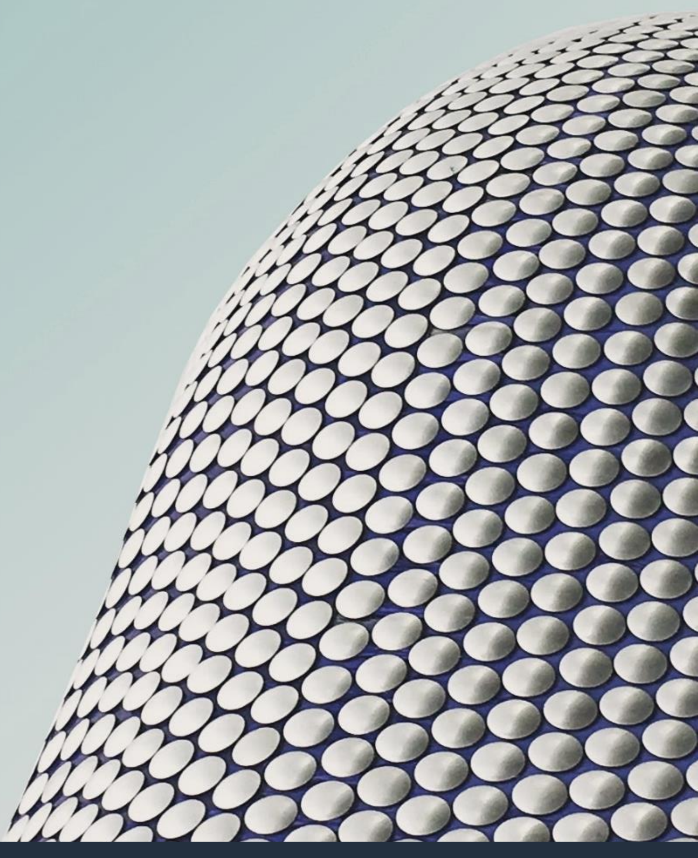
CIRIO

The modern contract that creates profitability and innovation

Relational contracts



CIRIO LAW FIRM

1 Introduction

The subject of relational contracts is increasingly discussed

A Google search for "**relational contract**" comes up with around 36 million hits. This is due to changes in the global economy. Most companies are unable to meet market challenges themselves, only together with others. A simultaneous and constantly intensified search for reduced costs, increased growth, innovation and increased flexibility has led to phenomena such as outsourcing, supplier networks, strategic business alliances, franchises, innovation networks, business clusters and other new ways of conducting business.

This means that there are new demands on how companies and organisations interact with others. Traditional arm’s length contracts written in order for the parties to protect themselves from each other need to be abandoned in favour of contracts that create prerequisites for truly successful collaborations. It is now that the relational contract fulfills its business-critical function. In this presentation we answer a number of important questions about the relationship-based contract.

2 What is a relational contract?

A relational contract is a written contract where a continuously effective commercial relationship is given priority over the specific transaction negotiated when the contract is signed.

The relationship is effective when the parties cooperate without friction in order to achieve the commercial goals of the contract. The secret to achieving this is continuous consistent interests, and the relational contract is therefore a flexible framework for achieving such consistency. The relational contract must be understood in relation to the dominant contractual form: the transaction-based contract. The transaction-based contract focuses on the specific negotiated business matter or transaction upon entry into the agreement. This contract typically rests on an assumption that the parties have conflicting interests. The majority of the clauses in the agreement are designed to deal with the risk that the counterparty will act opportunistically, contrary to the interests of the other party, and not to promote continuous collaboration towards common goals. While the relational contract establishes a partnership based on trust and social standards, the transaction-based contract establishes a relationship at arm's length, typically as a result of a power struggle that also continues after the agreement has been entered into.

The relational contract is not suitable for every business. The transaction-based contract has and will always have an important role in the market. The choice between the two types of contracts is made primarily by assessing the risk in the transaction and the degree of dependency between the parties. In principle, it is about assessing the costs that arise if the parties have conflicting interests. In a low-risk contract where the degree of dependency is low - i.e. it costs little to leave the relationship and maybe change the opposite party - then conflicting interests can be handled relatively effectively by just leaving the relationship.

The transaction-based contract can then be used and the parties can use their power to try to control each other. If, on the other hand, it is a transaction where significant values are at stake and the degree of dependency is high then it will be very costly if the parties have conflicting interests and may begin to act opportunistically.

In many complex contracts regarding e.g. outsourcing of logistics, IT or in construction and infrastructure projects, it can be very costly for the customer to switch supplier because the services can have a major impact on the company's profitability as well as the perception of the company, its services and products on the part of internal and external customers.

