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# Unpacking Relational Contracts

## Unpacking Relational Contracts

The Practitioner's Go-To Guide for  
Understanding Relational Contracts

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## UNPACKING RELATIONAL CONTRACTING

### Welcome to the Contracting Paradox

More and more companies are facing a *contracting paradox*. Contracting is about planning for future exchanges of goods and services for money, and about how to deal with the risks and opportunities entailed in such exchanges. Yet today – more than ever before – the search for the perfect plan is painful if not impossible. Today's market is faster, more global and more complex than ever before. Change is the new constant, making accurate planning and forecasting almost an illusion.

Psychological research has revealed the troublesome fact that evolution has made us ill-equipped to make good plans *and* at the same time well-equipped to believe we are good planners.<sup>1</sup> The result is a planning fallacy leading to the *contracting paradox*.

So what is the contracting paradox? It is 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.

The contracting paradox is a recent phenomenon. For centuries much of the business world ran on “handshake deals,” especially with buyer-supplier relationships. When he researched the use of contracts in 1963, Professor Stewart Macaulay discovered that: “Businessmen often prefer to rely on a ‘man’s word’ in a brief letter, a handshake, or common ‘honesty and decency’ – even when the transaction involves exposure to serious risk.”<sup>2</sup> At about the same time, legal scholar Ian Macneil coined the term *relational contract*, referring to the social contract of moral obligations guiding behavior in business that Macaulay and others had discovered.

However, it was also around this time that legal scholars and practitioners began what would start to be a significant trend to create more formalized “complete” contracts to document business agreements. As the decades passed, contracts grew longer and more complex, including more and more detailed plans trying to deal with an endless list of “what-if?” questions. As informal moral norms were replaced with formal contractual obligations, the old relational contract was replaced with the *transactional* contract that now dominates as the primary approach for contracting. Today, it is not uncommon for a contract to be hundreds, if not thousands, of pages. We have seen one government supply contract that was literally eight and one-half feet tall when printed out!

Unfortunately, many of these extensively negotiated agreements fail to deliver the desired results. Indeed, it is argued by some that their content and the process that supports their formation actually detract from the chances of success. Practitioners cite value leakage from contracts and contractual relationships and the trade press report good deals that have gone wrong. This has led to increasing questions over the effectiveness of contracts and the contracting process. But then we have to face the contracting paradox. To succeed in business, we cannot give up planning. But now we know how poor we are at planning. To abandon the detailed transactional contracts and return to the nice and cozy world of handshake deals is not perceived as an attractive alternative in a global world where contracts are most often made between people who don't know each other. It is simply perceived, and rightly so, as too risky.

But there is hope. A growing number of organizations have found ways out of the contracting paradox, reducing the value leakage while becoming better and better at dealing with the uncertainty and complexity of the modern economy. What we see is the *return of the relational*



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*contract*, but in a new form. Today's relational contract is not the informal "handshake" deal from a bygone era, but rather a formal relational contract depicted by a highly collaborative relationship where the parties consciously choose to make social norms contractually binding. Modern relational contracts also explicitly describe joint governance processes within which the parties can work together to deal with risk and uncertainty.

There is an undeniable and growing amount of research showing how and when relational contracts out-perform conventional transactional contracts in terms of cost advantages, time, quality and innovation. Researchers at the University of Tennessee and organizations such as the International Association for Contract and Commercial Management are squarely behind this movement to help individuals and organizations understand and make the shift to using the modern form of relational contracts when appropriate.

### Purpose of this Paper

This white paper brings practical insights and understanding into the why, what, how, and when of relational contracting. This paper is divided into these five sections:

Part 1: Provides a high-level introduction to relational contracting

Part 2: Seeks to explain why organizations need to make the shift to relational contracting

Part 3: Aims to help you understand the "what and how" to begin to develop a relational contract

Part 4: Provides guidance for when to use a relational contract

Part 5: Shares a short conclusion and call to action with some succinct advice for getting started

This is not an academic paper; rather it is a practitioner's guide to help individuals and organizations better understand relational contracting. We would like to challenge individuals who play a role in forming or managing business relationships and writing contracts to take time to read this white paper and reflect on how this approach could improve the results they currently achieve.

***We hope this collective work becomes the reference guide for relational contracting.*** With this goal in mind, we are making this white paper available as an open-source document and encourage you to share it with your colleagues, clients, customers, suppliers and business partners.



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### PART 1: INTRODUCTION TO RELATIONAL CONTRACTS

Webster's dictionary defines a *contract* as:

1. A) binding agreement between two or more persons or parties; especially one legally enforceable  
B) a business arrangement for the supply of goods or services at a fixed price <make parts on contract
2. A document describing the terms of a contract<sup>3</sup>

In short, contracts regulate the rules of business between individuals and/or organizations. We write contracts with suppliers, customers, business partners, employees, etc. when we depend on others to realize our business plans. But planning is a difficult task, especially in today's complex and global environment. And since we – as humans – unfortunately tend to act opportunistically, we need to agree with those others on the joint plans for the future. The result is a contract that outlines the rules we shall follow in our relationship and the parts of our agreements that will be legally binding and enforceable in court. Using the terminology of one of the pioneers of relational contracting – Wigmore Professor at Northwestern University Ian Macneil – contracts should be viewed as “instruments for social cooperation.”<sup>4</sup>

But just what is a *relational* contract?

Let's start by dispelling a myth. Just because it incorporates the word 'relational' does not mean it is soft and woolly. In fact, the opposite is true. A relational agreement brings added discipline because it codifies the framework for the relationship – the forums, behaviors and mechanisms within which interactions will occur. It recognizes that relationships are not just person to person, but also organization to organization.

There is an increasing volume of writing and a growing body of case law on relational contracts. Over the decades legal, economic, and social science research have all provided the foundational underpinnings that point us to defining what a relational contract is—or at least should be. We suggest the best way to understand a relational contract is to compare it to the dominating contract model we call the *transactional* contract.\* Exhibit 1 (following page) provides the comparison along five dimensions, showing the distinct differences between a relational contract and a transactional contract, while at the same time showing that these two contract forms exist on a continuum.


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\* Ian Macneil used the term “discrete contracts” for the contract we here refer to as the transactional contract.

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**Exhibit 1: Comparison of Contracting Models**

		
DIMENSION	TRANSACTIONAL CONTRACT	RELATIONAL CONTRACT
FOCUS	The commercial transactions	The commercial relationship
RELATIONSHIP	Arms-length relationship	Partnership
SOCIAL NORMS	Disconnected from social norms	Mutually discovered and agreed social norms are explicitly included as contractual obligations
PRIMARY RISK MITIGATION MECHANISMS	Risk mitigation by use of market power and state power	Risk mitigation and avoidance by creation of continuous alignment of interest
PLANNING	Aims for completeness, i.e. tries to have contract clauses covering all future events of the relationship	Accepts that complete planning is not possible and aims to create a fair and flexible framework for managing change and uncertainty

Based on this comparison, which we will return to several times in this white paper, we provide a formal definition of a relational contract, at the far right end of the continuum, as:

*A legally enforceable written contract establishing a commercial partnership 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.*

As mentioned earlier, transactional contracts dominate as the primary contracting vehicle used in business-to-business relationships. This is not surprising given the fact that in most cases, it is not that complex to do business with others, especially when contracting for the sale or purchase of commoditized goods or services and where there are many suppliers and low switching costs. However, as the nature of what we are exchanging (more intangible goods or services) and the environment in which we operate (more global, faster changing, less predictable and more regulated) grows more complex, transactional contracts are increasingly riskier because of the extent of the ‘incompleteness’ or uncertainty in contracts. Incompleteness has grown from an estimated average of around 5% when Ian Macneil was writing in 1960 to around 35 – 40% today.

Successful business relationships find ways to proactively address this incompleteness in a fair and balanced manner. IACCM research has shown there are nine “relational tenets” that typically recur in successful partnerships based on relational contracts. Those tenets are also areas of unrecognized risk. In other words, the research showed that their absence increases the likelihood of failure – yet they rarely appear in any risk register. What are those tenets? They are communication, risk allocation, problem-solving, no-blame culture, joint working, gain and pain



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sharing, mutual objectives, performance measurements and continuous improvements. A definition is provided in Appendix 1.

Traditional contracts are formulated on two foundations – price and power. Within these parameters, there is little room for shared values or principled governance. Therefore, one of the main reasons organizations fail to implement relational tenets into their contracts, moving from the left to the right on the continuum, stems from using conventional procurement and contracting processes that are not fit for establishing the trust and aligned interests needed to succeed with relational contracting.

For this reason, we recommend using a formal process and framework for mutually creating a relational contract. Exhibit 2 (following page) outlines a process based on a combination of the five focus areas defining the relational contract set forth above and the nine IACCM relational tenets. We explain the rationale behind this suggested step-by-step approach later in this white paper.

While this white paper promotes using a structured process to create a relational contract, we recognize many organizations may find themselves in an existing relationship and 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 found you created a more traditional transactional contract. As mentioned previously, transactional contracts are built around classical legal theories of risk allocation, which often leads 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 relationship you are involved in, don't become disenchanted because you got out the gate wrong. We encourage you to not give up. Rather, consider embedding as many of the relational tenets as possible into your existing relationship with the goal to improve the relationship, moving from left to right on the continuum. For example, try adopting a no-blame culture and instead seek to improve processes for managing performance and joint problem solving to get to the root cause and focusing on accountability, rather than blame. Or perhaps develop processes to improve communications and proactively managing changes.

Whether you start with the formal process we recommend – or you work to embed the relational tenets into an existing relationship – the investment will pay off.

As you make the shift to relational contracting, it is important to understand why it is essential to add relational contracts to today's contracting toolkit. We start Part 2 of this white paper by taking a look at the world and how it has changed during the last thirty years.



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### Exhibit 2: Relational Contracting Process

Process step	Description	Relational Tenets implemented
1. Focus on the relationship, not the deal	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.	Mutual objectives
2. Establish a Partnership	Before starting to build the relationship, analyze together whether there is enough trust, transparency and compatibility between the parties to create a successful partnership.	Joint working, communication
3. Embed social norms in the relationship	Jointly discover and agree on following the six guiding principles or social norms of the relational contract.	Risk allocation, communication, pain and gain sharing, no-blame culture
4. Avoid and mitigate risks through alignment of interests	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 look like. Also, ensure that the economic/pricing mechanisms later agreed upon support achievement of the vision and the objectives.	Mutual objectives, risk allocation, gain and pain sharing
5. Create a Fair and Flexible Framework	Agree upon the written contract clauses necessary to establish the more specific rules of the relationship, all of them aligned with the six guiding principles. Finally, establish a robust governance framework for continuous relationship management.	Communication, problem-solving, no-blame culture, joint working, mutual objectives, performance measurements and continuous improvements



### PART 2: WHY USE RELATIONAL CONTRACTS?

Back in 1963, Stewart Macaulay reported that most business executives saw little need for contracts and often felt that establishing a contract can ‘get in the way of a good relationship’. A high proportion of trading relationships were long-established and most were geographically or culturally ‘local’.

