

# “Opportunism control in exchange relationships: lessons from the French logistics industry”

## AUTHORS

Aline Boissinot  
Gilles Paché  <https://orcid.org/0000-0002-9316-0251>

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## SECTION 4. Practitioner's corner

Aline Boissinot (France), Gilles Paché (France)

### Opportunism control in exchange relationships: lessons from the French logistics industry

#### Abstract

Over the last few years, manufacturers have progressively abandoned the management of logistical operations to entrust it to the third party logistics (3PL), most efficiently structured on the basis of global distribution networks. Working with 3PL requires implementing a suitable governance to monitor relationships and also to ensure a protection against partners' opportunistic behaviors. A literature review is offered to determine the different strategies developed by companies to control partners' opportunistic behaviors in exchange relationships. Formal and informal control mechanisms are reviewed to determine their usefulness in relationships. Then three case studies are conducted in the French logistics industry as this sector is at the origin of many logistical tools and innovations. The most paradoxical finding is the tolerance shown by supply chain members to a moderate level of opportunism. The importance of interpersonal relationships (social ties) – considered to reduce opportunism – is also observed and emphasizes the power of embeddedness in social networks. The three case studies point out that tolerance of a moderate level of opportunism from the partners' part is undoubtedly a desirable option for top management. Opportunism control is expensive, it is therefore necessary to question the relevance of the application of formal or informal mechanisms of governance in exchange relationships. The original idea of a moderate level of opportunism which can be considered as acceptable represents a major novelty in supply chain management.

**Keywords:** exchange relationships, France, governance, logistics industry, opportunism, social networks.

**JEL Classification:** L24, L91, M21.

#### Introduction

In the French automotive industry, as in many other Western countries, manufacturers have progressively abandoned the management of logistical operations, and entrusted them to powerful third party logistics (3PL), most frequently and efficiently structured on the basis of global networks. With time, the scope of 3PL continued to grow until they took responsibility for the transport of components, sub-assemblies and finished products, then the management of supplier parks or the assembly of full systems (braking system, air conditioning, etc.). Taking into account the required investments which level of specificity is high, very few 3PLs are capable today of ensuring such complex logistics (Fulconis et al., 2011). As a result, manufacturers are relatively dependent on 3PLs, who usually enjoy a tacit knowledge, that the different partners have very little access to. In this context of information asymmetry, it is not surprising that a major French 3PL managed a few years ago to obtain a contract with a manufacturer by lying about its actual expertise and operational means. This case represents an established opportunistic behavior in Williamson's (1985; 1991) sense. The 3PL knowingly deceived the manufacturer by communicating wrong information about its past experience and its real level of flexibility in logistical capacities.

Exhibiting opportunistic behavior within an exchange relationship may have several purposes: capture a

larger part of the value created, obtain additional delivery time at customers' cost, not to keep a commitment of exclusivity with a partner to take advantage of relations with other partners, etc. Of course, firms are not condemned to live under the constant and pervading threat of opportunistic behaviors. Opportunism is simply the result of a business scheme in which cheating or deceiving is sometimes more profitable than showing loyalty (Williamson, 1991). Paradoxically, an increasing number of academic works is dedicated to the subjects of commitment, collaboration and trust between firms. Who could contest the fact that the business world remains characterized by arms-length relationships where tensions between firms are high, particularly under the pressure of shareholders? The crisis suffered by Western countries since October 2008 has amplified such tensions because of the increasing difficulties in creating value. In brief, we are more than ever confronted with the threat of opportunistic behaviors and the associated question of their control in order to avoid value destruction.

