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Contracting in the New Economy: What is New? Why the Need to Change? And a Suggested Approach for Creating Strategic Contracts

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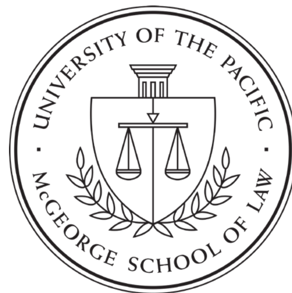

Contracting in the New Economy: What is New? Why the Need to Change? And a Suggested Approach for Creating Strategic Contracts

Kate Vitasek* and David Frydlinger**

TABLE OF CONTENTS

I. THE NEW ECONOMY: WHAT IS REALLY NEW? 583

II. WHY THE NEED FOR CHANGE? 586
A. Power-Based Approaches Promote Adversarial vs Collaborative Business Relationships 587
B. Transactional contracts create inherent perverse incentives.............588

III. A NEW APPROACH TO CONTRACTING 591
A. Sourcing as a Continuum 591
B. Contracting as a Continuum 600
C. The Case for the Formal Relational Contract 602
D. The Contracting Continuum 603
E. Five Steps for Creating a Relational Contract 610

IV. CONCLUSION 614

I. THE NEW ECONOMY: WHAT IS REALLY NEW?

The term "the New Economy" was popularized in a 1983 cover article in *Time*, titled "The New Economy," which described the transition from heavy industry to a new technology-based economy.[1] Over twenty years later, the term the New Economy is still used to describe new business trends and evolutions impacting how organizations do business.

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1. Charles P. Alexander, *The New Economy*, TIME (May 30, 1983), http://content.time.com/time/subscriber/article/0,33009,926013,00.html (on file with the *University of the Pacific Law Review*).

So just what has changed that calls for contracting professionals to rethink their strategic contracts?

For starters, today's markets are more ***global.*** In the past, markets were smaller and more confined by national boundaries. Globalization has torn down these boundaries.[2] While national market segmentations still exist, today's markets are generally geographically much more diverse than in the past. The World Bank created the trade openness index—an economic metric calculated as the ratio of a country's total trade (the sum of exports plus imports) to the country's gross domestic product—across various countries. To put it into perspective, U.S. trade grew from $1.85 trillion in 2010 to $2.38 trillion in 2019. The data reports exponential trade growth across most countries.[3]

Today's trade markets are also more ***outsourced***. The shift to outsourcing got a boost in 1989 when management guru Peter Drucker eloquently argued in his Wall Street Journal article that organizations should "Sell the Mailroom."[4] A year later, Prahalad and Hamel argued that corporations should focus on their core competencies in a highly influential *Harvard Business Review* article.[5] CEOs around the world began to mandate, "'do what we do best and outsource the rest."'

The result? Outsourcing exploded. By 2020 the global business process outsourcing market size was valued at $232.32 billion, and it is expected to register a compound annual growth rate (CAGR) of 8.5% from 2021 to 2028.[6] Today's organizations have a virtual network of suppliers and business partners around the globe that manage critical functions such as manufacturing, distribution, IT, facilities management, finance, HR, and more.

While outsourcing is growing, how organizations are outsourcing is also changing. Companies are shifting to strategic—not just tactical—outsourcing. The energy conglomerate BP and the Swedish Telco Telia offer good examples of this evolution in practice. In 2018, BP had outsourced its facilities management operations to six different regional suppliers. Five of the contracts were structured as approved provider models using a transactional contract, and one supplier

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2. *See generally* THOMAS FRIEDMAN, THE WORLD IS FLAT (1st ed. 2005).

3. *See* Esteban Ortiz-Ospina & Diana Beltekian, *Trade and Globalization*, OUR WORLD IN DATA, https://ourworldindata.org/trade-and-globalization#trade-around-the-world-today (last visited Jan. 21, 2022) (on file with the *University of the Pacific Law Review*) (referencing chart entitled "[v]alue of exported of goods and services, 1960 to 2020").

4. Peter F. Drucker, *Sell the Mailroom*, WALL ST. J., (July 25, 1989), http://www.wsj.com/articles/SB113202230063197204 (on file with the *University of the Pacific Law Review*).

5. *See* C.K. Prahalad & Gary Hamel, *The Core Competencies of the Corporation*, HARV. BUS. REV., May–June 1990, at 79, *reprinted in* C.K. Prahalad & Gary Hamel, *The Core Competence of the Corporation*, HARV. BUS. REV. (2003), https://edisciplinas.usp.br/pluginfile.php/5245277/mod_folder/content/0/The%20core%20competente_Prahalad%20and%20Hamel%201990.pdf?forcedownload=1 (on file with the *University of the Pacific Law Review*).

6. *Business Process Outsourcing Market Size, Share & Trends Analysis Report by Service Type (Customer Services, Finance & Accounting), By End-use (IT & Telecommunication, BFSI), By Region, And Segment Forecasts, 2021–2028,* GRAND VIEW RSCH., https://www.grandviewresearch.com/industry-analysis/business-process-outsourcing-bpo-market (last visited Jan. 21, 2022) (on file with the *University of the Pacific Law Review*).

operated under a Performance-Based Agreement. In 2020 BP signed a highly strategic Vested Outsourcing agreement with JLL to be their global strategic partner. Their goal? Rather than simply perform out-tasked services, JLL would invest to help BP transform their corporate real estate and workplace operations services. Under the outcome-based agreement, the parties jointly identified six Desired Outcomes—including one goal where the parties would invest in sustainability initiatives to help BP achieve a net-zero carbon footprint by 2050.[7]

Like BP, Telia also shifted from an approved provider model to a strategic Vested Agreement with Veolia. Under the agreement Veolia and Telia agreed on five Desired Outcomes with the goal to collaboratively transform Telia's network facilities and maintenance operations.[8]

Organizations' supply chains are also more ***complex*****.** The last century's mass-market economy depicted by Henry Ford's proclamation, "My customer can have a car painted any color he wants so long as it is black,"[9] is no longer viable. *The* customer no longer exists. Rather, today's market economy includes many customers with different tastes that change in unpredictable ways. Companies like Nike are responding with programs such as the 'Nike By You' program, which allows customers to customize their shoes.[10] Other companies have made entire businesses out of serving the 'long tail' of customer demand.[11]

Consumer and businesses markets are ***faster paced*** than ever before. The speed of the market—and market changes—is astonishing. New products and services can become obsolete in a matter of months. For instance, Samsung released 56 new models in 2014, which is 3–5 models each month.[12] And Apple has long been known for introducing a new iPhone approximately every year.

Innovation is also expected in business-to-business relationships. While innovation has always been important, innovation is now an imperative, requiring that organizations be flexible and responsive to change. For example, P&G and its strategic facilities and real estate management service provider JLL, go so far as to have an innovation metric to measure the effectiveness of how they come up

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7. Joanne Bestall, *BP and JLL Sign Multi-Year Vested Workplace Evolution Agreement*, JLL (Nov. 23, 2020), https://www.us.jll.com/en/newsroom/bp-and-jll-sign-multiyear-vested-workplace-evolution-agreement (on file with the *University of the Pacific Law Review*); EP Business in Hospitality, *Why Vested? in Discussion with BP and JLL*, YOUTUBE (Aug. 18, 2021), https://www.youtube.com/watch?v=ClO9cjK_D7g&t=5s.