Globally networked technologies and the emergence of new business practices in the 1980s disrupted patterns of trade and behaviors. Long-term relationships were discarded in the search for competitive advantage, whether in the name of innovation or cost reduction. The steady growth of global interdependence has come with growing tension and unpredictability. Today’s business environment is often depicted by the term ‘VUCA’ – volatility, uncertainty, complexity and ambiguity.<sup>5</sup> This shift offered fertile ground for lawyers to seek to perfect the “complete” contract. The saying “Nothing personal, it’s just business” emerged as a common excuse in the quest for opportunistic behavior. A consequence was greater adversarialism in a battle over minimum prices, onerous terms and attempts to pass maximum risk and responsibility for performance to the other side.

An alternative to this approach would have been to build more structured relationships, offering a framework through which the participants could better manage the impacts of VUCA. Unfortunately, there was no assessment of the cost associated with transactional contracting and the disruptive, poorly aligned behaviors that resulted from it.

Part 2 of this white paper is dedicated to explaining why organizations should consider relational contracts for more strategic relationships. We believe that without a clear understanding of the why, individuals and organizations will continue to resist and even openly reject relational contracting as a viable option. This section:

- Highlights the ***rise of the new economy***, which explains why organizations must think more strategically about supplier and other commercial relationships.
- Shows the real ***impact of value leakage*** in contracts. We share data about value leakage and provide real examples of how getting contracting wrong can cause long-lasting damage to an organization.
- Highlights ***weaknesses in transactional contracts*** that point to the fact that a transactional contracting model is often not appropriate for many of today’s more complex supplier and other commercial relationships.
- Shares ***scientific research*** that supports relational contracting. Simply put, relational contracting is not just a good idea; the fundamental construct and theory supporting relational contracts are based on indisputable research, including several Nobel Prize-winning concepts.

After reading Part 2 of the white paper we believe you will understand why a shift from transactional to relational contract is often vital for business success. Indeed, you may well conclude that relational components should be used much more widely in many of your trading relationships. You



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may ask: “Why would I not want more effective and efficient communications, clarity over objectives, a culture of accountability and continuous improvement?” Relational agreements are not an absolute; there is no sharp dividing line where one side must be ‘adversarial’ and the other ‘collaborative’. Rather, it is an issue of degree and the extent to which a fully relational model is justified by the strategic and economic impact of a particular relationship.

### The Rise of the New Economy

Most of the 20<sup>th</sup> century was dominated by the *vertically integrated enterprise*, incorporating complex supply and distribution chains in one company or group of companies. Harvard Business School’s Michael Porter literally wrote the manuals for creating a competitive strategy in a vertically integrated enterprise in his best-selling books *Competitive Strategy*<sup>6</sup> and *Competitive Advantage*.<sup>7</sup> For Porter, the enterprise was a combat unit on a battlefield forged by five market forces creating a threat of rivalry among existing firms, the threat of new entrants, the threat of substitute products or services, the bargaining power of buyers and the bargaining power of suppliers.<sup>8</sup>

Ironically Porter wrote the rulebook at a time when vertically integrated organizations were already beginning to shift to more decentralized and networked structures. The shift was brought to the forefront in 1989 when management guru Peter Drucker eloquently argued in his Wall Street Journal article that organizations should “Sell the Mailroom.”<sup>9</sup> A year later, Prahalad and Hamel argued that corporations should focus on their core competencies in their highly influential Harvard Business Review article.<sup>10</sup> CEO mandates around the world began to proclaim, “Do what we do best and outsource the rest.”

In the new economy, the combat unit is an organization’s network, not the discrete organization entity itself. The result is that organizations today have a virtual network of suppliers and business partners around the globe that supply not just commodities that feed the industrial engine of the past, but also highly strategic and essential services. Today’s flexible and innovative organizations are supported by strategic suppliers and partnerships that manage critical functions such as manufacturing, distribution, IT, facilities management, finance, HR and more. Let’s look at some of the key attributes of today’s market.

- Today’s market is more **global**. In the past, markets were smaller and more confined by national boundaries. Globalization has torn down these boundaries. While national market segmentations do still exist, the markets of today are generally geographically much more diverse than in the past.
- Today’s markets are more **complex**. In the mass-market economy with large vertically integrated corporations as the main players, demand was easier to predict. Orders were managed through a backlog and demand was to a large extent driven by the corporations themselves, as illustrated by the famous quote from Henry Ford proclaiming, “My customer can have a car painted any color that he wants so long as it is black.”<sup>11</sup> Today, *the* customer no longer exists; rather the economy includes a multitude of customers with different tastes



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that change in unpredictable ways. Entire companies have made businesses out of serving the long tail of customer demand.<sup>12</sup>

- Today's markets are **faster**. The speed of the market, and market changes, is astonishing. New products and services can become obsolete in a matter of months. While innovation has always been important, innovation is now an imperative, requiring that organizations be flexible and responsive to change.

To summarize, markets are more global, more complex, and faster; successful organizations rely on networks of more strategic commercial relationships to navigate in the new economy. This demands new levels of clarity, communication, collaboration and control, which is best answered through relational contracting.

### Value Leakage in the New Economy

The networked company can exist because of contracts between the entities in the network. It is therefore troublesome that there seems to be a significant *value leakage* in contractual relationships in the market today. IACCM research has shown that poor contracting costs the average organization the equivalent of 9.15% of its annual revenue.<sup>13</sup> Value leakage takes the form of increased costs, missed savings and lost revenues. The IACCM data does not even attempt to put a price on missed opportunities, the impact of non-renewals or costs of disputes or litigation.

IACCM is not the only one researching this topic. The Corporate Executive Board found that, in a typical outsourcing deal, the outsourcing company can erode up to 90% of anticipated value due to poor contract governance.<sup>14</sup> London School of Economics professor Leslie Wilcox studied 1,200 outsourcing agreements and found that 'power-based agreements' (those where the more powerful party imposes the terms) generate up to 40% higher costs than trust-based agreements.<sup>15</sup>

The stories of failed and value-eroding relationships because of poor contracting practices are legendary. Perhaps the most illustrative is the story of General Motors, which was once regarded as one of the best managed and most successful firms in the world. But between 1980 and 2009 its market share in the United States fell from 62.6 to 19.8 percent, and in 2009 the firm went bankrupt.

Research suggests many of GM's issues can be linked to GM's arm's length transactional contracting strategy.<sup>16</sup> GM encountered problems in developing contractual relationships essential to modern design and manufacturing. Researchers point to several possible causes for these difficulties, including GM's historical practice of treating its suppliers as homogeneous, interchangeable entities, its view that expertise could be partitioned, and that holistic decisions could be made using financial criteria. Essentially, this approach led to one major supplier observing: "When is a contract not a contract? The answer – when it is with GM." The sense was that GM (and indeed all the major US automotive manufacturers) demanded complete loyalty from suppliers, but offered almost none in return.<sup>17</sup>



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Researchers claim GM's heavy reliance on power-based supplier strategies and arms-length relationships led to significantly higher transaction costs, much lower degrees of information sharing with the suppliers, and low trust levels – all factors that contributed to GM's fall from the top. These strategies should be compared to Toyota's and other Japanese carmakers' supplier strategies, which are characterized by long-term relationships, high degrees of information sharing, and low transaction costs – all which create significantly more supplier loyalty and trust.<sup>18</sup> It is interesting to note that, since its near demise, attitudes and behaviors at GM have changed dramatically and many of the power-based, adversarial approaches to the market have been replaced.

But among all the stories of failures, there are a steady growing number of individual success stories. IACCM research confirms that organizations which make investments in enabling better relationships cut the percentage of value leakage dramatically, to around 3.5%.<sup>19</sup> So why is it that the stories of success are not more common? Why do organizations struggle to replicate these productive relationships? One answer is that the networked business world has not driven networked behavior. Trading partners are typically viewed with some level of suspicion and an assumption that they are driven by selfish instincts. In short, trading partners cannot be trusted.

To make matter worse, many organizations use performance metrics that often encourage short term thinking and promote opportunistic, negative behaviors. Case in point: A Fortune 100 company that provides a bonus to their procurement professionals for getting the best “deal,” measuring a buyer only on purchase price variance of reducing price versus laying the foundation for a successful relationship or reducing total cost of ownership. This is mirrored in the compensation schemes for many sales staff, where ‘victory’ is winning the deal, rather than ensuring it delivers long-term value to either organization. While management may talk increasingly about issues of honesty and integrity, they often do little to shift motivation from short-term opportunistic behavior – in part because they lack insight into the costs associated with transactional contracting behaviors or understanding of the alternative.

### The Characteristics and Weaknesses of the Transactional Contract

Another important and closely related reason for the relatively small number of success stories is the nature of transactional contracts themselves. In Part 1, we used five characteristics to describe the transactional contract. Let's take a closer look at those characteristics and we will see why a transactional contract is increasingly not fit for purpose in today's economy. A quick review reveals there can be little doubt that the characteristics and weaknesses of the transactional contract explain much of the value leakage and failures from contractual relationships in the market.

#### FOCUS ON THE “DEAL”, NOT THE “RELATIONSHIP”

The focus of contracting tends to be “this deal,” “this time” and under “this set of business and legal terms.” Negotiators and lawyers think, “Get a signature, and you are done.” It is a done deal, and the deal is the deal.



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A transactional contract definitely follows this logic. Let's look at a typical press release for a big "deal." The parties project success at signing, saying that company x has contracted with supplier y in a seven-year contract worth z million dollars. This assumes the parties know, at the date of the press release, all the transactions that will be carried out. A complex future is viewed as one big deal.

Today's dynamic business environment often makes it impossible to publish such a press release with a realistic claim for accuracy. In most complex customer-supplier relationships, the parties know that in reality, the "deal" must change over time because of changing demand, market circumstances, etc. Well crafted, transactional contracts deal with this through change control clauses, most often involving a change procedure from submission of change requests to signing of an amendment agreement. But as most contract managers know, post-signing contract negotiations can be tedious and costly exercises, often involving intense discussions whether the change request should lead to additional compensation or not, and, if yes, how much.

Those exercises generate transaction costs for which there can be only one name: waste. The cause of this waste is not how the change control clauses are written. The problem lies instead in the focus. Simply put, the parties persist to focus on the deal at the time of signing, even though they know that "this deal" will become irrelevant. Without a change of focus, this waste cannot be avoided.

### ARM'S-LENGTH RELATIONSHIPS

A transactional contract establishes an arm's length relationship. It is generally designed to limit commitment and to gain as much control over the other party's actions as possible while losing as little control as possible. A key goal in an arm's length relationship is to not get too "cozy" – especially if you are the buyer. Conventional logic is that becoming too dependent on the other party is seen as risky, and that buying organizations should avoid "lock-in."

To prevent too much dependency, organizations often use commercial terms to prevent "lock-in." For example, termination for convenience clauses combined with comprehensive exit management obligations create powerful tools that customers can use to control suppliers. Another example is intellectual property rights clauses where the customer acquires a right to ideas and innovations created by the supplier. The goal is to ensure the strings between the parties remain unattached.

As a general rule, buyers have more power than suppliers – at least up through the point of signing the contract. And, typically, the more powerful the organization, the more one-sided the clauses. The 1980s ushered in popular approaches for improving an organization's power. Business gurus such as Michael Porter stressed organizations should gain power over suppliers and customers as a way to create a competitive advantage. Peter Kraljic espoused that procurement organizations should gain power with "leveraging" tactics. Charles Karrass taught thousands of individuals how to play the "negotiations game" to tilt the deal in their favor.