Research in strategic management focusing on firms' mechanisms of governance produced numerous results on the different possible strategies used to control opportunism in exchange relationships. Applied to the monitoring of supply chains, where 3PL are among the most dynamic players (see Exhibit 1), the subject of control now seems to be essential to improve governance. The managerial issue is to be able to propose tools to increase the efficiency of supply chains by a reduction of opportu-

istic behaviors that are thought to destroy value creation, as the example of the French 3PL mentioned above shows, whose lying slowed the growth of a manufacturer in the market because of the lack of sufficient logistical resources. It is necessary to question the relevance of the application of formal or informal mechanisms of governance in exchange relationships between supply chain members and more broadly to question the capacity of firms to really control opportunistic behaviors. Three case studies conducted on 3PLs in the French automotive sector provide a contribution to the current debate. Each 3PL carries out various activities in the supply chain such as transport, warehousing, synchronous supply or the management of supplier parks. They represent major players in the logistics industry with the shared feature of having shown repeated opportunism with manufacturers.

*Exhibit 1: 3PL providers help shippers improve operations.*

*Capgemini Consulting, the global strategy and transformation consulting brand of the Capgemini Group, in cooperation with the Georgia Institute of Technology and global logistics provider, Panalpina, today announced the findings of the 15th Annual 3PL Study, examining the global market for 3PL services. The report reveals that 3PLs continue to provide important strategic and operational value to shippers throughout the world. However, significant uncertainty about the global economy has impacted spending, with an average of 11 percent of company sales revenues devoted to logistics, and an average of 42 percent of that directed to the outsourcing of logistics services, a decrease of 10 to 15 percentage points from recent years. At the same time, 65 percent of shippers reported an increase in the use of outsourced logistics services relative to total logistics services, suggesting that while outsourcing may have increased, expenditure on 3PL services overall has decreased.*

*The 2010 3PL Study is based on almost 1,900 responses from both shippers and logistics service providers in regions including North America, Europe, Asia-Pacific and Latin America, and also provides an in-depth look at the life sciences and fast-moving consumer goods (FMCG) industries. It reveals continued progress and improvement in the shipper-3PL relationship, with 89 percent of shipper respondents overall viewing their 3PL relationships as generally successful and 68 percent indicating that 3PLs help provide them with new and innovative ways to improve operations. However, the report's findings show that shippers continue their tendency to outsource transactional, operational and repetitive activities and less so those that*

*are strategic, customer-facing and IT-intensive despite a large proportion of 3PLs offering more advanced services.*

*“Many shippers regard logistics and supply chain management as key components of their overall business success. Increased use of outsourcing and high satisfaction levels suggest that 3PLs can certainly take some credit for helping shippers to weather the economic storm”, said Dr. C. John Langley Jr., Professor of Supply Chain Management, Georgia Institute of Technology. “Despite a challenging environment, 3PLs have an opportunity to continue to mature and grow by offering an increasing number of value-added services for shippers”<sup>1</sup>.*

## **1. An overview of the academic works**

Williamson (1985; 1991) places opportunism at the heart of his analysis of mechanisms of governance, referring to the transaction cost theory (TCT) inspired by Coase's (1937) seminal article. TCT leads to major differences from the standard economic analysis by introducing novel economic hypotheses on the behavior of economic players, as individuals or organizations. As Coase (1937) spoke little of the behavioral dimension when describing transaction governance, the approach initiated by Williamson (1985) can be seen as a real *epistemological rupture* as far as it associates cognitive capacities linked to a high degree of motivation to manipulate or deceive others (opportunism). The question of opportunism is not only a matter of organization, but also and above all a matter of corporate strategy.

**1.1. Opportunism in exchange relationships – Quo vadis?** The traditional approach of opportunism is referred to the research of Williamson (1985; 1991) in the field of TCT. Opportunism is considered by the TCT as a component increasing the cost of trading between organizations. Williamson (1985, p. 47) defines opportunism in a general way as “self-interest seeking with guile”. Opportunistic behaviors are not limited in time (a beginning and an end), and they can occur at each step of a transaction between individuals or between organizations. Furthermore, opportunism may be accentuated by information asymmetry, the bounded rationality of the actors, a small number of actors, the uncertainty of the environment, specific assets and the frequency of the relationship. Williamson (1991) identifies three types of opportunism: adverse selection, hold up and moral hazard.

