Contractual and Relational Governance Practices

Eric GP Esperne, JD, CPCM, President
James River Consulting LLC
eesperne@jamesriverllc.com   703-850-7061

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Abstract. Relationship management has become favored over written contracts for governance of long term complex services arrangements, because it is more flexible. But relationship management has its own problems, in particular its cost. These two approaches to governing third party services are not mutually exclusive, however. Rather they are two ends of a spectrum of contractual and relational governance methods, with performance measurements occupying the middle. A breakdown of the principles of good governance, and a decision workflow for how to decide on which governance approach is right for a given situation, are presented in this paper.

Introduction. The way business and government customers and service providers manage long term, complex services contracts has undoubtedly undergone a paradigm shift in recent years. Rather than entering into a transaction defined by legally binding terms, parties now purposely enter into a loosely defined cooperative relationship intended to produce business outcomes like more cost efficient operations or increased competitive advantage in the marketplace. Nowhere is this shift more evident than in outsourcing. The size and complexity of outsourcing deals, often reaching into the billions of dollars, the long and captive nature of outsourcing relationships lasting 5 years or more, and the unpredictability of changes in business conditions, technology and market forces has increasingly lead away from reliance on contracts to manage and control outsourcing, and towards the joint and dynamic "governance" of outsourcing relationships independent of definitive contractual terms.[1]

The End of Contract Management? Prominent outsourcing experts Sara Cullen and Leslie Willcocks maintain that aligning and maintaining "values" is more important to outsourcing than written contracts or arms length dealing.[2] Management consulting firm Vantage Partners, a spinoff of the Harvard Negotiation Project, brazenly states that written contracts are detrimental to the management of outsourcing. Scholars in the fields of management and information systems sciences have also argued that contracts and the negotiation process undermine outsourcing governance for several reasons. Contract negotiations and reliance on terms creates distrust between customer and provider, whereas governance is based on the existence of trust. Specification of service terms induces the moral hazard of not doing what is not written in the contract, while governance promotes it. The negotiation process required by contracts creates substantial up front transaction costs not present with governance. Creating detailed, complex contracts inhibits the free exchange between customer and provider that is at the heart of governance. The net effect of relying on both contracts and governance to manage outsourcing is a negative one.[3]

Downside of Governance. Surveys conducted by outsourcing advisory firms have found that outsourcing customers spend on average about 7% of total contract value on governance, but the range of spend figures can go as high as 11%.[4] The Carnegie Mellon eSourcing Capability Model for Client Organizations (eSCM-CL) states that governance costs should be between

2% and 12%.[5] The wide fluctuation in the cost of governance found in surveys should not be surprising. Governance is not self-limiting in the way contracts management is. Whereas contract management takes place within the explicit framework of a contract document and consists of monitoring performance and administering customer-provider interactions, governance has no self limiting characteristics. The size and cost of governance can be as much or as little as the parties perceive is needed to achieve desired outcomes. If objectives are not being met, the logical response is to increase the amount of governance. At the end of the day, governance must govern itself, an inherent flaw which itself creates governance on top of governance and further increases costs.

Unfortunately, increasing the amount of governance does not mean greater success in outsourcing. A 2007 survey by prominent outsourcing consultancy EquaTerra concluded that there is no correlation between the amount spent on governance and satisfaction with governance.[6] The same 2007 EquaTerra survey generated another interesting result: While almost half of respondents said that a strong contract was the most important driver of outsourcing success, only one third replied that outsourcing governance was most important.[7]

Finally, the organizational and personnel competencies required to conduct governance can be very difficult and costly to develop or obtain.

Purpose Driven Governance[TM]: A Best Practices Approach to Governance. What, then, should corporations and Government agencies consider as best practices in governing outsourcing and other long, complex services engagements? When should negotiating and enforcing contract terms be enough governance? When should governance practices far removed from contracts management be followed and how much should be invested in them? Can relational governance and classic contract law compliment each other and be used as part of a single governance strategy?

