



## Creating psychological and legal contracts through human resource practices: A signaling theory perspective

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### ABSTRACT

Despite the surge in research on the psychological contract over the past two decades, there has been little integrative research that has examined psychological contracts in conjunction with legal contracts. We address this shortcoming by presenting a framework for understanding the differences between psychological contracts and legal contracts in the United States. This is done by presenting definitions and examples of psychological contracts (i.e., relational and transactional) and the two forms of legal contracts: (a) express (written and oral), and (b) implied (quasi-contract and promissory estoppel). In addition, by utilizing signaling theory [Rynes, S.L. (1991). Recruitment, job choice, and post-hire consequences: A call for new research directions. In M. D. Dunnette & L. M. Hough (Eds.), *Handbook of industrial and organizational psychology*, (pp. 399–444). Palo Alto, CA: Consulting Psychologists Press.], we describe the means by which human resource practices such as recruitment, training, performance appraisal, compensation, and employee handbooks can create psychological and legal contracts. We conclude by proposing directions for future research and implications for practicing managers.

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Over the past two decades the psychological contract has received a great deal of attention in research on organizational behavior (OB) and human resource management (HRM). The psychological contract is defined as the employee's beliefs regarding the promises of the reciprocal exchange agreement between the employee and organization (Rousseau, 1989, 1995). Most of the research on this topic has focused on the consequences of a broken psychological contract (Zhao, Wayne, Glibkowski, & Bravo, 2007). In particular, research has examined the implications of psychological contract breach (PCB) on the attitudes and behaviors of employees (e.g., Johnson & O'Leary-Kelly, 2003; Robinson & Rousseau, 1994; Turnley & Feldman, 1999). The second most studied issue has been the content of the psychological contract (Conway & Briner, 2005). For example, content items can include: financial inducements (e.g., pay, overtime, subsidized health and fitness programs), family-oriented support (e.g., child care, spousal employment), and general support (e.g., promotion, training, benefits, loyalty, vacation leave) (Guzzo, Noonan, & Elron, 1994; Herriot, Manning, & Kidd, 1997; Rousseau, 1990). Recently research has begun to examine other issues associated with the psychological contract such as antecedents to PCB (e.g., Raja, Johns, & Ntalianis, 2004; Tekleab, Takeuchi, & Taylor, 2005) and mediators or moderators of the relation between PCB and workplace outcomes (e.g., Deery, Iverson, & Walsh, 2006; Suazo, Turnley, & Mai-Dalton, 2005). However, relatively little research has focused on the organizational factors that create psychological contracts. Therefore, the primary focus of this paper is the creation of the psychological contract.

In order to understand psychological contract creation it is necessary to understand the differences between a psychological contract and a legal contract. We argue in this paper that there is a great deal of confusion among many employees in the United States about the differences between psychological and legal contracts, and this confusion is due in large part to misunderstandings about what constitutes

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a psychological and legal contract. Understanding the differences is important because there are typically different consequences associated with each type of contract. For example, from an organizational perspective PCB typically leads to negative attitudes and behaviors (Conway & Briner, 2005; Zhao et al., 2007). However, in addition to negative attitudes and behaviors, the breach of legal contracts often results in grievances and lawsuits. Similarly, employees may have rights under legal contracts that are not available to them if the contract is merely psychological.

Despite the vast amount of research on psychological contracts, there is relatively little research on the factors that influence the creation of psychological contracts. Thus, we address this issue in the current paper by examining the impact of human resource (HR) practices on the creation of both psychological contracts and legal contracts in the United States. For instance, comments made by an interviewer about opportunities for permanent employment may lead applicants to perceive they have a psychological or legal contract with the organization. However, these perceptions may not be accurate. Likewise, employment manuals may imply permanent employment with statements such as “an employee can expect job security.” We believe that these HR practices may be harmful to both individuals and organizations. For example, if employees do not have an accurate perception of their psychological or legal contract with employers then they may assume they have a permanent job when they in fact do not. If these same individuals are laid off they are likely to perceive that their employment contract has been violated, and file a grievance or lawsuit against the employer. Similarly, employees who do not expect to be laid off may not be prepared for the negative consequences associated with job loss (e.g., loss of income, lack of skills needed to get another job). Thus, we believe that it would benefit both parties if employers took steps to ensure that employees have accurate perceptions of their psychological and/or legal contracts with organizations.

Given that HR practices may affect the accuracy of employees' perceptions of psychological and legal contracts, the purpose of this paper is fourfold. First, we will consider the differences between psychological contracts and legal contracts in the United States. Second, we will review the existing research on the antecedents of psychological contracts. Third, we will discuss the extent to which HR practices signal individuals' perceptions or misperceptions about their psychological or legal contracts. Finally, we will consider the implications that the relation between HR practices and perceived employment contracts may have for future research and practice.

## 1. Psychological versus legal contracts

Rousseau (1989) defined the psychological contract as

“an individual's beliefs regarding the terms and conditions of a reciprocal exchange agreement between that focal person and another party. Key issues here include the belief that a promise has been made and a consideration offered in exchange for it, binding the parties to some set of reciprocal obligations” (p. 123).

In addition, only those expectations that result from an employee's perception of the organization's implicit or explicit promises are part of the psychological contract (Robinson, 1996). Hence, in terms of its interpretation, the perceptual nature of the psychological contract makes it highly idiosyncratic. For this reason, it is possible for two employees working side-by-side in the same organization to have different perceptions about their psychological contracts.

In contrast, a legal contract in the United States is said to arise when three elements are present between the contracting parties (Sandoval, 2008): (a) an offer, (b) an acceptance of the offer, and (c) consideration (i.e., something bargained for and given in exchange for the promise). These three elements are essential for the manifestation of a legally binding contract (*Lucy v. Zehmer*, 1854). The following scenario provides an example of the creation of a legal contract. For instance, assume that Sally offers Carlos \$50,000 per year to work for her company, if Carlos is willing to work 40 h per week. Carlos says, “I accept!” In this hypothetical, the offer by Sally is the \$50,000. The acceptance is Carlos' acknowledgement of the offer and the verbalization of acceptance. The consideration, which is (a) something bargained for or (b) something given in exchange for the promise, manifests itself when Carlos receives \$50,000 in consideration for working 40 h per week over a 52-week period. Alternatively, consideration also exists when Sally receives 40 h of work per week for the \$50,000.

Our discussion up to this point has not considered the various types of legal contracts. However, legal contracts can be categorized as express contracts, which may be written or oral, and implied contracts (i.e., quasi-contract or promissory estoppel). Descriptions and examples of these types of contracts are provided below.

### 1.1. Express contracts

An express contract is one in which all of the elements (offer, acceptance, and consideration) of the contract are explicitly manifested either in writing or orally (Simpson, 1965). The following is an example of an express contract. Leroy owns a small software development firm. He was awarded a major software contract, and he needs to hire several temporary programmers so that he can meet his 12-month deadline. Leroy orally offers Carol a one-year position as a software programmer at a monthly salary of \$4200. Carol is expected to work 40 h a week at the company's headquarters. Leroy's offer does not include any health or retirement benefits. Carol accepts the offer of \$4200 per month that does not include any health or retirement benefits. Leroy and Carol can either document this employment contract in writing or their contract can remain an oral contract.

### 1.2. Implied contracts

An implied contract can be created when at least one of the elements (offer, acceptance, and consideration) of a contract is implied from the actions or inactions of the contracting parties (Simpson, 1965). For example, an implied contract can come about

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