*Adverse selection*, otherwise called hidden action, occurs when there is cheating before the contract is

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<sup>1</sup> <http://www.capgemini.com>. Access date: January 9, 2011.

signed: we are here confronted with *ex ante* opportunism. This form of opportunism is made possible by the existence of information asymmetry. One of the players in the relationship benefits from the weak knowledge of the other in order to sell a product that does not match the other partner's needs. Let us consider an outsourcing example in R&D. A client A wants to develop a new software package by an R&D center called B. The buyer, familiar with his products, can control his production schedule and delivery. A is not engaged in this type of development, it cannot estimate the time required for the execution of the contract. B may have a behavior of adverse selection by excessively increasing the delivery date of new software during the pre-contractual negotiation stage. The latter could potentially lose the deal with this type of maneuver but it should be noted that adverse selection is due to the buyer's market knowledge. Therefore we can assume that B knows the risks involved in such behavior.

The concept of *hold up* is defined as a behavior different from what was planned by the buyer, and accepted by the seller. The hold up is considered as *ex post* opportunism. This phenomenon, where one of the partners could benefit from the relationship in this way, is all the greater when the buyer uses specialized asset investments. Firm-specific assets have been defined as human assets, physical assets, and company-specific routines and knowledge that were not redeployable to another company. Indeed, the buyer does not have many alternatives and may be more easily victim of hold up by his buyer. Client A has negotiated and signed a contract with buyer B for the delivery of a specific service (or product). To honor the contract, B must make an important investment in production, logistics, etc. Once the investment has been made, B is in a situation of dependence on A. If A decides not to renew the contract when it expires and if there are not enough players in the market, B will be unable to sell the specific service (or product), and B will be the victim of A's opportunistic behavior.

*Moral hazard* is defined as cheating during the contract implementation phase. Moral hazard results from the incompleteness of contracts that are for example unable to assess how logistical technology is going to evolve in the medium term, and consequently how the distribution of costs between partners in a supply chain will change. This opportunistic behavior occurs when a player takes an action without notifying his partner for whom it is impossible or too costly to notice the action taken. From this point of view, moral hazard is also *ex post* opportunism, and may be easily developed when the transaction requires a lot of cost control. In this

case, buyer A may assume that seller B cannot monitor all of its activities because of the costs involved in these activities; A can act in violation of what the contract states, and thus, A takes advantage of B's inability to control A's unfair actions.

**1.2. How to control opportunism?** Opportunism may occur at any time in a transaction between sellers and buyers. It is potentially value destructive when the opportunistic threat becomes so high that it may destroy the firms' wish to sign a contract, even if this means that there is a risk of losing markets and entering a recession phase. The control of opportunism is a recurring subject in academic literature. It is understood that the three occurrences of opportunism (adverse selection, hold up and moral hazard) imply that developing different control means during the execution of contracts is essential. By control strategy, the authors mean the full range of tools and mechanisms available to managers to pilot exchange relationships with partners. Mechanisms of control could be formal or informal; they adopt as much the form of a management tool as of an implementation method to make sure the different partners' behaviors remain consistent with the business objectives assigned to the exchange relationship.

Formal control mechanisms include tools with explicit, authoritative and naturally repressive features. In the context of a conventional supply chain, and particularly in the relationship between a shipper and a 3PL, the major formal mechanisms identified remain contracts and audits (Parkhe, 1993). Opportunism control through the most comprehensive contractualization of exchange relationships remains the most studied strategic option. Of course, contracts between shippers and 3PL may include all the clauses the parties wish to be defined, for example in terms of delivery frequency, minimal stock level, or acceptable levels of stock-outs. But the uncertain environment and the bounded rationality of decision makers do not allow supply chain members to draw-up watertight contracts. Such loopholes facilitate the emergence of opportunistic behaviors and an important uncertainty of service quality, as the authors have mentioned previously. As Huang (2009, p. 176) writes, "when an enterprise gives up the application and development of its logistics technologies, it may become a logistics company-dependent enterprise to a certain extent, which increases the uncertainty of production and service of the enterprise".

