Avoiding supplier conflict and disputes before they begin

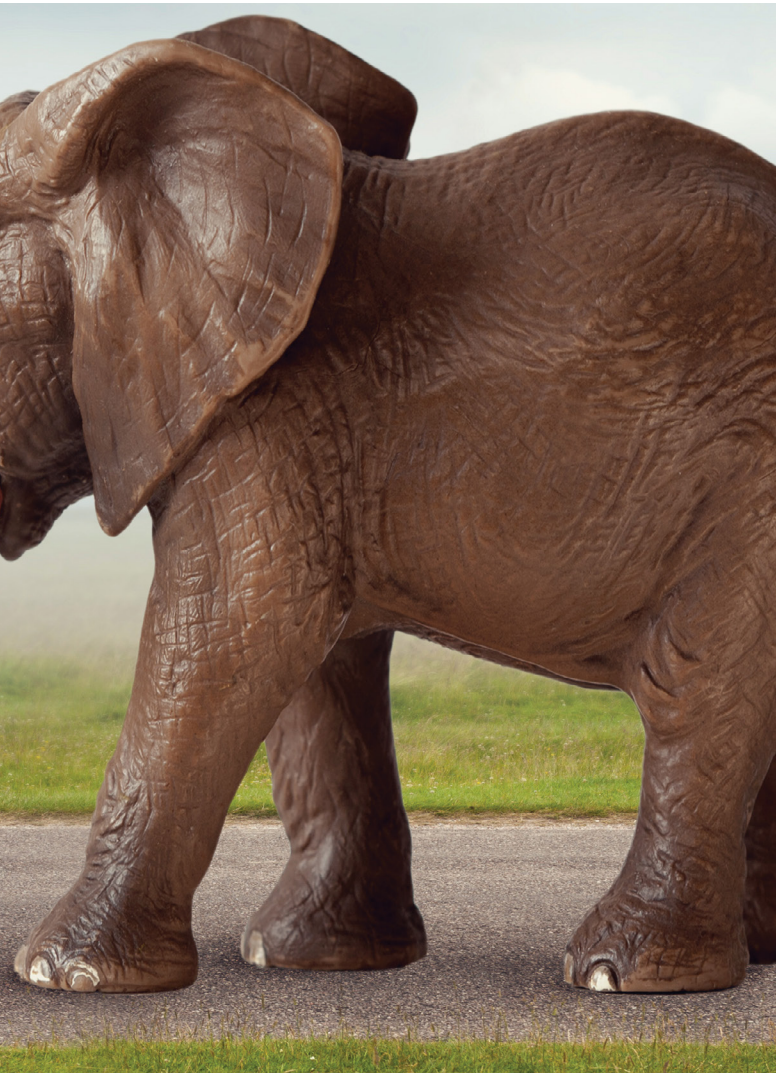
Contract disputes are more common than you think. Thankfully there are a host of proven dispute prevention mechanisms that you likely have never heard of but should be taking advantage of. Here are four of the most promising ones.

BY KATE VITASEK, JIM GROTON, AND ELLEN WALDMAN

Conflict is costly and can lead to disruptions in your supply chain. Take, for example, the failed relationship with Apple and GT Technologies. The dispute led to GT Technologies' bankruptcy and delayed one of Apple's iWatch launches—ending in Apple settling the case out of court for $3.5 million. Or the highly publicized dispute between Volkswagen (VW) and two of its suppliers that halted production at six VW plants in Germany. Or more recently the supplier dispute that caused the shortage of Huy Fong Foods' famed rooster siracha sauce.

KEY TAKEAWAYS

- Supplier disputes are costly, time-consuming and can eventually lead to expensive arbitration and or litigation.
- There are a host of proven conflict resolution mechanism that most companies are not taking advantage of.
- Some of the most effective occur before a supplier contract is even signed. These include collaborative bidding, using a third-party deal facilitator, creating formal relational contracts, and designing contracts so they are easier to understand.