While there are several methodologies available that help organizations design more effective relational governance, there are non that answer threshold questions about using relational governance in a larger context of contract management alternatives, constraints on governance, and alternatives to governance. Purpose Driven Governance[TM] is a methodology that seeks to craft, negotiate and implement optimal governance for outsourcing and long, complex services.[8] By first looking at the goals driving the outsourcing or services engagement, then working through a sequence of questions in a decision workflow, Purpose Driven Governance[TM] enables parties to determine the best governance practices for an outsourcing or services engagement. Results of the decision workflow can be presented by one party at the negotiating table, or both parties can jointly work through the methodology. The conclusions about governance reached through the workflow can also flow into many other critical decisions about the outsourcing or services engagement, including acquisition planning, negotiation strategy, vendor selection, and setting expectations among stakeholders and between the parties.

Figure 1 shows the Purpose Driven Governance[TM] decision workflow.

Governance = Decision making + Control. Governance is decision making. Decision making in outsourcing and services engagement can congregate around one of several distinct models, each containing sets of practices. At the root, what distinguishes these models of governance is the type of decision making they require.

Governance can be based on the established model of contracts and contracts management: Buyer and seller negotiate terms and hold each other to them. Final decisions must be reached prior to contract execution, otherwise there is no benefit in having a written contract. It requires rational or "classic" decision making, meaning that the decision maker has access to all of the information needed to make a decision, knows the choices and has had the opportunity to full deliberate about the decision. The decisions made are intended to stand with little or no change, unless the parties intend to renegotiate at a later time.

Alternatively, governance can be guided through "programmatic" decision making mechanisms incorporated into contract as terms. Decision making mechanisms are not the terms of service delivery per se but the rules by which terms of service are decided. Dispute resolution clauses are the best known example of mechanisms in contracts. The purpose of mechanisms in contracts is to lead the parties in making rational decisions about terms.

Relational governance follows a "non-programmatic" decision making model in which the parties make "administrative" type decisions in an environment of complexity and change and with limited information and opportunity to deliberate. This type of decision making is often perceived as inconsistent with written contracts because there really isn't any one set of terms or "bargain" defining the service.

Figure 2 places different governance tools and methods on a spectrum between classic transactional contract law and modern relational governance theory.

Definitive Contract Terms of Performance, Rational and Certain Decision making

Contract Mechanisms for Managing Performance, Programmatic Decision making

Non-Contract Performance Management, Intuitive and Flexible Decision making

GOVERNANCE SPECTRUM

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Service Level Agreements

Defined Requirements

Change Management Clauses (term specific, formal amendment)

Relationship Management

Value Management (eSCM)

3rd Party Benchmarks & Standards

Dispute Resolution Clauses

Economic Price Adjustment Clauses

Governance is also control. To rise to the level of governance, decisions must have a controlling effect on the actions of the parties to a transaction. How decisions are made within organizations and how they are communicated and implemented is the subject of a great amount of available research and commentary in the field of management science, particularly on decision rights and organizational structures.

The ways that the several outsourcing governance models control parties to outsourcing are distinguishable from each other by how the models establish authority behind governance decisions.

Control by contract-based governance is based on laws, courts, arbitrators, and police forces to enforce judgments. There are also informal controls, namely the threat of litigation, which carries a big price tag and which can create bad publicity for executive management in the customer company championing an outsourcing project and for the provider among its other customers. Theoretically speaking, contract based controls do not require any governance structures or charters or rules for making decisions.

Programmatic decision mechanisms in contracts are a form of decision rights. Unlike relational governance, it is the terms of the decision making provision in the contract that produce the decision, not the judgment of the persons following the terms. But unlike definitive contracts, decisions themselves are not terms. The semi-contractual practice of defining decision rights as contract terms rests in a kind of governance estuary where the limits of contract management and judicial enforcement meet and mix with simple forms of relational governance that may or may not involve organizational structures, charters or management plans.

