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## The Vested Way: A Model of Formal Relational Contracts

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# The Vested Way: A Model of Formal Relational Contracts

Kate Vitasek, Jane K. Winn, and Toni E. Nickel\*

I. THE PARADOX OF RELATIONAL CONTRACTS .....	125
A. <i>Relational Contracts Need Not Be Informal</i> .....	128
B. <i>Hold-ups, Incomplete Contracts, and Shading</i> .....	130
II. FIVE RULES OF THE VESTED WAY .....	132
A. <i>Rule 1: Focus on Outcomes, not Transactions</i> .....	132
B. <i>Rule 2: Focus on the “What,” Not the “How”</i> .....	133
C. <i>Rule 3: Agree on Clearly Defined and Measurable Outcomes</i> .....	133
D. <i>Rule 4: Pricing Model Incentives that Optimize the Business</i> .....	133
E. <i>Rule 5: Governance Structure that provides Insight, not Oversight</i> ..	134
III. LEARNING HOW TO “FORMALIZE” RELATIONAL CONTRACTS .....	134
A. <i>Overcoming Resistance to Formalizing Informal Relational         Contracts</i> .....	134
B. <i>The Development of the Vested Relational Business Model</i> .....	136
C. <i>Design Principles for Formal Relational Contracts</i> .....	138
IV. CONCLUSION .....	140

## I. THE PARADOX OF RELATIONAL CONTRACTS

In 1963, Stewart Macaulay exposed a paradox at the heart of modern contract law when he published the first academic account of what is now known as “relational contracts”: the theory and practice of contracting diverge sharply under some circumstances but not others for reasons that neither contract theorists nor contract practitioners were able to explain.<sup>1</sup> For more than half a century, economists, legal academics, managers, and lawyers have attempted to resolve that paradox. While many important insights have emerged from that debate, no attempt to resolve the paradox has been able to achieve universal acceptance among economists, legal academics, managers, and lawyers. Yet even in the absence of a universally accepted explanation for when they should and should not be used, recent court cases in the U.K. and Canadian high courts demonstrate that relational contracts remain important governance tools for many

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1. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

businesses.<sup>2</sup>

The inability to resolve the paradox of relational contracts to the satisfaction of all interested stakeholders is not due to the shortage of different theories advanced since 1963. The array of theories advanced since 1963 has succeeded in explaining some but not all the features of relational contracts. In 1968, Ian MacNeil extended Macaulay's insights and coined the term "relational contract."<sup>3</sup> In 1981, economist Charles Goetz and law professor Robert Scott first extended the emerging discipline of "law and economics" to the study of relational contracts.<sup>4</sup> In 1979, economist Bengt Hölmstrom distinguished between information that is merely observable by the parties to a contract and information that can be verified by independent third parties such as judges, an insight that would be incorporated into the economic theory of relational contracts.<sup>5</sup> In 1988, economist Oliver Hart suggested that relational contracts could be thought of as deliberately "incomplete" contracts.<sup>6</sup> Hart and Hölmstrom were awarded the Nobel Prize in economics in 2016 for their contributions to contract theory. In 1985, economist Oliver Williamson suggested that variations in transaction costs may explain variations in the business use of market contracts, relational contracts, or corporate hierarchies,<sup>7</sup> a contribution that earned him the Nobel Prize in economics in 2009.

By the mid-1980s, many lawyers and legal academics had joined the debate.<sup>8</sup> In 1990, the economic sociologist Woody Powell noted the decline of hierarchies and the rise of networks governed by something like relational contracts.<sup>9</sup> University of Chicago Law School professor Lisa Bernstein extended the theory of relational contracts to the New York diamond market in 1992.<sup>10</sup> In 1994, labor market economist Charles Sabel extended the theory of relational contracts to continuous improvement systems in industry.<sup>11</sup> In 2004, Duke Law School professor (and Williamson's Ph.D. student) Barak Richman extended those insights into a more general theory of the law and economics of private

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2. Yam Seng PTE Ltd. v. Int'l Trade Corp. [2013] EWHC 111 (QB); Bates v. Post Office Ltd [2019] EWHC 606 (QB).

3. IAN R. MACNEIL, *CONTRACTS: INSTRUMENTS FOR SOCIAL COOPERATION* 247 (1968).

4. See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

5. Bengt Hölmstrom, *Moral Hazard and Observability*, 10 THE BELL J. OF ECON. 74 (1979).

6. Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, 4 J. OF L., ECON., & ORG. 119, 124 (1988).

7. OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 16 (1985).

8. Robert W. Gordon, *Macneil, Macaulay, and the Discovery of Power and Solidarity in Contract Law*, 1985 WIS. L. REV. 566 (1985).

9. Walter W. Powell, *Neither Market nor Hierarchy: Network Forms of Organization*, 12 RES. IN ORG. BEHAV. 295 (1990).

10. Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. OF L. STUD. 115 (1992).