While these high-profile cases may seem like "unicorns" that happen only rarely, contract disputes are more commonplace than you might think. According to a 2022 survey of corporate lawyers by the Association of Corporate Counsel, 58% of all respondents had engaged in litigation related to breach of contract, making it the second most common form of corporate litigation after employment and labor disputes (70%).[1]

Dispute resolution continuum

Many contract disputes, however, could be avoided—or at least dealt with in a more timely and less expensive fashion. Ask anyone who has been involved in a contract dispute and they will almost always say the dispute started with a much smaller issue. In fact, you can think of dispute resolution as occurring along a continuum with five different phases as illustrated in Figure 1.

The Dispute Resolution Continuum[2] shown in Figure 1 highlights the fact that parties have maximum control over their respective time, cost, and risk allocations when they are in the *pre-contract prevention* or *problem-solving* modes. Here disputes and issues are either avoided by taking proactive measures or resolved by the two parties themselves, often through agreed-upon governance structures or resolution processes. If the parties cannot solve a problem, then issues become conflicts, and the parties often look to *facilitated resolution* (for example, bringing in a mediator). Issues that are still unresolved will then shift up the Dispute Resolution Continuum to full-blown arbitration *(binding resolutions)* or *litigation.* By this time, the parties are typically significantly unhappy, and the focus shifts from trying to create peace to full-blown war, with each party trying to get what they feel is right/fair.

Unfortunately, far too many individuals and organizations don't use proper dispute prevention mechanisms. Rather, they fall into a kick-the-can-down-the-road mindset, hoping issues will go away with time. Ultimately—while being a welcome relief in the short term—this mindset most often results in even bigger misalignments downstream.

Preventing disputes before they begin

The University of Tennessee (UT) and the International Institute for Conflict Prevention and Resolution (CPR) are strong advocates for orga-

nizations to adopt more proactive approaches to preventing disputes rather than focusing on ways to resolve them.

But where to start? The good news is there's a full spectrum of proven conflict prevention and resolution mechanisms you've likely never heard of that can help organizations avoid disputes before they begin. Collectively, UT and CPR have identified and profiled over two dozen dispute prevention mechanisms.

This article focuses on four of the most promising dispute prevention mechanisms, which take place during the "pre-contract prevention" mode of The Dispute Resolution Continuum: collaborative bidding, using a third-party deal facilitator, creating formal relational contracts, and designing contracts to be more easily understood. Each of these mechanisms helps to create healthier relationships with suppliers and prevent disputes before they begin. In a follow-up article, we will cover a fifth mechanism—using a "standing neutral" embedded into the parties' governance.

Collaborative bidding

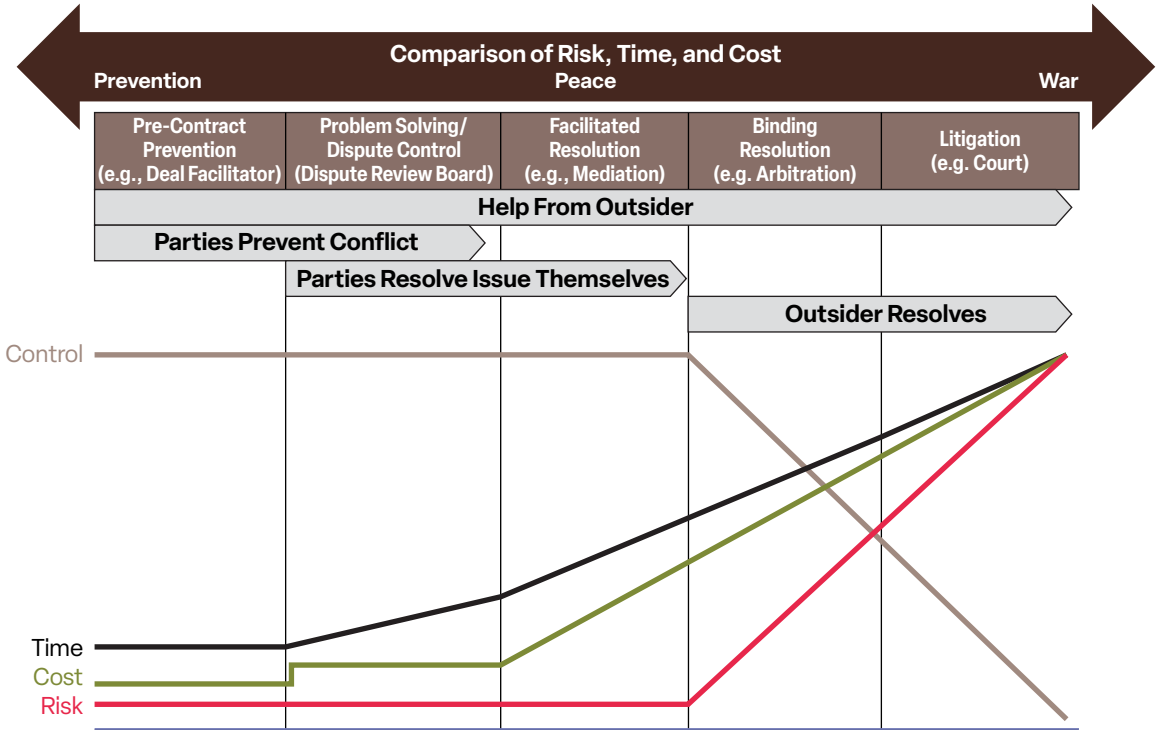
Some may be surprised to learn that the foundation for dispute prevention can be effectively laid during the partner assessment phase before a contract is even created.