Relational governance exemplifies transaction cost economics. The parties essentially sort out their rights between themselves instead of legally defining them up front in a contract and seeking to enforce contractual rights later. In a word, profit motive replaces the rule of law. Authority backing the decisions must in the end come from executive management (which takes authority from the board of directors) for both parties. Organizational structures, governance charters and explicit management rules for decision making take on paramount importance in relational governance. Otherwise enforcement of decisions will be inefficient and inconsistent.

Principles of Optimal Governance. Preferable and Optimal Governance. The overarching principle of Purpose Driven Governance[TM] is that there is always a preference to make rational governance decisions about outsourcing and other services engagement and incorporate decision making into the contract as definitive terms at the earliest possible point in the outsourcing lifecycle.[9] This preference holds true even when governance practices other than definitive terms are determined to be optimal. Under the methodology, governance through decision making mechanisms and relational practices should be conducted with the secondary objective of, or at least recognition of the potential for, ultimately reaching rational governance decisions that can then be set forth in contractual language. The preference is not meant to dilute implementation of these other means of governance or to call their use into question. Preferring contract based governance means recognizing opportunities for more rational decision making that can be created by good non-contract based governance practices.

Where rational decision making and complete terms for services delivery and the business relationship are not possible, contract terms defining programmatic decision making are the next most preferable governance practice. But just as bounded rationality makes definitive contract terms impossible in a given outsourcing scenario, a given outsourcing scenario may not allow for good programmatic decision making.

Mutual Assent and Trust. Whether contract or non contract based, all governance requires some amount of negotiated or non-negotiated mutual assent. Not all mutual assent is the same. Purpose Driven Governance[TM] recognizes that different governance approaches are driven by different forms and degrees of mutual assent. Assent to contractual governance can be as cut and dry as exchanging solicitation and proposal documents during the bid process. Arms length negotiation can be more advantageous where one or both parties have concluded that a contract management model is the optimal form of governance or where it is anticipated that the other party objects to relational governance. Where a mix of contractual and relational governance is being considered, a structured negotiation approach becomes more advantageous.

Highly relational (non-contractual) governance, such as Value Management in the eSCM, is heavily dependent on mutual assent. Unlike negotiated governance terms, highly relational governance exists purely as administrative decision making and must be assented to fully and on a continuing basis. To drive this continuing assent, both the long term business goals and short term commercial interests of both the buyer and seller must align with a relational governance model.

In recent years, management thought leaders have focused on the concept of "trust" in business dealings between customers and suppliers. Recognizing a need for trust in business dealings is another way of recognizing the need for the deeply committed mutual assent that is needed in relational type transactions. Purpose Driven Governance[TM] defines trust in outsourcing as the amount of mutual assent required to make the most rational decisions possible about services delivery and the business relationship, leaving open the opportunity for gaining mutual assent either in the form of a negotiated contract or through interactive management.

Constraints and Opportunities. The potential for the effectiveness of any form of governance is not just determined by buyers and sellers but by frameworks surrounding the

outsourcing: organization charts, corporate policy manuals; legal and regulatory frameworks; the outsourcing lifecycle.

Buyer and seller corporate organizations and corporate policies pose constraints on governance. It is harder to navigate and reconcile these constraints where governance is relational because decisions and decision making are unspecified and undocumented.

Governance potential is also dependent on identifying the best opportunities for engaging in governance during an outsourcing engagement. Purpose Driven Governance[TM] identifies opportunities for governance using the stages of outsourcing across the entire outsourcing lifecycle. Relational and incomplete contract theories do something similar when they define governance as ex ante or ex post contract.

Applying governance within the framework of the outsourcing lifecycle also accounts for shifts in bargaining power between buyer and seller. Buyers have greater bargaining power ex ante contract while sellers have greater bargaining power ex post contract, meaning that buyers and sellers may differ in what they see as governance opportunities.