11. Charles Sabel, *Learning by Monitoring: The Institutions of Economic Development*, in THE HANDBOOK OF ECONOMIC SOCIOLOGY 137, 139, 141–44 (Neil Smelser and Richard Swedberg, eds., 1994).

ordering.<sup>12</sup> While these important insights into the economic and legal dimensions of relational contracts shed light on different aspects of the theory and practice of relational contracts, none succeeded in persuading interested observers that the paradoxical relationship between contract theory and practice had been resolved.

A series of U.K. cases in recent years have fueled a public debate among U.K. lawyers and legal academics about the possible existence of a gap between contract law and commercial practice in the area of relational contracts.<sup>13</sup> In 2001, a U.K. court ruled that because English contract law did not recognize a general duty of good faith and fair dealing, such a duty could not provide the foundation for an implied relational contract between a retailer and a supplier.<sup>14</sup> The court explicitly rejected the suggestion that the academic discussion regarding “relational contracts” would lead to any other result.<sup>15</sup> But more recently, a U.K. court ruled that joint venture agreements, franchise agreements, and long term distributorship agreements might be considered “relational contracts” and as such, might require a higher degree of communication, cooperation, and predictable performance based on mutual trust and confidence than would be found in more discrete contracts.<sup>16</sup>

In 2019, the English court, interpreting the long-term subcontracting contracts between the U.K. Post Office and its network of sub-postmasters, expanded the holding in the 2013 *Yam Seng* case into a framework for distinguishing between relational contracts from discrete contracts:

- There must be no specific express terms in the contract that prevents a duty of good faith being implied into the contract;
- The contract will be a long-term one, with the mutual intention of the parties being that there will be a long-term relationship;
- The parties must intend that their respective roles be performed with integrity, and with fidelity to their bargain;
- The parties will be committed to collaborating with one another in the performance of the contract;
- The spirits and objectives of their venture may not be capable of being expressed exhaustively in a written contract;
- They will each repose trust and confidence in one another, but of a different kind to that involved in fiduciary relationships;
- The contract in question will involve a high degree of communication, co-operation and predictable performance based on mutual trust and confidence, and expectations of loyalty;

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12. Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328 (2004).

13. See generally, CATHERINE E. MITCHELL, CONTRACT LAW AND CONTRACT PRACTICE: BRIDGING THE GAP BETWEEN LEGAL REASONING AND COMMERCIAL EXPECTATION (2013).

14. Baird Textile Holdings Ltd v. Marks & Spencer plc [2001] EWCA (Civ) 274.

15. *Id.* at ¶ 16.

16. Yam Seng PTE Ltd v. Int'l Trade Corp. [2013] EWHC 111 (QB).

## *2020 / A Model of Formal Relational Contracts*

- There may be a degree of significant investment by one party (or both) in the venture. This significant investment may be, in some cases, more accurately described as substantial financial commitment; and
- Exclusivity of the relationship may also be present.<sup>17</sup>

Applying this framework, the court ruled that the contract between the Post Office and its sub-postmasters was a relational contract and as such subjected the Post Office to a duty to act in good faith towards its sub-postmasters.<sup>18</sup> By contrast, a New York State court in 2017 highlighted the dearth of impact that relational contract theory had on the development of American contract law in the courts.<sup>19</sup>

### *A. Relational Contracts Need Not Be Informal*

In a Harvard Business Review article published in 2019, Swedish lawyer David Frydlinger, economist Oliver Hart, and business school researcher and consultant Kate Vitasek (“FHV”) made yet another attempt to integrate the separate threads of relational contract theory into a coherent approach to relational contract practice rigorous enough to satisfy all interested parties.<sup>20</sup> In the article, they explicitly reject the assumption—often tacit—of informality embedded in most legal and economic analyses of relational contracts.<sup>21</sup> In place of a tacit assumption of informality, FHV define the concept of a “formal relational contract” as a written document designed to be legally enforceable “that specifies mutual goals and establishes governance structures to keep the parties’ expectations and interests aligned over the long term.”<sup>22</sup>

At first glance, it may appear that FHV’s claim to have come up with a “new approach to contracts” amounts to nothing more than obfuscation. In the economic theory of relational contracts, what makes the “relational” part of the contract different from a conventional market contract is that the relational terms are not legally enforceable because they are “incomplete,” or their performance cannot be “verified” by third parties. Viewed from this perspective, the FHV idea of a formal relational contract can be reduced to a kind of semantic error. But the response of FHV to such criticism might be similar to the response that Mark Twain is alleged to have made when he was asked whether he believed in infant

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17. *Bates v. Post Office Ltd* [2019] EWHC 606 (QB) [725].

18. *Id.* at ¶ 1122.

19. *Kamco Supply Corp. v. On the Right Track, LLC*, 49 N.Y.S.3d 721 (N.Y. App. Div. 2017) (“With its emphasis on trust, collaboration, reputation, and the ability to adapt in the face of changing circumstances, the relational contract has been extensively studied by economists, sociologists and game theorists, but thus far has generated little interest among lawyers.”).

