

FORMAL RELATIONAL CONTRACTING:

The New Paradigm for Long-Term Strategic Business Relationships

by Kate Vitasek



While 2019 will go down in history as the year the global pandemic started, 2022 will likely go down in history as being the year global supply chain systems had a meltdown. If you are at a breaking point with your supply chain partners, perhaps it is time to rethink your approach. Specifically, rethink your contracting approach to use formal relational contracts, especially with your more strategic suppliers where you do a significant amount of repeat business.

The concept of relational contracts is not new. Legal scholars Ian Macneil and Stewart Macaulay advocated for relational contracts in the 1960s. Relational contracts embrace the fact that many business dealings are not once-and-done deals but rather consist of ongoing business relationships where trading partners have a series of interactions over a long period. The idea is that business is dynamic and that the parties need to create a flexible contract framework where trading partners put the relationship first, rather than have a rigid, inflexible, and “complete contract”.¹

Macaulay and Macneil's concept of relational contracts never really gained traction in practice. One reason is that lawyers eschewed relational contracts as "fluffy" and akin to a "handshake deal". Most lawyers think of handshake deals and relational contracts and immediately think RISK! In fact, over the years, lawyers have been indoctrinated with the idea to write contracts that protect their clients at all costs. The result? A virtual negotiations tug of war of contract clauses. A case in point is that today's contracts are longer, more rigid, and more packed with legalese than ever before.

In her book *Rules for the Flat World*, Gillian Hadfield articulates how the transactional dimension of many business relationships dovetails with the legal boom beginning in the late 1960s. For example, in 1968 there were only 20 law firms in the United States that had over 100 lawyers. But Hadfield writes, "The 1970s saw the number of lawyers grow by 75% and lawyers per 100,000 people jumped over 250 – a 60% increase in just ten years. The 1980s saw the number of lawyers per 100,000 people pushed up another 20% to over 300. By the end of the twentieth century, there were almost 400 lawyers per 100,000 Americans."

With intensified attention to asserting legal protections, contracts became increasingly transactional. This transactional mentality has since dominated the business lexicon.

But is there a better way?

This is the question that University of Tennessee researchers began to ask as part of a large research project funded by the United States Air Force. At the same time – and unrelated – Harvard University's Oliver Hart began exploring ways to address incomplete contracts. In 2018, their work collided with a collaboration with Swedish attorney David Frydinger and the trio wrote a thought-provoking article

in *Harvard Business Review* entitled "A New Approach to Contracts: How to Build Better Long Term Strategic Partnerships".²

The premise? Use formal relational contracts.

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

In other words, a formal relational contract lays a foundation of trust, specifies mutual goals, and establishes governance structures to keep the parties' expectations and interests aligned over time. It stands as an alternative to traditional methods that ensures protection for both parties and allows room for a genuine partnership to develop. It pools the merits of the antiquated but neighbourly "handshake deal" of bygone eras with the legally protective elements of traditional sourcing to create a more modern, progressive method: the formal relational contract.

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Formal relational contracting has already been successfully implemented by major corporations and entities, including (but not limited to) the Canadian government, Dell, Intel, AstraZeneca, and the Swedish telecommunications firm Telia. Most recently, bp and supplier Jones Lang LaSalle made the shift to shift to a formal relational contract for global facilities and real estate management operations. Wendy Cuthbert – bp Global Head of Workplace Solutions – challenges organizations to rethink their traditional approaches to outsourcing. “The traditional way of working with suppliers, I’d like to think as has had its day now and that people will start seeing the real benefits of working alongside business partners in a mutual win-win relationship rather than it being one-sided.”³

The central aim of this model seeks (1) to best meet the respective needs of both the buyers and suppliers and (2) to create value with strategic supplier relationships.

If, perhaps, you are in a struggling business relationship, read on to learn how your traditional transactional contracts may be holding you back and how you can shift to formal relational contracting.

THE PROBLEM WITH TRADITIONAL CONTRACTING

Traditional purchasing contracts don’t work in 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, conventional contracts undermine them.

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Three common contracting obstacles that stand in the way of a successful relational contract are:

- The hold-up problem
- Incomplete contracts
- Shading

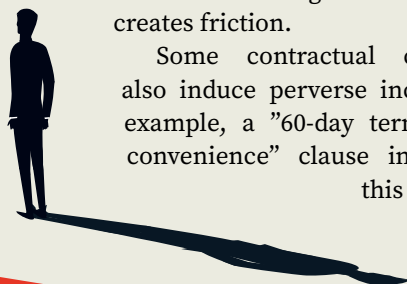
The hold-up problem is a fear that one party will be held up by the other. Companies spend an unimaginable amount of time ensuring they are not taken advantage of by the other party. However, in doing so, they might curtail their own opportunities. The fact that virtually all contracts contain gaps, omissions, and ambiguities – despite companies’ best efforts to anticipate every scenario – only exacerbates hold-up behaviour.



