results to those reported in Study 1 to arise, not just from whether an expectation is included within the contract or not, but also from differences in how an expectation within the contract is framed.

Third, we examine whether our findings would generalize beyond an undergraduate population to working adults with more contracting experience. Management scholars have observed that, while some differences can arise between students and experts (e.g., in performance), the outcomes related to broader psychological phenomena often do not significantly differ (Neale and Northcraft, 1986; Northcraft and Neale, 1987). Hence, we do not expect that our findings would differ for populations with greater contracting experience. Nevertheless, we decided to test our hypotheses with two additional populations (i.e., working professionals from Amazon's Mechanical Turk and MBA students) and assess the potential implications of these participants' level of experience with contracting as well.

## Method

To accomplish these goals, we designed a 2 (Violation Type: letter versus spirit)  $\times$  2 (Contract Complexity: high versus low) between-subjects experiment in which participants were randomly assigned to one of the four conditions. We furthermore sought to bolster the external validity of our findings by using adaptations of a real contract in an entirely different contracting context.

## Participants

We gathered two independent samples for this study. First, 97 participants were recruited from Amazon's Mechanical Turk and were paid for their participation. Mechanical Turk, which has been verified to yield research data that is at least as reliable as those obtained via traditional methods (see Buhrmester, Kwang, and Gosling, 2011), is particularly appropriate for this context in that we can test our predictions using a diverse sample of working professionals. Participants averaged 29.71 years in age ( $SD = 9.42$ ), averaged 6.0 years of full-time work experience ( $SD = 6.61$ ), 84 percent held at least a bachelor's degree, and 61 percent were male. Second, 108 MBA students, the vast majority of



whom were fully employed, were recruited to participate in this study from several evening MBA courses during a break from normal classroom time. Participants averaged 28.7 years in age ( $SD = 3.44$ ), averaged 6.0 years of full-time work experience ( $SD = 3.59$ ), and 60 percent were male.

### *Procedure and manipulation*

This study involved adaptations of short-term contracts that are regularly used to rent vacation homes. These types of contracts are quite common, vary widely in their complexity, and are the source of a number of contractual disputes. Moreover, these procedures were developed to reflect the way in which the contracting process operates in the rental property context. For instance, most property owners never meet their tenants, and instead typically send a contract to their future tenants, who sign it and send it back. Furthermore, because most property owners hire property managers to handle the day-to-day concerns, they typically have to deal with issues (e.g., contract violations) from a distance. As a result, conducting this survey with participants that have not met each other is virtually identical to how this process tends to operate.

Upon receiving the survey, participants were asked to take the role of a property owner who had rented a home to a tenant. They were told that they had drafted a contract, which the tenant had read and signed. The contract, which was either highly complex or not, was then given to the participant to read, followed by a measure of initial trust. In the high complexity condition, participants received a contract that was three pages long and contained 24 detailed terms. In the low complexity condition, participants received a contract that was one page long and contained six detailed terms. The six terms in the low complexity condition were identical to those in the high complexity condition. Regardless of the contract's complexity, both contracts contained the following term: "The maximum occupancy is 8. No additional persons are permitted to spend the night. Persons on the property are the sole responsibility of the Tenant." This contract term functioned as the source of our violation type manipulation.

Next, participants read the following: "During the tenant's stay, however, you discovered that they held a large party during the day with roughly 30 people. This led to two toilets getting clogged, a rose bush being trampled, a broken gate, and a noise complaint, which took time and money to rectify." This

was followed by one of two statements. In the letter violation condition, participants read the following: "After this incident occurred, you referred back to the rental agreement contract. The contract explicitly documents that the maximum occupancy for the property was 8, but the tenant violated that contract term by having more than 30 people at the home." In the spirit violation condition, participants read the following: "After this incident occurred, you referred back to the rental agreement contract. Even though the term referring to the maximum occupancy of 8 did not explicitly state that it applied to visitors during the day, the tenant violated the intent of that contract term by having more than 30 people at the home." Next, participants were told that they received an e-mail from the tenant a day after the tenant left with the following message: "I'm really sorry. This was my fault. If there's anything I can do, please let me know."

