A New Approach to Contracts

How to build better long-term strategic partnerships

by
David Frydlinger, Oliver Hart, and Kate Vitasek

Harvard Business Review (September–October 2019)

Cecil Touchon/Courtesy of Sears-Peyton Gallery, New York

Summary. In an era when businesses increasingly have to depend on their suppliers to lower costs, improve quality, and drive innovation, traditional contracts don't work. They often undermine the partnerlike relationships and trust needed to cope with external...more

When Dell originally selected FedEx, in 2005, to handle all aspects of its hardware return-and-repair process, the companies drew up a traditional supplier contract. The 100-page-plus document was filled with "supplier shall" statements that detailed FedEx's obligations and outlined dozens of metrics for how Dell would measure success. For nearly a decade, FedEx met all its contractual obligations—but neither party was happy in the relationship. Dell felt that FedEx was not proactive in driving continuous improvement and innovative solutions; FedEx was frustrated by onerous requirements that wasted resources and forced it to operate within a restrictive statement of work. Dell's attempts to lower costs, including bidding out the work three times during the eight-year relationship, ate into FedEx's profits.

By the eighth year, the parties were at the breaking point. Each lacked trust and confidence in the other, yet neither could afford to end the relationship. Dell's cost of switching to another company would be high, and FedEx would have trouble replacing the revenue and profits the contract generated. It was a lose-lose scenario.

Unfortunately, this story is not unique. Companies understand that their suppliers are critical partners in lowering costs, increasing quality, and driving innovation, and leaders routinely talk about the need for strategic relationships with shared goals and risks. But when contract negotiations begin, they default to an adversarial mindset and a transactional contracting approach. They agonize over every conceivable scenario and then try to put everything in black-and-white. A variety of contractual clauses—such as "termination for convenience," which grants one party total freedom to end the contract after a specified period—are used to try to gain the upper hand. However, these tactics not only confer a false sense of security (because both firms' switching costs are too high to actually invoke the clauses) but also foster negative behaviors that undermine the relationship and the contract itself.

We argue that the remedy is to adopt a totally different kind of arrangement: a *formal relational contract* that specifies mutual goals and establishes governance structures to keep the parties' expectations and interests aligned over the long term. Designed from the outset to foster trust and collaboration, this legally enforceable contract is especially useful for highly complex relationships in which it is impossible to predict every what-if scenario. These include complicated outsourcing and purchasing arrangements, strategic alliances, joint ventures, franchises, public-private partnerships, major construction projects, and collective bargaining agreements. A growing number of large organizations—such as the Canadian government, Dell, Intel, AstraZeneca, and the Swedish telecommunications firm Telia—are successfully using this approach.