But today, conventional approaches for using one's power causes a dilemma. Power-based strategies do not work in today's networked and hyper-competitive economy because enterprises depend on their network of customers, suppliers and business partners to succeed. Arm's length





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relationships simply are not enough – especially for more strategic and complex deals where there is a great deal of dependency. Successful organizations are abandoning the arm's length mentality, choosing instead to create highly collaborative strategic relationships with increased interdependence that are purpose-built to create a win-win competitive advantage with their strategic business partners. Professor Jeffrey Dyer and Harbir Singh are pioneering research in this area. They coined the term *relational rents* to refer to the above-normal returns generated by two or more companies using each other's knowledge and resources in unique ways that cannot be copied by others.<sup>20</sup> In an arm's length relationship, nothing unique can be created. Relational rents can *only* be generated through investments in relationship-specific assets, substantial knowledge exchange and combining of complementary resources.

Making the shift means today's contracts require far more thought and versatility in how the relationship is contractually structured and managed; it also demands a conscious departure from the one-size-fits-all mentality that remains prevalent in many organizations. Simply put, the strategic contract you structure with Strategic Supplier #1 is highly likely to be unique from the strategic contract you structure with Strategic Supplier #2.

And above all, creating strategic relationships requires abandoning the ambition to keep all commercial relations at an arm's length's distance. You cannot both generate relational rents through increased dependency and pooling of resources, *and* remain completely detached and independent simultaneously. The transactional contract with its arm's length character will fail to enable your strategic relationship to blossom and create the desired competitive advantage.

### DISCONNECT FROM SOCIAL NORMS

"It's not personal, it's just business." This is the mentality of the transactional contract. This mentality also means it is acceptable to violate fundamental social norms in pursuing a "good deal." In fact, opportunistic behavior is not only allowed, but expected as part of the "negotiation game." Millions of books have been sold on how to play the game. We are taught to justify going against the social norms of *reciprocity* and *equity* when you have power and can shift risk to the other party. Negotiations courses teach us we are still being *honest* when we withhold information if the other party does not ask for it – even if it may mean the other party is disadvantaged or could be financially hurt. Of course, the easiest way to justify one's opportunistic behavior is to say "sorry, it's not personal, it's just business."

In reality, violating social norms often generates risk instead of mitigating risks. Why? Because it is safe to assume the other party will try to create strategies to improve their position. In fact, most rational business people look for ways to protect themselves or to "get even." Unfortunately, protection often means a lack of openness and transparency, withholding data or information, and placing limits on communication. This mindset is not evil, but one of human nature based on *opportunism*. After all, if there is a conflict of interest and the risk is significant – it is rational to think that both parties will try to act in accordance with their *own* interest, not considering the other party's interests.



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Psychological research supports this “tit for tat” behavior, showing while humans are opportunistic, they have a strong sense of fairness or, in the terminology of behavioral economics *bounded self-interest*.<sup>21</sup> Most people want to treat others fairly and also want to be treated fairly. However, this also means that people are willing to punish unfair behavior, i.e. behavior in breach of social norms.<sup>22</sup>

The simple fact is that violating social norms makes the situation worse – not better. It prevents and distorts the conversations needed in any healthy relationship. It limits areas of discovery and stifles the very ideas that should lie at the heart of any long-term, productive agreement. Violating social norms by one party simply leads to a reaction (often a negative and opportunistic reaction) by the other party. And this results in unnecessary transaction costs.

Economists such as Oliver Williamson have shown how contractual, legal and social norms interact to guide the behavior of individuals and enterprises in all commercial relationships.<sup>23</sup> The findings are clear; in more complex commercial relationships, inefficiencies and transaction costs are generated when contractual norms come into conflict with the social norms which always exist in commercial relationships to a larger or lesser extent.

We are convinced that much of the value leakage in contractual relations is caused because transactional contracts have a “disconnect” from social norms. The more one-sided and power-based the contractual obligations, the more an individual is triggered by human nature with a strong sense of fairness to create a counter-reaction. Simply put, conventional transactional contracts create a disconnect from social norms, resulting in consequences rather than preventing them.

### RISK MITIGATION THROUGH MARKET POWER AND STATE POWER

As the saying goes “buyer beware.” We’ve been taught to do business at our own risk and not expect others to look out for us. It’s our fault if we have not taken enough precautions to avoid being taken advantage of. Organizations use contracts to mitigate any potential risk that might arise. Conventional wisdom teaches us to use one’s power to shift risk to the other party. While the other party might accept the risks – it rarely does so willingly. The reality is that the more one party seeks to shift risk, the more the other party seeks creative strategies to mitigate their risk or shift the risk back.

In a transactional contract, there are two main mechanisms to deal with the risks of opportunistic behavior. The first one is market power, the second state power. In combination, they give the impression of doing a good job in risk management. In reality, neither power-based mechanism does a good job. Let’s explore why each falls short.

We’ll look at market power first. By *market power*, we simply mean the power to leave the relationship and contract with another player in the market or the ability to impose onerous terms on the counter-party, with few obligations of your own. The power to leave is most effectively ensured by a termination for convenience clause, which grants a right to terminate the contract whether or not a breach has occurred or not. Onerous terms may take many forms but generally relate to issues around ownership of assets and consequences of failure. Under classical legal theory, there is a strong belief in driving performance through purely negative incentives.





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Mitigating risk through market power has serious downsides – not least of which is that it rarely works. In many commercial relationships, the costs of switching a supplier or losing a customer can be very high. Additionally, having such provisions often leads the counter-party to restrict their investment in the relationship. Consider, for example, whether a supplier forced into a corner will willingly provide assets or staff with invaluable knowledge and experience about the customer and its operations.

Market power has its place when there are many suppliers with low or no dependency and switching costs are low (in essence, you are buying a true commodity). But in situations of greater dependency or where there is potential for differentiated value, using market power in forming the agreement will invariably undermine potential results.

What about *state power*? By state power, we mean the power to legally enforce contractual obligations. Contractual obligations backed up by state power appear to be a great tool for risk mitigation. After all, the entire idea of a contract is based on the assumption of a possibility for enforcement.

We argue that the state power mechanism for mitigating the risks of opportunism has serious downsides. Why? The court system is not 100% effective and a contract breach will not automatically lead to enforcement. Besides, it is often very costly to go to court. For this reason, the vast majority of parties choose to settle out of court to avoid astronomical legal bills and the potential damage to their reputation. IACCM research supports this assumption, showing that while 30% of negotiated contracts encounter a substantial disagreement between the parties at some point during their execution, only 0.007% end with litigation or arbitration.<sup>24</sup> Even though most contracts rely on an implicit assumption of the effectiveness of the court system, in reality, state power is not used as a viable option.

In summary, the risk-mitigating mechanisms of the transactional contract – market power and state power – create an illusion of safety when in reality they can be weak in managing known risk and largely ineffective in dealing with unknown or unanticipated risks.

## COMPLETE PLANNING

A contract is first and foremost an economic instrument with the purpose to support the realization of business plans. To build a house or a railroad, to execute a marketing campaign, to ensure access to information technology, all this requires many activities from the parties in a contract. The goal of the contract is to ensure that the plans are realized. Conventionally this is done by allocating control over the activities through contractual obligations. For example, the buyer would create a prescriptive statement of work or service description of the activities to be performed.

The problem is, again, there is a tendency for opportunism. What if we have missed something when making a plan? What if we realize, after the contract has been signed, that building the railroad requires some additional work we forgot to include in the specification? Will not the other party take advantage of the situation? Most likely yes, especially if the prior negotiation was focused on minimizing price and maximizing supplier risk. But rather than recognizing these recurrent symptoms and learning from experience, many buyers react by becoming even more demanding



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in their negotiations. The result? The never-ending quest to make the contract more 'complete' so the supplier cannot 'take advantage' in the post-award phase.

These attitudes and behaviors are driven by the incorrect belief (historically peddled by consultants and advisory firms) that power rests with the buyer until contract signature and moves to the supplier once the deal is signed. This philosophy views trading relationships in the context of battlegrounds and relationships as a war of attrition. *To maintain control, the plan must be complete and written down in the signed contract.*

Complete planning is the attitude of the transactional, adversarial contract. But just as with risk mitigation and disconnection from social norms, achieving a complete plan in a complex environment is based upon a costly illusion. Indeed, 2016 Nobel prize winner Oliver Hart has shown that most contracts are incomplete. As we have written, today's business environment is complex, fast-moving and unpredictable. Supply and demand change quickly. Market threats come from all angles, ranging from new competitors, customer hypes, disrupting technology, regulation and unpredictable events such as dramatic fluctuation in oil prices. Essentially, we are dealing with a growing volume of the unknown or the unknowable. Relationships must be designed, not to eliminate these realities, but to cope with them. The transactional contract has no mechanisms for achieving the much needed flexibility and collaboration demanded by today's environment.

The fact is complete planning becomes harder and harder in the new economy. An irony about complete planning is that psychological research has revealed that we never were good planners to start with.<sup>25</sup> To borrow terminology from behavioral economics, we suffer from *bounded rationality* because we don't have enough time to gather all relevant information and that our brains cannot deal with all of the information. The conclusion? It has always been impossible for a transactional contract to live up to the ambition of complete planning.

### Research Supporting Relational Contracts

While the previous sections showed scientific support for the disadvantages of transactional contracts, this part of the white paper shares the advantages and benefits of the relational contract. We show relational contracting has the strong support of Nobel Prize-winning research in psychological, economic and social theory. As an example, in October 2016, the work of Professors Hart and Holmstrom was recognized when the Nobel Prize for Economics was awarded. Their research highlights the importance of contracts being 'properly designed to ensure that the parties take mutually beneficial decisions' - a philosophy that lies at the heart of relational contracts.

A key reason relational contracts make sense is that contracts are negotiated, written and entered into by human beings. This means that the logic of human psychology, as it has been formed by evolution, has a strong influence on the practice of contracting. But not only psychology plays a role; humans entering into a contract are acting within economic and social systems that together form the rules of the game of contracting, leading to either beneficial or non-beneficial economic results. Therefore, economic and social science also teaches us important lessons about contracting.



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While there are literally hundreds of research studies supporting the concepts and logic behind relational contracting, in this white paper we have limited ourselves primarily to the psychological research.

As stated, contracting is about planning for future exchanges of goods and services for money, and about how to deal with the risks and opportunities entailed to such exchanges. It is because the future is unknown and because we as humans have a tendency to act opportunistically that contracts are needed in the first place. As we have repeatedly said, contracts are written to deal with the future.

The problem is that we are psychologically ill-equipped to deal with the future. As far back as 1957, Nobel Prize winner Herbert Simon concluded that humans are rational, but only to a limited extent.<sup>26</sup> There is probably no one that has investigated deeper the limits of our rationality than professor Daniel Kahneman, 2002 Nobel Prize winner and author of the best seller *Thinking, Fast and Slow*.<sup>27</sup> We draw several important conclusions from Kahneman's work and the work of the psychological branch of economics – behavioral economics. We focus on three key concepts:

1. The systematic errors we make as a result of our bounded rationality
2. Our limited ability to correctly assess risks
3. Our sense of fairness

### 1. THE SYSTEMATIC ERRORS WE MAKE AS A RESULT OF OUR BOUNDED RATIONALITY

Instead of being omnipotent, all-knowing and fully rational creatures (which is the assumption of traditional economic theory), we tend to use rules of thumbs and simplified models of the world to get around. These rules of thumb are called *heuristics*. Since they are simplifications they are not necessarily correct, meaning they can lead to systematic biases or fallacies. From the perspective of contracting, the most important one is the *planning fallacy*, already mentioned in the introduction. Our bounded rationality severely limits our ability to plan for the future, which is a key component in all contracting. However, our mind also tricks us into thinking we are in fact good at planning for the future. Simply put, we suffer from *overconfidence*.