### *Dependent measures*

We adapted the measures of Perceived Intentionality ( $\alpha = 0.89$ ) and Trusting Intentions ( $\alpha = 0.90$ ) used in Study 1. We also asked a context-dependent question to gauge the participants' Willingness to Punish the violator: "If you could bring legal action against this tenant, how likely is it that you would do so?" (1 = *very unlikely*, 7 = *very likely*).

Contracting experience. We also developed five items to assess more directly participants' level of contracting experience. We asked participants, "How much experience have you had: (1) writing contracts, (2) negotiating contracts, (3) executing contracts, (4) implementing contracts, and (5) dealing with contractual disputes?" (1 = *very little*, 7 = *a lot*) ( $\alpha = 0.92$ ).

## **Results**

### *Preliminary analyses*

We conducted all analyses within each of the two samples independently, finding consistent results. As such, we report only the combined data to increase statistical power and conserve space. To begin, we conducted three preliminary analyses. First, we assessed whether our manipulation of Contract Complexity was effective, finding that the high complexity contract was perceived as significantly more complex ( $M = 3.56$ ) than the low

Table 4. Study 2—means, standard deviations, reliabilities, and intercorrelations

Variable	<i>M</i>	<i>SD</i>	$\alpha$	1	2	3	4
1. Initial trust	5.21	1.03	0.86				
2. Perceived intentionality	4.78	1.37	0.89	0.11			
3. Trusting intentions	3.35	1.76	0.90	−0.22**	−0.50**		
4. Willingness to punish	3.47	1.73	—	0.24**	0.42**	−0.48**	
5. Contracting experience	2.93	1.66	0.92	−0.02	−0.10	0.15*	0.06

*N* = 205.

Dash indicates that  $\alpha$  cannot be obtained, since it is a single-item measure.

\* $p < 0.05$ ; \*\* $p < 0.01$

complexity contract ( $M = 2.53$ ),  $t(1, 204) = 22.11$ ,  $p < 0.001$ . Second, because our manipulation of letter versus spirit violations involved a single contract term that was framed in two different ways, we validated that this manipulation was effective by asking participants: “How explicitly was the violated expectation documented in the contract?” Note that in *both* conditions, the violated expectation was documented. However, the key to this manipulation was the *degree* to which the violated party thought the violated expectation was explicit. More specifically, participants in the letter violation condition were led to interpret the contract term as clear-cut (i.e., more explicit), while participants in the spirit violation condition were led to interpret the contract term as more ambiguous (i.e., less explicit). As a result, we would expect that, while participants in both conditions are likely to believe that the violated expectation had been documented, those in the letter condition should believe that this expectation had been documented more explicitly than those in the spirit condition. Supporting this view, participants in the letter violation condition believed that the violated expectation was significantly more explicit ( $M = 5.45$ ) than those in the spirit violation condition ( $M = 3.86$ ),  $t(1, 204) = 40.94$ ,  $p < 0.001$ .

Third, we assessed initial trust levels using the same measures as in Study 1 ( $\alpha = 0.86$ ). Participants’ initial trust in their tenant was again quite high ( $M = 5.21$ ), consistent with the patterns observed in Study 1. Second, we also checked to make sure that participants’ initial trust across violation type,  $t(1, 204) = 0.12$ ,  $p = 0.73$ , and contract complexity,  $t(1, 204) = 0.31$ ,  $p = 0.58$ , did not significantly differ, thereby ensuring an equivalent starting point from which they would experience the contract violation. Finally, we compared this initial trust ( $M = 5.21$ ) to the level of trust after the subcontractor apologized for the violation ( $M = 3.35$ ), and noted that trust had indeed dropped as a result of

the contract violation,  $t(1, 204) = 11.94$ ,  $p < 0.001$ . Table 4 presents reliabilities and intercorrelations for the study variables.