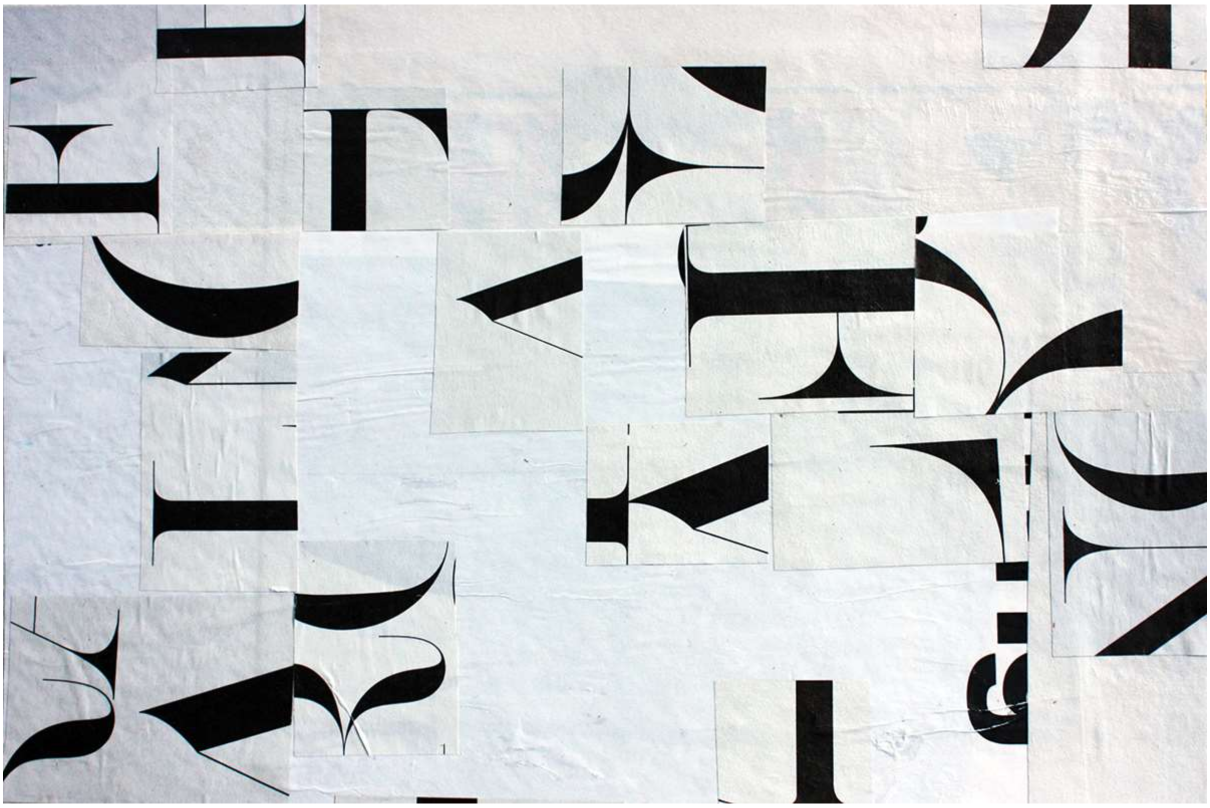
In this article, we look at the theoretical underpinnings of formal relational contracts and lay out a five-step methodology for negotiating them.

Hold-Ups, Incomplete Contracts, and Shading

Companies have traditionally used contracts as protection against the possibility that one party will abuse its power to extract benefits at the expense of the other—for example, by unilaterally raising or lowering prices, changing delivery dates, or requiring more-onerous employment terms. Economists call this the *hold-up problem*: the fear that one party will be held up by the other. The fact that virtually all contracts contain gaps, omissions, and ambiguities—despite companies' best efforts to anticipate every scenario—only exacerbates hold-up behavior.

Leaders employ a range of tactics to try to ensure that they are not taken advantage of by a powerful partner. These include contracting with multiple suppliers, forcing suppliers to lock in prices, using termination-for-convenience clauses, or obligating suppliers to cover activities that might arise after the initial contracting phase. Some companies go so far as to install a "shadow organization" to micromanage the supplier.

Early research by one of us (Oliver, who won the 2016 Nobel Prize in economics for his work on contracts) predicted that in response to the combined problems of hold-ups and incomplete contracts, companies are very likely to make distorted investments that produce poor outcomes. Using multiple suppliers instead of only one, for example, increases costs; so does operating a shadow organization. Termination-for-convenience clauses create perverse incentives for suppliers to not invest in buyer relationships. “A 60-day termination for convenience translates to a 60-day contract,” one CFO at a supplier told us. “It would be against our fiduciary responsibility to our shareholders to invest in any program for a client with a 60-day termination clause that required longer than two months to generate a return.” The implications for innovation are obvious. “Buyers are crazy to expect us to invest in innovation if they do the math.”



CECIL TOUCHON/COURTESY OF SEARS-PEYTON GALLERY, NEW YORK

In 2008, Oliver, together with economic theorist John Moore, revisited his work on contracts. They realized that an equally important problem is *shading*, a retaliatory behavior in which one party stops cooperating, ceases to be proactive, or makes countermoves. Shading happens when a party isn’t getting the outcome it expected from the deal and feels the other party is to blame or has not acted reasonably to mitigate the losses. The aggrieved party often cuts back on performance in subtle ways, sometimes even unconsciously, to compensate.