20. David Frydlinger, et al., *A New Approach to Contracts*, HARV. BUS. REV., Sept.–Oct. 2019.

21. See, e.g., Gillian K. Hadfield & Iva Bozovic, *Scaffolding: Using Formal Contracts to Support Informal Relations in Support of Innovation*, 2016 WIS. L. REV. 981 (2016).

22. David Frydlinger, et al., *supra* note 20.

baptism: “Believe in it? Hell, I’ve seen it done!”<sup>23</sup>

FHV’s idea of a “formal relational contract” differs from both the economists’ idea that with enough time and effort, the parties to a contract might be able to write out a formally “complete” contract that comes close to identifying all possible future states and explicitly allocates the risks of those future states to one party or the other, and an informal, “handshake” deal that is treated by some writers as synonymous with a “relational contract.” Negotiations to create a formal relational contract are not “positional” but require full disclosure on both sides before the hard work begins of building a governance framework both parties agree is fair. Because it may take weeks or months of negotiations before the parties can even achieve full disclosure, not to mention weeks or months to hammer out the details of a governance framework which both parties sincerely believe is fair, it may take between six and twelve months for the parties to produce a “formal relational contract” for a large-scale, long-term outsourcing agreement that is legally enforceable.

The basic insight behind the idea of a “formal relational contract” in this sense emerged from a five-year, \$25 million research contract awarded in 2003 by the U.S. Air Force to the University of Tennessee Executive Education Center. The Air Force knew that some of its large-scale, long-term outsourcing agreements had been spectacularly successful while others had been failures, but the Air Force’s procurement managers were unable to identify the underlying factors that had contributed to success or failure.<sup>24</sup> The Air Force’s annual budget for outsourcing contracts was more than \$60 billion annually, so the consequences of the success and failure of these outsourcing contracts could be large enough to have an impact on the military preparedness of the United States. Kate Vitasek was part of the team of University of Tennessee (“UT”) researchers who collected information about how public and private organizations negotiated the outsourcing agreements, the performance of the parties to the agreements, and the economic environment within which the agreements were performed in order to isolate the root causes of the success or failure of different agreements.<sup>25</sup>

Developing a framework within which comparisons among different outsourcing contracts could meaningfully be compared was profoundly challenging, given that very little appeared to remain constant across different services agreements. One of the primary deliverables of the research grant the Air Force awarded UT was the development of courseware for the Defense Acquisition University (“DAU”) that was used to teach Department of Defense procurement personnel how to operationalize the most important insights gleaned from the study. As the research team began to identify what appeared to be

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23. CHRISTOPHER C. ROBINSON, WITTGENSTEIN AND POLITICAL THEORY 35 (Edinburg Univ. Press 2011).

24. KATE VITASEK, ET AL., VESTED OUTSOURCING: FIVE RULES THAT WILL TRANSFORM OUTSOURCING 12–13 (1st ed. 2010).

25. *Id.*

critical factors for predicting the success or failure of large-scale, long-term outsourcing agreements, those insights were tested out by the procurement staff applying the DAU curriculum being developed. That feedback was used to improve the framework for analyzing the Air Force's agreements.<sup>26</sup>

After the successful conclusion of UT's research project for the Air Force, Vitasek and the team concluded that insights gleaned from the research were too valuable to limit to the DAU curriculum.<sup>27</sup> She launched the "Vested Way" curriculum and consulting practice to make those insights accessible to public and private sector organizations engaged in complicated outsourcing and purchasing arrangements, strategic alliances, joint ventures, franchises, public-private partnerships, major construction projects, and collective bargaining agreements.

### B. Hold-ups, Incomplete Contracts, and Shading

Oliver Hart's work on contract theory provides a theoretical foundation for formal relational contracts.<sup>28</sup> 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.<sup>29</sup>

Contracting parties may employ a range of tactics to ensure they are not taken advantage of by a dominant partner. These include contracting with multiple suppliers, forcing suppliers to lock in prices, using termination for convenience clauses, or obligating suppliers to cover activities that might arise after the initial contracting phase. Some companies go so far as to install a "shadow organization" to micromanage their suppliers.<sup>30</sup> Early research by Hart 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. Using multiple suppliers instead of only one, for example, increases costs; so does operating a shadow organization to micromanage an untrusted supplier.<sup>31</sup> Many of these costs stem from inherently perverse incentives created

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26. *Id.* at 13.

27. *Id.* at 2.

28. Oliver D. Hart, *Hold-Up, Asset Ownership, and Reference Points* (Nat'l Bureau of Econ. Research, Working Paper No. w13540, 2007), [https://papers.ssm.com/sol3/papers.cfm?abstract\\_id=1024143](https://papers.ssm.com/sol3/papers.cfm?abstract_id=1024143) (on file with the *University of the Pacific Law Review*); see also David Frydlinger, et al., *supra* note 20.

