Driving Strategic Change: Relational Contracts, Purpose and Sustainability

Rebecca Henderson & Kate Isaacs

This draft May 2nd, 2013

1. Introduction

Large, successful organizations often find it very difficult to implement wide-ranging strategic or organizational change, as many of the chapters in this volume suggest. New technologies often fail to deliver on their promise, existing customers frequently prove to be uninterested in new ways of doing things, and new opportunities can appear to be – and often are – significantly less profitable than the existing business (C. M. Christensen, 1997; Henderson & Clark, 1990). Firms can fall victim to their existing cognitive models, failing to see new opportunities (Tripsas & Gavetti, 2000), and finding themselves prisoners of "competency traps" or of older patterns of behavior (Iandoli & Zollo, 2008; Levitt & March, 1988; Zollo, Reuer, & Singh, 2002). The switch from a focus on operational excellence to one of innovation and creativity – and/or the challenges inherent in holding the tension between the two kinds of behaviors in a single organization – can be particularly difficult (O'Reilly & Tushman, 2008). And last but not least, most organizations are focused heavily on short term performance and measurable outcomes, leading their people not only to be heavily overloaded but also stressed and anxious, making it difficult to create the necessary psychological safety or access the kind of creativity that undergirds much real change (Baer & Frese, 2003; Edmondson & Roloff, 2009).

In the face of these kinds of challenges a large literature has emerged to support firms in attempting to manage through change, much of it summarized in the other chapters in this volume. Researchers have focused on techniques such as experimentation (Iansiti & Levien, 2004), scenario analysis (Phelps, Chan, & Kapsalis, 2001; Schoemaker, 1991), and reaching out to new "fringe" or "leading edge" customers (C. M. Christensen & Raynor, 2003; Von Hippel, 1986, 2005) as tools that can help firms to break out of their existing cognitive frames and to see the world differently. Many writers recommend creating new organizational units – teams, or separate divisions -- to explore new opportunities, allowing the firm to not only leverage existing assets but also to engage in some degree of organizational "forgetting" (C. Christensen & Bower, 1996; de Holan & Phillips, 2004; Gupta & Govindarajan, 2000). Firms have been advised to manage "ambidextrously" – carefully balancing the demands of the old and the new businesses through the use of differentiated incentives, milestones and organizational structures (O'Reilly & Tushman, 2008). A large literature has focused on the processes through which such a change process should be managed, from Kotter's 8-stage change process (Kotter & Cohen, 2002), through Ed Schein's suggestions of leadership moves to create psychological safety during change (Schein, 2006) to pathbreaking work on the conditions that make teams effective (Gladstein, 1984; Hackman, 2002; Sundstrom, De Meuse, & Futrell, 1990).

One of the central themes in this literature has been the idea that a well-defined, effectively communicated "purpose" may play an important role in driving change. Such a purpose may be an effective alignment mechanism, helping to foster the development of a widely understood strategic vision that can align action across the organization (Kanter, 2011). An effective purpose can also increase intrinsic motivation and deepen employee commitment, since people are likely to be significantly more committed to their work and significantly more creative and productive if that work is consequential, significant, and/or meaningful (Amabile & Kramer, 2012; Hackman, 2002; Locke & Latham, 1990; Meyer, Becker, & Vandenberghe, 2004).

These are powerful ideas but in our view this research leaves an important question unaddressed, namely that of whether it makes a difference for the success of strategic and organizational change if the purpose of the firm is predominantly instrumental versus whether it is explicitly rooted in normative values. Any kind of shared purpose is, in essence, a superordinate goal that requires the participation of many or all organizational members. Superordinate goals are "compelling and highly appealing to members of two or more groups…which cannot be attained by the resources and energies of the groups separately. In effect they are goals attained only when groups pull together" (Sherif, 1958, pp. 349–350). These kinds of goals have long been studied for their role in transforming the relationship between groups that are in conflict and aligning them around achieving a common purpose through cooperation. Instead of playing the game to maximize resources just for oneself (whether this is achieved through cooperation or competition), an individual considers how to also achieve goals that are important to the community of which they are a part . This represents a shift from concern solely about benefits and losses to "me" to include a consideration of how my behavior generates benefits/losses for our collective endeavor, the "we."

Much of the literature assumes that these kinds of superordinate goals should be – or are -- infused with some kind of "higher" or positive normative purpose, but in principle there is no obvious reason that this should be the case. Firms adopt all kinds of superordinate goals that don't include normative values—to make money, to control an industry or to be a market leader, for example. None of these might be normatively driven, but there is certainly evidence that they motivate people within the firm to advance collective goals. For example GE's famous commitment to "being #1 or #2 in all its markets," is an example of such an instrumental goal and has been credited as one source of GE's success under Jack Welch (Krames, 2005).

On what grounds might we believe that a purpose that has some normative commitment, such as Apple's commitment to "delight" its customers, or Southwest's avowed purpose of providing extraordinary customer service might make it easier to change the firm? The organizational literature offers two broad streams of explanation as to why firms that adopt a normatively driven purpose may be more successful than their rivals.

The first is that a shared goal beyond economic return – something that speaks to the normative values of the participants and thus to deeper sources of meaning and purpose – may act not only as an alignment device but also as a powerful source of creativity in thinking through the strategic problems facing the firm. A values-driven purpose can expand people's thinking beyond a calculative mindset to broader identification with a community of people—the firm—who are trying to achieve something meaningful. From this perspective, individuals may then expend effort and demonstrate a willingness collaborate with others to advance this larger common vision (De Dreu, Weingart, & Kwon, 2000; Locke & Latham, 1990; Weldon, Jehn, & Pradhan, 1991; Weldon & Weingart, 1993). For example, when United Stationers adopted a purpose of "enabling our partners to succeed" they opened up a novel conversation across the organization that led them to adopt a new strategy that had a revolutionary effect on the industry (Beer & Eisenstat, 2011). Similarly Rosabeth Moss Kanter suggests that one of the primary benefits to IBM of its extensive involvement in philanthropic activities in service to its core values has been that it has become aware of a wide range of potential new business activities, many of which have since been rebranded as the “Smarter Planet” (Kanter, 2011).

