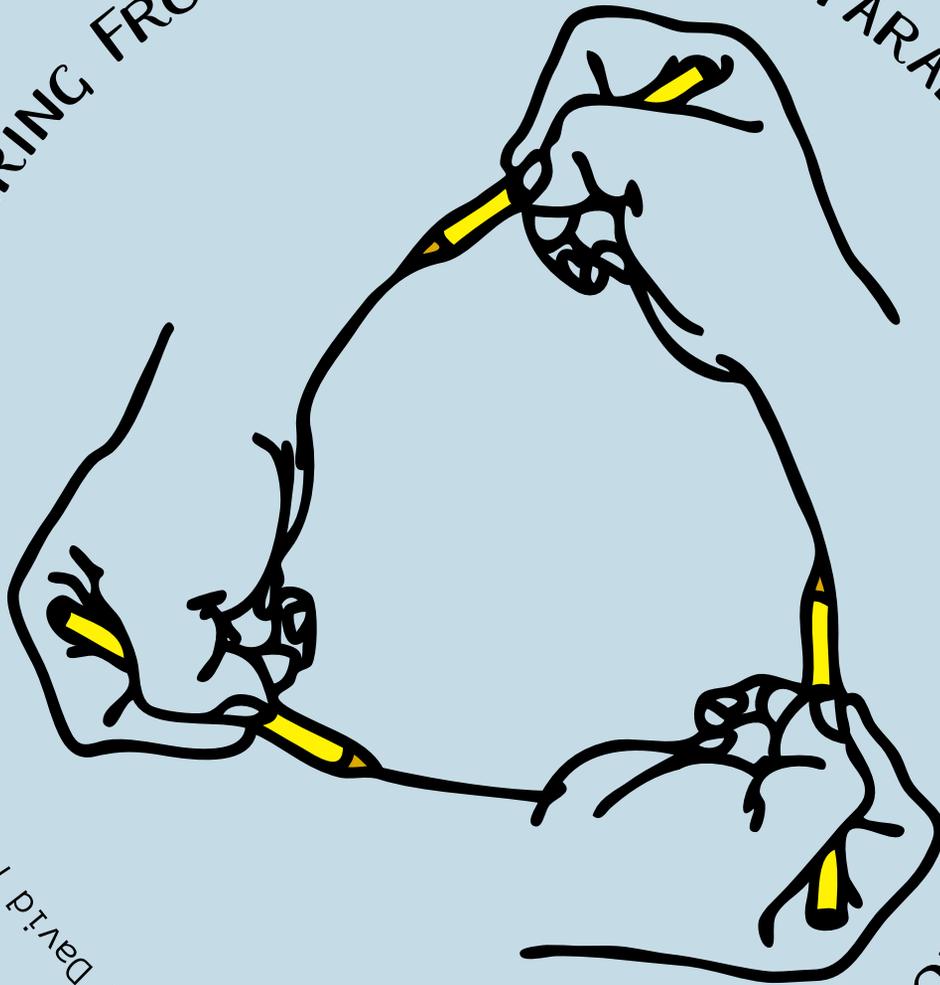


ARE YOU SUFFERING FROM THE CONTRACTING PARADOX? INTRODUCING THE "RELATIONAL CONTRACT" By Kate Vitasek and David Fydlinger



Take Apple's highly public debacle with GT Advanced Technologies for example. GT Advanced was Apple's manufacturer of sapphire glass for phone screens and consumer electronics, but it filed for Chapter 11 Bankruptcy in late 2014, citing "unsustainable" terms and conditions related to the production relationship with Apple.<sup>3</sup>

In another case from last year, Volkswagen imposed a production freeze triggered by a component supplier that had stopped shipping parts to VW plants in Lower Saxony, Germany. The supplier, Prevent, wanted €58 million for factory investments it had made for VW as part of a contract the automaker later cancelled.<sup>4</sup>

These incidents have led to increasing questions about the effectiveness of contracts and the contracting process—and a direct challenge to abandon the hope of establishing the perfect, "complete" contract. Two critics of complete contracts

that addresses every "what if." The result? It is not uncommon for an organization's most strategic and complex contracts to be hundreds, if not thousands, of pages long. We have seen one government contract that was over seven feet high when it was printed out!