The planning fallacy and related biases mean that, in the complex, fast and global economy, we *will with absolute certainty fail if we try to deal with the uncertainty of the future through a transactional contract*. Instead, relational contracts should be used, containing among other things mechanisms for transparently sharing information and feedback loops allowing the parties to adjust the contract as the future unfolds while at the same time keeping interests aligned.

### 2. OUR LIMITED ABILITY TO CORRECTLY ASSESS RISKS

Our limited rationality also means we are poor in assessing risks, another key activity in contracting. The planning fallacy means we most likely will fail to identify many of the most relevant commercial and contractual risks in the first place. And even if we identify a risk, we tend to rely on feelings when assessing it, instead of a rational analysis of likelihood and negative impact. The less we like



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a possible future event, the riskier it appears to us. Professor Cass Sunstein has coined the term *probability neglect* for the tendency—all too common among lawyers—to overemphasize the potential negative outcomes of an event, paying little or no attention to whether this outcome is likely to occur.<sup>28</sup>

Since the future has never been more uncertain, it has also never been riskier. We are not psychologically equipped to deal with such risks through the transactional contract, in which all risks must be addressed at the moment of signing. Instead, the relational contract must be used, including, among other things, governance mechanisms for continuous and collaborative risk management, allowing the parties to, over time, keep the risks of their partnership at acceptable levels.

### 3. OUR SENSE OF FAIRNESS

Daniel Kahneman and Richard Thaler, one of the founding fathers of behavioral economics, have also demonstrated our strong sense of fairness.<sup>29</sup> This sense of fairness has a positive and a negative side, both relating to our feeling for reciprocity. On the positive side, we have a natural tendency to act with fairness. On the negative side, it means we are willing to punish those who treat us unfairly, even if it is to our economic disadvantage or against our long-term interest.

The positive and negative side of our sense of fairness has been proven beyond doubt in experiments such as the Ultimatum Game. In this game, individual A – the proposer – is given a sum of money and is requested to suggest to individual B – the responder – how the money shall be shared between them. If the responder accepts, the money is split per the proposal. If the responder rejects the offer, neither party gets anything.

Against strict economic reasoning, the proposers typically offer 50/50 splits instead of offering as little as possible, showing the positive side of our sense of fairness. On the other hand, the responders typically reject offers of 70/30 splits or less, even if they would be better off with, say, 10% of the money than nothing. The responders are thus willing to punish unfair behavior, against their own strict self-interest.

Contracting is not only about planning for the future. It is also about dealing with opportunistic behavior. Here, the transactional contract suffers from a severe blind spot – a power-based contract disconnected from social norms. But as the Ultimatum Game shows, we don't respond well to use or abuse of power. Power-based processes and practices of the transactional contract often trigger opportunistic behavior. And we try to deal with opportunism through the threat of market or state power.

Simply put, we respond to power with power, to unfairness with unfairness.



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### THE NEED: CONTINUAL ALIGNMENT OF INTERESTS

Psychology and behavioral economics prove that (i) we are psychologically ill-equipped to succeed with the completeness ambition of the transactional contract, (ii) our limited ability to correctly assess risks grants an illusion of safety to the transactional contract, and (iii) the contracting and negotiation processes we typically use often generate opportunistic behavior instead of protecting against it. While we have offered three clear reasons to shift away from transactional contracts, these same three reasons also offer a compelling reason to shift towards relational contracts – especially when operating in a complex, fast-paced or uncertain business environment.

For more strategic contracts with higher risks and uncertainty, what is needed is a relational contract that seeks to continually align interests in the face of uncertainty. The relational contract—and equally important the process to enter into it—will bring out the positive side of our sense of fairness and help us best deal with these uncertainties in a much more constructive manner.

But just how do you create a relational contract? Read on to Part 3.

### PART 3: HOW TO CREATE A RELATIONAL CONTRACT

In Part 2, we illustrated the severe weaknesses and sometimes even the dangers of using a transactional contract when operating in a complex and uncertain environment. We also shared the logic for shifting to a relational contract. The purpose of Part 3 is to help you begin to understand *how* to develop a relational contract. As we will discuss below, a journey *towards* a relational contract can start by the parties implementing one or more of the nine relational tenets. While this will definitely benefit both parties, the full value from relational contracting won't be realized until the full relational contract with all its components is implemented. Therefore, this part 3 mainly focuses on the full relational contract on the far right side of the contract continuum shown on page 5.

A key goal of a relational contract is to create a continuous alignment of interests throughout the contract term. As we pointed out in the introduction, to achieve the best results it is important to place equal importance on both the process of entering into the contract as well as on the content of the relational contract.

There are two main reasons why the process matters as much as the content of the contract. The first reason relates to what we explained at the end of Part 2. Evolution has given us a dualistic nature; a tendency for both opportunism and a strong sense of fairness. 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 well illustrated by the research of Kathleen Vohs, professor at Carlson School of Management, University of Minnesota. Vohs' research shows how money makes us



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egoistic.<sup>30</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 before 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 the 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.

The second reason we recommend using a formal process at the start of the contracting process is to ensure 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, we believe *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 in focus: the relationship. As outlined in Part 1, there are five essential focus areas for developing a relational contract and nine main relational tenets. We use these five focus areas to outline each of the high-level steps in the relational contracting process. Through the process, the nine relational tenets are also implemented.

1. **Focus on the relationship, not the deal.** This step is designed to help you build the trust necessary to focus on the relationship. It includes ensure alignment within your own organization and using a process for choosing a partner that considers relational competencies in addition to service offerings, quality levels, etc.
2. **Establish a Partnership instead of an Arms-Length Relationship.** This step is designed to explore and lay the foundation of trust, transparency and compatibility between the parties to lay the foundation for a successful partnership.
3. **Embed Social Norms in the Relationship.** This step is designed to help the parties jointly discover and formally agree to the six guiding principles (social norms) of the relational contract.
4. **Avoid and Mitigate Risks by Alignment of Interests.** This step is designed to lay the foundation for continuously aligned interests. It starts with the parties agreeing upon a shared vision and strategic objectives for the partnership, specifying what joint success and value looks like. Also, ensure that the pricing arrangement and contractual clauses later agreed upon support the achievement of the vision and the objectives.





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5. **Create a Fair and Flexible Framework.** This step is designed to establish a robust governance framework for continuous relationship management. The parties agree upon the written contract clauses necessary to establish the more specific rules of the relationship, all aligned with the six guiding principles.

We go into each of the five steps in detail in this section of the white paper. At the end of this section, we share further thoughts and insights regarding the suggested process and whether there are other ways to enter into relational contracts.

### Focus on the Relationship, Not the Deal

It is common practice for a lawyer or an advisor to say, “I am working on closing the X transaction” or, “I am negotiating the Y deal.” As we have seen, a transactional contract puts the focus on the deal, viewing all the future transactions as one big deal. In a relational contract, the focus is put on the relationship, with the “deal” simply being components of the overarching relationship.

#### WHAT DOES IT MEAN?

Let’s consider what it means to focus on the relationship and not the deal by picking out a classic from the library. Thought leader Jim Collins provides an excellent analogy of what it means to have a long-term view versus a short-term view in his book *Built to Last*<sup>31</sup> (co-written with Jerry Porras). The book provides a telling comparison between successful and less successful companies by using the terms ‘clock builders’ and ‘time tellers.’<sup>32</sup> Some companies succeed because they have amazing products and services, but their success fades when those products and services fade in popularity. Those companies are time tellers. Other companies have successful products and services because they are created by amazing companies, clock-builders who will generate profits year after year by always producing new products and services that the market wants. In the race of the market, it is always the clock builders that win eventually.

The comparison between time tellers and clock builders can be used to compare transactional and relational contracts. In transactional contracting, the focus is on telling the time, on the deal. When the exchanges planned for in the deal have been carried out, the relationship terminates and no more value is created. In relational contracting, instead, the focus is on building a clock, i.e. a relationship that can continue to generate value when all the transactions of the initial deal have been carried out. This means the parties must begin discussions with a potential partner that sends signals about the importance of the partnership, and not the importance of the deal.

#### HOW DO YOU DO IT?

Focusing on the relationship instead of the deal has important consequences for both the contracting process and the actual contract content.

First, an organization must seek to create trust. Much has been written on the importance of building and sustaining trust in a relationship.<sup>33</sup> Trust is generated when there is alignment between words and actions, i.e. when you can feel a confidence that what someone is saying also will be followed by their actions. You can trust a person that shows integrity in this sense.





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But trust is not only something shown by and to individuals. There is such a thing as *organizational trust* and *organizational integrity*. To build trust, the organization must speak with one voice, or at least not with inconsistent voices. But since every organization is made of individuals, it is critical to identify all relevant stakeholders within your own organization as early as possible that may affect the trust level in the relationship you are about to enter into. And also, it is important to achieve alignment of goals and objectives among those stakeholders, laying the foundation for later on implementing the relational tenet of mutual objectives.

**Action:** Identify all relevant stakeholders involved in the process, including top management, external advisors, procurement and sales managers. Ensure alignment before approaching potential business partners.

Second, organizations must seek to find partners – not just vendors to provide a good or service. The University of Tennessee has been researching successful supplier relationships for more than a decade. An interesting finding is that most organizations shift to relational contracts with pre-existing relationships by converting their transactional contract into a relational contract. But what if your organization does not have an existing business partner to fulfill a particular need? In that case, it is necessary to first find the right partner.

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:

- Request for quote/price (RFQ) – which emphasizes selecting suppliers based on the price they quote.
- Request for Proposal (RFP) – used to seek a more formal proposal from potential suppliers beyond simply price. RFP’s use a requirements specification to outline the goods or services that the organization wants to acquire and the potential suppliers submit proposals on how they will meet the specifications.
- 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.

In all cases, the focus is typically on the deal, not the relationship. It’s about picking a supplier to meet a need – not about picking a potential partner. For example, there is little if any exploration of behavioral norms and cultural fit of the potential partners. In addition, the emphasis is on managing the supplier with performance metrics and compliance rather than on seeking to co-create a governance structure to maintain continual alignment of interests when “business happens.”

More strategic relationships should use what is referred to as a *Request for Partner* process.<sup>34</sup> A Request for Partner process helps an organization find a business partner with not only the right capabilities, but also the right “fit” for the commercial relationship—within which the parties jointly



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will explore the needs, objectives, relational competencies and optimal solutions that will change over time as business happens.

This will of course have important consequences for supplier evaluation. In traditional procurement situations, evaluation of bids focuses on the service or goods offered, their functionality, quality and, of course, price. When focusing on the relationship, all this will still be relevant, but the customer must add a critical dimension of evaluating the *relational capabilities* of the different suppliers.<sup>35</sup>

**Action:** When looking for a strategic supplier relationship, use a Request for Partner process to evaluate potential suppliers on both technical and relational capabilities.