In these situations, the relational contract should instead be used. This means that the relational contract is the most appropriate form of contract in most strategically important customer-supplier agreements or other collaborative agreements entered into today.

3 Why use relational contracts?

The answer to this question is simple: because it will lead to **better results economically in terms of revenues, costs, risks and opportunities** to use relational contracts where these are appropriate. It is important to clarify that there is a wealth of theoretical and empirical research within economics, game theory, sociology and other disciplines proving the benefits of the relationship-based contract. To use legalese, it has been proven beyond all reasonable doubt, and anyone considering using a traditional contract model in situations where the relational contract is better suited should be prepared to prove that there is a business case for it.

Many Nobel laureates, such as Oliver Hart, support the relational contract.

4 You often hear about “outcome-based contracts”. What is the difference?

There is some confusion here. The term ”**outcome- based contract**” actually refers to a business model where the supplier’s margin is linked to the achievement of specific strategy goals. In order to be successful, such a business model must be established in the context of a relational contract. It is therefore important not to confuse the contract model and the business model.

In a relational contract, business models other than the outcome-based can be used. In many cases, however, the combination of the outcome-based business model and the relationship-based contract is the best. That combination is the basis for the Vested model, within which Cirio is also an adviser.

5 The process for entering into a relational contract

First, it's important and foremost, to note the word **process**. In the relational contract, not only the content of the individual contractual clauses is important. It is equally important just to use an orderly process as this is a prerequisite for building up the trust, transparency and consistency of interests to be incorporated into the contract.

A relationship-based contract is typically concluded in **five steps**:

Lay a foundation of trust, transparency and compatibility
Establish a common vision and strategic goals for the transaction
Agree on the guiding principles regarding e.g. reciprocity, autonomy, fairness and loyalty
Negotiate the transaction that, with the application of the guiding principles, has the best prerequisite for the parties to achieve the common vision and strategic goals
Establish a framework for relationship management that also promotes innovation

Contact

For more information on how relational contracts could benefit your company, please contact us.

David Frydlinger

Partner

david.frydlinger@cirio.se

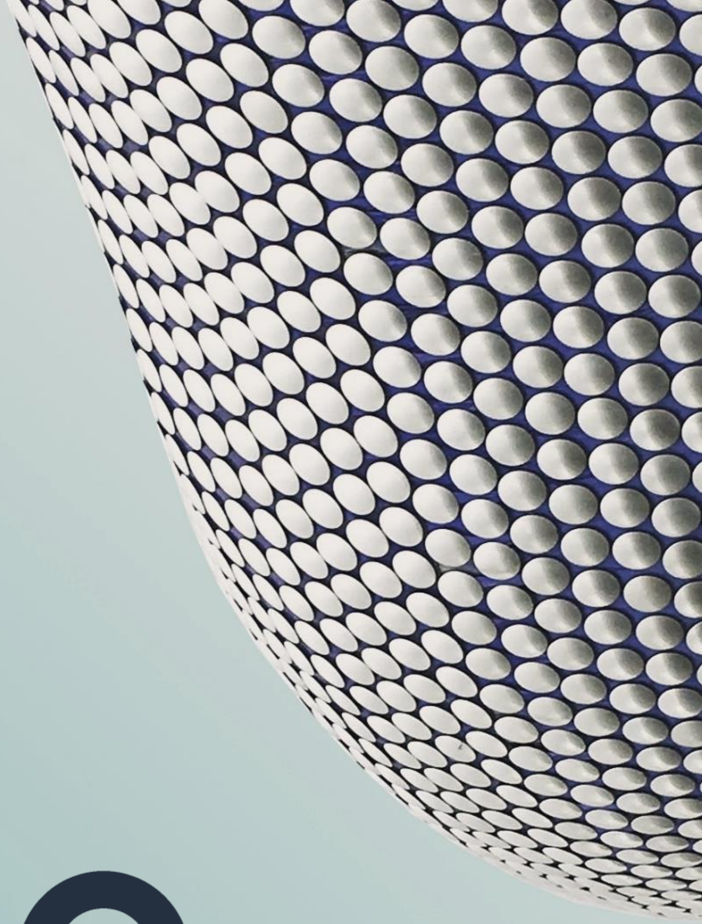
+46 (0)76-617 09 85

Erik Engström

Managing Associate

erik.engstrom@cirio.se

+46 (0)76-617 09 07



CIRIO

Cirio Advokatbyrå | Box 3294, SE-103 65 Stockholm | Biblioteksgatan 9
+46 (0)8 527 91 600 | contact@cirio.se | www.cirio.se