### Primary analyses

To conduct our primary analyses, we use regression and present means where applicable. Table 5 presents our findings. In Model 1, we include only the measure of Contracting Experience. Based on these analyses, we note that Contracting Experience only significantly correlates with Trusting Intentions, such that people with more contracting experience tended to exhibit less of a drop in trust after the violation. This may be due to those with greater experience being more familiar with problems arising in contracting relationships and thus reacting less strongly when something goes wrong. Most important, however, we note that Contracting Experience does not interact with Violation Type to predict any of our three dependent variables (Perceived Intentionality [ $b = -0.01$ ,  $p = 0.93$ ]; Trusting Intentions [ $b = 0.10$ ,  $p = 0.20$ ]; Willingness to Punish [ $b = -0.07$ ,  $p = 0.31$ ]), making it clear that experience does not alter our main effect findings in any meaningful way. Nevertheless, to be absolutely sure that it would not qualify our conclusions, we control for Contracting Experience when testing our hypotheses in Model 2.

Model 2 shows the regressions for each of our dependent measures and adds our two independent variables (Violation Type and Contract Complexity) as well as their interaction. This is because, while Hypotheses 1a and 1b predicted how people would likely interpret letter versus spirit violations, we also sought to examine whether Contract Complexity would function as a boundary condition for our findings. Our results indicate that letter violations were perceived as significantly more intentional ( $M = 5.24$ ) than spirit violations ( $M = 4.33$ ).

Table 5. Study 2—primary analyses

	Perceived intentionality (Hypothesis 1a/ Hypothesis 1b)		Trusting intentions (Hypothesis 2a/ Hypothesis 2b)		Willingness to punish (Hypothesis 2a/ Hypothesis 2b)	
	Model 1	Model 2	Model 1	Model 2	Model 1	Model 2
Violation type <sup>a</sup>		0.91***		−0.63***		0.52*
Contract complexity		−0.19		0.77***		−0.03
Violation type × contract complexity		−0.02		−0.04		0.04
Contracting experience	−0.08	−0.08	0.16*	0.16*	0.06	0.06
R <sup>2</sup> (adjusted R <sup>2</sup> )	0.01(0.00)	0.13(0.10)	0.02(0.02)	0.10(0.09)	0.00(0.00)	0.03(0.01)
F-value	1.81	7.14	4.75	5.75	0.64	1.36

<sup>a</sup> Given Violation Type was coded (letter = 1, spirit = 0), a positive coefficient represents letter violations being perceived as more intentional than spirit violations.

\* $p < 0.05$ ; \*\*\* $p < 0.001$

Next, we noted that the perceived intentionality of violations occurring within high complexity contracts ( $M = 4.69$ ) did not differ significantly from violations occurring within low complexity contracts ( $M = 4.88$ ). Furthermore, the interaction between Violation Type and Contract Complexity failed to reach significance. These results thus provide consistent support for Hypothesis 1b (i.e., the coordination perspective), regardless of Contract Complexity.

We next examined the influence of Violation Type and Contract Complexity on Trusting Intentions and the participant's Willingness to Punish the violator by taking legal action (Hypotheses 2a and 2b). Given that letter violations are indeed considered more intentional than spirit violations, an apology should ultimately repair trust more effectively after spirit violations than after letter violations. Consistent with this prediction, we observed significantly higher Trusting Intentions after spirit violations ( $M = 3.66$ ) than after letter violations ( $M = 3.04$ ). We also observed a significantly lower willingness to take legal action after spirit violations ( $M = 3.21$ ) than after letter violations ( $M = 3.73$ ). Finally, we found that, although violations occurring within high complexity contracts ( $M = 3.73$ ) resulted in higher Trusting Intentions than violations occurring within low complexity contracts ( $M = 2.95$ ), Contract Complexity did not affect participants' willingness to take legal action. Even more importantly, Contract Complexity was *not* found to moderate the effect of Violation Type in predicting either participants' Trusting Intentions or willingness to take legal action. Based on these

findings, Hypothesis 2b was again supported, regardless of Contract Complexity.