8. Kate Vitasek & William DiBenedetto, *Telia and Veolia: From Supplier to Strategic Partner*, UNIV. OF TENN., (2018), https://www.vestedway.com/wp-content/uploads/2018/10/Telia-Veolia-case-study-Sept-29-2018.pdf (on file with the *University of the Pacific Law Review*).

9. HENRY FORD, MY LIFE AND WORK 72 (1922).

10. *Nike by You*, NIKE, https://www.nike.com/nike-by-you (last visited Jan. 21, 2022) (on file with the *University of the Pacific Law Review*).

11. CHRIS ANDERSON, THE LONG TRIAL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE, 24 (2006).

12. *Why Does Apple Launch a New iPhone Model Every Year?*, QUORA, https://www.quora.com/Why-does-Apple-launch-a-new-iPhone-model-every-year (last visited Jan. 21, 2022) (on file with the *University of the Pacific Law Review*).

with and adopt new ideas.[13] One of their successes? Increasing speed to market in how they managed acquisition integration by 50%.[14]

Finally, markets are more ***volatile and uncertain***. For many organizations, the "business as usual" sentiment has shifted to "business happens." The popular press is littered with the supply chain crisis of the day. Many factors contribute to supply chain volatility, including: increased customer choices, product customization, rapid technological improvements, labor and equipment shortages, slow digital transformation, maintaining traditional inventories, and a lack of reliable data and insights. The COVID-19 pandemic exacerbated those longstanding issues and uncertainties for organizations' supply chains.[15] More than ever there is a need for agile and flexible supply chains.

II. WHY THE NEED FOR CHANGE?

Today's contracts—especially purchasing/supply contracts—have not evolved with the pace of the business changes noted in Part I. While there are many factors contributing to this gap, this paper addresses three factors that contracting professionals should challenge as they contract in the New Economy. These are:

- Power-based procurement and contracting approaches promote adversarial business relationships instead of fostering collaborative working relationships
- Transactional contracts create inherent perverse incentives that promote "silo-thinking" instead of cross-organizational collaboration
- The concept of "standard contract templates"—while driving efficiency in the contracting phase—can lead to contracts that are not fit for purpose

Each of these is explored below.

13. *Innovation in Outsourcing: The Case of the Procter & Gamble Company*, IAOP (2014), https://www.iaop.org/Download/Download.aspx?ID=2407 (on file with the *University of the Pacific Law Review*).

14. *Id.*; Kate Vitasek, et al., *How P&G and JLL Transformed Corporate Real Estate*, UNIV. OF TENN. 1, 3 (2012), https://www.vestedway.com/wp-content/uploads/2012/09/PG-Case-Study.pdf (on file with the *University of the Pacific Law Review*).

15. *See* Sean Ashcroft, *Pandemic: Will Volatility Be 'Normal' for Supply Chains?*, SUPPLY CHAIN (Nov. 24, 2021), https://supplychaindigital.com/supply-chain-risk-management/pandemic-will-volatility-be-new-normal-supply-chains (on file with the *University of the Pacific Law Review*); *see also* Emma Cosgrove, *Demand Volatility Is the Supply Chain Disruptor of 2020*, SUPPLY CHAIN DIVE (Oct. 30, 2020), https://www.supplychaindive.com/news/coronavirus-demand-supply-chain-disruptor-2020/587782/ (on file with the *University of the Pacific Law Review*).

A. Power-Based Approaches Promote Adversarial vs Collaborative Business Relationships

Sun Tzu wrote his classic treatise *The Art of War* over 2,000 years ago. The book offers observations about politics, psychology, and economics that remain relevant and part of today's lexicon. Sun Tzu suggests that winning comes from power-based behaviors—being ruthless, manipulative, and determined to win at any cost.

Power-based management techniques received a boost in the 1980s when Harvard Business School's Michael Porter best-selling book *Competitive Strategy: Techniques for Analyzing Industries and Competitors* hit the bookstores.[16] Porter wrote about the enterprise as if it were a combat unit on a battlefield forged by five market forces: the threat of rivalry among existing firms, the threat of new entrants, the threat of substitute products or services, the buyer's bargaining power, and the supplier's bargaining power.[17] Two of Porter's "Five Forces" for creating a competitive advantage were about using power.

Power-based approaches were even popularized in pop culture with movies such as the 1987 blockbuster *Wall Street.* The movie *The Art of War* is the contemporary corporate raider's Bible. Using power-based approaches soon worked their way into boardrooms and trickled down to procurement practices—especially for large business enterprises. Take, for example, the Kraljic Matrix, which McKinsey consultant Peter Kraljic introduced in a classic 1983 *Harvard Business Review* article, "Purchasing Must Become Supply Management."[18] Kraljic suggested buyers categorize purchases across two dimensions, profit impact and risk. To help organizations simplify the approach, Kraljic devised a simple quadrant "matrix" that became an instant hit. Once the spend categories were classified into the matrix, Kraljic suggested a buying organization's next step was to "weigh the bargaining power of its suppliers against its own strength as a customer."[19] Based on an organization's power relative to its supplier, he noted, there are three primary purchasing strategies: exploit (with buyer dominance), balance (with a balanced relationship), and diversify (with supplier dominance). Kraljic suggested an "exploit" strategy was the preferred approach, encouraging buying organizations to use their power to get the best price and terms from their suppliers. If an organization did not have power over its suppliers, he suggested techniques to help them increase their power. Many consider the Kraljic matrix and tactics to be the 'gold standard' for how to manage suppliers, and the concept is still taught in the majority of procurement textbooks around the world.

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16. *See generally* MICHAEL E. PORTER, COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS (1980).

17. *Id.* at 3–4.

18. Peter Kraljic, *Purchasing Must Become Supply Management*, HARV. BUS. REV., https://hbr.org/1983/09/purchasing-must-become-supply-management (last visited Jan. 28, 2022) (on file with the *University of the Pacific Law Review*).

19. *Id.*

Power-based approaches also worked their way into contracting practices. Organizations—fearing what economists call the hold-up problem—use a protectionist approach to prevent their contracting counterpart from abusing its power.[20] Contracting parties may employ a range of tactics such as: contracting with multiple suppliers, forcing suppliers to lock in prices, using termination for convenience clauses, or including a "'scope sweeper"' clause 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 their suppliers.[21]

Hart's early research predicted that in response to the combined problems of hold-ups and incomplete contracts, companies are likely to make distorted investments that produce poor outcomes. Companies see increased costs when using multiple suppliers or operating a shadow organization to micromanage an untrusted supplier.[22]

B. Transactional contracts create inherent perverse incentives

Transactional contracts are the mainstay for supply contracts. Contracting parties negotiate the details of the "'transaction"' such as scope and price and document their agreement in the contract. This "buy-sell" mindset underpins not only the relationship—but also the contract structure and economic model. For example, a transaction-based economic model pays a supplier for every transaction (e.g., per hour, per unit, per mile, per shipment, per call). The problem? The more transactions, the more money the supplier makes, which is often in direct conflict with the buyer's goals to reduce costs. The result? A never-ending battle over price with one party winning at the other party's expense.

