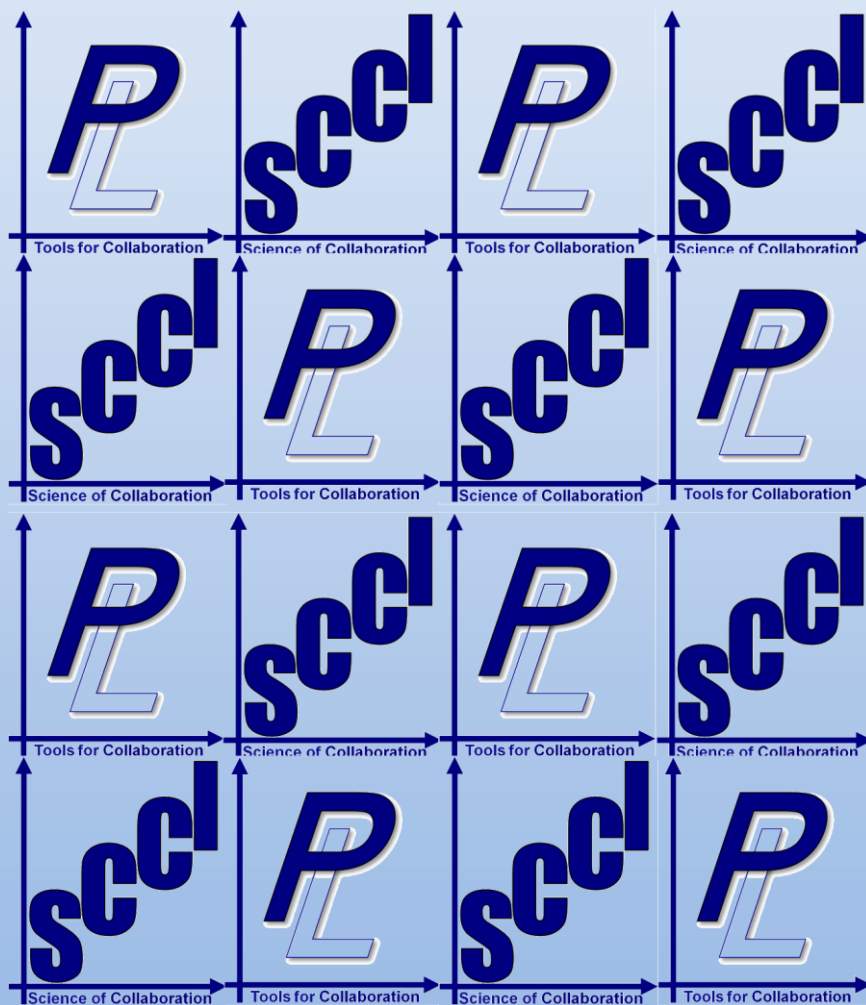


Contracts or Relationships: What's Right for Collaborative Enterprises?



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By Andrew Humphries & Linda McComie

Introduction

Traditional management theory on contracts states that partnering governance has to deal with three main challenges:

- Safeguarding exclusive investments
- Measuring relationship performance
- Adapting to unforeseeable changes

Thus companies have often relied on contract terms and conditions to manage suppliers. However, collaborative relationships are complex, strategic in nature and their outcomes are difficult to predict. In these circumstances writing comprehensive, enforceable contracts is extremely difficult to do.

This article reviews how these challenges manifest themselves in today's collaborative relationships. It then describes how organisations have responded by combining flexible contracts with relational governance within a management framework encompassing the joint enterprise.

The Governance Challenges

Exclusive investments are the specialised human and/or physical resources that each party contributes to the relationship. For example, an information systems supplier will have to provide a customized service to the client. Similarly, the client will have to develop an understanding of the supplier's procedures, approach and language to effectively utilize his service. Both parties may thus become 'locked in' to the relationship. This dependence on each other requires management effort to maintain positive outcomes and to avoid the friction that can arise from feelings of claustrophobia.

At the acrimonious dissolution of their relationship the High Court judge criticised IBM and Astra Zeneca in a highly publicised case for failing to have an Exit Plan which ensured the equitable distribution of IPR.

Performance Measurement is the difficulty linking relationship rewards to productivity which allows the partners to share the value they create fairly. It is thus important to build a clear, joint understanding of those aspects of the relationship that affect the bottom line and the ability to create value. In addition to those measures of "gain share", criteria such as levels of partnership effectiveness should be included. When there is a lack of transparency, trust diminishes as does commitment. Friction costs will eat away at profits.