Finally, we examined the role of Perceived Intentionality mediating the direct effect of Violation Type on Trusting Intentions and Willingness to Punish (Hypothesis 3). By using the Preacher and Hayes (2008) bootstrapping approach, and controlling for Contracting Experience, we again found that Perceived Intentionality mediated both Trusting Intentions (CILL = −0.87, CIUL = −0.34; adjusted  $R^2 = 0.25$ ,  $p < 0.001$ ) and Willingness to Punish (CILL = 0.28, CIUL = 0.74; adjusted  $R^2 = 0.17$ ,  $p < 0.001$ ), as evidenced by the 95 percent confidence intervals not including zero, providing further support for Hypothesis 3.

## Discussion

Study 2 provides a strong replication of our results from Study 1 and thus further support for the coordination perspective. Our results also extend the generalizability of these findings in several key ways. First, these findings reveal that, while contract complexity can affect trusting intentions in general, it does not significantly alter how people interpret and react to letter versus spirit violations. Second, these findings extend our understanding of what we might consider to be a letter versus spirit violation. In other words, while Study 1 was limited to a violated expectation that had been either entirely documented versus entirely omitted from the contract, Study 2 broadens our scope by demonstrating that the same pattern of results is found even with a far more nuanced distinction. More specifically,

people reacted to letter versus spirit violations in the same manner when they simply differed based on the degree to which they perceived the expectation to be explicit, even though in both cases the expectation was documented. And finally, our results were shown to replicate across both MBA students and working professionals, across different levels of experience, as well as in an entirely different context (i.e., vacation rentals) with a real contract.

## GENERAL DISCUSSION

The purpose of this paper was to investigate how people interpret contract violations as well as how such interpretations might affect subsequent attempts to address them. Our inquiry led us to consider people's reactions to violations of the letter versus spirit of the law, a fundamental distinction based on how we understand the responsibilities arising from a contract, and to consider the implications of two contracting perspectives. Consistent with the coordination perspective, our findings revealed that letter violations were interpreted to be more intentional than spirit violations, and, as a result, letter violations were repaired less effectively with an apology than spirit violations. These effects, furthermore, generalized across different populations (i.e., undergraduates, MBAs, and working professionals), levels of contracting experience, types of contracting contexts, levels of ambiguity within the contract, and degrees of contract complexity.

The key insight from our findings is that a violated party's reaction to a contract violation, as well as the violator's subsequent success in managing that relationship, markedly depends on the degree to which the violated party believes the violated expectation had been explicit. Moreover, the results reveal that, while this explicitness can arise from either documenting the expectation versus not documenting it, it may also result from simply framing an ambiguously documented expectation as having been more or less explicit. The findings are consistent with the notion that when the violated expectation had not been explicit, the violated party may take into account any number of possible external factors that could have reasonably accounted for the violator's actions (e.g., miscommunication by either party, bounded rationality of the violator, environmental factors outside the control of the violator, etc.). By acknowledging possible causes that are ostensibly outside the violator's control, it would

make sense to view the violator as less responsible, infer a lower level of intentionality, and allow trust to be repaired more easily. However, when the violated expectation is believed to have been explicit, and thus exceptionally clear, the violated party may end up focusing primarily on the fact that the violator had agreed to, yet still violated, such a clear expectation, and, as a result, end up ignoring the possibility that a broader set of external factors could have played a meaningful role in accounting for the violator's actions. This could, in turn, explain why violated parties were found to infer a higher level of intentionality, thereby making it more difficult to repair trust under such conditions.