### Establish a Partnership

The transactional contract establishes a relationship with clear boundaries between the parties, an arm's length relationship. A relational contract establishes a different kind of relationship, a partnership *per se*. We have hesitated to use the term 'partnership' in this white paper for two reasons. First, it is an often abused concept by business professionals. One supplier said, "When my customer tells me they want me to be more of a partner, it is typically followed with the expectation for me to open up my checkbook." Second, lawyers in some jurisdictions eschew the term due to the legal definition of a partnership (e.g. a partnership creates a legal entity such as a joint venture).

Nevertheless, we have purposefully chosen to use the word partnership to describe a relational contract because there simply is no other term that better describes what characterizes the relationship established through a relational contract. While a relational contract does not create a "legal" partnership, it does create the spirit of relationship that embodies the spirit of a partnership.

### WHAT DOES THIS MEAN?

The difference between an arm's length and partnership type relationship is perhaps best described by legal scholar Ronald Dworkin. Dworkin establishes a clear distinction between what he calls a "rulebook community" and a "society of principles."<sup>36</sup> While the distinction is aimed at societal relationships rather than contractual relationships, it is nevertheless highly useful.

According to Dworkin, a "rulebook community" is a community that

"...accepts a general commitment to obey rules established in a certain way in that community. Imagine self-interested but wholly honest people who are competitors in a game with fixed rules or who are parties to a limited and transient commercial arrangement. They obey the rules they have accepted or negotiated as a matter of obligation and not merely as strategy, but they assume that the content of these rules exhausts their obligations."<sup>37</sup>



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This description of a rulebook community – apart from the part about wholly honest people – clearly fits the kind of relationship established by a traditional, transactional contract. The attitude is that the parties have clear and written obligations, but hold no commitment to each other besides what is in the contract. When the contract is silent, no one else will speak.

This should be contrasted with Dworkin's description of a society of principles, which fits the kind of relationship established through a relational contract. The parties to a society of principles accept

“...that they are governed by common principles, not just by rules hammered out in /.../ compromise. /.../ Members of a society of principles accept that their /.../ rights and duties are not exhausted by the particular decisions their /.../ institutions have reached, but depend, more generally, on the scheme of principles those decisions presuppose and endorse.”<sup>38</sup>

In a society of principles, a partnership exists in which “each partner is concerned not just to keep explicit agreements hammered out at arm's length but to approach each issue that arises in their joint commercial life in a manner reflecting special concern for his partner as a partner.”<sup>39</sup>

In a transactional contract, the corporate boundaries are kept strictly separate with rights and obligations and do not extend beyond the written clauses, whereas the relational contract creates more of a “virtual entity” based on certain underlying principles. A key difference is that a relational contract establishes the mechanisms through which principle-based behaviors will be enabled and rewarded.

### HOW DO YOU DO IT?

The normal state for most organizations is to have arm's length relationships. It makes sense when you think about it because an organization typically has hundreds, if not thousands of suppliers. The contracting process is fairly straight forward, typically started by one party writing a draft contract, and sending it over to their counterpart. Thereafter the parties meet in the ring for negotiations.

Establishing a partnership requires a different process. You must begin by understanding if you and your potential partner have a foundation that is strong enough to build a partnership.

As mentioned previously, trust is a critical success factor in all successful relationships. However, trust does not exist at the start of a new relationship. Trust must be consciously built – and the relational contract is a fundamental building block. *Trust* must be combined with a high degree of *transparency* and *compatibility*.<sup>40</sup> Why? Given our limited abilities for planning, high transparency from both parties will be critical. You will need as many facts on the table as possible to be able to cope with the future in a changing market. But even if trust and transparency levels are high, differences in organizational cultures could lead to friction and problems to make the relationship work. Compatibility is not absolutely necessary, but is still highly important.

Using the process we have outlined enables the potential partners to sit down, first by themselves and then together, and ask some serious and sometimes also uncomfortable questions:

1. Are we trustworthy? Do we align our actions with what we say?



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2. Are we prepared to work collaboratively and in good faith with our partner, or do we feel we must use power to induce them to do as we want?
3. Is there evidence that our potential partner(s) share our values and readiness to operate under shared principles?
4. Are we both prepared to be transparent, i.e. to share information about our plans for the future, our internal challenges, our risk register, our costs and even margins?
5. Are we compatible? Do we share a base of organizational value, interests and views of the world? Is this alignment likely to continue?
6. Do we have evidence to support our answers, or are we just hoping?

By using this process, the parties lay the foundation for implementing the relational tenets of a joint working relationship and communication, which are critical for the success of governance of any commercial partnership.

**Action:** Find out if you are ready to become partners with each other by understanding your initial levels of trust, transparency and compatibility.

Once you have ensured you have laid a strong foundation, you can then create a strong ‘society of principles’ by embedding social norms in the relationship, as explained next.

### Embed Social Norms in the Relationship

The transactional contract establishes what Dworkin calls a rulebook community. When the ink has dried on the contract, all the rights and obligations of the parties can be read in the written document. When the written document is silent and none of the parties can prove there is some oral agreement, no rights or obligations exist. Opportunism can flourish.

Society outside a commercial environment is different. In society, people have moral obligations toward each other. These moral obligations impact behaviors, feelings and actions. Take the norm of *honesty*. If we lie to you and you find out, we will feel ashamed – a symptom of the breach of a social norm. You may avoid us in the future, creating a pattern of passive-aggressive behaviors and actions.

Or take for instance the *norm of reciprocity*, which creates an obligation to return in kind. If we invite you to dinner, you will feel obliged to reciprocate and invite us for dinner or do us some other kind of favor (bring flowers and wine or offer to take us sailing on your boat). If you don’t reciprocate, you most likely will feel ashamed. We may blow off your actions as forgetfulness. But over time if you do not reciprocate, we will quit investing in the relationship and stop inviting you to dinner because we will not feel our actions are valued.

Social norms are not just a nice thing to say or to write about. Social science has proven a clear tie between social norms and the effectiveness of a society or a group of individuals.<sup>41</sup>



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But can (or should) basic social norms be embedded in contracts? The answer is yes. In fact, to convert social norms into contractual norms is one of the most critical steps of the relational contracting process, dispelling any idea that relational contracting is something soft and should be used outside the courtroom. After all, if social science has unequivocally linked the success of societies to adherence to the social norms among individuals and groups of individuals, why wouldn't you want to embed the social norms contractually in a business relationship?

Embedding social norms into the foundation of the contract is where the informal relational contract discovered and explored by such researchers as Macaulay and Macneil, mentioned in the introduction, is transformed into the formal, modern form of relational contract needed in the new economy.

### WHAT DOES IT MEAN?

A relational contract establishes a “society of principles” when the parties contractually agree to adopt a set of social norms or *guiding principles for the partnership*. These six guiding principles should be adopted:<sup>42</sup>

1. The principle of **reciprocity** – the principle obliges the parties to *return in kind*.
2. The principle of **autonomy** – the principles obliges the parties to *abstain from using power*, allowing each party to make autonomous decisions, independent of undue influence from one another.
3. The principle of **honesty** – the principles obliges the parties to tell the truth about facts and their intentions.
4. The principle of **loyalty** – the principle obliges the parties to look out for each other's *interests* and treat each other's interests with equal value. This means, amongst other things, that risks and costs must be allocated to keep them as low as possible in the partnership.
5. The principle of **equity** – the principle obliges the parties to keep proportionality in the contract, for example between risk and potential rewards.
6. The principle of **integrity** – the principle obliges the parties to be consistent over time, i.e. to treat like cases alike and to avoid opportunistic behavior but to always, when in doubt, act in accordance with the other guiding principles.

Why do we list those guiding principles and not others? There are several answers to this question. First, think of what would happen if you try to establish a partnership and take any of those principles away. Would a partnership without honesty and loyalty survive for long? A relationship without equitable allocation of risks and costs would soon deteriorate, as would a relationship which, in breach of the integrity principle, is not consistent over time in applying the other principles.

Second, each of the six guiding principles are based on scientific research in psychological, social and economic theory. As we have said above, research has clearly proven a link that these principles are not only important, but also that societies and groups that adhere to these norms out-perform those where the principles are missing.



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Third, it should be noted, the six guiding principles listed are not necessarily an exhaustive list of all known social norms. Contracting parties of course may add any other social norms or guiding principles they think are relevant. For example, one organization added a guiding principle of transparency, creating an obligation to share information because it is was critical to the success of the partnership to transparently share information.

It is the authors' opinion that most other principles that organizations come up with can be related to these six principles or a combination of them. For example, the principle of transparency follows from the principles of autonomy, honesty and loyalty. To allow both parties to make autonomous decisions, they need as much good and relevant information as possible. Honesty does not only oblige the parties to ensure that what they say is true; it also obliges not to withhold important information. Holding back on information is also dishonesty. Finally, transparent sharing of information facilitates efficient and effective communication and problem-solving, ensuring that the total costs of the partnership are kept as low as possible, as required by the loyalty principle.

The guiding principles fulfill at least four important functions in the relational contract:

1. They will guide the parties during the rest of the negotiations. The only valid arguments in the discussions are those that can be justified under one or more of the guiding principles.
2. All the contract clauses shall be aligned to the principles. This will to a maximum extent ensure that the contract is fair, balanced and facilitates the creation of a frictionless relationship.
3. The guiding principles shall, together with the shared vision, constitute the basis for interpreting the agreement, both when the written clauses are ambiguous and when the contract is silent on a particular matter. We will deal with this further in the next section.
4. The guiding principles will also assist the parties when making changes to the contract.

Not only will the guiding principles ensure a fair and balanced agreement, but they will also ensure that the contract remains mutually beneficial throughout its term. To use power will be a contract breach because of the agreed-upon principle of autonomy, so when dealing with change the parties must find solutions sanctioned by the principles of loyalty and equity. Any solution that harms one party more than it is beneficial to the other party will be in breach of the principle of loyalty and the principle of equity will ensure avoidance of opportunistic risk transfer to the other party. As we will see in the next section, the guiding principles are therefore also a key instrument for risk avoidance and mitigation.

By embedding the guiding principles in the relationship, the parties also lay the foundation for implementing the relational tenets of risk allocation, communication, pain and gain sharing, and a no-blame culture, to be formalized in the fourth and fifth steps of the relational contracting process.

Will the guiding principles create a failsafe system? Of course not, but they will create a system that is in a much better position to create and keep interests aligned than the transactional contracts, which only deals with conflicts of interests as a fact that cannot be avoided at all.





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### HOW DO YOU DO IT?

To a greater or lesser extent, the guiding principles exist in most relationships. However, because they rarely are stated and openly discussed, we are often unaware of the presence of the principles as social norms in our relationships. In many cases, we deliberately (or subconsciously) ignore them in our search for short term advantages. The first step when adopting the guiding principles is therefore to have an open and candid discussion and define each of the guiding principles. We think of this as “discovering” each principle. As social norms, they exist between the parties before the discussions start, so they are not invented. For most, it will be the first time the parties (or even individuals) have ever openly discussed how to apply social norms in a business context – let alone a contract.