Imagine that a supplier of engineering services submits a proposal in a competitive bidding process and wins the contract. If demand is lower during the term of the contract than the buyer stated in the RFP or the scope expands in an unanticipated area, the supplier’s profit will take a hit. If the buyer refuses to adjust the supplier’s fee or the statement of work, the supplier may try to recoup losses by, for example, replacing the expensive A team it currently has on the project with its less costly C team. In long-term, complex deals, shading can be so pervasive that the tit-for-tat behavior becomes a death spiral. Oliver and Moore’s expanded theory focuses on contracts as reference points, a new perspective that emphasizes the need for mechanisms to continually align expectations—or update reference points—as unanticipated events occur and needs change over time.

A New Approach

At the same time that Oliver and Moore were looking at the contracting problem from an economics perspective, University of Tennessee researchers (including two of us, Kate and David) were working with companies to come up with a new approach that would produce healthier and more sustainable partnerships. Their efforts led to the vested methodology for creating formal relational contracts—a process that establishes a "what's in it for we" partnership mentality. (It's called vested because the parties have a vested interest in each other's success.) Written contracts that are legally enforceable (which is why we call them formal), they include many components of a traditional contract but also contain relationship-building elements such as a shared vision, guiding principles, and robust governance structures to keep the parties' expectations and interests aligned.

Relational contracts that rely on parties' making choices in their mutual self-interest are nothing new, of course. The benefits of informal "handshake" deals have been studied and promoted over the decades; legal scholars Stewart Macaulay and Ian Macneil were early advocates in the 1960s. Japanese *keiretsu*, an arrangement in which buyers form close associations with (and often own stakes in) suppliers, is a type of relational contract (see "The New, Improved Keiretsu," HBR, September 2013).

Perhaps unsurprisingly, most companies—and their legal counsels in particular—are uncomfortable with informal handshake deals, especially when the stakes are high. In fact, many companies now believe that even the vaunted keiretsu model, which Toyota and Nissan, among others, used so successfully, ties up capital and limits flexibility. The formal relational contract addresses these deficiencies.

Shading happens when one party isn't getting the outcome it expected.

When Dell and FedEx reached their breaking point, they chose to abandon their existing contracting process and create a formal relational contract that specified desired outcomes and defined relationship-management processes at the operational, management, and executive levels. In the first two years, Dell and FedEx were able to reduce costs by 42%, scrap by 67%, and defective parts per million to record-low levels. Both companies now consider the contracting approach a best practice and have applied it in other relationships.

To date, 57 companies have employed the vested methodology. (David and Kate have consulted on many of these projects, including several mentioned in this article.) Results have not been tracked for all of them, but many have told us that they and their partners are happy with the approach and cite benefits including cost savings, improved profitability, higher levels of service, and a better relationship.

Putting It into Practice

Before jumping into a formal relational contract process, companies must determine whether it is right for them. Some relationships, such as those involving the purchase of commodity products and services, are truly transactional and only need traditional contracts. But many organizations require long-term, complex relationships for which the vested methodology is well suited.

Which Type of Contract Is Right for You?
Buyers must consider three key factors when deciding what type of contracting arrangement is right for each ...

A case in point is Vancouver Island Health Authority and South Island Hospitalists, a partnership of administrators and doctors who work together to provide inpatient care for patients with the most complex medical issues in British Columbia. The entities decided to explore relational contracting in 2016, two years after their conventional contract had expired and countless hours of contentious negotiations had failed to replace it. Working with the University of Tennessee (including Kate), they embarked on the five-step process.

Step 1: Lay the foundation.

The primary goal of Step 1 is to establish a partnership mentality. Both parties must make a conscious effort to create an environment of trust—one in which they are transparent about their high-level aspirations, specific goals, and concerns. And if their previous contracting process led to distrust and a vicious cycle of shading, they should reflect on how and why that happened.

At Island Health and South Island, the parties tossed out the old contract and chartered a team of 12 administrators and 12 hospitalists to design a formal relational contract. Each individual worked with a counterpart from the other organization to establish connections in key areas. For example, Spencer Cleave, a hospitalist from South Island, and Kim Kerrone, Island Health's vice president for finance, legal, and risk, led a small group focused on rethinking the conventional fee-for-billable-service-hour payment structure.