Transaction-based contracts also promote silo-thinking instead of cross-organization collaboration. For example, a traditional transaction-based contract creates an inherent perverse incentive for the supplier to *not* reduce the number of non-value-added transactions because a reduction in the number of transactions results in lower revenue. University of Tennessee researchers coined this perverse incentive the "'Activity Trap."'[23] The book, *Vested Outsourcing: Five Rules that*

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20. *See* Oliver D. Hart, *Hold-Up, Asset Ownership, and Reference Points*, Q.J. ECON. 267, 267–268 (2009). Companies have conventionally 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.

21. KATE VITASEK, ET AL., VESTED OUTSOURCING: FIVE RULES THAT WILL TRANSFORM OUTSOURCING 3 (2010).

22. David Frydlinger & Oliver Hart, *Overcoming Contractual Incompleteness: The Role of Guiding Principles* 22, 26 (Harv. Univ., Working Paper, 2019).

23. VITASEK, *supra* note 21, at 30.

Will Transform Outsourcing provides excellent examples of the Activity Trap and how it creates disincentives for suppliers to drive down transactions.[24]

Even if the supplier's profit is a fixed amount, the typical organization will have a disincentive to invest in process efficiencies to drive costs down for their client. For example, consider a supplier with a fixed price "managed service" contract where a supplier makes a fixed "management fee" of $7,000 per month to provide a variety of cleaning and maintenance services to their client. In theory, suppliers operating under a fixed price are inherently incentivized to keep their costs below the price quoted (e.g., $7000 a month) because higher costs lead to lower profits. However, in practice, managed service agreements often cause their own set of perverse incentives because they almost always force the supplier to be rigid on the scope to preserve their profit margin; anytime the supplier does work that is not in the fixed scope of work the supplier must absorb the costs which in turn erodes their profit. Buyers and suppliers find themselves in a never-ending "scope creep" battle. To prevent this, buying organizations will try to negotiate a "scope sweeper" clause.[25]

Regardless of a cost-plus or fixed price transactional agreement, the buyer versus supplier mindset ultimately pits the buyer and supplier on opposite sides of the table, both when negotiating the contract and post-contract signing. A win for the buyer is a loss for the supplier, and vice-versa.

"Standard Contract Templates", while driving efficiency in the contracting phase, can create contracts that are not fit for purpose. Many organizations have been relying more on more on "standard contract templates."[26] Organizations such as Thomson Reuters encourage organizations to use standard contract templates:

> Having a trusted market-leading standard document, skeleton argument or legal contract template which you can call on at any moment allows your team to increase agility and efficiency when dealing with various stakeholders of a transaction. Meticulously reviewed and updated by our team of over 300 UK based ex-practitioners, Thomson Reuters suite of document templates, contract templates and agreement templates are constantly maintained at a best-of-class standard.[27]

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24. *See id.* For example, the book illustrates how a logistics service provider who was paid for every pallet stored opted to continue to charge the client for excess inventory (123 years' worth) rather than suggest the product be written off as obsolete.

25. Jim Steinberg & Meredith Francis, *Defining the Solution in Technology Contracts*, LAW.COM (Mar. 20, 2015), https://www.law.com/dailyreportonline/almID/1202721200591/?slreturn=20211110151656 (on file with the *University of the Pacific Law Review*).

26. *See Contract Templates and Agreements (From 25,000 Sales Documents)*, SIGNWELL, https://www.signwell.com/contracts/ (last visited Jan. 28, 2022) (on file with the *University of the Pacific Law Review*).

27. *Contract Templates and Standard Documents*, THOMSON REUTERS, https://legalsolutions.thomsonreuters.co.uk/en/explore/document-management/contract-templates-standard-documents.html (last visited Jan. 28, 2022) (on file with the *University of the Pacific Law Review*).

Unfortunately, using standard contract templates may not be fit for the purpose and could even create perverse incentives. Take, for example, a simple sixty-day termination for convenience clause put in an outsourcing contract. A business group had outsourced to an outsourcing firm in the hope of driving efficiencies and continuous improvement initiatives. As part of the "deal," the supplier would invest in continuous improvement initiatives. The standard termination of convenience clause was not fit for purpose because it had a perverse incentive for the supplier to not invest in the much-needed continuous improvement initiatives. One CFO of a Fortune 100 supplier explained the logic:

> A 60-day termination for convenience translates to a 60-day contract. . . . 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. . . . Buyers are crazy to expect us to invest in innovation if they do the math.[28]

Another good example is a standard payment term policy (e.g., 60-, 90-, or even 120-day payments terms). Many large corporations have mandated longer payment terms when doing contract renewals. A *New York Times* article cites large organizations such as Proctor&Gamble and Mondelez International are getting on board with the new "best practice" extending payment terms to 75 and even 120 days, respectively.[29] These new "policies" are finding their way into standard contract templates during contract renewals. This simple shift in two numbers in a standard contract template can have significant long-term negative impacts on both the buying and supplier organizations. While there is an immediate benefit of improved working capital for the buying organization (as pointed out in the *New York Times* article), the impact on suppliers can be severe as suppliers find their working capital being stretched thin. In fact, APQC—a leading benchmarking organization for Fortune 500 organizations—recently published two reports about how standardized "one-size-fits-all" contracting approaches are pushing suppliers, especially smaller suppliers, away.[30]

Julian Nyarko, assistant professor at Stanford Law School, has researched an interesting concept he calls contract "stickiness" in contract templates. His findings? Once a contract's terms or covenants are written into a contract it "only

28. David Frydlinger, Oliver Hart, & Kate Vitasek, *A New Approach to Contracts: How to Build Better Long-Term Strategic Partnerships*, HARV. BUS. REV. (Sept.-Oct. 2019), https://hbr.org/2019/09/a-new-approach-to-contracts (on file with the *University of the Pacific Law Review*).

29. Stephanie Strom, *Giant Food Companies Pay Later, Squeezing Their Suppliers*, N.Y. TIMES (Apr. 6, 2015), https://www.nytimes.com/2015/04/07/business/big-companies-pay-later-squeezing-their-suppliers.html (on file with the *University of the Pacific Law Review*).

30. Marisa Brown, *Small Suppliers Face Pain. From Changing Requirements*, APQC BLOG (Sept. 20, 2021), https://www.apqc.org/blog/small-suppliers-face-pain-changing-requirements (on file with the *University of the Pacific Law Review*); *Burdensome Contracts are Pushing Service Providers Away*, APQC (Sept. 15, 2021), https://www.apqc.org/resource-library/resource-listing/burdensome-contracts-are-pushing-service-providers-away (on file with the *University of the Pacific Law Review*).

rarely" gets changed or improved—hence the concept that contract terms are sticky.[31] Nyarko argues that economic and legal theory assumes that "sophisticated" parties will routinely write agreements that optimize their joint expertise or "surplus." But Nyarko's research found that theoretical good practice does not make it into real practice. Rather, people tend to use the same clauses over and over again, even if they don't make sense for a particular agreement. Why? The stickiness comes from over-reliance on templates and whether a contract includes a forum selection clause driven by the template used in the first draft. Nyarko found a "distinct apathy" among transactional lawyers that perpetuates contractual gaps and that "sticky" drafting practices characterize the most fundamental aspects of commercial transactions across a wide range of contexts. Nyarko's research illustrates the danger inherent in relying too much on contract templates.