The second focuses on the effect of a values driven purpose on the motivation of employees. Motivating work is challenging, which energizes people to exert effort to perform well, and it is clear and specific, which orients people towards a common direction and informs them about the actions that are desired. But it is also work that people find *consequential*, *significant*, or *meaningful* (Hackman, 2002; Locke & Latham, 1990; Meyer et al., 2004). A firm that subscribes to a values driven purpose – provided that its employees and other stakeholders find this purpose consequential, significant and meaningful – may thus be able to unleash very high levels of intrinsic motivation across the value chain.

In some cases a values-based purpose can flip instrumentality upside-down, motivating people to act *from* values in a way that is freer or free from a self-interested calculation. In some cases it can create a shift of identification from myself and what I can get for myself to identification to how I can contribute to the goals we share as a community, so that my focus is no longer on how I benefit the whole in order to benefit myself but on how I benefit the whole <u>because</u> it benefits myself. The kind of dedication, famously displayed by the engineers in Kidder’s famous book “The Soul of a new Machine” is precisely the dedication that is driven by deep identification with the purpose of the work and has been observed in many successful innovation efforts (Kidder, 2000; Tushman and Anderson, 2004).

In contrast the strategic literature describes the development of a firm’s mission or purpose as a powerful mechanism that can coordinate action across the firm in support of a particular strategy, but it does not suggest, so far as we know, that such a guiding mission should in any sense be based on normative values (Hax, 2009; Grant 2010). Indeed some researchers (and many managers) fear that the embrace of any normative values by management beyond meeting their commitment to their investors runs the risk of betraying the agency relationship on which much of modern capitalism relies (Henderson & Ramanna, 2013). They take seriously Milton Friedman’s famous dictum that “the social responsibility of business is to increase its profits” and fear the development of “cults” that can only destroy shareholder value (Clardy, 2004; Friedman, 2007).

This tension is given edge by the fact that while several recent intriguing qualitative studies have suggested that firms that embrace “higher commitment” or a “stakeholder perspective” in contrast to a single-minded focus on shareholder value maximization are likely to outperform their competitors (Arena, 2010; Beer, Eisenstat, & Norrgren, 2011; Kanter, 2008; Sanford, 2011), quantitative cross sectional work has in general failed to find any systematic relationship between this kind of broader orientation and economic success (Margolis and Walsh, 2003). Some more focused studies suggest that it may exist (Eccles, Serafeim, & Krzus, 2011), and studies of intermediate outcomes suggest that a normatively driven purpose almost certainly increases employee engagement and commitment, and reduces turnover (Baltazar, 2011; Brammer, Millington, & Rayton, 2007; Collier & Esteban, 2007; Galbreath, 2010; Harter, Schmidt, & Hayes, 2002), but there is no robust empirical evidence to suggest that firms whose central purpose is more normatively driven outperform their rivals.

This paper draws on recent research exploring the relationship between "relational contracts" and performance to explore this issue. We begin by briefly summarizing the role that relational contracts – tacit agreements play in sustaining supranormal performance in mature firms in relatively stable environments. Drawing on Gibbons and Henderson (2012) and a long literature that has explored the role of trust in commercial exchange, we argue that relational contracts – informal understandings within the firm based on subjective measures sustained by the shadow of the future – are central to the ability of any firm to persuade its employees, suppliers or customers that it is "trustworthy" and thus to elicit more than "perfunctory" or "letter of the law" performance. We outline the factors that make relational contracts are often difficult to build, focusing particularly on the problem of clarity – or on how difficult it can be to communicate the "terms" of a new contract, and on the problem of credibility – or on the fact that neither party may find the contract credible even once it is fully understood, and we highlight the ways in which significant organizational and strategy change requires the firm to build new relational contracts under conditions of great uncertainty.

We build on these ideas to suggest that in addition to enabling alignment and to improving intrinsic motivation, a normatively driven purpose supports the firm's ability to significant shift direction by making it significantly easier to build new relational contracts and thus by significantly improving *extrinsic* motivation.

Our framing has significant implications for managers who are attempting to transform their organizations to become more sustainable. Although an increasing body of research suggests that in many industries it is possible to build a compelling business case for investment in "greening" the organization[1] and many firms have made major commitments to acting in more sustainable ways (Dahlsgaard, Peterson, & Seligman, 2005; Mackey, 2011) many firms have yet to embrace these opportunities. Our work suggests that taking advantage of the normative potential implicit in becoming more sustainable may be a particularly powerful tool for driving change, and may be an effective way to accelerate the transition that our economy faces.

The conclusion takes up the question of authenticity, arguing that exploring the issue through the lens of relational contracts provides a powerful analytical framework for reconciling the need to be authentic with the need to maximize economic value in the long term if the firm is to survive.

2. Relational contracts and Supranormal Performance

Organizations – and indeed the entire economy – are shot through with informal understandings and social relationships that one might model as relational contracts. Research in social psychology has long noted the importance of "psychological contracts" in the work place, and a long literature in organizational behavior and strategy has stressed the important role that "trust"

[1] See particularly the research reported by the McKinsey Global Institute, available at http://www.mckinsey.com/insights/mgi/research/natural_resources (accessed May 4, 2013)

plays in many successful organizations and commercial relationships,[i] while within economics the concept has been elaborated in a long literature.[ii]

A relational contract is an understanding between two or more parties that is based on *subjective measures* enforced by the *shadow of the future* rather than by the threat of legal action. When a firm like McKinsey hires new associates, for example, they typically promise to give them "interesting work" and "exposure to a wide variety of problems": promises that many potential employees appear to take seriously but that have no legal force. Another famous example comes from Nordstrom. For many years Nordstrom's employee handbook was a single sheet of paper on which was written[iii]:

Welcome to Nordstrom
We're glad to have you with our Company. Our number one goal is to provide outstanding customer service. Set both your personal and professional goals high. We have great confidence in your ability to achieve them.