"We were no longer interested in just developing a contract," recalled Jean Maskey, a hospitalist at South Island who coheaded the contracting team, "but in building excellent relationships at multiple levels that would allow all of us to be leaders in Canadian health care, whether as administrators or hospitalists."

Step 2: Co-create a shared vision and objectives.

To keep expectations aligned in a complex and changing environment, both parties—not just the one with greater power—need to explain their vision and goals for the relationship.

The Island Health and South Island team held a three-day off-site to craft their vision: "Together, we are a team that celebrates and advances excellence in care for our patients and ourselves through shared responsibility, collaborative innovation, mutual understanding, and the courage to act, in a safe and supportive environment." They further established a set of four desired outcomes that flowed from the shared vision:

- Excellence in patient care (develop a formal and robust quality structure)

- A sustainable and resilient hospitalist service (strengthen recruitment, mentorship, and retention processes; create an efficient and flexible hospitalist scheduling model; clearly define hospitalist services and workload; develop stronger interdepartmental working relationships; and train and develop current and future hospitalist leaders)
- A strong partnership (continue to build a healthy relationship between Island Health and South Island)
- A best-value hospitalist service (proactively manage the budget, optimize billing, review workload, and increase operational efficiencies)

In a subsequent workshop the team delved deeper, crafting four high-level desired outcomes, seven goals, and 22 tactical and measurable objectives. One objective, for example, called for improving physicians' billing to the provincial Medical Services Plan (MSP) for cost recovery for the hospitalist fees. The parties created a joint project collaboratively working with billing support and IT technologists to develop an electronic billing program to maximize billing submissions, ultimately improving cost recovery from 87% to 100%.

Step 3: Adopt guiding principles.

Value-eroding friction and shading occur because one or both parties feel unfairly treated. This risk is highest when there are many unknowns about what will occur after the contract is signed. In Step 3, parties commit to six guiding principles that contractually prohibit opportunistic tit-for-tat moves.

The six principles—reciprocity, autonomy, honesty, loyalty, equity, and integrity—form the basis for all contracts using the vested methodology and provide a framework for resolving potential misalignments when unforeseen circumstances occur.

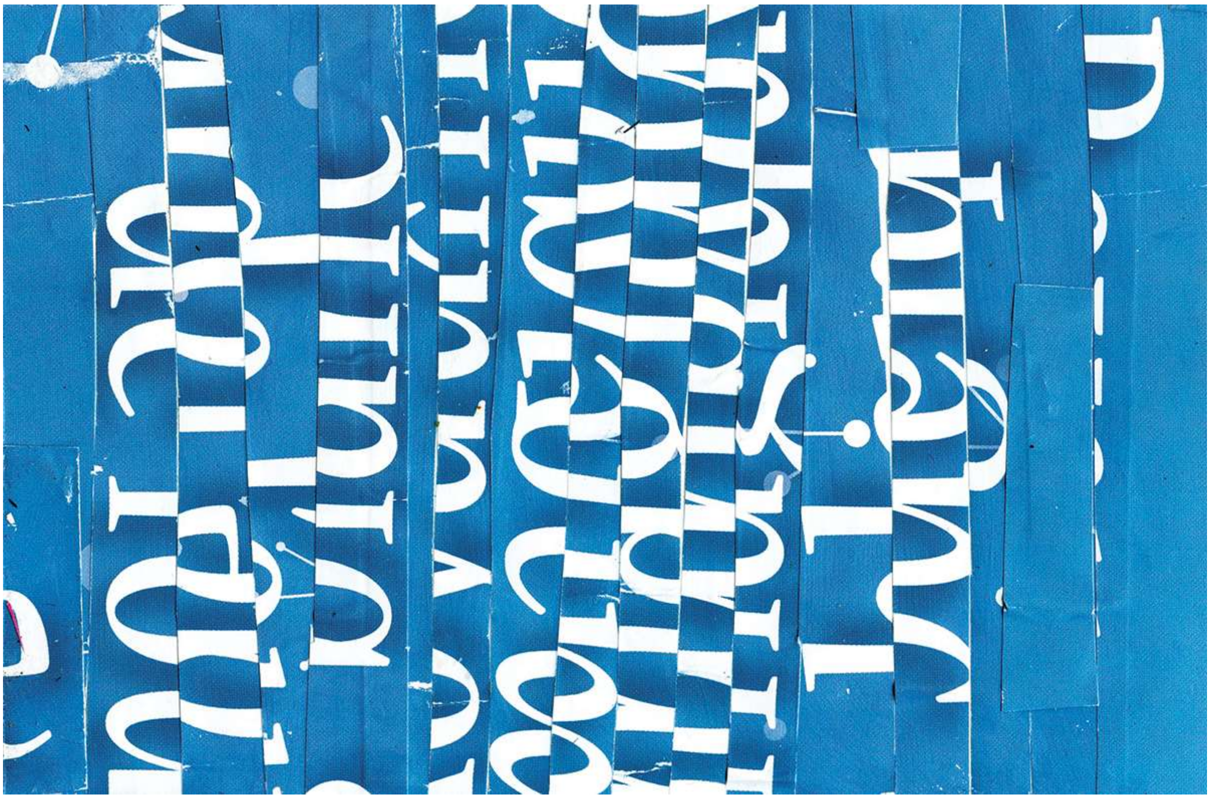
Drafting Your Guiding Principles
Formal relational contracts are built on a foundation of trust and are shaped by a shared vision and six universal guiding ...