III. A NEW APPROACH TO CONTRACTING

In a *Harvard Business Review* article published in 2019, Swedish lawyer David Frydlinger, economist theorist and Nobel Laureate Oliver Hart, and business school researcher and educator/consultant Kate Vitasek asserted that there is a potential "New Approach to Contracting" whereby contracting parties should shift to a more collaborative spirit for contracting.[32] But what are these other approaches? Contracting in the New Economy means looking at contracts from a different lens in both how organizations procure goods and services and how they contract for those goods and services.

A. Sourcing as a Continuum

For centuries organizations have thought of procurement as a "make vs. buy" decision. This is especially true as organizations explored outsourcing. Many falsely assume if they "buy," they should use competitive "market" forces to ensure they are getting the best deal. In doing so, the default approach is to use a transaction-based model. This works well for simple transactions with abundant supply and low complexity where the "market" can correct itself. The logic is simple: "if a supplier does not perform, just rebid the work."[33]

However, as organizations have outsourced more complex goods and services, this logic no longer works. All too often buyers become co-dependent on suppliers, switching costs are high, and suppliers have a "locked-in" position.

31. Julian Nyarko, *Stickiness and Incomplete Contracts*, 88 U. CHI. L. REV. 1, 23–29 (2021).

32. Frydlinger, et al., note 28.

33. *See* BONNIE KEITH, KATE VITASEK, KARL MANRODT, & JEANNE KLING, STRATEGIC SOURCING IN THE NEW ECONOMY 52–57 (2016); *see also* Kate Vitasek, Bonnie Keith, Karl Manrodt, & Jeanne Kling, *Unpacking Sourcing Business Models*, UNIV. TENN. 6 (2016), https://www.vestedway.com/wp-content/uploads/2019/12/Unpacking-Sourcing-Business-Models-1.pdf (on file with the *University of the Pacific Law Review*).

Dr. Oliver E. Williamson—professor of economics at the University of California, Berkeley—has challenged the concept that sourcing is a "make vs. buy" decision with his work in Transaction Cost Economics.[34] Williamson received the Nobel Prize for his work in 2009. One of the key lessons of Williamson's theory is that organizations should view sourcing as a continuum rather than a simple market-based make vs. buy decision. Perhaps the best way to think of Williamson's work is to consider (**Figure 1** below) free-market forces on one side and what Williamson refers to as "corporate hierarchies" on the other. In the middle, Williamson advocated that organizations should use a "hybrid" approach for complex contracts.

Exhibit 1

Organizations that procure goods or services typically use what Williamson calls the "market" to buy goods and services. The market uses the conventional free-market economy to determine how organizations will do business, including establishing a price. The assumption is that free-market forces incentivize suppliers to compete on low cost and high service. This approach also features an absence of dependency: if buyers or suppliers are not happy, they can switch at any time with relative ease.[35] Governance of the supply base is typically accomplished by switching suppliers or customers when a better opportunity comes along. As a result, the market approach relies purely on classical contract law and requires little administrative control.[36]

34. Oliver E. Williamson, *Outsourcing: Transaction Cost Economics and Supply Chain Management*, J. SUPPLY CHAIN MGMT. 5–16 (2008).

35. *See id.* at 8 ("[T]he market-mode features high-powered incentives, little administrative control and a legal-rules contract law regime, which combination is well suited to implement autonomous adaptations.").

36. The legal scholar Ian R. Macneil was instrumental in developing a wider view of the contract, known as relational contract theory. He said that most contracts are ill-equipped to address the reality of business needs. In IAN R. MACNEIL, CONTRACTS: INSTRUMENTS FOR SOCIAL COOPERATION EAST AFRICA (1968), Macneil wrote, "Somewhere along the line of increasing duration and complexity [the contract] escapes the traditional legal model." He argued that contracts are rooted in the classical approach to contract law and thus crafted to address transactions and legal protections such as pricing and price changes, service levels, limitation of liability,

The big advantage of using the market lies in its simplicity. The market mode enables a competitive process to determine whether an organization is getting a good transaction price. The heart of the market mode is a transactional business model. Competitive bidding processes establish market prices for everything from a per-unit price for a spare part, to a price per call for technical support, to a price per pallet stored in a warehouse, and even price per hour for a janitor to clean a building.

The downside to the market mode is that it often assumes that the purchase is somewhat standardized and therefore available from a variety of suppliers. Consequently, suppliers often "compete" into contracts that pose unnecessary risks. For example, Williamson points out that service providers might have "specialized investments" that can easily expose the business to significant loss if the contract fails and for which no safeguards have been provided.[37]

Innovation is one form of specialized investment that creates value, such as asset-specific product and process improvements designed to create competitive advantages for the buyer. As suppliers put effort into and make specialized investments to support process and product improvements and innovation, they look at risk versus reward. Often, they raise prices to reflect their increased level of risk.[38] However, buyers still want reduced prices as well as the benefits of investments in efficiency and innovation. Buyers and suppliers often find themselves in a "give and take" as a normal part of market-based negotiations with suppliers seeking to develop contractual safeguards.

Williamson's research shows that using the market for more complex contracts drives up transaction costs.[39] He argues that more complex contracts should use what he calls a "hybrid" approach with a conscious decision to build more trusting and secure supplier relationships. The goal should be to drive out opportunism and inject efficiencies in the buyer-supplier relationship.

University of Tennessee researchers questioned how organizations could apply Williamson's lessons. Their work led to the book *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models in Modern Procurement.*[40] The book outlines an approach researchers termed "Sourcing Business Model Theory." Organizations such as the Sourcing Industry Group and NEVI (the Dutch Association for Purchasing Management) have embraced the more collaborative and modern approach of Sourcing Business Model Theory and are embedding it into their practitioner certification programs.[41] Sourcing Business

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indemnification and liquidated damages. He said business-to-business contracts should be "instruments for social cooperation."

37. Williamson, *supra* note 34, at 9.

38. *Id.*

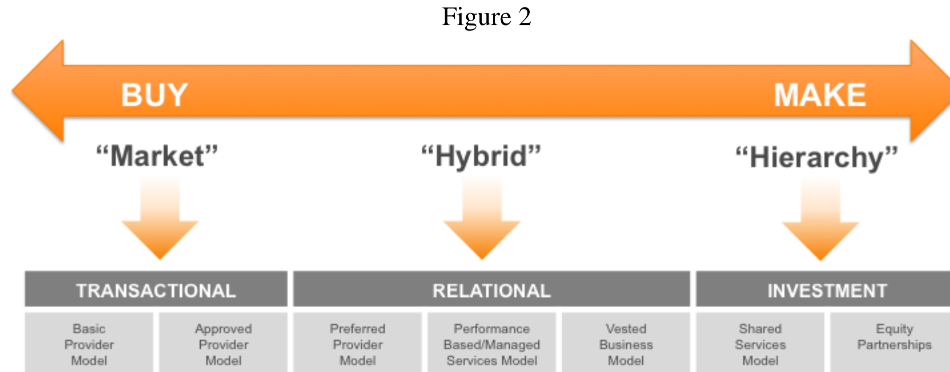
39. *Id.* at 12–13.