29. Hart, *Hold-Up, Asset Ownership, and Reference Points*, *supra* note 28.

30. VITASEK, ET AL., *supra* note 24, at 33.

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

by contract clauses that are ill-suited for the nature of more strategic partnerships.

Consider how a common contractual clause such as “termination for convenience” might backfire in a strategic business relationship. A termination for convenience clause grants one party total freedom to end the contract after a specified period. The clause is used to protect the party—typically the party with the most power—from getting trapped in a relationship. While a termination for convenience clause is designed to protect a company, it actually confers a false sense of security in complex and dependent relationships. Take for example the case of Vancouver Island Health (a health authority in British Columbia) and its Hospitalist. Hospitalists are a class of physician specialists that care for the most sick and vulnerable patients in the hospital and are incorporated as South Island Hospitalists, Inc. The switching cost for both firms is too high to actually invoke the termination clause. Could Island Health really terminate for convenience, in essence firing all of the Hospitalists? And, for Hospitalists living in British Columbia, would they really want to just up and leave their communities with a termination for convenience? This is highly likely when you factor in health care is provided by the government, meaning Island Health more or less had a monopoly on the Hospitalists jobs in Victoria, British Columbia. If the Hospitalists terminated the deal, they would be forced to physically move to another Canadian province to find a job.<sup>32</sup>

It is thus clear that even a simple and standard clause, such as termination for convenience, may create inherently perverse incentives in a complex, long-term commercial relationship. 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.<sup>33</sup>

In 2008, Hart together with economist John Moore revisited Hart’s earlier work on incomplete contracts and added a new dimension that they labeled “shading.”<sup>34</sup> While the hold-up problem may occur during contract negotiations, shading may occur after the contract is formed. Shading describes a retaliatory behavior taken by one party against the other and includes stopping cooperation, ceasing to be proactive in solving problems, or even making countermoves to the detriment of the other party. Shading happens when one party does not get the outcome it expected from the deal and feels the other party is to blame or has not

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<https://scholar.harvard.edu/hart/publications/overcoming-contractual-incompleteness-role-guiding-principals>  
(on file with the *University of the Pacific Law Review*).

32. See David Frydlinger, et al., *supra* note 20.

33. *Id.*

34. Oliver Hart & John Moore, *Contracts as Reference Points*, 123 Q.J. OF ECON. 3. (2008).

acted reasonably to mitigate losses. The aggrieved party often cuts back on its own performance in subtle ways, sometimes even unconsciously, to compensate. Shading often sets off a negative cycle of tit-for-tat behaviors where the parties play perfectly legal power-play games during the course of a contract—rationalizing their behavior.<sup>35</sup>

Hart and Moore’s expanded theory focuses on contracts as reference points, a new perspective that emphasizes the need for mechanisms to continually align expectations—or update reference points—as unanticipated events occur and needs change over time.<sup>36</sup> The logic is simple, yet profound. If a contract sets the reference point for expectations, the contract should also set out the mechanism to keep the parties aligned when “business happens,” and one (or both) of the parties are not meeting their expectations. Not keeping in alignment will undermine the relationship as the intentionally or unconsciously parties shade “to get even.”

The reason it may take months to negotiate what FHV calls a “formal relational contract” instead of days or weeks is that the process of designing reference points and incorporating them into a long-term, large-scale outsourcing contract may be profoundly challenging. Recognizing both the novelty and the difficulty of creating such reference points, Vitasek distilled the most important insights gleaned from the research project into a simple heuristic she calls the “Five Rules of the Vested Way.”

## II. FIVE RULES OF THE VESTED WAY

Expressed in the most general, abstract terms, the Five Rules provide:

- Focus on outcomes, not transactions;
- Focus on the what, not the how;
- Agree on clearly defined and measurable outcomes;
- Develop pricing model incentives that optimize the business; and
- Governance structure should provide insight, not oversight.<sup>37</sup>

Figure 1 is taken from Vitasek’s 2010 book, *Vested Outsourcing: Five Rules that Will Transform Outsourcing*, and illustrates how the rules work together to create win-win business relationships.<sup>38</sup>

### A. Rule 1: Focus on Outcomes, not Transactions

This rule has two elements. The first is shifting the mindset from a focus on specific transactions to desired outcomes, meaning that instead of buying

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35. David Frydlinger, et al., *supra* note 20.

36. Oliver D. Hart & John Hardman Moore, *Contracts as Reference Points*, SSRN, <https://ssrn.com/abstract=944784> (Nov. 14, 2006) (on file with the *University of the Pacific Law Review*).