According to a World Commerce and Contracting research report on "Ten Pitfalls to Avoid in Contracting," the number one cause of post-contract issues is a lack of clear scope of work and goals.[3] When this happens, contracting partners often suffer from misaligned expectations and "scope creep," leading to suboptimal outcomes, increased frustration, and disputes between trading partners.

UT research points to two collaborative bidding approaches that help buyers align more effectively with their potential suppliers during the bid process.[4]

A ***request for solution*** (also known as *request for proposed solution* or *competitive dialogue*) is a collaborative process between a buying organization and potential suppliers to determine the best solution to meet the buyer's needs. The buyer shifts from giving requirements to providing insight into the problems the company is trying to solve. The parties then go through a collaborative dialogue process to define/refine the solution. Suppliers then develop a formalized proposal that includes their solutions.

FIGURE 1: THE DISPUTE RESOLUTION CONTINUUM



A ***request for partner*** (also known as a *request for collaboration* or a *request for mutual value solution*) is similar to a request for solution in that the buyer is seeking to collaborate with potential partners on a solution. A key difference is the buyer is actively seeking not just a solution from a supplier but also a high degree of "cultural fit" and compatibility. A request-for-partner process is typically useful when selecting a supplier for a long-term relationship—such as a large outsourcing project that will require significant investment and alignment by the buyer and supplier.

A well-structured collaborative bidding process is transparent. Transparency is essential because it lets suppliers seek (and get) the needed information to properly develop their solutions. When buyers use collaborative bidding methods, they share information with prospective suppliers such as:

- Business goals and objectives,
- Any known or perceived constraints, and
- Operating data to provide a general landscape of the current situation. (This should include relevant operational information, existing service levels, high-level cost structures or estimated budget, and desired legal requirements.)

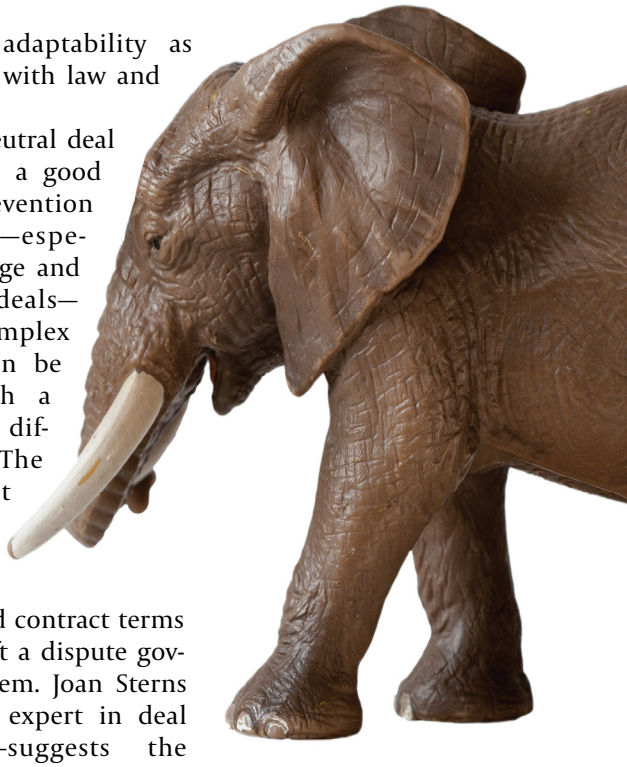
Suppliers then use the information to create a high-level concept proposal.