If a formal control still seems to be widely resorted to by organizations, looking for less costly informal mechanisms is now a reality (Zylbersztajn, 2004). This is the case of mechanisms based on socialization, defined as "the means by which individuals in

a buyer-supplier engagement acquire knowledge of the other enterprise's social values" (Cousins et al., 2008, p. 241). Thus a buyer may work with a previous client to maintain social bonds and interpersonal relationships. The notion of *embeddedness*, introduced by Granovetter (1985), can further analyze socialization. According to the author, people are sensitive to the opinions of others and obey the pressures of standards and values of society. Cousins et al. (2008, p. 239) add "that socialization mechanisms conducted within the context of a sup-

ply relationship enable each partner to learn about the other's culture, creating social norms and shared understandings between the parties involved". The purpose of informal mechanisms is not to abolish formal mechanisms, they supplement them with the advantage of acting on margins of maneuver not previously used. Wathne and Heide (2000) summarize the works on opportunistic behavior, and describe how to manage (and control) opportunism with monitoring, incentives, selection or socialization (see Table 1).

Table 1. Strategies for managing opportunism

Governance strategy	General purpose	Prerequisites	Primary effects on opportunism	Second-order effects
Monitoring	Reducing information asymmetry Facilitating the deployment of incentives	Identification of relevant criteria Implicit or explicit contract that legitimizes monitoring	Limited to information based opportunism Most effective under existing circumstances	Selection effects
Incentives	Reducing payoffs from opportunism Aligning interests	<i>Ex ante</i> bargaining power (hostages) Direct costs (price premiums) Information availability	Effectiveness under new circumstances is limited by range of self-enforcing contract	Hostages as productive assets Quality signal
Selection	Reducing information asymmetry Allowing for self-selection	Relevance of criteria Imposing selection costs on partner Risk of self-selection biases Information availability (reputation)	Effectiveness depends on relevance on selection criteria	Customer signal
Socialization	Promoting goal convergence	Completeness of socialization efforts	Effectiveness depends on applicability of role across situations	Customer signal Selection effects

Source: Wathne and Heide (2000, p. 44).

Control mechanisms are complementary and by combining them they are made more effective and less costly in the governance of exchange relationships. Organizations can use them simultaneously or even successively depending on the situations they are confronted with. In a period of pre-contractual negotiation, it will be undoubtedly advisable to develop socialization, while during the execution of the contract audits will take over to check that objectives are achieved. Similarly, operational activities such as building maintenance or repairs will require less formal monitoring and control than activities deemed strategic, like module assembling or product storage, where individual performance influences the collective performance of the supply chain itself. However, the multiplication of control mechanisms increases the monitoring cost of exchange relationships and does not always achieve a "cost saving" control compared to the achieved gains. The purpose of this article is to study the impact of control mechanisms on opportunistic behaviors, by investigating the effects of formal and informal mechanisms. The field of investigation is the French logistics industry, with three case studies.

## 2. An investigation in the French logistics industry

According to Yin (2003, p. 13), a case study is "an empirical inquiry that investigates a contemporary phenomenon within its real-life context, especially

when the boundaries between phenomenon and context are not clearly evident, and in which multiple sources of evidence are used". A case study provides a double understanding: the comprehensive understanding of a subject and the in-depth understanding of a specific phenomenon. The authors consequently conducted an exploratory case study in the powerful French logistics industry (see Exhibit 2). This sector has led to many logistical concepts and innovations (e.g. just-in-time delivery, synchronous supply, etc.), and is still participating in their evolution. The authors conducted 24 semi-structured interviews with supply chain decision makers at each stage of the relationship between a buyer and a 3PL: sales executives, managers of information systems, quality managers, logistics engineers and sales forecast managers. The interviews were directed face-to-face ones or by telephone.

