

Collaborative Cos. Should Consider Relational Contract Model

By **Glenn Meier, Kim Cooper and Jerrell Berrios** (June 30, 2023)

It's a volatile world to do business in, a fact highlighted by issues such as recent and ongoing supply chain disruptions first triggered by the COVID-19 pandemic.

Many businesses are looking to address that volatility by being agile and highly collaborative.

In a dramatic departure from widely accepted previous notions, almost 200 U.S. CEOs committed to operating their businesses in a way that served the interests of all stakeholders, the prior view being that the sole obligation of a company was to maximize shareholder return.

The Business Roundtable, an association of CEOs from U.S. companies, issued a statement on the "Purpose of a Corporation" four years ago — and reaffirmed it last year — identifying five different stakeholder groups: customers, employees, suppliers, communities and shareholders, and affirmed an obligation to work for the benefit of all of those groups.

At a basic level, this statement rejected the view of business as a win-lose game where players compete to maximize their allocation of a fixed pie, and called for business to operate as a win-win game where players collaborate to maximize the overall size of the pie, an approach that has come to be known as "stakeholder capitalism."

Volatile circumstances throughout the world further underscore the need for collaborative relationships between stakeholders. The most recent example of such volatility is the supply chain disruptions triggered by the COVID-19 pandemic.

As the practice of stakeholder capitalism grows, opportunities exist for the legal profession to deliver immense value to clients by helping them create and maintain highly collaborative relationships. One way forward is through the use of relational contracting models — contracts specifically designed to support collaborative relationships.

What Are Relational Contracts?

Traditional contracting is a potential breeding ground for conflict. Even well-intentioned parties likely genuinely interested in fostering a collaborative relationship often find themselves negotiating to maximize their individual interests.

The traditional contract approach views business relationships through a "winner takes all" mentality that tries to create contract terms that build advantages when unforeseen issues occur.[1] So instead of a contract that aids the parties in reaching a shared vision and amicably working through disagreements, contracts are traditionally used as a tool to protect against abuse in a relationship.[2]



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This tendency to build contracts as a protective tool rather than a relationship management tool has been identified by economics as the hold-up problem, or the fear that one party will be adversely held up by another.[3]

Driven by the above dynamics, parties resort to contractual terms used to ensure advantages over their partner.[4] These terms can 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," according to David Frydlinger, Oliver Hart and Kate Vitasek's 2019 article "A New Approach to Contracts." [5]

But from a business perspective, these types of terms create a perverse incentive for inducing worse outcomes.[6] For example, using multiple suppliers, instead of only one, balloons costs. Termination-for-convenience clauses incentivize suppliers to not invest in relationships or to innovate.[7]

So as a result, traditional contracts risk creating a "lose-lose" mindset among parties.[8]

Recognizing these issues, some U.S. companies have sought to employ formal relational contracts. In the aforementioned "A New Approach to Contracts," formal relational contracting is defined as an enforceable agreement that "specifies mutual goals and establishes governance structures to keep the parties' expectations and interests aligned over the long term." [9]

While formal relational contracts contain similar components to a traditional contract, they also contain relationship-building elements to help guide disputes and keep interests aligned, such as a shared vision, guiding principles and robust governance structures.

Assessing Suitability for Relational Contracts

The creation of a relational contract requires the investment of time and attention at the outset of the process to specifically define the parameters of the relationship. Prior to entering into a relational contract, parties must ensure they are willing to abandon default win-lose approaches to disagreement and disruption.

Formal relational contracts are most suited for ongoing, long-term commercial relationships that require a high degree of coordination, cooperation and trust. Such relationships often involve significant investments of time, money and resources, and may be characterized by complex interdependencies and frequent interactions.

Examples of relationships that may be suited to entering formal relational contracts include:

1. Strategic partnerships: Companies that collaborate to achieve strategic goals such as joint product development, market expansion or cost reduction may benefit from formal relational contracts.
2. Joint ventures: Companies that pool their resources to undertake a new business venture may need to establish formal relational contracts to clarify their respective roles, responsibilities and expectations.
3. Supply chain relationships: Companies that rely on a network of suppliers and vendors to source materials, components or services may benefit from formal relational contracts that

ensure a reliable supply chain.

4. Public-private partnerships: Public-private partnerships that involve long-term commitments related to the design, building and finance of infrastructure projects that then must be maintained, operated or leased may also benefit from formal relational contracts.

5. Labor-management agreements: The relationship between a business and the people who work for that business is critical to that business's operation. The relationship between labor and management is highly interdependent and will always have a major impact, either positive or negative, on the business's success. Moreover, as companies focus more on creating highly engaging cultures for their employees, an adversarial approach to the labor-management relationship can work counter to that effort.

Companies that engage in ongoing, complex and strategic relationships are most likely to benefit from formal relational contracts that provide a framework for coordination, cooperation and trust.

How To Create a Relational Contract

There are multiple models for creating relational contracts.[10] While each model can have certain unique aspects, they typically involve three general steps.