Island Health and South Island formally embedded their interpretations of the principles in the preamble of their contract. Each was crafted to establish a new norm for the partnership. Under "reciprocity," for example, they highlighted the need to "conduct ourselves in the spirit of achieving mutual benefit and understanding." Under "equity," they acknowledged the unavoidable imbalances that arise in contracts: "We are committed to fairness, which does not always mean equality. We will make decisions based on a balanced assessment of needs, risks, and resources."

Again, it's important to note that these guiding principles have teeth. Although the contractual language may be vague, courts are obligated to interpret it should there be a dispute. Indeed, the Canadian supreme court recently took up a case in which a franchisee alleged that it was not being treated fairly by the franchise owner. And therein lies the beauty of the formal relational contract. Few companies will want to risk an expensive court case for breaching the guiding principles; thus the contract becomes a deterrent against counterproductive behavior.

Step 4: Align expectations and interests.

Having set the foundation for the relationship in the first three steps, parties hammer out the terms of "the deal"—for example, responsibilities, pricing, and metrics. It is crucial that all terms and conditions of the formal relational contract are aligned with the guiding principles. With the right mindset, the development of the contract becomes a joint problem-solving exercise rather than an adversarial contest.



CECIL TOUCHON/COURTESY OF SEARS-PEYTON GALLERY, NEW YORK
About the art: Artist Cecil Touchon's collages of sliced and rearranged letterforms create "subliteral poems." In his Typographic Abstraction series, the compositions transform letters from a symbol of written language into a kind of visual architecture.

Consider how the Island Health administrators and South Island hospitalists tackled pricing, which had always been their sticking point. Historically, the two parties had operated under a shroud of opaqueness. For example, Island Health never shared the budget with the hospitalists. And South Island's less-than-optimal reporting processes meant inevitable bickering over billable hours.

Kim Kerrone, of Island Health, described how the vested methodology broke the impasse. "We consciously approached the economics of the relationship with full transparency and a problem-solving mentality instead of a negotiations mentality," she told us. "We put everything on the table, and we challenged the contracting team to figure out ways to work with the money we've got."