### *Exhibit 2: France's logistics industry: a major role in Europe*

*France is caught up in a pan-European logistics revolution. This upheaval is rooted in two sweeping economic trends – the expansion and integration of the Economic Union (EU) and the globalisation of supply chains. As the EU has grown, companies throughout Europe have strived to broaden their distribution networks from a national to a cross-border perspective. With France's central location*

and extensive highway system, most companies incorporate one or more French hubs into their pan-European distribution networks. By the mid-1990s, the first wave of property investors had recognized this nascent opportunity, and the influx of capital was used to build a new “breed” of modern, large distribution facilities. France today possesses the biggest inventory of large, modern distribution facilities on the Continent. Its logistics property market has attained a size sufficient to provide ample-enough liquidity and stability to attract global investors. Since 1999, investments in the logistics property market have yielded the second-highest income returns of all the commercial property types in France<sup>1</sup>.

Qualitative research is often used to explain and understand human factors like opportunistic behaviors. The case study helps create “proximity” with the interviewees, who are willing to mention sensitive issues such as cheating or deceiving in business relationships when a climate of trust is established with the researcher. This proximity allows a lot of information and tacit knowledge to be collected, that lead to a strong explanatory power of the strategies implemented to control opportunism. To shed light on the empirical research question, two sources of information were used: primary and secondary data. Primary data correspond to the information obtained during the face-to-face dialog with the interviewees. Secondary data come from many sources such as reports, press reviews, internal documents, etc. The data acquired were analyzed through inductive coding of key informant interviews, using the NVivo software.

The three case studies show that contracts, the control mechanism most frequently used by supply chain members in the French context (Avignon, 2007), are rarely signed before logistical services are actually started. At the same time, contracts are described by the interviewees as essential documents for the operation of exchange relationships. Contracts define price conditions, work procedures, and also the objectives supply chain members wish to achieve to avoid any problem during transactions. To sum up, contracts lead supply chain members to exchange information to make sure objectives can be achieved. Contracts reduce risks of opportunism of the *hold up* type (specific investments are agreed by A when B knows that the objectives may be unachievable) or of the *moral hazard* type (A having no access to reliable information from B on the relevance of objectives prefers working with another firm and develops the same know-how for that firm). It is also confirmed that building and governing an exchange relationship on a solid relationship

basis, by referring to socialization and trust, allows the control of the supply chain members’ opportunistic behaviors. The interviewees say that attitudes are different depending on the fact that a 3PL has been working for a shipper for a long time (exchanges based on “social embeddedness”) or that the 3PL is starting negotiations with the shipper for the first time (exchanges based on business criteria).

The three case studies also emphasize that geographical proximity between a 3PL and a shipper reduces the opportunistic threat considerably, particularly when 3PL are located in a supplier park, close to the original equipment manufacturer. Geographical proximity means both the short distance separating partners and easier relationships; it facilitates frequent exchanges, a rapid sharing of tacit information, and interactive learning, leading to an improved knowledge of the other party. Continuous exchanges between 3PL and automotive manufacturers help develop informal relationships to obtain strategic information (particularly in conjunction with estimated production volumes and with new vehicle projects). Finally, geographical proximity facilitates the creation of trust relationships and informal exchanges. But in spite of the development of numerous formal and informal control mechanisms, supply chain members still remain worried about the occurrence of opportunistic behaviors. Unlike what one may think, recent developments in communication tools facilitating exchanges do not reduce these fears.