40. BONNIE KEITH ET AL., STRATEGIC SOURCING IN THE NEW ECONOMY (2016).

41. *Certified Sourcing Professional*, SOURCING INDUS. GRP., https://sig.org/sig-university/certified-sourcing-professional (last visited Feb. 27, 2022) (on file with the *University of the Pacific Law Review*); *Sourcing Business Models*, NEVI, https://nevi.nl/en/inkoopthemas/strategische-inkoop/sourcing-business-models (last

Model Theory aligns seven sourcing business models to Williamson's continuum (**see Figure 2**).

Figure 2



Strategic Sourcing profiles a simple-to-use "business model mapping" toolkit that procurement professionals can use to determine the most appropriate sourcing business model.[42]

Each of the sourcing business models is profiled briefly below.

1. Basic provider

A basic provider model uses a transaction-based model, meaning it typically has a set price for individual products and services for which there is a wide range of standard market options. These products or services are usually readily available, with little differentiation in what is offered.

A basic provider model should be used to buy low-cost, standardized goods and services in a market where there are many suppliers and switching suppliers has little or no impact on the business. The buyer-supplier relationship is based largely on a performance review against set criteria. For example, did the supplier work the hours claimed? Did the goods received meet the agreed upon quantity, cost, and delivery times? Many organizations do not have contracts for basic providers and simply choose to use a purchase order requisition to trigger a transaction signal that the buying company agrees to buy preset quantities of goods or tasks (e.g., widgets or hours). Many organizations use frequent competitive bidding (often with pre-established electronic auction calendar events) and automated purchasing catalogue functionality to "buy" from basic providers. Some organizations even use purchase cards (a corporate credit card) for these types of simple purchases.

visited Feb. 27, 2022) (on file with the *University of the Pacific Law Review*).

42. The University of Tennessee has made the Business Model Mapping toolkit an open-source resource. *Vested's Open Source Toolkit*, UNIV. OF TENN., www.vestedway.com/tools (last visited Jan. 22, 2022) (on file with the *University of the Pacific Law Review*).

2. Approved Provider Transaction Model

An approved provider model also uses a transaction-based model, but in this example, goods and services are purchased from prequalified suppliers that meet specific performance or other selection criteria. Frequently an organization has a limited number of preapproved suppliers for various spend categories from which buyers or business units can choose. Multiple suppliers mean costs are competitive, and one firm can easily be replaced with another if the supplier fails to meet performance standards.

An approved provider is identified as a prequalified option in the pool of basic providers. Approved providers fulfill preconditions for specified service through a set of criteria or previous experience with performance reliability. To reach approved status, suppliers frequently offer some level of differentiation from other transactional suppliers and provide a cost or efficiency advantage for the buyer. The differentiation could come in the form of geographical location advantage, a cost or quality advantage, or a minority-owned business and is ultimately "approved" to meet an organization's social responsibility goals.

To create a seamless and readily accessible supply chain, many organizations develop lists of approved providers. The advantages are many. For example, a preapproved list saves time when seeking particular goods and services. The approval process ensures parity between bidding, qualified suppliers. As an organization selects its approved provider list, it molds the required qualifications to its unique business objectives and strategy. Procurement professionals typically use their organization's approved provider list as regularly solicited sources of supply when bidding is conducted. An approved provider may or may not operate under a master agreement, which is an overarching contract with the buying organization. Approved providers may or may not also have volume thresholds to be in an "approved" status. In addition, approved providers might participate in supplier management reviews.

3. Preferred Provider Model

Like the basic and approved provider models, a preferred provider model uses a transaction-based economic model. A critical difference between a preferred provider and the other transaction-based models is that the buyer has chosen to move to a more strategic relational model. Thus, contracts with specifically chosen suppliers assume a more collaborative relationship. Repeat business and longer-term and/or renewable contracts are the norm.

Similar to an approved provider model, buyers seek to do business with preferred providers to streamline their buying processes. Buying organizations typically will enter into multi-year contracts using master agreements to conduct repeat business efficiently. Preferred providers are still engaged in transaction-based economic models. However, the nature and efficiencies of how the organizations work together go beyond a simple purchase order and begin to

consider how a supplier can provide value-added services.

A preferred provider is a prequalified supplier. Often, they have unique differentiators—offering value-added services and/or demonstrating acceptable performance levels. For example, a preferred provider may have a superior software system that interfaces with an organization's own system. Sometimes a preferred provider is chosen because of its high-quality workforce and difficult-to-duplicate expertise. Typical conditions for supplier down-selection of a preferred provider are:

- Previous experience;
- Supplier performance rating (if the buying organization has a rating system);
- Previous contract compliance performance;
- Evidence of an external certification (e.g., ISO certification);
- Additional contributions to control costs, such as inventory management, training resources, and aligned geographical positioning.

It is common for preferred providers to work under a master agreement and/or use blanket purchase orders and rate cards that make conducting repeat business easy. For example, a labor-staffing firm may have a rate card that lists the hourly rate set for various staffing needs. The buying organization can easily request staffing support from the preferred provider using the predetermined blanket purchase orders and rate cards.

4. Performance-Based/Managed Services Model

A performance-based model is generally a formal, longer-term supplier agreement that combines a relational contracting model with an output-based economic model. A performance-based model drives supplier accountability for output-based service-level agreements (SLAs) and/or cost reduction targets. A performance-based agreement typically creates incentives (or penalties) for hitting (or missing) performance targets.

Sourcing decisions are based not only on a supplier's ability to provide a good or service at a competitive cost but also on its ability to drive improvements based on its core competencies. Performance-based agreements shift thinking away from activities to predefined *outputs* or events. Some organizations call the results outcomes. However, it is important to understand that a performance-based agreement should hold a supplier accountable only for what is under its control. For that reason, in performance-based models, the word *outcome* usually means a supplier's "output." An output is a well-defined and easily measured event or a deliverable typically finite in nature.

Some service industries are seeing an evolution in managed services agreements. Managed services agreements are a form of a performance-based

agreement. An example is where a supplier has a fixed fee with a pre-agreed price reduction target (e.g., a 3% year-over-year price decrease). The assumption is that the supplier will invest in productivity enhancements to drive efficiencies and improved performance. These guaranteed savings are often called a "glidepath" because there is an annual price reduction over time.

