

**Business Innovation through Proactive Contracting: A Conceptual, Interdisciplinary
Framework for Service Procurement Practices**

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Abstract. In order to succeed in today's interconnected and global economy, companies need to source and manage external resources. Quite often, these involve services and not just tangible goods. Suppliers, customers, and users have become co-creators of value and innovation. To manage collaborative arrangements and their outcomes, companies need tools and capabilities that help them make expectations and commitments explicit and transparent and roles, rights, responsibilities and remedies visible and implementable. This working paper presents interdisciplinary research in progress focusing on contracts and contracting: the tools and processes without which service procurement and collaboration cannot happen. Using a proactive approach to merging service development, contract design and the underlying laws that apply, this research aims at producing new, innovative tools for service contracting and for improved organizational understanding.

Introduction. With the tremendous growth of outsourcing and networking, supply chains have become more complex and global. An increasing part of products is being purchased from specialized suppliers in various parts of the world. The trend over the recent years goes towards actively managed supply chains (Sturgeon, 2002) and concentrates more on the commitment of the parties involved (Fawcett et al., 2006). Supply chains move from vertical integration towards collaborative processes that focus on continuous innovation and quality improvement and that need to be supported by supply chain contracts drafted in accordance with these changing business goals (Gilson et al., 2009).

In addition to this, the global economy is shifting from manufacturing towards services (Nystén-Haarala, 2009, Sorsa and Salmi-Tolonen, 2008). With the advances of technology, manufacturing companies are enhancing their offerings by attaching increasingly complicated services to their products. Along with selling equipment, manufacturers are taking over part of the customer's process. Different levels of service relationships like full service, performance partnering, and value partnering have developed over the recent years (Rekola and Haapio, 2009a), and these services become increasingly important for the supply chain.

In the current economic downturn, the pressures on increasing revenue and cutting costs and cycle time are growing. Traditionally, manufacturers have offered product support services such as maintenance without considering them a serious source for revenue or profit. Now the focus is more and more on services, and service providers are increasingly becoming responsible for creating value to the supply chain (Rekola, 2008). They must ensure that their service offerings meet the expectations of the customer and even the customer's customer and need to be prepared to suffer the consequences if they fail to deliver the promised value.

Being intangible – apart from materials, equipment, etc. connected to them – services are harder to test, evaluate, and compare than manufactured products. This presents challenges to service procurement professionals choosing between different suppliers and comparing their offerings. The legal framework for services is not the same as for goods, especially in the international context, where a uniform international sales law for goods exists, but one for services is still missing. Because of the intangibility of services it is often difficult to describe and specify expectations, roles, and responsibilities. This can be the case for both sides – service provider and customer alike.

These rapid and fundamental changes in the manufacturing industry entail new challenges for the whole organization, supply chain management, procurement practices, and product and service design included. They call for continuous interaction between buyers and sellers, which needs to be reflected in contracts. These new procurement contracts differ considerably from

traditional contracts for the purchase of goods and need to take into account the international dimension, new processes and different expectations of customers mentioned above.

With this research we hope to contribute to the understanding of the current situation and future challenges for service procurement practices, and to develop tools that can help achieve business innovation and improve performance through the merger of proactive service design and proactive contracting.

Scientific Context and Current Research. This research project is multidisciplinary. It is mainly located in the industrial management (or industrial engineering) paradigm, with close links to the emerging fields of proactive/preventive law, interorganizational governance research, and research on contracting, sensemaking and understanding (e.g., Vlaar, 2006), as well as positive organizational scholarship and design science. One of the main principles of positive organizational research is promoting and researching the positive, focusing on what works instead of what is wrong (e.g., Blatt, 2009, Fineman, 2006, Center for Positive Organizational Scholarship), which is also the goal in this project in particular and in the proactive approach in general. The ideas of design science are well suited to the constructive research method: aiming to bridge the gap between academic research and practitioners². The idea of making a connection between contracting and service/product development and design is the underlying assumption of this research, and does not come up much in current research into either industrial management, law, or related areas³.