## Implications for research on contracting

These findings contribute to research on contracting and interfirm exchange relationships in at least three ways. First, the primary focus of the contracting literature in both economics and strategy has traditionally been on contract formation rather than contract violation. Thus, while we now know a great deal about establishing proper safeguards (e.g., Argyres *et al.*, 2007; Macaulay, 1963) and developing contracts over time in greater detail (e.g., Mayer and Argyres, 2004; Vanneste and Puranam, 2010), we know dramatically less about what might occur if those contracts are subsequently violated. We are beginning to gain insight into this issue with recent work that examines contractual disputes (e.g., Lumineau and Oxley, 2012; Malhotra and Lumineau, 2011). However, while this work has been important for developing an understanding of dispute resolution processes and the relationship between contract structure and the likelihood of disputes, they have paid less attention to the individual-level cognitive mechanisms that would explain how contracting parties would interpret different types of contract violations and respond to attempts to restore the relationship. By addressing this limitation, we also extend recent work that has highlighted the importance of psychological influences in contracting (e.g., Weber and Mayer, 2011; Weber, Mayer, and Macher, 2011) as well as further demonstrate the benefits of using experimental methods in strategy research (Agarwal and Hoetker, 2007; Croson *et al.*, 2007).

Second, our findings contribute to a deeper understanding of how trust may operate in newly formed contracting relationships. In particular, there is a longstanding assumption across multiple literatures



that the initial conditions of newly formed relationships are best understood using the control perspective (e.g., Malhotra and Murnighan, 2002). This is because it is often thought that trust accumulates over time as people gain knowledge of and familiarity with one another (e.g., Gulati, 1995; Holmes, 1991; Lewicki and Bunker, 1995; Rousseau *et al.*, 1998), and that initial trust is generally very low. Given these considerations, we might view our focus on newly formed relationships as a conservative test of the coordination perspective, since this past research suggests that it is precisely under these conditions that this perspective is least likely to play a role. Nevertheless, we find that initial trust levels were actually quite high across both our studies, even with no history of interaction, suggesting that the coordination perspective is more consistent with how people *actually* react to contract violations in these types of situations. These findings reveal how the consideration of these initial conditions not only provides a better understanding of how to manage the initial stages of the relationship when a violation occurs, but also how such conditions might form the basis for ongoing renegotiations between parties as the relationship unfolds (Doz, 1996).

And finally, while the contracting literature has examined breakdowns in relationships in general (e.g., Macaulay, 1963) as well as the processes for dispute resolution (e.g., Lumineau and Oxley, 2012), it has not examined the effectiveness of common, everyday responses to contract violations (e.g., apologies, denials, justifications, etc.) that managers might offer as strategic attempts to renegotiate the perceptions of themselves and their organization. Thus, given that apologies have been suggested (Dirks *et al.*, 2009) and shown (Lamin and Zaheer, 2012) to be an important strategic organizational response after something goes wrong, knowing how and when to apologize can be considered an organizational capability, especially since the management of newly formed relationships can have important implications for the future (Ariño and De La Torre, 1998; Doz, 1996). Given that our findings support the notion that such responses can have a marked impact on how such violations are resolved (e.g., Kim *et al.*, 2004, 2006), contracting scholars might benefit by further exploring the role such responses play after contract violations occur. By connecting the macro-contracting literature with the micro-trust repair literature, this paper thus provides an initial step in this direction.

### Implications for research on trust repair

These findings, in turn, also contribute to a growing body of research in the micro-literature that examines how trust might be repaired after a violation. The trust repair literature has thus far focused primarily on interpersonal, rather than on formal contracting, situations (e.g., Ferrin *et al.*, 2007; Kim *et al.*, 2004). As a result, it was previously unclear whether formally documenting one's expectations as opposed to leaving them undocumented would affect the interpretation of a subsequent violation. Our findings thus extend this literature into the context of formal contracting by showing that documenting one's expectations, as well as how explicitly those expectations are perceived to have been documented, does indeed affect both one's interpretation and reaction when that expectation is subsequently violated. Moreover, this finding is particularly important in the contracting context, where the degree of explicitness and documentation often differs from what is found in everyday interpersonal situations. And because organizations rely so extensively on contracts in their daily operation to manage relationships, and often need to repair trust to sustain such relationships, this research provides a relevant theoretical extension into an important managerial context.