Nordstrom Rules:
Rule #1: Use good judgment in all situations.
There will be no additional rules.

Please feel free to ask your department manager, store manager, or division general manager any question at any time.

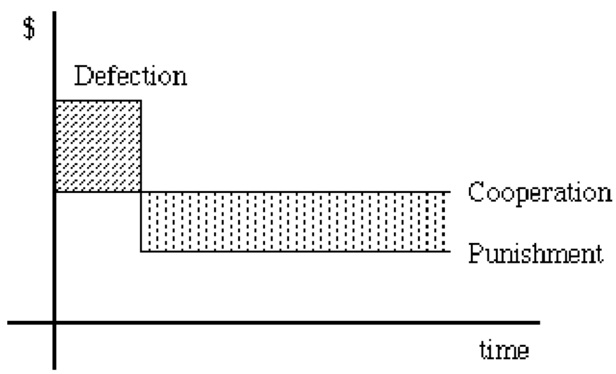
This is an invitation to enter into a relational contract. It's very difficult to imagine one could write a legally enforceable contract around an instruction to "use good judgment in all situations". How would one tell what "good judgment" was? And whether any particular action by an employee was exercising good judgment or simply wasting company resources? In the case of Nordstrom, for example, sales associates have reputedly accepted the return of snow tires (Nordstrom does not sell snow tires), driven for hours to deliver merchandise so that customers can be ready to attend family occasions, and changed the tires of customers stranded in the company parking lot.

Gibbons and Henderson have argued that the effective deployment of relational contracts is fundamental to supranormal performance in a wide range of industries through the essential role they play in supporting what have been called "high commitment work practices" including a number that are fundamental to the practice of continuous improvement including the ability to work successfully in cross functional teams and to take the initiative in local problem solving (Gibbons & Henderson, 2012). In essence they suggest that management practices that lead to competitive advantage must, by definition, be difficult to specify and describe ex ante, and that therefore that they cannot be motivated through the use of conventional, legally enforceable contracts.

They further argue that these contracts may be difficult to construct. Since they cannot be enforced in court they must be enforced by the shadow of the future. Both parties must trust the other to "do the right thing". When Nordstrom asks its employees to use their best judgment, for example, it is implicitly promising to take care of them – to pay them well and to give them opportunities for promotion, for example, -- if they do so. But Nordstrom's employees have no legal redress if Nordstrom fails to follow through. Similarly Nordstrom gives its employees considerable autonomy with the understanding that this autonomy will be used to serve its customers.

One way to think about the dynamics of this situation is given by the diagram in figure 1. Let's suppose that this represents the payoffs to Nordstrom of following through on their promises. In the long run the benefits to "cooperating", – that is, to rewarding employees when they seem to be showing good judgment – is probably quite high. In the short run there might be an incentive to "defect" – and not to follow through on the promise to reward employees who do the right thing, but in the long run not following through is almost certainly going to lead other employees to cease going out of their way, and the firm will be "punished".

Figure 1: A model of a relational contract



If the benefits of cooperation are C, the rewards to defecting are D and the returns to the firm when employees don't cooperate are P, then the time-path of cooperation will yield a higher present value than the time-path of defection if:

$$(1) \qquad \left(1+\frac{1}{r}\right)C > D + \frac{1}{r}P$$

where 1/r is the present value of a dollar to be received every period (until the relationship ends) starting next period. Rearranging (1) yields

$$(2) \qquad r < \frac{C-P}{D-C} \ ,$$

which is often restated as: if the players are sufficiently patient (*i.e.*, if r is sufficiently close to zero) then it is optimal to cooperate, foregoing the short-run temptation (D – C now) for the long-term gain (C - P thereafter). On the other hand if there is little expectation of a future relationship then it will be very hard to sustain cooperation.

Framed in this way it is clear that a relational contract is a very specific form of "trust". To the degree that we define trust as a well rooted expectation that another person will behave in a specific way, managers and employees linked by a successful relational contract can be said to trust each other. The manager trusts the employee to do the right thing and the employee trusts that if they do so they will be rewarded appropriately. This is "calculative trust" – trust based on a judgment that one's actions will generate the expected reward, as distinct from "affective" trust (I like you as a person); identity-based trust (I identify with you as a person, your ethnic group, your religion, your beliefs), "integrity-based" trust (you have proven that you keep your word), "benevolence-based" trust (I trust you to do good to me) and ability or competence-based trust (I trust you have the necessary ability or competence to complete a task) (Classic trust refs here). We expand on the relationship between "purpose" and these various forms of trust below. [iv]

Much of the economics literature assumes that if a particular relational contract offers economic advantage to both parties – that is if both equations (1) and (2) hold – that they can be simply announced and will be eagerly embraced by both parties. After all, if entering into the relationship will lead to significantly higher returns for both parties than not doing so, then why not enter into it?
Gibbons and Henderson outline two potential classes of reasons. In the first place, firms and individuals may suffer from problems of "clarity" – they may not be able to accurately describe the kind of relational contract they envision, either because they do not (yet) fully understand it themselves, or because they lack the language in which to communicate it. This is partly because learning just what it means to "cooperate", or what kinds of behaviors will, when adopted, lead to superior performance, is a complex learning problem of the kind that has been well explored in the research that has explored the tacit knowledge that lies behind the development of many organizational capabilities (Winter,1987; Zollo and Winter, 2002). It is one thing to say "do the right thing" and quite another to work out exactly what that means in any particular solution.