First, the parties align on the overall purpose and mission of the commercial relationship. Second, they adopt guiding principles that serve as a framework for addressing unanticipated circumstances over the life of the contract. Third, they adopt governance practices for the life of the contract that are designed to detect misalignment early and correct it.

Shared Purpose and Mission

The initial step of aligning on shared purpose and mission involves several key tasks, including:

- Building trust between the parties by openly discussing their respective objectives, motivations and values;
- Identifying the common goals and objectives that the parties share, and developing a shared vision for the relationship based on those goals;
- Establishing a shared understanding of the value that each party brings to the relationship, and identifying ways in which they can work together to create value for each other and for their stakeholders; and
- Developing a joint plan of action that outlines the steps that the parties will take to achieve their shared vision and establishing metrics for measuring progress.

Guiding Principles

In negotiating a contract, particularly one for an ongoing long-term relationship, it is a virtual certainty that parties will not be able to provide specific terms covering everything that will unfold throughout the contract.

Traditional contracts address such issues by having a neutral third party assess the intent of the parties based on interpreting the language of the document and potentially, parol evidence.

Relational contracts take the approach of equipping the parties with their own tools to address unanticipated circumstances — the use of guiding principles. This step involves several key tasks, including:

- Identifying the values and principles that are important to each party and finding areas of common ground;
- Developing a shared set of guiding principles that will serve as a foundation for the relationship, and that will help to ensure that the parties conduct themselves in a manner that is consistent with their shared vision;
- Incorporating the guiding principles into the formal relational contract and establishing processes for monitoring compliance; and
- Ensuring that the guiding principles are communicated to all stakeholders, and that they are reflected in the parties' day-to-day operations.

Governance Process

This step involves establishing clear expectations for the parties' roles, responsibilities and performance that are aligned with the guiding principles. It also involves creating processes that allow the parties to discover early if they have a potential disagreement and to engage with that disagreement in a way consistent with their guiding principles. The key tasks for this step include:

- Establishing clear roles and responsibilities for each party and ensuring that each party understands what is expected of them;
- Developing clear performance metrics and standards that will be used to evaluate each party's performance and establishing processes for monitoring and reporting on performance;

- Developing clear communication protocols that will ensure that each party is kept informed about important developments, and that issues are addressed promptly and effectively; and
- Establishing clear dispute resolution mechanisms and ensuring that the parties understand how disputes will be resolved if they arise.

Once a relational contract is in place, the parties should regularly consult it and follow along with the relational governance that they designed.

Relational contracts envision active and ongoing management of the relational aspects of the agreement. At a minimum, parties should regularly review and update their guiding principles to ensure that they remain relevant and reflective of the parties' shared vision.

Developed metrics should be tracked, and any shortfalls in performance should be addressed to ensure they don't develop into active disputes. This ongoing and active governance of the relationship between the parties provides ongoing opportunities to improve the relationship and identify new ways to create value for all parties.

Conclusion

It is essential to recognize the importance of effective contracting. However, in today's business environment, simply drafting a standard contract may not be enough.

This is where formal relational contracts come in. These contracts go beyond the traditional transactional approach and establish a long-term, collaborative relationship between parties.[11]

Attorneys must recognize the benefits of formal relational contracts and work with clients to develop contracts that are tailored to their specific needs. By doing so, lawyers can help clients establish strong, long-lasting relationships that are built on trust, collaboration and mutual success.

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[1] See, e.g., Manpreet Dhillon, Formal Relational Contracts – The New Corporate Practice?, ContractPodAI, <https://contractpodai.com/news/formal-relational-contracts-new-corporate-practice/>.

[2] Id.

[3] David Frydinger, et al., A New Approach to Contracts, Harvard Bus. Rev., <https://hbr.org/2019/09/a-new-approach-to-contracts>.

[4] Id.

[5] Id.

[6] Id.

[7] Id.

[8] In my practice litigating commercial contract cases, my anecdotal experience has taught me that disputes often arise over how to allocate risk of unforeseen issues. When these unforeseen issues arise, contract terms are commonly drafted in a way that forces conflict instead of resolving them. And while many Alternative Dispute Resolution models exist that leave space for the parties to work collaboratively, in my experience those opportunities are seized far less often than they could be.

[9] David Frydinger, et al., A New Approach to Contracts, Harvard Bus. Rev., <https://hbr.org/2019/09/a-new-approach-to-contracts>.

[10] See e.g. consciouscontracts.com; vestedway.com.

[11] Because parties to a relational contract envision a collaborative rather than an adversarial relationship, lawyers working with clients on relational contract must likewise be able to operate collaboratively. This can create tension with a lawyer's professional obligations particularly as they pertain to defining the scope of the client relationship, the scope of the lawyer's work, and the avoidance of conflicts of interest. A full exploration of these issues is beyond the scope of this article, but lawyers considering undertaking this work should thoroughly review the applicable rules and communicate with prospective clients to ensure the relationships and the lawyer's professional obligations are understood by all.