### 3. Implications for researchers and top managers

The monitoring costs generated by logistical outsourcing may increase strongly, particularly if logistical outsourcing is backed by several control mechanisms. In spite of the sophistication of techniques to help govern exchange relationships, the field study shows that opportunism is still quite present. Wouldn’t it be more relevant then if supply chain members tolerated some deviant behaviors whose impact does not question the lasting quality of an exchange relationship? During one of the interviews, we were told that a shipper knows that its 3PL is systematically overcharging for its logistical service, but the 3PL’s reactivity to unforeseen events is excellent, and this leads the shipper to tolerate the opportunistic behavior. Yet the academic literature mentions the methods for reducing opportunism with appropriate mechanisms more often than the benefits of making do with it, even if the works conducted by Koenig et al. (2000) point out that some control mechanisms may have the reverse effect of what Williamson (1985) stated. The multiplication of formal controls generates a negative appraisal of the partner under surveillance,

<sup>1</sup> Source: <http://ir.prologis.com>. Access date: December 29, 2010.

which increases its propensity for opportunism. In this case, the implementation of control methods is expensive for the organization and the behavioral consequences are negative.

Tolerance of a given level of opportunism for business necessities is the conclusion reached by Lapointe and Pageau (2000) and Fulconis and Paché (2008) from case studies conducted with several dynamic networks in Quebec and in France: opportunistic behaviors occur from time to time without questioning the existence of the dynamic networks, because they are accepted and anticipated by the members. A point of balance between “too much” control (leading to unbearable costs) and “too much” opportunism (destroying trust) must be found by the supply chain members. They have to elaborate a structure offering the maximum gains to each of the exchange relationship stakeholders and forcing them to reveal all available information (to avoid adverse selection) and undertake the expected correct actions (to avoid moral hazard). Of course, it would be essential to take into account the complexity of the automotive supply chain for an efficient point of balance between “too much” control and “too much” opportunism: “The scope of the distribution and logistics services required in the automotive industry is quite broad; while some parts may require simple bulk shipments to vendor managed inventories, other parts may require complicated sequencing and just-in-time shipments from a single manufacturing location to multiple, geographically dispersed assembly locations” (Reeves et al., 2010, p. 467).

From this point of view, all interviewees in our three case studies emphasized, at various levels, the importance of *embeddedness* in social networks and the central nature of interpersonal relationships to reduce decision makers’ tendency to opportunism. The intensity of exchanges between supply chain members favors rapprochements between decision makers, and creates strong ties from the beginning of negotiations on the purchase of a logistical ser-

vice. The first stage of the relationship implies frequent exchanges between 3PLs and shippers to launch the project successfully. 3PLs try to establish privileged relationships quickly in the governance of exchange relationships on three different levels:

- ◆ The first level is *operational*: its function is to settle the daily problems occurring while monitoring the supply chain, for example in case of sudden bad weather, unavailability of manpower due to a flu pandemic, etc.
- ◆ The second level is *tactical*: it defines the 3PL’s logistical activity load plan programming during the weeks to come in relation to the demand to be answered by the shipper.
- ◆ The third level is *strategic*: it deals with exchanges on major subjects binding 3PL and shippers in the long term, in terms of shared investments for example.

The field study shows that the frequency of exchanges means that each supply chain member must have some knowledge of the other supply chain members’ practices. People progressively get to know each other, with the result that the operation of partner organizations is better comprehended in terms of operational processes, control mechanisms used, decision makers’ strategic views, etc. As soon as decision-makers know each other better and appreciate each other, they can better see the advantages of a collaborative logistical approach as compared to getting the better hand. If the crucial significance of social networks were to be confirmed in a more efficient governance of exchange relationships, supply chain members would have to encourage their decision-makers to become members of professional reflection clubs or alumni networks. This evolution is quite clearly identifiable in France through the networks of old MBA students (former “*Grandes Ecoles*” students), and more than ever emphasizes that the strategic analysis of exchange relationships governance cannot afford to ignore the human dimension that works on SCM sometimes tend to neglect.

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