### Managerial implications

These findings also highlight several practical issues that may warrant managerial attention. As previously suggested, contracting is a process of communicating expectations. Yet managers face a trade-off when considering what to write in a contract. On the one hand, managers could attempt to reduce uncertainty by being more comprehensive, thereby making every expectation as explicit as possible. This increase in specification, however, comes at the risk of contract breaches being more likely to be interpreted as intentional (i.e., letter violations), thus resulting in more difficulties in repairing trust. On the other hand, managers could accept more uncertainty by being less comprehensive, thereby leaving expectations undocumented. While such lack of clarity in a contract may not always be feasible or desired, it might also bolster relationship resilience by increasing the chances that either party's failures would be interpreted as unintentional (i.e., spirit violations), which may more easily be addressed with an apology. These trade-offs suggest that it might be useful for

managers to consider how difficult the expectation would be to fulfill when determining the kind of contract to develop. To the extent that such fulfillment is straightforward, greater specification may increase the chances that one's interests would be satisfied while posing little risk to the relationship. However, as such fulfillment becomes more difficult, greater specification may not only be less likely to prevent contract failures, but also magnify their harm by making it harder to maintain the relationship after such failures occur, given the relative difficulty of repairing trust with an apology after letter violations.

Managers would also do well to recognize that increasing the comprehensiveness of contracts has the potential not only to improve clarity, but also to increase complexity. This, in turn, may make it more difficult to understand what one needs to do in order to fulfill their responsibilities. And given that increased contract complexity may add to the difficulty of fulfilling one's responsibilities, managers may assume that a potential victim might be more understanding if the manager ended up accidentally committing a violation. However, such assumptions should be cautioned, as our findings reveal that it is unlikely that the violated party will recognize the degree to which the complexity of the contract may have affected the action in question.

Given these considerations, trying to repair trust after violating a documented expectation may seem discouraging. While it is true that violating the letter of the law consistently leads to higher perceived intentionality and more difficulty in overcoming that violation, managers should take care to note that violating a documented term does not automatically lead to the perception of a letter violation, or its accompanying negative effects. Instead, the violated party's reaction highly depends on the *degree* to which they perceived the violated expectation as explicit. For this reason, even when an expectation has been documented, managers may still be able to affect how explicit (or ambiguous) the violated party perceives the expectation to be as a way of facilitating efforts to repair the damage to the contractual relationship.

### Limitations and future directions

Our findings also raise a number of questions for subsequent research. First, the types of reactions identified here are unlikely to hold true across all cultures. For example, scholars have suggested that

people in East Asian cultures conceive of individuals as more constrained and, thus less agentic, than do people in North American cultures (e.g., Menon *et al.*, 1999). If so, while individuals from North America may infer greater intentionality for letter than spirit violations due to the observed actions seeming more agentic, it may be harder to find this difference in individuals who do not make the same assumptions about agency. Instead, since individuals from East Asia tend to see others as more personally constrained, letter violations may not be seen as more intentional than spirit violations (or at least not to the same degree as with North Americans). For this reason, and because organizations are increasingly forming contracts with counterparts in other countries, we suggest that an important next step for this research would be to explore these implications by examining whether the differing views of human agency in East Asian cultures may lead its members to react less negatively to letter violations than do North Americans.