But building a relational contract is not only about learning how to create value by working together. It is also about learning how the various parties will be tempted to cheat, what kinds of actions constitute defection and what kinds of responses defection will elicit. For example in their account of the relational contract that underlies the practice of "science driven drug discovery" at Merck, Gibbons and Henderson identify the following set of actions as constituting the relational contract in place between the firm and its researchers:

Table 1: Elements of the relational contract that underlies "propublication" behavior at Merck

	Action		
Agent	Cooperation	Defection	Punishment
Scientist	Behave almost like an academic scientist, but be sure to develop useful knowledge for discovering new drugs.	Either shirk (represent lack of results as unlucky research) or behave exactly like an academic scientist (pursue problems for their own sake, build external reputation)	Behave like an academic scientist, or ignore research and become a drug hunter
Manager	Reward the scientist who displays high-science behavior even if no new drugs result.	Fail to increase resources for scientists who publish; reward only those who produce drugs	Fire the scientist, or cut funding

Notice that this is a complex set of behaviors, some of which – if the relationship were going well and both parties were cooperating – would never be observed, so that there would be little opportunity to learn about them.

The second reason it may be difficult to build cooperation is that even in those situations in which there is complete clarity about the scope of the proposed relationship, the two parties might not find it credible that it is in either parties best interest to follow through. This is a question not about the actions that constitute the contract but about their payoffs. Is it indeed the case that for both parties, the rewards to cooperation outweigh those to defecting from the relationship? Notice that developing an answer to this question might be even harder than learning about the behaviors that constitute cooperation and defection, since they imply knowledge of the economic return to cooperation for each party as well as of their outside options and of their discount rates. In the case of science driven drug discovery, for example, neither Merck itself nor its academic scientists probably knew initially exactly how beneficial the scientists "learning to act almost like academic scientists" was likely to be. Similarly the scientists did not know what the costs to Merck would be if they did not behave this way, nor what the costs do them would be if Merck did not follow through on its promises.

Gibbons and Henderson thus suggest that the slow development of relational contracts may be a very significant source of competitive advantage. They note that despite the fact that a large body of quantitative research suggests that high commitment work practices significantly increase work group productivity the use of these practices is still not widespread in many industries, and they point to firms like Toyota, Lincoln Electric and Merck as firms that appear to have built relational contracts over extensive periods of time.

3. Relational contracts, change and purpose

Kaplan and Henderson (Kaplan & Henderson, 2005) have argued that one of the reasons significant organizational and strategic change is so difficult is precisely because it requires the development of new relational contracts.

Consider, for example, the case of a senior manager at an electric utility company who is asked by her CEO to take a position as director of a new "Smart Grid" unit.[2] Smart Grid technology holds the promise of significantly improving the reliability and efficiency of the electric grid, and may make possible not only a much wider use of distributed sources of power such as local solar and wind, but also very significant improvements in residential and commercial energy efficiency. But it's also quite risky: a recent deployment in Boulder, Colorado, for example, was discontinued following significant budget overruns (Jaffe, 2012).

It creates all the classic problems we reviewed above, including uncertainty around whether the technology will work and/or consumers will want it, about whether it will be possible to build a profitable business model around it and about whether the firm can build the kinds of competencies required to compete in new ways. But it also raises calls for the creation of new relational contracts. Superior performance in the new assignment cannot be defined in advance. The firm can guess that it will probably require a range of behaviors including "appropriate" risk taking behavior, the ability to pull together the "right" team and to make the "right" investments" but it can't be sufficiently precise about any of them to write a formal contract on their basis. Nor can it reward the manager solely on the basis of her results, both because the firm may not know exactly what success looks like (How fast is it reasonable to expect the new unit to grow? How profitable can one expect it to be?) and because in order to persuade the new manager to work hard it may be important to persuade her that she will be rewarded even if things don't work out as well as might be hoped. In short the firm and the manager needs to develop a new relational contract in the face of tremendous uncertainty. While in her existing job the manager probably has a very clear sense of the existing relational contract – of the behaviors that are expected on both sides and of the fact that both sides will benefit – both psychically and financially – if the contract is fulfilled, everything is a lot murkier in the new case. The new manager is unsure:

- How best to run and manage the new unit, possibly having never developed a new business from scratch and certainly never having built this one
- Whether her boss has a good sense of what behaviors are most likely to constitute success and how performance should be evaluated
- What kind of support she is likely to need in terms of financial investment, key people or access to other critical resources
- What kinds of incentives the firm has to follow through on the promises they are now so freely making.

In short the manager doesn't know what cooperation looks like, nor what temptations either she or the firm will have to "defect". Perhaps the entire venture is a wild goose chase, and after having worked 24/7 for a year the firm will simply announce it is no longer interested in the space and the extra rewards she was promised – promotion, visibility, etc – are no longer

[2] Def'n of Smart Grid

available. The manager doesn't know either the full set of actions that constitute cooperation or defection, nor the payoffs to these actions. And her manager probably doesn't know them either.

Table 2: Building a relational contract to innovate

	Action		
Agent	Cooperation	Defection	Punishment
New Unit Head	Work very long hours – exercise creativity and imagination – hire and motivate a "great" new team – but don't take excessive financial risks	Either shirk (don't work too hard and represent lack of results as a reflection of a market that isn't ready for the Smart Grid) or behave like an untethered innovator (overinvest in the technology, build external reputation)	Never take an assignment like this again – and tell your colleagues never to do so either
CEO	Give the unit head the resources they need, despite the risk. Reward them if they act "innovatively" even if things appear to be going badly and the unit is not a success.	Fail to give the new units the resources it needs. Fail to promote or reward the unit head despite their putting in excellent effort.	Fire or demote the unit head, cut funding

We hypothesize that in these situations it is immensely easier to build the new relational contracts that are required if the firm and its employees share a well-defined "purpose" that is clearly based on widely shared normative values.

At the simplest level, a widely shared, deeply held purpose may make it easier to form a new relational contract because it increases both parties' returns to cooperation. In the case of the smart grid example we discussed above, for example, both the new division head and her manager may value successful innovation not only because it promises to increase returns to the company and thus, perhaps, bring them economic rewards, but also because rolling out a smart grid in their community is intrinsically valuable. By cooperating, both parties receive economic *and* psychic benefits for themselves. A shared, internalized purpose may also make the prospect of defecting from cooperation – and the subsequent consequences – less attractive for both parties. If I value the deployment of the smart grid for its own sake, for example, a failure to succeed may make me actively unhappy – indeed in some cases it may feel like a betrayal of my core purpose or a loss of my sense of meaning. Framed from this perspective the adoption of a shared purpose doesn't lead to my losing my sense of self interest entirely – I am still conducting an individualistic calculus – but it makes that calculus much more likely to "add up". Such a model might be useful for individuals who still pay careful attention to their wages, benefits and working conditions, for example, but who are simultaneously excited about the mission of the organization and willing to go the extra mile to support its goals.