Proactive Law. *Proactive law* has its starting point in law. The scientific context is, however, somewhat different. A range of research demonstrates the interdisciplinary character of proactive law. The interaction between legal theory and practice and between legal science and other sciences is crucial for the success of proactive law.

In the traditional legal field, discussions have been *ex post*-oriented. Legal research has been mainly concerned with failures – shortcomings, delays, and failures to comply with the law. Legal research in the field of contracts has concentrated on legal rules and case law: what courts have done, for example, to protect the weaker or less sophisticated party – in hindsight, *ex post*. The focus in this research is different; it is on the future, and on success rather than failure. Here, the question is not what courts have done or are likely to do, but what people and businesses can and should do – using foresight, *ex ante*.

The idea of an *ex ante* view (or proactivity) in law is not new in itself. It has been known for years that the earlier a dispute or a potential dispute is addressed, the better the chances of a fair and prompt solution. Most contract lawyers and in-house counsel actually practice future-oriented law: they help clients to plan and structure transactions and manage risk. In the context of practicing law, the idea of prevention was first introduced by Louis M. Brown (Brown, 1950, Brown 1955, Brown 1972, Brown 1986). In his ground-laying treatise *Preventive Law*, he states a simple but profound truth that has not lost any of its value in more than fifty years: “It usually costs less to avoid getting into trouble than to pay for getting out of trouble” (Brown, 1950)⁴.

² A supply-chain related study found that “Another poorly executed infrastructure element is the legal/contractual language that discourages collaboration. For both the primes and supply network, legal and finance are rarely involved in development of collaborative relationships and processes. The result is conflicting or restrictive clauses that protect against litigation rather than encourage trusting relationships.” National Council for Advanced Manufacturing, Supply Chain Integration: The Key to Aligning the Network-Centric Enterprise, 2007, p. 22.

³ Noteworthy exceptions include Gilson et al., 2009, Winn, 2008, Jennejohn, 2007, Vanderbergh, 2007, and Wuyts and Geyskens, 2005, but they do not specifically address service development and design.

⁴ For recent developments in Preventive Law see www.preventivelawyer.org.

The approach specifically called *proactive law* emerged in Finland in the 1990s. Its origins are in *proactive contracting* (Haapio, 1997/1998). Originally, the goal was to provide a framework for integrating legal foresight into the tangible practice of everyday business and to merge good contract, legal, project, quality and risk management practices with a proactive approach to law. Recently the proactive law approach has been taken over in other areas such as tax legislation (Zimmer, in Wahlgren, 2006), ICT (Information Communications Technologies) law (Magnusson Sjöberg, in Haapio, 2008, Jakobsen, in Wahlgren, 2006), data and information resources (Magnusson, in Wahlgren, 2006), and law-making (EESC Opinion 2009, Sorsa 2009)⁵.

Research Objectives. The proactive approach as described above differentiates two aspects of *proactivity*: one being the *promotive* dimension (promoting what is desirable; encouraging good behaviour) and the other being the *preventive* dimension (preventing what is not desirable, keeping legal risks from materializing) (EESC Opinion 2009). Along with this definition, this research analyses and seeks to provide solutions to the following questions:

How to incorporate contracting into the service design process? How to design contracts, services and related processes proactively in order to better achieve business innovation and value? How to take into account the growing international dimension of service procurement contracts and how to prevent legal problems and litigation?

Discussion. This paper describes a work in progress. The following discussion reflects the methodology used for this research and some initial findings and preliminary or expected answers to the research questions stated above and shows the directions of further research.

Traditional legal research is *explanatory* rather than *exploratory*. This research aims at producing new, innovative tools for service contracting and for improved organizational understanding. The methods of conventional legal research are unlikely to produce such results. Contracts are highly context-dependent. They often comprise several documents specifying their object and the parties' responsibilities, key performance indicators, pricing principles or fee structures, management routines, etc. Thus, contracts are a combination of financial, technical and legal aspects of business, added with relationship management, organizational and strategic issues. To bring about strategic innovations, research related to contracts and contracting must be cross-disciplinary.