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. In addition, some companies go so far as to install a “shadow organisation” to micro-manage the supplier. This primes the company to make distorted investments that produce poor outcomes. For example, using multiple suppliers instead of only one increases costs, and so does operating a shadow organisation.

Incomplete contracts (or ambiguous contracts) reduce accountability that the contract will be upheld. Correspondingly, when one or both parties view the other as likely to walk, they invest less energy and motivation toward achieving mutual goals. It creates friction.

Some contractual clauses can also induce perverse incentives. For example, a “60-day termination for convenience” clause indicates that this partner



can legally walk after 60 days without explanation. It's the equivalent of a 60-day contract – a highly problematic situation if shareholders must wait longer than two months to see any returns. Who would invest in innovation with such risks?

“Shading” is a retaliatory behaviour where one party stops cooperating, ceases to be proactive, or makes countermoves. The aggrieved party often cuts back on performance in subtle ways, sometimes even unconsciously, to compensate. This may make one party vulnerable to being blind-sided when they don't receive an expected outcome. In long-term, complex deals, shading can be so pervasive that the tit-for-tat behaviour becomes a death spiral.

BREAKING THE CYCLE: THE FIVE STEPS FOR CREATING A FORMAL RELATIONAL CONTRACT

Researchers at the University of Tennessee developed a simple five-step process for creating formal relational contracts. **The five steps are:**

- **Step 1: Lay the foundation**
- **Step 2: Co-create a shared vision**
- **Step 3: Adopt guiding principles**
- **Step 4: Align expectations and interests**
- **Step 5: Stay aligned**

Combined, the steps shift the focus on negotiating from “this deal” to how the parties can collaborate to create success in the relationship. A lynchpin for success? Before you ever start negotiating any aspects of the deal (step 4), slow down and negotiate the foundation of your business relationship.

Step 1: Lay the foundation

This phase focuses on negotiating the foundation of the relationship first and then proceeding to the details. Establishing a partnership mentality is pivotal to sustainable cooperation. When both parties begin the negotiations with genuine partnership as a formal (written) feature of the contract, it creates room for trust, transparency, and high-level aspirations to flourish – rather than an inherently adversarial mindset. Laying this foundation focuses on outcomes, not transactions, in the earliest phase of the partnership.

Step 2: Co-create a shared vision and objectives

This starts with identifying specific goals and concerns. These specific desired outcomes are complemented by clearly defined relationship-management processes. Both parties (not just the one with the upper hand) need the space to explain their desired outcomes and goals as well as tactical and measurable objectives. This can be thought of as focusing on the “what”, not the “how”. Essentially, in step 1, negotiating parties agree to go on a journey together; in step 2, they’re drafting a roadmap for where they both want to go.

Step 3: Adopt guiding principles

Once parties have clearly defined a set of measurable outcomes, adopting guiding principles can help pre-emptively steer away from potential potholes. These principles are designed to avoid value-eroding friction in the partnership at all costs. No one wants to be treated unfairly – or leave themselves open to exploitation. Likewise, the more unknowns there are in the picture, the higher the risk. Another phase of the negotiation tries to head off tit-for-tat behaviour and pre-emptively rewards reciprocity.