Performance-based agreements require a higher level of collaboration than preferred provider contracts because there is a higher degree of integration between a supplier and a buying organization. In addition, buyers need to apply more formalized supplier relationship management efforts to review performance against objectives and specify the incentive or service credit (also referred to as a malice payment or penalty) payments embedded in the contracts. [43]

5. Vested Sourcing Business Model

A Vested model is a hybrid relationship that combines an outcome-based economic model with a relational contracting model, incorporating the Nobel Prize-winning concepts of behavioral economics and shared value principles. Using these concepts, companies enter into highly collaborative arrangements designed to create and share value for buyers and suppliers above and beyond the conventional buy-sell economics of a transaction-based agreement. In short, the parties are equally committed (Vested) to each other's success.[44]

Vested Outsourcing ("Vested" for short) is a highly collaborative Sourcing Business Model where both the buying organization and the supplier have an economic interest in each other's success. A good example is Microsoft and Accenture's multi-year agreement, in which Microsoft challenged Accenture to transform Microsoft's back-office finance operation processes. The agreement is structured so the more successful Accenture is at achieving Microsoft's goals, the more successful Accenture itself becomes.[45]

The Vested business model was popularized when University of Tennessee researchers coined the term after studying highly successful buyer-supplier

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43. Supplier Relationship Management (SRM) is becoming a popular management technique for working with suppliers in a more strategic way. A Google search will reveal hundreds of articles and entries about SRM. *See, e.g.*, Diann Daniel & Mary K. Pratt, *Supplier Relationship Management (SRM)*, TECHTARGET, https://searcherp.techtarget.com/definition/supplier-relationship-management-SRM (last updated Nov. 2020) (on file with the *University of the Pacific Law Review*) (defining SRM as "the systematic approach to evaluating vendors that supply goods, materials and services to an organization, determining each supplier's contribution to success and developing strategies to improve their performance").

44. *See* Kate Vitasek, Jane K. Winn, & Toni E. Nickel, *The Vested Way: A Model of Formal Relational Contracts*, 52 U. PAC. L. REV. 125, 136–37 (2020).

45. *See generally Vested for Success: Microsoft/Accenture One Finance*, Kate Vitasek, Karl Manrodt & Srini Krishna, UNIV. OF TENN., (Case Study, 2013), https://www.vestedway.com/wp-content/uploads/2012/09/Microsoft.pdf; *see also* KATE VITASEK, KARL MANRODT, & JEANNE KLING, VESTED: HOW P&G, MCDONALD'S, AND MICROSOFT ARE REDEFINING WINNING IN BUSINESS RELATIONSHIPS 89–117 (2012).

relationships such as Microsoft and Accenture.[46] A Vested business model is best used when an organization has transformational and/or innovation objectives it cannot achieve by itself or by using conventional transactional sourcing business models (Basic Provider, Approved Provider, Preferred Provider) or a Performance-Based agreement.

6. Shared Services Model

Organizations that struggle to meet complex business requirements with a supplier can always invest in developing capabilities themselves (or insource). One approach is to create an internal shared service organization (SSO) to centralize and standardize operations that improve operational efficiencies. A shared services model is typically an internal organization based on an arms-length outsourcing arrangement. Using this approach, processes are often centralized in an SSO that charges business units or users for their services.[47] In some instances, SSOs are formed externally to the company (such as a subsidiary).

SSOs typically act like outsourced suppliers, performing services and then "charging" their internal customers on a per-transaction or actual cost basis. SSOs generally mirror conventional preferred provider models.[48] The main difference is that the SSO is an internal supplier rather than an external supplier.

Organizations can use a shared services model for a variety of functional services, such as human resources (HR), finance operations, or administrative services (such as claims processing in health care). For example, large organizations may centralize HR administration into an SSO to provide benefits management to their employees and even external clients. Small enterprises can benefit from a shared services model by joining forces to create specialized service centers that economically provide a functional service to each of the smaller firms.

7. Equity Partnerships

An equity partnership creates a legally binding entity. Equity partnerships can take different legal forms, such as buying a supplier (an acquisition), creating a subsidiary, equity-sharing joint ventures, or entering into cooperative (co-op) arrangements. Equity partnerships are best used when an organization does not have adequate internal capabilities and does not want to outsource. For example, some organizations decide they do not have internal capabilities and do not want to invest in a Shared Services organization. In these cases, organizations may opt

46. *See generally* KATE VITASEK, MIKE LEDYARD, & KARL MANRODT, VESTED OUTSOURCING: FIVE RULES THAT WILL TRANSFORM OUTSOURCING (2nd ed. 2013).

47. SSOs can also be "center led," meaning resources may not physically be centralized.

48. Companies can structure SSOs with highly collaborative Vested philosophies; however, most companies structure SSOs as conventional preferred provider transactional models that are arm's length in nature.

to develop an equity partnership—such as a joint venture or another legal form—to acquire mission-critical goods and services.

Equity partnerships, by definition, bring costs "in-house" and create a fixed cost burden. As a result, equity partnerships often conflict with the desires of many organizations to create more variable and flexible cost structures on their balance sheet.[49]

8. Different Models, Different Systems

It is important for organizations to select the most appropriate Sourcing Business Model for their situation. Think of a Sourcing Business Model as a "system," as each is purpose-built to optimize the business needs given critical operating factors. The book *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models in Modern Procurement* details each of the seven Sourcing Business Models and shares insights into how to strategically source and architect each model.[50]

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49. See Williamson *supra* note 34, at 5. Williamson argues that a corporate hierarchy provides low incentives, high administrative costs, and a legal system that is "deferential to the management." *Id.* at 8. Because of these bureaucratic costs, Williamson says that "the internal organization is usually thought of as the organization of last resort." *Id.* at 9. In other words, if at all possible, companies should outsource noncore services."

50. *See generally* BONNIE KEITH, KATE VITASEK, KARL MANRODT, & JEANNE KLING, STRATEGIC SOURCING IN THE NEW ECONOMY (2016).

Figure 3 below provides a "cheat sheet" into how each Sourcing Business Models should be structured.

TRANSACTIONAL (MARKET) — RELATIONAL (HYBRID) — INVESTMENT (HIERARCHY)

	BASIC PROVIDER	APPROVED PROVIDER	PREFERRED PROVIDER	PERFORMANCE-BASED/MANAGED SERVICES	VESTED	INVESTMENT (EQUITY PARTNER/ SHARED SERVICES)
BUSINESS MODEL						
Business Model: Economic Model	Transaction Based (per Transaction, Hour or Unit)	Transaction Based (per Transaction, Hour or Unit)	Transaction Based (per activity, hour or unit)	Output Based	Outcome Based	Transactional, Output or Outcome Based
Business Model: Relationship Model	Transactional/ no relationship	Transactional/ Supplier Vetted on "Approved" List	Relational Contract— Emerging Collaboration	Relational Contract— Collaborative	Relational Contract— Highly Collaborative	Investment Based
Vision & Intent	Supply at Lowest Cost	Recurring Commodities at Fair or Lowest Costs	Value Added Capabilities at Best Value	Performance to SLA— Process Efficiencies	Shared Vision, Desired Outcomes & Value Creation	Sustainable Value
SCOPE OF WORK						
Statement of Work & Objectives	"Who" and/or "How"	"Who" and/or "How"	"Who" and/or "How" with Jointly Defined "How"	"What" Limited Emphasis on "How"	"What"	"What if", "What for" and "When"
PERFORMANCE MANAGEMENT						
Performance Focus	Simple Three Way Accounting Match	PO Requirements	Activity Based Service Level Agreements	Output Based Service Level Agreements	Strategic Desired Outcomes	P&L Based Measures
Performance Measures	Right Quantity, Right Price, Damage Free	Basic Provider Metrics + Increased Quality Emphasis	Operational + Customer Satisfaction	Operational + Relational (Values & Behaviors)	Operational + Transformational + Relational System Wide KPIs	Joint Measures of Success
PRICING						
Pricing Model & Incentives	Fixed Price/Typically No Incentives/Volume Rebates	Fixed Price/Low No Incentives/Volume Rebates	Fixed Price/Low Incentives/Volume Rebates	Price with Incentives and/or Penalties	Pricing Model with Value Based Incentives	P&L Based Equity Sharing
GOVERNANCE						
Relationship Management	Delivery & Pricing Validation (Three Way PO Match)	Some Performance & Pricing Oversight	Limited Supplier Relationship Management	Oversight Emphasis: Supplier Relationship Management	Insight Emphasis: Strategic Relationship Management	Shared Control and Management
Improve, Transform, & Innovate	None/Market Driven	Limited/Market Driven	Beginning to Focus on Incremental Improvement	Supplier Driven to Meet SLAs/Price Glide Path	Joint & Proactive Transformation Management	Core Innovation Capabilities
Exit Management	One Way/Limited Commitment to Buy	One Way/Termination for Cause & Convenience	One Way/Termination for Cause & Convenience	Perf Based Termination for Cause w/Safeguards	Joint Exit Management Plan	Divestiture
Compliance & Special Concerns	Compliance Driven/ Survey Based	Typically Compliance Driven/ Survey Based	Typically Market Based/Minimum Audit Requirements	Corporate Based Audit Requirements	Outcome Based Joint Requirements	Investment Based Joint Requirements