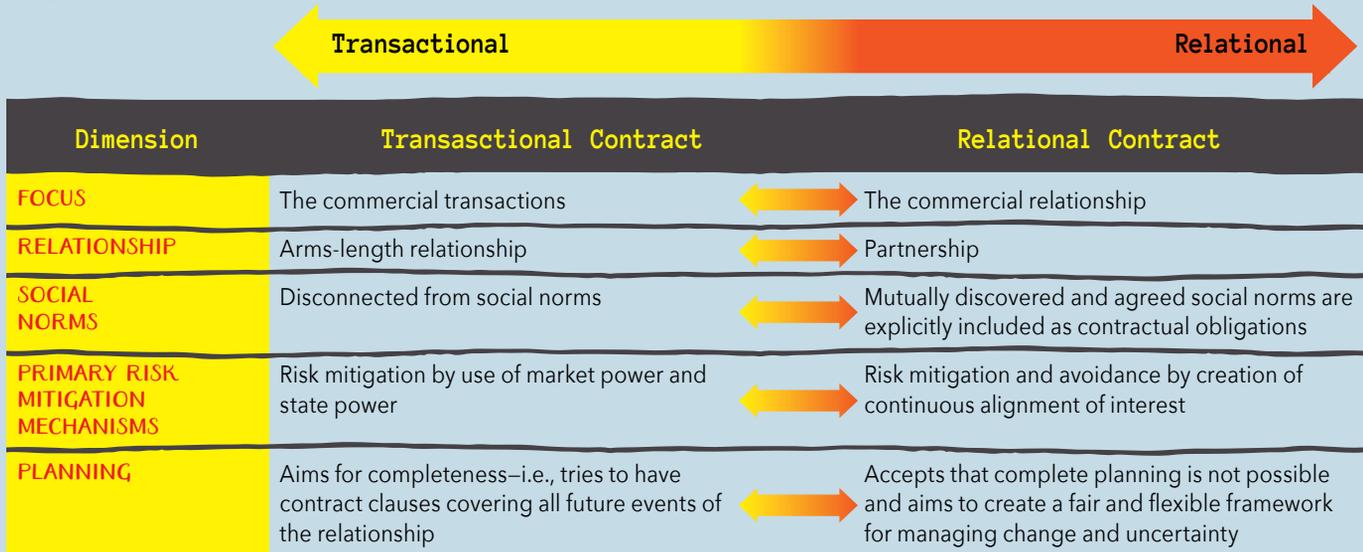
But despite the effort, practitioners continue to cite "value leakage" from contracts and contractual relationships. In fact, poor contract management and contracting processes can lead to value leakage of, on average, 9.5% of annual revenue.<sup>2</sup> The trade press frequently reports on highly strategic "good deals" gone wrong that surface, usually as a result of court disclosures.

**The Contracting Paradox:**

The delusion that we write contracts to make plans, but we cannot really plan accurately. And, as a nice twist, we trick ourselves into believing that we can plan.<sup>1</sup>

It is easy to fall into the contracting paradox. After all, contracting and commercial management experts are chartered with the herculean task to write contracts that plan for the future. They try to address every risk and limit every possible liability. In short—they are in search of the "complete" contract

FIGURE 1. Transactional vs. Relational Continuum



are Nobel laureates Oliver Williamson<sup>5</sup> and Oliver Hart.<sup>6</sup> Both advise that by nature all complex contracts are incomplete, no matter how hard we try to make them “airtight.”<sup>7</sup>

This is where the contracting paradox enters: To succeed in business, we cannot really abandon planning; but at the same time, we are poor at planning and that is why contracts will always be incomplete.

So, because we cannot really plan for every contract eventuality, and yet we must plan a contract framework and relationship, what do we do about this paradox?

Enter the relational contract.

**THE RELATIONAL CONTRACT**

Let’s start by dispelling a myth. Just because the word “relational” is used does not mean the contract is “soft” or “fluffy.” In fact, the opposite is true.

Today’s relational contract is not the informal “handshake” deal of a bygone era, but rather a formal contract depicted by a highly collaborative relationship where the parties consciously choose to make social norms contractually binding. Relational contracts recognize that relationships are not just person to person, but also organization to organization, and obligate contracting parties to create a flexible contracting framework to promote a fair

and balanced exchange with the common understanding that business is dynamic and things will change.