The parties ultimately came up with an alternative to the standard fee-for-billable-hours method. They designed a hybrid pricing model with a combination of fixed and variable rates, coupled with incentives to improve efficiencies. The model also gave the hospitalists autonomy in scheduling. After all, the team realized, who better to optimize the scheduling for superior patient care than the doctors on the front lines? Under the new pricing model, when the inpatient population is low, the hospitalists can opt to take time off and save Island Health money. When the population is high, they manage their hours in a way that's within the budget and optimizes patient care. South Island has the opportunity to earn incentives if they improve efficiency and billing, which they can invest in research and quality-of-care initiatives they are passionate about. Both parties felt that the new model was a win-win solution that would have been unachievable under previous contracts.

Step 5: Stay aligned.

In this step, contracting parties go beyond crafting the terms of the agreement and establish governance mechanisms that are formally embedded in the contract.

Island Health and South Island created four joint governance teams chartered to "live into" the relational contract:

- **The relationship team** focuses on monitoring the health of the relationship.
- **The excellence team** focuses on quality control, transformational initiatives, continuous improvement, and prioritization and tracking of innovation ideas.
- **The sustainability team** focuses on workload, scheduling, recruiting, and retention.
- **The best value team** focuses on finance, billing, workload optimization, and operational efficiencies.

Each team meets at regular intervals to review progress against the shared vision, goals, outcomes, and measures.

The contract also specifies a second governance mechanism—a "two in a box" communication approach in which an administrator is teamed with a hospitalist for each of the four governance teams. The approach encourages trust and honesty between the two sides, said Ken Smith, a hospitalist at South Island. "Before, we had no one to speak with [if concerns arose]. Now I have someone I know fairly well at a high level in administration. If I need to make an urgent decision or have a difficult issue that can't wait for the next formal meeting, I can phone my two-in-a-box partner and ask to meet."

Such pairings are also highly encouraged outside the governance teams to strengthen the relationship and build trust between parties at all levels. For example, Kim Kerrone and Jean Maskey, informal partners, both say that formal relational contracting was "transformational" for their respective organizations. Both point to the surveys conducted immediately before the process began and one year after the relational contract was in place: The number of people who expressed a positive attitude toward the relationship increased by 84% in just two years. Administrators and hospitalists who had called their relationship "broken," "dysfunctional," and "distrustful" now describe it as "collaborative," "trusting," and "supportive."

Kerrone points to financial benefits as well. "For the first time, the administration and our doctors are innovating together to drive efficiencies and optimize for patient care with our limited budget," she said. "We not only came in under budget, we also increased our revenue by improving our MSP billing process. And in a publicly funded health care environment, that is exactly what we need to be focusing on."

The governance structure also helped the parties surmount the tricky problem of scope creep. While the contract was being developed, in 2016 and 2017, Canada passed a law legalizing medical assistance in dying. At the time, there were too many unknowns about how it would be implemented to address the issue formally. So the sustainability team came up with a pilot project to address how to fairly add the additional scope of work and new role for health care providers to the hospitalists' schedule and pricing model. Gone were the battles of "not in scope"; instead, there was a spirit of "how can we accommodate this new reality given our statement of intent?"

The Future: Contracting for Competitive Advantage

Formal relational contracts will never completely replace traditional transactional contracts. Nor should they. But the process we have outlined should be part of the contracting tool kit to govern highly complex relationships that demand collaboration and flexibility.

Glenn Gallins, the attorney representing South Island Hospitalists and a law professor at the University of Victoria, offers the following advice when it comes to embracing formal relational contracts: "The focus on negotiating the foundation of the relationship first is brilliant. But the real power is it threads all the way down to core decisions on how the parties would work." In a business world where strategic, long-term relationships are critical to competitive advantage, leaders have no choice but to overturn the status quo.

A version of this article appeared in the September–October 2019 issue of *Harvard Business Review*.
Read more on **Negotiation strategies** or related topic **Supply chain management**

- DF
  David Frydlinger is the managing partner at Cirio, a law firm in Stockholm, Sweden, and an adjunct lecturer at the University of Tennessee, Knoxville's Haslam College of Business.
- OH
  Oliver Hart is the Lewis P. and Linda L. Geyser University Professor at Harvard University and a 2016 corecipient of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel.
- **Kate Vitasek** is a member of the graduate and executive education faculty of the University of Tennessee, Knoxville's Haslam College of Business.