The second reason that sharing a values-driven purpose may help firms transition to a new kind of relational contract is that it helps with the problem of *clarity* that we outlined above, and specifically with the difficulty of outlining the relational contract ex ante. If the firm can suggest that “cooperation” requires “doing everything that we can to increase the success of our customers”, for example, that may not only drive strategic creativity but also make it much easier to build a shared understanding of what constitutes appropriate behavior.

Lastly, if everyone in the firm is fully convinced that everyone else shares both their normative values and their shared purpose, when unexpected events occur and people react in unanticipated ways it may be easier to persuade everyone concerned that no one has betrayed the relational contract. Technically, if I can be persuaded that you are a trustworthy “type”, when you take an ambiguous action I may be less likely to anticipate it as defection (Gibbons & Henderson, 2012).

For example….

5. Implications for action – and for sustainability!

If a values-driven purpose can indeed make a significant difference in increasing a firm’s ability to change significantly, what are the implications for managers who are attempting to lead strategic change – and in particular for managers who are attempting to respond to the challenge of sustainability? What does the hypothesis that one of the roots of this success is the complementarity between values-driven purpose and values-based relational contracts add to our existing understanding of these questions?

We know from the existing literature that a values-driven purpose can only support performance if it is widely believed to be authentic, or “genuine”, if it is extensively modeled and reinforced by senior leaders, if there is time and space to build shared meaning and if it is reinforced by complementary changes in organizational structure and incentives. One interpretation of all four imperatives is that they help to lay the groundwork for the development of new relational contracts.

Genuine purpose
For example purpose involving values-based service cannot be simply a move up the ladder of instrumentality, deploying new, more sophisticated means to achieve instrumental ends – manipulating workers and other stakeholders in order to create shareholder value. The aspiration to live up to values must be authentic and genuine. If it is not, this usually sooner or later becomes evident with disastrous results, engendering active distrust among employees, customers, and other important stakeholders. Indeed the psychological literature suggests that pretending to be authentic and then breaking trust may have worse effects than never attempting authenticity in the first place (Elangovan & Shapiro, 1998; Isaacs, 2013; Sitkin & Roth, 1993). If one of the reasons authenticity is so important is that it represents to persuade key stakeholders that senior management is “trustworthy” and has strong internal preferences for “doing the right thing” and can thus be a trusted partner in the development of new relational contracts, anything

that contradicts this message could be expected to have very severe consequences, pushing the firm back into the equivalent of "work to rule".

Leadership modeling and reinforcement

Leaders of successful change efforts actively and consistently model and reinforce stated values and commitments (Burke & Litwin, 1992; Schein, 2010). This happens both on a day-to-day basis in employee interactions, and through symbolically important or highly visible moves. Take, for instance, the case of Louisiana Pacific. There had historically been a constant debate within the company about whether productivity or safety should come first until the CEO settled the issue. According to a plant worker, "We had had three reportable injuries in a 10-day period. Two were relatively minor, and one was serious. The CEO made a decision to shut all the plants down at midday on Sunday. That wasn't a decision to be taken lightly: he had to explain it to the board and Wall Street. All employees were paid as if they had worked their regular shift, and we had an employee meeting in town for all 400 employees about safety. And then we started the plant back up Monday am at 7 AM. After that, productivity versus safety was a moot point" (Isaacs, 2010).

Notice that these kinds of gestures are consistent with the hypothesis that the CEO is taking a costly action – one that at least initially does not appear to be economically rational – to demonstrate credibly that his values are authentic and that he is willing to act on them in costly ways. Such a move may be a particularly credible signal of his "type" and one might expect that they would greatly facilitate the organization's ability to form new relational contracts.

The case of Toyota take-over of the management of GM's NUMMI plant is another classic example. Toyota initially told their new workforce that they expected them to be fully engaged at work in support of the Toyota Production system – an expectation that encompassed a wide range of behaviors that could only be modeled and coached, but that could not be specified in advance. In return they promised not only interesting and enjoyable work but also that they would not lay people off "unless it was absolutely necessary". When the industry went through its next downtown the NUMMI workforce expected significant layoffs "as usual" – but instead Toyota kept its promise and put the idled workers through additional training. Apparently the incident was critical in cementing the relationship between the new work force and Toyota and performance significantly increased afterwards (Adler, Goldoftas, & Levine, 1997) ,

Merida Meridian, a small rug company in Boston, created a new organizational purpose to "Unify relationships within Merida to lead through collaboration with customers, in order to change their lives through making and selling rugs." This purpose was purportedly grounded in the company's internal relationships, and included treating each other with respect and dignity. When Merida planned a move of its factory to another location 50 miles away, it could have left its hourly factory workers to fend for themselves. But this would not have been consistent with the company's values and instead, Merida offered its hourly factory workers three options: a generous severance, help with moving costs, or daily van service to the new location. Eight of the ten employees chose van service, and to date this seems to have been one of the things that have enabled the firm to move through a very difficult strategic tradition (Henderson and Isaacs, 2013).

Time and space to build shared meaning
In describing how to create successful organizational change, Schein (2010) recommends that leaders establish practice fields and support groups for learning. A focus on relational contracts gives a new perspective on this excellent advice. Effective relational contracts rest on well understood guidelines for behavior that individuals interpret in specific situations, since in these situations individual judgment must replace detailed specifics that could be spelled out by contracts. Creating spaces where people can discuss different interpretations of organizational purpose and generate new shared meanings about what constitutes mission-consistent behavior are plausibly central to developing these new contracts.