Once organizations determine the most appropriate sourcing model for their strategic buyer-supplier relationships, the next step is to incorporate those learnings into the contract.

B. Contracting as a Continuum

As procurement organizations look to different approaches for more strategic contracts, contracting professionals must keep pace. David Frydlinger, Oliver Hart, and Kate Vitasek, in their *Harvard Business Review* article, advise the best way for organizations to contract for strategic relationships in the New Economy is using formal relational contracts. Their rationale?

> "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. The Cause? 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. This adversarial mindset creates a downward spiral of negative tit-for-tat behaviors. The Solution? 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."[51]

Frydlinger and Vitasek took the concepts of a formal relational contract introduced in the *Harvard Business Review* article and expanded on it in their book, *Contracting in the New Economy: Using Relational Contracts to Boost Trust and Collaboration in Strategic Business Relationships*.[52] The book advises that organizations must harness the power of strong, collaborative strategic alliances through formal relational contracts. The parties in a relational contract should jointly embrace the fact that business is risky. Rather than striving to shift risk, contracting parties should seek to create more value with a strong foundation of transparency and trust by formally incorporating guiding principles and proven relational governance mechanisms designed to keep the parties in continual alignment when "business happens." The premise? Working together to mitigate risk is much better than merely shifting risk to the weaker party and places the relationship on a strong foundation for the long term.

Reviewing the sourcing continuum (**see Figure 2**), we see where the relational contract continuum intersects with sourcing models.

51. Frydlinger, Hart, & Vitasek, *supra* note 28.

52. DAVID FRYDLINGER, KATE VITASEK, JIM BERGMAN, & TIM CUMMINS, CONTRACTING IN THE NEW ECONOMY: USING RELATIONAL CONTRACTS TO BOOST TRUST AND COLLABORATION IN STRATEGIC BUSINESS RELATIONSHIPS (2021).

C. The Case for the Formal Relational Contract

It is common for complex "transactions" to be hundreds of pages long. We have seen one government supplier contract eight and one-half feet tall when printed on standard-sized paper! Many argue they need to hammer out every detail in black and white because they do not trust their partner. Consider the fact that today's business partners are no longer your neighbor; they are frequently an organization based halfway around the world, with a significantly different culture.

But is it realistic to believe organizations can address every commercial scenario in a contract? The concept of complete contracts is one many scholars have studied over the years— including Nobel laureates Oliver Williamson and Oliver Hart. In the words of Oliver Williamson, "All complex contracts will be incomplete there will be gaps, errors, omissions and the like."[53] Both Olivers strongly advocate that chasing the perfect contract is a fool's errand. Why? We live in a dynamic world. Writing a contract for a dynamic and complex relationship *"today"* will often not help us "*tomorrow*." Simply put, business happens. Things change, including the underlying deal covered by the contract.

Oliver Hart's work pointed out how contracts can create a hold-up problem.[54] In 2008, Hart revisited his work on contracts with economic theorist John Moore.[55] They realized that—equally important to the hold-up problem—organizations suffer from a post-contract signing problem they coined *shading*. Shading is a retaliatory behavior in which one party stops cooperating, ceases to be proactive, or makes countermoves. Shading happens when a party is not getting the outcome it expects 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 for the perceived imbalance between the parties.

Shading often launches a negative cycle of tit-for-tat behaviors where the parties pursue power-play games during a contract—often rationalizing their behavior in the quest to earn what they view is a fair outcome. Shading behavior creates distrust and adversarial relationships—something neither contracting party wants.

53. Williamson, *supra* note 34, at 5–16.

54. *See generally* Hart, *supra* note 20 at 267, 267–268.

55. *See generally* Oliver Hart & John Moore, *Contracts as Reference Points*, 123 Q.J. ECON. 1 (Feb. 2008), https://scholar.harvard.edu/files/hart/files/contractsasreferencepointsqje.pdf (on file with the *University of the Pacific Law Review*).

Author Steven M.R. Covey, Jr. suggests distrust in relationships results in seven “taxes.”[56]

1. Redundancy is unnecessary duplication. It stems from the mindset that people cannot be trusted unless they are closely watched.
2. Bureaucracy is when too many rules and regulations are in place or when too many people have to “sign off” on something.
3. Politics is when one uses a misaligned “strategy to gain power.” Too much time is spent interpreting other people’s motives and trying to read hidden agendas.
4. Disengagement is when people are still getting paid even though they “clocked out” years ago. They will put in the minimal effort required to get their paycheck.
5. Turnover results when the best performers in an organization leave an organization, pursuing jobs where they are seen as trusted and a contributor adding value.
6. Churn is the effort and costs associated with constantly having to find new “customers, suppliers, distributors, and investors” because there is a lack of loyalty.
7. “Fraud is flat-out dishonesty.” Fraud is a circular tax; when companies tighten the reins to prevent fraud, they reduce their fraud-related losses, but they inevitably see an increase in the other six areas.

Today 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.[57]

D. The Contracting Continuum

The best way to understand a relational contract is to compare it to the dominant contract model we call the *transactional* contract. **Figure 4** provides the comparison along five dimensions, showing the distinct differences between a relational contract and a transactional contract, while at the same time showing these two contract forms exist on a continuum.

56. STEPHEN M. R. COVEY, THE SPEED OF TRUST: THE ONE THING THAT CHANGES EVERYTHING 250–54 (2006).

57. *See generally* FRYDLINGER, VITASEK, BERGMAN, & CUMMINS, *supra* note 52. The book includes a comprehensive review of research supporting relational contracting. Part II of the book includes 4 chapters that provides detail about the various legal, social science, economic, and psychology research supporting relational contracts. Part V provides an in-depth review of case law pertaining to relational contracts.

Figure 4: Comparison of Contracting Models

TRANSACTIONAL ⟷ RELATIONAL

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

A brief overview of each dimension follows.