“Their mentality is to make the most money from us and there is very little of working as a partnership towards a common goal, sharing objectives and risks.”

Uncertainty challenges the partners to adapt to problems raised by unforeseeable events. For example in the external environment rapidly changing technology is a dominant feature. Adaptation requires a high degree of C³ Behaviour (coordination, cooperation and collaboration) by relationship partners. These behaviours require significant management effort and are critical to relationship survival.

“The benefit of our partnering arrangement is we are ‘future-proofed’, uncertainty is removed, we can plan and we can really focus on the customer”.

Contract Management

Formal contracts represent promises or obligations to perform particular actions in the future. They specify require actions and conditions of contractual breach and also a framework for resolving disputes. The three challenges singly or in combination make effective contracting difficult to achieve. They also stretch the ability of the relationship to adapt. The 2008 terrorist attack in Mumbai caused a number of companies to rethink their overseas sourcing strategies. The recent shift to total service contracts in facilities management requires a completely different approach to performance measurement. The temptation is therefore to write more complex contracts containing clauses to cope with every eventuality but inevitably they will always be incomplete. This comes with high costs, both up-front and on-going. For example clauses may specify third party monitoring, disclosure of necessary records to justify work done, and, if possible, the use of benchmarks to gauge the performance of the work done.

A global food manufacturer outsourced some seasonal product lines to a small, world-class, niche producer. The supplier was expected to fill retailers’ shelves with high-quality, low-cost items. However, the customer insisted on controlling raw material sourcing and demanding weekly production statistics as if it was one of its own factories. The result was severe friction between the partners and disagreement over the performance of third-party logistics providers.

Thus, formal contracts of this type impair the efficiency of strategic, collaborative relationships. Furthermore, they can signal distrust of your partner and encourage rather than discourage opportunistic behaviour such as actively looking for ‘holes in the small print’ and finding ways of minimising the profit you have to share.

Some have said that contracts are not appropriate for collaborative relationships where a ‘hand-shake’ should suffice. However, there is still a critical need for contracts to provide a legal structure to support the joint enterprise. But they must shift from merely specifying deliverables to providing frameworks that facilitate the evolution of highly cooperative, flexible relationships that are focused on outcomes – relational contracting. An example in common use is the NEC3 ECC Form of Contract used in engineering, construction and other sectors. "Where traditional forms of contract can promote an adversarial relationship

between contractor and client, the NEC promotes a partnering, collaborative approach which has a consistent record of delivering projects on time and on budget at its core.”

A pair of successful SMEs had grown their businesses together over 20 years without a contract in place. However, difficulties with creating and launching a new product made them realise that their processes, communications and technical co-ordination had become disjointed. The lack of a clear framework for managing the relationship resulted in higher process costs, communication disconnects, loss of competitive edge and growing hostility.

The process of sitting down together to agree on value goals, operational tactics, the relationship management structure and performance measurement will promote collaborative working. Moreover, it will ensure that the relationship is flexible and constantly able to maximise its potential.

“Now that we have a partnering arrangement around a good framework contract we just concentrate on the customer, we no longer refer to the small print”.

Relational Governance

There is some confusion over what collaboration between outsourcing organisations actually means and looks like. Traditional business relationship management approaches to working with customers and suppliers often ignore the essential jointness implied by collaboration. Our view of collaboration is where firms enter into buyer-seller relationships, supply chain partnerships, services provision or any other alliance combinations. They work together using their specialised resources innovatively to achieve aims and objectives that they could not realise on their own at an acceptable cost.

Collaborative relationships are based on the meeting of minds. Joint relational governance emerges from the values and agreed processes found in social relationships which may work better to minimise the effects of the challenges than detailed contracts. These are usually scattered across any number of roles and individuals who are working to achieve local outcomes such as the salesman who is keen to keep the customer happy so he can land the follow-on deal.

Relational governance promotes positive attitudes resulting in:

- Flexibility - the ability to adapt in a fluid environment.
- Solidarity - encouraging joint problem solving and creating a commitment to joint action through negotiation.
- Information sharing - encouraging transparency, short and long-term planning and joint goal setting.

As the parties commit to these the result is C³ Behaviour.

Two Food Supply Chain Relationship Managers got on really well together. Both had complete handles on their organisations and their operations. They had worked through

their firm's goals and developed a workable plan to achieve value for both organisations. Their attitudes and professionalism permeated the entire relationship. They not only trusted each other but also respected each other's capabilities to the extent that they were able to form a successful, united front when dealing with their end customer, a major supermarket retailer.