A key part of a collaborative bidding process includes interactive "dialogue" workshops where a buying organization works with each supplier to define and refine the supplier's concept and align more deeply on things like goals and scope. These workshops enable the buyer to "test drive" suppliers through interactive discussions. An additional benefit is that team members from both the buyer and supplier organizations begin to work together during the process and build trust.

Using a third-party "deal facilitator"

One innovative approach that companies are turning to is using a neutral third-party "deal facilitator." The general idea of a deal facilitator is similar to a mediator, except the third-party neutral assists contracting parties in negotiating and/or drafting a fair and balanced agreement on their behalf.

Michael Hager and John Pritchard introduced using a neutral third party to help with deal development in 1996 in a *Foreign Investment Law Journal* article.[5] The paper states that using a neutral third party is a "potentially powerful tool for lawyers who negotiate global deals for parties who seek wise and fair agreements in complex environments. It has as much to do with issues of culture, values, trust, and adaptability as it has to do with law and contracts."



Using a neutral deal facilitator is a good dispute prevention mechanism—especially for large and complex deals—because complex contracts can be fraught with a myriad of difficulties. The neutral not only helps the parties adopt fair and balanced contract terms but also craft a dispute governance system. Joan Sterns Johnsen—an expert in deal facilitation—suggests the beauty of using neutral deal facilitators is that they have no stake in the outcomes and can apply their skills "in an evenhanded manner to serve the interests of the deal rather than those of any party in interest."[6] When contracting parties use a deal facilitator, the neutral has no incentive to obtain any specific terms or benefit for a particular party. For this reason, the deal facilitator can engage in "reality testing" of proposals and positions.

Vancouver Island Health Authority (Island Health) and South Island Hospitalist Inc (SIHI) provide an excellent example of the benefits of engaging a neutral deal facilitator. Between 2000 and 2014, Island Health and the SIHI went through contentious contract negotiations four times. The parties—recognizing the critical need to build a new relationship—engaged a neutral deal facilitator.

The deal facilitator—a graduate of UT's Certified Deal Architect program—helped the parties collaboratively rethink their contracting and negotiation approach. All agree they could not have broken the stalemate without a deal facilitator. Janet Grove, legal counsel for Island Health, shares, "The advantage is it [using a deal facilitator] creates a safe environment. There is an element of neutrality that is quite helpful because the facilitator can call a spade a spade when people are taking ridiculous positions or extreme positions or unfounded ones."

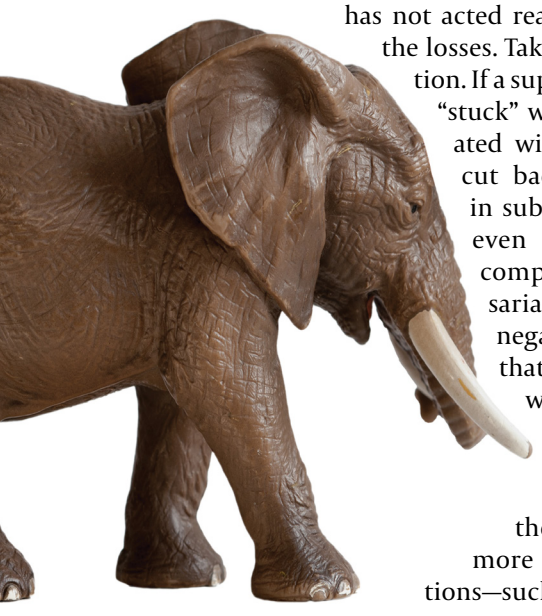
Formal relational contracts

Instead of traditional, transactional contracts, a 2019 *Harvard Business Review* article proposed that formal relational contracts should be used for complicated outsourcing and purchasing arrangements, strategic alliances, joint ventures, franchises, public-private partnerships, major construction projects, and collective bargaining agreements.[7]

A formal relational contract creates a contractual commitment for the parties to use a flexible contractual framework based on social norms and jointly defined objectives. The parties commit to prioritizing the health of the relationship before the details of the commercial transaction. This is done by embedding relational constructs into the actual contract, such as guiding principles and relational governance mechanisms.