1. 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. A transactional contract 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 all the transactions that will be carried out at the date of the press release. A complex future is viewed as one big deal.

A 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 a formal contract change control process. But as most contract managers know, post-signing contract negotiations can be tedious and costly exercises, often involving intense discussions about 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 in

focusing 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 is unavoidable.

2. 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 not to get too "cozy," especially if you are the buyer. The conventional logic is that becoming too dependent on the other party is considered 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 creates 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 supplier-created innovations. 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. As shown previously, the 1980s ushered in popular approaches for improving an organization's power, such as Porter's Five Forces and the Kraljic Matrix.

In the New Economy, conventional approaches for using one's power causes a dilemma. Power-based strategies do not work in today's networks because enterprises depend on their network of customers, suppliers, and business partners to succeed. Arm's length relationships simply are not enough—especially for more strategic and complex deals with 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 others cannot copy.[58] 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 prevalent in

58. Jeffrey H. Dyer & Harbir Singh, *The Relational View: Cooperative Strategy and Sources of Interorganizational Competitive Advantage*, 23 ACAD. MGMT. REV. 660, 660–679 (1998).

many organizations. Simply put, the strategic contract you structure with Strategic Supplier #1 is highly likely to be unique from the strategic contract that's structured with Strategic Supplier #2.

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

3. 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 written 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. Negotiation 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 disadvantage or could financially hurt the other party.[59] 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. 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, while not considering the other party's interests.

Psychological research supports this "tit for tat" behavior, showing that while humans are opportunistic, they have a strong sense of fairness or, in the terminology of behavioral economics, *bounded self-interest.*[60] 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.[61]

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59. *See, e.g.*, CHARLES KARRASS, THE NEGOTIATING GAME *passim* (1992) where the author has taught thousands of individuals to play the "negotiations game" to tilt the deal in their favor.

60. Cass R. Sunstein, Christine Jolls, & Richard H. Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1479 (1998).

61. *Id.* at 1492.

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 and relationship "taxes," as explained previously.

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.[62] The findings are clear: in more complex commercial relationships, inefficiencies and transaction costs are generated when contractual norms conflict with the social norms that always exist in commercial relationships to a larger or lesser extent.

We are convinced much of the value leakage in contractual relations is 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.

4. 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 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 is 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 fall 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 counterparty, 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.

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62. *See, e.g.*, Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LITERATURE 595 *passim* (2000).

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 counterparty 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 ability 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 assumes 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, most parties choose to settle out of court to avoid astronomical legal bills and the potential damage to their reputation. World Commerce & Contracting (WCC, formerly the International Association for Contract and Commercial Management) 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.[63] Even though most contracts rely on an implicit assumption of the effectiveness of the court system, 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; in reality, they can be weak in managing known risk and largely ineffective in dealing with unknown or unanticipated risks.

5. *Complete Planning*

A contract is first and foremost an economic instrument to support the realization of business plans. Whether one is trying to build a house or a railroad, to execute a marketing campaign, or to ensure access to information technology, all require 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

63. MAXIMIZING ROI FROM EFFECTIVE CONTRACT MANAGEMENT – VALUE LEAKAGE REPORT, WORLD. COM. AND CONTRACTING, (Mar. 2015), https://www2.iaccm.com/resources/?id=8484 (on file with the *University of the Pacific Law Review*).

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 signing the contract, 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 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.[64]

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 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 most contracts are incomplete.[65] 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 oil price fluctuations. 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 significantly more challenging in the New Economy. An irony about complete planning is that psychological research has revealed we never were good planners to start with.[66] To borrow terminology from behavioral economics, we suffer from *bounded rationality* because we don't have enough time to gather all relevant information, and our brains cannot deal with all of the data. The conclusion? It has always been impossible for a transactional contract to live up to the ambition of complete planning.

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64. While we use examples of buyers using the power, suppliers may also have a dominant role and use/abuse their power.

65. Frydlinger & Hart, *supra* note 22, at 3.

66. DANIEL KAHNEMAN, THINKING, FAST AND SLOW *passim* (2011).

E. Five Steps for Creating a Relational Contract

Contracting in the New Economy details five steps for creating a formal relational contract, summarized below:

- Step 1 – Lay the foundation for the partnership by focusing on the commercial relationship instead of the commercial transaction (or "deal").
- Step 2 – Promote a "partnership" versus an arms-length relationship by co-creating a shared vision and strategic objectives for the relationship.
- Step 3 – Adopt guiding principles for the partnership by mutually agreeing on social norms (or guiding principles) that will be explicitly included in the contract.
- Step 4 – Align interests and expectations on the specific deal points that represent the core business and commercial aspects of the contract.
- Step 5 – Stay aligned by developing and following a governance structure specifically designed to manage change and uncertainty, with the goal to stay continually aligned.

An excellent example of how the five steps work in practice to create a formal relational contract is Vancouver Island Health Authority (Island Health) and South Island Hospitalists (South Island). These organizations are 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 explored relational contracting in 2016, two years after their conventional contract had expired and countless hours of contentious negotiations had failed to replace it. They embarked on a journey to put the five steps into practice.[67]

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 twelve administrators and twelve 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

67. The following case study is an excerpt from Frydlinger, Hart, & Vitasek, *supra* note 28, at 122–125. The full-length case study is profiled in the book FRYDLINGER, VITASEK, BERGMAN, & CUMMINS, *supra* note 52.

for finance, legal, and risk, led a small group that 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 co-headed 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 twenty-two 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.

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 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; 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, developing the contract becomes a joint problem-solving exercise rather than an adversarial contest.

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 using formal relational contracting practices 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. 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 the new model was a win-win solution, which 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.

Kim Kerrone and Jean Maskey both say formal relational contracting was "transformational" for their respective organizations. Some of the results include:

Relationship Health: Surveys measuring the relationship health, conducted before and after the parties deployed relational contracting, revealed 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."

Financial Benefits: Kim Kerrone states, ["f]or the first time, the administration and our doctors are innovating together to drive efficiencies and optimize for patient care with our limited budget. We not only came in under budget, but 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."

Managing Scope Creep: 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 a 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?"

Promoting Innovation: The contract also promotes collaborative work on innovative approaches. When the COVID-19 pandemic hit in March 2020, the Island Health system suddenly faced a dramatic change in its patient mix. The impact on the budget and workload was drastic. The parties collaborated to quickly implement a new scheduling process to better balance workload. In addition, they deployed a new "Hospitalists at Home" program, which entailed the hospitalists seeing patients in their homes.

IV. Conclusion

Getting contracts right can create millions—if not billions—of dollars of value. But getting them wrong can cost millions of dollars when the parties become misaligned. Even if the misalignment does not end in a lawsuit, there is wasted time, energy, and hard costs associated with the friction caused by opportunistic hold-up behavior and shading.

Contracting in the New Economy requires organizations to rethink both their procurement and contracting practices to incorporate proven collaborative relational constructs that encourage—and even contractually commit—the parties to work together to mitigate risks and continually align interests in a fair and balanced manner. This means challenging the often-adversarial mindset and practices that come with transactional contracts and contract templates. It also means having an open mind to incorporate guiding principles and relational governance mechanisms into the contracts. This will result in a a formal relational contract built to help keep the contracting partners in continual alignment as "business happens."