Second, our research design examined only short-term contracting relationships in which there was limited interaction. This approach should not raise concerns regarding whether initial levels of trust existed and had been subsequently violated, given the consistent evidence supporting these notions in our study as well as in previous research (Dirks *et al.*, 2011; Ferrin *et al.*, 2007; Kim *et al.*, 2004, 2006). Nor does this design choice represent a weak test of trust repair, given recent evidence that trust repair may actually be easier in long-term relationships, since those in such longer-term relationships are likely to exhibit greater motivation to maintain those ties (Finkel *et al.*, 2002). Nevertheless, the study of longer-term contracting relationships may offer an opportunity to examine the impact that more deeply embedded social relations might have on the interpretations of contract violations. For example, since our findings were based on initial trust being quite high, one might find that our conclusions may actually be strengthened for longer-term relationships, given that trust has often been observed to improve with repeated interactions (e.g., Mayer and Argyres, 2004). On the other hand, scholars have recently suggested that parties with high initial trust may be exhibiting an optimism bias when entering new relationships and, in these situations, may actually show declining trust over time (Vanneste, Puranam, and Kretschmer, forthcoming). If this happens, contracting parties may end up developing a lower

level of trust in their counterparts, eventually producing a situation in which spirit violations could be perceived as more intentional than letter violations. More work is needed to explore these divergent possibilities that may emerge over time.

Third, increased interaction may also offer more insight into how the other party thinks, and thereby lead people to engage in increasingly higher levels of iterative reasoning (i.e., whereby people take into account what each thinks the other may be thinking) than exhibited in our studies. Specifically, our present efforts were based on the assumption that people would judge their counterpart's intentionality by considering factors such as the situation (e.g., the context) as well as their counterpart's actions (e.g., the violation itself) and possible motives (e.g., earning extra money), without taking into account what the other party may have been thinking. And while research in economics (Mehta, Starmer, and Sugden, 1994; Nagel, 1995) and psychology (Heider, 1958; Kelley, 1973; Knobe, 2003; Malle and Knobe, 1997) provides support for this assumption in newly formed relationships, it may be worth exploring whether longer-term relationships enable parties to acquire more information about how the other party thinks (Nagel, 1995), possibly enabling increasingly higher levels of iterative reasoning as the relationship progresses. For instance, a violated party may eventually take into account the possibility that the violator not only knows how the violated party typically reacts to spirit violations (e.g., he or she tends to be forgiving), but also is consistently taking advantage of this fact. This, in turn, may lead the violated party to actually interpret spirit violations as more intentional.

A fourth limitation with our present methodology is that we only examined one side of the contract violation. Although considering only one party's interpretation does not invalidate their interpretation and actual response, it may not account for the kinds of full, bilateral social interactions that would naturally occur and affect trust in organizations (e.g., Kim, Dirks, and Cooper, 2009). For example, although we notified participants that the other party agreed to all their contract terms, it is possible that a different level of personal investment or expectations of the other party would occur if they had both been involved in writing the contract. Even further, since the focus of the present research is on what the violated party's subjective interpretations of the violation might have been, this leaves open the possibility that such interpretations

could be wrong and that the violator might seek to address such misinterpretations if given the opportunity. For these reasons, and given the potential for ongoing social interactions to influence the interpretations of each other's actions (Ariño and De La Torre, 1998; Swann, 1987), considering both contracting parties and the ongoing dynamics of the relationship would be a logical next step.

And finally, our studies only examined violations of expectations that could be documented in the letter of the law if an attempt was made to do so. Such scope limitations were critical in this context, since we were interested in specifically comparing the interpretations of letter versus spirit violations while keeping the actual nature of the expectation constant. Nevertheless, people certainly maintain expectations that they may not be able to document fully. For instance, deeply held, taken-for-granted cultural assumptions of what is considered "fair dealing" may be an incredibly strong expectation in an exchange agreement, but may not be easily translated into words. Future research may consider exploring these more deeply held expectations and how parties attempt to manage their subsequent violation.

## CONCLUSION

By weaving together macro- and micro-literatures in order to explore this phenomenon, a large number of both theoretical and empirical questions have been identified and remain to be answered. This paper presents an important first step towards understanding how people respond to contract violations. We believe that further consideration of how people not only interpret contract violations, but also attempt to repair trust, is of vital importance to how organizations manage their relationships. Given the numerous opportunities this area of research presents, we expect it to receive much more attention in the future.

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