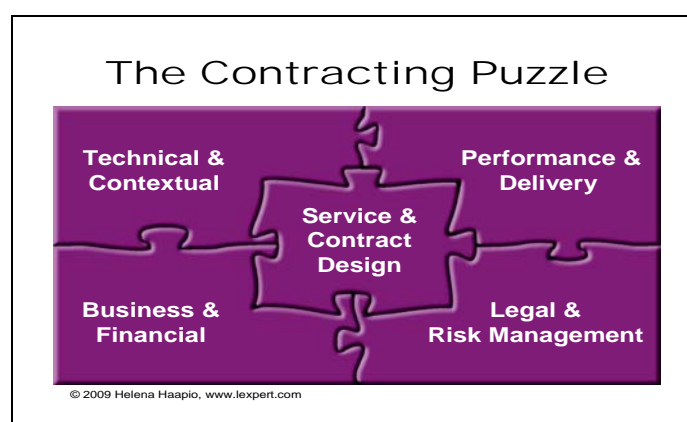


Figure 1: The Contracting Puzzle

⁵ The importance of exploring the proactive law approach has recently been recognized in the European Union, in the Opinion of the European Economic and Social Committee (EESC) published on 28 July 2009 in the Official Journal of the European Union (OJ C175, available in all official EU languages). Co-author Helena Haapio acted as Expert to the EESC in preparing this Opinion.

Many industrial companies operate globally and procure from their suppliers more than half of what they offer to their customers. As the number and complexity of trading relationships continues to grow, companies need a reliable foundation for business. Contracts can provide this foundation. Contracts enable companies to define and shape their transactions and relationships. Within the global inter-connected economy it becomes increasingly important to know what to expect from foreign laws and jurisdiction. Unlike the international sale of goods which is governed by an international treaty – the Convention on Contracts for the International Sale of Goods (CISG) - there is no such international treaty providing a common legal ground for services. Therefore, in international service contracts, there is a particular need for the parties to the contract to understand both business and legal issues and to provide solutions to the legal difficulties raised by varying laws and jurisdictions through a carefully drafted service contract.

Today's companies develop new solutions, business models and revenue streams at a growing speed. Design, marketing, and production processes are no longer under one roof: companies rely on others to provide products and services for them. New methods of collaboration and new technologies are creating new opportunities and, at the same time, increasing uncertainties. As companies innovate, outsource, network, and collaborate, they become more and more dependent on each other – and on contracts.

Still in the vocabulary of many managers and researchers, the word “contract” implies legal documents which can be assigned to legal professionals. Such a narrow approach bears the risk that business goals, for example innovation, are not sufficiently taken into account in the written document. As contracts have many functions, they cannot and should not be evaluated by their legal qualities alone. Contracts must capture, merge and articulate different stakeholders’ interests and requirements: strategic, financial, technical, legal, regulatory, etc. In addition to the core actors on the sell-side and buy-side during negotiations, the stakeholders include product and service owners, project and delivery team members, people accountable for monitoring performance, and many others. At the pre-contract and contract design stage, expectations need to be recognized, aligned, and managed. Shared expectations must be translated into responsibilities, which must be appropriately reflected in contracts. The supplier must understand and solve the customer’s problem while satisfying its own requirements for profitability and risk management. The following figure illustrates how expectations, intentions, promises and the ability to deliver the agreed service come together in the service relationship, guided by a service contract as a road map.