A well-structured relational contract codifies the framework for the relationship, including:

- The shared vision;
- Statement of intentions; and
- The forums, behaviors, and mechanisms within which interactions will occur.

One way a relational contract does this is by directly describing joint governance processes within which the parties can work together to deal with risk and uncertainty. Another way is by formally embedding social norms that promote non-opportunistic behaviors between the parties when “business happens.”

The best way to understand a relational contract is to compare it to the dominant contract model, the *transactional* contract. **FIGURE 1** provides the comparison along five dimensions, showing the differences between a relational contract and a transactional contract, while at the same time showing that these two contract forms exist on a continuum.

Based on this comparison, the following formal definition of *relational contract* is offered:

**Relational Contract**

noun | re.la.ti.on.al con.trakt | \rē-lā-shnəl kăn-trakt\

A legally enforceable written contract establishing a commercial agreement within a flexible contractual framework based on social norms and jointly defined objectives, prioritizing a relationship with continuous alignment of interests before the commercial transactions.

**MAKING THE SHIFT**

Today, the majority of legal scholars and practitioners use more formalized, or “complete,” contracts to document business agreements. As noted, contracts have grown longer and more complex, including more and more detailed plans trying to deal with an endless list of “what-if” questions. The result is that informal moral norms are being replaced with formal contractual obligations. What was once the original notion of the relational contract, depicted by a “handshake,” has been replaced with a purely transactional relationship. Today, transactional contracting dominates as the primary contracting approach. Researchers at the University of Tennessee and organizations such as the International Association for Contract and Commercial Management (IACCM) are behind the movement to help individuals and organizations understand and make the shift to using the modern form of relational contracts when appropriate.

However, relational contracting has been slow to take off, despite the rightness of the idea. Why? Unfortunately, many people and companies are hesitant to make such a shift for several reasons. One reason is the fear that the "other guy" will have a tendency to act opportunistically. It's a natural fear, after all, because people inherently act in self-interest. However, according to one of the pioneers of relational contracting—Ian Macneil, who was the Wigmore Professor at Northwestern University—contracts should be viewed as "instruments for social cooperation."<sup>8</sup> Instead of combatting opportunism with more formal and rigid contracts that outline "black and white" obligations, why not incorporate a

more flexible contracting framework that understands that "business happens"?

### CREATING A RELATIONAL CONTRACT

A key goal of a relational contract is to create a continuous alignment of interests throughout the contract term. The process of negotiating and jointly creating the relational contract is not just a means to get to the written document, but an important part of creating what is actually the focus: the relationship. For the parties to mutually create a relational contract, a formal five-step process and framework may be used,<sup>9</sup> as depicted in **FIGURE 2**.

### The Bidding Process

In most situations, contract negotiations are preceded by a competitive bidding process used to pick the best supplier. The type of bidding method varies, but is almost always focused on getting the best "deal." Most organizations use one of three competitive bidding methods. While organizations may use different names for each method, their overall purpose and emphasis is the same:

**Request for quote/price (RFQ)**—Emphasizes selecting suppliers based on the price they quote.

**Request for proposal (RFP)**—Used to seek

**FIGURE 2.** Components of the Relational Contracting Process

Process Step	Description	Actions
<b>1. FOCUS ON THE RELATIONSHIP, NOT THE DEAL</b>	To build the trust necessary to focus on the relationship, ensure alignment within your own organization and thereafter use a process for choosing a partner that considers relational competencies in addition to service offerings, quality levels, etc.	<ul style="list-style-type: none"> <li>Identify all relevant stakeholders involved in the process, including top management, external advisors, procurement, and sales managers.</li> <li>Ensure alignment before approaching potential business partners.</li> <li>When looking for a strategic supplier relationship, use a "request for partner" process to evaluate potential suppliers on both technical and relational capabilities.</li> </ul>
<b>2. ESTABLISH A PARTNERSHIP</b>	Before starting to build the relationship, analyze together whether there is enough trust, transparency, and compatibility between the parties to create a successful partnership.	<ul style="list-style-type: none"> <li>Find out if you are ready to become partners with each other by understanding your initial levels of trust, transparency, and compatibility.</li> </ul>
<b>3. EMBED SOCIAL NORMS IN THE RELATIONSHIP</b>	Jointly discover and agree on the six guiding principles (or social norms) of a relational contract: <ol style="list-style-type: none"> <li>Reciprocity,</li> <li>Autonomy,</li> <li>Honesty,</li> <li>Equity,</li> <li>Loyalty, and</li> <li>Integrity.</li> </ol>	<ul style="list-style-type: none"> <li>The parties should "discover" and together define the guiding principles and formalize them as part of their contract.</li> </ul>
<b>4. AVOID AND MITIGATE RISKS THROUGH ALIGNMENT OF INTERESTS</b>	To lay the foundation for continuously aligned interests, agree upon a shared vision and strategic objectives for the partnership, specifying what joint success and value looks like. (Also, ensure that the economic/pricing mechanisms later agreed upon support achievement of the vision and the objectives.)	<ul style="list-style-type: none"> <li>Create a shared vision for your partnership and document it.</li> <li>Break down the shared vision into strategic objectives.</li> <li>Agree on clauses regarding contract interpretation, saying that when ambiguous or silent, the contract shall be construed in light of the shared vision and guiding principles.</li> <li>Jointly work out the economic model that best incentivizes the parties to achieve the shared vision and strategic objectives.</li> </ul>
<b>5. CREATE A FAIR AND FLEXIBLE FRAMEWORK</b>	Agree upon the written contract clauses necessary to establish the more specific rules of the relationship (all of which align with the six guiding principles) and establish a robust governance framework for continuous relationship management.	<ul style="list-style-type: none"> <li>Jointly agree on the best governance structure and mechanisms to enable the parties to, with respect to the guiding principles, achieve their shared vision and strategic objectives while also dealing with change and unforeseen events.</li> </ul>

**FIGURE 3.** Seven Governance Mechanisms for Jointly Managing the Relationship

Mechanism	Description
1. <b>CREATE A TIERED MANAGEMENT STRUCTURE</b>	<ul style="list-style-type: none"> <li>• Number of tiers can vary based on the scale and complexity of the relationship.</li> <li>• The most common is a three-tier structure:                             <ol style="list-style-type: none"> <li>1. Operational level,</li> <li>2. Management level, and</li> <li>3. Strategic (or executive) level.</li> </ol> </li> </ul>
2. <b>ESTABLISH CLEAR ROLES</b>	<ul style="list-style-type: none"> <li>• Good governance ensures the parties focus on:                             <ul style="list-style-type: none"> <li>◦ Managing for today (service/product delivery),</li> <li>◦ Managing for tomorrow (transformation and change management),</li> <li>◦ Managing the economics (commercial management), and</li> <li>◦ Managing the overall relationship.</li> </ul> </li> <li>• Larger contracts should clearly spell out the roles to enable proper focus.</li> <li>• A separate transformation role is essential for large-scale outsourcing deals where transformation and innovation is essential</li> </ul>
3. <b>ESTABLISH PEER-TO-PEER COMMUNICATIONS PROTOCOLS</b>	<ul style="list-style-type: none"> <li>• Enable efficient and effective communication.</li> <li>• The parties should shorten communication lines and let the right people on each side connect and communicate directly—not via an account manager or contract manager.</li> </ul>
4. <b>DEVELOP A COMMUNICATIONS CADENCE</b>	<ul style="list-style-type: none"> <li>• Keep momentum in the relationship.</li> <li>• The parties should agree on a frequency for meetings at the operational, tactical, and strategic levels.</li> </ul>
5. <b>DEVELOP A PROCESS TO MAINTAIN CONTINUITY</b>	<ul style="list-style-type: none"> <li>• A relationship is created by people, and if people in the governance structure change, it is critical to have processes to ensure that new individuals on-boarded into the relationship are properly educated, trained, etc. in a way that ensures continuity.</li> <li>• Larger contracts should establish "key man" provisions for both parties.</li> </ul>
6. <b>ESTABLISH A PERFORMANCE MANAGEMENT SYSTEM</b>	<ul style="list-style-type: none"> <li>• The parties should agree on joint reports to follow up on their performance.</li> <li>• Such reporting should show efforts to achieve the shared vision and strategic objectives.</li> </ul>
7. <b>ESTABLISH PROCESSES FOR RISK MANAGEMENT AND CONTRACT CHANGES</b>	<ul style="list-style-type: none"> <li>• The parties should agree on a process for reviewing whether the contract needs changes to ensure that the shared vision is met and the guiding principles are followed.</li> <li>• The parties should agree on a process to continuously identify, assess, and deal with upcoming risks.</li> <li>• If a need for change arises (e.g., a new risk is identified), the parties should have a simple process for formalizing such changes and make them legally binding.</li> <li>• All changes must be aligned to the adopted guiding principles.</li> </ul>