Triodos Bank in the Netherlands offers an example of how this might work. The Bank has a mission to use the money entrusted to them by savers and investors to work for positive social, environmental and cultural change by: helping to create a society that promotes people's quality of life and that has human dignity at its core; enabling individuals, institutions and businesses to use money more consciously in ways that benefit people and the environment, and by promoting sustainable development; and by offering customers sustainable financial products and high quality service. People at the bank regularly encounter loan "dilemmas" that might be aligned with some dimensions of the Triodos mission but run contrary to others. One example that Triodos shared with us, for instance, was that of a shoe factory that wanted a loan for a sustainable energy project, but which relied on leather derived from cows that were constrained indoors in inhumanely small spaces (Henderson, Isaacs, & Kaeufer, 2013).

In order to help its loan officers understand how to make these kinds of mission-centric decisions, Triodos runs an internal workshop on loan decisions entitled, "Values in Lending: Daily dilemmas or Why we do what we do in the way that we do." At these workshops, people talk about different interpretations of the Triodos mission as they apply to specific loan decisions. The intention is to create a space where the Bank's purpose is not spelled out by specific loan criteria, but instead involves employees in actively defining shared meaning of organizational purpose and how to enact it in daily decisions.

Aligning organizational structures and incentives with purpose
As many scholars have suggested, a key aspect of communicating the credibility of a firm's stated purpose is ensuring that internal structures and incentives are organized to actively support, or at least not oppose, that purpose. From our perspective, this is consistent with the view that suggests that unless the firm can follow through on the promises it is seeking to create in shaping new relational contracts, purpose alone will be insufficient to drive change.

One example of this in action is what appears to be a genuine attempt at aligning organizational structures and incentives with purpose is Ford Motor Company. Although the company has been criticized in the past for its strategic reliance and heavy promotion of gas-guzzling vehicles, more recently the firm has embraced sustainability as part of its One Ford plan, the outcomes of which are defined as Great Products, Strong Business, and Better World.

The company has taken on the challenge to "fully integrate sustainability issues into our core business structures and processes, rather than manage them separately," and is taking concrete steps towards this goal. For example, Ford's Product Development unit, rather than a specialized sustainability function, is taking the lead on the company's sustainable mobility efforts.

Ford has embedded Better World responsibilities into its governance structures. It has a long-standing board-level Sustainability Committee, and full Board responsibility for strategically important sustainability concerns. The company has included sustainability metrics in the performance scorecards for its business units and major functions like Manufacturing, Product Development, and Purchasing. These affect executive compensation and are also formally reviewed at Ford's weekly business plan review meetings, which are convened by the CEO, and cover sales, financial, manufacturing, and other critical information, including the sustainability performance of each business unit.

Ford also appoints credible senior people to lead its sustainability integration process. For instance, the company named the former chief engineer for the Ford Expedition, one of the company's largest and most fuel inefficient vehicles, as its Global Director for Sustainability and Vehicle Environmental Matters (Ford Motor Company, 2013). While it is still probably too early to tell if these results will be as successful as the company hopes, there is at least some preliminary evidence that Ford's commitment to sustainability is being taken very seriously within the company and has supported extensive innovation (ref?)

What can we say about types of purpose and sustainability?
Can we deduce anything from this discussion about the types of purpose that might be particularly effective in supporting strategic change, and in particular about whether and how purposes framed in terms of sustainability might be more or less effective?

Some companies have focused on creating exceptional value for customers as their central purpose, while some are oriented to creating value for employees and some to both constituencies. A wide variety of qualitative research and some intriguing preliminary quantitative work suggests that these orientations can lead to significantly enhanced performance (Beer et al., 2011; Gibbons & Henderson, 2012; Homburg, Hoyer, & Fassnacht, 2002; Jones, Busch, & Dacin, 2003; Rucci, Kirn, & Quinn, 1998; Wright, Pearce, & Busbin, 1997).

How should we think about a commitment to "sustainability" in this context? A small minority of firms define their purpose not just in terms of customers and employees but also in terms of serving other stakeholders like suppliers, NGOs, the broader society and the planet and future generations. We suspect that while a focus on serving employees and customers may be very powerful, in many circumstances a purpose that aims to address a broader set of stakeholder interests may help not only to create alignment and strategic imagination across the value chain and to greatly increase intrinsic motivation throughout the firm's ecosystem but also to enable to the firm to build new relational contracts in powerfully effective ways.

The CEO of Unilever, for example, has committed to doubling the size of the organization while halving its environmental footprint. In focusing attention on the environmental limits that our economy faces he has not only refocused attention on the firm's consumers and suppliers – highlighting the ways, for example, in which looming water shortages imply that Unilever needs to find new ways to help keep themselves and their clothes clean, and moving rapidly to build a sustainable agricultural supply chain that treats both farmers and the land with care – but has also very significantly increased employee engagement across the firm, giving thousands of people a reason to feel passionate about their work and to engage in innovation in an open ended, flexible way. Might sustainability be a key that unlocks innovation across a very wide range of organizations?

5. Conclusions

In this paper we have attempted build a strong case for the idea that the embrace of a values driven purpose can significantly improve a firm's ability to change and thus its performance. We have noted that such a purpose may not only greatly increase alignment, strategic creativity and motivation, but that it may also be powerful because it makes it easier to build the new relational contracts that are fundamental to successful strategic change.

Is there a tension between authenticity and fiduciary responsibility? How should we think about it? When it is appropriate to act on normative values when one is using other people's money?

What does all this mean for managers?

References

Adler, P. S., Goldoftas, B., & Levine, D. I. (1997). Ergonomics, employee involvement, and the Toyota Production System: A case study of NUMMI's 1993 model introduction. *Industrial and labor relations review*, 416–437.

Amabile, T., & Kramer, S. (2012). How leaders kill meaning at work. *McKinsey Quarterly*, (1), 124–131.