Why use formal relational contracts for strategic contracts? Traditional purchasing contracts don't work for complex strategic relationships where the parties are highly dependent on each other, future events can't be predicted, and flexibility and trust are required. Instead of promoting the partnership-like relationships needed to cope with uncertainty, transactional contracts undermine trust by using conventional contract clauses such as a termination for convenience and rigid scope/price requirements that prevent flexibility.

This "us versus them" adversarial mindset leads to what Harvard University's Oliver Hart (the 2016 Nobel Prize winner in economics for his work on contract theory) calls "shading." 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. Take, for example, inflation. If a supplier feels it is being "stuck" with the costs associated with inflation, it may cut back on performance in subtle ways, sometimes even unconsciously, to compensate. This adversarial mindset creates a negative tit-for-tat cycle that can cause a downward spiral in the relationship, which can result in disputes.



Instead of taking the traditional route, more than 100 organizations—such as BP, Intel, Astra Zeneca, and the Canadian government—have worked with the University of Tennessee to implement a formal relational contract, which has led to more flexible, win-win contracts and stronger, less adversarial supplier relationships. (For more information on BP's efforts, attend "Innovating in Outsourcing: How a Vested Business Model Enables Exponential Innovation" at the CSCMP 2024 EDGE Conference on October 1.)

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Contract design

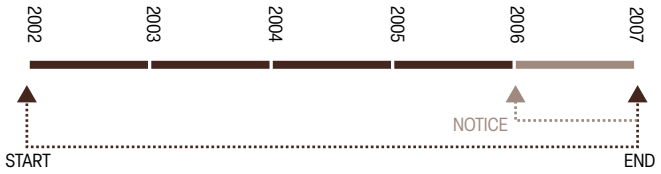
Studies reveal contracts are getting longer, more complex, and are harder to read. When contracts are hard to read or have ambiguous clauses it can lead to misunderstanding and disputes. Case in point is research in the construction industry, which found that poorly drafted and incomplete documents and parties' failure to understand their contractual obligations were the first and third most significant causes of disputes.[8]

Contract design is emerging as a strategy to help organizations make their contracts easier to read, understand, and comply with. Two contract design techniques gaining traction are plain-language contract drafting and the use of visualization and design patterns to make it easier for readers to understand and use contracts. Plain-language contracting is the conscious decision to move away from a more formal and legalistic style of writing contracts, while visualization is the use of diagrams, images, and visually structured layouts to make contracts more searchable, readable, and understandable.[9]

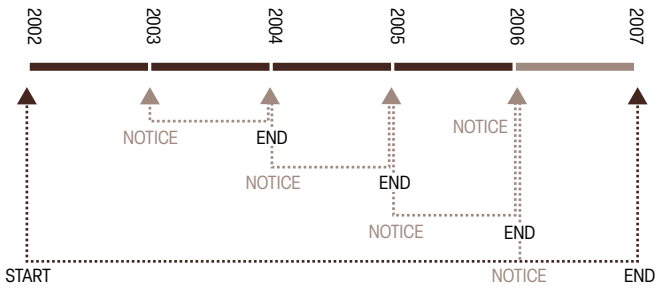
A widely cited case study of how contract design can prevent disputes is the support structure agreement between the Canadian cable television provider Rogers Communications Inc. and the telecommunications service provider Bell Aliant Regional Communications Income Fund. Rogers contracted with Aliant for use of its telephone poles. Aliant terminated the agreement after a disagreement on rates—believing it had the right to terminate with a one-year notice. However, Rogers—believing the contract was still valid—objected to the termination.

FIGURE 2: VISUALIZATIONS IMPROVE CONTRACT COMPREHENSION AND AVOID DISPUTES

ROGERS' UNDERSTANDING:
The contract is valid for an initial period of 5 years. One year prior to the end of this period, either party can give one year's notice to terminate.