a more formal proposal from potential suppliers beyond simply price. RFPs use a requirements specification to outline the requirements of the goods or services that the organization wants to acquire and the potential suppliers submit proposals on how they will meet the specifications and at what price.

**Request for solution (RFS)**—Used when an organization does not know the best way to achieve specific business needs. Rather than developing specifications, the organization instead states its needs and objectives, leaving it to the supplier to propose a *solution* to meet them.

More strategic relationships should use what is referred to as a "request for partner" process,<sup>10</sup> which is a process that helps an organization find a business

partner with not only the right capabilities, but also the right "fit" for the commercial relationship. Within this relationship, the parties will jointly explore the needs, objectives, relational competencies, and optimal solutions that will change over time as business happens.

**Governance Structure**

A key component of a relational contract is a structure or set of mechanisms for managing the relationship after the contract signing. This is referred to as "governance," which is crucial to:

- Sustain the relationship,
- Ensure continual alignment of interests, and
- Focus the parties on the vision and objectives.

Sound governance includes incorporating seven mechanisms for jointly managing the relationship after the contract signing, as depicted in **FIGURE 3**.

As noted, the main focus of contracting today is typically on the deal, not the relationship. It's about picking a supplier to meet a need—not about picking a potential partner. The emphasis is too often placed on managing the supplier with performance metrics and compliance, rather than on seeking to co-create a governance structure to maintain a continual alignment of interests in a dynamic business environment.

**Process vs. Content**

In order to achieve the best results, it is important to place equal importance on both the process of entering into the relational contract as well as on the content of

"Evolution has given us a dualistic nature; a tendency for both opportunism and a strong sense of fairness."

the relational contract. There are two main reasons why the process matters as much as the content.

► Reason No. 1

Evolution has given us a dualistic nature; a tendency for both opportunism and a strong sense of fairness.<sup>11</sup> The relational contract attempts to build on and leverage our sense of fairness while avoiding opportunism and the high transaction costs and value leakage that come with it. While it is possible to adopt relational contracting tenets at any point in a relationship, using a process to lay a strong foundation at the outset of a relationship is the easiest way to success because it helps us avoid opportunism from the start.

The importance of this is illustrated by the research of Kathleen Vohs, professor at Carlson School of Management, University of Minnesota. Vohs' research shows how money makes us egotistic.<sup>12</sup> For example, in one experiment, some individuals were exposed to words and thoughts about money and some were not. The individuals

were then tested for their willingness to help others. Those individuals exposed to money prior to being asked to help others showed a significantly lower willingness to help than individuals who had not been exposed to money. Vohs' work suggests it is critical *not* to start a relational contracting process by negotiating the deal, where money is always a key component. Instead, the seeds of a non-opportunistic relationship must first be cultivated, by which our opportunistic tendencies can later be avoided or at least minimized.

► Reason No. 2

Using a formal contracting process at the start ensures that organizations and individuals feel there has been a fair process for establishing the contract. The situation is analogous to legislation in a democracy. In legislation, both the content and the process for generating the content matter. A law adopted through democratic voting that denies a group of people fundamental rights will be fair from a process perspective, but will be unjust from a substance perspective. Likewise, a law adopted by a dictator giving equal voting rights to men and women will be just from a substance perspective, but will be unfair from a process perspective. If the process is perceived as unfair, the adopted laws will lack legitimacy and the people's willingness to follow them will be diminished.

For these two reasons, the *process* for developing the relational contract is equally as important as the contract's *content*. The process of negotiating and jointly creating the relational contract is not just a means to get to the written document, but an important part of creating what is actually the focus: the relationship.