Arena, C. (2010). *The High-Purpose Company: The TRULY Responsible (and Highly Profitable) Firms That Are Changing Business Now*. HarperCollins e-books.

Baer, M., & Frese, M. (2003). Innovation is not enough: Climates for initiative and psychological safety, process innovations, and firm performance. *Journal of Organizational Behavior*, *24*(1), 45–68.

Baltazar, A. P. (2011, June). *Corporate Social Responsibility from an Employees' Perspective: Contributes for Understanding Job Attitudes*. Instituo Universitario de Lisboa.

Beer, M., & Eisenstat, R. (2011). United Stationers: Enabling Our Partners to Succeed. *Harvard Business School Case 912-407*.

Beer, M., Eisenstat, R. A., & Norrgren, F. (2011). *Higher ambition: How great leaders create economic and social value*. Harvard Business School Press.

Brammer, S., Millington, A., & Rayton, B. (2007). The contribution of corporate social responsibility to organizational commitment. *The International Journal of Human Resource Management*, *18*(10), 1701–1719.

Burke, W. W., & Litwin, G. H. (1992). A causal model of organizational performance and change. *Journal of management*, *18*(3), 523–545.

Christensen, C., & Bower, J. L. (1996). Customer power, strategic investment, and the failure of leading firms. *Strategic management journal*, *17*(3), 197–218.

Christensen, C. M. (1997). *The innovator's dilemma: when new technologies cause great firms to fail*. Harvard Business School Press.

Christensen, C. M., & Raynor, M. E. (2003). *The innovator's solution: Creating and sustaining successful growth*. Harvard Business School Press.

Clardy, A. (2004). *Kroning at Pac Bell* (Working Paper No. 04-Clardy-01). Towson University.

Collier, J., & Esteban, R. (2007). Corporate social responsibility and employee commitment. *Business Ethics: A European Review*, *16*(1), 19–33.

Dahlsgaard, K., Peterson, C., & Seligman, M. E. (2005). Shared virtue: The convergence of valued human strengths across culture and history. *Review of General Psychology*, *9*(3), 203.

De Dreu, C. K., Weingart, L. R., & Kwon, S. (2000). Influence of social motives on integrative negotiation: a meta-analytic review and test of two theories. *Journal of personality and social psychology*, *78*(5), 889.

De Holan, P. M., & Phillips, N. (2004). Remembrance of things past? The dynamics of organizational forgetting. *Management Science*, *50*(11), 1603–1613.

Eccles, R. G., Serafeim, G., & Krzus, M. P. (2011). Market interest in nonfinancial information. *Journal of Applied Corporate Finance*, *23*(4), 113–127.

Edmondson, A. C., & Roloff, K. S. (2009). Overcoming barriers to collaboration: Psychological safety and learning in diverse teams. *Team effectiveness in complex organizations: Cross-disciplinary perspectives and approaches*, *34*.

Elangovan, A. R., & Shapiro, D. L. (1998). Betrayal of trust in organizations. *Academy of Management Review*, 547–566.

Ford Motor Company. (2013). Sustainability Governance and Integration - Sustainability 2011/12 - Ford Motor Company. Retrieved May 3, 2013, from http://corporate.ford.com/microsites/sustainability-report-2011-12/blueprint-governance-sustainability-integration

Foster, R. N. (n.d.). Innovation: The Attacker's Advantage, 1986. *New York: Summit*.

Friedman, M. (2007). The social responsibility of business is to increase its profits. In *Corporate ethics and corporate governance* (pp. 173–178). Springer.

Galbreath, J. (2010). How does corporate social responsibility benefit firms? Evidence from Australia. *European Business Review*, *22*(4), 411–431.

Gibbons, R., & Henderson, R. (2012). Relational contracts and organizational capabilities. *Organization Science*, *23*(5), 1350–1364.

Gladstein, D. L. (1984). Groups in context: A model of task group effectiveness. *Administrative science quarterly*, 499–517.