37. David Frydlinger, et al., *supra* note 20.

38. VITASEK, ET AL., *supra* note 24, at 51.

transactions, companies purchase outcomes, which can include targets for availability, reliability, revenue generation, employee or customer satisfaction, and the like. A key part of Rule 1 is for the parties to agree on a mutually defined shared vision and top-level desired outcomes the parties agree to collaborate on. Second, the parties agree on guiding principles (social norms). Contracting parties put the shared vision, desired outcomes, and guiding principles front and center into the actual contract—essentially framing the agreement to put the relationship front and center above any specific deal points (Rules 2–4).<sup>39</sup>

See Appendix 1 for the actual example of how Island Health and the Hospitalist incorporated Rule 1 into the contract.<sup>40</sup>

*B. Rule 2: Focus on the “What,” Not the “How”*

A key purpose of a Vested, highly strategic relationship is to drive improvements and innovation which will help the contracting parties achieve their desired outcomes established in Rule 1. In Rule 2, contracting parties shift from a traditional “supplier shall” Statement of Work to a bi-lateral taxonomy of all the work needed to achieve the desired outcomes. The parties also develop a workload allocation defining responsibilities of who is doing which work, recognizing success comes when the parties collaborative work together.<sup>41</sup>

*C. Rule 3: Agree on Clearly Defined and Measurable Outcomes*

In Rule 3, the parties begin to link performance metrics to the desired outcomes established in Rule 1. Rule 3 embodies two key elements. The first is for the parties to collaboratively establish the actual metrics the parties will use. This includes creating definitions and calculations for each metric. The second is to develop a performance management plan which will guide the parties in how they will do reporting and use the metrics to manage the business.<sup>42</sup>

*D. Rule 4: Pricing Model Incentives that Optimize the Business*

Like Rule 1, Rule 4 is designed to shift the parties away from traditional transactional thinking. In this Rule, the parties set out to create a win-win economic model that highly motivates the supplier to invest in innovation and transformation that will benefit the customer. A well-structured Vested pricing model is almost always highly transparent with a focus on reducing the total cost

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39. *Id.* at 52–57.

40. David Frydinger, et al., *supra* note 20.

41. VITASEK, ET AL., *supra* note 24, at 53; *see also* KATE VITASEK, ET AL., VESTED: HOW P&G, MCDONALD’S AND MICROSOFT ARE REDEFINING WINNING IN BUSINESS RELATIONSHIPS, 37–59 (Palgrave Macmillan, 2012).

42. VITASEK, ET AL., *supra* note 24, at 54.

of ownership and measuring ROI for investments. In addition, the pricing model should be structured to ensure the service provider assumes risk only for decisions within its control. For example, a transportation service provider should not be penalized (or rewarded) for the changing costs of fuel, or a distribution provider should never be penalized for product mix shifts leading to a decrease of throughput. Finally, the pricing model should link incentives to the desired outcomes, thus highly motivating a service provider to invest in innovation and transformation initiatives. The more effective the service provider is at achieving desired outcomes, the more incentives (or profits) it will make.<sup>43</sup>

*E. Rule 5: Governance Structure that provides Insight, not Oversight*

Rule 5 is an essential part of the formal relational contract because it is where the parties put in the mechanisms to “live as we.” Here, the parties design a flexible and credible governance framework to enable Rule 1–4 to work in sync. The structure of the relationship should instill transparency and trust in how operations are developing and improving.<sup>44</sup>

III. LEARNING HOW TO “FORMALIZE” RELATIONAL CONTRACTS

*A. Overcoming Resistance to Formalizing Informal Relational Contracts*

In 2003, UT researchers began work analyzing successful and failed outsourcing relationships in order to help procurement professionals working for the U.S. Armed Forces succeed more consistently. The research involved both Air Force agreements as well as outsourcing contracts entered into by Procter & Gamble, Microsoft, McDonald’s, and the U.S. Department of Energy. A key differentiator for successful relationships was the parties engaged in successful outsourcing relationships worked jointly towards shared goals to drive innovation, create value, and reward success. They consciously laid the foundation of trust, most often with deep levels of transparency. Researchers described their observations as a “Vested” mindset because of the true win-win nature of the relationships based on mutually defined desired outcomes.

One thing that fascinated UT researchers studying the outsourcing contacts was how informal relational contracting practices could be wildly successful but were nevertheless often eschewed as “fluffy” and rarely embedded into a formal contract. Even worse, the “goodness” from these informal relational practices outside of the contract was often abandoned when new stakeholders or leadership entered into the picture. Take for example the widely touted Chrysler supplier relationships profiled in the July/August 1996 issue of *Harvard Business*

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43. *Id.* at 54.

44. *Id.* at 57.

*Review*.<sup>45</sup> The article profiles how Chrysler began to adopt relational contracting practices in 1989 to foster more collaboration and innovation from many of its key suppliers.