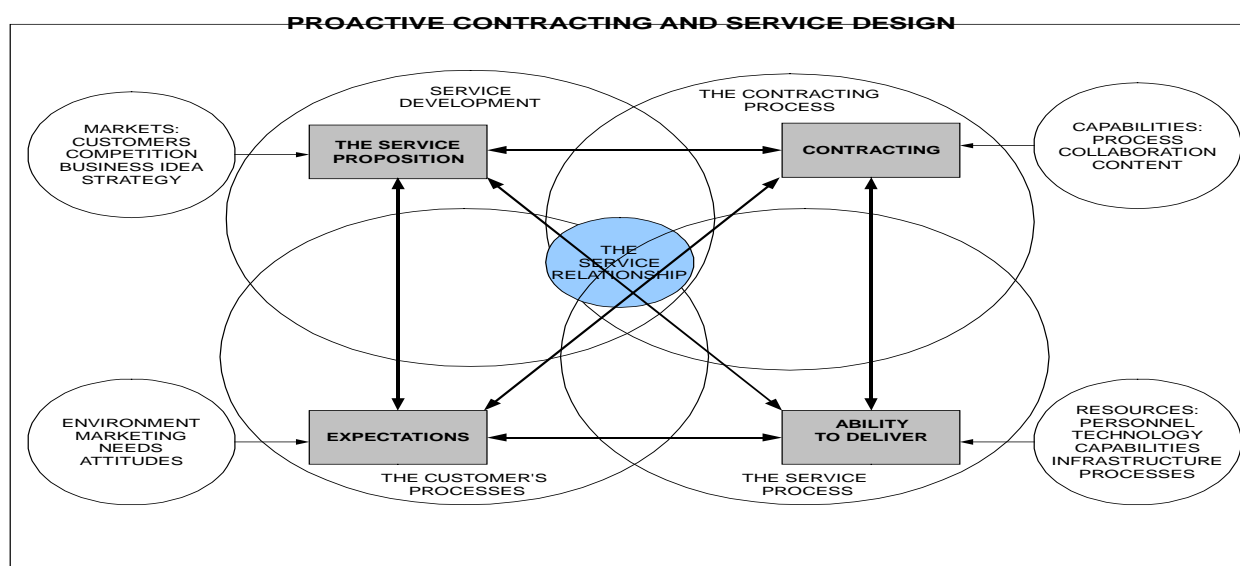


Figure 2: Proactive Contracting and Service Design (Rekola and Haapio, 2009a)

In order to function as business and management tools, contracts must translate goals, expectations and promises into a language that is understood in the way intended and, in turn, translates into successful performance. Taking into account the number of participants involved, the challenge is to achieve a balance between the different requirements and preferences and to facilitate communication and coordination, including a seamless transition between the different stages of the life-cycle of the contract. One possible way to achieve this goal is through *contract visualization* (Rekola and Haapio, 2009b) as a possible means to manage complexity, attract attention, and convey information quickly. *Contract visualization* makes contract information more interesting and accessible and helps to make complex contracts more comprehensible and understandable, internally, inside the company, and externally, between the different parties in, for instance, a supply chain. The goal is to get new products and services to the market faster, to make selling and buying easier, and to prevent problems. This involves (re)designing and reorganizing information and using graphs, charts, diagrams, maps, pictures, visualizations, sample risk lists, review checklists, term sheets, heads of agreements and other means of effectively identifying, assessing, negotiating, managing and implementing information.

Largely unexplored remains also the application of *user-centered design* to contracts. Hardly ever are the needs, wants, and limitations of business users given attention during contract design or related research. If users of contracts are discussed, they are deemed to be lawyers, judges and arbitrators rather than business users, such as sales, procurement, and project managers or delivery team members. The proactive law approach aims at changing this perspective.

Contracts have the ability to make companies and supply chains stronger and to support offerings and projects throughout their life-cycle. Well thought-out and communicated contracts can also help to clarify the interfaces between different offerings, projects and contracts (such as contracts for the supply of equipment and services, financing, transportation and insurance) and to synchronize the terms of the contracts that are connected. For example in the case of “back-to-back”, the concept that in a supply chain, the sub-supply contract should, as far as possible, be consistent with the supplier’s obligations under the main contract. The supplier’s obligations and risks relating to the main contract, the scope and duration, etc., should pass through to the sub-supplier. In this way, disturbances can be minimized and risks can be maintained at an acceptable level. In theory, it should work well in both long-term supply arrangements and in one-time major equipment supply projects. Yet in practice, companies encounter major challenges. While best practice corporations have addressed the integration of buy-side and sell-side contracting, many still procure products that lack appropriate terms that back up their offerings to their customers or fail to address crucial requirements early and explicitly so that they are available to those in the supply chain who need to know about them (Haapio, 2007).