The six guiding principles are best codified in a code or charter to the relational contract – preferably right upfront. Some organizations put this in the main body of the contract while others create a Schedule (often the first Schedule) to codify their intentions of how the parties will behave over the life of their relationship. In appendix 2, we have included an example of how the guiding principles can be documented in a contract.

**Action:** The parties should “discover” and together define the guiding principles and formalize them as part of their contract.

### Avoid and Mitigate Risks by Alignment of Interests

As we have seen in Part 2, a transactional contract mitigates risk through the use of a combination of market and state power. The conflicting interests are accepted and their symptoms are attacked. Even if the parties to some extent do share goals and objectives, they rarely have any obligations to look out for each other’s interests when goal conflicts arise.

In the relational contract, you take a different approach: you attack the causes of conflicting interests and not their symptoms. The intention is to always keep interests aligned.

### WHAT DOES IT MEAN?

Misaligned interests are the most common cause of value leakage and unnecessary transaction costs. *It is only when the parties’ interests are misaligned that opportunism becomes a problem in a commercial relationship.* The source of misaligned interests is *conflicting goals and objectives*. If a customer’s goals and objectives can be achieved only at the cost of a supplier not achieving its goals and objectives, interests will be misaligned and opportunism and friction will follow as a necessary consequence. For example, an important source of value leakage is that the customer’s goal of lowering their costs comes into conflict with the supplier’s goal of increasing their revenue and margin. This is not a goal conflict given by nature, but instead a result of conventional economic models most often used in commercial relationships today.

A relational contract – by design – seeks to align interests by avoiding goal conflicts between the parties. Joint – not separate - goals and objectives should be adopted. To do this follows logically





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from the adoption of the guiding principle of *loyalty* described in the previous section. Loyalty requires that each party's interests are treated with equal value. To build in conflicting interests into the relationship would be a breach of loyalty since it will mean that one party's interests will be considered less valuable.

There are three main components in a relational contract that aim for risk mitigation and avoidance through aligned interests:

1. The six guiding principles
2. A shared vision and a set of common strategic objectives for the partnership
3. A governance process for continuous risk and change management

We have already discussed the six guiding principles and we will discuss governance later. Below we focus on the shared vision and strategic objectives. We will also briefly discuss the importance of finding the right economic model for the partnership.

### HOW DO YOU DO IT?

To adopt a shared vision and strategic objectives is to adopt a common view of what is valuable. An individual's and an organization's interests are tied to what they perceive as valuable. In the market, what is valuable is most often tied to goals and objectives that, when achieved, generate revenues or improves productivity. For public and non-profit organizations, what is valuable is often tied to the task or function to be fulfilled, for example providing health care, infrastructure or education.

A shared vision for the partnership can be created based on what the parties perceive is valuable. This is a powerful exercise and should always be done jointly. An effective method is to let everyone in the room think about a few words that they want to be included, words like "together", "customer satisfaction", "empower" and "world-class quality". Everyone in the group then can assign three votes to the words that the group has come up with, thereby indicating a direction for the continued work. After this, the parties can create draft statements, which step-by-step are merged into a view of a bright future – the shared vision. A good shared vision should not be too long, paint a successful common future, and be aligned to both parties' business strategies. You know when you have a good shared vision when everyone in the room smiles and feels engaged and wants to roll up their sleeves immediately to achieve the vision. For example, Vancouver Coastal Health and its strategic partner for environmental services created the shared vision below<sup>43</sup>.

*Patient and Resident focused Environmental Services that are of the highest quality and reliability. Our commitment to collaboration, innovation, and shared governance will drive value and create an exceptional healthcare environment for all.*

The process for getting to a first draft can often be quick, but we advise that the parties then take a break for a day or two, allowing for the organizations to socialize the draft and time for individuals to reflect. This will allow for new insights and thoughts about changes or adjustments. It will also prevent the urge to spend hours wordsmithing.



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**Action:** Create a shared vision for your partnership and document it.

When you have created a shared vision, it is often a good idea to break it down into several shared objectives, which specifies in more detail what the shared vision means. The objectives range based on the intent of the relationship. Objectives typically fall into one of three categories.<sup>44</sup>

- Outcome-based – which are boundary spanning transformation business outcomes that typically can be achieved only with a high degree of collaborative (e.g. the mountain climber cannot get to the top of Mt. Everest without the Sherpa).
- Output-based – which typically tie to a specific scope of a one or both parties (e.g. Service Level Agreements tied to a supplier's workscope)
- Transactional – which is typically linked to the effectiveness of a specific task or activity.

In a relational contract, the objectives should typically be outcome-based or output-based. Common objectives can be to increase customer satisfaction, lower the total cost of ownership, gain market shares, avoid business interruptions, etc. We advise using a maximum of 4-6 objectives – otherwise, the parties will lose focus in governing the relationship.

**Action:** Break down the shared vision into strategic objectives.

Having adopted a shared vision and strategic objectives, the relational tenet of mutual objectives will have been implemented. We must however emphasize that these alone may not be enough to align interests. It is typically also necessary for the parties to take a hard look at how risks will be allocated and at the economics of the deal, as both can create perverse incentives due to conflicting interests. Each of these is discussed in more detail.

We'll first look at risk allocation. Risk should be allocated following the guiding principles, which would have already been agreed to and adopted. It is important to understand the role of the guiding principles in avoiding and mitigating risks in the partnership. As stated previously, the guiding principles will not only guide the relational contract process and negotiation; they will also have hard consequences for the contract content.

It is important to recognize – again – that no matter how perfect your objectives and planning are at the onset of the contract, all contracts are incomplete. Conflicts of interests will unavoidably arise anyway - as business happens, changes in the market occur, and priorities shift. Your contract will be full of cracks and holes with risks and events not dealt with in the contract clauses. When this happens, it is important to go back to your shared vision and guiding principles. Why? The shared vision and guiding principles fulfill an important role in dealing with the tricky combination of arising conflicts of interest in an incomplete contract. This is done by agreeing on how the contract shall be interpreted when something is ambiguous or even silent in the contract.



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How to interpret contracts is an important part of contract law in most jurisdictions. But the legal rules and principles for interpreting contracts vary significantly. In Common Law countries, the four corners of the document principle is a key component, even though the principle today has so many exceptions it can be discussed to which extent the principle still applies. In other legal traditions, for example in civil law countries, more attention is paid to the intentions of the parties at the time of signing the contract.

In a relational contract, the parties should contractually agree that the contract clauses shall be interpreted in the light of the shared vision and guiding principles. They should clearly agree that the shared vision and principles shall, so to say, fill in the blanks when the contract is silent on which rights and obligations the parties have in a particular situation. For some, this may seem to be a controversial move to make. To say that the shared vision and guiding principles shall apply when the contract is silent means to add obligations where the contractual language in the contract is silent or uncertain. For a contract lawyer used to “Entire Agreement” clauses where the goal is to ensure contract obligations are exhausted by the written word, this will seem risky. This perception is, however, based on the incorrect transactional contract assumptions that contracts can and should be complete. As we have seen, this is an illusion. All complex contracts are incomplete and unless the cracks and holes are dealt with through the shared vision and guiding principles, opportunism will enter and value will erode. To ensure that the contract is interpreted in light of the shared vision and guiding principles therefore *decreases* the risk of the relationship significantly. Remember also Dworkin’s description of a society of principles shared above; by definition, a partnership contains rights and obligations broader than the written word.

<p><b>Action:</b> 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.</p>
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The second key consideration comes in structuring the economics of the relationship. It would be naïve to think that money doesn’t matter. As such, it is important to understand the context of an economic model as it relates to a relational contract. To be clear, the economic model of the relationship - how which the parties generate and allocate value between themselves – is *not* an integral part of the relational contract. Different economic models can be used in a relational contract. Rather the economic model is a component of the relational contract. Think of the relational contract as setting the *rules of the game* for the relationship and the economic model as establishing the stakes of this game.

The economic model can in many deals create either aligned or conflicting interests. When these are conflicting, it will undermine the relational contract’s purpose to create continuous alignment of interests. The very process of creating the relational contract enables the parties to solve the often toughest part of any commercial negotiation – the price/value negotiation. As a result of adopting the guiding principles, the parties will be both obliged and incentivized to find a model that, without the use of power, respects loyalty and equity, i.e. that treats both parties’ interests with equal value and apply proportion between risk and rewards. The important relational tenet of sharing of gains



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and pains should be implemented here. The various economic models that can and should be used under different circumstances in customer-supplier relationships are thoroughly examined in the book *Strategic Sourcing in the New Economy*.<sup>45</sup>

**Action:** As part creating a relationship with aligned interests and maximized value creation, jointly work out the economic model that best incentivizes the parties to achieve the shared vision and strategic objectives, while respecting the guiding principles and relational tenets,

### Create a Fair and Flexible Framework

As we have discussed, a transactional contract tries to be complete in the sense that there should be no future events that the contract cannot deal with. The theory and practice is that transactional contracts should never be silent, no matter what happens.

This ambition can actually succeed in some cases. Often, a transaction is a simple exchange of a product for money and all the likely risks can be dealt with through a contract. But, as we have seen, more and more organizations are entering into contracts that are not simple. Many contracts are rooted in an environment that is complex, uncertain, and demands flexibility and speed. Attempting to write a complete contract dealing with everything in the future is naïve. Remember the contracting paradox discussed in the introduction of this white paper. This does however not mean that those authoring contracts should resign, succumbing to their limited ability to predict and plan for the future. Rather it means today's contracting professionals need to adapt to new ways of authoring contracts that are both fair and flexible.

#### WHAT DOES IT MEAN?

A relational contract gives up the ambition of completeness and accepts that complete planning is impossible. The contracting parties try to establish a fair and flexible framework for their deal *and* their relationship. The relational contract operates as a *framework*, setting forth clear rights and obligations as the parties pursue their mutually defined shared vision and objectives. But on a more general level, a relational contract is designed for *flexibility*, enabling the parties to deal with change – not just change control. This means creating a sound governance structure and mechanisms to help the parties manage the business in a dynamic environment, not just enabling the customer to manage the supplier. The guiding principle and relational tenets ensure that the explicitly laid out rights and obligations *and* the processes for managing the relationship are kept *fair* during the term of the contract.

We have stated previously that the foundation of a relational contract is trust. Sometimes we are asked if the relational contract should contain common clauses like service scope, service levels, confidentiality, termination clauses, limitation of liability, dispute resolution, etc. The underlying question is whether it is compatible with trust to want to implement legally enforceable rights and obligations in the relationship. Isn't it a signal of distrust to ask for such rights and obligations?



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This requires some reflection. Trust is a complex phenomenon. But it should not be mistaken for naivety. We have noted how as humans we tend toward opportunism, looking out for our own interests to the detriment of others. Evolution has made us that way and it would be naïve to ignore this fact. And somewhat paradoxically, trust exists because of opportunism. To trust someone is to have confidence that she will do what she says, *despite* her opportunistic DNA. Without opportunism, trust would serve no purpose.

But trust also exists because evolution simultaneously has made us into moral creatures, having a strong sense of fairness, shown for example in the Ultimatum Game referred to previously. If we were *only* opportunistic, trust would – again – serve no purpose. To trust someone is to have faith that a person's sense of fairness will be stronger than her tendency for opportunism.