In the article, Professor Jeffrey Dyer explained how Chrysler adopted supplier management practices—including involving suppliers in product development and process improvement—that “radically chang[ed] the nature of the relationship” to one of a strategic partnership with shared risk and shared reward. However, many of the commitments and collaborative relationship building and supplier management practices Chrysler adopted with its suppliers were never formally documented in the supplier contracts. For example, the *Harvard Business Review* article states, “Chrysler has given oral guarantees to more than 90% of its suppliers that they will have the business for the life of the model they are supplying and beyond.”<sup>46</sup>

After the DaimlerChrysler merger in 1998, Daimler’s stronger command and control culture for managing suppliers overtook the softer and more collaborative approach Chrysler had built during the early 1990s. By 2000, many of the senior Chrysler leaders who had led the transformation of the firm during the previous decade had left DaimlerChrysler, either voluntarily or through firings, and had been replaced by Daimler personnel. The “new” Chrysler executives ushered back in the conventional adversarial approaches,<sup>47</sup> and suppliers did not have a leg to stand on with much of Chrysler’s commitments being simple oral “handshake” deals and management practices.

UT researchers found while informal relational contract practices such as those implemented by Chrysler can yield significant short-term results, they often are not sustainable because they may be discarded when a so-called “New Sheriff” rides into town. John Henke’s research supports this, arguing that Chrysler missed out on \$24 billion of profits between 2002 and 2012 after Chrysler shifted back to adversarial approaches with its suppliers and abandoned the informal handshake commitments it had made to its suppliers to support the adoption of continuous improvement and to accelerate innovation.<sup>48</sup>

The UT researchers’ observations led them to become advocates of creating formal relational contracts in which the “fluffy” aspects of the parties’ relationship that create value would be formally documented into a legally enforceable contract (which is why FHV call them formal). A well-structured formal relational contract includes many components of a traditional contract but also contains relationship-building elements such as a shared vision, guiding

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45. Jeffrey H. Dyer, *How Chrysler Created an American Keiretsu*, HARV. BUS. REV., July–Aug. 1996.

46. *Id.*

47. Susan Helper & Rebecca Henderson, *Management Practices, Relational Contracts and the Decline of General Motors*, J. ECON. PERSP., Winter 2014, at 49.

48. John W. Henke, Jr., et al., *Lost Supplier Trust, Lost Profits*, SUPPLY CHAIN MGMT. REV., May/June 2104, at 24, 26, 32, [https://www.scmr.com/article/lost\\_supplier\\_trust\\_lost\\_profits](https://www.scmr.com/article/lost_supplier_trust_lost_profits) (on file with the *University of the Pacific Law Review*).

principles, and robust governance structures to keep the parties' expectations and interests aligned.

The UT researchers' premise is simple. Parties should use a series of collaborative working sessions where stakeholders co-create a flexible contract framework built to guide the parties to continuous alignment over the life of the relationship. Rather than negotiate the points of the deal, the parties negotiate the nature of the relationship and guiding principles based on proven social norms first. Only when those elements are in place should the parties turn their attention to negotiating specific deal terms.<sup>49</sup>

#### *A. The Development of the Vested Relational Business Model*

After critical success factors for large-scale, long-term outsourcing relationships had been identified, the next step for UT researchers was to codify those insights into a repeatable methodology that organizations could follow to improve their outsourcing relationships.<sup>50</sup> Figure 2 illustrates the idea that successful Vested relationships leverage an outcome-based business model, insights from behavioral economics, and investing in the articulation of shared values.

- Outcome-based approaches, which have roots in the aerospace and defense industries, center around paying a supplier or service provider for achieving a defined set of business outcomes rather than paying for a transaction or activity to be performed.
- Behavioral economics is the study of the quantified impact of individual behavior or of the decision-makers within an organization. Behavioral economics is evolving more broadly into the concept of relational economics, which proposes that economic value can be expanded through positive (win-win) relationships thinking rather than adversarial relationships (win-lose) thinking.
- Shared value principles are concepts to generate economic value in a way that builds value for all parties. Entities work together to bring value that benefit all parties—with a conscious effort that the parties gain or share in the rewards. UT researchers call this a “what’s in it for we” mindset.

These three modern business principles combine to form the Vested model, which stresses the importance of building highly collaborative, mutually

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49. JEANETTE NYDEN, ET AL., GETTING TO WE: NEGOTIATING AGREEMENTS FOR HIGHLY COLLABORATIVE RELATIONSHIPS 80, 119, 121 (2013).

50. BONNIE KEITH, ET AL., STRATEGIC SOURCING IN THE NEW ECONOMY: HARNESSING THE POTENTIAL OF SOURCING BUSINESS MODELS FOR MODERN PROCUREMENT 4 (2016).

successful relationships with suppliers while emphasizing creating and sharing value for everyone involved.<sup>51</sup>

The Vested model represents such a departure from the conventional wisdom regarding sourcing strategy that the reaction of many business leaders upon learning about it was skepticism. For example, Rob McIntosh, a Senior Vice President at Dell Global Fulfillment, Logistics and Trade, later explained why he was initially skeptical and why Dell ultimately committed to participating in a Vested pilot with their reverse logistics outsource partner, Genco (now a part of FedEx). The Dell–FedEx relationship began in 2005 when Dell outsourced some of its reverse logistics activities to Genco. The relationship and contract expanded after FedEx took over Genco and agreed to acquire Dell’s buildings, assets, and people under a three-year outsourcing contract.<sup>52</sup>