Along with the *contractualization* of business, companies face another major trend impacting their business models: *servitization*. Recent developments are pushing manufacturing companies towards offering services and solutions. In service and solutions business, value is co-created with the customer. In order to succeed, the parties need to know their roles and responsibilities. This calls for a new approach to contracts and contracting.

As companies are increasingly dependent on external services to succeed in their own business, effective procurement practices and methods to test, evaluate, and compare services are needed. To further complicate the situation, the services often form or are part of a complex supply chain that consists of both services and manufactured products. This means that traditional approaches to supply chain management do not necessarily work. Some service testing and evaluation methods and tools do exist, for example so-called mystery shopping (Rekola and Rekola, 2005), but most of them do not work in the particular situation of a

manufacturing company buying and selling industrial B2B services. What is needed is a simple, practical method to assess B2B services by for example assigning points to different aspects of the service and then weighting them case by case. The method should also take into account the placement of the service in the supply chain in order to be able to optimize service procurement decisions taking into account how they affect and are affected by decisions elsewhere in the value chain. A theoretical framework for service procurement as part of a supply chain can then provide the basis for more practical, hands-on approaches, methods and tools.

Modular product design can help optimize for example the maintenance and repair processes, thus affecting the quality and cost of service. Modular thinking can be extended to service/offering design and contract design as well, making it easier for service procurement professionals to make smart service acquisitions and simplifying the contracting process. *Service productization* – which is an essential part of the proactive service design agenda and promotes modularity – is a way to not only facilitate selling services, but productized services are also easier to buy, evaluate, compare, monitor and validate. Consequently one indication of the quality of a service might then be whether – and how well – it has been productized. The research also aims to explore the possibilities of extending the principles of productization to contracting in order to help promote easier understanding and acceptance of contracts as tools and also facilitate a smoother contracting process in the form of productized contracts or terms and conditions, for example.

Considering the servitization trend and the relative novelty of the idea of industrial services as chargeable products in their own right, there is a need for new understanding of how to innovate and improve service contracting practices, especially in the context of service procurement and services as part of international supply chains. Companies need and want practical tools and methods, but there is also a gap in the theoretical arena. This research aims to add to the theoretical understanding by developing a framework for service procurement practices and also provide a starting point for the development of practical tools.

Future Research Direction. So far our research has been theoretical, mainly pointing out the problematic and specific features of service contracting and analyzing what needs to be changed in order to enhance business innovation through productization, service design and proactive contracting including visualization. Besides an in-depth analysis of the international legal environment for service contracts, the next step will be to provide practical tools and methods to achieve the goals set out in the discussion above through a qualitative approach. The novelty of the area of study, the complexity of the involved processes and the limited availability of large amounts of data to be studied, speak for the appropriateness of case study approach for this research (Yin, 1994; Gummesson, 1993; Gummesson, 2000). According to Gummesson (2000) case studies offer an opportunity for a holistic view of the studied process. In a holistic view the whole is not identical with the sum of its parts, and can thus only be understood by treating it as the central research objective.

According to the concept of constructive research (Kasanen et al., 1991, Kasanen et al. 1993) and the case study approach, the idea is to select projects from the participating companies to this research for closer observation as well as to collect data from existing contracts and related documents and other relevant material. Based on those observations, literature review and theoretical findings, further research should aim at developing and testing proactive tools and methods for service contracting, demonstrating that the proposed tools and methods work, show the theoretical connections and the research contribution of the solution concept and examine the scope of the applicability of the solution.

Further research could include an organizational aspect: how to make organizations more proactive and how to facilitate the adoption of new tools and methods, such as the service

procurement method and contract productization and visualization. This research could be initiated during the developing and testing of the aforementioned tools. In fact, if the proactive tools were to be accepted and become part of a company's regular practices, it would, besides being a validation for the tools themselves, provide a fruitful target for research on how a company has become and is becoming more proactive.

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