ALIANT'S UNDERSTANDING:
The 5-year contract can be terminated at any time with one year's notice.



Source: Stefania Passera and Helena Haapio, © 2011

The parties went through an 18-month dispute over the following wording in their termination clause: *"This agreement shall be effective from the date it is made and shall continue in force for a period of five (5) years from the date it is made, and thereafter for successive five (5) year terms, unless and until terminated by one-year prior notice in writing by either party."* (An interesting twist in this case was that the clause was not drafted by either party. Instead, their agreement was based on the English language standard form issued by the Canadian Radio-Television and Telecommunications Commission.)

Contract design experts and scholars Stefania Passera and Helena Haapio illustrate how a simple graphic visualization would have prevented the confusion leading to the dispute in Figure 2.[10]

The two graphics show how each party's interpretation led to very different understandings of the clause. Haapio argues, "Had the parties or their lawyers drawn two simple timelines on a flipchart, they could have seen the gap between their understandings. Had they discovered this, discussed their needs and expectations, and articulated their interpretation of the meaning of the clause, they could have come to a mutual understanding and removed the ambiguity—or they would have realized that they had no basis for a deal and walked away."[11]

The case study proves that sometimes a picture is worth 1,000 words—or, in the case of Rogers and Aliant, preventing an 18-month contract dispute.

The bottom line

The bottom line? It is *your* bottom line. Conflict—even if it does not lead to an official dispute—creates friction and costs money and wasted energy. Today, there is no excuse for taking a more proactive approach by using proven dispute prevention mechanisms. ›

Editor's Note: In the next issue of *Supply Chain Xchange,* we will provide a detailed overview of a fifth dispute prevention mechanism: embedding a standing neutral into the parties' ongoing relationship management governance.

Notes:

1. "The State of Corporate Litigation Today Survey Report," Association of Corporate Counsel, October 10, 2022: https://www.acc.com/state-corporate-litigation-today-survey-report

2. This version of the Dispute Resolution Continuum was the result of a collaboration between Jim Groton and Kate Vitasek for a white paper titled "Unpacking the Standing Neutral." University of Tennessee, Feb 2020.

3. "Commercial Excellence: Ten Pitfalls To Avoid in Contracting," International Association for Contract & Commercial Management, p.5: http://tinyurl.com/z9qytkg

4. The University of Tennessee's work has led to three white papers and three case studies on the collaborative bidding. For more information visit UT's Vested research library at www.vestedway.com.

5. L Michael Hager and Robert Pritchard, "Deal Mediation: How ADR Techniques Can Help Achieve Durable Agreements in Global Markets," *ICSID Review - Foreign Investment Law Journal,* Volume 14, Issue 1, Spring 1999, pp. 1–15.

6. Joan Stern Johnsen, "Alternative 'Deal' Resolution: The Facilitated Negotiator of Transactions," (Albany Law School, 2011).

7. David Frydlinger, Oliver Hart, and Kate Vitasek, "A New Approach to Contracts," *Harvard Business Review,* Sept-Oct 2013.

8. "13th Annual Construction Disputes Report North America," Arcadis, 2023: https://www.arcadis.com/en-us/knowledge-hub/perspectives/north-america/united-states/2023/construction-disputes-report-2023

9. World Commerce and Contracting provides a free Contract Design Pattern Library which provides tools and examples of contract visualization at https://contract-design.worldcc.com.

10. Stefania Passera and Helena Haapio. "Facilitating collaboration through contract visualization and modularization," in *Dittmar A and Forbrig P (eds) Proceedings of the 29th Annual Conference of the European Association of Cognitive Ergonomics*, New York, NY: Association for Computing Machinery, 2011: pp. 57–60.

11. Ibid

Kate Vitasek is an international authority for her award-winning research and Vested business model for highly collaborative relationships. She is a Distinguished Fellow for the University of Tennessee's Global Supply Chain Institute and is the author of seven books.

James P. Groton is one of the early pioneers in dispute prevention piloting many prevention techniques in the construction industry. He is a retired partner of the Atlanta law firm Eversheds-Sutherland.

Ellen Waldman is the Institute of Conflict Prevention and Resolution's Vice President of Advocacy & Educational Outreach.