The problem was Dell and FedEx made the shift to a more strategic relationship, which was more complex, risky, and interdependent than the original transactional-type work. Unfortunately, the transactional structure of the agreement was far from strategic: it remained a typical transaction-based contract in which FedEx assumed the risk of meeting a set “price per activity” while maintaining service levels. The agreement worked reasonably well for a time, but Dell’s leaders continued to face cost pressures, and they insisted on an “every dollar, every year” procurement principle—even though under the more strategic relationship FedEx assumed much of the risk under the contract terms.<sup>53</sup>

After Dell and FedEx committed to carrying out the first Vested methodology pilot project, they found they had the tools they needed to transform their relationship. In the first two years, Dell and FedEx were able to reduce costs by 42%, scrap costs by 67%, and bring defective parts per million to record-low levels. Both companies now consider the Vested contracting approach a best practice and have applied it in other relationships. FedEx also benefited with a tripling of its margins. John Coleman, FedEx’s general manager of operations for Dell’s reverse logistics business, explained the power of a collaborative win-win approach: “It’s like we broke open an innovation piñata. Genco (FedEx) employees now know that we will share in the reward for good ideas.”<sup>54</sup>

In 2020, Dell is only one of more than fifty organizations that have successfully applied the Vested methodology to spend categories as diverse as

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51. KATE VITASEK, ET AL., *THE VESTED OUTSOURCING MANUAL* (2011); *see also* BONNIE KEITH, ET AL., *STRATEGIC SOURCING IN THE NEW ECONOMY: HARNESSING THE POTENTIAL OF SOURCING BUSINESS MODELS FOR MODERN PROCUREMENT* (2015); Kate Vitasek, *The Catch-22 of Outsourcing Relationships*, *FORBES* (May 19, 2019, 5:00 PM), <https://www.forbes.com/sites/katevitasek/2019/05/19/the-catch-22-of-outsourcing-relationships/#6de00b9e1177> (on file with the *University of the Pacific Law Review*).

52. Kate Vitasek, et al., *How Dell and FedEx Supply Chain Reinvented their Relationship to Achieve Record-Setting Results* 3, *VESTED WAY* (June 26, 2018), <https://www.vestedway.com/wp-content/uploads/2018/07/Dell-FSC-long-teaching-case-June-26-2018-PDF.pdf> (on file with the *University of the Pacific Law Review*).

53. *Id.*

54. *Id.*; *see also* David Frydinger, et al., *supra* note 20.

facilities management, reverse logistics, third party logistics, environmental services, fiber optic network management, and labor services. At the time of writing this article, more than 350 companies have sent nearly 1,600 people to study Vested in one or more UT courses offered in its Certified Deal Architect program. To date, fifty-seven companies have employed the Vested methodology in an effort to improve their outsourcing relationships. Indeed, Telia, a Swedish telecommunications company, has five Vested deals.<sup>55</sup>

Dawn Tiura, President and CEO of the Sourcing Industry Group (“SIG”), appreciates the emphasis organizations are starting to place on relational contracting: “Far too often. Procurement professionals fail to recognize that they can’t use power-based, arms-length contracting tactics when they are seeking to have a strategic relationship with their suppliers or business partners. The process outlined in *Getting to We* is excellent for helping put relational contracting theories into practice.”<sup>56</sup>

Tim Cummins, CEO of the International Association of Contract and Commercial Management, shared his perspective in IACCM’s Commitment Matters blog: “Relational contracting—the integration of the relationship terms into the contract—has been an evolving reality . . . There is growing interest by the legal profession and by the courts in making sense of relational agreements, with a number of recent cases highlighting these developments.” The law “is catching up with commercial reality,” he noted.<sup>57</sup>

### B. Design Principles for Formal Relational Contracts

UT researchers worked with the International Association for Commercial and Contract Management and legal contract professionals to lay out how the Vested Rules could be incorporated into a contract. The result was a second book, *The Vested Outsourcing Manual*.<sup>58</sup> This eventually led to UT researchers launching the “Creating a Vested Agreement” online course where joint deal architect teams would take the course together to learn the basics, and then set out to “do” using a series of toolkits designed to help the contracting parties put the theory into practice.

As the parties work through the course and complete the deliverables, one of the team members (often a lawyer or commercial manager) will translate the

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55. Kate Vitasek, *The Evolution of the Vested Business Model: From Research to a Methodology to a Movement*, NATIONAL CONTRACT MANAGEMENT ASSOCIATION (June 1, 2019), <https://www.ncmahq.org/news/magazine-details/the-evolution-of-the-vested-business-model-from-research-to-a-methodology-to-a-movement> (on file with the *University of the Pacific Law Review*).

56. Kate Vitasek, *Driving Integrity: Relational Contracting on the Rise*, FORBES (May 20, 2015, 07:48 AM), <https://www.forbes.com/sites/katevitasek/2015/05/20/driving-integrity-relational-contracting-on-the-rise/#170625b55525> (on file with the *University of the Pacific Law Review*).