So, trust rests on our combined and opposing tendencies for opportunism and sense of fairness given to us by millions of years of evolution. The relational contract aims to create circumstances favorable for our sense of fairness to dominate over our opportunistic nature. But that does not mean this opportunistic nature is ignored.

It is therefore not necessarily a signal of distrust to ask for clear and legally enforceable rights and obligations in the relational contract. Instead, it would be naïve, and often commercially very risky for the relationship, not to include clear rights and obligations. The key is: *It is not personal when we ask for clear legal rights and obligations, it's just accepting how evolution has made us.* But since we also must accept our strong sense of fairness, those rights and obligations must not be listed in excess, which would indeed be a strong signal of distrust. And also – and this is critical – those rights and obligations must all be aligned with and be justifiable under the guiding principles described earlier.

### HOW DO YOU DO IT?

At this stage of the process, three cornerstones of the framework have been placed. These cornerstones are the shared vision, the strategic objectives and the guiding principles. Here is how they work together.

- The shared vision and the objectives are set at the beginning of the relationship. They can of course be changed over time, but they should typically lay the foundation for the foreseeable duration of the contract.
- The guiding principles should be considered fixed and should be strictly adhered to not only during the contracting process, but also post contract signing.
- The parties should be flexible in the means they use to achieve shared vision and objectives, as long as they always act in accordance with the guiding principles.

To create a fair and flexible framework based on the three cornerstones requires the parties to agree on clear rights and obligations regarding 'the deal' and the risks related to it and the relationship. In addition, the parties must agree on a robust governance process for managing the relationship.

As set out above, the parties must agree on clear rights and obligations regarding the goods or services of the deal, their quality and timely delivery. The parties will also have to agree on the



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contract duration, payment terms, confidentiality, rules for terminating the contract, how to compensate each other if breaches occur, what limits should be set to the parties' liabilities, ownership of intellectual property, etc.

The trick is to find an appropriate level of detail to ensure that it is a *framework* and not a complete manual. The clauses you adopt in the contract will play a role in interpreting the contract. But the contract language you don't write will play an important role in providing the flexibility you need to manage change in a dynamic business environment. The key is finding the right balance.

The guiding principles play a vital role in developing and interpreting contractual clauses and language. First, the parties must ensure that all the written clauses are aligned to guiding principles from the start. Second, the guiding principles provide a way of interpreting the clauses (and lack of contract language).

A quick look at a typical transactional contract shows that many of the typical clauses are in breach of the guiding principles. Some examples are:

- Non-reciprocal and non-equitable audit rights, indemnification rights or limitations of liability.
- Sweeper clauses obliging the supplier to provide services without a right to compensation per the equity principle.
- Termination for convenience clauses giving one party discretionary power in the relationship, in breach of the autonomy principle.
- Limitation of liability clauses that fail to keep the risks for the relationship low, breaching the loyalty principle.

To be clear, clauses about audit rights, indemnification, limitation of liability, termination for convenience, etc. are not as such in breach of the guiding principles. But in transactional contracts, they are typically written in breach of those principles. In a relational contract, they can and often should be used. But the intent and wording must be fair and balanced, aligning to the guiding principles.

Think about this: what would it mean to make all the clauses of the contract aligned to the guiding principles? Take, as an example, the limitation of liability clause. To make this clause aligned to the guiding principles would mean to find the allocation of risks that keeps the risks as low as possible for the partnership. Part of the solution is to, according to the loyalty principle, allocate risks to the party having the cheapest insurance policy covering the potential liability. But it is impossible to buy insurance for all risks and for those risks the parties must, according to the equity principle, make sure that the party carrying those risks is also compensated with proportionate potential rewards.

And what about the allocation of risks for unforeseen factors regarding a set of outsourced services that could potentially have been but was not discovered during the due diligence phase of the contract negotiations? A powerful customer would typically shift those risks to the supplier, using a scope sweeper clause. Of course, this is something the supplier would resist, wanting to be compensated for unforeseen additional costs. The guiding principles will here help the parties to find the right balance between the customer's obligation to transparently inform the supplier about





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the services and the supplier's obligations to use its knowledge and expertise to investigate and ask questions before offering prices.

Or what about termination for convenience? Could such a clause be compatible with the guiding principles? That seems a challenge, especially since this kind of clause is a classic power instrument used by the customer side. But what if the reciprocity principle is used, making the termination right mutual? That would create more of a power balance between the parties. And what if the parties also negotiated equitable compensation clauses, making sure that neither party loses money apart from future revenues as a result of the termination for convenience clause.

It is important to understand that there is seldom one “right” answer or solution when it comes to clauses such as the ones discussed above. What would be an unfair indemnification clause in one contract could be compatible with the guiding principles in another. This is partly because it is necessary to always look at the total risk allocation in the contract when assessing its overall fairness. It is also because the *process* of agreeing on a particular clause – with honesty, reciprocity and autonomy – is as important for a clause's fairness as its actual *content* or the result of the process.

The last remaining cornerstones of a relational contract is creating a structure and mechanisms for managing the relationship post contract signing. This is often referred to as *governance* and it is crucial to sustaining the relationship, ensuring continual alignment of interests and helping the parties to remain focused on the vision and objectives. Sound governance includes incorporating these seven mechanisms into how you will jointly manage the relationship post-contract signing<sup>46</sup>:

- 1. Create a tiered management structure.** The number of tiers can vary based on the scale and complexity of your relationship. The most common is a three-tier structure that enables the parties to focus at the operational, management, and strategic or executive levels.
- 2. Establish clear roles.** Good governance ensures the parties focus on managing for today (service/product delivery), managing for tomorrow (transformation and change management), managing the economics (commercial management) and managing the overall relationship. We recommend larger contracts not only clearly spell out the roles, but also establish separate roles for areas to enable proper focus. A separate transformation role is essential for large scale outsourcing deals where transformation and innovation are essential.
- 3. Establish peer-to-peer communications protocols.** To enable efficient and effective communication, the parties should shorten the communication lines and let the right people on each side connect and communicate directly and not via an account manager or contract manager.
- 4. Develop a communications cadence.** To keep momentum in the relationship, the parties should agree to a frequency for their meetings at the operational, tactical and strategic levels.
- 5. Develop a process to maintain continuity.** A relationship is created by people and if people in the governance structure change, it is critical to have processes ensuring that new individuals are educated and taken on board the relationship in a way that ensures continuity. We recommend larger contracts establish “key man” provisions for both parties.





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6. **Establish a performance management program.** The parties should agree on joint reports to continuously follow up their performance, i.e. their journey towards the shared vision and strategic objectives.
7. **Establish processes for risk management and contract changes.** 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. As part of this, they should agree on a process to continuously identify, assess and deal with upcoming risks. If a need for change arises (i.e., identification of new risk or other factors), the parties should have a simple process for formalizing such changes and make them legally binding. It goes without saying that all changes must be aligned to the adopted guiding principles.

By incorporating the seven mechanisms above into their governance structure, the parties will have implemented the relational tenets of communication, problem-solving, no-blame culture, joint working, mutual objectives, and performance measurements. If the commercial deal is about the delivery of service, the parties should also incorporate the relational tenet of continuous improvement and create mechanisms for driving developing, measuring and monitoring improvement opportunities.

**Action:** Jointly agree on the best governance structure and mechanisms to enable the parties to, respecting the guiding principles, achieve their shared vision and strategic objectives while also dealing with change and unforeseen events.

### Relational Contracting as a Process

People sometimes ask us whether it is necessary to use the formal process we have outlined in this white paper when architecting a relational contract. They argue creating a solid relationship should come naturally and should not feel “forced” with the process.

We want to be clear; we have definitely seen many organizations that have created very successful relational contracts and did not use this, or any, formal process. Instead, they discovered the journey for themselves, often by intuitively implementing the various components we suggest – for example, the relational tenets. While we know getting to a good relational contract can be done without using a formal process, we do want to emphasize that we believe using the simple five-step process we have outlined will definitely help you facilitate the foundation for a sound relational contract.

Clearly, the process we recommend in this white paper is not the only one that can be used. However, we do recommend the process in this white paper for three reasons.

First, we have seen firsthand that the process outlined in this white paper works. It has been used by many organizations with success.



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Second, we suggest following the formal process because it helps ensure the parties do not start from the wrong position. For example, it is very easy to start by discussing the deal and the money related to it. But as seen previously, this will bring out our opportunistic nature from the start. Getting out of the gate wrong can make it very hard if not impossible to build a strong foundation of trust needed if the parties have not intuitively followed the guiding principles we outline.

Last, following the formal process we have outlined ensures that your relational contract will have the essential elements of success – i.e. the shared vision, guiding principles, nine relational tenets and so on.

Is it necessary for a relational contract to include all the nine relational tenets or components – for example, mutual objectives? The answer is likely not. Should you formally document the guiding principles as we suggest, or can you rather just “do” them? The answer is it depends. In some organizations, the culture is such that they consistently live into the guiding principles. In others, individuals may be tempted to violate these essential social norms, which will most likely erode trust. In these organizations, it is essential to document and institutionalize the guiding principles. The critical point is to ensure that the guiding principles are adopted in practice. It is for example only then that the relational tenets will deliver their full value.

In Part 4 we show the importance of a relational contract grows as interdependency, risk, costs and complexity grows. At the higher end of the spectrum of those factors (the most valuable and strategically important relationships), it will be very hard to succeed without including all the components we recommend. At the same time, this means that not all components must necessarily be used for relationships that may less interdependency, risk, costs and complexity. For example, the typical organization has hundreds if not thousands of suppliers. Simply put, relational contracts should not be used for all of your supplier relationships. Do you really need a relational contract for working with a pen supplier? However, as your relationships shift along the sourcing continuum, you will likely find value in using a more formal process for creating a relational contract.

We want to emphasize that using a relational contract approach from a certain perspective is an all-or-nothing choice. *You cannot, if you want to succeed, play an opportunistic and a collaborative game simultaneously.* The opportunistic player will then take advantage of the collaborative player and the relationship will fail. Therefore, you have to *jointly* choose which game to play and stick to that choice. With that in mind, you can then determine how formal of a process you want to use for embedding the concepts we outline into your relationship. We highly recommend that no matter what process you use or how formal or informal the process, it is essential to make the six guiding principles a key focal point of any relational contract. A relationship where reciprocity, autonomy, honesty, loyalty, equity and integrity do not exist will never establish the level of trust and transparency needed to get out of the contracting paradox discussed in the introduction.

### PART 4: WHEN TO USE A RELATIONAL CONTRACT

While transactional contracts may be acceptable in many situations, this paper argues that they are not fit for more strategic and complex commercial agreements. Simply put, the business world has evolved and organizations must evolve their contract vehicles as well. The new economy demands that organizations take a broader view of contracting by adopting relational contracts as a critical enabler for doing business.

The reasons for choosing the relational contract will vary depending on who is making the choice and the situation at hand. A good way to think about it is to ask, “Is beef a commodity?” It might be to the local grocery retailer but for McDonald’s, beef is a strategic weapon and commands a highly strategic relationship with suppliers.<sup>47</sup> A customer thinking about outsourcing will have a different perspective than a supplier trying to gain a competitive advantage. A government planning to build a hospital will have a different perspective than a technology company that wants to join create a strategic alliance to join forces with companies in other markets. And so on.