**IT'S NEVER TOO LATE TO BECOME MORE RELATIONAL**

While using a structured process to create a relational contract is recommended, many organizations may find themselves in an existing relationship where it is impossible to go back and lay the foundation from the beginning. If you are like many organizations, you may have entered into discussions with the intent to have a more strategic relationship, but along the way created a more traditional transactional contract. As mentioned previously, transactional contracts are built around classical legal theories of risk allocation, which often lead to frustrations and tensions, as the arm's-length nature of the contract structure encourages more opportunistic and adversarial behaviors.

If this has happened in a business relationship you are involved in, don't become disenchanted because you got off on the wrong foot straight out of the gate. Consider embedding as many of the relational

FIGURE 4. Four Starting Points to Begin the Relational Contracting Journey

<p><b>ARM YOURSELF WITH FACTS ABOUT TRANSACTIONAL AND RELATIONAL CONTRACTS</b></p>	<ul style="list-style-type: none"> <li>• Investigate whether you suffer from problems in your transactional contracts and analyze whether the problems can be understood.</li> <li>• Investigate your most successful commercial relationships and analyze whether success may be a result of the use of relational contracting elements.</li> <li>• Facts must be your weapon when confronting superstitious beliefs and skepticism about relational contracts.</li> </ul>
<p><b>INVOLVE THE RIGHT STAKEHOLDERS</b></p>	<ul style="list-style-type: none"> <li>• Upper management should become aware of the potential advantages and economic upsides associated with relational contracting.</li> <li>• Make them your allies and sponsors.</li> </ul>
<p><b>START WITH A LOWER-RISK CONTRACT AND CALL IT A PILOT</b></p>	<ul style="list-style-type: none"> <li>• De-risk and build a success story that you can build from.</li> <li>• Continue using relational contracting for bigger and more business-critical contracts.</li> </ul>
<p><b>BE FORGIVING AND PATIENT WITH NAYSAYERS AND SKEPTICS</b></p>	<ul style="list-style-type: none"> <li>• Relational contracting likely will meet resistance, regardless of the evidence of its advantages in many situations.</li> <li>• We are all humans and typically don't like change.</li> <li>• Hesitation should not be confused with bad intentions. Instead, try education as your change agent.</li> <li>• The good news is there is a growing body of research, writing, and case law that supports relational contracting.</li> </ul>

tenets as possible into your existing relationship with the goal to improve the relationship, moving from left to right along the "Transactional vs. Relational Continuum" (FIGURE 1). For example, try adopting a "no-blame" culture, instead seeking to improve processes for managing performance and joint problem-solving to get to the root cause of any issues that arise, being sure to focus on accountability, not blame. Or perhaps develop processes to improve communications and proactively manage changes.

## STARTING YOUR JOURNEY

Individuals who play a role in forming or managing business relationships and writing contracts may start their relational contracting journey by taking time to reflect on how relational contracting can improve the results for the organization. FIGURE 4 on page 48 shows four specific things to think about when starting the journey toward relational contracting.

The bottom line is that relational contracting is about enabling organizations to adapt to and support the new rules of business in the new economy. It is time to put past dogmas, policies, and contract templates aside and embrace new methods. This does not mean transactional contracts should be abandoned—rather, they should be used only when they are a good fit, leaving room for the relational contract when it is the *best* fit. **CM**

**NCMA<sup>MAX</sup> COLLABORATE**

Post about this article on  
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## ENDNOTES

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## KATE VITASEK

- ▶ International authority recognized for her award-winning research and the Vested business model for highly collaborative relationships
- ▶ Author of six books on Vested and a faculty member at the University of Tennessee
- ▶ Lauded by *World Trade* magazine as one of the "Fabulous 50+1" most influential people impacting global commerce
- ▶ Has shared her insights on CNN International, Fox Business News, Bloomberg, and NPR

📍 [www.vestedway.com](http://www.vestedway.com)

[in](https://www.linkedin.com/in/katevitasek) /in/katevitasek

## DAVID FRYDLINGER

- ▶ Attorney and head of the Information & Communications Technology practice group at the Lindahl Law Firm in Sweden
- ▶ Vested Certified Deal Architect
- ▶ More than 15 years' experience in drafting and negotiating outsourcing and other complex commercial contracts
- ▶ Teaches relational contracting at the University of Tennessee
- ▶ Author and coauthor of several books, including *Getting to We—Negotiating Agreements for Highly Collaborative Relationships*

📍 [www.lindahl.se](http://www.lindahl.se)