Grant, Robert M. Contemporary Strategy Analysis: Text Only Wiley 2010

Gupta, A. K., & Govindarajan, V. (2000). Knowledge flows within multinational corporations. *Strategic management journal*, *21*(4), 473–496.
Hackman, J. R. (2002). *Leading teams: Setting the stage for great performances*. Harvard Business Press.
Harter, J. K., Schmidt, F. L., & Hayes, T. L. (2002). Business-unit-level relationship between employee satisfaction, employee engagement, and business outcomes: A meta-analysis. *Journal of applied psychology*, *87*(2), 268–279.
Hax, Arnoldo. The Delta Model: Reinventing Your Business Strategy, Springer 2009
Henderson, R., & Clark, K. B. (1990). Architectural innovation: the reconfiguration of existing product technologies and the failure of established firms. *Administrative science quarterly*, 9–30.
Henderson, R., Isaacs, K., & Kaeufer, K. (2013). Triodos Bank: Conscious Money in Action. *Harvard Business School Case N9-313-109*.
Henderson, R., & Ramanna, K. (2013). *Managers and Market Capitalism* (No. Working Paper 13-075). Harvard Business School.
Homburg, C., Hoyer, W. D., & Fassnacht, M. (2002). Service orientation of a retailer's business strategy: dimensions, antecedents, and performance outcomes. *The Journal of Marketing*, 86–101.
Iandoli, L., & Zollo, G. (2008). *Organizational cognition and learning: building systems for the learning organization*. Information Science Publishing.
Iansiti, M., & Levien, R. (2004). The keystone advantage: what the new dynamics of business ecosystems mean for strategy, innovation, and sustainability. Harvard Business School Press.
Isaacs, K. (2010, May). Louisiana Pacific Learning Journey Report. Dialogos International.
Isaacs, K. (2013, June). *Glimpsing possibility in company-stakeholder engagements: How relational ambivalence and quasi-cooperation foreclosed cooperative outcomes*. Massachusetts Institute of Technology.
Jaffe, Mark "Xcel's SmartGridCity Plan Fails to Connect with Boulder," *The Denver Post,* October 28, 2012, http://www.denverpost.com/business/ci_21871552/xcels-smartgridcity-plan-fails-connect-boulder, accessed March 2013.
Jones, E., Busch, P., & Dacin, P. (2003). Firm market orientation and salesperson customer orientation: interpersonal and intrapersonal influences on customer service and retention in business-to-business buyer–seller relationships. *Journal of Business Research*, *56*(4), 323–340.
Kanter, R. M. (2008). Transforming giants. *Harvard Business Review*, *86*(1), 43.
Kanter, R. M. (2011). *How great companies think differently*. Harvard Business Review.
Kaplan, S., & Henderson, R. (2005). Inertia and incentives: Bridging organizational economics and organizational theory. *Organization Science*, *16*(5), 509–521.
Kidder, Tracy, The Soul of A New Machine Back Bay Books 2000
Kotter, J. P., & Cohen, D. S. (2002). *The heart of change: Real-life stories of how people change their organizations*. Harvard Business Press.
Krames, Jeffrey, Jack Welch and the 4 E's of Leadership: How to Put GE's Leadership Formula to Work in Your Organization, McGraw Hill, 2005
Levitt, B., & March, J. G. (1988). Organizational learning. *Annual review of sociology*, 319–340.
Locke, E. A., & Latham, G. P. (1990). Work motivation and satisfaction: Light at the end of the tunnel. *Psychological science*, *1*(4), 240–246.
Mackey, J. (2011). What Conscious Capitalism Really Is: A Response to James O'Toole and David Vogel's "Two and a Half Cheers for Conscious Capitalism." *California Management Review*, *53*(3), 83–90.
Margolis, Joshua D., and James P. Walsh. "Misery Loves Companies: Rethinking Social Initiatives by Business." *Administrative Science Quarterly* 48 (June 2003): 268–305.
Meyer, J. P., Becker, T. E., & Vandenberghe, C. (2004). Employee commitment and motivation: A conceptual analysis and integrative model. *Journal of applied psychology*, *89*(6), 991–1007.
O'Reilly, C. A., & Tushman, M. L. (2008). Ambidexterity as a dynamic capability: Resolving the innovator's dilemma. *Research in organizational behavior*, *28*, 185–206.
Phelps, R., Chan, C., & Kapsalis, S. C. (2001). Does scenario planning affect performance? Two exploratory studies. *Journal of Business Research*, *51*(3), 223–232.
Rucci, A. J., Kirn, S. P., & Quinn, R. T. (1998). The employee-customer-profit chain at Sears. *Harvard Business Review*, *76*, 82–98.
Sanford, C. (2011). *The responsible business: Reimagining sustainability and success*. Jossey-Bass.
Schein, E. H. (2006). *Organizational culture and leadership* (Vol. 356). Jossey-bass.
Schein, E. H. (2010). *Organizational culture and leadership* (Vol. 2). Jossey-Bass.

Schoemaker, P. J. (1991). When and how to use scenario planning: a heuristic approach with illustration. *Journal of forecasting*, *10*(6), 549–564.

Sherif, M. (1958). Superordinate goals in the reduction of intergroup conflict. *American journal of Sociology*, 349–356.

Sitkin, S. B., & Roth, N. L. (1993). Explaining the limited effectiveness of legalistic “remedies” for trust/distrust. *Organization science*, *4*(3), 367–392.

Sundstrom, E., De Meuse, K. P., & Futrell, D. (1990). Work teams. *American psychologist*, *45*(2), 120–133.

Tripsas, M., & Gavetti, G. (2000). Capabilities, cognition, and inertia: Evidence from digital imaging. *Strategic Management Journal*, *21*(10-11), 1147–1161.

Tushman, Michael and Philip Anderson (Editors). Managing Strategic Innovation and Change: A Collection of Readings Oxford University Press 2004

Utterback, J. M. (1996). *Mastering the dynamics of innovation*. Harvard Business Press.

Von Hippel, E. (1986). Lead users: a source of novel product concepts. *Management science*, *32*(7), 791–805.

Von Hippel, E. (2005). Democratizing innovation: The evolving phenomenon of user innovation. *Journal für Betriebswirtschaft*, *55*(1), 63–78.

Weldon, E., Jehn, K. A., & Pradhan, P. (1991). Processes that mediate the relationship between a group goal and improved group performance. *Journal of personality and social psychology*, *61*(4), 555–569.

Weldon, E., & Weingart, L. R. (1993). Group goals and group performance*. *British Journal of Social Psychology*, *32*(4), 307–334.

Winter, Sidney. 1987. “Knowledge and Competence as Strategic Assets,” in David Teece (ed.), *The Competitive Challenge: Strategies for Industrial Innovation and Renewal.* Cambridge, MA: Ballinger, pp. 159–184.

Wright, N. D., Pearce, J. W., & Busbin, J. W. (1997). Linking customer service orientation to competitive performance: does the marketing concept really work? *Journal of Marketing Theory and Practice*, 23–34.

Zollo, M., Reuer, J. J., & Singh, H. (2002). Interorganizational routines and performance in strategic alliances. *Organization Science*, *13*(6), 701–713.

Zollo, Maurizio, and Sidney Winter. 2002. “Deliberate Learning and the Evolution of Dynamic Capabilities.” *Organization Science* 13: 339–351.

[i] Bachmann, R., A. Zaheer. 2006. *Handbook of Trust Research*. Edward Elgar Publishing, Northampton Ma.
[ii] See, for example, Baker, G., R. Gibbons, K. J. Murphy. 2002. Relational Contracts and the theory of the Firm. *Quarterly Journal of Economics* **117**(1) 39–84 and Levin, J. 2003. Relational Incentive Contracts. *American Economic Review* **93**(3) 835–857
[iii] Spector, Robert, and Patrick McCarthy. 2012. *The Nordstrom Way to Customer Service,* second edition. Hoboken, NJ: Wiley.
[iv] Williamson, O. E. 1993. Calculativeness, Trust, and Economic Organization. *Journal of Law & Economics* **36**(April) 453–486.