Goals and Impacts. Outsourcing governance, like the outsourcing itself, should serve a customer's strategic business goals. Purpose Driven Governance[TM] recognizes that governance supports achievement of goals in two ways. One of relational governance's biggest assets is realignment of outsourcing services with strategic goals over time and in response to changing assumptions. There is another way that governance aligns outsourcing with goals, through the type of impact on services delivery and the business arrangement. Goals may call for the assessment of penalties for performance. Assessing penalties through relational governance is very difficult.

Conclusion. A strategic, methodological approach to implementing governance, such as Purpose Driven Governance[TM], can generate better value for both the customer and the provider by tying governance to business goals, identifying optimal governance practices, and reducing governance's transaction costs.

REFERENCES

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[1] To date there is no good single industry definition of outsourcing governance. The International Association of Outsourcing Professionals (IAOP) defines governance "the oversight and management of all aspects of the outsourcing relationship," a definition so broad as to provide little guidance. Outsourcing Professional Body of Knowledge, Version 8.0 (Revised February 2008, IAOP), p. 157.

[2] S Cullen & L Willcocks, Intelligent IT Outsourcing: Eight Building Blocks to Success, Section 7.3 Relationship Management (2003 Elsevier Ltd.)

[3] The Poppo and Zenger article is the seminal work on the relationship of contracts and governance in outsourcing. After summarizing the academic work arguing against the use of both governance and contracts, the authors, citing other sources, argue that contracts and governance not only complement each other but strengthen each other in a feedback loop (called "complimentarity"), which they substantiate with a survey of key informants. Contracts safeguard against attempts to realize short term gains and carry the parties through until they have developed trust. Contracts can be written to create bilateral frameworks for cooperation instead of specifying requirements. In return, governance can respond to unforeseen disturbances when contracts cannot, and governance can fine tune complex contracts through amendment. And contracts serve as a sort of "pre-nuptial" agreement when the marriage between a customer and provider comes to an end. pp. 712-713.

[4] Managing Sourcing Relationships: Essential Practices for Buyers and Providers, p. 43. In the Vantage survey, respondents spent an average of 7.2% of annual contract value on governance and between 3 and 7%. The report also cites survey figures from research firms that go as high as 11%.

[5] eSCM-CL v1.1 Part 2 mgt01 Perform Sourcing Management p. 262

[6] "Outsourcing Management and Governance: Building a Foundation for Outsourcing Success," p. 5 (June, 2006, Updated May, 2007, EquaTerra). EquaTerra's survey looked at the relationship between spend on governance and overall outsourcing satisfaction. It found that almost half of respondents spent between 1-4% of total contract value on governance and one quarter spent 4-7%; governance spend did not drop off in succeeding years; and that a governance spend of 4-7% returned slightly more satisfaction. The survey did not find any correlation between governance spend and satisfaction with governance itself. http://www.equaterra.com/fw/main/Outsourcing-Management-and-Governance-Building-a-Foundation-for-Outsourcing-Success-15C361.html?LayoutID=

[7] "Outsourcing Management and Governance," pp. 16-17 Figure 9.

[8] Purpose Driven Governance is a trademark of James River Consulting LLC. For more information about the methodology contact Eric Esperne, President, James River Consulting at eesperne@jamesriverllc.com.

[9] J Barthelemy, "The seven deadly sins of outsourcing," *Academy of Management Executive*, Vol. 17. No. 2 (2003). Writing a poor contract is identified as the third of the seven deadly sins. Barthelemy, who is widely published on the subject of outsourcing, recommends that contracts should be written precisely and as completely as possible prior to outsourcing. "The notion that outsourcing vendors are partners and that contracts play a minor role was popularized by a landmark IT outsourcing deal. In 1989, Eastman Kodak outsourced a large part of its IT operations to IBM, Digital Equipment, and Businessland. As the relationships between Eastman Kodak and its vendors were both cooperative and based on loose contracts, it has been wrongly inferred that tight contracts were not necessary to be successful with outsourcing." p. 90.