Step 4: Align expectations and interests

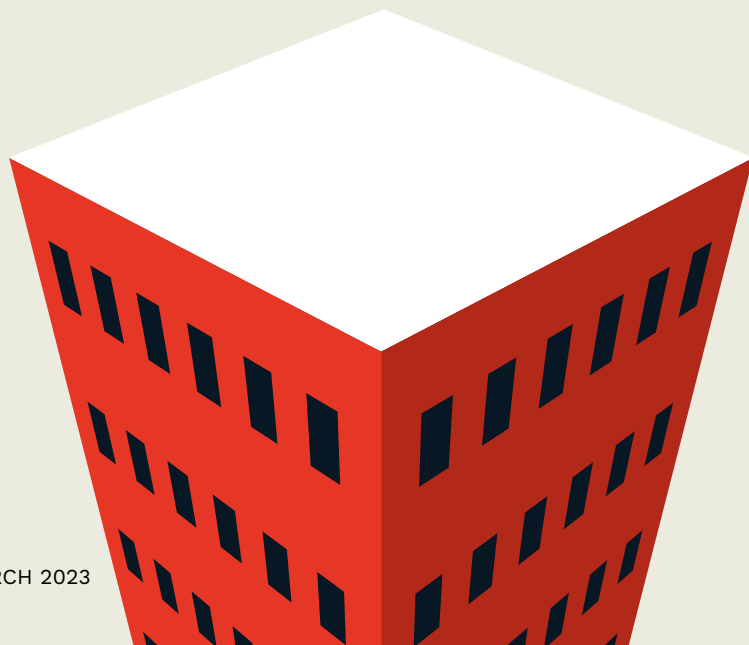
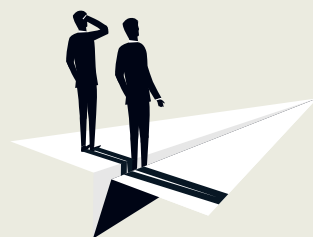
While we can think of the Guiding Principles as a compass telling us which direction we’re going in, aligning expectations and interests demands more instruction. We need more detail than an arrow pointing north, south, east, or west; it’s time to hammer out the details. This demands full transparency and applies to all terms and conditions of the relational contract, such as responsibilities, pricing, metrics, etc. It also underlines a problem-solving mentality instead of a negotiation mentality.

Step 5: Stay aligned

Staying aligned requires creating robust governance mechanisms that provide insight, not oversight, while holding the contracting parties accountable to living into the intentions. Staying aligned applies to all contributing teams on all levels of each party. This can involve regular check-ins, follow-ups, and feedback to keep tabs on shared vision and goals. In this phase, we focus on outcomes and measures with the understanding that, over time, successfully meeting these expectations can yield greater trust and honesty.

FROM THEORY TO PRACTICE

While the *HBR* article was published in 2019, the concept of using formal relational contracts was being tested in practice as early as 2010. David Frydlinger, a practising Swedish attorney, had



been a fan of the University of Tennessee's work in the area of Vested Outsourcing agreements. The concept of Vested Outsourcing was the brainchild of UT's research; it promoted a methodology whereby buyers and service providers collaborated to co-create a win-win outsourcing contract based on Five Rules and ten contractual elements. As part of the Vested methodology, the parties develop a formal relational contract.

Since 2010, over 100 organisations have developed formal relational contracts using the Vested methodology taught at the University of Tennessee. Frydinger has been at the forefront of helping companies create formal relational contracts.


You might be asking yourself, "Sure, it sounds good, but can formal relational contracts really help me navigate today's dynamic business environment?" The answer is yes.

For example, a formal relational contract helped a pharmaceutical company and its facilities management supplier.⁴ When the pandemic forced the pharma company to send employees home, the need for services such as cleaning and dining virtually evaporated. Had the pharma company and facilities services company had a conventional contract, the former would have undoubtedly slashed payments to the latter. But their formal relational contract led them to try to find tailored solutions that would balance the needs of both. For example, one win-win idea to prevent the furloughing of dining service employees was to have them provide tailored meal services for the scientists who were working around the clock to develop a COVID-19 vaccine. Another solution included pulling forward required maintenance initiatives that had been budgeted for, but not yet been scheduled. As a result, the two companies will emerge from the pandemic with a stronger, not a weaker, relationship.

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THE BOTTOM LINE

The bottom line on formal relational contracts? Traditional transactional contracts will always remain an option on the table. Still, in a business world where strategic, long-term relationships are critical to competitive advantage, leaders have no choice but to overturn the status quo. 

REFERENCES

¹ https://en.wikipedia.org/wiki/Complete_contract

² <https://hbr.org/2019/09/a-new-approach-to-contracts>

³ Visit the University of Tennessee's dedicated research site at www.vestedaway.com to download the Dell, Intel and bp case studies.

⁴ <https://hbr.org/2020/10/an-innovative-way-to-prevent-adversarial-supplier-relationships?registration=success>

ABOUT THE AUTHOR



Kate Vitasek is an international authority on the art, science and practice of highly collaborative business relationships. Kate's award-winning research at the University of Tennessee has led to the Vested® business model for highly collaborative relationships and has been featured on CNN International, Bloomberg, NPR, and Fox Business News. She is the author of seven books and her work has been featured in over 300 articles including *Harvard Business Review*, *Chief Executive Magazine*, and *Forbes*.