57. Tim Cummins, *The Evolution of Relational Contracts*, COMMITMENT MATTERS (Feb. 19, 2015), <https://commitmentmatters.com/2015/02/19/the-evolution-of-relational-contracts/> (on file with the *University of the Pacific Law Review*).

58. KATE VITASEK, ET AL., *supra* note 51.

decisions and deliverables into an actual contract. Figure 3 below provides a conceptual overview of how the Vested Five Rules interact with ten contractual elements that are essential to create a Vested Agreement.<sup>59</sup>

A key design principle behind a Vested agreement is to create a flexible contracting framework. The legal terms and conditions remain the master agreement, but the majority of the business aspects, including their associated legal clauses, shift to contract schedules ideally written in plain language.

After ten years and with over fifty organizations piloting the Vested methodology for creating a formal relational contract, one thing is clear: most contracting and legal professionals still view formal relational contracts as “fluffy” when they start to learn about the concept. But their mindset quickly changes when they begin to use the methodology and later see the results.

David Frydinger, Partner at Cirio Law Firm in Stockholm, Sweden, offers a unique perspective on how to put relational contracting theories into practice. Before becoming an attorney, Frydinger studied both sociology and law. As a practicing lawyer at one of the largest law firms in the Nordics, as well as an adjunct faculty member who teaches a collaborative contracting course at the University of Tennessee Haslam College of Business Administration, he is an international authority on relational contracts. Frydinger suggests that:

In relational contracts, social norms like loyalty, autonomy and integrity that are proven to be value-creating for the parties, are transformed into contractual norms. The contracting process and the contract itself embed ethical social norms in the commercial relationship. This has worked very effectively in the Vested model, which is designed for highly collaborative and strategic relationships. One of the key reasons the Vested approach has been so successful is because people trust the process, and as such begin to trust each other.<sup>60</sup>

In a recent academic paper, *Overcoming Contractual Incompleteness: The Role of Guiding Principles*, David Frydinger and Oliver Hart emphasize the importance of incorporating guiding principles that can bring parties to a new contracting reality. The adoption “of guiding principles such as loyalty and equity” in contracts can help bring reasonableness to contracts while avoiding “abnormal” states and deadweight losses.<sup>61</sup>

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59. Kate Vitasek, *Five Rules & Ten Steps to Collaborative Contracting*, DHL (Dec. 2014), <https://www.dhl.com/global-en/home/about-us/delivered-magazine/articles/2014-2015/five-rules-and-ten-steps-to-collaborative-contracting.html> (on file with the *University of the Pacific Law Review*).

60. Telephone Interview with David Frydinger, Partner, Cirio Law Firm, (Dec. 15, 2020).

61. Frydinger & Hart, *supra* note 31, at 1.

#### IV. CONCLUSION

Only time will tell whether the theory of formal relational contracts advanced by FHV is innovative enough and powerful enough to resolve the paradox of relational contracts. Because the theory of formal relational contracts grew out of an in-depth empirical search for the root causes of success and failure with the U.S. Air Force's long-term, large-scale outsourcing contracts, it is more rooted in contemporary commercial practice than earlier theoretical advances based on modern economics which rely heavily on abstract models of behavior that can be modeled mathematically.

Not all business relationships are good candidates for formal relational contracts. If there is too little at stake on either side to justify the steep investment in building a "Vested Way" framework for collaboration, then positional negotiating behavior and a transactional approach to contracting may be the best strategy. If asymmetries in the parties' interests are too great, then it is possible that no amount of effort invested in applying the Five Rules of the Vested Way will be enough to mitigate the risk of opportunism by one party.

The theory of formal relational contracts may help to diminish the fundamental disconnect in modern business practices that comes from treating financial measures of the success of an enterprise as equivalent to successful collaboration designed to produce something real people would truly value.<sup>62</sup> The process of hammering out a formal relational contract may be slow and difficult, but it should be allowed to continue until the parties have created a system within which both feel confident their investment in the outsourcing relationship will be fairly rewarded. A formal relational contract should be legally enforceable, not because the parties took the time to identify all possible future outcomes and explicitly allocated the risks of those future outcomes to one party or the other, but because the parties took the time to create a shared governance mechanism that provides concrete, consistent rewards to constructive behavior, while discouraging opportunistic behavior.

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62. See, e.g., Clayton M. Christensen & Derek C.M. van Bever, *The Capitalist's Dilemma*, HARV. BUS. REV. June 2014.

Scott Cook, the founder and executive chairman of Intuit [described] what he sees as the tyranny of financial metrics. He has observed that a focus on financial outcomes too early in the innovation process produces "a withering of ambition." He argues that financial metrics lack predictive power. "Every one of our tragic and costly new business failures had a succession of great-looking financial spreadsheets," he says. Now new-product teams at Intuit do not submit a financial spreadsheet to begin work and testing; rather, he notes, they focus on "where we can change lives most profoundly."

*Id.*