Relational governance fosters expectations of continuity. It encourages the partners to take a long –term view of the relationship including investments, performance, innovation and rewards. Over time trust will develop and strengthen. Under these conditions working together is likely to bring about increased interdependence where the parties become reliant on each other to achieve their goals. The growth of trust ensures that neither feels constrained by the loss of autonomy.

“We need to create a more open environment of trust where either party can raise an issue which gets actioned.”

However, although relational governance creates an environment to overcome the governance challenges, it is unstructured and unbounded in nature. It therefore limits the effectiveness of teamwork and the performance improvement that collaboration can achieve. The provision of a formal management structure is therefore critical to collaborative relationship success but this does not come without a cost.

Enterprise Relationship Management

The Enterprise Relationship Management (ERM) framework is a structure for co-ordinating all the business activities that are essential to the success of a joint/multi-party endeavour. It brings partnership management into sharp focus because it becomes proactive and accountable. It is comprised of formal organisational arrangements that ensure all activities are jointly managed at all levels. It needs to be supported by an objective performance measurement system that allows creation of a clear, joint understanding amongst the partners and enables them to get things done to time, cost and quality. Moreover, it puts in place a management system that has the ability to always create and capture the maximum joint value possible within the relationship. Its success is dependent upon the commitment of dedicated resources but it will become a valuable capability in its own right as expertise grows in the management of complex outsourcing relationships.

“We are starting to face up to performance issues at our regular meetings. In the past mutual defensiveness got in the way of making improvements. This has been a very hard matter to tackle but it is getting easier as we get used to working together”.

In practice Enterprise Relationship Management is carried out operationally by Relationship Managers who will focus typically on matters such as:

- Review performance targets in last period and issue statistics
- Review work/orders in progress

- Review forecasted work, sales and orders in next period
- Consider and solve problems
- Actively seek out and initiate process improvements
- Review future plans (including new products) and initiate preparation
- Review industry and technology updates
- Identify policy issues to refer to senior management
- Involve other supply chain partners
- Review and update the commercial agreement
- Update the Enterprise Relationship Management Plan

“Regular meeting to discuss lead times, deliveries and technical problems are essential enablers to building trust.”

A key part of this is the management of innovation and the joint improvement process which would:

- have a cross functional view
- track ideas
- identify potential benefits
- prioritize initiatives
- establish joint roles and responsibilities for implementation

A supplier placed one of its electronics specialists in its customer’s R&D team. By replacing a number of older components with a single module he was able to slash production costs by 20% and shortened the development of a new product by a year. The new product had a greater range of features, was more reliable, used less power and its potential market life was extended. The final offering proved to be competitive breakthrough in terms of technology, price and improved market share. Both firms secured 30% revenue increases.

Effective Collaboration

Collaboration is where firms freely enter into relationships in order to work together using their specialised resources innovatively to achieve aims and objectives. The customer wants more than an efficient, cost-effective turn-key operation. He wants a successful, cutting-edge supplier to contribute to the achievement of his strategic objectives. The supplier wants a deeper, more valuable, long-term relationship with a successful customer. Bring these two together within an effective relationship and it is possible to open up new opportunities to share increased returns.

The secret to doing this is to combine framework contracts and relational governance within the ERM structure which provides the joint, formal organisational arrangements. The framework contract defines the required governance structure and the broad objectives of the relationship. It becomes a living entity that adapts to the changing needs of the joint business. It promotes stability and thus supports the relationship’s capacity to respond to the challenges. Relational governance provides the essential behaviours and attitudes such

as openness, honesty, trust, co-operation and long-term orientation that enable effective teamwork.

It is this combination of framework contracts and relational governance within Enterprise Relationship Management that generates higher collaborative relationship performance than any governance mechanism in isolation. In particular, the effective collaborative will provide greater resilience in the face of operational and commercial risks.

“Whether you have a Supplier in Tianjin or 15 miles down the road, whether you have a Joint-Venture Partner in Madrid or New York, whether you have an OEM Customer in Loughborough or Sao Paulo; an unrelenting focus on developing and maintaining mutually successful medium and long-term business partnerships through meaningful collaboration is critical to building a Company in the 21st Century. After all, with the complexities and competitiveness of today's business environment, none of us can do it all on our own, can we?”

Further Reading:

Andrew Humphries & Linda McComie (2022), **Implementing and Managing Collaborative Relationships – A Practical Guide for Managers**
Routledge, New York, ISBN 978-1032-1173-86
155 pages

Do formal contracts and relational governance function as substitutes or complements?
Poppo, Laura; Zenger, Todd, *Strategic Management Journal*; Aug 2002; 23, 8

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