However, given what everyone is trying to achieve with any contract – to plan for the future while coping with our limited capabilities for planning and the tendency for opportunism – some common factors will always point towards a relational contract as the optimal choice.

IACCM suggests that organizations use more relational contracting vehicles as interdependence, risk, complexity and rising costs. Research from the University of Tennessee offers additional insights, building on the work of Nobel Prize winner Oliver Williamson. University of Tennessee researchers suggest that business relationships fall along a continuum separated into three classifications: 1) transactional, arm’s length relationships, 2) relational contracts and 3) investment-based relationships where business transactions are managed and controlled through ownership in joint ventures, shared service centers, etc.<sup>48</sup> Which relationship model is best to use varies depending on the characteristics of the environment and the deal, and what the parties want to achieve. The researchers outline 12 attributes that point practitioners to the most appropriate classification for their situation. These attributes fall into three categories:

- What is the overall level of dependency associated with the product or service?
- What is the strategic impact of the product or service category? Does this product or service provide your organization with a core competency or competitive advantage?
- What is the degree of risk associated with this product or service category?

To find the best-fit relationship model, practitioners can use a relationship model mapping tool (an example is shown on the next page).<sup>†</sup>

Let’s look at an example of how the mapping tool works on the following page when a pharmaceutical company mapped supplier dependency for Clinical Research Outsourcing with a strategic supplier.

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<sup>†</sup> The complete tool also enables the parties to find the best fit economic model for the relationship. The tool can be downloaded on <http://www.vestedway.com/self-assessment/>

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**Exhibit 3 – Example Mapping Exercise to Determine Appropriate Relationship Model**

Attributes to Determine Best Relationship Model	Transactional Contract		Relational Contract			Investment
	A	B	C	D	E	F
<b>Dependency</b>						
Overall cost to switch suppliers	Low	Low	Medium	Medium to High	Medium to High	High
Physical asset specificity (location, machinery, processes)	Low	Low	Medium	Medium to High	Medium to High	High
Skill level needed for predominant personnel	Unskilled	Semiskilled	Skilled	Professional	Professional	Expert
Level of supplier integration/interface required (systems, support processes)	None	Low	Medium	High	Very High	Critical

Using the tool is not a mathematical exercise, but instead is a way to obtain a common understanding of the business, enabling the parties to make a wise decision on which type of contract to use.

Even though the mapping tool involves many attributes, the underlying logic is simple. The basic question to ask is *to what extent is the alignment of interest between the parties important*. In a situation characterized by high dependency, risk, and complexity, the costs of misaligned interests will often destroy any potential value in the deal. Under such circumstances, it will not be possible to use power without facing the costs of retaliation. Therefore, it is critical to use a relational contract that enables the parties to continuously align their interests.

When dependency, risk, and complexity are low, an arm's length transactional contract can be used since the risks of misaligned interests can be mitigated through market power.

When using the mapping tool, it is easy to understand why a relational contract is the recommended approach for more strategic deals being done in the new economy. Contracts regarding outsourcing of integrated facilities management, finance processes, integrated IT services, complex construction projects, or supply chain management services are a few good candidates for a relational contract. Relational contracts are good for these types of relationships because typically a competitive advantage cannot be gained in an arm's length relationship and misalignment of interests creates friction and high transaction costs.

### PART 5: CONCLUSION AND CALL TO ACTION

Think of this analogy. Newtonian physics - largely discovered and developed by Sir Isaac Newton and many of his 17th-century contemporaries, was the mainstay of classical mechanics through much of the 20<sup>th</sup> century. When Albert Einstein came along with his theory of relativity, Newtonian physics was not abandoned but incorporated into a broader system of thinking.

The same intellectual action is needed in contracting. The relational contract will not and should not replace the transactional contract. Instead, it is necessary to incorporate transactional and relational contracts into a more comprehensive system that explains the characteristics of both, including explaining when each contract model is needed.

In this white paper, we set out with a goal to become the go-to practitioner's guide to help individuals and organizations better understand relational contracting. We end with the challenge for those individuals who play a role in forming or managing business relationships and writing contracts to take time to reflect on how relational contracting can improve the results for your organization.

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

Here are four things you can start doing today in your journey towards relational contracting:

1. Arm yourself with facts about transactional and relational contracts. Investigate whether you suffer from problems in your transactional contracts and analyze whether the problems can be understood as a result of the weaknesses we have discussed in this white paper. Investigate your most successful commercial relationships and analyze whether success may result from the use of relational contracting elements. Facts must be your weapon when confronting superstitious beliefs and skepticism about relational contracts.
2. Involve the right stakeholders. Upper management should become aware of the potential advantages and economic upside associated with relational contracting. Make them your allies and sponsors.
3. Start with lower-risk contracts and call it a pilot. De-risk and build a success story from which you can continue using relational contracting for bigger and more business-critical contracts.
4. Be very forgiving and patient with nay-sayers and skeptics. Relational contracting will meet resistance, regardless of the undeniable evidence of its advantages in many situations. We are all humans and typically don't like change. Hesitation should not be confused with bad intentions. Instead, try education as your change agent. *Please remember that this white paper is available as a free, open-source document and we encourage you to share it with your colleagues, clients, customers, suppliers and business partners.*

## UNPACKING RELATIONAL CONTRACTING



If you are hesitant and still want to try, start by implementing one or a few of the relational tenets and see what happens. Start the journey from left to right on the continuum showed on page 5! It should then be clear to you this will not mean you are creating a relational contract - that will only happen when you make the guiding principles the true North of the relationship. But you will then maybe have started a relationship journey that hopefully will lead you to adopt the relational contracting approach in full in those commercial relationships where this contract model is the best fit and will produce the most value to your organization.

Good luck with your relational contracting!



# UNPACKING RELATIONAL CONTRACTING



## APPENDIX 1

### Definitions of Nine Tenets of Relational Contracting

Relational tenet	Description
Communication	A defined framework for communication planning – what, when and how – and a forum established for monitoring the effectiveness of communications and driving future improvement.
Risk allocation	Ensuring that the allocation of risk under the contract does not act as a disincentive to collaboration and there are methods established to deal with the unknown or unexpected.
Problem-solving	Agreeing on principles for how problems or future misalignments and change requirements will be identified and resolved, including clarity over review and escalation procedures and paths.
No-blame culture	Establishing operational principles that focus first on resolution and the principle ‘we are in this together’, but with clarity over individual roles, responsibilities and accountability for performance.
Joint working	Defining the benefits and rationale for joint working and establishing criteria to determine when and for how long it is required.
Gain and pain sharing	Ensuring the allocation of risk and reward provides each party with the right incentives for success and for introducing added-value through continuous improvement and innovation.
Mutual objectives	Aligning goals and objectives across the parties to ensure consistency or understand different interests; establish where there are areas of uncertainty and the likelihood of changes in objectives over time.
Performance measurement	Determine the measures and performance indicators that are critical to success for each party and ensure there are methods for shared data gathering and review.
Continuous improvement	Develop a framework for delivery of continuous improvement and verify that the necessary mechanisms exist; for example, through the approaches established for communication, gain share, performance measurement.



## APPENDIX 2

### Example Contract Language for Including the Six Guiding Principles

The Guiding Principles below set the tone for a collaborative business relationship that replaces a traditional competitive relationship characterized by conflicting, negative or non-productive social norms, often leading to deterioration in trust between the parties and the creation of a dysfunctional working relationship.

#### 1. Guiding Principles

The parties commit to adhere to the Guiding Principles during the establishment of their relationship and to maintain that commitment throughout the term of the contract for the scope of Services in this contract. This commitment is intended to assist the parties to establish a positive environment designed to purposefully build trust in the relationship.

##### 1.1. Reciprocity

We will strive to make fair and balanced exchanges that are mutually beneficial to the parties. We will not place any expectation upon the other that we ourselves are not willing to return in kind. We recognize that reciprocity lies at the heart of our partnership's ability to reach its goals and will ensure that short-term and long-term requests are for the benefit of the relationship.

##### 1.2. Autonomy

Neither party will seek to use its power against either party's best interests or those of the relationship. We will strive to transparently make as much information available as possible to allow our partner to make good decisions for itself and the relationship. We recognize that working together and being free from coercion ensures our ability to reach our own goals and those of the partnership.

##### 1.3. Honesty

We will have accurate and genuine conversations at all levels within the relationship. We will speak the truth about facts and about our intention, not withholding information being relevant for the success of our partnership. We will also separate the facts from people's observations, perceptions, and experiences, and we will speak to our own perception. We will then look for the greater good that can come from accepting all points of view as relevant for seeking greater value for all stakeholders.

##### 1.4. Loyalty

We will champion and protect the value of the other party's interests to the same extent that we value our own individual interests. The partnership creates more value for both parties than acting separately. We will therefore be loyal to our partnership, striving to allocate costs and risks to the party in the best position to carry and mitigate them.

##### 1.5. Equity

We acknowledge that some situations will require an unequal distribution of risk or investment. In those situations, we will strive to compensate each party in proportion to the value, risk, costs incurred, or investment made to the partnership.

##### 1.6. Integrity

We will avoid opportunistic behavior and continually strive to make decisions consistent with the Guiding Principles in the best interests of the partnership. To achieve results, we will align our actions with our words. We will do what we say.

## UNPACKING RELATIONAL CONTRACTING

### ABOUT THE AUTHORS



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**Kate Vitasek** is an international authority for her award-winning research and Vested® business model for highly collaborative relationships. Vitasek, a Faculty member at the University of Tennessee, has been lauded by *World Trade Magazine* as one of the "Fabulous 50+1" most influential people affecting global commerce. Her work has led to 7 books, including: *Vested Outsourcing: Five Rules That Will Transform Outsourcing*, *Vested: How P&G, McDonald's and Microsoft Are Redefining Winning in Business Relationships* and *Getting to We: Negotiating Agreements for Highly Collaborative Relationships*. Vitasek has also been featured on CNN International, Bloomberg, NPR, and on Fox Business News.



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***Cirio*** law firm is one of the largest business law firms in Sweden, with a particular focus in ICT, energy, life science and real estate. The firm also offers advice to Swedish and international clients on relational contracting and Vested deals in outsourcing, supply chain and strategic partnerships.

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## UNPACKING RELATIONAL CONTRACTING

### FOR MORE INFORMATION

**The University of Tennessee** is highly regarded for its Graduate and Executive Education programs. Ranked #1 in the world in supply chain management research, researchers have authored seven books on the Vested business model and its application in strategic sourcing.



We encourage you to read the books on Vested, which can be found at most online book retailers (e.g., Amazon, Barnes and Noble) or at [www.vestedway.com/books](http://www.vestedway.com/books).

For those wanting to dig deeper, UT offers a blend of onsite and online courses including a capstone course where individuals get a chance to put the Vested theory in practice. Course content is designed to align to where you are in your journey ranging from Awareness to Mastery. For additional information, visit the University of Tennessee's website dedicated to the Vested business model at <http://www.vestedway.com/> you can learn more about our Executive Education courses in the Certified Deal Architect program. You can also visit our research library and download case studies, white paper and resources. For more information, contact [kvitasek@utk.edu](mailto:kvitasek@utk.edu).



\* Prerequisites for **Creating a Vested Agreement** class are:

*Five Rules, Is Vested Right?, Getting Ready, and the Vested 3-Day Executive Education Course*



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### ENDNOTES

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